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Scrutiny of Retained Asset Accounts Continues

BY KRISTIN SHEPARD & KAREN BENSON

Courts, legislators, and regulators are all examining life insurers' use of Retained Asset Accounts (RAAs) as a payout mechanism for life insurance proceeds.

The inner workings of RAAs get a close look

Courts: Various class action lawsuits pending in state and federal courts challenge the use of RAAs based on several legal theories. Thus far, **actions under state common law have been resolved on dispositive motions in favor of the insurer**. In one recently decided case, *Clark v. Metropolitan Life Insurance Company*, the Nevada federal district court granted summary judgment for the insurer finding that there was no "special or confidential" relationship between the insurer and the beneficiary, and that the plaintiff suffered no damages because the RAA credited interest above the prevailing money market rate.

Legislators: The U.S. House of Representatives passed legislation (H.R. 5993) requiring life insurers to provide disclosure regarding the use of RAAs to pay veterans' group life insurance benefits. A companion bill (S. 3718) is pending in the U.S. Senate. A Committee of the National Conference of Insurance Legislators is finalizing a draft Beneficiaries' Bill of Rights, which permits the use of RAAs as a default option contingent on prior disclosure to beneficiaries. California, New York and Pennsylvania legislators also have introduced bills regulating RAAs.

Regulators: State regulators in New Jersey, New York, Georgia, Nevada, and Kentucky are among those scrutinizing RAAs. The New Jersey Department of Banking and Insurance ordered authorized or admitted insurers to make certain disclosures about RAAs and submit RAA materials for Departmental review. It plans to propose rules requiring life insurers to file for approval RAA disclosure statements. **New York's Attorney General subpoenaed selected life insurers offering RAAs, and Georgia's Insurance Commissioner ordered market conduct examinations of two insurers' RAA programs.** Nevada's Insurance Commissioner issued a Consumer Alert regarding RAAs, and the Kentucky Department of Insurance published an "Advisory Opinion" stating that RAAs are permissible on an "opt-in" basis only.

Additionally, the National Association of Insurance Commissioners' RAA Working Group has been examining RAA disclosure practices, and planned to make recommendations to its parent committees at the Fall National Meeting (see *NAIC Fall National Meeting Update*, p.4). More information on the work of the NAIC RAA Working Group and NCOIL Committee can be accessed through Jorden Burt's client alerts.

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NAIC Fall National Meeting Update

BY STEVEN KASS & ANN FURMAN

Highlights from the NAIC Fall National Meeting held in October in Orlando include:

- **Retained Assets Accounts (RAA).** The 2010 Annual Statement will include RAA interrogatories covering, among other things, life insurance policy claims counts and amounts in RAAs; RAA interest rates credited and spreads; and narrative disclosure on a number of topics, including whether a RAA is the default method. Separately, NAIC staff presented summary results of its survey of major insurers' current RAA practices. The NAIC's 1993 RAA "Sample Bulletin" will be updated to address deficiencies in current practices, including disclosures related to interest rates as well as guaranty fund and FDIC coverage (or lack thereof), and is expected to include a requirement that RAA disclosure documents be filed for departmental approval.

- **Annuity Disclosure.** Following an industry trade group discussion of a new section of the Annuity Disclosure Model Regulation on standards for annuity illustrations, the working group moved up the revised model to the Life Insurance and Annuity (A) Committee. The revised model will be exposed for public comment for 30 days, during which time only "new" issues may be raised. Forms of the NAIC Annuity Buyer's Guide were taken out of the revised model and will be considered separately by the working group. The revised model imposes a new requirement for variable annuities that calls for the NAIC-approved Annuity Buyer's Guide to be provided.

- **Stranger-Originated Annuity (STOA) Transactions.** Comments were taken on the Model Insurer Bulletin that has been under development since the summer, and a subgroup will incorporate these comments into an updated draft Bulletin to be circulated later this fall for comment. It was reported that many insurers have already incorporated STOA safeguards into their annuity operations to curb abusive practices.

- **New Market Regulation Initiatives.** For 2011, the Market Regulation and Consumer Affairs (D) Committee will undertake two new initiatives: (i) creating a Social Media Working Group to evaluate how insurers and producers are using social media, to identify attendant regulatory and compliance issues, and to provide guidance on how to address such issues, including examinations; and (ii) creating a joint working group with the Health Insurance and Managed Care (B) Committee to review issues related to limited medical benefit plans, including misrepresentations in sales and marketing, product utility, and unauthorized producers.

- **Long-Term Care.** Industry comments were taken on specific consumer disclosures for communicating rate increases in long-term care insurance policies to existing insureds. Consumer advocates suggested more explicit rate increase disclosure be provided when a policy is purchased. State regulator guidance to ensure compliance with disclosure requirements is under consideration.

- NAIC developments on separate account insulation and risk charges, and annuity suitability in the context of the Harkin Amendment, appear elsewhere in this issue of Expect Focus.

High Court Review Sought in Wal-Mart Class Action

BY BRIAN PERRYMAN

A petition for writ of certiorari to the U.S. Supreme Court was filed August 25, 2010 in the *Dukes v. Wal-Mart Stores, Inc.* class action. The class seeks billions of dollars under Title VII of the Civil Rights Act of 1964, claiming that Wal-Mart's managers intentionally engaged in gender discrimination. The case was discussed more fully in *Expect Focus*, Vol. II Spring 2009. The questions framed by the petition are: (i) whether claims for monetary relief can be certified under Federal Rule of Civil Procedure 23(b)(2); and (ii) whether the certification conformed to the requirements of Title VII, the Due Process Clause, the Seventh Amendment, the Rules Enabling Act, and Federal Rule 23. The petition for certiorari has been fully briefed (including multiple amicus briefs), and has been distributed for the Court's November 23 conference. Jorden Burt will continue to monitor the *Dukes* case for developments.

Future SEC Regulation of Indexed and Other Products in Question

BY GARY COHEN & KRISTIN SHEPARD

Although Rule 151A has been vacated by the U.S. Court of Appeals for the D.C. Circuit, legislatively overridden by the Harkin Amendment to the Dodd-Frank Act (DFA), and officially withdrawn by the SEC (see SEC Release No. 33-9152), questions regarding the potential securities regulation of indexed products remain.

