EXPECT FOCUS®

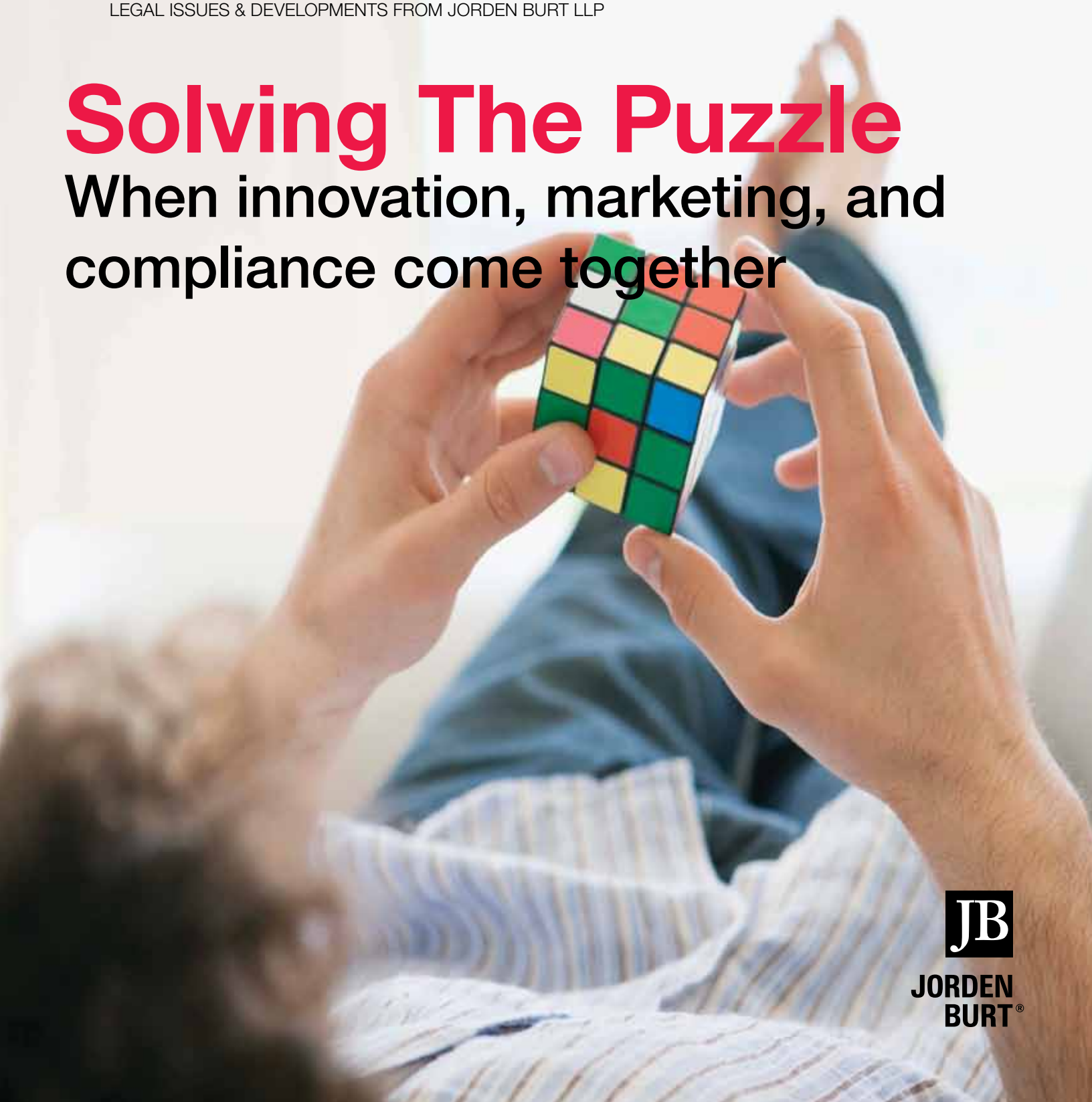
VOLUME IV FALL 2012

In This Issue:

LEGAL ISSUES & DEVELOPMENTS FROM JORDEN BURT LLP

Solving The Puzzle

When innovation, marketing, and compliance come together



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EXPECT**FOCUS**® VOL. IV FALL 2012

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IN THE SPOTLIGHT

Considering Financial Services Mobile Apps?

BY DIANE DUHAIME

It seems that everyone is offering a mobile app these days. Perhaps your company already offers one or more apps to its customers/advisers, such as apps that enable advisers to run their businesses from a mobile platform, or apps that allow customers to keep a watch on their portfolio balances and initiate transactions. The number of mobile apps is likely to continue increasing, especially as apps provide the ability to perform functions that cannot be accomplished from a laptop or desktop computer. The following is a list of some of the key legal considerations associated with developing, introducing and maintaining a financial services-related mobile app.

Platform choice (e.g., iOS, Blackberry OS, Android)	In addition to the technical, marketing, and financial considerations in selecting the platform(s) for the app, review the applicable mobile application developer terms and conditions to ensure compliance is feasible. Watch for language that provides the platform owner with ownership rights (as opposed to non-exclusive license rights) to your app.
Determination of app ownership	Determine ownership prior to commencing development of the app, whether the app is developed by company IT personnel only, by a third-party developer only, or by a combination of personnel resources. Consider whether the ownership will be pursuant to work made for hire/ written assignment. Address the right to modify the app and ownership of modifications to the app.
Intellectual property rights	Evaluate whether a license is required for (a) developing the app (e.g., the app is an outgrowth of software to which your company is a non-exclusive licensee without the right to develop apps related to the licensed software) or (b) for any of the content that will appear in the app (e.g., videos, images, trademarks of other parties). Determine how best to protect the intellectual property rights in the app (patent, trademark, trade secret, copyright), and evaluate whether any aspects of the app potentially infringe on others' intellectual property rights. Consider U.S. and foreign protections, and file applications as appropriate. Incorporate digital rights management and other technical means to prevent unauthorized access and use of the app.
Regulatory compliance	Review and modify the app to ensure compliance with all applicable laws and regulations, including those applicable to electronic transactions, just as all other products must comply with such laws and regulations.
End User License Agreements	Develop appropriate terms and conditions to be entered into by the purchasers/users of the app (e.g., license terms, ownership, prohibited uses, export restrictions, limitation of liability, warranty disclaimer, confidentiality, breach, term/termination, governing law, jurisdiction, dispute resolution); avoid conflicts with the terms and conditions set forth in the platform providers' agreements.
Privacy and security concerns	Address traditional privacy issues (e.g., log-in credentials, user verification, protecting personally identifiable information, opt-in and opt-out requirements, data storage and retention, e-discovery). Address personal location tracking information issues (e.g., collecting/using location tracking information). Develop an appropriate privacy policy consistent with the company's other privacy policies and in compliance with applicable laws and regulations. Include contact information for user complaints. Consider privacy and ownership of user-generated content, and liability issues related to user-generated content. Consider the copyright agent and take-down provisions of the Digital Millennium Copyright Act. Take steps to ensure the app is not for users under age 13, or develop and implement app policies that comply with the Children's Online Privacy Protection Act and other laws applicable to users under age 13. Consult the Mobile Applicable Privacy Policy Framework of the Mobile Marketing Association, the Payment Card Industry Security Standards Council guidelines entitled "PCI Mobile Payment Acceptance Security Guidelines" (if payments can be made via the app), and the FTC guide concerning marketing of mobile apps, which includes compliance with basic privacy principles.

