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EXPECT FOCUS®

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SEC Brings Broker-Dealer Electronic Recordkeeping Rules Out of Deep Freeze

BY ANN FURMAN

More than 25 years have elapsed since the SEC adopted Exchange Act Rule 17a-4(f) governing electronic recordkeeping by broker-dealers. In an effort to update the rule to reflect "technology neutral" concepts, the SEC adopted amendments to the rule that became effective on January 3, 2023.

Since its adoption in 1997, the rule has reflected the predominant "electronic storage media" of that time—optical platters, CD-ROMs, or DVDs. The amended rule replaces the concept of "electronic storage media" with a concept of "electronic recordkeeping system," which means a system of preserving records in "a digital format in a manner that permits the records to be viewed and downloaded." The amended rule, however, also retains the concept of "micrographic media," including microfiche and microfilm.

In addition to making the rule more technology neutral, the amendments modernize the rule by:

- Eliminating a requirement that a broker-dealer notify its "designated examining authority" before employing an electronic recordkeeping system;
- Adding a time-stamped "audit-trail" alternative to the "write once, read many" (WORM) requirement. Under the audit-trail alternative, a broker-dealer's electronic recordkeeping system must be able to maintain and preserve electronic records in a manner that permits the recreation of an original record if it is modified or deleted;
- Modifying certain required undertakings to make them more technology neutral and to provide certain alternatives for who must make those undertakings and the substance thereof, subject to specified conditions; and
- Expanding alternatives for the current requirement to retain a duplicate set of records to include: (a) a backup electronic recordkeeping system that meets the other requirements of the rule and retains the records in a manner that will serve as a redundant set of records if the original electronic recordkeeping system is temporarily or permanently inaccessible; or (b) other redundancy capabilities that are designed to ensure access to the required records.

The SEC release adopting amendments to Rule 17a-4(f) also adopted similar changes to Exchange Act Rule 18a-6 governing electronic recordkeeping for records preserved by security-based swap dealers and major security-based swap participants.

As a result of the modernized rule, broker-dealers have until May 3, 2023, to evaluate their current electronic recordkeeping policies and procedures and revise their electronic recordkeeping systems as needed.

SEC Would Mandate Swing Pricing

Badly Upending Most Funds' Procedures

BY TOM LAUERMAN

In November 2022, the SEC published a proposal that would mandate "swing pricing" procedures for the purchase and redemption of shares of most open-end investment companies. The proposal, however, does not apply to exchange-traded funds, money market funds, or feeder funds in master-feeder arrangements.

The SEC discussed the market disruptions that occurred in March 2020, which caused reduced liquidity in certain types of funds and, according to the SEC, demonstrated the need for the proposed procedures. The basic aim of the swing pricing proposal is to pass costs resulting from shareholder purchase or redemption activity on to the shareholders engaging in that activity, thus reducing the possibility of unfair dilution of other shareholders' interests in the fund. (Although the SEC also proposed refinements to its requirements for fund liquidity risk management programs, those liquidity proposals are not within the scope of this article.)

The November 2022 swing pricing proposal is similar to, but also in important ways different from, both (a) the optional swing pricing procedures that the SEC authorized for most open-end investment companies in 2016, and (b) the mandatory swing pricing requirements that the SEC proposed for institutional money market funds in 2021. The substance of those 2016 procedures received a cold shoulder from the industry, as no funds have opted to implement them. The SEC's 2021 swing pricing proposal for money market funds also generated significant adverse comments from industry sources, and the SEC has not yet taken further action thereon.

The Terms of the SEC's Proposal

The types of funds to which the November 2022 swing pricing proposal applies (Funds), would be required to make extensive and fundamental changes in the way they price and implement purchases and redemptions of their shares. To summarize (very briefly), this would require Funds to:

- **Implement a "hard close" procedure** under which, in order to be effected at a given net asset value (NAV), a purchase or redemption order must be received by the Fund, its transfer agent, or a registered clearing agency (and not merely by some other authorized intermediary) by the time as of which the NAV is struck. This procedure is intended to provide more reliable and timely information about fund inflows and outflows than Funds currently can obtain. On the other hand, the SEC's Chief Economist and Director of the Division of Economic and Risk Analysis has expressed her view that the most significant costs of the proposal – which would be borne by investors – would likely stem from this hard close requirement.
- **Have a "swing pricing administrator"** who could be the Fund's investment manager or an individual or group of persons. However, no portfolio manager of the Fund may serve in a swing pricing administrator role, although a portfolio manager may provide input to the swing pricing administrator.
- **Adjust its NAV by a "swing pricing factor"** for any day when (a) it has net purchases that exceed 2% of its net assets (or such lower percentage as the swing pricing administrator determines, subject to certain conditions imposed by the proposal), or (b) it has any amount of net redemptions.
  - **The "swing pricing factor" must reflect** the swing pricing administrator's good faith estimate, based on supporting data, of the costs the Fund would incur if it sold or purchased a pro rata amount of

each investment in its portfolio (i.e., a "vertical slice" of the portfolio) equal to the amount of the day's net redemptions or purchases. For this purpose, the swing pricing administrator must consider:

- brokerage commissions, spread costs (subject to certain exceptions), and certain other costs associated with purchases or sales of Fund portfolio assets; and
- the market impact of such purchases or sales, except that market impact associated with a day's net redemptions need be considered only if those redemptions exceed 1% of the Fund's net assets (or such lower percentage as the swing pricing administrator determines, subject to certain conditions imposed by the proposal).

- **Report their swing factor adjustments publicly** on Form N-PORT.

A Fund's board, including a majority of its directors who are not interested persons of the Fund, would be required to approve the Fund's swing pricing policies and designate the swing pricing administrator. The board also would be required to review, at least annually, a written report prepared by the swing pricing administrator.

Alternatives to the SEC's Proposal

The SEC requested commenters to address whether any of three possible alternatives to its proposed hard close requirement would be able to generate sufficient investor flow information to effectively implement the swing pricing proposal:

1. requiring intermediaries (e.g., broker-dealers, banks, and retirement plan record-keepers) to provide Funds, either before the Fund's pricing time or a set time thereafter, with a daily estimate of the orders the intermediary will place with the Fund for that day;
2. allowing Funds to estimate their orders for each day by, for example, developing models that incorporate the information available to them, as well as historical order flow information; or
3. requiring intermediaries to provide their orders to a designated party within a limited time period (e.g., two or three hours) after a Fund's pricing time for the day.