Rule 151A is gone but clarity is still needed

The Harkin Amendment conditions indexed products' exemption from Section 3(a)(8) of the Securities Act of 1933 on meeting state standard nonforfeiture and suitability laws. Hence, **questions arise such as whether synthetic products without cash values can meet state nonforfeiture laws and whether indexed life insurance — or indeed any other life insurance product covered by the Harkin Amendment — can meet state suitability standards designed for annuities**.

Despite vacating Rule 151A, the Court of Appeals found the SEC to be "reasonable" in regulating indexed products under the Rule, and did not object to the "more likely than not" test articulated under that Rule. Consequently, questions arise as to whether the investment risk, marketing, and mortality risk tests traditionally used to determine the securities status of insurance products have been modified.

The Harkin Amendment is articulated in terms of "exemption" from the securities laws rather than "exclusion." Unlike "exclude[d]" products, exempt products remain subject to certain provisions of the federal securities laws, including the anti-fraud provisions. Although SEC Chairman Mary Schapiro has testified that the SEC has no plans to re-engage on this matter, **query whether the SEC could bring actions against issuers of indexed and other products covered by the Harkin Amendment**. In addition, DFA authorizes the SEC to adopt rules regulating broker-dealer point-of-sale disclosure of "investment products." Still unknown: whether the SEC might seize on this provision to regulate disclosure of indexed products notwithstanding the Harkin Amendment.

Finally, FINRA has sought to "regulate" indexed annuities through requirements regarding "outside business activities" of associated persons of broker-dealers and jawboning regarding "source of funds" to buy indexed annuities. Questions arise as to whether FINRA will continue to assert jurisdiction on these grounds.

STOLI and STOA Litigation: A Study In Contrasts

BY DAWN WILLIAMS

Due to a well-developed body of case law concerning stranger-originated life insurance (STOLI) transactions, an insurer facing such litigation often knows what to expect from both the opposition and the court. Recently decided cases involving stranger-originated annuity (STOA) transactions, however, indicate that such predictability does not necessarily extend to litigation involving these products.

Numerous federal courts have issued opinions concerning STOLI recently, with the majority finding in the insurer's favor due to a lack of insurable interest. Even less insurer-friendly outcomes – for example, the federal district court in Minnesota recently dismissed an insurer's cause of action for misrepresentation as barred by the incontestability clause – have been reasonably foreseeable in light of case law precedent and the state statutory provisions that were at issue.

The path forward for STOA cases, however, may be considerably murkier – largely because of the different statutes and principles applied to annuities. At least one federal court has found that an insurer will not prevail on an insurable interest argument, and the federal district court in Rhode Island recently granted a motion for judgment on the pleadings against an insurer because it had not properly invoked a termination clause. On the other hand, a New York court in a similar case recently found in favor of the insurer, dismissing the counterclaims against it and discharging the insurer from liability.

Lifetime Income Public Hearing

BY SCOTT SHINE

In mid-September, the Department of Labor and the Department of the Treasury held a hearing on several specific issues relating to lifetime income for participants and beneficiaries in retirement plans. Testimony was given on:

- The education of and information given to participants.
- Making lifetime retirement options available in plans on an optional or mandatory basis.
- The concerns of sponsors in making available lifetime retirement options.

The government panel and witnesses discussed the need for educational initiatives and additional information to plan participants. **Research showed that once people visualize themselves in the future, they would be more likely to increase their savings rate.** Many believed that if participants received information on the lifetime income streams they would receive from their account values, they would save more. Research also reflected that selecting lifetime income for at least part of plan participants' retirement income is beneficial. No one agreed to take responsibility to educate participants and sponsors raised issues about their fiduciary liability. To protect against liability, Interpretive Bulletin 96-1 would need to be expanded so that sponsors would not be viewed as giving investment advice. While some suggested that the government could provide education, the panel questioned whether it was the government's role to do so.

Several witnesses discussed the availability of lifetime income options in plans. Some discussed that in-plan options and mandatory options would reduce the cost of lifetime income options. Others asserted that these options should not be mandatory because of participants' differing circumstances. In addition, if these options were mandatory, several raised issues as to who would select the mandatory option and the potential fiduciary liability.

Several witnesses discussed that **sponsors are concerned about their increased exposure to fiduciary liability if they provide lifetime income options** and the due diligence required to include these options. Several suggested that Interpretative Bulletin 95-1 should be updated to provide a safe-harbor for sponsors including lifetime income options. They commented that the current guidance is vague and unclear.

The departments stated they would consider the information gathered from the hearings but did not indicate a specific time frame for any action.

Separate Account Regulatory Initiatives

BY STEVEN KASS

One area of current NAIC focus is insurance company separate account operations. A 2008 NAIC survey of life insurers identified a broad array of life and annuity product offerings through separate accounts, many of which products were comparable to, or contained features comparable to, general account products.

As a result, four NAIC working groups have been taking **a hard look at various aspects of insurers' separate account operations and existing laws to determine whether such laws provide appropriate regulatory control in light of insurers' current practices and products**. Given the magnitude of assets held in insurers' separate accounts, the NAIC is particularly interested in the following issues:

- Whether assets held in a separate account supporting guaranteed products (or guaranteed elements of variable products) are, or should be, insulated;
- Whether these products or features raise guaranty fund issues regardless of whether they include general account guarantees or are legally insulated;
- Whether the general account is being adequately compensated for risks the insurer assumes in supporting separate account products guaranteed by the general account; and
- Whether using a separate account for certain product designs is appropriate.

In addition, the NAIC has been evaluating and expanding financial reporting with regard to separate account products, with significant information to be included in the 2010 Annual Statements.

At the NAIC's Fall National Meeting in Orlando, the Receivership Separate Accounts (E) Working Group was presented with a list of Model Laws, Regulations and other NAIC materials (e.g., Annual Statement Instructions, etc.) pertaining to separate accounts as well as with preliminary results of a survey of the respective states' positions on select separate account-related issues. **This survey identified diverging regulatory positions, and we expected significant activity by the working groups**, with possible recommendations that certain Model Laws and/or Regulations be modified in 2011.

Third Circuit Resurrects *In re Insurance Brokerage Antitrust Litigation*

BY LYNN HAWKINS & DENISE FEE

Nearly three years after a New Jersey district court dismissed all claims in *In re Insurance Brokerage Antitrust Litigation*, the Third Circuit Court of Appeals revived a portion of the class action antitrust conspiracy claims. This litigation arose following the 2004 investigation and enforcement action filed by then-New York Attorney General, Elliot Spitzer. Spitzer's complaint, alleging that insurance broker Marsh and McLennan "had solicited rigged bids for insurance contracts, and had received improper contingent commission payments in exchange for steering its clients to a select group of insurers," spawned a number of private lawsuits that were ultimately consolidated into this multi-district litigation.

