VOLUME II, JUNE 2017

EXPECT FOCUS®

LIFE INSURANCE INDUSTRY

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

KEEPING AN EYE ON DISRUPTIVE TECHNOLOGIES

The "Revised Temporary" DOL Fiduciary Rule

Colorado Proposes Cybersecurity Regulations Governing Broker-Dealers and Investment Advisers

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CARLTON FIELDS
JORDEN BURT

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The "Revised Temporary" DOL Fiduciary Rule

IRA Insurance and Annuity Sales: Observations on Potential Litigation Issues

BY JAMES F. JORDEN

Previously, I wrote about potential litigation under the Department of Labor's then proposed fiduciary rule (*see Expect Focus*, Vol. II, 2015). I predicted the following as to sales of index annuities to IRAs if the rule was adopted as proposed:

> "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."

Over the next several months, we will provide comments and further predictions regarding risks of, and defenses for, potential litigation under the revised, "temporary" DOL rule and its progeny as both the debates and the DOL's review of the rule continue. Given the amount of ink that has been (and continues to be) dedicated to this subject, our observations will assume readers have a sufficient level of understanding, eliminating the need for detailed background on each issue.

With that premise, we pose these questions:

Q Does it make a difference, from a potential litigation perspective, whether a commissioned sale of an annuity to an IRA relies on Prohibited Transaction Exemption (PTE) 84-24 or the best interest contract (BIC) for its exemption?

A Probably not. Under either the BIC or PTE 84-24, the sales agent who is now (at least from the DOL's perspective) a fiduciary must adhere to the Impartial Conduct Standards when using either exemption. Those fiduciary standards will apply to the sale and the potential exists for litigation asserting the violation of "fiduciary" duties (more on that below). Of course, depending on the practices adopted by the financial institution (under the BIC) or the sales agent (under 84-24), the nature and content of disclosure will differ. There will likely be some difference due, in part, to the requirements of the exemptions themselves. Under 84-24, there is a requirement to "obtain advance written authorization" and a "written disclosure" while the requirements for written "Transition Disclosures" originally imposed under the BIC have been removed. Nevertheless, both exemptions require adherence to the Impartial Conduct Standards. The difference in the methods used to achieve such adherence should not alter the nature or results of litigation for breach of a fiduciary duty. A plaintiff's pleadings in some future allegation of a fiduciary breach will not focus on the exemption's status, but rather on the applicable fiduciary standards, which, under the DOL's exemptions, are identical.

Q Can we assume that all state courts, when confronted with an IRA sale that is not preempted by or subject to ERISA federal jurisdiction, nor tethered to existing ERISA case law and principles, will nonetheless conclude that the DOL's standards of "Best Interest" must necessarily be followed in determining the boundaries of any "fiduciary duty" assumed by the agent or broker of the sale under state law? Does the creation of this fiduciary duty under the DOL's exemption result in a potential cause of action at all under state law? If so, what state law or duties will be applied if and when a purchaser chooses to attempt to enforce that fiduciary duty in a state court litigation?

A It depends. Some (probably the DOL) will say, "Of course the courts will rely on the DOL's articulation of the duties and applicable standards." But, apparently at least some at the DOL thought it necessary, when the BIC exemption was first proposed, to embody those standards in a written contract so that both the sales agent and the IRA purchaser agree as to the standards. The nature and contours of a "fiduciary" duty relationship have traditionally been considered necessarily consensual, and the intent of two parties to such relationships has been crucial to the enforcement of the duty. For example, in *Allstate Life Ins. Co. v. Parnell*, we know that for many years state courts have routinely concluded that, absent facts to the contrary, the mere sale of insurance/annuities does not create a fiduciary relationship between an insurer or its agent and the insured. Why should state courts conclude otherwise based on an interpretation of a federal statute by the DOL? At least during the transition period, and absent some specific representations as part of the sales transaction, there will be no clear articulation of what standards would apply to this "imposed" fiduciary duty, other than what the DOL claims must be employed to gain the exemption. There is potential for a wide variety of results here. There are 50 state laws governing fiduciary conduct, and numerous variations from state to state on how those standards should be applied. Based on existing precedents, there is a very real possibility that state courts will refuse to impose a state law fiduciary duty absent other indicia of a fiduciary relationship during the transaction.

Our next article on this subject will review some of the variances among a few selected states regarding the application of the fiduciary principles, discuss potential theories likely to be asserted in a class action context by plaintiff's counsel, and provide readers some suggestions for addressing these potential theories in advance.

Recent Ninth Circuit Rulings Uphold Plaintiffs' Efforts to Predicate Claims on Alleged Insurance Code Violations — Likely More to Come

BY SHAUNDA PATTERSON-STRACHAN

Recent rulings suggest insurers face increased risk of suits predicating breach of contract and state unfair trade practices claims on alleged violation of state insurance laws, notwithstanding the lack of an express private right of action. In no jurisdiction is this more a concern than California, as illustrated by two recent Ninth Circuit opinions involving claims under California's Unfair Competition Law (UCL).

Most recently, in May, the Ninth Circuit reversed a California federal district court's dismissal of putative class action UCL claims in *Friedman v. AARP, Inc.*, an action by a Medicare beneficiary and purchaser of UnitedHealth supplemental health insurance coverage bought through a group Medigap policy, for which AARP was the policyholder. The suit names as defendants multiple affiliated AARP and UnitedHealth entities but, for ease of reference, those sets of defendants are referred to collectively as "AARP" and "UnitedHealth." The plaintiff alleges that, by soliciting insurance and accepting a commission, AARP unlawfully transacted insurance business without a license in violation of California Insurance Code § 1631, which prohibits persons subject to the Code from "solicit[ing], negotiat[ing], or effect[ing] contracts of insurance" without "a valid license from the commissioner."

At the heart of the dispute is AARP's and UnitedHealth's Medigap arrangement, which the Ninth Circuit describes as governed by a joint agreement requiring, *inter alia*, that purchases of UnitedHealth's Medigap coverage be made through AARP's group policy, and that AARP manage certain program elements, including a requirement that AARP solicit its members' participation in the Medigap plan. In connection with the same, AARP is allowed to collect insurance premiums from members and, after first investing the collected payments and deducting and retaining 4.95 percent of each dollar paid by the enrollees, forwarding the appropriate payment to UnitedHealth. While AARP argued the 4.95 percent retention is a permissible "royalty," the plaintiff contends it is an undisclosed commission on the sale of insurance, resulting in the payment by insureds of "an artificially inflated insurance price."