The SEC also requested commenters to address two possible alternatives to swing pricing:

1. "liquidity fees" that Funds could assess at different rates for purchase and redemption transactions on a given day; or
2. "dual pricing" structures under which Funds could quote a NAV for purchases on a given day that differs from the NAV for redemptions on the same day.

Such liquidity fee or dual pricing arrangements could result in a more precise allocation of transaction-related costs, because they permit a different allocation of those costs as between Fund share purchasers on a given day and Fund share redeemers on that day.

Particular Issues for Variable Insurance Products

The November 2022 proposal has generated a decidely icey reaction from industry sources. It has been controversial even within the SEC itself, with the SEC's two Republican members having published written dissents from the proposal.

The proposal could have especially significant implications for underlying Funds that support variable insurance products. For example, the "hard close" component could be interpreted to overturn the long-standing SEC staff position that allows Fund share orders placed by insurance company separate accounts after a 4:00 p.m .closing time on a given day to nevertheless receive that day's 4:00 p.m. NAV, so long as the orders correspond to variable contract owner orders received prior to that time. Indeed, the SEC specifically requested comment on whether certain relief from the proposals' requirement would be appropriate for transactions in Fund shares by an insurance company separate account. In this regard, even if Fund swing pricing administrators were permitted to use estimates of the amount of Fund net purchases and redemptions for each day, it may be especially difficult for such administrators to reasonably make such estimates if (a) the Funds are unaffiliated with the insurance companies placing the orders, and (b) the orders continue to be submitted by the insurance companies after the 4:00 p.m. closing time each business day.

In any event, implementing the swing pricing procedures in the SEC's November 2022 proposal in its current form would require such fundamental changes in their operating procedures that insurance companies and underlying Funds will undoubtedly continue to strenuously resist this proposal.

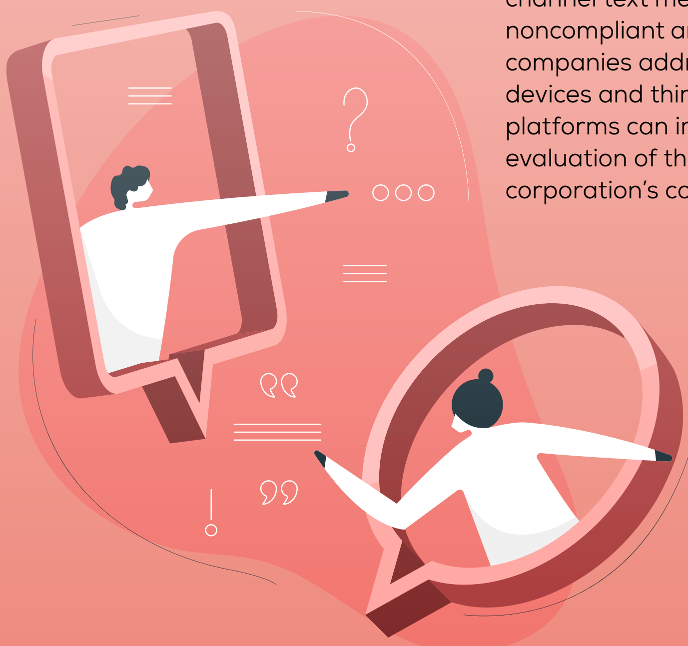
SEC and CFTC Fines for Texting Augur Billions More from DOJ

BY MICHAEL YAEGER AND TINO LISELLA

In September 2022, the SEC and CFTC fined some of the largest financial services firms in the world approximately $1.8 billion for texting. Specifically, for failing to maintain or preserve "off-channel communications" on platforms such as WhatsApp. The DOJ's new policies regarding corporate violations disapprove of unpreserved texts and ephemeral messaging on personal devices, and suggest the DOJ will impose similar penalties for off-channel texting.

A number of large financial institutions paid $125 million each to the SEC and $75 million each to the CFTC, for a total of $200 million per firm for record-keeping violations. In fact, even the procedural violations were somewhat ethereal, as the SEC orders described them with language such as "[the firm] *likely* deprived the Commission of these off-channel communications in various investigations" (emphasis added).

Not that technical violations were absent. The financial services firms apparently did not comply with Section 17(a) of the Exchange Act and Rule 17a-4(b)(4), which require broker-dealers to preserve originals of all communications received and copies of all communications sent relating to their business for at least three years. Still, the fines are far beyond any previously meted out for record-keeping violations, and appear especially severe, given that the regulators allege no specific harm to customers.



The significance of the SEC and CFTC orders extends beyond the regulatory realm into criminal law, as the DOJ has already announced its intent to explore similar territory. And there's virtually no daylight between the expectations of the DOJ and those of the SEC and CFTC. In a memo setting out the DOJ's new policies, Deputy Attorney General Monaco states, "The ubiquity of personal smartphones, tablets, laptops, and other devices poses significant corporate compliance risks, particularly as to the ability of companies to monitor the use of such devices for misconduct and to recover relevant data from them during a subsequent investigation. The rise in use of third-party messaging platforms, including the use of ephemeral and encrypted messaging applications, poses a similar challenge." Then, Monaco's memo pointedly suggests that off-channel text messages will be deemed noncompliant and uncooperative: "How companies address the use of personal devices and third-party messaging platforms can impact a prosecutor's evaluation of the effectiveness of a corporation's compliance program, as well as the assessment of a corporation's cooperation during a criminal investigation."

In response, companies will need to shepherd any straying employees back onto the record. Both regulators and law enforcement agencies expect policies and procedures governing the use of personal devices and the retention of messages, and disappointing those expectations could be costly. But merely commanding that wayward employees sin no more will be insufficient in many cases. Smartphones and their apps are designed to be tempting, and many people, including customers, prefer text messaging to other forms of communication. Accordingly, the threat of disciplinary actions or terminations for off-channel texting may not be enough by itself to discourage employees.

Instead, companies should consider how to make compliant messaging possible. And some already have. In the securities industry, some broker-dealers have begun using apps that automatically archive text messages sent and received. Such apps can even be used on employee-owned devices with separate business phone numbers, thus allaying privacy concerns regarding nonbusiness related communications. Compliance is more likely to be effective when it's convenient.

