EXPECTFOCUS®

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Sprouting Industry News

Plus:
In Deep
In Subprime

JordenBurt LLP

EXPECTFOCUS® Vol. II Spring 2008

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Graphics and Design
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Subscriptions
Changes in address or requests for subscription information should be submitted to:

Moira Demyan
mfd@jordenusa.com

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E-mails Constitute Signed Writings to Modify Contracts

BY BRUCE LESHINE

Any supplement to or modification of any provision of this Agreement must be in writing and signed by authorized representatives of both parties.

The clause above is a fairly standard term found in virtually every commercial contract, the essence of which is that only a signed writing can modify the terms of an executed agreement. However, in *Stevens v. Publicis, S.A.*, the New York appellate court has expanded what constitutes just such a "signed writing" to include email correspondence between the parties.

Following the acquisition of his company by another, an executive of the acquired company entered into a new employment agreement with the parent company. Subsequently, poor performance by the acquired company prompted discussion to terminate the executive's employment. A senior representative of the parent company outlined, in a series of e-mails, proposed changes to the executive's responsibilities. Although the executive agreed to these changed responsibilities in several e-mails, his employment was shortly thereafter terminated.

Affirming the lower court's decision finding for the executive in his action for breach of contract, the appellate court held that the e-mail between the executive and the parent company's representative (i) constituted "signed writings" within the meaning of the statute of frauds, since their names at the end of the e-mail signified their intent to authenticate the contents; and (ii) satisfied the employment agreement's requirement that any modification be signed by all parties.

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Individuals Can Sue For Mismanagement of Their 401(k) Accounts

BY STEVE KRAUS

The Supreme Court recently expanded the scope of ERISA Section 502(a)(2) to allow individuals to recover the impaired value of their 401(k) accounts due to mismanagement by a plan fiduciary.

If funds are mismanaged, individuals can sue

In *LaRue v. DeWolff, Boberg & Associates, Inc.*, a plan participant alleged that he had directed the plan fiduciary to make certain changes in his 401(k) account but that his investment directions were never implemented. As a result, the value of his account was substantially depleted. The participant originally brought suit under ERISA Section 502(a)(3), seeking "make-whole or other equitable relief," which was denied by the Fourth District Court. On appeal, the participant argued that he had a claim not only under ERISA Section 502(a)(3), but also under Section 502(a)(2). The Circuit Court of Appeals rejected both claims and the Supreme Court granted *certiorari* on both rulings. In finding that an action was available to individuals under ERISA Section 502(a)(2), the Supreme Court declined to address the Section 502(a)(3) claim.

The Supreme Court had previously held, in *Massachusetts Mut. Life Ins. Co. v. Russell*, that ERISA Section 502(a)(2) "provides remedies only for entire plans, not for individuals…. Recovery under this subsection must 'inure to the benefit of the plan as a whole,' not to particular persons with rights under the plan." In *LaRue*, the Court distinguished between the disability plan at issue in *Russell*, which did not have individual accounts, and the defined contribution plan in *LaRue*, which was an individual account plan under ERISA. With regard to defined contribution plans, the Court held that "although § 502(a)(2) [of ERISA] does not provide a remedy for individual injuries distinct from plan injuries, that provision does authorize recovery for fiduciary breaches that impair the value of plan assets in a participant's individual account."

A concurring opinion by Chief Justice Roberts and Justice Kennedy strongly suggests that the action should have been brought under ERISA Section 502(a)(1)(B) and that the two remedies are mutually exclusive. Having to bring an action under ERISA Section 502(a)(1)(B) could be of potential significance depending on whether lower courts would apply requirement "safeguards" in Justice Roberts' words that are clearly applicable to ERISA Section 502(a)1)(B) such as the exhaustion of plan administrative remedies and deferential review of plan administrator and fiduciary decisions. Justice Roberts further observed that the non-application of such safeguards to claims under ERISA Section 502(a)(2) is not settled. In a separate concurring opinion, Justice Thomas, joined by Justice Scalia, found the issue governed by the clear terms of ERISA Section 502(a)(2), because 401(k) account assets are plan assets, despite the individual account features of such plans.

SEC Extends Effective Date for Rule 2821 Principal Review

BY CHIP LUNDE

On April 17, 2008, FINRA filed with the SEC a proposal to delay the effective date of paragraphs (c) and (d) of new Rule 2821 until 180 days after the SEC either approves or rejects a substantive rule change that FINRA intends to file in the near future.

Rule 2821 imposes new sales practices, supervisory, and training requirements for purchases and exchanges of deferred variable annuities. Paragraph (c) of the Rule imposes specific principal review and approval requirements. Paragraph (d) of the Rule imposes requirements related to supervisory procedures.

According to the proposal, in the near future FINRA plans to propose amendments to Rule 2821 that would:

- Change the event that triggers the beginning of the period within which the principal must review and determine whether to approve or reject the application;
- Limit application of the rule to recommended transactions; and
- Clarify various other issues, including whether (and, if so, under what circumstances) a broker-dealer can forward funds to an affiliated insurance company prior to the principal's approval of the transactions.

FINRA explained that the proposed delay will give firms sufficient time to comply with expected changes to the Rule. Paragraphs (a), (b) and (e) of Rule 2821 will become effective as scheduled on May 5, 2008.

On January 29, 2008, the SEC approved delaying the effective date of NASD Rule 2821's principal review and approval requirements until August 4, 2008.

Regulatory Interest in Protecting Senior Investors

BY ANN FURMAN

Believe it or not, many of us have something in common with Bill Clinton and George W. Bush. We are baby boomers, born between 1946 and 1964, and soon to be considered senior citizens.

With the aging of the baby boom generation and growing number of investors at or near retirement age, regulators have placed a high priority on protecting older investors. Following the SEC "Seniors Summit" in July 2006, the SEC, FINRA and North American Securities Administrators Association (NASAA) formed a coordinated initiative to protect seniors from investment fraud and sales of unsuitable securities.

Regulators focusing on sales to seniors

State and federal legislators and regulators have identified certain annuity sales practices, such as "free lunch" seminars and senior financial specialist designations, as leading causes of unsuitable product sales to seniors. While some states have imposed heightened suitability requirements on the sale of variable annuities to seniors, the Connecticut legislature in February introduced two bills that take a different approach. The first, Raised S.B. No. 155, would impose an outright prohibition on the sale of variable annuities to individuals age 65 or older. The second, Raised Bill No. 5158, would amend the Connecticut insurance code by requiring the Insurance Commissioner to adopt standards for the sale or exchange of any type of annuity and for making recommendations to senior consumers.

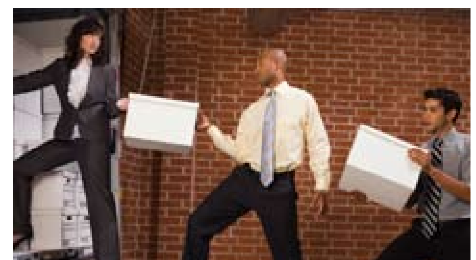
Last fall, the New York State Insurance Department established an elder protection unit within the department to provide support and protection for the elderly in insurance matters. Then, in late February, the New York legislature introduced an amendment to the New York insurance law in relation to the purchase of annuities by seniors.

The proposed New York legislation (Senate Bill 7005 / Assembly Bill 10002) defines seniors as persons 70 years or older and requires certain disclosures to be made to seniors, including the estimated amount of the producer's commission as well as the length of time the insurer will impose surrender charges for termination of the annuity. The proposed legislation also includes a suitability standard for annuity sales to seniors and provides an extended free look or "cooling off" period. If enacted, the new law would permit seniors to cancel their contracts within 30 days, or if the sale occurs in the home of a senior, 60 days.