For the Ninth Circuit, the inquiry was straightforward: "At issue therefore is whether Friedman has adequately pled that AARP has engaged in any of those … activities [listed in § 1631]. … We conclude that he has." Along the way, the court rejected AARP's effort to rely on the method of calculation of the fee it receives — calculated as a percentage of all premiums paid in connection with the program, regardless of the source — as evidence the fee does not qualify as a "commission." As the court explained, "[r]egardless of the nominal form of the arrangement called for by the AARP-United Agreement, the complaint alleges that AARP receives a 4.95% fee for every member that enrolls in UnitedHealth's Medigap program." Also key to the court's analysis were AARP's marketing materials. The court noted, for example, pieces that "expressly state in bold font: **'This is a solicitation of insurance.'"** Indeed, the Ninth Circuit also found that the plaintiff adequately pled that AARP violated the UCL's other two prongs, the "unfair" and "fraudulent" prongs, which claims are based on allegations of misrepresentation as to the nature of the payments.

Friedman, though, is not the first action to allow a plaintiff to state a UCL claim based on an alleged violation of § 1631's licensing requirements. It is a reaffirmation of the ability.

Two months before issuing *Friedman*, however, in *Walker v. Life Insurance Company of the Southwest*, a certified class action involving the sale of indexed universal life insurance policies, the Ninth Circuit issued a ruling representing an *expansion* of the recognition of a plaintiff's ability to pursue certain California Insurance Code violations via the UCL. In particular, the court reversed a California federal district court's May 2011 dismissal of claims that the defendant insurer violated the UCL's unlawful prong, which had been predicated on the insurer's alleged violation of California's illustration statute, California Insurance Code § 10509.950 et seq. As we previously discussed (*see Expect Focus*, Vol. I, 2017), in *Walker*, which also featured a jury verdict for the insurer on the plaintiff's fraudulent concealment claim and the district court judge's subsequent ruling for the insurer on the plaintiff's remaining UCL claims, the dismissal of the illustration statute-based UCL claim was but one of several elements of the Ninth Circuit's review of the trial court proceedings. Given the potential exposure, however, this aspect of the ruling is worth revisiting.

As set forth in the code itself, California's illustration statute was enacted to "ensure that illustrations do not mislead purchasers of life insurance and to make illustrations more understandable by providing illustration formats, prescribing standards to be followed when illustrations are used, and specifying the disclosures that are required in connection with illustrations." According to the plaintiff, *inter alia*, the insurer failed to "specifically disclose and identify the cost of buying and maintaining the policies" and, instead, embedded them in the illustrations so policyholders could not make informed decisions. After noting there is no private right of action under California Insurance Code § 10509.950, the district court ruled that the plaintiff's claims under California's UCL could not be based on the illustration statute because claims under the UCL's "unlawful" prong cannot be based on violations of any statute lacking a private cause of action. In its March 2017 reversal of this aspect of the trial court proceedings, however, the Ninth Circuit found that the lack of a private right of action *was not* in fact dispositive. Instead, citing the California Supreme Court, the federal appellate court ruled that "private UCL claims are barred only when the underlying statute either actually bars private rights of action or provides a 'safe harbor' that renders the alleged conduct lawful." These circumstances are not present as to the illustration statute.

While these rulings might portend the *furtherance* of a trend, the use of state insurance laws as a predicate for claims in civil litigation is far from a new phenomenon. Consider plaintiffs' continued focus on California's senior notice statutes, California Insurance Code §§ 10127.13 and 10127.10, which, collectively, are intended to protect seniors through mandatory language regarding the surrender charge period as well as what are termed "associated penalties." A California federal district court's September 2010 ruling in *Rand v. American National* remains an instructive illustration of a plaintiff's effort to predicate UCL claims on an alleged failure to comply with these statutes, in part because the opinion continues to stand as one of the strictest readings by a court of these provisions. More specifically, the *Rand* court read the senior notice provisions strictly to require disclosure about policy elements the company — and perhaps the regulator — clearly never contemplated to be covered by the statutes, forcing companies to think critically about the real possibility that disclosures that appear consistent with the statutes' requirements may nevertheless fail to satisfy the stricter obligations a court might impose in its interpretation of those provisions.

Of course, plaintiffs' efforts in this regard are not limited to suits that assert UCL claims. Plaintiffs also continue to point to alleged violations of insurance code provisions to bolster breach of express and implied contractual requirements. For example, in recent suits, policyholders have brought contract and UCL claims based on alleged noncompliance with California Insurance Code §§ 10113.71 and 10113.72 — enacted in 2013 — which, generally, require that insurers notify insureds of their right to designate a third party to whom notice of a nonpayment of premium or potential policy lapse or termination may be sent, prior to any termination.

Eighth Circuit Affirms Dismissal of RICO Claim in So-Called Shadow Insurance Suit

BY STEPHEN JORDEN

In *Ludwick v. Harbinger Group*, the U.S. Court of Appeals for the Eighth Circuit affirmed the dismissal under the McCarran-Ferguson Act of a federal RICO claim against Fidelity & Guaranty (and its owner and several affiliates) alleging that F&G had engaged in statutory accounting fraud to create a false impression of capital adequacy.

The crux of Ludwick's claim was that F&G hid its true financial condition by transferring billions of dollars in liabilities to affiliated reinsurers that did not have sufficient covering assets. According to the complaint, as a result of these transactions, had F&G followed Statutory Accounting Principles promulgated by the NAIC, it would have had to report negative, not positive, capital surplus. Ludwick alleged that she bought her F&G annuity based in part on F&G's apparent financial condition and thus overpaid for the annuity.

Ludwick appealed the district court's dismissal of her claims on the ground that they were reverse-preempted by the McCarran-Ferguson Act, which provides in relevant part that "[n]o act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance…." On appeal, the Eighth Circuit addressed only whether the RICO claims would "impair" state insurance regulation under the Act.