SEC Revamps Fund Shareholder Reporting and Fee/Expense Advertising Rules

BY EDMUND ZAHAREWICZ

On October 26, 2022, the SEC adopted rule and form amendments establishing a new framework for annual and semiannual reports provided by mutual funds and exchange-traded funds that are registered on Form N-1A (funds). The SEC also voted to amend the advertising rules for registered investment companies and business development companies. The rulemaking consists of four principal elements.

Tailored Shareholder Reports

The new rules will require funds to transmit to shareholders "concise and visually engaging" annual and semiannual reports that highlight key information for investors such as fund expenses, performance, and portfolio holdings. The focused content requirements are expected to reduce the length of shareholder reports to a few pages. The new rules will also give funds the ability to make electronic versions of their shareholder reports more user-friendly and interactive. In addition, funds will be required to tag the information in their shareholder reports by using structured data language, which will allow investors and other interested parties to use automated analytical tools to readily extract information from within a filing.

Availability of Additional Information

The new rules will require that more in-depth information, such as a fund's schedule of investments and other financial statement elements, be made available to shareholders online. This information will have to be filed with the SEC on a semiannual basis on Form N-CSR and will also have to be delivered free of charge in paper or electronically upon request.

Diminished Scope of Rule 30e-3

As an alternative to delivering shareholder reports in paper, Rule 30e-3 generally permits investment companies to meet shareholder report transmission requirements by making these reports and other materials available online and providing a notice of the reports' online availability. This method of transmitting shareholder reports has been available to funds since January 1, 2021. The new rules, however, will exclude investment companies that are registered on Form N-1A from the scope of Rule 30e-3, including funds that serve as underlying funds of insurance company separate accounts. This change is sure to dismay many, especially those who now needlessly have spent time and resources altering their existing shareholder report delivery systems to avail themselves of the rule's optional delivery framework.

Fee and Expense Information in Advertisements

The new rules will require that presentations of investment company fees and expenses in advertisements and sales literature be consistent with relevant prospectus fee table presentations and be reasonably current. These rule amendments will affect all registered investment company and business development company (BDC) advertisements that include fee and expense figures. The new rules also address presentations of fees and expenses that could be materially misleading.

Compliance Dates

The new rules had an effective date on January 24, 2023. There is an 18-month transition period to allow funds time to adjust their shareholder reports and comply with the Rule 30e-3 changes. Investment companies and BDCs also have an 18-month transition period to comply with the new advertising rules. However, the new rules addressing presentations of fees and expenses apply on the effective date.

FINRA Settles Its First Reg BI Action

BY JUSTIN CHRETIEN

On September 28, 2022, FINRA settled its first formal action alleging violations of Regulation Best Interest, Rule 15l-1(a) under the Securities Exchange Act of 1934 (Reg BI).

In *Charles v. Malico*, the respondent consented to findings, without admitting or denying them, that he willfully violated the Best Interest Obligation under Reg BI by recommending a series of transactions in the account of a retail customer that was excessive in light of the customer's investment profile, and therefore was not in the customer's "best interest." Specifically, FINRA found that the respondent recommended that his customer make more than 350 trades in his account over a 17-month period, causing the customer to pay more than $54,000 in commissions, while losing more than $17,500 during the same period. Collectively, the trades resulted in an annualized cost-to-equity ratio exceeding 158%, meaning that the customer's account would have to grow by more than 158% annually just to break even. Respondent settled for a six-month suspension and a $5,000 fine.

The notable part of this first FINRA Reg BI settlement is simply that it is a re-labeled churning case that could have been brought under other FINRA rules, such as FINRA Rule 2111 (suitability), possibly FINRA Rule 2020 (manipulation), or even Exchange Act Section 10(b), Rule 10b-5 (fraud). As such, it plows no new ground. Instead, it is a telling sign that FINRA's prior authority over retail trading is now greatly diminished as the SEC wields its new tool – Reg BI – over such trading, while FINRA's suitability rule has been laid to rest, at least as it pertains to retail trading. See "SEC Files Groundbreaking Reg BI Complaint," *Expect Focus – Life Annuity and Retirement Solutions* (August 2022).

Still, it should be remembered that the SEC has, in the past, taken the initial lead in prosecuting major violations of new Exchange Act rules (*e.g.*, Exchange Act Rule 15c3-5, the "market access rule," adopted in 2010) with FINRA filling the gaps at first, and then gradually replacing the SEC as the primary regulator for all but the largest cases. In a few years, expect FINRA to be handling the majority of Reg BI cases.

A Coming Seismic Shift in Administrative Law?

Or Just a Tremor?

BY NATALIE NAPIERALA AND DAVID WRIGHT

Article I of the U.S. Constitution articulates the fundamental principles that "[a]ll legislative Powers … shall be vested in a Congress," "[t]he executive Power shall be vested in a President," and "[t]he judicial Power … shall be vested in one supreme court, and in such inferior Courts as the Congress may … ordain and establish." This separation of powers was—and is—a defining feature of the Constitution and, according to the Federalist Papers, meant to be "the great security against a gradual concentration of the several powers in the same department."

Nevertheless, the modern administrative state consists of a wide variety of agencies that each wield all three powers—legislative, executive, and judicial—with minimal accountability. For example, the SEC is empowered to promulgate regulations, bring enforcement actions, and conduct administrative hearings to enforce those regulations, having its own administrative law judges to try alleged violations. What's more, administrative agencies often escape judicial review under the standard laid down by the Supreme Court's 1984 opinion in *Chevron, U.S.A. v. Natural Resource Defense Council*, which says that "[i]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."

In recent years, however, a movement against the mixing of separate powers into single bodies has begun to snowball. For example, in 2018, Florida amended its constitution to prohibit state judges from deferring to an administrative agency's interpretation of a state statute or rule. In the 2022 case of *Jarkesy v. SEC*, the Fifth Circuit ruled that the SEC's in-house adjudication of an alleged violation of securities laws violated the Seventh Amendment, that Congress unconstitutionally delegated legislative power to the SEC, and that restrictions on the removal of the SEC's administrative law judges violated Article II of the U.S. Constitution.