Annuity Litigation and Enforcement Action Update

BY ANTHONY LALLA

The opening months of 2008 saw a continued focus by state attorneys general on the sale of deferred annuities to senior citizens. Minnesota Attorney General Lori Swanson is perhaps the most active in focusing on such sales, filing several complaints last year alleging improper and unsuitable sales of deferred annuities to seniors. In February, Ms. Swanson announced that Minnesota had settled its lawsuit against American Equity Life Holding Company, while also announcing that the state had filed yet another complaint against another company. It remains to be seen to what extent other states' attorneys general will follow Minnesota's lead and pursue their own investigations or lawsuits concerning sales of deferred annuities to seniors.



State Attorneys General filing more complaints

Meanwhile, the first months of 2008 saw few significant developments in the various class actions involving the sale of deferred annuities to seniors (see *Expect Focus*, Vols. II & III, 2007). However, dispositive motions have been fully briefed in some of these actions, and courts should be issuing rulings on those motions in the months to come. *Expect Focus* will continue to monitor and report on developments in these matters.

LTC Class Action Dismissal Affirmed

BY RAUL CUERVO & ANTHONY CICCHETTI

The U.S. Court of Appeals for the Third Circuit has affirmed the dismissal with prejudice of a putative class action alleging fraud in the sale of long term care (LTC) insurance coverage. In *Alvarez v. Insurance Company of North America* (INA), the plaintiff claimed that he and others in the putative class were fraudulently induced into purchasing "guaranteed renewable" LTC coverage alledging that INA knew but did not disclose that premiums would increase. The Third Circuit held that, because the policy explicitly reserved the insurer's right to raise premiums at any time after payment of the first premium, the plaintiff could not "seriously claim to have been misled into believing that [a premium increase] would never happen." Moreover, the "guaranteed renewable" feature of the policy simply meant that the insurer could not unilaterally cancel an individual's coverage unless the individual failed to pay the required premium. "[C]ontrary to [plaintiff's] interpretation, the policy was guaranteed renewable, not guaranteed affordable."

"Guaranteed renewable" doesn't equal "guaranteed affordable"

The court also rejected allegations that the insurer had a duty to disclose possible future premium increases and related actuarial assumptions. The court found that the "guaranteed renewable" clause, and representations that premiums had been "expertly priced," were not "half-truths" that created a duty to disclose. The court also found that no confidential relationship existed between the parties that required additional disclosures by the insurer. Accordingly, the court concluded that neither "the policy nor the promotional materials contained any false or misleading representation, and INA did not have any duty to disclose the possibility of future premium increases or the underlying actuarial assumptions for that possibility."

Jorden Burt represented INA in this matter.

"Revenue Sharing" Motions to Dismiss Denied

BY BEN SEESSEL

Expect Focus recently reported that a class was certified in the "revenue sharing" case *Tussey v. ABB, Inc.* (f/k/a *Kennedy v. ABB, Inc.*), pending in district court for the Western District of Missouri (*Expect Focus*, Vol. I, Winter 2008). The class consists of plan participants in ABB, Inc's 401(k) plan who, allege that defendants ABB, Inc., Fidelity Management Trust Company, and Fidelity Management & Research Company breached ERISA fiduciary duties by causing their plan to include investment options carrying undisclosed, unreasonable, and excessive fees, not incurred solely for the benefit of the plan. Since publication, the Eighth Circuit denied ABB Inc.'s Rule 23(f) petition to appeal class certification, rendering its decision on February 5, 2008.

Getting revenue sharing class action updates

A week after the Eighth Circuit's decision denying the Rule 23(f) petition, the district court denied defendants' motions to dismiss. The court rejected the Fidelity defendants' arguments that plaintiffs failed to allege sufficient facts to demonstrate that fees charged to the plan were excessive or unreasonable, and further rebuffed Fidelity's argument that plaintiffs could not, as a matter of law, obtain equitable relief under ERISA Section 502(a)(3), where the "revenue sharing" fees at issue could not be traced to plan assets. The court held that a factual dispute precluded such a finding on a motion to dismiss. The court also refused to dismiss claims against Fidelity Management, an investment adviser to Fidelity's mutual funds, although it found that these claims "appeared tenuous."

Indexed Annuity Class Action Lawsuit Dismissed

BY BRIAN PERRYMAN

AZ plaintiff heading home after MA denial

A federal court in Massachusetts granted a motion to dismiss a complaint claiming that an insurer deceptively sold fixed indexed annuities to the plaintiff and other persons aged 65 and older. In *Mear v. Sun Life Assurance Company of Canada* (U.S.), the plaintiff alleged that the insurer's salesman failed to disclose the risks and shortfalls of the annuity to her, and accused the insurer of a wider scheme to market inappropriate fixed indexed annuities to a putative class of senior citizens.

After determining that Arizona law governed her claims, the court ruled that the plaintiff lacked standing to sue because she merely described potential economic losses and failed to allege that she had actually suffered any harm. Although the court might have stopped there, it then turned to the legal sufficiency of the claims, dismissing the fraud claims insofar as the plaintiff failed to state them with the requisite particularity, dismissing a claim under RICO because the complaint did not allege a criminal enterprise distinct from any unlawful activity, and dismissing a claim under the Massachusetts consumer protection law since Arizona law applied. The court also dismissed several negligence-based claims on the grounds that Arizona law does not permit recovery of purely economic losses for such claims, as well as a claim for unjust enrichment, explaining that equitable relief is not available where an express contract exists.

IRS Expands Permissible Investors in "Insurance Dedicated" Funds

BY STEVE KRAUS

In order to be treated as an annuity or life insurance contract for federal income tax purposes, a variable contract must be adequately diversified in accordance with IRS regulations. If a variable contract is not adequately diversified, all income under such contract will be taxed currently as ordinary income.

In determining whether the investments of a segregated asset account supporting a variable contract are adequately diversified, IRS regulations provide that if "look-through" treatment is available, a beneficial interest in a regulated investment company, a real estate investment trust, a partnership or a grantor trust will not be treated as a single investment of a segregated asset account. Rather, the segregated asset account will be treated as owning a pro rata portion of each asset of such entity for diversification testing purposes.

IRS opens door for more investors

In order for "look-through" treatment to apply, beneficial interests must be held only by insurance company segregated asset accounts and other "permissible investors" as defined in the regulations (e.g. insurance company general accounts and qualified pension plans). The final regulation expands the list of permissible holders to include: (1) IRC § 529 qualified tuition plans; (2) foreign pension plans primarily for the benefit of individuals substantially all of whom are nonresident aliens; and (3) accounts, which pursuant to Puerto Rican law or regulation, are segregated from the general asset account of the life insurance company that owns the account, provided certain conditions are met.

Texas Supreme Court Finds Exemplary Damages are Insurable

BY JONATHAN STERLING

In *Fairfield Insurance Company v. Stephens Martin Paving, LP*, the Supreme Court of Texas was asked to decide whether public policy allows employers to insure against lawsuits for exemplary damages in the workers' compensation context. The case arose following the death of an employee in a construction accident. After the employee's family collected workers' compensation benefits, it sued his employer, claiming that his death was caused by the employer's gross negligence. Though the family was statutorily barred from collecting actual damages in its lawsuit, it sought exemplary damages from the employer.

Shortly after the family's lawsuit was filed, the employer's workers' compensation insurer filed a declaratory judgment action in federal district court seeking a ruling that it had no duty to defend or indemnify the employer with regard to the underlying lawsuit. The district court disagreed and found that such a duty existed. The insurer appealed, and the federal appeals court certified to the Texas Supreme Court the question of whether public policy allowed such coverage.

