LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

Volume II, May 2023

EXPECTFOCUS®

LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS

TOO MANY COOKS?

LEGAL RECIPE CHANGES ABOUND

vII INSIDE

EXPECTFOCUS®

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS MAY 2023

Executive Editor Thomas Lauerman
Assistant Editors Stephanie Fichera
Todd Fuller
Production Manager Jessica Bennett
Art Director & Designer Frances Liebold

EXPECTFOCUS® is a review of developments in the life, annuity, and retirement solutions industry, provided on a complimentary basis to clients and friends of Carlton Fields.

Reg BI Cooking Instructions

Based on SEC/FINRA Exams

BY ANN FURMAN

FINRA intends to conduct 1,000 Regulation Best Interest (Reg BI) examinations — covering almost one-third of FINRA member firms — by year-end.

For broker-dealers distributing and selling variable annuities, examinations will test for compliance with Reg BI *and* FINRA Rule 2330 because both standards apply to variable annuity sales. Firms distributing and selling variable annuities may benefit from following regulators' cooking instructions to prepare for these examinations and enhance Reg BI procedures. Both the SEC and FINRA have been sending firms' compliance practices back to the kitchen for further attention.

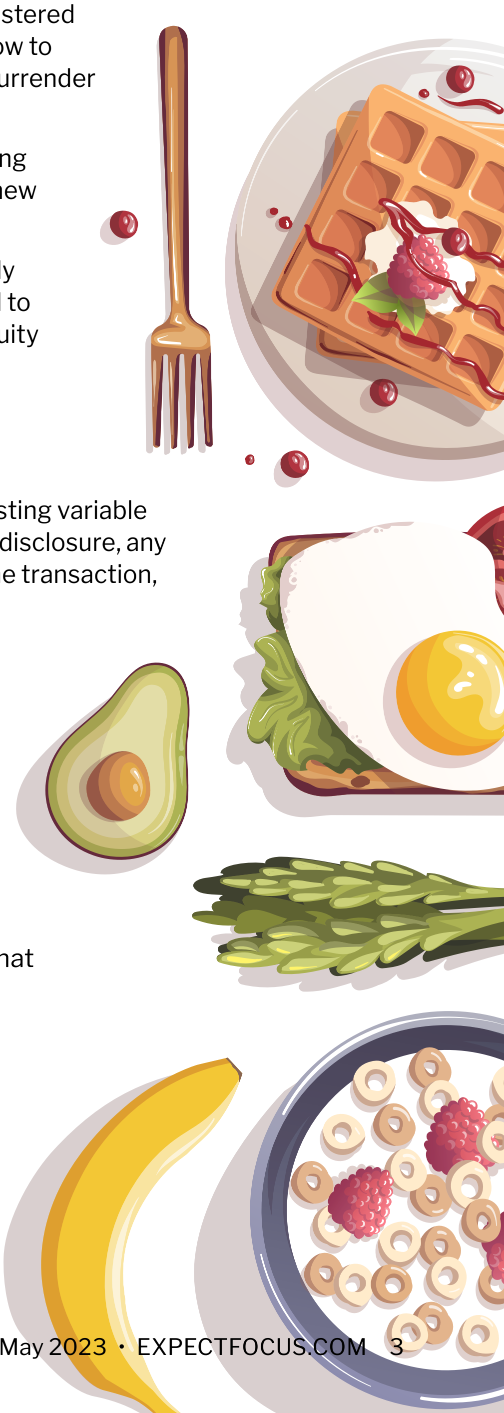
For its part, the SEC Division of Examinations issued a risk alert on January 30, 2023, in which it highlights what it considered to be deficiencies and weak practices noted during Reg BI examinations. These related to broker-dealers' practices in connection with each component obligation of Reg BI, as follows:

- **Compliance Obligation** – not having adequate written policies and procedures, including instances of generic written policies and procedures that were not tailored to the firm's business model.
- **Care Obligation** – directing financial professionals to consider reasonably available alternatives to recommendations, or costs, without providing any guidance on how to do so.
- **Conflict of Interest Obligation** – identifying only those conflicts associated with prohibited activities (e.g., churning), rather than identifying all conflicts; or using high-level, generic language (e.g., "we have conflicts related to compensation differences") that did not describe the conflicts with enough specificity.
- **Disclosure Obligation** – not providing disclosures to retail customers in writing but instead posting Reg BI disclosures only on the broker-dealers' websites or merely referencing the disclosures in other documents delivered to customers.