Currently, the constitutionality of FINRA is being challenged in *Scottsdale Capital Advisors Corp. v. FINRA*. There, the plaintiffs allege that FINRA improperly exercises executive power, FINRA's structure violates the "appointments" clause of the Constitution, and Congress improperly delegated legislative powers to FINRA. It remains to be seen whether this lawsuit against FINRA will follow *Jarkesy* and whether the burgeoning trend against the comingling of separate governmental powers in a single agency will become an avalanche. What is certain is that the spate of recent lawsuits challenging the SEC's and FINRA's constitutionality signals an unstable status quo for administrative law.

Increased Visibility Into Fund Proxy Voting

SEC Adopts Controversial Requirements

BY GARY COHEN

The SEC has adopted rule and form amendments requiring mutual funds, ETFs, and certain other registered funds (funds) to report more details about their voting of portfolio company proxies.

The requirements, although highly technical, raise substantive issues that caused Republican Commissioners Hester Peirce and Mark Uyeda to dissent. The Investment Company Institute supported many, but not all, of the requirements.

Reports of Fund Voting

Essentially, the SEC amended reporting Form PX to require that funds – including those supporting variable insurance products – disclose votes in a consistent manner and machine-readable format. SEC Chair Gary Gensler said that the rules "will allow investors to better understand and analyze how their funds and managers are voting on shares held on their behalf."

Specifically, the amendments require funds to:

- Identify each voting matter as falling within one of 14 categories specified in the form;
- Tie the description and order of voting matters to the issuer's proxy card;
- Disclose (if applicable, by series) the number of shares that were voted, how the shares were voted, and whether the vote was for or against management's recommendation;
- Use a structured data language to make the filings easier to analyze; and
- Provide the voting record on (or through) their websites and make the record available free of charge upon request.

Institutional Managers' "Say-on-Pay" Disclosures

The amendments also require institutional investment managers to disclose how they voted on executive compensation, or so-called "say-on-pay" matters. This requirement fulfills one of the remaining rulemaking mandates under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

What is at Stake

The SEC justified the amendments on two policy grounds. First, funds own approximately 32% of the market capitalization of all U.S.-issued equities outstanding and, therefore, "can influence the outcome of a wide variety of matters that companies submit to a shareholder vote, including matters related to governance, corporate actions, and shareholder proposals." Second, more than 45% of U.S. households own funds, and "[d]ue to funds' significant voting power and the effects of funds' proxy voting practices on the actions of corporate issuers and the value of these issuers' securities, investors have an interest in how funds vote."

Opponents of the amendments countered that: there was scant evidence investors wanted such detailed information; costs would outweigh benefits; and the amendments would enable third parties – whose preferences may differ from the beneficial owners' – to pressure funds to vote in a particular way.

Moreover, regardless of how many potential proxy vote categories Form PX might specify, the types of statistical analyses that the amendments facilitate often will not provide a reasonable understanding of the merits of the proposals faced by a particular fund or the reasoning behind the fund's votes. Accordingly, it seems inevitable that some interest groups will cite such analyses to support conclusions that, although having an air of mathematical precision, are at best questionable. Funds, on the other hand, may struggle to find effective means of communicating a more nuanced view to the broad population of their investors.

Also controversial, is a new requirement that funds disclose the number of securities loaned and not recalled, and thus, not voted. The decision whether or not to recall loaned shares for voting involves weighing the benefits of continuing to earn revenue for shareholders against the value to shareholders of voting on a particular proposal. Opponents fear that failing to recall loaned securities could subject funds, especially ESG funds, to adverse criticism and even discourage funds from realizing revenue from securities lending.

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The new rules and form amendments will be effective for votes occurring on or after July 1, 2023, with the first filings subject to the amendments due in 2024.

No Hibernation for Issuers of Index-Linked Variable Annuities and Index Universal Life

BY ANN BLACK AND JORDAN LUCZAJ

After a blustery fall, the NAIC's Life Actuarial (A) Task Force (LATF) adopted the following at its December 2022 meeting:

- Actuarial Guideline LIV – Nonforfeiture Requirements for Index-Linked Variable Annuity Products (ILVA AG 54), and
- Revisions to Actuarial Guideline XLIX-A – The Application of Life Illustrations Model Regulation to Policies with Index-Based Interest Sold on or After December 14, 2020 (AG 49-A).

The ILVA Actuarial Guideline

LATF's ILVA AG 54 removed the fog as to ILVAs' status by considering ILVAs that satisfy the ILVA AG 54's requirements as variable annuities and thereby exempting ILVAs from NAIC Model 805, *Standard Nonforfeiture Law for Individual Deferred Annuities*. Under the ILVA AG 54, ILVAs seeking such exemption from Model 805 must provide equity between contract holders and the issuing insurance company in determining the ILVA's interim value. Specifically, to benefit from the exemption, an ILVA's interim value must be materially consistent with the value of the "Hypothetical Portfolio" supporting the ILVA's index account(s) over the term of the index account(s). The Hypothetical Portfolio consists of hypothetical fixed income assets and a package of hypothetical derivative assets established at the beginning of an index term and designed to replicate credits provided at the end of the index term.

While earlier drafts of the ILVA AG 54 threatened a whiteout on ILVAs by requiring a market value adjustment in determining the interim values, that snowstorm never materialized. Rather, the LATF-adopted ILVA AG 54 allows the value of the Hypothetical Portfolio to be determined by a fair value methodology, or by applying an MVA to book value and allows states to consider whether to apply an MVA. To plow the way and avoid delays for states assessing whether including or excluding an MVA is appropriate, one regulator forecasted that an insurer should include an actuarial discussion in its filing as to why an MVA was or was not included. This discussion would be in addition to the actuarial certifications required by the ILVA Actuarial Guideline.

The LATF-adopted ILVA Actuarial Guideline has an effective date of July 1, 2024 for contracts, riders or endorsements issued on or after that date.

The AG49-A Revisions

LATF also adopted revisions as a "quick fix" to AG49-A, which pertains to illustrations for indexed universal life policies (IUL). The revisions freeze the differences between the illustrated rates for "traditional" capped S&P 500 benchmark indexed accounts (BIAs) and the illustrated rates for indexed accounts based on uncapped volatility controlled indexes that include a fixed bonus. The revised AG 49-A accomplishes this by limiting the leverage that may be illustrated on all indexed accounts options, based upon the leverage on the BIA. It does so by calculating the leverage percentage on the BIA and multiplying that by the lower of the hedge budget for the BIA and the hedge budget for the respective indexed account options available under an IUL. This fix also accounts for current option costs: when volatility is higher and option costs are higher, the leverage permitted to be illustrated would be lower.