The court of appeals easily concluded that allowing Ludwick's RICO claims to proceed would disrupt state insurance regulation, initially remarking that "[q]uestions about insurance companies' solvency are, no surprise, squarely within the regulatory oversight by state insurance departments." The court found that Ludwick's claims sought adjudication of the same issues vested to the regulation of the insurance departments with oversight of F&G's conduct and financial condition. Specifically, the court observed that reinsurance transactions with affiliates must be submitted to and approved by state insurance regulators, who are directed to consider whether those transactions adversely affect policy owners and leave the insurer with adequate assets and surplus. Litigating Ludwick's claims would require second-guessing the insurance departments' approvals of the reinsurance transactions at issue in the lawsuit.

The Eighth Circuit rejected Ludwick's arguments for avoiding application of the McCarran-Ferguson Act. First, the court rejected Ludwick's attempt to reformulate her claims as challenges to F&G's accounting practices and disclosures, rather than the legitimacy and financial impact of the transactions themselves. The court reasoned that "[t]o decide whether F&G's reported financials reflected a significant departure from the accounting principles it claimed to have followed, a federal court would need to ask what the result of the transactions should have been under those principles." This inquiry would require second-guessing the regulators' oversight and determinations.

The court also rejected Ludwick's argument that her claims could proceed against the non-insurer defendants, noting that pursuing the same allegations against the non-insurer defendants would be equally disruptive of state insurance regulation.

Finally, the Eighth Circuit disagreed with the district court's reasoning that the absence of a private right of action under the insurance statutes was "dispositive" of whether the suit would impair state insurance regulation. However, given that Ludwick had not demonstrated "that the specific sort of misconduct that she alleges—an insurer lying about its financial condition and accounting—would be actionable under the common law of each implicated jurisdiction," there was no basis for inferring that the states would allow it to proceed, even if those states generally permitted fraudulent inducement claims against insurance companies.

The decision signals the end of a brief wave of policy owner lawsuits spurred by a 2012 New York Department of Financial Services' report alleging that insurers were using so-called "shadow insurance" transactions with affiliated reinsurers to misrepresent the adequacy of their capital positions. However, similar "shadow insurance" allegations are being pursued in a few cost of insurance lawsuits pending in the federal courts, where they have not been subject to attack on McCarran Ferguson Act grounds.

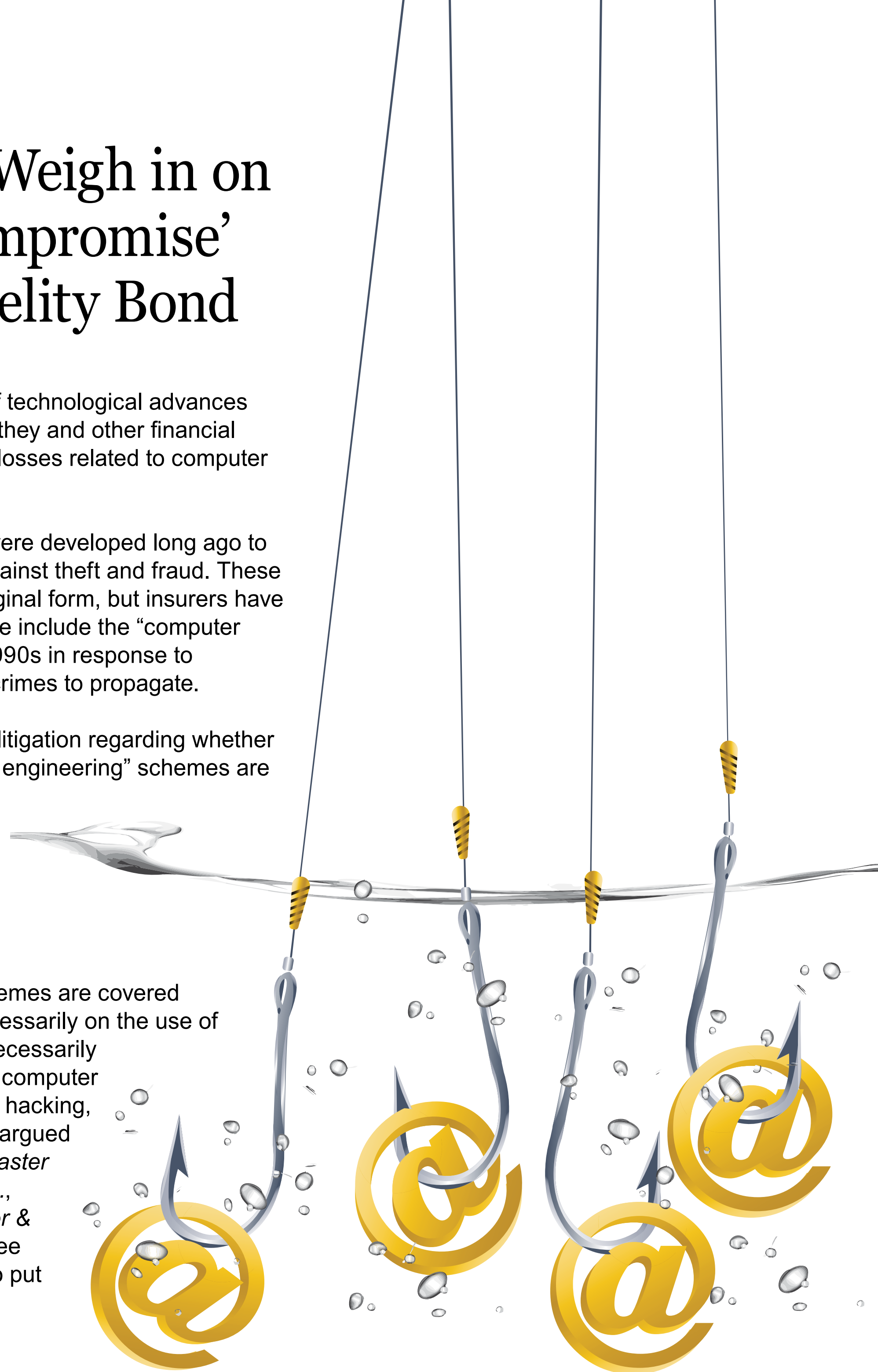
Eleventh Circuit to Weigh in on 'Business Email Compromise' Coverage Under Fidelity Bond

BY JOHN PITBLADO

Banks have historically been at the forefront of technological advances in commerce. So it should be no surprise that they and other financial institutions were also among the first to suffer losses related to computer fraud and hacking

Financial institution bonds or "fidelity" bonds were developed long ago to insure banks and other financial institutions against theft and fraud. These policies have not changed much from their original form, but insurers have responded to new risks by adding riders. These include the "computer fraud" rider, which became prominent in the 1990s in response to technological advances that allowed hacking crimes to propagate.