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Show Me the Money: Retention of Premiums in STOLI Cases

BY DAWN WILLIAMS

The insurer has succeeded: the court has decided (or the parties have agreed) that the insurance policy is void due to misrepresentation or lack of insurable interest. But which party is entitled to the premiums paid? That question, most courts find, is one of fact not readily susceptible to determination as a matter of law. For example, the Southern District of Florida recently reversed its earlier grant of summary judgment awarding premiums to an insurer due to new evidence indicating that the insurer may have had knowledge of the STOLI scheme prior to accepting additional premium. The court found that the investor was entitled to a trial on the disputed factual issues.

Similarly, the Northern District of Illinois issued two opinions in the last two months, the first ordering additional discovery about retention of premiums. The second, *Penn Mut. Life Ins. Co. v. GreatBanc Trust*, found that the court could not make a determination either way: the court could not order return of premium or that the insurer retain the premium – it was required to leave the parties "where they put themselves," dropping the case like a "hot potato."

Conversely, the District of Rhode Island granted summary judgment in favor of an insurer recently, finding as a matter of law that the policy had been procured by fraud and the insurer was innocent, and so it was entitled to the premiums.

The lesson: evidence sufficient to persuade a court that a policy is STOLI may not convince the court that the insurer should retain the premiums paid. This is often due to issues such as waiver, unclean hands, or estoppel, which are not at issue in determining the merits, but are when determining which party is entitled to the premiums paid.

National Association of Insurance Commissioners Amends Actuarial Guideline XXXVIII

BY STEVEN KASS & CLIFTON GRUHN

On September 12, 2012, the National Association of Insurance Commissioners (NAIC) amended Actuarial Guideline XXXVIII (AG 38), as proposed by a Joint Working Group of the Life Insurance and Annuities (A) and the Financial Condition (E) Committees. AG 38 provides guidelines for setting reserves on universal life products with secondary guarantees (ULSG), and the amendment process was precipitated by conflicting views regarding whether some insurers' ULSG reserving methodologies provided an unfair advantage. The amendments are intended to provide a "level playing field."

The AG 38 amendments take effect January 1, 2013, and for business in force prior to then, AG 38 requires that insurers use a form of principles-based gross premium reserving. For business written starting on that date, insurers must apply a reserving methodology similar to that outlined in an August 22, 2011 statement published by the NAIC's Life Actuarial Task Force (available on the NAIC website). AG 38 provides for regulatory oversight through detailed actuarial memoranda requirements, including review of insurers' reserving methodologies by the NAIC's Financial Analysis Working Group (FAWG). In response to industry concern that this would transform the NAIC into a regulatory entity, **the Working Group's Chairperson assured the NAIC's Executive and Plenary Committees that the amendments did not provide the NAIC with regulatory oversight authority, but instead simply served to ensure uniformity** because FAWG is comprised of regulators from numerous states who can provide consistent resolutions to issues.

Given the impending January 1, 2013 effective date and the likelihood that some insurers will be refiling ULSG products before then, the Working Group encourages regulators to process such filings on an expedited basis.

Amendments seek to provide elusive "level playing field"

How Risky Are You?

BY STEVEN KASS

On September 12, 2012, the NAIC adopted the "Risk Management and Own Risk Solvency Assessment Model Act." This Model would require that insurers maintain a "risk management framework" to assist in assessing, monitoring, managing and reporting on risk. The Model also would require insurers to complete an "Own Risk and Solvency Assessment" (ORSA) and mandates the annual filing of a confidential ORSA Summary Report in accordance with an "ORSA Guidance Manual."

Per the Guidance Manual, the ORSA Summary Report should include a description of the insurer's risk management framework, an assessment of its risk exposure, and a group risk capital and prospective solvency assessment, addressing these elements from both a qualitative and a quantitative perspective. Ultimately, this information is intended to assist regulators in forming subjective assessments of the quality of the insurer's risk and capital management. Evaluating and documenting an insurer's own risk profile for this purpose will likely be as much an art as a science.

Insurer Victory in Bonus Annuity Putative Class Action

BY DAWN WILLIAMS

Mary Helen Eller, Ronald Krainz and Paul Harrington alleged, individually and on behalf of a putative class, that EquiTrust Life sold bonus annuities without disclosing to them that the bonuses would be recouped, failed to adequately explain the market value adjustment (MVA), and failed to disclose that its contracts violated state nonforfeiture laws. Plaintiffs claimed this conduct unjustly enriched EquiTrust and violated RICO and state consumer protection statutes.

In *Eller v. EquiTrust Life Ins. Co.*, the federal district court in Arizona granted EquiTrust's motion for summary judgment on all counts, and denied plaintiffs' motion for class certification as moot, while noting that it would have "more probably than not, denied the motion for class certification." The court deemed plaintiffs' MVA allegations unfounded, because the MVA was clearly explained in the documents and other federal courts have "uniformly" determined that there is no duty to disclose internal pricing structures or spreads. **The court also found that the use of the word "bonus" did not trigger a duty to disclose internal pricing plans, and that, as a factual matter, a bonus was added to the account value of plaintiffs' annuities.** Finally, the court determined that plaintiffs failed to offer any evidence that the contracts violated the state's nonforfeiture law; in any event, a misrepresentation of law would not serve to properly underpin a RICO claim.

The court also rejected the purported RICO enterprise between the insurer and its agents, finding that the materials and training given to the agents differed, as did the meetings between agents and their clients. The court further determined that plaintiffs' plain assertion of classwide fraud was contradicted by EquiTrust's disclosure of the bonus, crediting rates, the MVA and its discretion to set crediting rates at or above the guarantee. Plaintiffs' consumer protection and unjust enrichment claims were dismissed for similar reasons.