A May 1, 2023 effective date was adopted by LATF. However, consumer representative Birny Birnbaum raised several questions about this effective date and LATF chair Fred Anderson noted the discussion in his remarks.

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On February 24, 2023, the (A) Committee will consider the adoption of IVLA AG 54 and the revisions to AG 49-A.

Digital Assets: An Expanding Arena for Insider Trading and Market Manipulation

BY TOM SJOBLOM

Both the SEC and DOJ are creatively and aggressively attacking the use of digital assets as a medium for insider trading or market manipulation. While the jurisdictional battle over digital assets still rages between the SEC and the CFTC, the SEC alone brought more than two dozen cases involving cryptocurrencies during its fiscal year 2022, and the SEC has formed a Special Unit within its Trial Unit in the Enforcement Division to prosecute crypto and digital asset cases.

Although this article discusses a few key cases involving insider trading and market manipulation, the digital asset arena is rife with other potential legal violations. This is amply shown, for example, by FTX, which we will address more fully in our next edition of *Expect Focus*.

Insider Trading

The SEC is bringing insider trading cases for digital assets that the SEC deems to be "crypto asset securities." The SEC defines this to include "an asset that is issued or transferred using distributed ledger or blockchain technology" such as "so-called digital assets, virtual assets, coins, and tokens that meet the definition of a security under the federal securities laws." Most digital assets arguably satisfy the familiar four-prong *Howey* test of what constitutes an "investment contract" (*i.e.*, an investment of money, in a common enterprise, with the expectation of profits, based on the efforts of others) and thus are "securities."

The SEC has relied on the misappropriation theory of insider trading. Unlike the classical theory which charges *inside* officers and directors with having breached their fiduciary duties to shareholders, the misappropriation theory applies to *outsiders* who may not be officers, directors, or employees of the issuer but who use or tip material non-public information (MNPI) in breach of a *duty of trust and confidence* owed to the source of the information. The misappropriation theory also has been used by the DOJ in criminal suits charging wire fraud and conspiracy to commit wire fraud. Thus, **SEC civil and DOJ criminal concepts increasingly are being merged to bring novel prosecutions**.

Non-Fungible Tokens (NFTs)

- In *United States v. Nathaniel Chastain*, the first ever insider trading case in digital assets, the DOJ criminally charged Nathaniel Chastain with wire fraud and money laundering in violation of 18 USC §1343 and 18 USC §1956 (c)(7), respectively, for using confidential business information of Ozone Networks d/b/a OpenSea, to purchase NFTs prior to being featured on OpenSea's homepage. Each statute carries a maximum sentence of 20 years in prison, and the DOJ's indictment also alleged asset forfeiture under 18 USC §91(a)(1)(C) and 28 USC §2461(c) of all property, real or personal, traceable to the crime, as well as forfeiture of substitute assets and other property under 21 USC §853(p) and 28 USC §2461 up to the value of the forfeitable property.

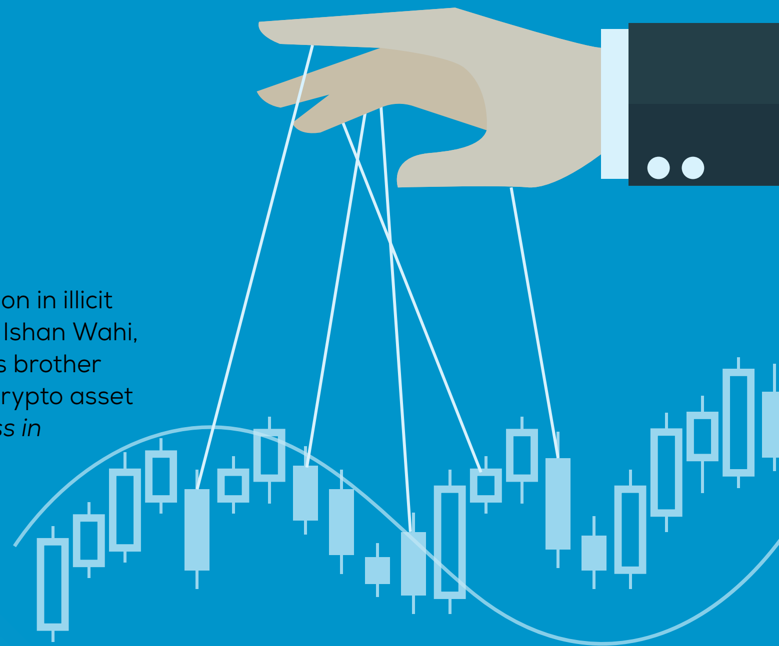
  NFTs are digital assets associated with a digital object, such as a piece of digital artwork (e.g., one-of-a-kind trading card, picture of soccer player, Donald Trump, or even Melania Trump's eyes), and provides proof of ownership and a license to use that object for specific purposes. An NFT has a unique identifying code and is stored and traded on a blockchain, which is a digitized and decentralized ledger of transaction information. NFTs have grown to more than a $40 billion market. OpenSea is the largest online marketplace for NFTs.

  Chastain, as product manager responsible for selecting NFTs to be featured on OpenSea's homepage, had advance knowledge of which NFT would be featured. He misappropriated that confidential business information to purchase NFTs prior to their appearance on the homepage and then sold them afterwards at two to five-times higher than his initial purchase price. Chastain tried unsuccessfully to conceal his fraud by using anonymous digital currency wallets and anonymous accounts on the blockchain.

Tokens

- In *SEC v. Ishan Wahi*, the SEC charged Ishan Wahi, his brother, and a close friend with insider trading in coin-based tokens in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Ishan Wahi was manager at Coinbase Global, Inc (Coinbase), one of the largest crypto asset trading platforms in the United States. He was part of a "tight circle" at Coinbase that was entrusted with knowledge of which crypto asset securities would be listed and when.