Meanwhile, FINRA outlined several variable annuity sales practices that it found problematic under Reg BI in its 2023 Report on Examination and Risk Monitoring Program, issued on January 10, 2023, including:

- **Key Information** – not adequately collecting and retaining key information on variable annuity transactions, particularly in connection with recommended exchanges into new variable annuity contracts.
- **Training** – not sufficiently training registered representatives and supervisors on how to assess and compare costs and fees, surrender charges, and long-term income riders.
- **Exchanges** – not reasonably supervising recommendations of exchanges into new variable annuity contacts.
- **Insurer Buyout Offers** – not reasonably supervising recommendations related to issuer offers to "buy out" variable annuity contracts from existing holders.
- **Additional Premium Payments** – not evaluating and supervising registered representatives' recommendations of additional premium payments into existing variable annuity contracts, including review of disclosure, any applicable surrender fees related to the transaction, and the rationale for the addition.
- **Reasonably Available Alternatives** – insufficiently considering reasonably available alternatives to a recommended variable annuity purchase, surrender, or exchange.

By attending to the regulators' guidance before the examiners call to make reservations, firms involved in variable annuity sales or distribution can reduce the likelihood that the examiners might get indigestion.



SEC Relief for RILA Issuers to Use Statutory Financials

Has the Moratorium Been Lifted?

BY THOMAS CONNER

Innovative registered index-linked annuity (RILA) contracts have become a permanent fixture in the retirement savings marketplace. RILAs provide investors with a product that offers upside potential with downside protection, and RILA sales have been robust.

While the SEC is developing a new registration statement form tailored for RILAs, insurers currently must register RILA offerings on one of the “catchall” SEC registration forms, Form S-1 or Form S-3. These forms generally require insurers registering RILAs to include insurance company financial statements prepared in accordance with generally accepted accounting principles (GAAP). For insurers that currently only prepare financial statements in accordance with statutory accounting principles applicable to insurance companies (SAP), preparing GAAP financial statements can be extremely daunting and expensive.

A number of RILA issuers that do not prepare GAAP financial statements have obtained relief under Rule 3-13 of Regulation S-X to use SAP financials in their registration statements instead. Rule 3-13 provides that the SEC “may, upon the informal written request of the registrant, and where consistent with the protection of investors, permit the omission of one or more financial statements required by Regulation S-X or the filing in substitution thereof of appropriate statements of a comparable character.”

Such Rule 3-13 relief is available only to insurers registering their RILA offerings on Form S-1. Those insurers also generally rely on Rule 12h-7 under the Securities Exchange Act of 1934 to avoid filing periodic reports such as Forms 10-K and 10-Q. Importantly, the exemption is not available to insurers using Form S-3 because a registrant must file 1934 Act reports to be eligible to use, or remain on, Form S-3. Accordingly, RILA insurers may conclude that registration on Form S-1 is preferable to Form S-3.

Interestingly, while letters granting Rule 3-13 relief for the use of SAP financial statements in RILA registration statements were issued on an increasingly regular basis until October 2022, no letters were issued after that until March 2023. We understand that several companies were close to receiving such relief when the letters stopped being issued last year in October.

On March 17, 2023, however, a letter granting Rule 3-13 relief was issued to a RILA issuer. While neither the SEC nor its staff to our knowledge has provided formal information on this point, some practitioners have attributed the moratorium to a renewed interest by the SEC and its staff in whether SAP financials are appropriate for RILA registration statements, as they consider what type of financial statements the new tailored RILA registration form should require.

It remains to be seen if other RILA issuers will receive Rule 3-13 relief for that purpose going forward.

AML Whistleblowers Now Have More Appetizing Options

BY TINO LISELLA

On December 29, 2022, President Biden signed into law the Anti-Money Laundering Whistleblower Improvement Act. The law contains important enhancements to the Anti-Money Laundering Act, which created a whistleblower program for anti-money laundering enforcement, administered through the Treasury Department. Until now, although a whistleblower under this program could receive up to 30% of the monetary sanctions collected that exceeded $1 million, there has been no guaranteed minimum as provided for in several other whistleblower programs. The program also has been limited to violations of the Bank Secrecy Act and anti-money laundering laws.

The new legislation makes the program more palatable to whistleblowers in important ways. First, it adds a 10% minimum award for whistleblowers whose information leads to the collection of monetary sanctions that exceed the program's $1 million threshold. The maximum remains at 30%.

Next, the legislation expands both the pool of individuals who can qualify as whistleblowers and the range of violations on which whistleblowers can report. Previously, individuals serving in a compliance or audit function with an allegedly violating firm were ineligible to collect awards as whistleblowers. However, the new law removes this restriction.