In its opinion, the Texas Supreme Court noted that the state Legislature was sensitive to issues of insurance coverage of exemplary damages and had prohibited coverage of those damages in certain situations. However, the court found that the policy form at issue in the case provided coverage for claims based on gross negligence, and that this form had been approved by the Texas Department of Insurance. As such, the court found an express intent that, in the workers' compensation context, Texas public policy does not prohibit coverage for exemplary damages. This ended the court's inquiry, but it went on to state the principles that it would consider when evaluating whether public policy precludes insurance for exemplary damages in other contexts. These principles include the freedom to contract and the punitive purpose behind exemplary damages, which can be at odds.

Texas Supreme Court drilling into P&C issues

Drilling Into Excess Policy, Court Finds No Reimbursement Rights

BY JOHN PITBLADO

In *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew and Rental Tools, Inc.*, the Supreme Court of Texas affirmed the lower court's decision Frank's Casing was not required to reimburse Excess Underwriters for a settlement paid on Frank's Casing's behalf.

Frank's Casing manufactured an offshore oil-drilling platform for ARCO/Vastar (ARCO). The platform collapsed and ARCO. Excess Underwriters insured Frank's Casing for liability in excess of its $1,000,000 primary policy, up to $10,000,000, but asserted defenses to coverage under the policy in a reservation of rights letter, filed a declaratory action, and thereafter participated in the underlying defense by association with counsel retained by the primary carrier. Frank's Casing procured a settlement offer from ARCO on the eve of trial for $7.5 million, and sought Excess Underwriter's agreement to pay the settlement. Excess Underwriters ultimately tendered the payment, but asserted its right to seek reimbursement from Frank's Casing in the event the underlying claims were determined not to come within the excess policy's coverage in the declaratory action. This assertion was memorialized in the underlying settlement agreement.

In the declaratory action, which included Excess Underwriters seeking reimbursement of the settlement payment, the trial court found in favor of Frank's Casing on the theory that the policy did not explicitly provide for reimbursement. Excess Underwriters appealed. The Texas Supreme Court affirmed, specifically declining to adopt the reasoning of cases from California and Florida, that found an implied right to such reimbursement. The Texas Supreme Court instead relied on its own precedent in holding that "insurers, on balance, are better positioned to handle [such coverage risks] either by drafting policies to specifically provide for reimbursement or by accounting for the possibility that they may occasionally pay un-covered claims in their rate structure."

No Prejudice-by-Default

BY JACOB HATHORN

Under California law, an insured's breach of a notice provision does not excuse the insurer's performance unless the insurer can show that it suffered actual, substantial prejudice from the lack of notice. Applying this rule, a California appellate court recently concluded in *Belz v. Clarendon America Insurance Company* that an insurer does not automatically suffer such prejudice merely from being deprived of an opportunity to investigate a claim or present a defense prior to entry of a default judgment against its insured.

A contractor's non-response affected the insurer

In *Belz*, a homeowner sued his former contractor to recover for property damage caused by alleged construction defects. Where the contractor failed to respond to the complaint in that action, the homeowner obtained a $191,000 default judgment. He brought a separate suit more than two years later to enforce against the contractor's liability insurer, Clarendon America Insurance Company.

Clarendon defended by arguing that the express terms of the contractor's CGL policy did not provide coverage for default judgments entered without timely notice. Since Clarendon did not receive notice of the underlying suit from its insured until after that suit ended in a default judgment, it could not be liable for the judgment. The trial court granted Clarendon's motion for summary judgment.

The appellate court reversed, from its insured lack of notice (1) the insurer is liable on the judgment unless it suffered actual, substantial prejudice, and (2) the mere inability to investigate the claim thoroughly or to present a defense in the underlying suit does not satisfy the prejudice requirement. The appellate court held that, since Clarendon made no showing that it had suffered actual, substantial prejudice, the summary judgment motion should have been denied. The court did not express a view as to precisely what Clarendon would have to show in order to meet the actual, substantial prejudice standards. Based on the similar California cases examined in the opinion, Clarendon would likely have to establish that, but for the failure of its insured to provide notice, there was a substantial likelihood—as opposed to some assumed possibility—that Clarendon could have either prevailed in the underlying action, or at least settled on more favorable terms.

Xactimate Update: Battle Over the Class Action Fairness Act

BY JOHN PITBLADO

Louisiana's Attorney General James Caldwell has filed suit against several property insurers, alleging that they conspired and colluded among themselves, and with co-defendants Xactware, Inc., Insurance Services Office, Inc. (ISO), and McKinsey & Company Inc., to artificially reduce the value of property claims by manipulating a claim database used as an industry reference (see *Expect Focus*, Vol. I, Winter 2008).

Following the defendants' removal of the case to federal court, on January 7, 2008, the plaintiff sought remand to Louisiana state court. The parties asserted their respective positions as to whether the federal Class Action Fairness Act (CAFA) requires the case to remain in federal court. The plaintiff argued that CAFA does not apply to a state action brought by its attorney general, insofar as it is not a "class action," "has no representative party," and "the mere fact that others may ultimately benefit from the relief sought does not render them real parties in interest" or subject the case as a class action subject to CAFA's jurisdictional provisions.

Defendants, on the other hand, argued that the suit qualifies as either a "class action" or a "mass action" as those terms are to be broadly interpreted under CAFA. Defendants cited the testimony of Senator Chuck Grassley (R-IA), as he successfully sought to block an amendment that would have carved out an exception to CAFA's jurisdictional provisions for cases such as this, urging "[w]e should not risk creating a situation where State attorneys general can be used as pawns so that crafty class action lawyers can avoid the jurisdiction provisions of this bill." Judge Jay Zainey of the U.S. District Court in the Eastern District of Louisiana denied the motion to remand. The plaintiffs petitioned for an interlocutory appeal, which was granted by the Fifth Circuit. The court ordered an expidited briefing and a hearing date in the first week of June2008. *Expect Focus* will continue to monitor the case and report developments.

Liquidator May Avoid Arbitration Provisions Of Reinsurance Agreements It Seeks To Enforce

BY ROLLIE GOSS

Liquidators of insurance companies seem to have many advantages when assembling assets and controlling expenses, including the ability, at least in Ohio, to repudiate arbitration obligations. In *Credit General v. John Hancock*, Credit General sued the insurer in federal court to recover amounts allegedly owed under 13 reinsurance agreements, and Hancock compelled arbitration under an arbitration clause in the agreements. The court permitted a state liquidator to change strategies, abandoning an arbitration it had initially elected to continue the pursuit of its claims in state court.

"I know it says arbitration, but …"

The insurer attempted to remove the case to federal court. After an unsuccessful attempt, the insurer then moved in the state court for a stay and an order compelling the liquidator to resume the pending arbitration. The trial court denied the motions, and the insurer appealed. The Ohio Court of Appeals held that Ohio's Liquidation Act precluded the enforcement of the arbitration provisions, even though the liquidator had assumed the reinsurance contracts and was suing to collect under them. The court held that Ohio's paramount interest in liquidation proceedings outweighed the general policy favoring arbitration as a means of settling disputes, and that the unenforceable arbitration clauses should be severed from the reinsurance agreements. The court further held that, pursuant to the McCarran-Ferguson Act, the Ohio Liquidation Act preempted the Federal Arbitration Act, preventing the enforcement of the arbitration provisions under the FAA. The liquidator therefore succeeded in moving the dispute out of arbitration, out of U.S. District Court, and into the state courts, even though it had initially elected to participate in the arbitration compelled by the federal court.