  Wahi repeatedly tipped MNPI about the content of Coinbase's "listing announcements" to his brother and a close friend, who, in turn, used the



MNPI to trade ahead of any listing, earning more than $1.1 million in illicit profits in nine different crypto asset security tokens. As tipper, Ishan Wahi, violated his duty of trust and confidence owed to Coinbase. His brother and friend, as the tippees, violated securities laws by trading crypto asset securities "on the bases of" MPNI that they "*knew, were reckless in not knowing or consciously avoided knowing*" that Wahi had provided them in breach of his duties to Coinbase. Wahi "benefited" from his tip because he "bestowed gifts" of MNPI on his brother and close friend.

Although Wahi, his brother, and friend took steps to conceal their communications through use of a web of anonymous accounts, blockchain wallets, and addresses on multiple platforms, the suspicious trading of the brother and friend was brought to the attention of Coinbase's director of security operations by a third party, who noticed several blockchain wallets linked to the brother and friend that showed trades in 25 crypto assets within 24 hours before each token was listed for trading.

Even though the DOJ could have brought criminal charges of insider trading under Section 10(b) of the Exchange Act and Rule 10b-5, it instead opted for a more expansive approach. Specifically, it criminally charged Wahi, his brother, and his friend together with participating in a *scheme* to engage in insider trading and thus *conspiracy to commit wire fraud* under 18 USC §1349, as well as charging each individually with wire fraud under 18 USC §1343, which makes it a crime to devise or participate in a scheme or artifice to defraud and to obtain money and property by false and fraudulent pretenses. Unlike Rule 10b-5, noticeably absent is the need for the DOJ to show a personal "benefit" to Wahi under the wire fraud statute.

The indictment charged all three defendants with trading in all 25 digital assets for realized and unrealized gains of $1.5 million, not just the nine tokens singled out by the SEC as crypto asset securities. As in *Chastain*, the DOJ requested asset forfeiture of all property, real or personal, traceable to the crime, as well as forfeiture of *substitute* assets, and other property up to the value of the forfeitable property.

Market Manipulation

In *SEC v. The Hydrogen Technology Corporation*, the SEC filed civil charges against The Hydrogen Technology Corporation and its former president and CEO, Michael Ross Kane, and against Tyler Ostern, president and CEO of Moonwalkers Trading Limited. Hydrogen "minted" approximately $11.1 billion "hydro tokens" to raise capital. The SEC alleged that, from January 2018 through April 2019, Hydrogen and Kane offered and sold these unregistered crypto asset securities and hired Ostern to manipulate the price and volume of the hydro tokens traded on crypto asset trading platforms. To effect the manipulation, Ostern, a self-described crypto asset "market maker," created the false appearance of robust trading and artificially propped up the price of the hydro tokens.

Ostern accomplished the manipulation by using a customized trading bot (*i.e.*, a computer program that automates trades) and by placing and cancelling trades at random increments of price and volume. Ostern told Kane that he would keep the sell pressure to a minimum until he could "build enough capital to really get the market moving upward" and then "pump the price and sell into the FOMO (*i.e.*, fear of missing out) guys down the road." Ostern later bragged to Kane that his trading bot and "volume shenanigans" on a popular trading platform had generated an illusion of a million hydro tokens bought and sold in a matter of three seconds, about one half of which were fake. Hydrogen reaped profits of more than $2.2 million.

The SEC sought disgorgement and civil monetary penalties from all defendants as well as an officer and director bar against Kane. Ostern entered into a consent injunction and also agreed to a bar prohibiting him from participating as a finder, promoter or agent in any offering or trading in penny stock.

A Flurry of Algorithmic Activity at the NAIC 2022 Fall National Meeting

BY ANN BLACK AND JORDAN LUCZAJ

At the National Association of Insurance Commissioners (NAIC) 2022 Fall National Meeting (Fall Meeting), the various NAIC groups hit the industry with an array of snowballs of various actual and proposed surveys, guidance, and at least one framework.

Surveys

As the most prolific group, the Big Data and Artificial Intelligence (H) Working Group (Big Data WG) reported on its Artificial Intelligence and Machine Learning (AI/ML) state surveys for:

- Private passenger auto (PPA) insurance – The Big Data WG trumpeted the results from the 193 responses. The PPA survey addressed:
  - How AI/ML is used by PPA insurers;
  - Data used by PPA insurers in AI/ML;
  - Whether insurers are providing additional information about data elements to consumers other than what is required by law. The Big Data WG noted that, although the number of reporting companies is lower than expected, the answers reported are almost unanimously "no" for each of the insurers' respective operations, except for rating, which had about 32% of the responses reporting "yes";
  - Consumers' ability to correct data. As to whether consumers have more opportunity to challenge or correct their specific data than is mandated by the federal Fair Credit Reporting Act (FCRA), many did not answer. Of those who did, about 50% said "yes" for rating and underwriting, 40% said "yes" for claims and marketing, 15% said "yes" for fraud detection, and less than 10% said "yes" for loss; and
  - Governance practices as they relate to the NAIC's Principles on Artificial Intelligence. The Big Data WG noted that "a sizable number" did not answer the questions.

  The survey also asked about PPA insurers' documentation practices.

- Home insurance – The Big Data WG heralded that this survey is in process; and
- Life insurance – The Big Data WG proclaimed that it was modifying the survey based on comments received on an exposure draft. The American Council of Life Insurers commented that the draft survey would be a polar vortex for insurers, as the questions were more numerous than earlier surveys. Consumer representative Birny Birnbaum believed the broad blanket of questions failed to obtain specific enough information about biases, testing for biases, and the use of biometics. He also asserted that the survey was foggy as it would not allow regulators to see whether the data and algorithms used by insurers are reasonable or unreasonable.

The Big Data WG also decreed that that 192 call letters will be sent out, of which six will go to insurtech companies. The Big Data WG plans to open its survey website and distribute initial call letters in January, with a formal call letter in February. After the formal call letter is sent, the companies will have 30 days to bundle up their responses.

The Big Data WG explained that the results from the three surveys would be used to evaluate whether changes should be made to regulatory frameworks.

Guidance/Framework

In addition, during the Big Data WG meeting, the Accelerated Underwriting (A) Working Group (AUWG) joined the fireside chat by stating that in the New Year, it plans to expose draft regulatory guidance for accelerated underwriting practices. It plans on collaborating with multiple working groups, committees, and the collaboration forum on the guidance document. Again, Mr. Birnbaum raised concerns about credit and biometric information being used in accelerated underwriting. He proposed that insurers should have to show there is no bias if they want to use biometric information in accelerated underwriting.