The Third Circuit's August 16, 2010 ruling agreed with the district court's decision to dismiss most of plaintiffs' claims, finding that, under antitrust law's heightened pleading requirements, the complaint's allegations did not "provide plausible grounds to infer a horizontal agreement" between the insurers to protect each other's business. However, the court reversed on the issue of whether plaintiffs adequately pled conspiracy between Marsh and the insurers with whom it had entered into contingent commission agreements.

The Court of Appeals also supported the district court's holding that the defendants' conduct was not exempt under the McCarran-Ferguson Act, concluding that plaintiffs' allegations did not concern whether or to what extent a prospective insurance purchaser would transfer risk to an insurer, but merely to which insurer that risk would be transferred. As such, the conduct did not constitute "the business of insurance," a necessary requirement for McCarran protection.

The parties now return to the district court to resume discovery and further litigation on plaintiffs' surviving claims.

Plaintiff's Benefits Claim Affirmed Despite Shortcomings

BY JOHN KIMBLE & W. GLENN MERTEN

The Fifth Circuit recently affirmed a Mississippi district court's ruling in favor of the plaintiff on a wrongful denial of benefits claim, in spite of plaintiff's failure to exhaust administrative remedies and filing the claim beyond the plan's contractual limitations period.

Perfect? No. But it works.

In *Baptist Memorial Hospital-Desoto, Inc. v. Crain Automotive, Inc.*, the spouse of a Crain Automotive employee received treatment at Baptist Memorial Hospital-Desoto (BMHD), which submitted a claim for the treatment. The Crain Automotive plan administrator called BMHD's billing office to complain that the charges were excessive and that he wanted to settle the claim for a lower amount. Calls between the hospital and the plan administrator continued for a time until BMHD's phone calls to Crain went unreturned. BMHD then filed suit against Crain Automotive for recovery of plan benefits.

The majority opinion asserted that, under the plan's contractual limitations period, BMHD had 30 days to file its claim after the last unsuccessful attempt to contact Crain. This limitations period was far too short, the Court held, particularly in a situation such as this one where the plan administrator failed to properly deny the claim and misled the party submitting the claim. The majority also found that Crain was **not required to exhaust its administrative remedies because the plan administrator failed to substantially comply with the procedural requirements for denying a claim**.

The dissent argued that the majority mistakenly divorced exhaustion and timeliness by evaluating the limitations period under a "worst-case scenario" rather than examining what actually occurred. The dissent reasoned that BMHD had 214 days to file its suit under the contractual limitations period, which was not an unreasonable limitation, even if the claim did not accrue until Crain ceased to respond to BMHD. The dissent further argued that, if the claim did not accrue at least by the date on which BMHD was on notice that Crain did not intend to pay the claim, then it never accrued and therefore should be dismissed for lack of ripeness.

Dodd-Frank Triggers Flurry of Activity

BY ROLLIE GOSS

Regulators respond to the DFA

NAIC and state actions: Although the Dodd-Frank Act (DFA) did not include any significant provisions with respect to reinsurance collateral requirements, it did prohibit states from denying credit for reinsurance if the domiciliary state of the ceding insurer recognizes such credit under certain circumstances. In light of the NAIC's previously proposed Reinsurance Regulatory Modernization Act (RRMA), Florida's existing reinsurance collateral reduction provision (69O-144.007) and the perceived interest of states in moving forward with "individual state-based reinsurance collateral reduction reforms," the NAIC's Financial Regulation Standards and Accreditation Committee made an "informal request" to the Reinsurance Task Force "to consider which key elements of the [RRMA] should be considered in reviewing any individual state initiatives, and whether these key elements should be incorporated into the Credit for Reinsurance Model Law and Regulation." The Task Force has already received comments on a draft recommendation that cites and contains many similarities to the Florida regulation. Meanwhile, the New York Insurance Department published a Notice of Proposed Rulemaking for proposed amendments to New York's reinsurance collateral requirements, which include provisions for the management of reinsurance credit risk and a sliding scale for required collateral based upon the financial strength of the reinsurer. **It appears that rather than promoting uniform collateral reform, the NAIC will be permitting state-by-state variations with some form of guidance.** In addition, the NAIC's Executive Committee formed a special task force to consider issues relating to surplus lines premium taxes raised by the DFA.

Federal actions: As the Office of National Insurance and the Financial Stability Oversight Council are being organized, one point of interest for those in the reinsurance and insurance industries is the rulemaking with respect to swaps and other financial products. The principal focal points of those efforts are the SEC and the CFTC, which held a joint swap roundtable and are engaged in rulemaking on a broad range of DFA-related issues.

Treaty Tips: Addressing Non-Payment Contingencies

BY ANTHONY CICCHETTI

Two recent cases illustrate the potential for very different economic results depending on whether reinsurance parties provide in their agreement for an interest rate applicable to overdue payments. In the first, the agreement provided for an interest rate on overdue payments of 1.5% per month. The reinsurer, found to owe the cedent approximately $1 million, argued that a lower statutory interest rate should apply. Emphasizing that the parties had addressed the interest rate in their reinsurance agreement, the court held that the higher rate set forth therein must apply.

In the second case, a reinsurer withheld more than $32 million with respect to reinsured claims. The cedent ultimately prevailed and collected the full amount, but because the reinsurance agreement did not provide for a specific interest rate on overdue amounts, it was left to the court to decide the interest rate. Although the applicable state statute allowed for as much as 10%, the court cited a declining economy over the relevant period (2006-2008) and concluded that the appropriate rate should be the corresponding one-year constant maturity Treasury rate (CMT). The CMT ranged from a high of approximately 5% to a low of approximately 0.5% over that period. The absence of a specified contractual interest rate on overdue payments in this case may have cost the cedent hundreds of thousands of dollars.

A point or two here and there can really add up!