Recently, there has been a spate of coverage litigation regarding whether "business email compromise" (BEC) or "social engineering" schemes are covered events under the standard computer fraud rider. And related losses are mounting. According to FBI data, since January 1, 2015, BEC losses in the United States have grown an astonishing 1,300 percent, reaching 22,143 cases with losses totaling over $3 billion.



Courts have struggled with whether these schemes are covered "computer fraud" because they do not rely necessarily on the use of computers, and, even if they do, they do not necessarily entail a fraudulent "alteration" or "change" to a computer system, as would be the case with an ordinary hacking, required for coverage to obtain. Insurers have argued that these schemes are not covered. In *Pestmaster Servs., Inc. v. Travelers Cas. & Sur. Co. of Am.*, *Apache Corp. v. Great Am. Ins. Co.*, and *Taylor & Lieberman v. Federal Insurance Company*, three circuit courts of appeals decisions appeared to put the issue to rest, siding with insurers in finding these events are not covered.

But the story isn't over. Despite notice of the *Pestmaster*, *Apache* and *Taylor* decisions, in *Principle Solutions Group, LLC v. Ironshore Indem., Inc.*, a Georgia federal court bucked the trend and found coverage for a BEC scheme. The insurer defendant filed a notice of appeal and the case will move to the Eleventh Circuit Court of Appeals. A similar case remains pending in federal court in New York, awaiting decision on the parties' cross-motions for summary judgment.

Thus, the issue remains unsettled. Fidelity policyholders and insurers alike should stay abreast of the shifting coverage landscape, and what it could mean if a policyholder suffers losses from BEC schemes. It is important to discuss coverage and particular concerns like BEC scheme losses before they happen to make sure your company will be protected by the most up-to-date insurance products in this developing sphere.

Colorado Set to Regulate Cybersecurity Practices of Broker-Dealers and Investment Advisers

BY JOSEPHINE CICCHETTI & THADDEUS H. EWALD

On May 15, Colorado became the latest state to publish major regulations tackling cybersecurity in the financial services industry when the Colorado Division of Securities released amendments to existing division rules previously proposed in late March 2017. These new rules clarify what broker-dealers and state registered investment advisers must do to protect the security of "confidential personal information," defined as a first name or initial and a last name in combination with any one of a variety of data elements such as a Social Security number, driver's license or identification card number, or credit card number accompanied by a password or access code information. The rules detail the factors the Division will consider when assessing whether a firm's cybersecurity procedures are sufficient.

Substantively the rules for broker-dealers (51-4.8) and investment advisers (51-4.14(IA)) contain identical language. They require broker-dealers and investment advisers to establish and maintain written procedures "reasonably designed" to ensure cybersecurity. When assessing whether the procedures are "reasonably designed," the Commissioner will consider:

i. the firm's size;

ii. the firm's relationships with third parties;

iii. the firm's policies, procedures, and training of employees with regard to cybersecurity practices;

iv. the firm's authentication practices;

v. the firm's use of electronic communications;

vi. the firm's use of automatically locking devices with access to confidential personal information; and,

vii. the firm's process for reporting lost or stolen devices.

Firms also are required to include cybersecurity as part of their risk assessments. Furthermore, the regulations specify that the following procedures be included within the adopted written cybersecurity policies, to the extent "reasonably possible":

i. annual cybersecurity risk assessments;

ii. use of secure email for emails containing confidential personal information;

iii. authentication practices for access to electronic communications, databases, and media by employees;

iv. authentication procedures for client instructions received electronically; and,

v. disclosures to clients regarding the risks of using electronic communications.

Colorado follows in the footsteps of New York and Vermont — both of which have adopted cybersecurity regulations — continuing a trend of increased proactivity by states in regulating cybersecurity absent uniform, binding federal legislation or regulations. New York's regulations are more comprehensive than Colorado's; however, they do not apply to investment advisers or broker-dealers because individuals not licensed or registered under New York banking, insurance, or financial regulations do not qualify as covered entities. Colorado's regulations were modeled after Vermont's, which apply to "securities professionals" including broker-dealers and investment advisers, but Colorado's rules stop short of Vermont's requirements that securities professionals maintain evidence of "adequate" cybersecurity insurance proportional to the firm's business and provide free restoration services to victims if a cybersecurity breach occurs.

The Colorado regulations are the latest at the state level to impose mandatory cybersecurity procedures upon broker-dealers and investment advisers. The SEC and FINRA have acknowledged the importance of cybersecurity protections via their respective regulatory and examination priorities issued over the past three years, and FINRA issued an extensive report on cybersecurity practices in February 2015. However, SEC and FINRA involvement in cybersecurity has largely been in the form of general guidance. For instance, the SEC's Division of Investment Management issued cybersecurity guidelines in April 2015 for registered investment companies and registered investment advisers. The Colorado and Vermont regulations impose mandatory requirements on state registered investment advisers. And while both FINRA and the SEC require broker-dealers to adopt written data security policies and procedures, Colorado and Vermont's regulations go further by requiring broker-dealers to conduct annual cybersecurity risk assessments and articulating specific cybersecurity procedures to include in broker-dealers' written cybersecurity policies.

Early in May, the Colorado Division of Securities held a public hearing and took written comments before publishing the rules. Next, the state attorney general's office will release an opinion on the rules, and the secretary of state will set an effective date for later this year.

Summary Judgment for Insurer in Annuity Sales Practices Action

BY DAWN WILLIAMS

On March 31, in *Chambers v. N. American Co. for Life & Health Ins.,* an action alleging RICO violations and other claims in the sales of deferred annuities to seniors, the Southern District of Iowa granted the insurer's motion for summary judgment. Like many of the bonus annuity class actions brought in the mid-2000s, the plaintiff in *Chambers* claimed that the insurer misrepresented the terms of the bonus, that there were no "sales fees," and that the interest adjustment applied to partial surrenders. She also brought claims for violation of the standard nonforfeiture law and alleged unjust enrichment.