NAIC Spring National Meeting Update

BY STEVEN KASS

The NAIC held its Spring National Meeting in Orlando, FL, March 28-31, 2008. The following topics were discussed:

- Reinsurance Regulation. The Reinsurance Task Force of the Financial Condition (E) Committee continues to work on the Reinsurance Modernization Framework. Issues related to the single-state regulatory system and collateral requirements were highlighted, with further discussion on these and other issues to occur throughout 2008.

- Foreign Travel Underwriting. After two years of debate, the Life & Health (A) Committee approved a proposed amendment to the Unfair Insurance Trade Practices Model Act to prohibit life insurance underwriting on the basis of past or future foreign travel, except under limited circumstances. We expect the NAIC Plenary will formally approve this amendment at the Summer National Meeting.

- Annuity Guides. A subgroup of the Life & Health (A) Committee's Consumer Guides Subgroup is drafting updates to the "Buyer's Guide" for annuities. Proposed new Buyer's Guide(s), along with a likely recommendation that they be delivered at the point of application (instead of contract delivery), will likely be presented to the Life & Health (A) Committee at the Summer Meeting.

- Principles Based Reserving. NAIC-wide efforts to revise the Standard Valuation Law to allow for Principles Based Reserving continue "full speed ahead." Drafting issues threaten to delay the Summer Meeting target for Plenary approval of "SVL-2." Guidance on federal tax issues appear in the recently issued Treasury Notice 2008-18, and additional discussions with Treasury will take place in coming months.

- FINRA "Suitability, Supervision & Enforcement." At the NAIC's request, a panel of senior FINRA staff provided an overview of FINRA's approach to examinations and enforcement, with primary emphasis on suitability and supervision. FINRA invited insurance regulators to an upcoming training conference, and it is possible the NAIC may incorporate certain FINRA practices into its risk-focused examination processes.

Insured's Direct Access to Reinsurance Proceeds Permitted in Liquidation

BY BOB SHAPIRO

When an insurer becomes insolvent and is placed in rehabilitation or liquidation, state insurance laws are very clear that reinsurance proceeds owed by the insolvent insurer's various reinsurers may not be denied or reduced as a result of the insolvency. The insurer's policyholders, however, may only look to the estate of the insurer for payment of claims. But, what happens in a situation where the insolvent insurer never took on any risk but merely acted as a fronting carrier for the reinsurer?

This issue was addressed by the Commonwealth Court of Pennsylvania in a case which resulted from the insolvency of Reliance Insurance Company. Reliance had acted as a fronting company for Swiss Reinsurance America Corporation (Swiss Re) on a loss portfolio transfer (LPT) of self-insured workers' compensation risks for the Tribune Company. Swiss Re had, under a claims service agreement, been directly responsible for the payment of claims. On the insolvency of Reliance, Swiss Re refused to continue paying claims directly to Tribune unless the Pennsylvania Insurance Commissioner, as Liquidator, consented. The Liquidator refused to give his consent, and an appointed Referee found that Reliance had not borne any risk and thus Swiss Re, as the true insurer of these risks, should bear direct responsibility for payment of claims to Tribune.

The Commonwealth Court, in reviewing the findings and conclusions of the Referee, determined that the evidence established that Reliance was only acting as a fronting company that was used to pass through Tribune's self-insured obligations to the "true obligor." Since Reliance retained no risk and the claims service agreement with a third party administrator provided for Swiss Re's direct funding of a claim account, Tribune, as the insured, should be permitted direct access to the funds owed by Swiss Re under the reinsurance agreement.

The fight between the insurer and reinsurer needed a referee

IRS Pronouncements Impact Captive Insurers

BY LYNN HAWKINS

New tax changes might have accountants on call

The IRS recently issued guidance on the standards for determining whether protected cell captive arrangements constitute insurance for federal income tax purposes. A cell captive arrangement is one in which a captive insurer establishes a segregated account for the risks of a specific insured. In Revenue Ruling 2008-8, the IRS stated that this question turns on whether the captive cell relationship is a parent-subsidiary arrangement or a brother-sister affiliate. The Ruling concludes that when the only risks placed with a cell are those of the cell's shareholder parent, the arrangement lacks the elements of risk-shifting and risk distribution necessary to qualify as insurance. As such, the cell's parent-participant is not entitled to deduct the premium it pays to the cell. Conversely, the insured affiliates in brother-sister arrangements are permitted to deduct premiums paid to the cell captive. This determination is made on a cell-by-cell basis – whether a transaction with a particular cell is treated as insurance has no bearing on whether transactions of each of the other cells in the protected cell company are treated as insurance.

On a separate note, the IRS has withdrawn a proposed regulation that would have eliminated certain tax benefits for captive insurance and reinsurance companies. Specifically, the proposal would have postponed the tax deduction for an incurred loss arising from related party business until the loss was paid, instead of permitting an earlier deduction for certain loss reserves. Following heavy lobbying from the captive industry, the IRS withdrew the proposed regulation and canceled the hearing on the proposal. The action has been viewed in the trade press as a substantial victory for captive insurers.

Awake at the Switch
The NAIC Responds to the Subprime Mortgage Crisis

BY STEVEN KASS

Criticism has been heaped on ratings companies such as S&P and Moody's for being "asleep at the switch" on subprime mortgage risks inherent in certain residential mortgage-backed securities, collateralized debt obligations, and other structured products. One by-product of the ratings companies' failure to promptly recognize and respond to the subprime crisis has been a proactive effort by the NAIC and its Securities Valuation Office (SVO) to be "awake at the switch."

SVO studies during the second half of 2007 show that the insurance industry has limited exposure to subprime investments, with over 95% of the insurance industry's subprime investments being investment grade. Thus, for the industry as a whole, the subprime crisis appears to be anything but. Carrier-specific subprime risks, however, have become a point of intense NAIC focus. To assess these risks, the NAIC modified the 2007 Annual Statement blanks to require insurers to identify their subprime risks, which include not only their investment holdings but also underwriting risks. The NAIC's new risk-focused approach was also evident at the NAIC Spring National Meeting. There, regulators and insurers were warned about broader subprime related risks, such as if an insurer's business model depends upon capital markets access (e.g., securitizations to fund "non-economic" reserves for XXX or AXXX life exposures or cat risk P&C exposures). Another potential subprime fallout for insurers stems from pending initiatives to prohibit the use of credit scoring in underwriting personal auto and homeowners policies.

Given the NAIC's move towards risk-focused financial analysis and examinations, insurers should expect careful regulatory scrutiny of their 2007 Annual Statements for subprime and related risks, with the analysis extending beyond the investment portfolio. Insurers would be well advised to perform their own risk analysis in advance of any regulatory inquiry.

Subprime Fallout Will Push The Limits of D&O Coverage

BY JEFF WILLIAMS & JOHN PITBLADO

As the subprime mortgage crisis – and the credit crisis more generally – continues, D&O carriers and their policyholders will likely face ever-steeper exposure, and may likely find themselves at odds over coverage. The Supreme Court's recent decision in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. et al.*, does not bode well for directors and officers of corporations alleged to have orchestrated and carried out fraudulent financial schemes related to the subprime crisis. *Stoneridge* effectively cuts off the liability of non-speaking third parties who may have participated in, or facilitated, allegedly fraudulent schemes. As plaintiffs' counsel seek to find potential new sources of liability, one expected consequence of *Stoneridge* is an increase in the exposure of directors and officers of the primary defendant. The decision also notes that secondary actors are subject to criminal penalties and civil enforcement by the SEC – signaling that greater SEC scrutiny of third parties is appropriate.