NY Advances Changes to Credit for Reinsurance Regulations

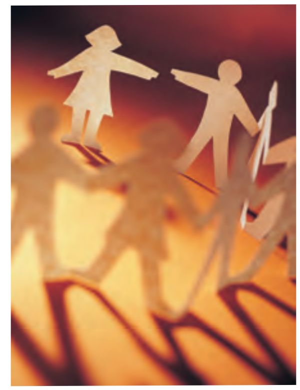
BY ANTHONY CICCHETTI

New York has published for comment proposed amendments to its regulations governing credit for reinsurance. The proposed regulations establish, *inter alia*, a ratings-based framework for the determination of collateral requirements. The applicability clause as included in this latest proposal indicates that New York intends the regulations to apply to reinsurance ceded by all insurers authorized to do business in the state, subject to one major exception: where the state of domicile of a foreign ceding insurer recognizes credit for a ceded risk and is an NAIC-accredited state (or has financial solvency requirements substantially similar to the requirements for NAIC accreditation), the foreign ceding insurer may take credit for the reinsurance.

Thus, while recognizing Dodd-Frank Act mandates relating to allowance for reinsurance credit, it appears that New York is aiming to impose certain principles of prudent reinsurance credit risk management on all NY-authorized insurers, without exception. Those principles, appearing in the proposed amendments as a new Section 125.3, include notification requirements for ceding insurers triggered when reinsurance recoverables from, or reinsurance cessions to, a single reinsurer, or affiliated group, exceed certain thresholds. A 45-day public comment period commenced on September 15, 2010.

Lloyd's Underwriters Must Reveal "Names" To Establish Jurisdiction

BY JOHN PITBLADO



Certain underwriters at Lloyd's brought suit in Florida federal court to seek adjudication of the binding effect of a purported settlement agreement it had entered with certain insureds. The insureds challenged the court's jurisdiction on a motion to dismiss, asserting that Lloyd's had to specifically allege the residence of each of the "names" actually sponsoring the insurance, for whom liability attaches severally under pertinent British statutory laws governing Lloyd's. The trial court denied the motion. In *Underwriters at Lloyd's, London v. Osting-Schwinn* (Aug. 5, 2010), the Eleventh Circuit Court of Appeals reversed, holding that **Lloyd's must allege each of the actual "names" bringing suit for purposes of establishing diversity jurisdiction**. In reaching its decision, the court detailed the history of Lloyd's, its nature as an unincorporated association of "names" who sign on to particular risks, which are administered by "syndicates," and the manner in which liability attaches to the "names," akin to the members of a partnership.

Verdict Reversed Because Reinsurer Ignored "Storm Warnings"

BY JOHN PITBLADO

The Second Circuit Court of Appeals reversed a $34.3 million jury verdict against AIG on fraudulent inducement claims asserted by AXA Versicherung AG, with which AIG entered into certain reinsurance facilities in 1998. AXA alleged it was induced to enter into the facilities by AIG's misrepresentations that it would treat the facilities as facultative and would cede only a cross-section of the primary layer risks, when AIG did not intend to retain any primary layer risks. AXA brought suit in December 2005, relying on the two-year "discovery" prong of the statute of limitations for fraud claims. The jury found that AXA did not discover, and could not have discovered, facts necessary for it to recognize the alleged fraudulent misrepresentations until December 2003.

The Court of Appeals, in *AXA Versicherung AG v. New Hampshire Insurance Co.* (Aug. 23, 2010), reversed, holding that AXA failed to prove the claims were timely brought. The court found that AXA was on inquiry notice of the alleged fraud as early as 1998, when it signed wordings that the court found clearly indicated the manner in which AIG intended to operate the facilities. Despite what the court described as the "storm warnings" of these wordings, and other indications of AIG's intentions from 1998 through 2000, AXA did not bring suit until 2005. Finding the claims time-barred, the court reversed the judgment and remanded with instructions to enter judgment in favor of AIG.

Chinese Drywall Update

BY CLIFF GRUHN

On September 15, 2010, attorneys from the Plaintiffs' Steering Committee in the Chinese Drywall MDL litigation pending in the Eastern District of Louisiana filed a class action complaint naming as defendants 91 insurers of homeowner's policies in Louisiana, Florida, Alabama, Mississippi and Texas. Throwing caution to the wind, the plaintiffs intend to pursue this potentially massive and diverse class action by alleging a subclass for each of the insurers named in the complaint. According to the complaint, the insurers issued substantially similar policies to the putative class, and the insurers have either denied or intend to deny coverage to the insureds based on a number of exclusions contained in their policies, including pollution, inherent defect and faulty workmanship exclusions.

Post-Loss Assignment Question Punted

BY JAMES GOODFELLOW

The State of Louisiana's "Road Home" program provides compensation of up to $150,000 to underinsured homeowners affected by Hurricanes Katrina and Rita for damage to their homes. To prevent any duplication of benefits, Louisiana requires recipients to assign any post-loss insurance payments to the state. This requirement, however, brought unintended consequences: insurers allegedly had an incentive to underpay, and homeowners had little incentive to file a claim or challenge low settlements, giving rise to a billion dollar shortfall in the program.

Accordingly, Louisiana filed suit against over 200 insurers, seeking to recover this shortfall. The insurers removed *In re Katrina Canal Breaches Litigation* to federal court and filed a motion to dismiss, arguing that the anti-assignment clauses found in the recipients' policies invalidated any assignments. The district court denied the motion, but certified an interlocutory appeal.

The Fifth Circuit Court of Appeals, citing a split in Louisiana authority, certified the anti-assignment clause question to the Louisiana Supreme Court. It noted that **ordinarily, post-loss assignments create little risk for insurers but that in this case, broader questions were raised, as the state sought to re-litigate claims that had already been pursued**. The Fifth Circuit also stated that the Louisiana Supreme Court's decision will be dispositive of the issues raised in the appeal.

Onslaught of BP Oil Spill Claims Expected

BY LIAM BURKE

After the worst oil spill in U.S. history, property casualty insurers are facing a growing onslaught of claims – this despite BP's $20 billion compensation fund being administered by the Gulf Coast Claims Facility (GCCF). **Property casualty insurers can expect to see numerous first-party business interruption and property damage claims as a result of the spill's primary and secondary effects on the fishing industry, as well as hotels, restaurants, and other businesses that rely on tourism and suffered losses due to decreased travel to the Gulf Coast region.** Moreover, P&C carriers are also setting reserves under liability coverages, as class action suits and other litigation continue to pile up against parties connected to the oil rig failure, as well as those involved in clean-up efforts. The litigation will raise numerous issues, including notice, mitigation and cooperation issues, as well as pollution, mechanical failure, and business risk exclusions.