A year ago, the district court denied her bid for certification of a nationwide class. It held that plaintiff could not prove causation via common proof — even if the varying written materials were sufficiently uniform. The court found testimony that the named plaintiffs did not read those materials, plus an informal poll of class members, sufficient to show that there was no singular causal link between the defendant's representations and injuries to the class. The court also determined that the nonforfeiture laws of the states varied across time and states.

Nearly a year later, the court entered judgment for defendant on the remaining individual claims. It first addressed the RICO claims, and held that there was no cognizable RICO enterprise because the insurer and the agents did not share a common fraudulent purpose and did not have sufficient relationships. Nor was there a continuity of relationships, where the agents ceased their appointment with the companies years before.

Significantly, the district court also held there was no scheme to defraud. Specifically, the court said the alleged "sales charges" misrepresentation was nonsensical, the plaintiffs' annuities were credited with the bonus and interest credits in exactly the way the contract promised, and the interest adjustment formula itself was set forth in the marketing materials.

Plaintiff's breach of contract claim rested on the premise that the contracts violated their states' nonforfeiture laws as applied to optional maturity date contracts, versus contracts with set maturity dates (which plaintiffs' annuity contracts had). The court relied heavily on the Ninth Circuit's 2015 decision in *Eller v. EquiTrust Life Insurance Company,* rejecting this argument. Finally, it found that the plaintiff could not bring a claim for unjust enrichment where a contract governed the terms of the parties' relationship.

Plaintiff has filed an appeal.

FINRA Moves to Protect Seniors and Other Vulnerable Persons

BY GARY COHEN

FINRA has taken another step to protect against what it calls "financial exploitation of vulnerable individuals or individuals with diminished capacity." These include seniors (at least age 65) and persons (at least age 18) with a mental or physical impairment preventing them from protecting their own interests.

Effective April 10, FINRA revised its sanction guidelines so that all disciplinary proceedings it brings are required to determine whether a firm "exercised undue influence over the customer." FINRA's sanction guidelines do not prescribe fixed sanctions for particular violations. Instead, they list 19 potentially mitigating or aggravating factors that "should be considered in conjunction with the imposition of sanctions with respect to all violations."

Previously, FINRA decisions acknowledged that the exercise of undue influence is an aggravating circumstance "on a case-by-case basis." The revision "makes clear" that the sanction guidelines "contemplate coverage for vulnerable individuals or individuals with diminished capacity, which may include senior investors."

FINRA's revision of its Sanction Guidelines follows recent actions to shore up FINRA rules to protect seniors and other vulnerable persons. Among other things, FINRA amended its Rule 4512 to require members to make reasonable efforts to obtain, from each customer for whom they maintain an account, specified information about a "trusted contact person." FINRA also adopted a new Rule 2165 that permits, but does not require, FINRA members to place temporary holds on disbursements from customer accounts. *See* "SEC Approves FINRA Efforts to Protect Seniors and Other Vulnerable Persons," *Expect Focus*, Vol. I, 2017.

FINRA Proposes to Loosen Restrictions on Performance Projections

BY GAIL JANKOWSKI

In March, FINRA solicited comments on proposed amendments to Rule 2210, Communications with the Public, that would create an exception to the rule's prohibition on projecting investment performance. The proposed exception would permit broker-dealer firms to provide clients with customized hypothetical investment planning illustrations that include the projected performance of an "asset allocation or other investment strategy." It would not, however, permit such illustrations for an "individual security" or that are not "designed for a particular client or multiple clients that share an account."

The proposed exception is of interest to many life insurance companies, as it could potentially be available for asset allocation or investment strategies that include, or are offered within, life insurance or annuity products. Moreover, the proposal does not appear intended to modify other applicable FINRA rule provisions and guidance applicable to variable insurance product illustrations.

FINRA expects these amendments to particularly assist FINRA-registered firms or representatives that are also subject to investment adviser regulation by the SEC. Historically, broker-dealers have been subject to more restrictive regulation of projections than investment advisers, and the proposed amendments may simplify such dual registrants' compliance strategy and minimize costs by better aligning the different regulatory schemes to which their projections are subject. FINRA also anticipates that most of the approximately 20 firms that currently file "investment analysis tool" communications with FINRA would take advantage of the proposed amendments to also distribute customized hypothetical investment planning illustrations. FINRA also believes that many other firms providing products and services to retail investors would likely choose to rely on the proposed exception.

The proposed exception would be subject to several conditions, including that all material assumptions and limitations applicable to the projection be disclosed and that there be a reasonable basis for all assumptions, conclusions, and recommendations.