In addition, the legislation adds violations of U.S. economic sanctions laws to the categories of violations that can give rise to anti-money laundering whistleblower awards. Therefore, whistleblowers can now collect awards for reporting on persons who are providing money, weapons, and technologies to sanctioned countries. In large part, this expansion was a direct and bipartisan response by lawmakers hungry to impose consequences on Russia for its invasion of Ukraine.

Finally, and to avoid taxpayer indigestion, Congress made the anti-money laundering whistleblower program self-funding through the establishment of a "Financial Integrity Fund," which can maintain a balance of up to $300 million and will come from fines collected by the departments of Justice and Treasury.

This new legislation serves as a good reminder to firms to review, and strengthen if necessary, their procedures for detecting and preventing anti-money laundering, Bank Secrecy Act, and sanction law violations.

Regulators Looking to Various Kitchen Tools to Regulate Insurers' Use of Artificial Intelligence and Machine Learning

BY ANN BLACK, EDMUND ZAHAREWICZ, ERIN VAN SICKLE, AND JORDAN LUCZAJ

Various chefs within the National Association of Insurance Commissioners and some individual states' chefs continue to address insurers' use of artificial intelligence (AI), machine learning (ML), the use and protection of consumer data, and related issues.

NAIC

1. The **Innovation, Cybersecurity, and Technology (H) Committee** is drafting a principles-based model bulletin on AI/ML governance. In regard to the draft model, Commissioner Kathleen Birrane emphasized that there was strong agreement among the chefs to:

   - Avoid using tongs to reach vendors of consumers' data, AI, and ML. Rather, the chefs will instruct insurers on their responsibility over vendors. The bulletin may also include suggestions on the specific provisions that an insurer should include in its vendor contracts, including audit rights, the ability to understand the vendor's AI/ML governance, and an obligation to make the vendor available to the insurer's regulator.
   - Require insurers to use a scale to measure the extent of their use of AI and ML.

   The chefs' model bulletin will contain four sections: introduction, definitions, regulatory standards, and regulatory oversight/examination. The regulatory standards section will focus on documented governance that includes risk management. The regulatory oversight section will set the expectation on what companies will need to be prepared to produce when examined. The bulletin is expected to be exposed over the summer and discussed at the NAIC Summer National Meeting.

2. Workstream #1 of the **Big Data and Artificial Intelligence (H) Working Group** is working with 14 states to measure life insurers' use of AI/ML techniques. To avoid throwing in the kitchen sink, this survey focuses on three operational areas — pricing and underwriting, marketing, and risk management. However, it does ask insurers to list other areas in which they use AI/ML. Other items on the menu include:

   - The survey requests for each type of AI/ML used — the level of deployment, name of the model, the ML techniques used, whether it was developed internally or externally, the level of influence (i.e., the model makes the decision without human intervention, the model suggests an answer, the model supports a human decision), the types of data used, and whether there is a model governance framework in place.
   - The governance section seeks to understand an insurer's awareness of specific risk areas tied to the NAIC's artificial intelligence principles.
   - The FAQs explain that if a vendor contract does not allow insurance regulators to review the information from the vendor, that contract might be void for public policy reasons. In any event, the information used by an insurer is subject to the regulatory authority of the participating states.

3. Workstream #2 of the **Big Data and Artificial Intelligence (H) Working Group** seeks to give regulators the proper utensils to ask insurance companies about models and data via their draft model and data regulatory questions for regulators. At the group's March 22 meeting, Commissioner Doug Ommen recognized the need for changes based on the comments received from interested parties on the draft questions. The reviews on the draft questions include the following subjects:

   - The scope of the questions and the need for a limited, principles-based approach to encourage innovation without overregulation, including redundant regulations.
   - Compliance costs for smaller companies and vendors.
   - The impact of making insurers responsible for third-party vendors.
   - The need to safeguard vendors' proprietary information.
   - Methods for testing data and models.
   - Based on the comments received, Ommen stated that a revised draft should be prepared by the end of May.

4. The **Accelerated Underwriting (A) Working Group** issued a draft guidance document as another tool to assist regulators when reviewing accelerated underwriting programs used by life insurers. This tool provides sample questions and areas for review by regulators when preparing their dish to serve up to insurance companies. The draft incorporates various ingredients like the NAIC's artificial intelligence principles, in framing questions that facilitate regulators' assessment of whether the accelerated underwriting programs are fair, transparent, and secure, as required by existing law. The group explained:

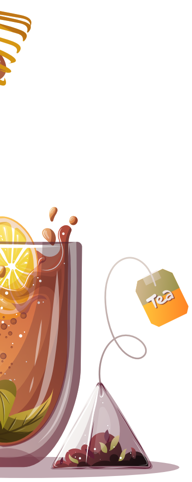
> Making sure that the use of accelerated underwriting is fair to consumers is important because its use impacts both the availability and affordability of life insurance to consumers. Ensuring that insurers use accelerated underwriting in a transparent manner is important because consumers should understand what personal data is being accessed by insurers and how that data is being used. Lastly, insurers accessing sensitive consumer data have a duty to secure that data to protect consumers from the harm of unauthorized disclosure.