Moreover, the GCCF – which is designed to handle claims from individuals and businesses that incurred damages as a result of remediation costs, damage to real or personal property, and lost earnings or profits in exchange for a relinquishment of rights – presents uncertainties likely to be sorted out in the courts, including the claims process, accord and satisfaction issues meant to prevent double recoveries, and subrogation issues. If the reports concerning the number of fraudulent claims already submitted to the GCCF are accurate, yet another significant issue likely looms for insurers.

SEC Issues Guidance on Money Market Fund Reform

BY SCOTT SHINE

The SEC has issued guidance on two issues related to Rule 2a-7, which was amended in February as part of the agency's money market fund reform initiative. Under the rule, a money market fund may not maintain a dollar-weighted average portfolio maturity that exceeds 60 days. In a no-action letter, the SEC staff stated that for purposes of calculating the weighted average portfolio maturity, a money market fund may treat a short-term floating rate security that is subject to an unconditional demand feature as having a maturity equal to the period remaining until the principal can be recovered through demand.

Rule 2a-7, as amended, also requires the board of a money market fund to designate, by December 31, 2010, at least four nationally recognized statistical rating organizations (NRSROs) whose ratings the fund would use to determine the eligibility of portfolio securities under the rule. However, in light of Section 939A of the Dodd-Frank Act – enacted after Rule 2a-7 was amended – which requires the SEC to remove from its regulations all references to credit rating agencies and substitute a standard of creditworthiness the SEC deems appropriate, **the SEC issued no-action guidance stating that it would not recommend enforcement action if a money market fund board does not comply with the NRSRO requirements before the SEC has modified Rule 2a-7 as required by Dodd-Frank**.

Although most of the compliance dates for the money market fund reforms have passed, two still remain. By December 7, 2010, all money market funds must begin filing information on Form N-MFP pursuant to Rule 30b1-7, and by October 31, 2011, funds must be able to process transactions at prices other than stable net asset value. Additional guidance related to Rule 30b-7 and Form N-MFP, as well as other aspects of the of money market fund reforms, can be found on the SEC website in the form of "Staff Responses to Questions" regarding these matters.

SEC Stays Proxy Access Rules

BY SARAH JARVIS

The SEC, on October 4, 2010, granted an order to stay recently approved revisions to its rules which would make it easier for shareholders to nominate directors of public companies, including mutual funds. The SEC action came in response to the U.S. Chamber of Commerce's motion to stay and its related petition filed with the U.S. Court of Appeals for the District of Columbia. The Chamber has taken the position that the revisions give activist investors too much power and will allow them to promote narrow interests.

Under the current rules, shareholders must mail a separate ballot to other investors at their own expense and persuade those investors to vote with them. **The rule changes would make it easier for shareholders to nominate directors by allowing investor groups who have owned at least three percent of a company's stock for at least three years to nominate board members on the annual proxy ballot sent by the company to its shareholders.** The Chamber claims that the changes "will give small groups of special-interest activist investors significant leverage over a business's activities."

Revised proxy rules trashed – for now.

Ninth Circuit Bars Shareholder Suit

BY JAMES GOODFELLOW

The Ninth Circuit Court of Appeals has determined that mutual fund shareholders do not have a private right to enforce section 13(a) of the Investment Company Act of 1940 (1940 Act), which requires an investment company to obtain shareholder approval before deviating from fundamental investment policies. In so doing, the Court of Appeals emphasized that its holding squared with Second Circuit precedent and the modern trend, which has been to deny private enforcement of the 1940 Act.

In *Northstar Financial Advisors v. Schwab Investments*, Schwab moved the district court to dismiss a shareholder class action suit filed by Northstar, asserting that section 13(a) contains no implied private right of action. The court disagreed, reading into the provision Congressional intent to provide a private right of action based on the enactment of the Sudan Accountability and Divestment Act of 2007 (the SADA Amendments), which added to the 1940 Act, as section 13(c), a provision barring suits against investment companies for divesting from Sudanese-based investments.

In reversing the district court's decision on interlocutory appeal, the Court of Appeals noted that (1) section 13(a) focuses squarely on the party to be regulated, not on those protected; (2) the 1940 Act thoroughly delegates enforcement authority to the SEC; and (3) Congress had created private rights of action for certain specific provisions of the 1940 Act, but declined to create a corresponding right for section 13(a).

The Ninth Circuit found that **the legislative history did not evince intent to create a private right of action**. Among other things, it found the SADA Amendments were intended to provide a "safe harbor" for compliance with SADA and noted that recent amendments to section 13(c) expressly state that it does not create or affect the existence of private enforcement of section 13(a).

Shareholders Challenge Underlying Fund Fees

BY STEPHANIE FICHERA

Observing that § 36(b) of the Investment Company Act (ICA) "creates a private right of action for all 'security holders' in the registered investment company, including persons who possess an interest in a mutual fund that is acquired through a fund of funds[,]" the U.S. District Court for the Southern District of Iowa recently held that **shareholders in a "fund of funds" had standing to bring excessive advisory fee claims under § 36(b) on behalf of the fund's underlying funds**. The court, in *Curran v. Principal Management Corporation* (June 8, 2010), also held that the plaintiffs sufficiently stated a claim against the investment adviser for excessive advisory fees with respect to the fund of funds and each of the underlying funds; each were part of the same family of funds and shared the same investment adviser.

With respect to the standing issue, the court analyzed the language of § 36(b), the legislative history of the ICA, case law, and the "analogous" § 16(b) of the Securities Exchange Act. As to § 16(b) comparison, the court observed that neither statutory provision places any "significant restriction on the type of security adequate to confer standing," and that "'any security' will suffice."

In analyzing the excessive fee claims, the court applied the Supreme Court's recent adoption of the Second Circuit's Gartenberg standard for § 36(b) actions. The court found that the plaintiffs were not required to make a "conclusive showing" of each of the Gartenberg factors, but could "state a § 36(b) claim by alleging any combination of facts that plausibly support an inference that a particular fee, given all of the surrounding facts and circumstances, is disproportionately large to the services rendered in exchange for that fee." According to the court, plaintiffs' allegations in this regard supported a reasonable inference that the adviser collected excessive fees.

CFTC Mulls Reset of Futures Trading Restrictions

BY ED ZAHAREWICZ & JACOB HATHORN

The National Futures Association (NFA) has petitioned the Commodity Futures Trading Commission (CFTC) for rulemaking to restore certain regulatory restrictions that would limit the marketing and trading activities of registered investment companies engaged in futures trading. The petition is aimed at preventing mutual funds from operating, in effect, as public commodity pools without the protections afforded to investors by federal commodity futures laws and regulations.