Class Certification Denied in Malpractice Action Against Plaintiffs' Class Counsel

BY ABIGAIL KORTZ

The District of Arizona recently issued a favorable decision for class action defendants, holding that **plaintiffs failed to meet Rule 23(b)(3)'s requirements because the class action implicated the laws of fifty states**. In *Bobbitt v. Milberg, LLP,* plaintiffs sought certification of a nationwide class based on state negligence and breach of fiduciary duty claims asserted against defendants for legal malpractice. Defendants had represented plaintiffs in a prior class action suit brought against VALIC for violation of federal securities laws in the sale of variable annuities (the Underlying Case). In the Underlying Case, the district court had certified a class of more than one million annuity customers located in all fifty states, but subsequently decertified the class when plaintiffs failed to meet the deadline for expert disclosures. The Ninth Circuit subsequently affirmed.

Differences in the laws of fifty states precludes certification

In the malpractice action, plaintiffs sought to certify a class consisting of the same class members in the Underlying Case. Performing a thorough choice of law analysis, the court found that the law of up to fifty states applied because: 1) the place of injury is where each putative class member suffered economic loss; 2) the putative class members were domiciled across the fifty states; 3) the conduct that caused the injury occurred where counsel was located (in three separate states); and 4) the defendants had not established a relationship with the absent class members since they had not yet sent notice of the class action. As such, the court held that plaintiffs could not meet the Rule 23(b)(3) predominance requirement and denied plaintiffs' motion for class certification.

Recent Decisions in § 419 and § 412(i) Litigation

BY ENRIQUE ARANA & TODD FULLER

The Fifth Circuit Court of Appeals recently reviewed the first case on appeal from MDL No. 1983, a multidistrict litigation proceeding designed to address claims related to employee benefit plans created under §§ 412(i) and 419 of the Internal Revenue Code. At issue was a putative nationwide RICO and common law fraud case alleging the insurer and its agents fraudulently sold § 419 employee benefit plans by misrepresenting the validity and tax consequences of those plans. The district court dismissed the claims on a 12(b)(6) motion finding that no plausible RICO enterprise was pled because the complaint merely alleged that the insurer was selling insurance through agents and similarly concluded that the complaint failed to allege a pattern of racketeering activity or the requisite predicate acts. **The district court also dismissed the common law fraud claims holding that the alleged representations regarding the tax laws were simply opinions or predictions about how the IRS would apply the tax laws in the future and not false statements of fact;** and in any event it was unreasonable for an employer to rely upon an insurance company for tax advice. The Fifth Circuit affirmed on all grounds, effectively adopting the opinion of the lower court.

The federal court for the Middle District of Florida recently granted in part and denied in part the defendant insurer's motion for final summary judgment in a lawsuit relating to the use of life insurance policies to fund defined benefit pension plans under § 412(i) of the Internal Revenue Code. Several years after the plan was established, the IRS audited plaintiffs' plan and concluded that the plan failed to comply with certain provisions of § 412(i). Plaintiffs alleged that the insurer's purported agents misrepresented the validity and tax consequences of the plans and failed to disclose the IRS's public expression of an intent to begin scrutinizing § 412(i) plans fully funded with life insurance and administered as a "tax avoidance scheme." With respect to plaintiffs' fraud theory, the court noted that **"if the parties deal in an 'arm's length' transaction and if each party possesses an equal opportunity to discover the material information through diligence, neither party owes a duty to disclose."** The court also explained that an opinion or omission about a future event is actionable ***only if the person expressing the opinion is one having "superior knowledge" of the subject of the statement*** and the plaintiff can show that the person knew or should have known from facts in his or her possession that the statement was false.

The court further rejected plaintiffs' notion that the insurer owed a duty to disclose the IRS's public comments at a pension trade conference as plaintiffs, their accountant, and their tax attorney, each of whom investigated the § 412(i) plan proposal, had an equal opportunity to discover this publicly available information through diligence. The court also explained that the insurer possessed no "superior knowledge" of these public comments because the IRS's stated intent to scrutinize certain types of § 412(i) plans was publicly-available information. Contrary to plaintiffs' argument that the insurer's internal discussions, in light of the IRS's public comments, was evidence of its fraudulent intent, the court held that such internal discussions exhibited "merely a common and responsible reaction by a corporation under the circumstance and evidences neither fraud nor intent to defraud." The court allowed the fraud claim to proceed only if plaintiffs could identify a positive false statement of existing material fact. The court also dismissed plaintiffs' negligent misrepresentation claim holding that plaintiffs could not, as a matter of law, demonstrate reasonable reliance upon any alleged representations regarding the validity or tax consequences of the plan, or any other tax advice, in light of the written materials' myriad disclosures.

Jorden Burt represented the defendant insurers in these cases.

SCRIBNER, HALL & THOMPSON, LLP

IRS Industry Issue Resolution – An Important Tool for Resolving Industry Tax Issues

BY SAMUEL A. MITCHELL

On July 30, 2012, the Commissioner of the IRS's Large Business & International Division (LB&I) issued a Directive to LB&I examiners that resolves a very significant tax issue for the insurance industry. (LB&I-4-0712-009) The Directive allows insurance companies to claim partial worthlessness tax deductions by adopting a Statement of Statutory Accounting Principle (SSAP) 43-R approach, provided that they make an adjustment to eliminate non-credit losses that they may have previously taken. Companies are allowed to adopt this safe harbor in any tax year 2009 through 2012. If a company does so, the Directive generally provides that LB&I examiners are not to challenge the company's partial worthlessness deductions claimed in prior years for eligible securities covered by SSAP 43-R. Regular interests in Real Estate Mortgage Investment Conduits (REMICs) are the most common type of instrument subject to the Directive.

The Directive resulted from a collaborative process between an industry coalition and the IRS's LB&I. In September 2010, the coalition filed a request for guidance under the Industry Issue Resolution program outlined in Revenue Procedure 2003-36, 2003-1 C.B. 859. By the time the coalition filed the request, the partial worthlessness issue had become the most commonly raised issue in insurance company examinations. Insurance companies relied on a conclusive presumption of tax worthlessness in Treasury Regulation § 1.166-2(d)(1) for regulated industries to support the write-downs. LB&I examiners disagreed and disallowed the deductions on failure-of-proof grounds, which could result in costly factual disputes and controversy because of the complex nature of REMICs and similar instruments. Fortunately, LB&I leadership recognized and acknowledged the potential strain on resources on both sides and agreed to a global resolution. It is anticipated that most insurers that hold impaired REMICs will adopt the Directive's safe harbor and avoid a prolonged dispute with the IRS.

Reinsurance: Giving Credit Where It's Due

BY ANTHONY CICCHETTI

The NAIC adopted the revised Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786) in November 2011. **By September of this year, 11 states had implemented changes to their credit for reinsurance requirements to allow for a ratings-based methodology providing for reduced collateral requirements for certified, non-U.S. reinsurers**. These states include: Florida, New York, New Jersey, Pennsylvania, California, Connecticut, Delaware, Georgia, Indiana, Louisiana, and Virginia. Certain of these states, most notably Florida and New York, already had moved in this direction before the NAIC adopted its revised Models, but a number enacted legislation during their recently completed legislative sessions.