The Innovation, Cybersecurity, and Technology (H) Committee announced that, to freeze the ability for AI to result in illegal bias and discrimination, it would be developing a regulatory framework on algorithmic bias. This regulatory framework will be in the form of a model bulletin, which will include the following sections: background, definitions, regulatory expectations, and regulatory oversight and examination standards. A number of working groups that are part of the "collaboration forum" will assist with drafting.

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As the NAIC continues to explore consumer data and AI/ML, forecasts show that these Fall Meeting flurries could develop into a blizzard as the New Year develops.

New Year, New Privacy Shakedowns: Six Resolutions for Keeping Warm

BY ANN BLACK AND PATRICIA CARREIRO

Class action privacy litigation's icy grip tightened around financial services providers in late 2022, and the forecast shows no signs of melting. The plaintiffs' creeping application of old law to new technologies is extending the wall of ice.

Voiceprints

- In September 2022, five large financial institutions were sued in California federal court by plaintiffs asserting that prior express written consent was required under California Penal Code § 637.3 before the institutions could record phone calls to create voiceprints. Some institutions broke the icy grip with quick settlements, while others battled longer winters. The plaintiffs, however, suffered a major defeat in a recent motion to dismiss ruling that voiceprints used only for identity verification were not a violation of California Penal Code § 637.3. The decision, while a welcome relief, may not shelter users of other voice-based analytics, and plaintiffs may use their opportunity at an amended complaint to raise other bases to support their claims. The litigations are just one more example of the frosty risks associated with biometrics, even for an industry that has largely (though not entirely) avoided litigation under Illinois's Biometric Information Privacy Act.

Website Technologies

- These cold fronts began outside the financial service industry, but the industry is now feeling their blusters. Hard-freeze areas include:
  - Session Replay Technology.

    Plaintiffs are using a variety of theories (e.g., wiretapping statutes, unfair trade practices, invasion of privacy claims (both common law and statutory, such as pursuant to California's Invasion of Privacy Act)) to allege insufficient notice and consent related to website technologies. When it comes to session replay technology, plaintiffs have claimed that they are owed:
    - Pre-recording website pop-up messages alerting them to the session recording; and
    - Specific disclosures in companies' website privacy policies.
  - Website Video Viewing Data.

    The latest winter bomb cyclone involves the Video Privacy Protection Act of 1988 (VPPA) and educational and marketing videos appearing on websites. The VPPA was intended to protect individuals' video rental and sale history, but its chill has expanded over the years. The atmospheric pressure significantly dropped in September 2022, when one such claim survived a motion to dismiss, triggering a blizzard of putative class actions.

    Plaintiffs allege that any sharing of information reflecting their viewing of a video on a website (*e.g.*, sharing information that a particular user viewed a video so that that individual can be targeted for further advertising) requires informed, written consent. Although the VPPA has several exceptions (most obviously, sharing "for the exclusive use of marketing goods and services directly to the consumer," which only requires opt-out consent, and "incident to the ordinary course of business"), these exceptions have not yet been applied in relation to current technologies. Shakedown communications are blanketing entities with websites that include videos. The communications commonly allege that the website has been sharing video viewing data with companies, such as through the use of Facebook pixels, and demand compensation.

Such litigations frequently include substantial claims for statutory damages and attorneys' fees and are based on allegations that the defendants have not: (1) provided the requisite notice; and (2) secured necessary consent. Below are six New Year resolutions to fight the frost.

1. Take an inventory of the technologies being employed on your websites, the data flows involved, and the optional settings available.
2. Sensitize your team to the associated requirements and risks involved in different technologies, settings, and data practices.
3. Review your existing privacy notices and processes for documenting consent, and if appropriate, bolster them, even if not legally required.
4. Negotiate vendor contracts to favorably allocate risk.
5. Revise website terms of use to maximize the enforceability of arbitration and class action waiver provisions.
6. If you receive a shakedown communication, be wary of the thin ice.

Bundle up; it's going to be a long winter.

Insurors' Vendor Relationships May Get Wintery Gusts

A Chill for Consumer Data, Artificial Intelligence (AI), and Machine Learning (ML) Services?

BY ANN BLACK AND JORDAN LUCZAJ

As 2022 ended, various groups of the National Association of Insurance Commissioners (NAIC), as well as the Colorado Department of Insurance (CO DOI), continued to gain a better understanding of insurers' use of consumer data, AI, and ML. They learned that insurers may be heavily relying on third party vendors. The regulators discussed the need that any regulation of insurers' use of consumer data, AI, and ML blanket insurers as well as the third party vendors.

During the NAIC Fall National Meeting, the Big Data and Artificial Intelligence (H) Working Group (Big Data AI WG) and the Innovation, Cybersecurity, and Technology (H) Committee (H Committee) discussed the role of third party vendors and what regulatory actions should be taken in that connection.

The results of its survey on private passenger auto insurance informed the Big Data and AI WG about insurers' reliance on third parties who provide operational support using AI or ML. The Working Group also posited the need for information from, and the enhanced regulatory oversight over, these third party vendors. In this regard, Workstream 2 of the Big Data AI WG plowed ahead and drafted proposed questions for regulators to ask insurers about data and models they use, including whether the data or model was obtained from third parties. The Working Group released the nine page draft of questions for a 62-day comment period. Industry representatives cautioned that the avalanche of questions could white out innovation and efficiency, precipitating consumer harm. Birny Birnbaum viewed such industry comments as mere slush, but cautioned about the antitrust concerns if multiple insurers rely on the same vendor.

Meanwhile, the H Committee forecasted that insurers and other licensees ultimately will be responsible. Thus, insurers should ensure that if they use consumer data, AI, and ML from third parties, such use complies with applicable law.

In addition, in its Life Insurance Stakeholder Meeting #5, the CO DOI conveyed that insurers will need to comply with model regulations even if they use third party vendors. Colorado's Commissioner Conway emphasized that his state is "not going to have insurers hide behind third parties [and] that he does not want there to be roadblocks from those third parties." The Commissioner reiterated that "it is [his] expectation that if [an insurer] is using third parties, then you will still need to comply with the regulations" and "[i]f insurers want to use third parties, that is not going to be a way to avoid compliance."