Mutual funds that engage in commodity futures and options trading typically rely on CFTC Rule 4.5 to avoid having to register with the CFTC as a commodity pool operator (CPO). Rule 4.5 provides an exclusion from the definition of CPO for certain entities that are subject to oversight by another regulator. To rely on Rule 4.5, a mutual fund must file a notice of eligibility with the NFA and comply with the rule's conditions.

The NFA is requesting that the CFTC amend Rule 4.5 to restore operating restrictions on registered investment companies that are substantially similar to those in effect prior to 2003. Rule 4.5, as then in effect, prohibited a registered investment company from marketing itself as a futures trading vehicle or committing more than 5% of the value of the company's portfolio to speculative positions in commodity futures or options contracts.

In 2003, the CFTC eliminated those restrictions. **The NFA is concerned that the CFTC's action has allowed certain mutual funds to market themselves to investors as commodity futures investments, while also being "indirectly invested substantially in derivatives and futures products."** According to the NFA, "although these funds are structured differently than public commodity pools … their aim is the same—targeting retail investors … who want exposure to actively managed futures strategies."

Scribner, Hall & Thompson, LLP

IRS Guidance on Basis Reporting by Securities Brokers

BY JANEL C. FRANK

The IRS recently released final regulations (T.D. 9504) describing new basis reporting rules that brokers who deal in securities will be required to follow starting January 1, 2011. Brokers already are required to report gross proceeds received from the sale of securities by providing the customer and the IRS with Form 1099-B. Under the new regulations, brokers also will be required to report the customer's adjusted basis and whether any gain or loss is long-term or short-term with respect to the sale of covered securities. The term "security" is defined broadly to include stock in a corporation, notes, bonds, debentures, commodities, derivative contracts and "other financial instruments" if the Secretary determines that adjusted basis reporting is appropriate. Generally, brokers will be required to report the basis in stock on a first-in, first-out (FIFO) method if a customer fails to specifically identify the stock that was sold. However, the basis of stock in a regulated investment company (RIC) or dividend reinvestment plan (DRP), may be reported using the average basis method if that method is elected by the customer. Under the regulations, a customer may elect or change from the average basis method at any time. **Significantly, a change in the basis determination method is not treated as a change in method of accounting because basis determination does not involve the "elements of consistency and regularity inherent in methods of tax accounting"** presumably because basis methods can be determined sale by sale, while a method of accounting applies from year to year. Effective January 1, 2011, brokers also will be required to report the adjusted basis and holding periods for stock that is transferred to another broker, although under IRS transitional relief, no penalties will be asserted for failure to provide a transfer statement in 2011.

Bar Lowered for SEC to Charge Aiding and Abetting

BY STEPHAN VOUDRIS

The Dodd-Frank Act (DFA) has reduced the scienter requirement from "knowingly" to "knowingly or recklessly" in any federal court action instituted by the SEC for providing substantial assistance (i.e., aiding and abetting) in connection with a violation under the Securities Exchange Act of 1934. DFA also added provisions to the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 that, for the first time, explicitly authorize the SEC to bring actions for aiding and abetting violations under those statutes. As under the revised 1934 Act provision, the scienter standard for aiding and abetting actions under these other three statutes is "knowingly or recklessly."

More reason than ever to proceed cautiously

By way of example, a lawyer who assists in the preparation of a false press release could "knowingly" aid and abet a violation only if the lawyer knew of the falsity. In contrast, the lawyer could "recklessly" aid and abet the violation merely by failing to investigate the release's accuracy.

Jorden Burt expects difficult questions to arise under the lower standard; in many cases it will be uncertain whether (and how much) investigation is required in order to avoid potential exposure as an aider and abettor. This quandary will not only affect lawyers, but also other "gatekeepers," such as such as accountants and banks.

So far, this change is not applicable to private actions, because there is no private right of action for aiding and abetting federal securities law violations. DFA, however, directs the U.S. Comptroller General to study the potential impact of such a private right of action.

Mandatory Industry Arbitrators Slated for Extinction

BY TOM LAUERMAN

In October, FINRA proposed to the SEC that all investors making arbitration claims have the right to request an "all-public" arbitration panel. If the SEC approves this proposal, it would make permanent and extend to all investors a temporary pilot program under which some investors have had the option of replacing the customary "non-public" (i.e., industry-affiliated) arbitrator with a public arbitrator.

According to FINRA, approximately three-quarters of investors in the pilot program opted for an all-public panel, and such panels ruled in favor of the investor substantially more often than panels that included an industry arbitrator.

This change may reduce the likelihood that the SEC will altogether prohibit mandatory arbitration provisions in customer agreements. The Dodd-Frank Act grants the SEC clear authority to take such action with respect to broker-dealers and investment advisers. DFA also directs the new Bureau of Consumer Financial Protection to study the use of pre-dispute mandatory arbitration agreements by firms under its jurisdiction and empowers the Bureau to take appropriate action in this area. Moreover, DFA generally directs the SEC and the Bureau to coordinate their positions and strive for consistency on matters of this type.

Arbitration is changing–where does it go next?

Increased Whistleblowing Threatens Counsel

BY PAULA CRUZ CEDILLO & LIAM BURKE

The SEC has seen a sharp increase in the number and quality of tips it has received since the enactment of the Dodd-Frank Act (DFA). DFA provides that the SEC must pay a bounty to whistleblowers who provide it with original information that leads to an enforcement action resulting in sanctions of $1 million or more. The SEC is required to award such whistleblowers an amount between 10 and 30 percent of the sanctions collected.

The DFA provides incentives to tell all

Apart from the fact that employees may forgo internal channels and provide information directly to the SEC hoping to receive an award, one of the most significant but less obvious effects will be the increased risk of "gatekeeper," or aider and abettor liability. "Gatekeepers" are the professionals, including in-house and outside counsel, who may have rendered advice or services in connection with violative conduct. As discussed in *Bar Lowered for SEC to Charge Aiding and Abetting*, on page 14, DFA reduced to mere recklessness the scienter requirement for the SEC to bring aiding and abetting charges.

With the potentially lucrative bounties and the new lower standard required for aiding and abetting, counsel and other gatekeepers now have considerably more exposure to enforcement actions.