Some of the state legislation has included variation from the NAIC Models. For example, California's law, signed by Governor Brown in early September, authorizes the insurance commissioner to disallow credit for reinsurance under certain circumstances notwithstanding technical compliance with the new requirements. This law goes into effect January 1, 2013, but will be deemed automatically repealed on January 1, 2016, unless separate legislation provides otherwise. **Thus, it appears that California may be taking the NAIC's revised Model on a three-year test drive.**

At the NAIC, the Reinsurance (E) Task Force continues its work on credit for reinsurance matters. Most notably, its Qualified Jurisdiction Drafting Group, led by Missouri's Director John Huff, is focusing on developing the list of qualified jurisdictions. Under the Models, this list will identify the non-U.S. jurisdictions qualifying as acceptable domiciliary jurisdictions for non-U.S. reinsurers to be eligible for consideration for certification and, potentially, reduced collateral obligations. An extensive summary and analysis of the NAIC's revised Models can be found in a *Special Focus* article at *ReinsuranceFocus.com*.

The Fifth Circuit Takes a Fresh Look at ERISA Preemption

BY ROBIN SANDERS & GLENN MERTEN

In the coming months, the Fifth Circuit Court of Appeals is expected to issue an en banc decision in *Access Mediquip LLC v. UnitedHealthcare Insurance Co.* that could result in the reversal of two decades worth of the court's ERISA preemption precedent, or, at a minimum, provide clarification regarding the contours of ERISA-preemption within the Fifth Circuit.

Access Mediquip, a third-party medical service provider, asserted myriad state law and ERISA §§ 502(a)(1)(B) & 502(a)(3) claims in a mass action challenging the accuracy of United's pre-authorization coverage communications related to medical services provided to more than 2,000 ERISA-governed plan participants and beneficiaries. Access Mediquip asserted its claims both in its individual capacity and, for purposes of the ERISA claims, as an assignee of plan participants. The district court holding, that all of Access Mediquip's state law claims were preempted under ERISA, was affirmed in part and reversed in part by the Fifth Circuit.

In its now withdrawn decision, the Fifth Circuit held that because Access Mediquip's misrepresentation-based claims challenge only the accuracy of United's pre-authorization communications, rather than its ultimate coverage decisions, the claims do not relate to ERISA-governed plans for purposes of preemption. **The court noted that unlike Access Mediquip's unjust enrichment and quantum meruit claims, the misrepresentation-based claims are not dependent on, and do not derive from, the participants' rights to recover ERISA-governed benefits and therefore are not preempted.**

United petitioned for and was granted rehearing en banc. During supplemental briefing, the Department of Labor submitted an *amicus curiae* brief in support of Access Mediquip, while America's Health Insurance Plans submitted an *amicus curiae* brief (co-authored by Jorden Burt) in support of United, as did numerous Blue Cross Blue Shield entities. Oral argument was held on September 19, 2012.

Ninth Circuit Extends Fiduciary Exception to Plan Fiduciary Insurers

BY GLENN MERTEN

In a decision that could have far-reaching consequences, the Ninth Circuit Court of Appeals became the first federal appellate court to find that the fiduciary exception to the attorney-client privilege applies to insurance companies as well as plan trustees. In *Stephan v. Unum Life Insurance Company of America*, plaintiff Mark Stephan, who was injured in a bicycle accident, challenged his disability insurer's calculation of benefits under his ERISA long-term disability insurance policy, and brought an action in the United States District Court for the Northern District of California.

In an effort to demonstrate the insurer's purported conflict of interest, Stephan sought in discovery a series of internal memoranda created by in-house counsel in connection with his claim. The district court assumed that the fiduciary exception to the attorney-client privilege applied, but held that "the interests of plaintiff and defendant had sufficiently diverged at the time the disputed memoranda were created," and denied access to the material.

On appeal, the Ninth Circuit reversed and remanded, concluding, in an issue of first impression in the Circuit, that ***there was no principled distinction for purposes of the fiduciary exception to the attorney-client privilege between plan trustees and insurance companies also serving as ERISA fiduciaries***. The court offered little analysis, but recognized that it had split with the Third Circuit, the only other appellate court to consider the issue.

The Ninth Circuit also disagreed with the district court's holding that the fiduciary exception did not apply because the interests of the beneficiary and the insurer had "become sufficiently adverse," observing that "it is not until after the final determination – that is, after the final administrative appeal – that the interests of the Plan fiduciary and the beneficiary diverge for purposes of application of the fiduciary exception." In other words, ***insurers that also are plan fiduciaries cannot avail themselves of the attorney-client privilege to protect communications containing legal advice made in the course of benefits determinations***.

Arizona Court Accepts Profit Targets as Evidence of an Insurer's "Evil Mind"

BY BERT HELFAND

When MetLife became a publicly-traded company, then-Chairman Robert Benmoche set a goal for the underperforming Auto and Home Division: increase profits 300% in 2002. That year, MetLife allegedly mishandled the claim of a family whose truck had been vandalized. Under Arizona law, the family could recover punitive damages for bad faith, by demonstrating "evil mind"—that is, showing the insurer had "consciously pursued … conduct … that … created a substantial risk of significant harm to others." In May, an Arizona appellate court held that the aggressive measures MetLife implemented to pursue its profit target constituted "clear and convincing evidence" of the requisite "evil mind."

Plaintiffs in *Nardelli v. Metropolitan Group Property and Casualty Insurance* held a MetLife auto policy when car thieves damaged their Ford Explorer. For several months, adjusters refused to declare a total loss, offered insufficient repair estimates and failed to disclose relevant endorsements. An Arizona Court of Appeals ruled that these facts supported a verdict finding MetLife liable for bad faith.

The jury also awarded $55 million in punitive damages, which requires an additional showing of "evil mind." Plaintiffs' showing focused on corporate communications: In presentations to offices around the country, MetLife officers emphasized the 300% target, warned that the Auto and Home Division might be sold if it fell short of that goal, and specifically communicated that the claims department was "expected to contribute." Employees were told of a company policy to "be tougher on claims." Compensation in claims offices was tied to the average payment per claim through performance reviews and bonuses.

The Court of Appeals held that this evidence supported a finding of "evil mind." (On Due Process grounds, it also reduced the punitive damages award to make it equal the amount of compensatory damages.) The court held, in other words, that **an insurer's aggressive campaign to increase profits can, in and of itself, constitute "a substantial risk of harm"** to insureds—especially if the insurer fails to take affirmative steps to guarantee that claims will be resolved impartially. The ruling underscores the critical importance of carefully managing communications about business issues with claims personnel.