The repercussions of the *Stoneridge* decision will have significant implications for both policyholders and underwriters. Corporate directors and officers and their liability carriers will now face the prospect of increased civil litigation costs as a result of fewer outside parties being named in litigation – and thus contributing to settlements – while at the same time increased SEC and other regulatory scrutiny will likely give rise to coverage issues under policy exclusions for deliberate or willful violations. The subprime crisis is likely to result in litigation that will crystallize these issues.

ERISA Fiduciary Litigation 2.0: The Subprime Mortgage Meltdown

BY ROBIN SANDERS

Following in the footsteps of the recent stock drop cases, ERISA breach of fiduciary duty litigation is fast becoming a popular vehicle for litigation related to the sub-prime mortgage market crisis. To date, two types of cases have been brought. The first asserts claims against retirement plan investment providers whose stock or bond fund products included investments in subprime mortgage-backed or mortgage-related securities. The second is nearly identical to the stock drop cases in that the claims are related to the employer-sponsored plan's investment in company stock, rather than the investment in a third-party stock or bond fund.

In the latter half of 2007, State Street Bank was the first defendant alleged to have acted improperly in these types of cases. Generally, the complaints allege that State Street breached its ERISA fiduciary duty by offering bond funds to retirement plans that invested in risky mortgage-backed or mortgage-related securities (*Prudential v. State Street* and *Unisystem v. State Street*). The individual complaint against State Street asserts ERISA claims by Prudential Retirement, as a result of its service provider business' continued offering of State Street's bond product as a conservative investment option for its retirement plan clients. The putative class action was filed by Unisystem, Inc. on behalf of all retirement plans that invested in the State Street's bond funds.

The second type of sub-prime ERISA case is exemplified by two cases filed by employees participating in retirement plans offered by Washington Mutual and Bear Stearns. The complaints allege that, among other things, the plans' continued investment in company stock was imprudent because of the employer/sponsor's participation in the sub-prime mortgage market and the company's risk of significant losses and consequently a significant decrease in the value of its stock resulting from such participation.

These cases are in their infancy and while no crystal ball exists to tell us what is likely to happen, the wealth of authority expected to result from the stock drop cases will undoubtedly be an invaluable tool for the future.

Suits Targeting Mutual Funds Expected To Continue

BY THOMAS FINN & LIAM BURKE

Mutual funds may increasingly be targeted by plaintiffs' lawyers in the subprime crisis, particularly because most subprime lenders have either filed for bankruptcy or are no longer economically viable targets. These suits are being filed as class actions and are targeting funds that incurred losses due in large part to subprime investments.

In the first class action suit filed against mutual funds, *Atkinson, et al. v. Morgan Asset Management, Inc., et al.*, Morgan Keegen & Co., a subsidiary of Regions Financial Corp., is alleged to have over-concentrated its conservative fund portfolios with collateralized debt obligations. The suit alleges that the plaintiffs suffered losses because the fund misrepresented and omitted material information in its prospectuses and fund registration statements concerning its high-risk investments in collateralized debt obligations. It has been reported that several other funds that have suffered significant losses as a result of their investments in collateralized debt obligations are preparing for litigation as well.

SEC Proposes ETF Rules

BY RICHARD CHOI

On March 11, 2008, the SEC issued a release proposing two new rules under the Investment Company Act of 1940 (Act) that would facilitate the formation and operation of exchange-traded funds (ETFs) and investment company investments in ETFs. The SEC staff estimates that 150 new ETFs will form and operate each year, adding to the 601 ETFs in existence at the end of 2007. The comment period expires May 19, 2008.

Proposed Rule 6c-11 would permit ETFs organized as open-end companies to begin operating without the expense and delay of obtaining individual SEC orders of exemption from certain provisions of the Act. The proposed rule would codify much of the exemptive relief and conditions previously granted to index-based ETFs, and expand the scope of the relief to include transparent, actively managed ETFs. Portfolio transparency would take the form of either (a) web site disclosure each business day of the identities and weightings of the ETF's securities and other assets, or (b) an ETF's stated objective of obtaining results that correspond to the returns of a securities index whose provider discloses on its web site the component securities and other assets of the index. The proposed rule would not exempt broker-dealers from having to deliver a final prospectus to investors who acquire ETF shares in secondary market transactions.

Proposed Rule 12d1-4 would permit investment companies to acquire ETF shares in excess of the limits of Section 12(d)(1) of the Act, subject to certain conditions. The proposed rule would codify exemptions provided in SEC orders, but without many of the same conditions. The proposed rule, however, would not permit acquiring funds that rely on the rule to redeem ETF shares in excess of the three percent limit in Section 12(d)(1)(A)(i) of the Act.

Related rule and form amendments include proposed changes to Form N-1A to provide more useful information regarding ETFs, and proposed amendments to Rule 12d1-2 to permit funds of funds relying on Section 12(d)(1)(G) to invest in unaffiliated ETFs beyond the statutory limitations and to invest in assets other than securities.

RAND Report: Worth the Wait?

BY SARAH JARVIS

The much anticipated RAND Report on the practices of the investment adviser and broker-dealer industries was released by the SEC on January 3, 2008. The Report was commissioned following the D.C. Court of Appeals' decision to overturn the SEC's 2005 fee-based brokerage rule. While the Report did not contain any ground-breaking conclusions, it is as expected, a well-researched synopsis of current business practices and investor knowledge. Chairman Christopher Cox said the SEC is anxious to review the Report to "assist the Commission's efforts to update [its] regulations to improve investor protections in today's new marketplace."

Rand Report says individual investors are confused

Among the findings of the Report are: (1) distinctions between services provided by investment advisers and broker-dealers are eroding; (2) both industries are "composed of heterogeneous firms engaged in a variety of relationships with their clients and with other firms"; (3) individual investors given the disclosure documents reviewed by the Report "would likely be left to turn to individual professionals to summarize the key aspects of the prospective relationship"; (4) many investors do not understand key distinctions between investment advisers and broker-dealers duties, titles used, firms worked for or services offered; (5) most investor participants expressed satisfaction with their financial service provider, often arising from the personal attention received; and (6) many investors are uncertain/confused about fees they pay.

No Use of Plan Assets For Political Purposes

BY STEVE KRAUS

The Department of Labor (DOL) Advisory Opinion 2007-07A held that "the use of pension plan assets by plan fiduciaries to further policy or political issues through proxy resolutions that have no connection to enhancing the value of the plan's investment in a corporation" violates ERISA's fiduciary prudence and solely-in-the-interest requirements.

Plan assets have no place in politics

The Advisory Opinion confirms the position taken by the DOL in Interpretive Bulletin 94-2, which set forth the DOL's view that, in voting proxies, the plan fiduciary must take into account only those factors that, affect the value of the plan's investment and not unrelated objectives. The Advisory Opinion went on to state that "the mere fact that plans are shareholders in the corporations in which they invest does not itself provide a rationale for a fiduciary spending plan assets to pursue, support, or oppose a proxy proposal unless the fiduciary has a reasonable expectation that doing so will enhance the value of the plan's investment…. [P]lan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits to support or promote goals not directly related to the plan."

SEC Proposes Form ADV Amendments

BY KAREN BENSON

The SEC has proposed amendments to Form ADV, Part II—the adviser brochure—and related rules under the Investment Advisers Act. The proposed amendments are designed to provide advisory clients with clearer, more meaningful and current disclosure of the business practices, conflicts of interest, and background of investment advisers and their personnel.