FINRA Public Offering Proposal Excludes All Insurance Contracts

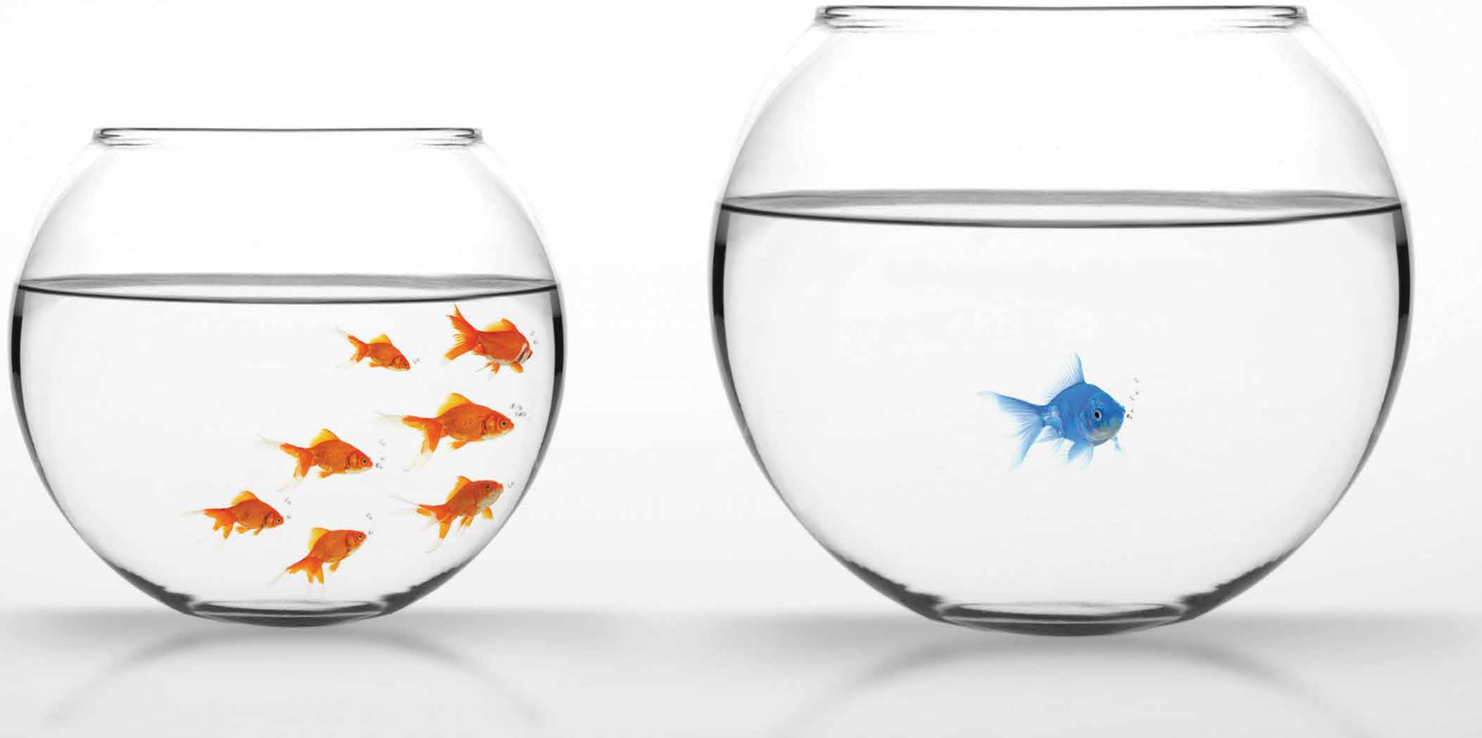
BY TOM LAUERMAN

For the first time since 2004, FINRA has proposed major amendments to its requirements that govern the terms of the underwriting arrangements for most public offerings of securities and mandate that such arrangements be submitted to FINRA for review.

Currently, these requirements specifically exclude offerings of "variable contracts," as well as "modified guaranteed annuity contracts and modified guaranteed life insurance policies." However, it has not been clear whether certain other insurance product securities, if offered publicly, might be subject to FINRA's requirements governing underwriting arrangements. This has included, for example, certain index-linked annuity contracts and index-linked life insurance policies that are publicly offered, and do not qualify for the Dodd-Frank Act's so-called "Harkin Amendment" exclusion from regulation under the Securities Act of 1933.

FINRA's proposed amendments, however, resolve any lingering uncertainty for these and any other novel insurance products that may be developed in the future. Specifically, the amendments would exempt offerings of "insurance contracts" not otherwise included in the specific exemptions mentioned above. In its proposing regulatory notice (no. 17-15), FINRA explained that this change is appropriate, because it relates to "highly regulated offerings" and "may reduce costs to firms."

Although underwriters of insurance products historically have not had occasion to file many insurance products' underwriting arrangements with FINRA for review, the proposed clarification is very welcome.



FINRA Issues New Guidance on Social Media and Digital Communications

BY GAIL JANKOWSKI

In April, FINRA issued Regulatory Notice 17-18, which reiterates previous rules and provides additional guidance regarding the application of several key rules governing communications with the public to digital communications. It is intended to supplement, rather than alter, previous FINRA Regulatory Notices 10-06 and 11-39, as well as the February 2013 amendments to Rule 2210 and the December 2014 Retrospective Rule Review Report.

The new guidance recalled many principles from past guidance and also contained several question-and-answer clarifications as to the interpretations of previous rules. For example, FINRA recalled past guidance regarding recordkeeping, such as Regulatory Notice 11-39, which notes that whether a communication must be retained depends on its content and not on the type of device or technology used in its transmittal. Further, regarding third-party posts, the new guidance restates language from Regulatory Notice 10-06, which holds that, generally, posts by customers or other third parties on social media sites established by a firm or its personnel do not constitute communications with the public by the firm or its associated persons, unless the firm or an associated person has either (1) paid for or been involved in the content's preparation (which FINRA would deem "entanglement") or (2) explicitly or implicitly endorsed or approved the content (which FINRA would deem "adoption"). Additionally, regarding hyperlinks to third-party sites, the new guidance reiterated that Regulatory Notice 11-39 requires that a firm not establish a link to any third-party site that the firm knows or has reason to know contains false or misleading content.

The question-and-answer clarifications provide additional advice pertaining to several common issues firms face when interpreting these rules under topics such as hyperlinks and sharing, testimonials, native advertising, and text messaging.

SEC Seeks Public Comments on Standards of Conduct for Investment Advisors and Broker-Dealers

BY CHRISTINE STODDARD

On June 1, SEC Chairman Jay Clayton issued a statement seeking comments from interested parties regarding the standards of conduct for investment advisers and broker-dealers providing investment advice to retail investors. The statement came just before the June 9 partial applicability date of the DOL's Fiduciary Rule, and responded to labor secretary Alexander Acosta's previously expressed desire that the SEC and DOL work together as both continue to assess potential changes in this area.

Although Clayton noted that the SEC has been assessing these standards for over a decade, he emphasized that significant changes in this area — including the fiduciary rule itself, and recent technological innovations impacting the marketplace — have renewed the need to examine the current regulatory framework. He also expressed his intent to coordinate with the DOL and to pursue more harmonized regulatory treatment of investment advice given to retail customers by investment advisors and broker-dealers.

To that end, Clayton asked interested parties to submit data, suggestions, and other information that will help the SEC assess this regulatory framework and inform potential future actions — the first such request since the SEC sought public comment on these standards in 2013. There is no specific deadline, and interested parties can submit comments online and by email outside of official comment periods. And while the chairman clarified that the SEC seeks all relevant information, he posed a long list of specific questions and particular areas of interest.