Keeping an Eye on the Late Notice Landscape

BY JOHN PITBLADO

Liability policies typically contain provisions that make timely notice of claims a condition precedent to coverage, but the impact of those provisions varies widely across jurisdictions. Since coverage often depends on this issue, it is frequently litigated, and the governing law is constantly developing. Here is some recent news:

In Texas, late notice will excuse the insurer from providing liability coverage, **if the insurer has been prejudiced**. In *Berkley Regional Ins. Co. v. Philadelphia Indemnity Co.*, a District Court awarded summary judgment against an excess liability carrier, because the insurer owed no duty to defend, and so could not have been prejudiced by late notice. In August, the U.S. Court of Appeals for the Fifth Circuit reversed that decision, on the ground that late notice had deprived the excess carrier of its right to investigate the claim, to "join in" the insured's analysis of the claim, and, most importantly, to participate in mediation. These considerations did not conclusively establish prejudice, but they raised material issues that precluded summary judgment.

Connecticut has been atypical on these issues. It applied a hybrid rule: Late notice does not bar coverage where the insurer has suffered no prejudice, but the burden of proving the absence of prejudice was on the insured. Not anymore. In *Arrowood Indem. Co. v. King*, in response to certified questions from the Second Circuit, Connecticut's Supreme Court abandoned its own, longstanding rule and held that insurers now bear the burden of proving prejudice. It was a surprising reminder that even rules in this area that appear well-settled remain in a state of flux.

Insurance Regulators Hear Plea for Increased Supervision of Claim Review Tools

BY ANN YOUNG BLACK

In August 2012, during the Summer Meeting of the National Association of Insurance Commissioners, the NAIC's Market Regulation and Consumer Affairs (D) Committee discussed the Consumer Federation of America's request for an investigation of computerized claim systems. The impetus for the discussion was the CFA's report on a tool called "Colossus," which helps insurers evaluate the non-monetary component of bodily injury claims. Consumer advocates urged that regulators implement immediate reforms on **monitoring and regulating claim review tools**.

The report warns that "computer-based assessment" of claims has replaced "the experience and knowledge of" adjusters, and that automated systems are susceptible to system-wide manipulation to lower valuations. Colossus, for example, uses each insurer's historic claims data to suggest a range of payments for new claims that is consistent with past practice. If the data is improperly limited or modified, the tool can mislead an adjuster, suggesting a range that is artificially low.

At the Committee meeting, representatives of two consumer groups, United Policyholders and The Center for Economic Justice, asserted that Colossus and another tool (Xactimate, which organizes and processes information about property claims) are causing insurers to undervalue both bodily injury and property damage claims. The groups urged the regulators to conduct an investigation, with testimony from vendors and insurers, into how various claim systems were developed, how they work, how insurers actually apply them, and whether they have provoked consumer complaints.

Witnesses also suggested the NAIC could directly regulate vendors of claim review systems, on the ground that their tools facilitate rate setting, and so that the vendors are analogous to rating agencies. They urged the Committee to investigate the effect that claim tools have had on determining rates. The Committee adjourned the meeting without action, but took these suggestions under advisement.

Variable Annuity Holder Granted Standing to Sue for Excessive Underlying Mutual Fund Fees

BY SCOTT SHINE

The United States District Court in New Jersey recently issued an unpublished ruling that a variable annuity holder had standing to sue for allegedly excessive management fees paid by an underlying mutual fund.

Under Section 36(b) of the Investment Company Act of 1940, an investment adviser has a fiduciary duty with respect to receipt of compensation for services it provides to a mutual fund. However, that Section by its terms authorizes only the SEC or a "security holder" of the mutual fund to bring an action for breach of such duty.

In this case, *Sivolella v. AXA Equitable Life Ins. Co.*, the defendant argued that the undefined term "security holder" refers to the legal owner of a security. According to the defendant, therefore, a variable annuity holder did not have standing to bring a claim under Section 36(b), because the insurance company separate account, rather than the annuity holder, was the legal owner of the shares issued by the mutual fund. The plaintiff countered that the term "security holder" referred instead to the equitable or beneficial owner of a security.

The court concluded that annuity holders "paid all of" the management fees in question; had the right to instruct how the mutual fund shares would be voted; bore "the full risk of poor investment performance"; and would pay any taxes owed upon any decision by the annuity holder to "withdraw her investment in the [mutual funds]". The court also stated that assets in the insurer's separate account would be "immune from the claims of [the insurer's] creditors, while being vulnerable to the claims of the [annuity holders'] creditors."

Accordingly, **the court found that the annuity holder had "all of the economic stake in these transactions"** and granted standing under Section 36(b).

CFPB Eyes Financial Advisors to Seniors

BY TOM LAUERMAN

In establishing the Consumer Financial Protection Bureau, the Dodd-Frank Act was not aiming primarily at investment advisors or broker-dealers. Nevertheless, it is possible that the CFPB will seek to regulate some activities of such firms, particularly financial advisory activities.

Now the CFPB's Office for the Financial Protection of Older Americans is conducting research, including input that the Office solicited from the public, concerning financial advisory services that are provided to seniors. Among other things, the Office is evaluating senior financial adviser certifications and designations, as well as the sources of information available to seniors about such senior advisor credentials.

These efforts will help the Office to fulfill certain specific mandates under Dodd-Frank, including:

- to monitor senior advisor credentials and to alert the SEC and state regulators of credentials that are unfair, deceptive, or abusive; and
- to make legislative and regulatory recommendations to Congress concerning best practices for (i) disseminating information to seniors about the legitimacy of senior advisor credentials, (ii) enabling seniors to identify the most appropriate financial adviser for their needs, and (iii) enabling seniors to verify a financial advisor's credentials.

Accordingly, the Office's current research and study may ultimately result in further action by the SEC, state regulators, or Congress concerning the qualifications of financial advisors to seniors. **There is no indication, however, that the Office or the CFPB will seek to directly regulate such advisors.** The future, however, remains somewhat cloudy in this regard.

CONGRATULATIONS!

JORDEN BURT is pleased to announce that Miami Partner **Sonia Escobio O'Donnell** and Miami Associate **Clifton Gruhn** are recipients of Pro Bono awards for their work on the Cuban American Bar Association's Pro Bono Project. The project assists low-income families in Miami-Dade County, Florida with legal inquiries and issues.

Sonia Escobio O'Donnell, Partner in the Miami office, recently received an Editor's Award from the Litigation Section of the ABA for her role in the Appellate Practice Section's award for best web content of any ABA Litigation Committee. Ms. O'Donnell was appointed Co-Chair of the Appellate Practice Section earlier this year.

