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INTHESPOTLIGHT

Mixed Results In Rule 151A Opinion

BY GARY COHEN

The U.S. Court of Appeals for the District of Columbia Circuit opined, on July 21, 2009, that it was not unreasonable for the SEC to adopt Rule 151A designating indexed annuities as securities, but that the SEC failed to meet its obligation to consider the Rule's effect on efficiency, competition, and capital formation. The Court of Appeals remanded the matter to the SEC to address its obligation.

Court to SEC: re-examine efficiency

While the Petitioners "lost" on the reasonableness of Rule 151A, the SEC "lost" on Rule 151A's effect. The SEC has a number of options on how to proceed. It can drop the Rule, try to persuade the Court of Appeals that the SEC is not required to consider the Rule's effect, proceed with the consideration of the Rule's effect, change and re-propose the Rule, or ask the U.S. Supreme Court to review the Court of Appeals' decision.

The Petitioners and the SEC have until September 4, 2009 to seek a rehearing of the three-judge panel or a hearing of the full Court of Appeals.

Meanwhile, members of the National Association for Fixed Annuities continue to press for legislation to overturn Rule 151A. Bills have been introduced in both the House and Senate, and each bill has more than one sponsor.

Though Rule 151A remains in flux, two companies – Eagle Life Insurance Company, an affiliate of American Equity Investment Life Insurance Company, and Nationwide Life Insurance Company – recently have filed Form S-1 registration statements for indexed annuities with the SEC.

Save the Date

The ALI-ABA Conference on Life Insurance Company Products will take place November 5-6, 2009 in Washington, DC. Jorden Burt Partner **Richard Choi** is co-chair of the conference with **Ann Black** and **Gary Cohen** on the faculty. For more information, visit www.ali-aba.org.

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Insurance Regulatory Reform Update

BY ANN FURMAN

Market events over the last year have escalated the debate over the best form of regulation of insurance companies, insurance agencies, and insurance producers. There are two camps: one favoring federal regulation and another favoring the current state-based system of insurance regulation.

The NAIC and state insurance commissioners assert that the state-based system of insurance regulation has been successful and that any reform initiatives should not displace the current system. In late May, more than 35 state insurance commissioners and NAIC Chief Executive Officer Therese Vaughan met with members of Congress to discuss regulatory reform and promote the state-based system over a federal insurance regulator.

Conversely, parts of the insurance industry and several members of Congress assert that lack of uniformity in state regulation as well as the goals of efficiency and modernization justify federal regulation in the form of an Optional Federal Charter. With co-sponsor Ed Royce (R-CA), Rep. Melissa Bean (D-IL) introduced H.R. 1880, the National Insurance Consumer Protection Act (NICPA) on April 2, 2009. The NICPA would establish a system of regulation and supervision for insurers, insurance agencies, and insurance producers that would allow them to elect state or federal regulation, charters, and licenses.

The NICPA would establish an Office of National Insurance, would be charged with (1) overseeing organization, incorporation, regulation, and supervision of national insurers and insurance agencies, and (2) licensing, regulating, and supervising national insurance producers.

The NICPA would require the President to designate a systemic risk regulator for covered institutions, defined to include national insurers and insurers organized and supervised under state law.

The Obama Administration has published proposed legislation that is much less sweeping in scope, establishing an Office of National Insurance to, inter alia: (1) monitor the insurance industry and identify regulatory gaps: (2) coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters; (3) determine whether state insurance measures are preempted by such international agreements; and (4) consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance. The legislation also provides for the designation of certain companies for comprehensive prudential federal regulation and resolution authority. Insurance holding companies or insurance companies would be subject to such regulation only if they are designated by the Federal Reserve Board as Tier 1 Financial Holding Companies.

The Retirement Security Needs Lifetime Pay Act is Reintroduced in the House

BY AILEEN WARREN

On June 9, 2009, Representatives Earl Pomeroy (D-ND) and Ginny Brown-Waite (R-FL) introduced the Retirement Security Needs Lifetime Pay Act of 2009 (H.R. 2748), to encourage retirees to receive some of their retirement savings in the form of annuities with guaranteed lifetime income. The legislation excludes from taxable income (1) 50 percent of annual annuity payouts from a non-qualified plan, up to $10,000 per year, and (2) 25 percent of annual annuity payouts from Individual Retirement Accounts and qualified retirement plans other than defined benefit plans.

The legislation also creates a tax incentive for the purchase of longevity insurance (an annuity designed to begin payments when the annuitant attains an advanced age, e.g., 85). It excludes the value of longevity insurance from amounts subject to required minimum distributions, thus allowing for higher annual payments when an annuitant delays the start of payouts. The act also clarifies the taxation of payments from partially annuitized deferred annuity contracts by giving such payments the same tax treatment as other annuity payments.

This bill, and similar legislation, has been proposed before. None of the three prior bills has made it out of committee. With the growing concern over the financial stability of Social Security, the prospects of passage of the current legislation might appear more likely; however, with the President's proposed "pay as you go" legislation, which would require that any increased spending or tax cuts be off-set by an equal amount of savings from other programs, H.R. 2748 is likely to face considerable resistance in Congress.

Enhanced Remedies Available to Seniors Asserting California UCL Claims

BY EVAN TAYLOR

Senior citizen James Clark filed suit against National Western Life Insurance Company in 2004, alleging that deceptive business practices induced him and a class of other California senior citizens purchase high-commission annuity contracts with large surrender penalties in violation of, among other things, California's Unfair Competition Law (the UCL). The suit sought restitution of the allegedly improper surrender penalties and enhanced remedies under Section 3345 of the California Civil Code. Section 3345 authorizes awards of up to three times the amount of a fine, civil penalty "or any other remedy the purpose or effect of which is to punish or deter" that would otherwise be awarded in actions brought by or on behalf of senior citizens or disabled persons seeking to "redress unfair or deceptive acts or practices or unfair methods of competition."

Plaintiffs' bar excited over enhanced remedies

On November 14, 2008, the trial court granted National Western's motion for judgment on the pleadings, concluding Section 3345 is inapplicable in a private action seeking restitution under the UCL because "restitution, the only available remedy, does not have the purpose or effect of punishment or deterrence." Clark, on behalf of the certified class, petitioned for writ of mandate compelling the trial court to vacate its ruling. On May 21, 2009, the California Court of Appeal granted the petition, labeling the trial court's conclusion that the UCL's restitution remedy is not intended to deter unlawful conduct "unduly cramped." Finding that California courts have long recognized that restitution awarded under the UCL has a deterrent purpose and effect, the Court of Appeal agreed with Clark that enhancement is authorized under the plain language of Section 3345. National Western has petitioned the California Supreme Court to review the appellate court decision.

Ninth Circuit, Stressing Importance of "Predominance" Inquiry, Twice Rejects Class Certification

BY BRIAN PERRYMAN

In a pair of recent opinions, the U.S. Court of Appeals for the Ninth Circuit rejected class certification of claims alleging the unlawfulness of employers' internal policies treating their employees as exempt from overtime laws. While holding that "reverse uniform" wage exemption policies are relevant to the federal class certification analysis, trial courts may not rely on such policies to the near exclusion of other factors touching on whether common issues will predominate at trial including, for example, whether the employees were actually performing similar duties. Thus, the Ninth Circuit reversed the grant of class certification in I*n re Wells Fargo Home Mortgage*, and affirmed the denial of certification in *Vinole v. Countrywide Home Loans, Inc.*

Rejected class certifications signal to trial courts

These opinions apply outside the context of labor law, since they articulate the standards for certification applicable to any type of class action suit brought in the Ninth Circuit. Significantly, the opinions remind trial courts that they may consider the merits of the claims to the extent relevant to the "predominance" inquiry, and admonish that trial courts cannot simply hope that so-called "innovative procedural tools"– such as questionnaires, statistical or sampling evidence, representative testimony, expert testimony, or separate judicial mini-proceedings—will ease the trial burdens if there is no showing at the certification stage how these tools would actually assist the court.