The SEC proposed similar amendments in April 2000, but deferred taking action to study industry comments more fully. The proposed amendments reflect comments received by the SEC on the April 2000 proposal. Interested parties have until May 16, 2008 to submit comments on the current proposal. Some highlights of the current proposal include:

- Changing the brochure format. In lieu of the current "check-the-box" format, the proposal requires advisers to prepare and deliver to clients a plain English narrative brochure. The proposed narrative format is similar to the one used in Schedule H of Form ADV for "wrap fee" program brochures.
- Requiring enhanced disclosure. The proposal requires the narrative to provide more detailed information concerning the adviser's conflicts of interest and disciplinary history.
- Distributing a brochure supplement. The proposal requires advisers to distribute to certain clients a brochure supplement that contains background information about the advisory personnel on whom clients rely for investment advice.
- Requiring annual and interim updates. The proposal requires advisers to deliver their current brochure to existing clients annually, and provide interim updates promptly when material changes are made to the brochure regarding disciplinary information. Brochure supplements would also be subject to interim updates.
- Requiring electronic filing. The proposal requires advisers to file their brochures and updates electronically through the IARD system, which would be made publicly available on the SEC's website. Brochure supplements would not have to be filed.

SEC Proposes Amendments to Regulation S-P

BY ED ZAHAREWICZ

Citing growing concern "with the increasing number of information security breaches… and the potential for identity theft and other misuse of personal financial information," the SEC has proposed amendments to Regulation S-P that would significantly expand the scope of current information safeguards and disposal rules. Among other things, the amendments would:

New information security requirements - not biometrics (yet)

- Require registered investment companies, advisers, and broker-dealers subject to the safeguards rule to develop, implement, and maintain a comprehensive "information security program," including "written policies and procedures that provide administrative, technical, and physical safeguards for protecting personal information, and for responding to unauthorized access to or use of personal information."

- Broaden the scope of the information covered by each of the safeguards and the disposal rules to include the information currently covered by the other rule, as well as "information identified with any consumer, or with any employee, investor, or security holder who is a natural person…that is handled by the institution or maintained on the institution's behalf."

- Extend the disposal rule to apply to natural persons who are supervised persons of a registered adviser or associated persons of a broker-dealer.

In addition, the SEC is proposing an amendment that would allow advisory and brokerage firms to transfer limited client contact information to another firm without running afoul of S-P's privacy notice and opt out requirements when personnel move from one firm to another.

If the amendments are adopted as proposed, many institutions—even those that consider themselves to already have robust procedures—may find that they still have a significant amount of work ahead of them. Interested parties had until May 12, 2008 to send the SEC comments on the proposal.

Sudan Accountability and Divestment Act

BY ARAM BLOOM

In accordance with the Sudan Accountability and Divestment Act, the SEC has amended Form N-CSR and Form N-SAR to require disclosures by registered investment companies that divest from securities of issuers that the investment companies determine conduct or directly invest in certain business operations in Sudan.

The Act provides, inter alia, that no civil, criminal, or administrative action may be brought against any registered investment company or its employees, officers, directors, or investment advisers based solely upon that company divesting from, or avoiding investing in, securities issued by persons that the company determines (based on credible, publicly available information) conduct or have investments in "certain business operations" in Sudan. To avail itself of the immunity provided for by the Act, the company must make disclosures in accordance with regulations prescribed by the SEC. Toward that end, the SEC requires each registered investment company that divests pursuant to the Act to disclose the divestment on the next Form N-CSR or Form N-SAR that it files following the divestment. The amendments require disclosure of the issuer's name; exchange ticker symbol; CUSIP number; total number of shares, or for debt securities, principal amount divested; and dates the securities were divested. In addition, the company is required to provide information about whether it has a continuing position in the issuer whose securities were divested.

The Act was signed into law on December 31, 2007. The SEC adopted the new rules on April 24, 2008.

Supreme Court Rejects Scheme Liability

BY LIAM BURKE

Not responsible for issuer's misleading financials

In a landmark decision, the U.S. Supreme Court recently rejected the so-called "scheme" theory of liability under Securities Exchange Act Rule 10b-5. In *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, the Court determined that certain customers/suppliers of an issuer would not be liable to investors in a private action under the rule.

The customers/suppliers had agreed to arrangements that facilitated the issuer's publication of misleading financial statements that affected the price of the issuer's stock. The Court found this conduct of the customers/suppliers was so remote from the damages incurred by the plaintiff investors that those investors could not satisfy the "reliance" requirement necessary for a recovery under Rule 10b-5. The Court took account of the fact that the customers/suppliers did not themselves participate in preparing or disseminating the issuer's misleading financial statements or otherwise make public any misstatements. Nor did they owe any duty of disclosure to the issuer's investors. Finally, no disclosure of the customers/suppliers' deceptive conduct was made to investors at any time relevant to liability.

Under the "scheme" theory, the customers/suppliers might have been deemed to have participated in a deceptive undertaking with the issuer under circumstances where the customers/suppliers could be liable to investors, even though only the issuer had directly made any misleading communications to investors or to the public. The Court concluded, however, that the scheme theory did not overcome the plaintiff investors' inability to satisfy the reliance requirement as to the customers/suppliers' conduct.

The Court recognized that the customers/suppliers may have aided and abetted the issuer's violation of Rule 10b-5. Under a previous Supreme Court decision, however, there is no private right of action for aiding and abetting under the rule.

Opinions Differ About Fairness Of Securities Arbitration Practices

BY PATRICK LAVELLE

Disgreements continue over the current securities arbitration system (*Expect Focus*, Vol. I, Winter 2008 and Vol. III, Fall 2007), as Congress and regulators consider reforms to the process.

State securities regulators have recommended reforms such as eliminating mandatory industry arbitrators, eliminating pre-dispute arbitration clauses in customer agreements, prohibiting arbitrators who have ties to the industry, and discretionary monitoring of arbitration proceedings, among other reforms. The state regulators argue that a recent study performed by the Securities Industry Conference on Arbitration (SICA) supports the need for such reforms to achieve fairer treatment of investors.

Which way will it go?

The Securities Industry and Financial Markets Association (SIFMA) and FINRA contend, however, that the current system works fairly and continues to offer a widening array of protections to investors. These organizations have criticized the SICA study, arguing that it is based on incomplete and inadequate data. SIFMA and FINRA believe that the state regulators' proposed reforms may do investors more harm than good. Also, SIFMA has itself published a white paper that generally supports the current system. This debate will continue for some time to come.

Private Plaintiffs Get Access to Internal Investigation Documents

BY THOMAS FINN

Another federal court has directed that documents created during an internal investigation be turned over to private plaintiffs. In *In re Initial Public Offering Securities Litigation*, the federal court in the Southern District of New York held that documents created by Credit Suisse Securities (USA) LLC during an internal investigation and disclosed to federal authorities were discoverable by private plaintiffs in subsequent securities class action litigation.

Disclosing internal investigation documents may cause headaches

Credit Suisse's general counsel conducted an internal investigation with the aid of outside counsel, in response to inquiries by federal prosecutors and the SEC regarding alleged misconduct concerning the allocation of shares in IPOs. Credit Suisse then disclosed 169 memoranda created during the internal investigation to the federal authorities and the NASD (now FINRA) "to escape or limit liability." Credit Suisse also produced the documents in arbitration proceedings pursuant to either an order of production or a protective order. In directing Credit Suisse to turn the documents over to private plaintiffs in subsequent litigation, the court found that Credit Suisse waived its work product privilege by providing the documents to federal authorities, who the court noted were adversaries to Credit Suisse.

The decision underscores the importance of recognizing that documents created during an internal investigation and then disclosed to authorities in an effort to mitigate liability may very well find their way to private plaintiffs in subsequent litigation.

Insurance Regulatory News

States Differ on LTC Training Requirements

BY SARAH JARVIS

Firms that sell long-term care insurance in more than one state are having to pay close attention to the different producer training requirements that may apply.