Coming Soon: Ads for Private Placements

BY RICHARD CHOI

As mandated by the JOBS Act, the SEC is proposing to permit the use of general solicitation and advertising (general advertising) for private securities offerings made in reliance on Rule 506 of Regulation D. Consistent with the JOBS Act, new Rule 506(c) would permit the use of general advertising, *provided* that: (1) the issuer takes "reasonable steps" to verify that the purchasers of the securities are accredited investors, and (2) all purchasers of securities are accredited investors (either because they come within one of the enumerated categories of accredited investors in Rule 501(a) or the issuer "reasonably believes" that they do, at the time of the sale of the securities). The SEC left alone Rule 506(b), thereby preserving the ability of issuers to conduct Rule 506 offerings without the use of general advertising to up to 35 non-accredited investors, in addition to an unlimited number of accredited investors.

Whether particular steps to verify accredited investor status are "reasonable" would be, according to the SEC, an "objective determination" based on the facts and circumstances of each transaction. Thus, **issuers would have some flexibility to adopt different approaches to verification to suit their circumstances**. The SEC anticipates that many current practices used by issuers in connection with Rule 506 offerings could satisfy the proposed verification requirement. The proposed Rule's failure to prescribe specific methods of verification, however, has drawn sharp criticism from state securities administrators. The North American Securities Administrators Association, for example, has commented that the "lack of guidance in this area will lead to serious consequences – namely, litigation … . [E]ach state regulator will have to make an independent determination whether an issuer has taken reasonable steps to verify, and those determinations will ultimately be reviewed by judges across the country. The likely result is not only costly litigation but inconsistent interpretations."

Consistent with the JOBS Act, the SEC reiterated its historical practice of regarding Rule 506 transactions as non-public offerings for purposes of the private fund exclusions of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940. Accordingly, privately offered funds could use general advertising under revised Rule 506, as proposed, without losing either of these exclusions.

The SEC, which already has missed the deadline that the JOBS Act imposed for these amendments, may seek to adopt a final rule promptly.

Bumps on the Road to IFRS

BY TOM LAUERMAN

The SEC staff has issued a Final Report on its Work Plan for considering the incorporation of international financial reporting standards (IFRS) into the U.S. financial reporting system. At stake is whether, when, and how U.S. companies will be permitted or required to use IFRS in financial statements filed with the SEC. The Work Plan was initiated in February 2010, as a means for the SEC staff to obtain information relevant to answering these questions.

At that time, SEC Chairman Mary Schapiro expressed her expectation that in 2011 the SEC would be able to make a recommendation concerning IFRS incorporation. However, the Final Report on the Work Plan indicates that **the staff has identified a number of issues that cast doubt on when any final SEC recommendation will be forthcoming and what that recommendation will be**.

Among other things, the Final Report concludes that:

- IFRS provides less tailored guidance than U.S. GAAP for certain types of companies—including investment companies, broker-dealers, and insurance companies—and more consideration needs to be given to such discrepancies.
- Requiring a complete conversion to IFRS over a short time frame would impose very substantial direct and indirect costs on U.S. companies.
- The International Accounting Standards Board (IASB) should do more to address issues and provide authoritative guidance on IFRS on a timely basis.
- IFRS is applied differently by different countries, and more cooperation among countries' regulators is required in order to achieve all the intended benefits of an international system.
- The IASB's reliance on major public accounting firms for much of its funding raises governance concerns in that body's role as IFRS standard setter.

Bigger SEC Enforcement Penalties Loom

BY BEN SEESSEL

Senators Jack Reed and Charles Grassley have introduced a bill to significantly increase the monetary penalties that can be assessed in civil lawsuits and administrative proceedings brought by the SEC. Enforcement actions in the form of civil lawsuits have lately stirred up some controversy. See "SEC Enforcement Evolves" and "Judges Refuse to Rubber Stamp SEC Settlements" in Expect Focus, Vol. I Winter, 2012. **The SEC would probably bring more enforcement actions as administrative proceedings, if the penalties are increased, given the potential procedural advantages of such proceedings to the SEC.**

The most dramatic increase in penalties would occur for so-called "Third Tier" offenses, i.e., those involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. The limits on penalties for such offenses would be increased to the greater of (i) $1 million for each violation by a natural person or $10 million for each violation by a company, (ii) three times the amount of any pecuniary gain, or (iii) the amount of losses incurred by victims. Additionally, the new law would add a "Fourth Tier," which multiplies the potential penalties for repeat offenders. It would also harmonize the penalties available to the SEC in administrative proceedings and in civil lawsuits.

Commentators predict that the bill will become law, as it has broad bipartisan support in Congress and from the SEC.

Rules for SEC Rule-Writers

BY GARY COHEN

The SEC staff has made public a potentially significant March 2012 memorandum providing internal guidance to SEC rule-writers about the economic analysis required in SEC rulemakings.

The requirements and standards for economic analysis have increasingly impacted the rulemaking process. For example, the SEC's very prominent recent failure to propose additional money-market fund reforms resulted in part from two commissioners' stated view that further risk-benefit study was necessary. Also, the SEC has deferred any action on the much-debated question whether to "harmonize" the legal duties of broker-dealers with those of investment advisers, pending an ongoing staff study of the type contemplated by the internal memorandum.

Internal memo responds to recent criticism

On its face, the 17-page memorandum defines "good economic analysis" as a process that: (1) clearly identifies the justification for the proposed rule; (2) defines the baseline against which to measure the proposed rule's economic impact; (3) identifies and discusses reasonable alternatives to the proposed rule; and (4) analyzes the economic consequences of the proposed rule and the principal regulatory alternatives—including quantification of costs, benefits, and attending uncertainties.

The memo in part responds to criticism leveled at the SEC's rulemaking proposals by recent court decisions, reports of the U.S. Government Accountability Office, the SEC's Office of Inspector General, and Congressional inquiries. **Indeed, the memo acknowledges that "[m]uch of the guidance" and "practices" "have already been incorporated into our rulemaking."**

Nevertheless, individual SEC commissioners can be expected to continue to dissent, at least in part, from rule proposals that are on the SEC's agenda. Based on past experience, the Chamber of Commerce, Business Roundtable and other industry groups will also likely challenge some of the SEC's economic analyses in court. Although the memo aims to better position the SEC in the face of such challenges, its actual impact will require some time to assess.

FINRA Encourages Flexibility in Jumbo Arbitrations

BY CHRIS BARNES

FINRA has launched a pilot program for arbitrating claims of more than $10 million. Approximately 200 such arbitrations are currently pending. While parties have been able to modify many aspects of FINRA's standard arbitration procedures, the pilot program now offers a more formal approach for tailoring a set of rules to the parties' particular case.