FINRA Facing Credibility Crisis with Members

BY MARILYN SPONZO

Disgruntled member firms presented a number of non-binding proposals at FINRA's August 2010 annual meeting. The proposals, which the members approved by more than a two-thirds vote, called for FINRA to:

- Disclose annual compensation for its ten most highly compensated employees;
- Disclose information about its investment activities;
- Make Board of Governors' meetings public;
- Give member firms a "say on pay" for FINRA executives;
- Conduct an independent study of relationships between the Bernard Madoff family and FINRA officers and directors;
- Release all correspondence with the Internal Revenue Service regarding the $35,000 payment to member firms in connection with the merger of NASD and NYSE Regulation; and
- Hire an independent inspector general.

In response, FINRA's Board agreed to disclose executive compensation, and the identities of the money management firms FINRA uses. Although the Board declined to make its meetings public, it agreed to publish rulemaking items discussed and/or resolved at Board meetings.

The Board declined to take action on the remaining proposals. FINRA Chairman and CEO Richard Ketchum explained that "say on pay" could create the perception that member firms could improperly intimidate FINRA staff. At the same time, a Board subcommittee released a report addressing allegations by Amerivet Securities, Inc. that FINRA overpaid executives while sustaining significant investment losses due to reckless investing. The report approved FINRA's practice of benchmarking executive salaries against financial services firms, rather than against non-profits and government agencies, because FINRA requires of its executives a "different skill set and knowledge base" than many of the latter organizations.

Three representatives of small member firms also have criticized FINRA for awarding $1 million to four law schools to fund clinics helping small investors file claims against brokerage firms. At the August meeting, these three representatives defeated FINRA-endorsed candidates for seats on the FINRA Board.

SECURITIES

New Training Requirements May Disrupt Annuity Marketing

BY ANN FURMAN

The NAIC's recently-revised Suitability in Annuity Transactions Model Regulation (2010 Suitability Model) may have the unintended consequence of reducing the number of broker-dealers who are willing to sell an insurer's variable annuities.

The 2010 Suitability Model imposes on insurance producers two new training requirements: (i) product-specific training and (ii) a one-time four credit annuity training course approved by the state department of insurance. These training requirements may vary as implemented by different states. **The training requirements apply to all types of annuities**, including variable annuities sold by registered representatives, who are also subject to additional training requirements imposed by FINRA.

One giant broker-dealer headache?

An insurer may contract with a third-party (including a broker-dealer) to perform training-related functions, although the insurer is responsible for verifying that its insurance producers have completed all the training required under the 2010 Suitability Model. A broker-dealer may receive requests from one or more insurers to assist in this regard by tracking its registered representatives' completion of such training.

Broker-dealers may find such tracking to be burdensome, particularly where a large number of different annuity products, states, and insurers are involved. Accordingly, **some broker-dealers have considered reducing the number of affiliated insurers (and annuity products)**. For example, one large independent broker-dealer that currently works with twenty insurers has indicated that it may reduce that number to six.

Insurers offering variable annuities may be required to accept a reduced selling group, while some, in the alternative, could themselves implement a training tracking system for the registered representatives. This alternative would, however, obviously be more difficult for insurers distributing variable annuities through independent broker-dealers. At the other end of the spectrum, a few larger insurers with captive sales forces are already set to track completion of training requirements.

Mark Your Calendars

Kristin Shepard, Partner, and **Joan Boros**, Of Counsel, will be presenting at PLI's Security Products of Insurance Companies in the Face of Regulatory Reform 2011, January 28, 2011 in New York City. They will be on a panel discussing issues on insurance product design. Ms. Boros, a co-chair of the conference, is also speaking on the SEC Agenda. To register, visit www.pli.edu.

Class Certification Motion: You Snooze, You Lose

BY MICHAEL WOLGIN

An Eighth Circuit Court of Appeals' recent decision demonstrates that the rigor central to a court's analysis of a motion for class certification applies in equal measure to the procedural conduct of the putative class plaintiff and counsel. In *Rattray v. Woodbury County* (Aug. 5, 2010), a suit by an arrestee for allegedly illegal strip searches, the Court of Appeals affirmed the denial of the motion for class certification due to excessive delay in bringing the motion. The plaintiff initially filed an individual complaint in February 2007, alleging that the sheriff employed a broad strip search policy that violated the Fourth Amendment rights of arrestees at the county jail. In October 2007, a magistrate judge permitted an amendment of the complaint to assert class allegations and in April 2008, the plaintiff moved to certify a class. The district court denied the motion, holding that the delay in bringing the motion was "disturbing" and showed that the plaintiff and her counsel were inadequate to represent the class under Rule 23(a)(4).

Eighth Circuit to would-be class plaintiffs: Tick-Tock!

On appeal, the plaintiff argued that the district court abused its discretion because the magistrate judge had found that there was "good cause" to amend the complaint and extensive class discovery had been taken. The Eighth Circuit disagreed, explaining that the magistrate judge's finding of "good cause" was not persuasive given the relatively low standard to amend pleadings under Rule 15, as compared to the "rigorous analysis" essential to certify a class under Rule 23. The court explained that the "inquiry into adequacy of representation, in particular, requires the district court's close scrutiny, because the purpose of Rule 23(a)(4) is to ensure due process for absent class members." The court further noted that the original individual complaint "forecast[ed] that a broad strip search policy was in effect," that plaintiff's counsel knew that "a potential class existed," and that the fourteen months that passed between the initial complaint and the motion for class certification "undermines confidence in the zeal with which [the plaintiff] would represent the interests of absent class members."

Issuer's "Substitution" of Credit Cards May Trigger TILA Disclosures

BY KIM FREEDMAN

In *Acosta v. Target Corp.* (Sept. 23, 2010), the District Court for the Northern District of Illinois denied Target's motion to dismiss a complaint brought by a consumer alleging that the store's substitution of his store credit card with a general purpose card violated the Truth in Lending Act (TILA) and state tort law. The consumer received an unsolicited general purpose Target VISA card, which was designed to replace his store-only credit card. After activating the card, the consumer discovered that the terms and conditions were significantly less favorable than those of his prior store-only credit card. The consumer filed a class action alleging violations of TILA and various state law causes of action, including fraud. The district court denied Target's motion, finding that the consumer properly stated a violation of TILA's prohibition against the issuance of unsolicited credit cards because **the Target VISA card was not a mere "substitute card" and was therefore not exempt from that prohibition**. The court also held that the consumer stated a claim for violation of TILA's disclosure requirements because the relevant facts indicated that the new card did not upgrade the existing account, but instead opened a new account for which certain disclosures were required. Finally, the district court found that the consumer's common law fraud claim was not preempted by TILA because state law fraud claims served to enforce TILA's disclosure requirements.