Over a year ago, the NAIC amended the producer training requirements of the Long-Term Care Insurance Model Act. Motivated in part by producer training requirements under the 2005 Deficit Reduction Act, the NAIC amendments require eight hours of initial training and four hours of ongoing training for producers who sell, solicit, or negotiate traditional long-term care insurance and/or insurance intended to qualify under a state's long-term care insurance partnership program. (Partnership programs allow purchasers of certain LTC policies to protect a portion of their assets that otherwise must be "spent down" to qualify for Medicaid.)

While many states have yet to revise their long-term care producer training provisions to reflect the NAIC amendments, the states that have added such provisions differ as to when the training is required. To date, 19 states have adopted training requirements based on the NAIC Model, which apply to producers selling, soliciting, or negotiating any type of long-term care insurance. Seven other states have created similar training provisions, but apply them only to producers who sell, solicit, or negotiate long-term care insurance policies that qualify under the state partnership program. Additionally, some states require insurers to confirm producer training to the state insurance department, which goes beyond the NAIC model's requirement to maintain records of producer training that are available to the commissioner upon request.

Expect Focus will continue to monitor developments in connection with long-term care products.

SEC Staff Eases Broker-Dealer Record Retention Burden

BY PETER PANARITES

Broker-dealers may now rely on their Web CRD electronic filings to satisfy certain record retention requirements under the Securities Exchange Act. The SEC's Division of Market Regulation took this position in a no-action letter, dated February 19, 2008, in response to a request from FINRA.

Broker-dealers use uniform registration related forms filed through Web CRD, which is owned and operated by FINRA. Forms U4 and U5 are used, respectively, to register and terminate registrations of persons associated with a broker-dealer. Form BR is used to register and deregister branch offices of a broker-dealer. Under the Division's no-action letter, broker-dealers may rely on their Web CRD filings to satisfy their record retention obligations for

- Form U4 amendments and Form U5 initial filings and amendments, that, in each case, do not require the registered person's signature. (Initial Forms U4 and any amendments requiring a signature are not covered by the no-action relief.)
- Form BR initial filings and amendments

FINRA members who comply with the terms of the Division's no-action letter will not be required to maintain hard copies or electronic images of the Forms covered by the no-action letter.

Common Deficiencies in AML Tests

BY KAREN BENSON

FINRA recently hosted an anti-money laundering (AML) phone-in workshop, which provided information and guidance on the AML independent testing requirement applicable to broker-dealers. The workshop addressed a variety of compliance issues related to the independent testing requirement, including who can conduct a test (i.e., who is "independent"), how to conduct and evaluate a test, and how to follow up on deficiencies noted in the testing results. The workshop also identified (among others) the following independent test deficiencies that FINRA recently has uncovered in its AML examinations of broker-dealers:

Reviewing anti-money laundering tests

- The test was not independently conducted or the person conducting the review had inadequate experience.
- The test failed to cover all applicable AML requirements.
- The test involved only a review of the AML policies and procedures and no actual testing thereof was performed.
- The test failed to follow up on a previous year's weaknesses and recommendations to ensure that deficiencies were corrected.
- The test failed to review the adequacy of exception reports (e.g., whether they are appropriate, effective, and cover aspects of the broker-dealer's business).

Announcing

Jorden Burt is pleased to welcome Thomas J. Finn, Paula Cruz Cedillo, and Liam S. Burke to the Connecticut office. As Partner, Mr. Finn will be leading our Securities Industry Group. Ms. Cedillo joins as Of Counsel and Mr. Burke is an associate, working with securities litigation, complex commercial litigation and class action defense.

Fifth Circuit Vacates Clandestine Fee Award

BY MICHAEL SHUE

Court finds, and vacates, clandestine fee

In *In re High Sulfur Content Gasoline Products Liability Litigation*, the Fifth Circuit vacated a secret attorney's fee award approved by a district court as part of a class action settlement. Shell Oil Company settled a class action alleging it produced contaminated gasoline, and agreed to set aside $6.875 million to pay the 79 plaintiffs' attorneys who worked on the case. To allocate the fee, the lower court appointed five of the attorneys to a Fee Committee charged with preparing a proposal to apportion the fee. The Committee presented its proposed allocation to the court at an ex parte hearing. None of the other 74 attorneys had seen the proposed fee allocation, and they were not notified of, and did not attend, the ex parte proceeding. The hearing lasted only 20 minutes, and the district court signed the proposed order without modification. The fee order awarded nearly half of the $6.875 million to the five attorneys on the Committee, placed all fee awards under seal, prohibited all attorneys from disclosing their respective awards, required fees to be "distributed immediately", mandated that fee checks bear a full and final release, and severely curtailed the attorneys' abilities to challenge the awards.

In a detailed review of the procedures employed, the Fifth Circuit held that the district court abused its discretion by abdicating its responsibility to ensure that the fee awards were fair and reasonable, by rubber-stamping the Committee's proposal, and by placing a "gag order" on the attorneys. While the Fifth Circuit acknowledged the propriety of employing committees to assist in determining equitable fee distributions, it explained that courts cannot "delegate their duty to allocate a fee award to a committee of interested attorneys who have reached no agreement among themselves and then approve the allocation after a perfunctory review." It added that the decision to convene an ex parte hearing was "plainly unauthorized," and violated "basic judicial standards of transparency and fairness."

Wisconsin Federal Court Redefines And Certifies FDCPA Class

BY ELIZABETH BOHN

The federal district court in Wisconsin certified a class of consumers who claimed that a debt collection agency's prerecorded messages violated the Fair Debt Collection Practices Act by failing to disclose that the calls were from a debt collector. In *Drinkman v. Encore Receivable Management*, the plaintiff sought to certify a class of consumers who had received messages from the agency that failed to meaningfully disclose the caller's identity as required by §1692d of the Act.

The court found that the plaintiff's class definition would necessitate individual inquiries of potential class members to establish whether they received "meaningful disclosures." But, rather than deny class certification, the court *sua sponte* redefined the class to include only consumers who received a message that "left nothing more" than the caller's name, phone number and reference to "an important matter."

Class certified in phone message case

Fear of Injury Insufficient to Confer Standing

BY TODD FULLER

The Texas Supreme Court recently dismissed a putative class action for lack of jurisdiction because the plaintiffs' claims were too speculative and hypothetical to confer standing. In *DaimlerChrysler v. Inman*, three putative class representatives alleged that the seatbelt buckles on their vehicles were "dangerously subject to accidental release." The plaintiffs had not personally experienced any malfunction of their buckles or sustained any injury as a result of a malfunction, but sought damages for the cost of replacement with buckles that are harder to unlatch. Plaintiffs estimated that the replacement cost and loss of use while repairs were undertaken did not exceed $800 per vehicle, and no more than $8 billion for the class. The trial court certified two nationwide classes consisting of individuals who owned or leased DaimlerChrysler vehicles equipped with the allegedly defective buckles.

DaimlerChrysler appealed, arguing that the plaintiffs lacked standing because they had not sustained any legally cognizable injury, and that the court failed to consider choice-of-law issues. The court of appeals rejected the standing argument, but agreed that the trial court still had significant pre-certification work regarding choice-of-law. DaimlerChrysler petitioned the Texas Supreme Court to review its standing argument.

In a 5-4 decision, the supreme court ruled in favor of DaimlerChrysler, stating that "[t]o hold that [the plaintiffs] have standing would drain virtually all meaning from the requirements that a plaintiff must be 'personally aggrieved' and that his injury must be 'concrete' and 'actual or imminent.'" The court observed that "when a claim of injury is extremely remote, the jurisdictional inquiry cannot be laid aside in an expectation that the claimant will also lose on the merits. A court that decides a claim over which it lacks jurisdiction violates constitutional limitations on its authority, even if the claim is denied." The court added that the plaintiffs' fear of a potential injury was too remote and hypothetical for a court to afford redress.