NAIC Suitability in Annuity Transaction Model Regulation

BY STEVEN KASS & ANN BLACK

On July 2, 2009, the NAIC's Suitability of Annuity Sales (A) Working Group published an updated set of proposed revisions, which followed discussions with industry regarding the different distribution channels for annuity products.

The latest proposed revisions allow insurers to contract with third parties, including FINRA member broker dealers, to supervise annuity transactions. The July 2 draft exempts insurers from performing a suitability review of annuity transactions for which a FINRA member broker dealer is responsible and the insurer has determined that such broker dealer's supervision system conforms with FINRA principal review requirements. The latest draft also permits an insurer to use an automated suitability review system for all recommended annuity sales through other distribution channels. In all cases, however, the insurer remains responsible and liable for compliance with the suitability review requirements, including for any deficiency in an automated system, and the insurer shall not issue an annuity recommended to a consumer unless the annuity is suitable.

The July 2 draft clarifies the ongoing nature of insurers' distribution monitoring requirements: insurers must establish a continuous monitoring system reasonably designed to identify producer violations of suitability requirements as well as failures to comply with the insurer's supervision system. Insurers must also continuously collect and analyze relevant data, and evaluate the effectiveness of implemented supervision systems and procedures.

The July 2 draft specifically addresses opt-outs by consumers to provide suitability information by imposing additional requirements on insurers, insurance producers and insurance agencies. Insurers that permit opt-outs will be required to interview each consumer who does not provide suitability information.

The Working Group has requested comment on specific questions concerning: (i) restricting or prohibiting producer compensation for non-recommended sales, (ii) comparisons with alternative financial products, and (iii) training requirements.

State Suitability Initiatives

BY STEVEN KASS & ANN BLACK

Florida and New York continue their efforts to address suitability of sales of annuities. Florida continues its work on its proposed Rule 69B-162.011 – "Suitability and Disclosure in Annuity Contract – Forms Required." New York announced a series of hearings to gather information about life insurance and annuity sales transactions.

Measuring up state suitability

On June 16, 2009, Florida held a public hearing on its proposed Rule, which adopts two forms producers (or insurers when no producer is involved) must use for an annuity sale to senior consumers. At the hearing, industry members raised various global comments as well as technical drafting comments to the draft forms, and the Florida Department of Financial Services agreed to receive additional written comments for 10 days. Once DFS reviews the comments, it will determine whether modifications to the proposed Rule and/or Forms are needed, and if so, DFS will publish a formal Notice of Change, which will trigger a 21-day comment period on the revisions.

The New York State Insurance Department announced on July 8, 2009, that it is seeking input from consumers, members of the industry, academics and members of the general public with experience or expertise on the subject of suitability in the sale of life insurance or annuities. The NY Department will hold four hearings throughout New York, during August and September to assess whether there is a problem concerning unsuitable sales of life insurance and annuities in New York. The NY Department is seeking to determine if its current regulatory scheme is effective and whether the NY Department should promulgate new regulations that specifically bar unsuitable sales of life insurance and annuities. The NY Department is also exploring whether any new regulation should apply to all life insurance and annuity sales or just a certain portion, and what form any new regulation should take.

IRS Provides Guidance Regarding Life Insurance Contracts

BY STEVE KRAUS

In Notice 2009-47, the IRS requests comments on a proposed safe harbor regarding the application of Internal Revenue Code (IRC) Sections 7702 (definition of life insurance) and 7702A (definition of modified endowment contracts) to life insurance contracts that continue after an insured attains age 100. The need for guidance arises from the new 2001 CSO tables, which extend to age 121, while the computational rules of IRC Section 7702 assume a contract matures between ages 95 and 100.

Piecing together IRS Guidance

Under a proposed safe harbor, the IRS will not challenge the qualification of a contract as a life insurance contract or assert that a contract is a MEC if the contract satisfies all of the "Age 100 Testing Methodologies" set forth in the Notice. One of the requirements of the safe harbor is that a contract remaining in force after age 100 would be required to provide at all times a death benefit equal to or greater than 105 percent of its cash value.

In Notice 2009-48, the IRS provides guidance concerning the treatment of employer-owned life insurance contracts under IRC Sections 101(j) and 6039I (information reporting with respect to employer-owned life insurance contracts). The Notice clarifies the definition of "employer-owned life insurance contract" and provides guidance with respect to several other provisions.

The Notice was effective June 15, 2009. Further, the IRS states that it will not challenge a taxpayer who made a good faith effort to comply with IRC Section 101(j) based on a reasonable interpretation of that provision before that date. No guidance is given as to what constitutes a "reasonable interpretation" of IRC Section 101(j). Comments should be submitted on or before October 13, 2009.

Scribner, Hall & Thompson, LLP

There May Be a Hidden Tax Gem in April

BY SUSAN HOTINE

In PLR 200915006 (April 10, 2009), the IRS ruled that investments in publicly-available mutual funds by several insurance-dedicated funds will not cause variable contract holders that allocate amounts to such funds to be treated as the owners of the fund shares for federal income tax purposes. There also may be a hidden tax gem in the ruling. The PLR's facts indicate a taxpayer concern about whether the I.R.C. § 4982 excise tax on RIC undistributed income would apply if the policyholders were considered owners of the shares. The PLR includes as a Representation a legal quid pro quo: "All the shares of each Existing Fund and the New Fund will be held directly or indirectly by segregated asset accounts of life insurance companies that are held in connection with variable contracts, as defined in Code § 817(d), *and each Existing Fund and New Fund therefore will qualify for the exception from federal excise tax provided by Code § 4982(f),* ***unless*** *a variable contract holder is treated as a shareholder of the relevant fund pursuant to the investor control requirements of Revenue Ruling 81-225, 1981-2 C.B. 12, and Revenue Ruling 82-54, 1982-1 C.B. 11* (emphasis added)."

Apart from the facts and this Representation, the PLR does not discuss I.R.C. § 4982. However, if a Representation states a legal conclusion as part of a quid pro quo, and the IRS accepts it as being true for purposes of the ruling (or, why else would it be included in the ruling?), has not the IRS effectively agreed with the legal conclusion? The PLR states that, "[e]xcept as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter." But, arguably, the legal conclusion that an insurance-dedicated fund qualifies for the excise tax exception even when its shares are held indirectly by a segregated asset account through another insurance-dedicated fund was "expressly provided" in the PLR when it concluded that the contract holders should not be treated as the owners of the fund shares. Despite a potentially adverse literal reading of the I.R.C. § 4982(f) excise tax exception for fund-of-funds insurance RICs, the PLR's taxpayer may have bootstrapped a favorable conclusion with respect to the I.R.C. § 4982(f) excise tax exception.

Colorado Supreme Court Reverses Certification of Class Alleging "Fraud on the Market" in Insurer's Sales of UM/UIM Coverage

BY JIM GOODFELLOW

The Colorado Supreme Court recently reversed a class certification order in a case challenging the manner in which uninsured/underinsured motorist (UM/UIM) coverage was marketed and sold. The plaintiff, Mark Benzing, alleged that Mid-Century Insurance Company and its parent, Farmer's Insurance Exchange, engaged in deceptive trade practices by failing to comply with the disclosure requirements announced in a recent Colorado Supreme Court decision which held that UM/UIM coverage applies to an insured person regardless of whether the insured occupied the insured vehicle at the time of injury. The effect of the court's decision was to make unnecessary the purchase of additional UM/UIM coverage for additional family vehicles. Mr. Benzing had purchased a second family vehicle, and alleged he was "duped into paying more than [he] would have paid" had he known the effect of the court's decision. Mr. Benzing brought claim under the Colorado Consumer Protection Act on behalf of himself and an alleged class of those similarly situated.