Tenth Circuit Clarifies Standard for Appeal of CAFA Remand Orders

BY LARA O'DONNELL GRILLO

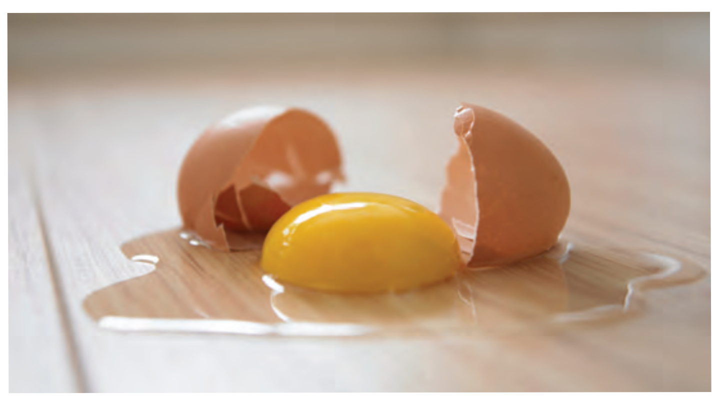
In *BP America, Inc. v. Oklahoma* (July 29, 2010), the Tenth Circuit Court of Appeals granted BP leave to appeal the district court's denial of removal jurisdiction under CAFA. BP had removed the case to federal court under CAFA's "mass action" provision after the state Attorney General sued BP under various provisions of the Oklahoma Consumer Protection Act. The district court held the lawsuit was not a "mass action" and remanded the case to state court. BP appealed the remand order under CAFA § 1453(c)(1), which allows a court of appeal to "accept an appeal from an order of a district court granting or denying a motion to remand a class action to the state court from which it is removed" if the petitioner makes a timely application. A court of appeals has discretion under this provision to hear such appeals notwithstanding the general prohibition of appeals from remand orders in § 1447(d). In considering whether to exercise its discretion to hear the appeal, the court stated that although it was a novel question in the Tenth Circuit, other circuits had addressed the issue and "left behind useful guidance." **The court analyzed the question under the First Circuit's eight-factor test, and concluded that each factor favored appellate review.** The court granted BP's application for leave to appeal, noting that "whether to grant leave to appeal remains a matter 'committed to the informed discretion of the reviewing court,' and the factors we have outlined are no more than considerations or guides to help inform that analysis."

When navigating CAFA, courts are not shy about asking for directions.

Eleventh Circuit Reverses Itself; Drops $75,000 Jurisdictional Requirement

BY KRISTIN SHEPARD

In *Cappuccitti v. DirecTV, Inc.* (July 19, 2010), a panel of the U.S. Court of Appeals for the Eleventh Circuit held that, in order for a federal court to have jurisdiction under the Class Action Fairness Act (CAFA), at least one plaintiff must satisfy the $75,000 amount in controversy requirement. The Court held this requirement existed in addition to CAFA's requirement that the aggregate amount in controversy for the entire class exceed $5 million.



The Eleventh Circuit gets a do-over.

Following widespread criticism of the opinion as contrary to CAFA's plain language, on October 15, 2010, the same Eleventh Circuit panel granted petitions for rehearing and vacated its earlier opinion. The panel stated: "Subsequent reflection has led us to conclude that our interpretation was incorrect," and further clarified that "[t]here is no requirement in a class action brought originally or on removal under CAFA that any individual plaintiff's claim exceed $75,000." In dicta, the panel added that the $75,000 amount in controversy requirement continues to apply to Eleventh Circuit CAFA mass actions.

FACTA Truncation Requirement Not Applicable to Email Receipts

BY EDDIE KIRTLEY

According to the Seventh Circuit Court of Appeals, the federal requirement prohibiting vendors accepting credit or debit cards from including an expiration date or more than the last five digits of the card number on any "electronically printed" receipts only applies to physically printed receipts, not those emailed over the internet. In *Shlahtichman v. 1-800 Contacts, Inc.* (Aug. 10, 2010), the Seventh Circuit examined the truncation requirement of the Fair and Accurate Transactions Act of 2003 (FACTA) and affirmed the district court's dismissal of Shlahtichman's putative class action suit, reasoning, as the district court did, that FACTA's truncation requirement applies only to receipts that are physically "printed" on paper by the vendor, not to receipts that are emailed. After considering the plain meaning of the word "print," the statute's context and purposes, and the import of what Congress has said in other statutes, the Court of Appeals, in a decision of first impression at the appellate level, concluded that the truncation requirement was aimed only at transactions where receipts are physically printed using electronic point of sale devices like electronic cash registers or dial-up terminals. The court explained that to "print" a receipt means to commit it to paper and "[t]hat is why [the plaintiff] had to print a copy of his receipt to get it off of his computer; it is why the machine used to transfer text from a computer to paper is called a printer; and it is why a judge who asks a law clerk to print a case does not intend for the clerk to merely display the case on his computer screen."

Email receipts may reveal a whole host of credit card information

Arbitration Roundup

BY LANDON CLAYMAN

Mandatory forum selection clauses can render an arbitration agreement unenforceable if the forum is unavailable when the dispute arises. In *Renzy v. Tijerina* (Aug. 25, 2010), the parties' arbitration agreement specified that disputes "shall be resolved" by the National Arbitration Forum (NAF), but when the dispute arose the NAF no longer handled the kind of consumer claim made by the plaintiff. The district court held that the NAF designation was a mandatory, integral part of the agreement and declined to appoint an alternative forum or arbitrator. The Fifth Circuit affirmed the denial of the defendants' motion to compel arbitration.

The arbitration world's attention is certainly locked in on *AT&T Mobility LLC v. Concepcion*, pending before the United States Supreme Court, in which more than twenty-five amicus curiae briefs have been filed. This case presents the question of whether the Federal Arbitration Act (FAA) preempts California's rule that a class action waiver provision in a consumer arbitration agreement is unconscionable and unenforceable when, in essence, the damages available for the claim do not provide sufficient incentive for the consumer to pursue individual arbitration. In light of the Supreme Court's arbitration decisions last Term, **there are expectations that its decision in this case will reduce or eliminate the uncertainty that presently exists in many jurisdictions concerning the application of state law unconscionability principles to class action waivers** in arbitration agreements.

Can California simply cut out a class action waiver provision?

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