At the beginning of each case, FINRA will appoint a specially trained and experienced case administrator to assist the parties with developing a plan for administrating the case. The parties can agree to deviate from some of FINRA's standard procedures, including:

- arbitrator qualifications and method of selection (off-roster arbitrators being acceptable);
- motion practice;
- official record of proceedings;
- hearing facilities; and
- explanation of decisions.

The parties can also agree to use any forms of discovery that would be available in litigation, including interrogatories, requests for production, depositions (which FINRA's standard rules usually permit only in rare circumstances), and requests for admission. The pilot program also provides for a discovery arbitrator, if the parties so choose, whose only role would be to rule on discovery disputes.

Participation in the program is voluntary and comes with additional costs such as a $1,000 administrative fee for each party, higher rates for the arbitrators, and additional costs for hearing facilities. Because **the pilot program more closely resembles full-blown litigation (without all the procedural safeguards) than the streamlined arbitration process many have come to know**, it will be interesting to see how many participants the program attracts.

Flip-Flop Fortifies FINRA Foes

BY ANN FURMAN

Complaints about FINRA's arbitration program are common, and a recent case has provided ammunition to the critics.

To set the stage, remember that FINRA arbitration is mandatory in customer complaints against brokers; in order to be eligible, an arbitrator generally must be on FINRA's approved list; and FINRA receives its revenue from its members, including large Wall Street firms.

The case in question involved a complaint against Merrill Lynch, alleging that its registered representative failed to adequately monitor two customers' accounts. Three FINRA-approved arbitrators ruled in favor of the customers, awarding $520,000 in damages.

Over the next several months, however, FINRA notified each of the three arbitrators of their removal from FINRA's roster of approved arbitrators. The arbitrators, two of whom had many years' experience, objected to their removal and one filed a whistleblower complaint with the SEC. After the firing was made public, FINRA reinstated all three.

FINRA denies that it removed these arbitrators because of any pressure from Merrill Lynch or the size of the award.

New at the Consumer Finance Protection Bureau

BY ELIZABETH M. BOHN

CFPB Targets Credit Card Add-on Products

CFPB investigations have resulted in entry of consent enforcement orders against credit card issuers Discover Bank and Capital One for deceptively marketing credit card add-on products to customers. The orders demonstrate how the CFPB is stepping up as the new sheriff in town, intensely scrutinizing the marketing of consumer financial products, and using enforcement authority granted under Dodd-Frank to punish practices it finds deceptive.

The Capital One Consent Order

On July 17th, the Bureau and the OCC jointly entered the first enforcement order against Capital One. This order was based on the findings by CFPB examiners that Capital One's call center vendors misled consumers when offering them add-on payment protection products. Specifically, the CFPB determined that sales vendors engaged in high pressure sales tactics directed at consumers with poor credit, misled the consumer about the costs and benefits of the products, and sometimes enrolled the consumers without their consent. The Order required Capital One to refund $140 million to consumers who had enrolled in the products and to pay an additional $25 million penalty. The full text of the Capital One Order can be found on the Administrative Adjudication page of the CFPB's website, *consumerfinance.gov*.

Since it opened for business last summer, the CFPB has been accepting consumer complaints on credit card and mortgage products. As previously reported, it created a web interface by which consumers can file such complaints in detail on line. After issuing the enforcement order in Capital One, the CFPB stated that the complaints it has received and its own supervisory experience indicated that other consumers have been misled by marketing and sales practices associated with credit card add-on products. Therefore, it issued a guidance bulletin on such products on July 18th. The full bulletin can be found on the Guidance Documents page of the CFPB's website.

The Discover Bank Consent Order

Given the Capital One Order and comments made by the Bureau in July, the second consent enforcement order involving such products entered more recently should come as no surprise. This order was entered jointly by the CFPB and the FDIC based on their joint investigation of Discover's telemarketing of payment protection, credit monitoring, and identity theft products. The agencies found the telemarketing scripts used by Discover contained misleading language about the cost of the products and how and when the customers would be charged. The agencies also found that Discover representatives sometimes enrolled consumers without their consent. Discover was ordered to refund approximately $200 million to the consumers and pay a $14 million civil penalty. The full text of the consent decree can be found on the Administrative Adjudication page of the CFPB's website.

CFPB Supervised Entities Responsible for Third Party Vendors

Capital One's call center sales force was operated by a third-party vendor, not Capital One. However, **the Bureau takes the position that it will hold supervised entities responsible for the actions of their outside vendors**; in a CPFB bulletin issued in April, the Bureau set forth its expectation that supervised entities control their outside service providers to insure compliance with federal consumer financial laws. The Bulletin details activities it expects supervised entities to undertake to ensure their service providers understand and are capable of complying with the laws, including conducting due diligence reviews of each service provider's compliance procedures and training manuals and requiring compliance with consumer laws in vendor contracts. The bulletin can be found on the Guidance Documents page of the CFPB's website.

CFPB Proposes New Regulations to Protect Mortgage Borrowers

The Bureau has also proposed new mortgage servicing rules aimed at protecting homeowners from "surprises and costly mistakes" by mortgage servicers. The rules seek to address consumer complaints about poor record keeping by servicers and problems experienced with the loan modification process. The rules will go into effect January 13, 2013.

The first set of rules is intended to increase transparency. These rules would require mortgage servicers to provide consumers with clearer and more detailed monthly statements, earlier advance disclosure of interest rate adjustments for adjustable mortgages, and advance notice and pricing information before charging consumers for force-placed insurance. They would also require the servicer to terminate and refund the borrower premiums for force placed insurance within 15 days of receiving evidence that borrower has necessary insurance, as well as to make good faith efforts to contact delinquent borrowers and inform them of options to avoid foreclosure.

The second set of rules relate to handling of the consumer's account. These rules would require services, *inter alia*, to credit payments the day they are received, establish policies to maintain accurate and current information on borrowers' accounts, make timely investigation of errors reported by consumers, help borrowers on options to foreclosure, and oversee contractors and outside foreclosure attorneys. They would also require servicers to provide their borrowers with "easy, ongoing access" to employees dedicated to helping delinquent borrowers, and prohibit proceeding with foreclosure sale while loan modification applications are pending.

The proposed mortgage servicing rules are available on the Regulations page of the CFPB's website.