Court keeping an eye on fraud on the market theory

The trial court initially certified the class, but, after a transfer, it was decertified on the basis that the plaintiff had failed to establish injury on a class-wide basis, because the additional (allegedly unnecessary) coverage may have provided a benefit to some insureds. However, Colorado's intermediate Appellate Court reversed, finding certification was appropriate, because a "fraud-on-the-market" theory could suffice to establish class-wide injury. The Colorado Supreme Court then reversed that holding, finding that the plaintiff could not avail himself of the fraud-on-the-market theory to establish class-wide injury because (1) the plaintiff's claims were not based on the market price of the policies and the integrity of the market but rather on Farmers' lack of disclosure in individual transactions, and (2) the plaintiff could not establish that the market was "efficient" – meaning that the market price reflected all available public information – because the court's prior decision was public information at the time, and was allegedly not reflected in the pricing of policies, meaning plaintiff's claims relied on the inefficiency of the market. The court thus reversed the Appellate Court, with instructions to remand to the trial court, effectively reinstating the original decertification order.

Congress Takes Second Look At Homeowners' Defense Act

BY LARA GRILLO

On May 21, 2009, Representative Ron Klein (D-FL) introduced the Homeowners' Defense Act of 2009 (H.R. 2555), which would provide federal support for state-sponsored insurance programs created to assist homeowners in the event of natural catastrophes. Senator Bill Nelson (D-FL) introduced the Senate version of the bill (S.505) on February 27, 2009. Rep. Klein reintroduced the bill this year after it died in the Senate in 2008. The bill, referred to the House Financial Services Committee, currently reflects 56 cosponsors from over 25 states.

The bill would create a National Catastrophe Risk Consortium, a nonprofit consortium of states that have reinsurance funds for natural disasters not covered by private insurance. It would pool the risk from hurricanes and other disasters to reduce premiums. The bill authorizes the Secretary of Treasury to guarantee debt issued by eligible state programs assisting in financial recovery from natural disasters and to make reinsurance coverage available for purchase to those programs. It also authorizes grants for eligible programs to prevent and mitigate losses from natural catastrophes.

Proponents of the bill believe it will lower premiums for homeowners in participating states, expand the market for private insurance, and reduce the overall cost of responding to natural disasters. Critics, however, express concern that the bill would encourage development in high risk or environmentally sensitive areas, undermine the private market, and leave taxpayers on the hook for liabilities and commitments reflected in the bill. Rep. Klein has stated that he believes the bill now has stronger support in the Senate and that President Obama also has signaled his support for the legislation.

Chinese Drywall Litigation Update

BY JOHN PITBLADO

The pace of Chinese drywall litigation is increasing, with several new class action cases filed in the last few months alleging classes of homeowners from Florida, Louisiana and nationally, who were affected by allegedly toxic components in certain drywall manufactured in China and used during post-Katrina reconstruction and the housing boom.

The China-based drywall manufacturing entities are alleged to have known of the problems with the drywall and the suits also name various U.S. distributors and construction companies who installed it in U.S. homes. There has been no definitive regulatory response yet, though various federal entities, including the EPA, are addressing the issue.

The suits allege that particular substances in the drywall emit volatile organic compounds that corrode HVAC coils, refrigeration units, plumbing, electrical, and other metal and chrome fixtures, and produce a noxious "rotten egg"-like smell. The suits also raise allegations of personal injury, ranging from cough, nausea, shortness of breath, fatigue, headaches, and dizziness to miscarriage and reproductive health issues.

Alleged toxic building materials likely to have big impact for P&C carriers

The suits are now pending in federal court (at least one of which was removed to federal court pursuant to the CAFA), and were recently consolidated under the multi-district litigation rules and will be managed in the Eastern District of Louisiana. The suits allege various theories of negligence, breach of implied warranty, state unfair trade practices laws, and strict liability.

Given its scope and quickening pace – the judge presiding over the multi-district litigation has indicated that a number of test cases will be expedited to trial by the end of the year – the litigation will likely have a substantial impact on P&C carriers, raising coverage and defense issues pertaining to first party property and third party liability coverages, excess and reinsurance. Jorden Burt will continue to monitor developments.

Class Action Defense Costs Were Recoverable Under GL Policy

BY JONATHAN STERLING

In *Liberty Mutual Insurance Co. v. Pella Corp.*, the United States District Court for the Southern District of Iowa issued orders setting forth Liberty Mutual's responsibilities with regard to coverage for two putative class action lawsuits filed against its insured, a window manufacturer. The main issue in dispute was when Liberty Mutual's duty to reimburse the insured's defense costs was triggered under commercial liability policies.

The insured argued that Liberty Mutual's obligation to pay defense costs was triggered by the mere allegations in the underlying complaints that those plaintiffs sustained covered property damage. Liberty Mutual disagreed, taking the position that an actual "occurrence" was needed to trigger the duty to reimburse defense costs. Furthermore, Liberty Mutual argued that its policy was a true excess policy, and that the insured's self-insured retention was not exhausted until after coverage under any other applicable policies was exhausted. The insured argued that once the amount of the self-insured retention had been met, Liberty Mutual was required to reimburse defense costs without the insured having to first exhaust its other policies.

In its decision, the court noted that the policies were ambiguous on the issue of whether an actual "occurrence" was required to trigger Liberty Mutual's obligation. The court then found that the insured's interpretation was reasonable. The court next decided that the policies were intended to provide primary, and not excess coverage. The court reached this decision in part because the policies did not require the insured to maintain another primary policy as a condition of coverage, and Liberty Mutual's policies were in fact the insured's only coverage for five of the six years that they were in effect.

Legislative Update

BY DAN CRISP

Recent federal and state legislative activity includes proposals and enactments of bills relating to captive insurance, catastrophe risk, and other reinsurance matters.

Captive Insurance: South Carolina (SB 323) has made changes relating to incorporation, licensing, capitalization, and other requirements for captive insurance. **Vermont** (SB 42) revised its captive provisions to include a $7,500 tax credit for new captive formations and to increase state funding for captive regulation. **Missouri** House Bill 577 modifies various provisions of its captive insurance laws.

Federal Catastrophe Risk: The Homeowners' Defense Act of 2009 (H.R. 2555) proposes to provide federal support for state-sponsored insurance programs and to establish the Federal Natural Catastrophe Reinsurance Fund and the National Catastrophe Risk Consortium, whose functions include gathering and maintaining an inventory of catastrophe risk obligations held by state reinsurance funds and issuing securities and other financial instruments linked to the catastrophe risks.

State Catastrophe Risk: Texas (HB 4409) has provided for reform and funding of the Texas Windstorm Insurance Association. **New York** introduced SB 4188 to establish a state catastrophe fund and an advisory council specifically charged with developing disaster prevention and mitigation standards, as well as a consumer education program. **Louisiana** introduced SB 295 to create the Louisiana State Catastrophe Fund and provide for a program of reinsurance using monies in the fund.

Federal Reinsurance: The Nonadmitted and Reinsurance Reform Act of 2009 (H.R. 2571) proposes to streamline the regulation of nonadmitted insurance and reinsurance. The principal provisions of the Act: (1) regulate premium taxes for nonadmitted insurance; (2) provide that the placement of nonadmitted insurance shall be subject to regulation solely by the insured's home state; (3) limit the ability of a state to establish eligibility requirements for U.S.-domiciled nonadmitted insurers that vary from the Non-Admitted Insurance Model Act; (4) require a GAO study of the nonadmitted insurance market; (5) regulate the extent to which a state may not recognize credit for reinsurance for an insurer's ceded risk; (6) partially pre-empt the extraterritorial application of the law of a state to a ceding insurer not domiciled in that state; and (7) provide that in most circumstances a state that is the domicile of a reinsurer shall be solely responsible for regulating its financial solvency. The **Municipal Bond Insurance Enhancement Act of 2009** (H.R. 2589) proposes to establish a program to provide reinsurance for insured losses of qualified municipal bond insurers.