Some of these topics address recent developments, such as the multiple standards of conduct that will apply under the fiduciary rule and the impact of technological advances. Many, however — including retail investor confusion about the applicable standards, the effects of the differing standards, potential conflicts of interest, and the trend toward a fee-based advisory model — overlap with information gathering and analysis the SEC previously undertook in response to the Dodd-Frank Act's mandate that it consider standardizing regulations in this area. Differences among SEC commissioners at that time meant that little ultimately came of that prior assessment. This time, however, the result may be different, as the chairman is committed to a more active approach and the potential exists for coordinated efforts by the SEC and DOL.

SEC Guidance Seeks Enhanced Disclosures by Robo-Advisers

BY JOSHUA WIRTH

In February, the SEC staff issued a guidance update focusing on "robo-advisers," i.e., registered investment advisers (RIAs) who provide online, automated investment advice, through the use of an algorithmic program. As RIAs, robo-advisers are subject to the fiduciary and other substantive requirements under the Investment Advisers Act of 1940. Unlike other RIAs, robo-advisers have little, if any, face-to-face interaction with clients.

This, among other factors, has led the SEC staff to assert that robo-advisers should consider providing the following disclosures to their clients:

- A statement that an algorithm is used to manage individual client accounts;
- The functions performed by the algorithm;
- The limitations and particular risks of using the algorithm;
- Any circumstances that might cause the robo-adviser to override the algorithm;
- Any third-party involvement in the development, management, or ownership of the algorithm, including an explanation of any related conflicts of interest;
- Fees and costs that the client will pay, directly or indirectly;
- The degree of human involvement in the oversight and management of client accounts; and
- How the robo-adviser uses the information gathered from the client to create recommendations, and how and when a client should update such information.

The guidance update also emphasizes, among other things, that disclosures should be in plain English and reminds robo-advisers to carefully consider whether their disclosures are presented in a way conducive to client understanding. For example, the staff stated that advisers may wish to consider:

- Presenting certain disclosures to prospective clients before they sign up for an account;
- Using design features such as pop-up boxes, and interactive text to emphasize key disclosures or provide additional information; and
- Whether the presentation and formatting of any disclosure made available on a mobile platform have been appropriately adapted for that platform.

Chief Compliance Officers Beware

BY NATALIE NAPIERALA & GABRIELLA PAGLIERI

In recent years, financial regulators have increasingly taken enforcement action against chief compliance officers (CCOs) and others in compliance oversight roles, rather than just against their employers.

In the Matter of Windsor Street Capital, L.P., initiated in January of this year, is a case in point. There, the SEC alleged that a broker-dealer firm violated the Securities Act of 1933 by engaging in dozens of non-exempt unregistered penny-stock sale transactions. The SEC further alleged that the firm violated requirements under the Securities Exchange Act of 1934 by failing to file anti-money laundering (AML) suspicious activity reports (SARs) in connection with such transactions and that the firm's CCO aided, abetted, and caused those AML violations.

That the SEC charged the CCO with complicity in the AML violations (but not the Securities Act violations) may have been partly because the CCO also served as the AML officer under the firm's AML program and, in that capacity, was directly responsible for monitoring clients' suspicious trading activity and ensuring compliance with SAR reporting requirements. Moreover, the SEC alleged that the firm had strong indicia that its clients' penny-stock sales entailed suspicious trading activity under the firm's AML program, as well as under FINRA and SEC guidance, and that the firm and the CCO ignored these "red flags."

This case is consistent with other recent actions where the SEC charged CCOs for gross failure to perform specific responsibilities assigned to them under firm policies. In *In the Matter of Susan M. Diamond*, the CCO was sanctioned for misrepresentations in the firm's Form ADV, which falsely claimed three funds advised by the firm underwent annual audits, where the CCO was responsible for preparing and filing the form. The SEC, however, remains less likely to charge CCOs based on compliance failures in which the CCO is less directly and seriously implicated.

More Fund Companies Sanctioned for Misusing Fund Assets for Distribution

BY ED ZAHAREWICZ

The SEC recently settled enforcement actions against William Blair and two Calvert companies for using mutual fund assets to pay distribution-related expenses in violation of Investment Company Act Rule 12b-1 and for certain other misconduct. The cases follow a similar 2015 enforcement action against First Eagle, the first casualty of the SEC's "distribution-in-guise" sweep, and the SEC staff's January 2016 Guidance Update on Mutual Fund Distribution and Sub-Accounting Fees.

Although the improper payments in these cases were made to broker-dealer firms, similar violations could result from mutual fund assets being paid to other intermediaries, including insurance companies whose separate accounts invest in the fund. Regardless of the nature of the intermediary, Rule 12b-1 prohibits the use of fund assets to pay directly or indirectly for distribution except pursuant to a board-approved, written 12b-1 plan.

In the two recent cases, fund assets were used to make payments under certain agreements that the fund companies, apparently through administrative error, considered to be for "sub-transfer agency" services. In fact, the agreements clearly included the provision of distribution and marketing services although no 12b-1 plan was applicable. The two cases thus, like First Eagle, spotlight obvious violations of Rule 12b-1, but shine little light on harder questions where it may be unclear whether a portion of sub-accounting or similar fees are being used to pay directly or indirectly for distribution, one of the many issues raised in the staff's 2016 guidance.

Also of interest is that William Blair misspent $1.25 million of fund assets and was fined $4.5 million, while Calvert misspent nearly $18 million but was fined only $1 million. In both cases the SEC acknowledged that the fund companies took prompt remedial actions (including making the funds whole), but only in Calvert did the SEC acknowledge self-reporting of the improper fee payments and significant cooperation with the SEC's investigation by the fund companies, which "assisted the [SEC] staff in efficiently investigating the conduct."

Special Purpose National Bank Charter for FINTECH Firms

BY TOM LAUERMAN

The office of the Comptroller of the Currency (OCC) published a draft supplement to its licensing manual, to define and tailor the requirements for FINTECH companies that apply for special purpose national bank charters. This furthers the plans for such charters that the OCC announced last year (*see* "SEC and OCC Seek Accommodation with"SEC and OCC Seek Accommodation with FINTECH Firms," *Expect Focus*, Vol. IV, 2016).

The draft makes clear that FINTECH special purpose banks will not be permitted to engage in any activity that is prohibited for other national banks and will be required to engage in at least one "core banking activity" such as lending money or paying checks. The OCC, however, would administer these requirements flexibly. For example, "issuing debit cards or engaging in other means of facilitating payments electronically may be considered the modern equivalent of paying checks."