Fear of spiders won't get you certified either

FACTA Class Certified in Illinois, but not in California

BY ELIZABETH BOHN

The truncation rules of the Fair and Accurate Credit Transactions Act, prohibiting disclosure of more than the last five digits of credit card numbers or card expiration dates on customer receipts, went into full effect in December 2006. Since then, numerous class actions alleging willful violations of the truncation requirements have been filed in California, presumably to take advantage of the Ninth Circuit's position that "willful" includes "reckless" for purposes of the Fair Credit Reporting Act, arguably paving the way for statutory and punitive damages for truncation violations (FACTA provides statutory damages of between $100 and $1,000 for each violation).

Credit card receipts lead to some certified class actions

Arguments successfully raised to defeat class certification in California have included inadequacy of the plaintiff as class representative; lack of superiority because a potential damage verdict would annihilate the defendant, although the plaintiff and putative class suffered no actual injury; and that potential damages are excessive and disproportionate to the actual harm to plaintiff and the putative class. *Spikings v. Cost Plus*; *Najarian v. Avis Rent-A-Car*; *Simon v. Ashworth* (all in the Central District of California).

Illinois is another story. In *Troy v. Red Lantern Inn*, the Northern District of Illinois certified a FACTA class, rejecting arguments as to superiority, adequacy of the class representative, and that the potential damage award for the 5,000 class members would be excessive. The *Troy* decision cites *Murray v. GMAC Mortgage*, in which the Seventh Circuit held that annihilating damages are not a bar to class certification because excessive damages can be reduced after verdict. Although the annihilation argument has succeeded in California district courts in defeating class certifications, the Ninth Circuit has yet to rule on it.

Arbitration Roundup

BY LANDON CLAYMAN

Second circuit extends immunity to arbitration witnesses

Witnesses testifying in judicial proceedings generally enjoy immunity from subsequent civil suits against them based upon the testimony they provide. Immunity is premised upon the desire to prevent self-censorship by witnesses who may have concerns about subsequent damages liability. Ruling that "the truth-seeking function of arbitration is no less robust" than that of the judicial process, the U.S. Court of Appeals for the Second Circuit extended witness immunity to arbitration proceedings in *Rolon v. Henneman* (Feb. 25, 2008), so long as the arbitration is conducted "in a manner equivalent to a judicial process."

Although the court did not define the "minimum safeguards" necessary for immunity to attach to a witness's testimony in an arbitration proceeding, in *Rolon* the witness took an oath, offered testimony, responded to questions on direct and cross-examination, and could have been prosecuted for perjury. The Second Circuit found that because the arbitration witness in *Rolon* performed "substantially the same function" as witnesses in judicial proceedings, with "nearly identical procedural safeguards," absolute immunity attached to the witness's testimony.

Eleventh Circuit Slams "Illegality" As Basis For Voiding Policies

BY FARROKH JHABVALA

Drivers can't sue under Florida's anti-sliding statute

The Eleventh Circuit has finally put the kibosh on the theory that any violation of a Florida insurance statute in connection with the sale of an insurance contract automatically results in an "illegal" and void contract under Florida law, necessitating disgorgement of all premiums. This theory underpinned the claims in *Buell v. Direct General Insurance Agency, et al.*, in which plaintiffs alleged on behalf of a class of Florida insureds that five ancillary insurance products were "slid" into their purchases of auto insurance policies. Florida's anti-sliding statute is part of its Unfair Insurance Trade Practices Act and prohibits: (i) representing to customers that an ancillary insurance policy is required by law in conjunction with the product being purchased when it is not, (ii) representing to customers that an ancillary policy is included in the sale at no extra charge when there is an extra charge for that policy, or (iii) charging a customer for an ancillary policy without the customer's informed consent. The district court dismissed the complaint on the ground that the specific statute at issue provided no-private-right-of-action. The plaintiffs appealed, arguing that under Florida common-law they (and the putative class) were entitled, as "innocent" parties to unlawful contracts, to rescind the ancillary policies and recover the entire premiums they had paid for all of those policies. The Eleventh Circuit affirmed the dismissal because the statute at issue provided no private cause of action, explaining: "We will not use the common law of contracts to circumvent this deliberate remedial limitation." The court added that plaintiffs' argument "runs afoul" of Florida case authority which makes legislative intent to create a remedy "paramount" in determining whether a statutory violation is actionable.

Jorden Burt led the charge on the no-private-right-of-action defense in the case.

NEWS & NOTES

Speeches

The ALI-ABA Insurance Industry and Financial Services Litigation Conference was held April 3-4, 2008 in Scottsdale, AZ. Managing partner **James Jorden** was the planning chair and partners **Markham Leventhal** and **Wally Pflepsen** were on the faculty for the conference.

Elizabeth Bohn chaired "Keeping House and Home Together - New Regulations, Legislation and Strategies for the Consumer Mortgage Industry in the Wake of the Subprime Meltdown," April 11, 2008 for the ABA in Dallas.

Steven Kass spoke on Life Insurance Fundamentals at the PLI course "Understanding Insurance Law," April 14-15, 2008, in New York, NY.

Richard Choi moderated the Investment Manager Roundtable at the Financial Research Association's 2008 Retirement Income Distribution Evolution Summit in Boston. MA on April 30, 2008.

Publications

Diane Duhaime's article "Why should Corporate Counsel Become Familiar With Virtual Environments? Aren't They Just Fun and Games," has appeared in the *World Trademark Yearbook 2008* and the *Connecticut Law Tribune*.

Pro Bono Corner

BY SHEILA CARPENTER

Jorden Burt recently was named a member of the U.S. Southern District of Florida's court-appointed counsel group (CJA) for appeals by indigent criminal defendants.

Jorden Burt's CJA briefing team, all from our Miami office, included Sonia O'Donnell, former prosecutor in the U.S. Attorney's Office, Southern District of Florida, and associates Ari Gerstin and Lara Grillo. Together they donated approximately 300 hours to brief the appeal in *United States v. Luroy Jennings*. The appeal involved charges of interstate transportation for purposes of prostitution, a crime that has been featured prominently in the news recently. The issues on appeal include: a jurisdictional issue of first impression in the Eleventh Circuit, sufficiency of the evidence, constitutional issues of Fourth Amendment search and seizure, and sentencing issues. We are waiting to hear if the Eleventh Circuit will grant oral argument.

Thank you to Sonia, Ari and Lara for their enthusiastic support of Jorden Burt's efforts to give back!

Mark your Calendars

The NAVA Compliance and Regulatory Affairs conference will be held June 1-3, 2008 in Washington, D.C. Ann Furman, a planning committee member, and Richard Choi will moderate a panel on senior investors.

JORDEN BURT LLP

JORDEN BURT LLP is the premiere national legal boutique providing litigation and counseling services to the financial services sector. The firm serves clients in six key industries:

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For more information, visit our website at www.jordenburt.com.

SOUTHEAST
Suite 500
777 Brickell Avenue
Miami, FL 33131–2803
305.371.2600
Fax: 305.372.9928

WASHINGTON, D.C.
Suite 400 East
1025 Thomas Jefferson St., N.W.
Washington, D.C. 20007–5208
202.965.8100
Fax: 202.965.8104

NORTHEAST
Suite 201
175 Powder Forest Drive
Simsbury, CT 06089–9658
860.392.5000
Fax: 860.392.5058