Coast-to-coast reinsurance updates

State Reinsurance: Oregon's HB 2755 requires the Department of Consumer and Business Services to conduct a study of reinsurance alternatives for individual and small employer group health insurance markets. **Massachusetts** introduced a similar bill (SB 495) to establish a reinsurance program to protect consumers of small group health insurance. **New York** introduced a bill (SB 5994) to permit mortgage guaranty insurers to obtain credit for reinsurance in a manner conforming to the requirements prescribed by the Superintendent of Insurance.

"Solvency II" On Track in Europe

BY JOHN PITBLADO

Insurance and reinsurance regulation in the European Union has moved from the solvency issue-based initial phase, dubbed "Solvency I," to a broader phase, known as "Solvency II." Solvency II focuses on concepts of capital requirements, risk management practices, supervisory activities, reporting, and disclosures. The Solvency II initiative recently passed a notable milestone with approval by the European Parliament in April 2009, and by the European Union's Economic and Financial Affairs Council in May 2009. It appears to remain on track for implementation in 2012.

Whether Solvency II will affect the volume of reinsurance writing remains to be seen. The new regulation of capital requirements may mean that small and mid-size insurers may need to look more to reinsurance. On the other hand, the new regulations will require new, more precise, risk management models for larger insurers, but at the same time may allow them to fulfill the new capital solvency requirements without reinsurance. Consequently, the net effect on reinsurance business may not change dramatically.

The Solvency II framework will now enter a so-called "Quantitative Impact Studies" phase. This phase is essentially a data collection undertaking by the various government and industry participants to fine tune the program. *Expect Focus* and Jorden Burt's reinsurance blog (*www.reinsurancefocus.com*) will track and report on developments as they occur.

NAIC's Proposed Modernization Legislation Meets With Criticism

BY ANTHONY CICCHETTI

The NAIC's Reinsurance Task Force in late March exposed draft federal legislation titled the "Reinsurance Regulatory Modernization Act of 2009" as one of the vehicles to implement the NAIC's Reinsurance Regulatory Modernization Framework. The exposure draft drew many comments critical of the proposed bill. Some comments strongly opposed the basic regulatory principles set forth in the proposed bill. A number of comments criticized the proposed bill as being unconstitutional. The Reinsurance Association of America submitted one of the strongest oppositions to the proposed bill, asserting among other things that reliance on individual states to adopt NAIC model laws as a means to implement the objective of single-state regulation is "unnecessarily cumbersome and unworkable." At the NAIC's summer meeting, the Task Force placed this proposal on hold pending the receipt of a legal opinion regarding the proposed bill's constitutionality.

All of the comments submitted to the NAIC on the proposed bill can be found on the NAIC's website. A "Special Focus" article discussing these comments in greater detail can be found on Jorden Burt's reinsurance blog at *www.reinsurancefocus.com*.

Treaty Tips: Shortcut Drafting Can Mean Good Business For Expert Witnesses

BY ANTHONY CICCHETTI

Reinsurance wording can sometimes cause us to scratch our heads or even wince with pain as we search for the parties' intent. Usually, the seemingly opaque language becomes understandable as to its intent, and apparent in its appropriateness, after the agreement is studied as a whole. At times, however, the unavoidable conclusion is that the wording resulted from poor drafting.

A common characteristic of problematic drafting is the use of essential terms in short-hand fashion and without definition on the assumption that anyone who picks up the agreement will understand their meanings. Expert witnesses love this approach to drafting inasmuch as it makes for good business (for them).

For example, a bankrupt reinsured argued that it was not liable for unpaid premiums under a reinsurance agreement because the contract was lacking in consideration and, therefore, illusory. At issue in this case (*In re: Acceptance Insurance Companies Inc.*) was the meaning of "subject net retained premium," which was a component of "subject ultimate net loss," itself the key term in defining the specific layer of the reinsurer's exposure. "Subject net retained premium" was not defined in the agreement. However, it did include a definition for "subject net retained premium income." The resulting ambiguity served as the basis for the reinsured's attempt to essentially avoid its premium payment obligations. The U.S. Court of Appeals for the Eighth Circuit eventually shot down the argument, but not after it had wound its way through the courts and expert witnesses weighed in on each side.

Intellectual Property & Technology

Massachusetts Revises Identity Theft Regulations

BY PAULA CEDILLO & DAN CRISP

On August 17, 2009, the Massachusetts Office of Consumer Affairs and Business Regulation (OCABR) revised the Commonwealth's identity theft regulations again by extending the effective date to March 1, 2010, and easing compliance requirements for small businesses by clarifying that the regulations are risk-based in implementation, which allows businesses to take into account factors such as the size and scope of the business when developing a written security program. OCABR also amended the definition of "encryption" to be technology neutral and eased third-party service provider requirements by providing a two-year window for compliance and making the requirements consistent with federal law. The original regulations had required businesses to select and retain third-party service providers capable of maintaining safeguards for personal information and to require, via contract, that these service providers maintain such safeguards. Additionally, prior to allowing third-party service providers access to personal information, businesses were to obtain from the service provider written certification stating that the service provider has a written, comprehensive information security program in compliance with Massachusetts identity theft regulations.

Massachusetts working to prevent identity snoops

The Massachusetts regulations compel all businesses to develop, implement, and maintain, a comprehensive, written security program for paper and electronic records that contain personal information about Massachusetts residents. Personal information is defined as a Massachusetts resident's first name or initial and last name combined with a Social Security number, driver's license or state-issued identification card number, credit or debit card number, or financial account number. They also provide for specific security requirements for computer systems such as the encryption of all personal information stored on laptops, flash drives and other portable devices, and all wirelessly transmitted data containing personal information. The text of the regulations can be found at: *http://www.mass.gov/Eoca/docs/idtheft/201CMR1700reg.pdf*.

Special Focus

Task Force on Modernizing Financial Services Regulation

Jorden Burt LLP's Task Force on Modernizing Financial Services Regulation is preparing a series of analyses of recent proposals to address perceived inadequacies in the regulation of various aspects of the financial services industry. These Bulletins discuss certain of the most significant implications of current proposals for the insurance (including reinsurance) and fund industries. For the latest edition, or to review prior editions, please visit the Task Force's web page at *www.jordenusa.com*.

Intellectual Property & Technology

Google's "AdWords" Policy Under Class Action Fire

BY DIANE DUHAIME & JOHN PITBLADO

Google's advertising service, called "AdWords," allows companies to purchase keywords which, when entered in Google's search engine, bring up that company's advertisement in a separately demarcated "sponsored links" portion of a Google search results page. For example, a search in Google on the keywords "roofing materials" produces a Google search results page with a listing of sponsored links advertising companies that sell roofing materials. Many entities have brought suit against Google over its AdWords policy (e.g., GEICO, American Airlines, American Blind and Wallpaper Factory, Flowbee International, Inc., Rescuecom Corp, Rosetta Stone, Stratton Faxon). Nevertheless, Google's AdWords service remains in full force and effect today. Google even recently liberalized the policy in the U.S. to allow some sponsored link ads to use trademarks in the ad text, even when the advertiser does not own the trademark or have express prior approval from the trademark owner to use the trademark.

When the owner of Firepond, a software company in Texas, entered the company's trademark into Google's search engine, its competitors' ads appeared in the sponsored links section of the Google search results page, because those competitors had purchased the keyword "firepond" through Google's AdWords service. Firepond filed suit, styled *FPX, LLC (d/b/a Firepond) v. Google, Inc.*, in the U.S. District Court for the Eastern District of Texas on May 11, 2009, alleging that Google's policy violates the Lanham (Trademark) Act and Texas common law. Firepond filed its lawsuit on behalf of what it claims is a class of similarly situated Texas trademark owners. On May 14, 2009, a similar class action suit was filed, also in the U.S. District Court for the Eastern District of Texas, styled *John Beck Amazing Profits, LLC v. Google, Inc.* This second suit alleges a nationwide class of similarly situated trademark owners. We will publish an update in a future issue of *Expect Focus* should either case obtain class certification.

Will Patents for Financial Services Products be Restricted by the High Court?