MARKYOUR CALENDAR

The 39th Annual ABA TIPS Mid-Winter Symposium on Insurance & Employee Benefits, focusing on emerging issues and litigation relating to life, health, disability and ERISA, will be held from January 17-19, 2013 at the Fort Lauderdale W hotel. Washington Associate **Robin Sanders** is the Program Chair. Miami Partner **Sonia O'Donnell** will moderate the *View From the Bench* session, which will provide judicial insight into issues regarding attorney conduct and ethics, including civility and conduct during the discovery process. Miami Partner **Steve Kass** will moderate, and Washington Partner **Shaunda Patterson-Strachan** will be a panelist for, the *Litigation and Regulatory Activity Related to Non-Guaranteed Policy Elements in Life Insurance* program, which will address class action litigation and regulatory activity and considerations regarding the setting and modifying of non-guaranteed policy elements in life insurance. For more information and to register, visit www.americanbar.org/tips.

The Practising Law Institute's 16th Annual seminar, *Securities Products of Insurance Companies in the Course of Regulatory Reform 2013*, will be held at PLI's New York Center and via Live Webcast, on January 23, 2013 in New York, NY. Washington Of Counsel **Joan Boros** is the Co-Chair. Washington Partner **Richard Choi** will be on the *Distribution of Insurance/Securities Products; Advertising*; *and Ethics* panel, covering FINRA and social media, suitability, advertising standards, and ethical practices in distribution.

Washington Of Counsel **Gary Cohen**'s article *SEC Financial Literacy Study Report: Dead End or Future Fodder?*, an analysis of the SEC's recently released report to Congress and the Report's impact, is scheduled to be published in the December 2012 issue of *The Investment Lawyer*.

ARBITRATION ROUNDUP

BY LANDON CLAYMAN

Legal wrangling about class arbitration, and waivers thereof, continues apace in the courts of the Second Circuit of Appeal. ***Rame, LLP v. Popovich*** concerned an arbitrator's clause construction award, which ruled that collective proceedings would be allowed in arbitration even though the arbitration agreement was "silent" on the question. A New York federal district court declined to vacate the award, emphasizing the limited grounds available under the FAA for vacating arbitrators' awards, and the "considerable burden" that must be met. The court's decision is another reminder that contracting parties are well-advised to make their intent regarding class arbitration explicit in their arbitration agreements.

In ***Fromer v. Comcast Corp.,*** a federal district judge in Connecticut applied the Second Circuit's controversial ***American Express III*** decision to deny a motion to compel arbitration on grounds the class arbitration waiver precluded the plaintiff from pursuing federal statutory remedies. The court found that the cost to plaintiff of pursuing his federal antitrust claims in an individual arbitration proceeding were prohibitive, and thus the class arbitration waiver was void because if it was enforced he could not pursue those claims. The case was allowed to proceed as a putative class action in federal court.

American Express III distinguished the US Supreme Court's opinion in ***AT&T Mobility LLC v. Concepcion*** as involving the FAA's preemptive effect on a state common law rule that deemed most class arbitration waivers unconscionable, rather than the validity of such waivers when they impair the ability to vindicate federal statutory rights. That distinction, and the ***American Express III*** opinion, may receive Supreme Court review, because following the Second Circuit's denial of rehearing en banc (with five judges dissenting, including a vigorous written dissent by Chief Judge Jacobs), the American Express defendants filed a petition for a writ of certiorari.

When do Employees or Former Employees Violate the Computer Fraud and Abuse Act? The Circuits are Split

BY JONATHAN STERLING

The federal Computer Fraud and Abuse Act of 1986 (the CFAA) provides criminal and civil liability for individuals who obtain information, commit a fraud, or cause damage, where they have done so by accessing a computer or information on a computer without authorization, or have done so by exceeding his or her authorized access to a computer or such information. In a 2006 case, *International Airport Centers, LLC v. Citrin*, the Seventh Circuit held that where an employee accesses a computer or information thereon to further interests that are adverse to his or her employer, the employee violates his or her duty of loyalty, thereby terminating the employee's agency relationship and losing any authority the employee had to access the computer or any information on it. The First, Fifth and Eleventh Circuits have similarly adopted a broad view and held that an employee violates the CFAA when he or she accesses a computer or information on a computer and violates the employer's data use policies. This could include, for example, where an employer authorizes employees to utilize computers for any lawful purpose but not for unlawful purposes. An employee would exceed permitted access if he or she used that access to misappropriate trade secrets. The Second, Third and Eighth Circuits have all interpreted CFAA in a similar manner, though they have yet to decide a case directly on the issue.

Earlier this year, in *United States v. Nosal*, the Ninth Circuit, sitting en banc, interpreted the CFAA terms "without authorization" and "exceeds authorized access" more narrowly, partly based on the "Rule of Lenity," which favors a narrow interpretation of criminal statutes. The decision further clarified the narrow construction of these terms set forth in a 2009 Ninth Circuit decision, limiting the CFAA to computer "hacking" situations where an individual accesses a computer or information on a computer without permission, and excluding from the CFAA's reach situations where an individual violates only data use restrictions. **Under the Nosal view, an employee would not be violating the CFAA if the employee used his or her permitted access to misappropriate trade secrets.** Several district courts have since adopted the *Nosal* view.

In a July 2012 decision, *WEC Carolina Energy Solutions LLC v. Miller*, the Fourth Circuit became the first federal appeals court to join the view of the Ninth Circuit in *Nosal*. In *Miller*, the defendant, while working for the plaintiff, allegedly downloaded proprietary information for the benefit of his subsequent employer. The Fourth Circuit stated that the CFAA is a criminal statute that must be construed narrowly and is meant to target hackers, not "workers who access computers or information in bad faith, or disregard a use policy." This circuit split is ripe for a determination by the Supreme Court.

SEC Guidance on Cyber-Disclosure Becoming De Facto Rule?

BY JASON MORRIS & DIANE DUHAIME

In issuing its "New Cybersecurity Disclosure Guidance" in October 2011, the Securities and Exchange Commission warned that "public companies may violate existing laws and regulations for failure to comply with it," despite the guidance not having "the force of a binding SEC rule or regulation." Among other things, the guidance indicates that disclosure of threats to cyber security may be appropriate "prior to any actual cyber attack or incident, as well as during and after an incident."

Since this guidance was issued, SEC agency letters show that the SEC has asked at least six firms – including financial institutions – to improve their disclosures of cybersecurity risks. In April, 2012, Amazon agreed to disclose, in its next quarterly filing, the January 2012 cyber attack on its Zappos.com unit, an attack that resulted in the theft of the addresses and credit card digits of 24 million customers. Similarly, this past May, Google agreed to include a previously disclosed cyber attack in one of its earnings reports. The SEC letters requesting increased disclosures are available on the agency's website.

On a related note, the most recent Congress reviewed a bill intended to fortify defenses against cyber attacks, including potential safe harbors for firms that follow specified standards in guarding their critical information system networks; however, Congress failed to pass the bill before breaking for recess. In response, the White House is drafting an executive order to address cyber-threats. Homeland Security Secretary Janet Napolitano recently confirmed that the draft of the executive order is "close to completion."

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