To avoid a cold blast from regulators, insurers using third party vendors for consumer data, AI, or ML will need to ensure that the third party vendors cooperate with regulatory inquiries and are prepared to demonstrate, at a minimum, that no illegal discrimination or bias is occurring.

Suicide-By-Cop Precludes Death Benefits

BY SEAN HUGHES

The Eleventh Circuit Court of Appeals recently ruled in *North American Company for Life and Health Insurance v. Caldwell* that the beneficiaries of two life insurance policies were not entitled to the policies' death benefits after the insured of those policies committed "suicide-by-cop." In a case of first impression, the insurer had issued two insurance policies on the life of Justin Caldwell. Each policy provided a $1 million death benefit to the beneficiaries, one of whom was Justin's wife, Michelle Caldwell. Each policy contained a clause that excluded suicide from coverage under the policy.

On October 8, 2020, Justin demonstrated signs of suicidal intent after learning that Michelle wanted a divorce. Michelle called 911 to report that Justin was "suicidal" and that he "wanted to die by law enforcement." Once the police officers arrived to the scene, Justin was shot and killed after he attempted to point his personal rifle at the police.

"Suicide-by-cop" is a colloquial phrase that indicates a form of suicide in which the suicidal person intentionally engages in life-threatening behavior to induce a police officer to shoot him or her. The beneficiaries of the policies argued that the fact that the officer fired the deadly bullet necessarily detached Justin's death from his intent to die. The district court originally ruled that Justin died "as a result of being shot by another person," not "suicide," and granted judgment in favor of the beneficiaries. The Eleventh Circuit, however, reversed, finding that the ordinary meaning of "suicide" included suicide-by-cop.

The appellate court looked to the ordinary meaning of the word "suicide," finding that a death is considered a suicide when a person intentionally causes his or her own death, the specific method of which is irrelevant. English language and legal dictionaries confirmed that the ordinary meaning of "suicide" covered any method used by someone to end his or her own life voluntarily and intentionally. The court also examined other materials, including scientific journals and past court decisions, to find additional support for its conclusion that "suicide-by-cop" is a form of suicide.

In its conclusory remarks, the Eleventh Circuit cautioned that it was not deciding that the ordinary meaning of "suicide" covers all imaginable instances of suicide-by-cop, noting that many instances may require case-by-case factual determinations regarding the decedent's intent or actions.

Seasoned Financial Services Lawyer W. Thomas Conner Joins Carlton Fields

Carlton Fields is pleased to announce that W. Thomas Conner has joined the firm's Financial Services Regulatory Practice as a shareholder in Washington, D.C. Tom has a wealth of experience handling complex regulatory matters involving life insurance and annuity products, mutual funds (including ETFs), investment advisers, commodity pools, and commodity pool operators.

Tom enhances Carlton Fields' industry-leading Financial Services Regulatory Practice, with more than three decades of experience working with both SEC-registered and non-registered financial products and entities. His extensive track record includes service as an official with the SEC's Division of Investment Management, as general counsel of a major retirement industry trade association, and as a shareholder in other law firms with leading practices in the areas of financial products and investment services

Carlton Fields Launches Privacy & Cybersecurity Compliance Consultancy

Carlton Fields has launched a privacy and cybersecurity consultancy, CTRL, which helps companies comply with regulations that will affect virtually all companies across a range of industries. This includes, in particular, insurance and other financial and investment service businesses.

CTRL is a privacy and cybersecurity compliance consultancy offering flexible, practical, and cost-effective privacy and security compliance solutions. Its team of professionals have decades of experience helping clients build effective compliance frameworks to protect their businesses and minimize exposure.

CTRL's services run the gamut, from building full-scale compliance programs and implementing contractual frameworks and vendor management, to developing data ethics programs, guiding clients to industry-standard certifications, and providing proactive data incident solutions.

The consultancy offers more than 125 products for customers to purchase and essentially "plug and play." Companies can also customize the products after purchase. The products provide companies with a variety of privacy and training solutions, as well as custom training and white label solutions to accommodate businesses of all sizes in privacy readiness and compliance. This includes training to meet compliance requirements imposed by various state laws, HIPAA, and foreign laws and regulations, such as the GDPR in the UK and Europe.

NEWS & NOTES

Carlton Fields is sponsoring the IRI Annual Conference on March 15-17, 2023, in Miami, FL. The conference will cover business, technology, political, and regulatory issues facing the complete supply chain of the insured retirement industry.

The firm is a sponsor of the Global Insurance Symposium on April 18-20, 2023 in Des Moines, IA, which offers an educational and networking opportunity for over 500 insurance and financial services company executives, national and international regulators, state and federal government representatives, entrepreneurs, and startup tech firms.

Carlton Fields earned national first-tier rankings for several practices in the *U.S. News and World Report and Best Lawyers®* Best Law Firms 2023 guide. In addition, the firm achieved 35 metropolitan first-tier rankings across nine of its offices.

Carlton Fields welcomes the following attorneys to the firm: Shareholders Lauren Fenton-Valdivia (business litigation, Tampa), Michael Hensley (business litigation, New Jersey), and F. Joseph Ullo Jr. (government law and consulting, Tallahassee); Senior Counsel Geoffrey Cooper (real estate and commercial finance, Washington, D.C.); Of Counsel Thomas Findley (white collar and government investigations, Tallahassee), Garland Gantt (real estate and commercial finance, Washington, D.C.), Jason Gould (life, annuity, and retirement litigation, Washington, D.C.), and Tino Lisella (securities litigation and enforcement, Miami); and Associates Ryan Allen (business litigation, New Jersey), Andrea Bonvicino (business litigation, New Jersey), Ashley Cullinan (construction, Washington, D.C.), Katarina Dobsinska (appellate and trial support, Miami), Jorkeell Echeverria (business litigation, New Jersey), Steven Fernandez (business litigation, New Jersey), Kevin Major, Jr. (property & casualty insurance, Orlando), Jimmy Pham (real estate and commercial finance, Orlando), Saray Ravelo (business litigation, Tampa), Andre Revaz (mass tort and product liability, Tampa), Nicole Stone (property & casualty insurance, Atlanta), Madison Wahler (property & casualty insurance, Tampa), and Carter Wallace (business litigation, New York).

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