BY DIANE DUHAIME & DAN CRISP

On June 1, 2009, the U.S. Supreme Court granted a petition for a writ of certiorari in the case of *In re Bilski* (en banc), to determine if the Court of Appeals for the Federal Circuit was correct when it held that the machine-or-transformation test outlined by the Supreme Court in 1981 (*Diamond v. Diehr*) is the proper test of patentability for a process. As we reported in *Expect Focus* (Vol. I Winter 2009, p. 13) and in a January 29, 2009 client alert, the U.S. Court of Appeals for the Federal Circuit stated that a process tied to a particular machine or transforming an article will generally result in a concrete and tangible result, but the useful, concrete and tangible test is insufficient to determine whether a process is patent-eligible under 35 U.S.C. § 101 and that test was never intended to replace the Supreme Court's machine-or-transformation test. Under the machine-or-transformation test, a process is patentable if it is tied to a particular machine or apparatus or if it transforms a particular article into a different state or thing.

The petition presents two issues:

- Whether a process must be tied to a particular machine or apparatus, or transform a particular article into a different state or thing to be eligible for patent protection; and
- Whether the machine-or-transformation test for patent eligibility contradicts Congressional intent that business methods/processes are entitled to patent protection.

The Supreme Court should issue its decision in 2010.

Providing Investment Advice Under ERISA

BY STEVE KRAUS

Prior to the passage of the Pension Protection Act, insurance companies and others could provide certain non-tailored information to plan participants and beneficiaries under a safe harbor issued by the Labor Department but could not provide particularized information without being exposed to potential fiduciary liability under ERISA. The Pension Protection Act makes a person providing such advice a fiduciary under ERISA but relieves such person of potential liability under the prohibited transaction rules of ERISA, if certain requirements are met.

Delayed again: Effective date pushed to November

On January 21, 2009, the Department published final investment advice regulations providing general guidance with respect to the statutory exemption's requirements. The regulations were originally to be effective March 23, 2009. However, on January 20, 2009, the Obama Administration requested all Agency Heads to consider extending for 60 days the effective date of all regulations published in the Federal Register that had not yet become effective.

In response to this request, the Department delayed the effective date of its investment advice regulations until May 22, 2009. The Department further delayed the effective date of the regulations until November 18, 2009 to allow for the review of additional comments that were received.

On the legislative front, the House Subcommittee on Health, Employment, Labor and Pensions considered a bill (H.R. 1988) that would revoke the investment advice legislation contained in the Pension Protection Act and require investment advice to plan participants be provided only by independent investment advisers, as defined in the legislation. The bill was reported to the House Committee on Education and Labor on June 17, 2009 for its consideration.

The prospects for this legislation are unclear, as is what the final rules for the provision of investment advice to plan participants and beneficiaries will be.

Evergreen Charged With Overvaluing Securities

BY SARAH JARVIS

Evergreen Investment Management Company, LLC and an affiliated broker-dealer were charged by the SEC in an enforcement action with violating numerous provisions of the securities laws by overstating the "fair value" of mortgage-backed securities held by its mutual fund, the Ultra Short Opportunities Fund. The SEC found that the value of the Fund was overstated by as much as 17% in 2007 and 2008 due to Evergreen's improper valuation practices which included failing to take into account readily available information on the assets of the Fund and withholding negative information from the committee responsible for valuing the assets. According to the SEC, Evergreen committed fraud under Section 206(2) of the Advisers Act by charging advisory fees based on an overstated NAV and violated Rule 22c-1(a) under the Investment Company Act by selling and redeeming shares at prices not based on NAV.

The SEC also found that once the valuation problems were discovered and the holdings were being re-priced, Evergreen disclosed material, nonpublic information on the problems to only select shareholders of the Fund, which would have enabled them to cash out of the Fund before additional re-pricing of the shares caused the value to further decrease. Evergreen also allegedly violated provisions of the Advisers Act and the Exchange Act by failing to have written policies and procedures reasonably designed to prevent such misuse of material, nonpublic information. Additionally, the SEC found that Evergreen engaged in prohibited cross-trades by causing other Evergreen funds to purchase securities from the Fund.

Without admitting or denying the SEC's findings, Evergreen agreed to pay more than $40 million in compensation to shareholders, penalties and disgorgement of ill-gotten gains in order to settle the case, as well as a related enforcement action by the Massachusetts Securities Division.

Fourth Circuit Reverses Dismissal of Fraud Suit Against Investment Adviser

BY STEPHANIE FICHERA

In *In re Mutual Funds Investment Litigation*, the U.S. Court of Appeals for the Fourth Circuit reversed and remanded a district court's dismissal of a putative class action complaint brought by shareholders of a publicly traded asset management firm against the firm and one of its subsidiaries, a mutual fund adviser, for damages allegedly caused by misleading disclosures in the defendants' mutual fund prospectuses. The plaintiffs alleged that the defendants' prospectuses contained misleading statements relating to their policies for prohibiting and preventing market timing trading in their mutual funds and fraudulently induced investors to invest in the funds. Contrary to the statements contained in the prospectuses, the funds' managers allegedly permitted significant market timing transactions to occur.

The issues on appeal involved whether the complaint sufficiently alleged reliance and causation to maintain a cause of action for securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5. The court held that the complaint sufficiently alleged fraud-on-the-market reliance against the fund adviser because interested investors relied on misleading statements in the prospectuses, which were made available to the public. In addition, because the prospectuses listed the adviser's duties to the fund and stated that it provided advice and recommendations relating to the fund's investments, they were deemed attributable to the adviser. The court also held that the plaintiffs sufficiently pled causation against the adviser, reasoning that the decrease in the value of the parent firm's stock that occurred when the fraud was publicly revealed indicated a link between the misleading prospectuses and stock value.

The court declined to allow the fraud-on-the-market claim against the parent firm to go forward on the grounds that the firm's role in disseminating the prospectuses on its website was not a sufficient basis for investors to infer that the firm had prepared and approved them. The plaintiffs, however, adequately alleged a claim of control person liability against the parent firm due to the fact that it wholly owned and shared management with its subsidiary fund adviser and had the authority to regulate the adviser's market timing activities.

FinCEN Wants to Regulate Mutual Funds as BSA Financial Institutions

BY KAREN BENSON

FinCEN has issued a Notice of Proposed Rulemaking that would define mutual funds as "financial institutions" under rules implementing the Bank Secrecy Act (BSA). As such, mutual funds would become subject to rules requiring the filing of currency transaction reports (CTRs) and the creation, retention, and transmittal of records or information on transmittals of funds and other specified transactions.

Mutual funds currently file reports on IRS/FinCEN Form 8300 for the receipt of more than $10,000 in currency. The proposal would instead require funds to file CTRs on FinCEN Form 104. Both forms document a transaction in currency over $10,000, but differ in some technical respects.

One notable difference between the forms is the definition of "currency." Both forms define "currency" to include cash, but Form 8300 also defines "currency" to include certain monetary instruments such as cashier's checks, bank drafts, traveler's checks, and money orders with a face amount of $10,000 or less. By moving to the CTR filing requirement, mutual funds would no longer have to report transactions involving such instruments

The proposal also would subject mutual funds to the Travel Rule and related recordkeeping requirements in 31 CFR 103.33. The Travel Rule requires a financial institution to obtain and retain certain information relating to transmittal of funds of $3,000 or more, and that this information be passed along to other financial institutions in the payment chain. The amount and type of information a financial institution must obtain, retain, and/or transmit depends upon its role in the funds transfer process. Additionally, mutual funds would be required to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities, and credit.

The rule proposal is available at *www.FinCEN.gov*. The comment period expires on September 3, 2009.

President Sends Congress Private Fund Adviser Legislation

BY ED ZAHAREWICZ

The Obama Administration has sent Congress draft legislation that would require advisers to certain types of private investment funds, including hedge funds, private equity funds, and venture capital funds, to register with the SEC under the Investment Advisers Act of 1940. The proposed Private Fund Investment Advisers Registration Act of 2009 follows the recommendations outlined in the Treasury Department's recent white paper on financial regulatory reform and is modeled after the Private Fund Transparency Act of 2009, S. 1276, introduced by Senator John Reed in June.