Therefore, a wide variety of FINTECH companies may be able to qualify for special purpose charters, avoiding some duplicative or conflicting regulation under state laws to which they otherwise would be subject, and, in some cases, escaping the purview of the Consumer Financial Protection Bureau or other federal regulators.

Nevertheless, the OCC intends to hold special purpose FINTECH banks to high standards, such as:

- No inappropriate comingling of banking and commerce
- No predatory, unfair, or deceptive business practices
- No "light touch" supervision by OCC

To the extent that, as the OCC says, FINTECH special purpose banks will be held to the same high financial and regulatory standards as all other national banks, firms considering applying for special purpose charters will have to weigh the potential disadvantages of federal bank regulation. These include not only direct regulatory compliance costs and capital requirements, but also potential restrictions or delays in undertaking new business initiatives.

Mutual Fund Advisers Win Again on Section 36(b) Claims

BY BEN SEESSEL

Following a four-day bench trial, New Jersey District Judge Renee Bumb granted judgment to defendant Hartford mutual fund advisers on "excessive fee" claims brought by fund shareholders under Section 36(b) of the Investment Company Act of 1940. The court's decision in *Kasilag v. Hartford Investment Financial Services, LLC*, is the second recent industry-favorable decision issued by the United States District Court for the District of New Jersey, the first being the August 2016 decision in *Sivolella v. AXA Equitable Ins. Co*. A number of similar Section 36(b) "excessive fee" cases remain pending in various courts.

Section 36(b) imposes a fiduciary duty on investment advisers regarding the compensation they receive from mutual funds. The Supreme Court's 2009 *Jones v. Harris* decision adopted the *Gartenberg* standard to assess an investment adviser's Section 36(b) fiduciary liability. To succeed on a Section 36(b) claim, a plaintiff must establish that an investment adviser's fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." Courts look to six factors under *Gartenberg*: (1) the nature and quality of the adviser's services; (2) adviser profitability; (3) "fall out" benefits to the adviser; (4) economies of scale realized by the adviser; (5) other funds' fee structures in comparison; and (6) the independence and conscientiousness of the fund's board in approving the adviser's fee.

The court decided the issue of the board's conscientiousness in favor of Hartford on summary judgment, but held that triable issues remained on other *Gartenberg* factors. In a 70-page order, reflecting the heavy burden plaintiffs face, the court rejected plaintiffs' theory that an investment adviser and sub-adviser provide the same services. It also refused to accept plaintiffs' "retained fee" theory, which would have calculated defendants' profitability without accounting for sub-adviser fees.

Carlton Fields sponsored the IRI Government, Legal and Regulatory Conference June 11-13, in Washington, D.C. Panels included The Evolving Variable Annuity Market (moderated by **Chip Lunde**), Cybersecurity Update: Managing Regulatory Challenge (moderated by **Josephine Cicchetti** and with panelist **Edmund Zaharewicz**), The Hottest Litigation Topics from the Year in Review (moderated by **Waldemar Pflepsen** and with panelists **Shaunda Patterson-Strachan** and **Michael Valerio**), and Exploring the Latest Federal Regulatory Trends Affecting Variable Products and Underlying Funds (with panelist **Richard Choi**).

On May 9, shareholders **Barry Leigh Weissman**, **Josephine Cicchetti** and IS process & security manager **Gary Slinger** hosted a webinar, "NYDFS Cybersecurity Regulation," which provided subject matter expertise on the latest New York Department of Financial Service cybersecurity regulation effective March 1, 2017. The purpose of the regulation is to secure "nonpublic information" from misuse, disruption, and unauthorized access.

Carlton Fields shareholder **James Jorden** co-chaired the ACI's National Forum on Life Insurance Litigation, Regulatory Enforcement & Enterprise Risk Management April 19-20, in New York. Topics included Enterprise Risk Management and Regulatory Roundtable, Regulatory Priorities and Responses for 2017 and Beyond (moderated by **Josephine Cicchetti**), Product and Sales Practice Class Actions and Complex Litigation (with panelist **Stephen Jorden**), Individual Product Litigation Roundup: Life Insurance, Annuities, Mutual Funds and More (with panelist **Shaunda Patterson-Strachan**), and Litigation Forecast: Status of the Department of Labor's Fiduciary Rule (with panelist **James Jorden**).

Carlton Fields shareholder **Jeffrey Michael Cohen** spoke at the American Bar Association Litigation Section Insurance Coverage Litigation Committee (ICLC) in Tucson, Arizona on March 4. This is the 11th consecutive year Cohen has presented at this conference. The presentation, "The Bad Faith Trial From Complaint to Verdict," addressed evolving issues in bad faith litigation including choice of jurisdiction, scope of pleadings, discovery, jury selection, and trial themes.

Carlton Fields was recognized as a "Top Firm" on the subjects of Class Actions and Insurance by *JD Supra* in its 2nd annual Readers' Choice Awards. The Readers' Choice Awards reflect 2016 data. In each category 10 authors and one law firm were recognized for consistently high readership and engagement within that category.

American Lawyer ranked **Carlton Fields** a top 20 law firm (No. 17) in its 2017 Diversity Scorecard, which ranks *AmLaw 200* and *National Law Journal* 250 firms according to the percentage of minority attorneys — Asian-American, African-American, Latino or Hispanic, Native American, and self-described multiracial lawyers — in the firm as a whole and in the partnership.

Carlton Fields is pleased to announce that 12 of the firm's practices and 32 attorneys earned top rankings nationally, and in California, Connecticut, Florida, and Georgia in the *2017 Chambers USA Guide to America's Leading Business Lawyers.*

BTI Brand Elite 2017: Client Perceptions of the Best-Branded Law Firms lists **Carlton Fields** as one of its 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 value.

Carlton Fields welcomes the following attorneys to the firm: shareholder **Menasche Nass** (business transactions, Los Angeles), of counsels **Henry Reitzenstein** (business transactions, Los Angeles) and **Lowell Walters** (business transactions, Tampa), senior director of government consulting **Beth Vecchioli** (property and casualty, Tallahassee), and associate **Eric Coleman** (business litigation, Miami).

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