The President's legislation would require registration by removing the current exemption for private fund advisers and by excepting private fund advisers from the current exemption for intrastate advisers. It also would add a new exemption for "foreign private advisers," which would include any adviser who has no place of business in the United States and who during the preceding 12 months has had fewer that 15 clients in the United States and less than $25 million in assets under management attributable to such clients. In addition, the legislation contains provisions that would:

- Authorize the SEC to require advisers to keep such records of and submit such reports regarding their "private funds" "as are necessary or appropriate in the public interest and for the assessment of systematic risk" by the Board of Governors of the Federal Reserve System and the President's proposed Financial Services Oversight Council, and to make available to such Board and Council those reports and records or the information contained therein.

Advisers get lots more paperwork in new legislation

- Require that the requisite records and reports include, at a minimum, the following information for each private fund: amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices.
- Subject all records regarding an adviser's private funds to such periodic, special, and other examinations as the SEC may prescribe.
- Require advisers to provide "such reports, records and other information to investors, prospective investors, counterparties, and creditors," of their private funds as the SEC may prescribe by rule "as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk."
- Permit information required to be filed with the SEC regarding private funds to be shared with Congress and any federal agency or self-regulatory organization requesting the information for purposes within the scope of its jurisdiction.
- Clarify the SEC's rulemaking authority, including the authority of the SEC to ascribe different meanings to terms (including the term "client") used in different sections of the Advisers Act.

The proposed legislation surprised some for its scope, covering not only hedge fund advisers but also advisers to private equity funds and venture capital funds, as well as potentially offshore funds with investors in the United States. It also has raised a number of issues. For example, some have expressed concern over the proposed authority of the SEC to meddle in the affairs of private funds by mandating reports and other disclosures to "investors, prospective investors, counterparties, and creditors," while others have expressed concern that the legislation does not do enough to protect proprietary information that private funds may be required to provide in reports filed with the SEC. It remains to be seen how the legislation will be received by Congress.

Broker-Dealers Eye Proposed Consumer Agency

BY TOM LAUERMAN

The Obama Administration in July published draft legislation that would establish a Consumer Financial Protection Agency (CFPA) to regulate a wide variety of financial products and services that are provided to a consumer primarily for personal, family, or household purposes.

The draft legislation specifically would not apply to SEC-regulated broker-dealers, investment advisers, or investment companies. (And there is a comparable exclusion for CFTC-regulated entities.) However, this exclusion applies only to the extent that the SEC/CFTC-regulated entity is acting "in a registered capacity," and it is very unclear what "in a registered capacity" means for this purpose.

For example, the draft legislation would cover many products and services that are not central to the business of most broker-dealers, such as:

- issuing and servicing, consumer loans, and credit cards;
- money transfer, check guarantee, and bill payment services;
- debt counseling and credit repair;
- credit insurance, life insurance, and mortgage insurance; and
- tax preparation.

Legislation covers products beyond usual broker-dealer business

If an SEC-regulated broker-dealer were to conduct any of these activities, could it be deemed to be doing so "in a registered capacity" and thus escape regulation by the CFPA? Would the answer be different for services that are more central to the business of broker-dealers? For example, the CFPA also would generally regulate the provision of financial advisory services, including educational courses and instruction materials on individual financial management matters, and tax planning services, unless such services were rendered by the broker-dealer in its registered capacity.

If the draft legislation were enacted in its current form, potentially difficult jurisdictional questions of this type would abound. These questions would be of considerable importance because the regulatory scheme administered by the CFPA could potentially be highly substantive and thorough.

FINRA Revises Proposed Rumor Rule

BY PATRICK LAVELLE

On June 1, 2009, the Financial Industry Regulatory Authority re-proposed its anti-rumor rule in Notice 09-29. Proposed Rule 2030 would prohibit member firms from circulating rumors about securities they know (or have reasonable grounds to believe) are false or misleading and likely to impact the price of the security. Also, the member would have to report any such rumor to FINRA, if the member knows or has reasonable grounds to know that the rumor was originated or circulated for the purpose of improperly influencing the market price of a security.

The new proposal is similar to a widely-criticized earlier proposal, issued in November 2008, with some important distinctions. For example, the new proposal includes additional supplemental material to the effect that a statement is not considered a rumor "if it is clearly an expression of an individual's or firm's opinion, such as an analyst's view of the prospects of a company."

The supplemental material also carves out three exceptions that were not found in the earlier proposal:

- A rumor published by widely-circulated public media may be discussed, provided its source and unsubstantiated nature are disclosed.
- A rumor may be discussed among market participants, when necessary to explain market or trading conditions.
- Associated persons of a member may discuss a rumor among themselves, in order to evaluate the truthfulness of the rumor, provided its source and unsubstantiated nature are disclosed.

The new proposal also adds a requirement that member firms adopt written policies and procedures concerning how they will identify and respond to rumors.

Broker-Dealer Anti-Money Laundering SAR Decisions May Be Second-Guessed

BY KAREN BENSON

Will the examiner second-guess a decision not to file a suspicious activity report (SAR)? Securities regulators frequently hear that question in connection with examining broker-dealers' suspicious activity reporting programs. The Staffs of the SEC and FINRA recently addressed this subject in an article published in the Financial Crimes Enforcement Network's (FinCEN's) 15th Issue of The SAR Activity Review – Trends, Tips & Issues.

Not so fast, Sherlock!

The article states that examiners will accept a broker-dealer's decision not to file an SAR, if the broker-dealer demonstrates that it had reasonable risk-based controls and a reasonable decision-making process, and the examiner finds that the broker-dealer's decision not to file an SAR was reasonable under the circumstances. This standard seems to afford examiners considerable discretion to substitute their own judgment for that of the broker-dealer being examined as to the reasonableness of a particular SAR decision.

In contrast, FinCEN and federal bank regulators have articulated standards that seem to leave examiners less discretion. Too much examiner second-guessing promotes "defensive" SAR filings that are filed out of an overabundance of caution. FinCEN and the federal bank regulators have concluded that the relevant regulatory objectives are best served by having a smaller pool of SAR filings that are relatively "actionable," rather than a larger pool of filings, many of which are primarily defensive in nature.

It is not entirely clear whether SEC and FINRA examiners are in fact exercising more discretion concerning SARs than FinCEN and the bank regulators believe is appropriate or, if so, why. Nevertheless, in anticipation of possible second-guessing by examiners, broker-dealers will want to ensure that they have an established SAR decision-making process that is well documented, particularly in circumstances where a decision is made not to file an SAR, and that they are following their policies and procedures.

More Pressure on Payments for Pension Fund Business

BY LIAM BURKE

The SEC, expanding on an investigation being conducted by it and the New York Attorney General, recently asked over two dozen financial firms, pension fund managers, and placement agents for information concerning finders' fees and other similar payments, as well as the services that are performed in exchange for the payments. Among other things, the SEC is investigating whether such payments may represent an improper means to help investment managers secure pension fund business. The firms the SEC has contacted reportedly include Goldman Sachs, Credit Suisse, UBS, and Bank of America Merrill Lynch.

This comes in the wake of recent charges of a criminal "kickback" scheme to which certain individuals already have pleaded guilty in connection with the New York State Common Retirement Fund, which is New York's largest pension fund. Also, private-equity firm Carlyle Group agreed to a $20 million settlement payment as well as an overhaul of how it does business with state pension funds. Similarly, at least one other pension fund manager has agreed to return fees it earned in connection with an investment it received from the New York State Common Retirement Fund.

Additionally, the SEC recently proposed a rule under the Investment Advisers Act that would, among other things, bar any person from serving as an investment adviser to a pension fund (or other government client) for a period of two years after that manager or certain of its related persons had contributed to any political campaign of an individual that oversees the fund. Regardless of whether the proposed rule becomes final, the SEC clearly has a strong and continuing interest in keeping up the pressure to ensure that firms selected to manage pension assets are chosen by virtue of their merits, rather than any improper payment or a "pay to play" scheme.

FINRA Seeks Expanded Suitability Jurisdiction

BY MARILYN SPONZO

In its recent proposal to consolidate NASD and NYSE suitability rules and adopt the NYSE know-your-customer requirement (FINRA Regulatory Notice 09-25), FINRA would significantly expand broker-dealers' suitability obligations. Moreover, in the ongoing regulatory scrimmage about broker-dealers and investment advisers, the proposal seems a transparent attempt by FINRA to assert jurisdiction over certain investment advisory activities.

Know-your-customer requirements expanding

The proposed suitability rule would require a broker-dealer to have a reasonable basis to believe that a recommended transaction or investment strategy involving a security is suitable. While FINRA cites current interpretive material regarding suitability obligations to institutional customers (IM-2310-3) as precedent, it ignores the explicit application of the current NASD suitability rule solely to transactions, i.e., the recommended purchase, sale or exchange of any security. To compound this jurisdictional scope-creep, FINRA also seeks comment on whether it should propose expanding suitability obligations to all recommendations of investment products, services and strategies, regardless of whether they involve securities.

Additionally, the proposed suitability rule would expand the information a firm must consider in determining suitability to include age, other investments, investment experience, time horizon, liquidity needs, and risk tolerance. The suitability analysis would need to consider not only information disclosed by the customer to the registered representative making the recommendation, but also other information about the customer that is known by the broker-dealer.

Finally, in proposing the adoption of the current NYSE know-your-customer rule, FINRA would require firms to use due diligence, in regard to the opening and maintenance of every account, to know essential facts concerning every customer. The obligation would arise at the beginning of the customer/broker relationship, regardless of whether a recommendation has been made, and would continue through the relationship, regardless of whether transactions were effected.

Broker-Dealers Probe Reps' Personal Affairs

BY ANN FURMAN

Growing bank accounts, luxury vehicles, exotic vacations, expensive jewelry, and an extravagant lifestyle are several examples of red flags that an investment adviser or registered representative may be living beyond his or her means, particularly when increasing expenses are coupled with declining commissions.

David McMillan, a former registered representative of Royal Alliance Associates, Inc., operated a one-man satellite office in Bullhead City, Arizona. McMillan defrauded at least 28 investors in a classic Ponzi scheme. He told his clients that he was investing their money in particular investments, but instead used the money for his own use and to repay other investors.

Even though Royal Alliance prohibited registered representatives from depositing client checks into bank accounts owned or controlled by the registered representative, the broker-dealer did not have supervisory policies and procedures in place requiring review of bank records and addressing red flags. In a recent enforcement action, the SEC determined that a substantial drop in McMillan's commissions coupled with continuing high expenses was a red flag and imposed a penalty on Royal Alliance of $500,000 for its failure to implement an adequate supervisory system.

Some broker-dealers are taking to heart the lessons learned from the Royal Alliance penalty and other post-Madoff Ponzi schemes uncovered by the SEC. For example, as part of enhanced procedures to supervise registered representative expenses, a Minnesota-based broker-dealer announced that it monitors the financial circumstances of its registered representatives, as well as their spouses and "significant others."

Eleventh Circuit Takes Aim At CAFA Removals

BY JONATHAN HART

The Eleventh Circuit's recent decision in *Thomas v. Bank of America Corp.* evidences the wide gap that has developed between that Circuit and other federal circuits regarding removals under the Class Action Fairness Act. The *Thomas* court relied on *Lowery v. Ala. Power Co.*, and held that "[a] case does not become removable as a CAFA case until a document is 'received by the defendant from the plaintiff — be it the initial complaint or a later received paper … that unambiguously establishes federal jurisdiction.'" The court clarified: "In other words, a defendant may not simply file a notice of removal thirty days after the filing of the complaint unless that document shows that the CAFA's jurisdictional requirements … are met."

Eleventh Circuit diverges from other circuits' decisions

The *Thomas* complaint sought recovery of premiums paid for credit protection plans, as well as treble damages and attorney's fees under RICO, but did not estimate the number of class members or the amount in controversy. Bank of America's removal was supported by a declaration stating that it had enrolled 77,787 customers and collected $4,825,809 in fees for the credit protection plans. It argued that the estimated number of class members and total premiums collected, coupled with the claims for treble damages and attorney's fees, established CAFA's requirements. The district court ordered the case be remanded and the Eleventh Circuit affirmed, finding that Bank of America failed to satisfy CAFA's amount in controversy and size requirements.

Under the Eleventh Circuit's approach, CAFA removals are likely to become very rare, if not extinct, standing Congress' purpose in enacting CAFA on its head. The Eleventh Circuit's standard also is in stark contrast to that of other circuits. For example, the Seventh Circuit recently held in *Spivey v. Verture, Inc.*, that "[o]nce the proponent of federal jurisdiction has explained plausibly how the stakes exceed $5 million, then the case belongs in federal court unless it is legally impossible for the plaintiff to recover that much."

Assumptions Sink CAFA Removal

BY JAMES KIRTLEY, JR.

In *Bartnikowski v. NVR Inc.*, a wage and hour employment class action brought under state law, the Fourth Circuit Court of Appeals held that the employer/defendant failed to satisfy the amount in controversy requirement for federal removal jurisdiction under the CAFA because the employer relied upon unsupported assumptions as to the average hours of overtime worked per week by the putative class of employees. The *Bartnikowski* plaintiffs had not specified the amount of damages in their complaint, and therefore the employer had the burden of showing the jurisdictional threshold was met. In attempting to do so, the employer extrapolated the number of overtime hours class members allegedly worked by looking to one plaintiff's declaration in an unrelated lawsuit that he had worked an average of five extra hours per week. The employer argued that if all class members had worked an average of five hours of overtime per week, then the amount in controversy would be satisfied. The court of appeals rejected this approach, reasoning that the employer's "calculations" were wholly unsupported, as there were no records or other evidence suggesting the five-hours-per-week average was a reasonable assumption. The court pointed out that the employer might be able to remove the case at a subsequent stage in the litigation because Congress eliminated the one-year time limitation on removals under CAFA. One member of the panel dissented, arguing that "the five-hour estimate is not so speculative as to not even require a response from [the plaintiffs]." The dissenting judge took the view that the employer had made a prima facie showing removal was proper and it was now up to the plaintiffs to come back with rebuttal evidence demonstrating otherwise.

Unsupported assumptions of overtime approach rejected

Administration Proposes "Plain Vanilla Products"

BY ELIZABETH BOHN

The Obama Administration wants to require consumer financial service industry providers to offer simplified "plain vanilla" products; its proposed Consumer Financial Protection Agency (CFPA) may set new rules requiring them to do so.

The CFPA would be established by the Consumer Financial Protection Agency Act of 2009 (the Act), recently delivered by the Administration to Congress as part of its plan to restructure financial services regulation by year end. The CFPA would be charged with protecting consumers of "credit, payment and other consumer financial products and services" from "abuse, unfairness, deception or discrimination and regulating such products and services." "Any person who engages directly or indirectly in financial activity, in connection with a consumer financial product or service" would be covered by the proposed Act.

The CFPA would have sole authority to promulgate and interpret regulations under existing consumer financial services and fair lending statutes such as TILA, ECOA, and the FDCPA. The CPFA would also have supervisory, examination and enforcement authority over all persons covered by the statutes it would implement and would create a "floor" for consumer protection, with its rules overriding weaker state laws, but leaving states free to enact stronger measures. To promote simplicity, fairness and transparency in consumer transactions, the act would authorize the CFPA to define standards for "plain vanilla" products that are "simpler and have straightforward pricing," and "require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer."

The "plain vanilla products" proposal responds to complaints by consumer rights advocates that consumers have been harmed by complicated products and confusing fee and penalty practices. However, one size does not fit all, and the cost involved in forcing industry to provide "plain vanilla products" may ultimately limit access to credit which the current variety of consumer financial products has provided.

The CFPA also is proposed to have authority to "place tailored restrictions on product terms and provider practices" … "where efforts to improve transparency and simplicity have proved inadequate to prevent unfair treatment and abuse, if the benefits of such restrictions outweigh the costs." In light of such potential restrictions on product terms, forcing the industry to offer "plain vanilla" products as well might be viewed as excessive.

TILA Disclosures Must Be "Clear and Conspicuous"

BY ANDRES CHAGUI

In *Barrer v. Chase Bank USA*, the Ninth Circuit recently explained that disclosures in credit card agreements must be "clear and conspicuous" to comply with the Truth in Lending Act. The suit, filed in the District Court for Oregon, complained that Chase did not disclose that if a cardholder's credit report revealed certain "risk factors" Chase could increase the cardholder's Annual Percentage Rate. The complaint alleged that Chase raised plaintiffs' APRs on their outstanding loan balances from 8.99% to 24.24% based on adverse information obtained by Chase from a credit report. The district court granted Chase's motion to dismiss the class action complaint.

The Ninth Circuit reversed, explaining that, even if Chase could not know what the potential increased rate would be when it made its original disclosures, TILA still required Chase to "provide an explanation of the specific event or events that may result in the increased rate." The court added that Regulation Z, which elaborates on TILA's requirements, requires creditors to make disclosures "clearly and conspicuously." It explained that "clear and conspicuous disclosures … are disclosures that a reasonable cardholder would notice and understand" and that although "[n]o particular kind of formatting is magical … the document must have made it clear to a reasonable cardholder that Chase was permitted under the agreement to raise the APR … for any reason at all." Chase's disclosures were not clear and conspicuous, the court concluded, because the change-in-terms provision of the agreement was "buried too deeply in the fine print" for a reasonable cardholder to realize that Chase could raise the APR for reasons other than those listed in the agreement. Accordingly, the circuit court found that plaintiffs had stated a claim and reversed the district court's dismissal order.

Coming Soon: New FCRA Reporting Rules

BY ELIZABETH BOHN

The FTC and bank regulators recently published Final Rules, required by the Fair and Accurate Credit Transactions Act amendments to the Fair Credit Reporting Act. The Rules seek to enhance the accuracy and integrity of information in consumer reports, and to identify circumstances under which entities that furnish the information (Furnishers) to consumer reporting agencies (CRAs), will be required to investigate disputes about the accuracy of information at the consumer's direct request. The Final Rules take effect on July 1, 2010. Some noteworthy new features are as follows:

Accuracy and Integrity Regulations. Furnishers must establish, implement, and regularly update reasonable written policies and procedures regarding the accuracy and integrity of the information they report to CRAs that are appropriate to and reflect their business activities, the nature and frequency of information they report, and the technology they use for that purpose. "Accuracy" is defined to mean that information provided must correctly reflect the terms of and liability for the account, the consumer's performance with respect to the account, and the consumer's identity. "Integrity" is defined to mean that information provided must be substantiated by the Furnisher's records, provided in a form and manner designed to minimize the likelihood that it will be reflected incorrectly in a consumer report, and include information whose absence would mislead users in evaluating creditworthiness.

Direct Dispute Rule. Furnishers also will be required to investigate disputes received directly from consumers about the accuracy of reported information relating to the liability on their accounts, account terms, balances, potential identify theft, and "any other information contained in a consumer report regarding the consumer's relationship with the furnisher which "bears on the consumer's creditworthiness, credit standing, [and] character." The Furnisher must report the results of its investigation to the consumer within 30 days of receiving the consumer's written dispute notice.

Arbitration Roundup

BY LANDON CLAYMAN

Continuing its recent extraordinary interest in issues involving the Federal Arbitration Act, the U.S. Supreme Court has granted the petition for writ of certiorari in *Stolt-Nielsen S.A. v. Animal-Feeds International Corp.* to consider whether the FAA permits class arbitration to be imposed when the arbitration agreement is silent on the question. *Stolt-Nielsen* presents the Court with an opportunity to resolve the uncertainty in the lower courts following its 2003 decision in *Green Tree Financial Corp. v. Bazzle*, in which a plurality of the Court held that the arbitrator must in the first instance decide as a matter of state law whether class arbitration is permissible despite the agreement's silence. Since *Bazzle*, there have been numerous decisions by arbitrators, primarily in consumer arbitrations, allowing class arbitrations despite "silent" clauses. Some courts, including the Second Circuit in the *Stolt-Nielsen* case, consider *Bazzle* to have ruled that the FAA does not prohibit class arbitrations when the agreement is silent. Other courts have ruled that *Bazzle* did not reach the issue, and have held that the FAA prohibits a class arbitration unless the agreement expressly allows it. This important issue of whether the FAA requires affirmative evidence of intent to permit class arbitration now will be addressed by the Supreme Court.

AAA cutting out new credit card arbitration

Consumer arbitrations continue to come under fire in various ways. There are legislative proposals in Congress to invalidate every pre-dispute contractual arbitration agreement requiring arbitration of employment, consumer, or franchise disputes. As part of a settlement with the Minnesota Attorney General, the National Arbitration Forum, a major administrator of consumer arbitrations, has ceased to administer consumer arbitration disputes. And the American Arbitration Association, the world's largest provider of ADR services, has announced that, pending its determination that "broadly acceptable due process protocols specific to these cases are in place," it will not accept new consumer debt collection arbitration filings in which the consumer has not agreed to arbitrate at the time of the dispute, and the dispute involves a credit card or telecom debt, or a consumer finance matter.

NEWS & NOTES

Speeches and Publications

Joan Boros recently wrote “Synthetic Annuities” which was published in the *ALI-ABA Business Law Course Materials Journal*. The article is available on our website, *www.jordenburt.com.*

The ALI-ABA Conference on Insurance and Financial Services Industry Litigation was held July 9-10, 2009 in Boston, MA. Managing Partner **James F. Jorden** is the planning chair for this conference. Partners **Wally Pflepsen**, **Gary Cohen**, and **Stephen Jorden** served as faculty. Mr. Cohen moderated a panel on “The Litigation Impact of Rule 151A Adoption and the Continuing Regulatory Battles over Suitability Standards between ‘Securities’ Regulation and ‘Insurance’ Regulation.” Mr. Pflepsen spoke on a panel on “Retirement Plan, ERISA, and Related Litigation Developments”, and Mr. Jorden presented a panel on “The Developing Law of Standards for Class Certification.”

The 2009 NAVA Operations & Technology Conference was held June 28 through July 1, 2009 in Boston, MA. Washington partner **Michael Kentoff**, who serves on the planning committee for this conference, moderated a panel on “Defending the Castle: Why You Must Know How to Authenticate E-Documents.” **Gary Cohen** discussed Indexed Annuities on a separate panel.

Connecticut partners **James Sconzo** and **Thomas Finn** were featured in a panel at the Connecticut Bar Association’s Annual meeting on June 8, 2009. The topic was “Navigating the Minefield of Investigations and Whistleblower Protections.” Mr. Sconzo moderated and Mr. Finn was featured as a panelist.

Washington partners **Richard Choi** and **Jason Gould,** and Miami partner **Enrique Arana** spoke at the NAVA Government & Regulatory Affairs Conference in Washington, DC June 7-9, 2009. Mr. Choi was the moderator for a discussion of SEC Regulation and Rulemaking. Mr. Gould moderated an Annuity Litigation Update and Mr. Arana spoke on the Annuity Litigation Update.

Congratulations!

Rollie Goss, Partner in the Washington office, has been named a contributing editor to Harris Martin’s Reinsurance Report. His regular articles will appear in their publication as well as on Jorden Burt’s reinsurance blog, *www.reinsurancefocus.com*.

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