Colorado Division of Insurance

1. Before its February 7 stakeholder meeting, the Colorado Division of Insurance issued its draft proposed "Algorithm and Predictive Model Governance Regulation" and solicited informal comments on the draft. The informal comments are now available on the division's website. The division has not taken any further action, so it seems the draft regulation is still cooking.

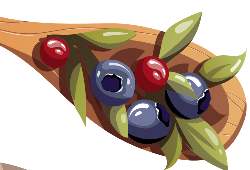
2. On April 6, 2023, the division held its first stakeholder meeting on private passenger auto insurance. The meeting was an appetizer to the main course to come. Specifically, the division reiterated the goal of legislation and introduced the issues raised by insurers' use of external data and AI in the context of private passenger auto insurance. The division opened the floor to questions in which interested parties got their bite at the onion. Interested parties provided feedback on the legislation, with the main concerns focusing on moving too quickly and undercooking the final dish.

Other States



1. New York

In January 2019, the New York State Department of Financial Services issued Circular Letter No. 1 to advise insurers authorized to write life insurance in New York of their statutory obligations regarding the use of external consumer data and information sources in underwriting for life insurance. The letter also requires insurers to (1) determine that the external tools or data sources do not collect or use prohibited criteria and (2) establish that the underwriting or rating guidelines are not unfairly discriminatory. The letter goes on to warn that an insurer "may not simply rely on a vendor's claim of non-discrimination or the proprietary nature of a third-party process as a justification for a failure to independently determine compliance with anti-discrimination laws. The burden remains with the insurer at all times."



2. Connecticut

The Connecticut Insurance Department issued a notice on April 20, 2022, on the usage of big data and avoidance of discriminatory practices. The notice sought to remind insurers of the expectation that they will comply with anti-discrimination laws in the use of technology and big data. The department discussed its authority to require insurers and third-party data vendors, model developers, and bureaus to provide the department with access to data used to build models or algorithms included in any rate, form, and underwriting filings. The department emphasized the importance of data accuracy, context, completeness, consistency, timeliness, relevancy, and other critical factors of responsible and secure data governance.

3. California

On June 30, 2022, the California Department of Insurance released its bulletin titled "Allegations of Racial Bias and Unfair Discrimination in Marketing, Rating, Underwriting, and Claims Practices by the Insurance Industry." It reminded insurers of their "obligation to market and issue insurance, charge premiums, investigate suspected fraud, and pay insurance claims in a manner that treats all similarly-situated persons alike." The department posited that "conscious and unconscious bias or discrimination . . . can and often does result from the use of artificial intelligence, as well as other forms of 'Big Data' (i.e., extremely large data sets analyzed to reveal patterns and trends)" and warned that the use of algorithms and models must have a sufficient actuarial nexus to the risk of loss. It further noted that even when the "models and data may suggest an actuarial nexus to risk of loss, unless a specific law expressly states otherwise, discrimination against protected classes of individuals is categorically and unconditionally prohibited."

Private Fund Advisers on the Hotplate

SEC Turning Up the Heat

BY MEDERIC DAIGNEAULT

Private fund advisers are once again featured prominently among the SEC Examination Division's exam priorities. As previously reported, this is unsurprising, given the scope and intensity of the SEC's increased pressure on private fund advisers in the past couple of years. *See* "A Hailstorm for Private Fund Advisers?" and "SEC Proposes Sea Change in Private Fund Regulation," *Expect Focus – Life, Annuity, and Retirement Solutions* (April 2022).

Among other areas, the division's recently published 2023 exam priorities include:

- **Conflicts**. As fiduciaries, private fund advisers must identify material conflicts of interest and either eliminate them or mitigate and timely disclose them. Common conflicts include practices pertaining to the allocation of investment opportunities, financial relationships between investors and the adviser, undisclosed agreements with investors, and undisclosed interests in recommended investments. As applicable, these and other conflicts should also be addressed in a private fund adviser's risk assessment and compliance manual.
- **Fair Calculation and Allocation of Fees and Expenses**. The SEC has spotlighted this subject for nearly a decade. For 2023, the division underscored the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds. As applicable, and in advance of any examination, private fund advisers should assess whether practices align with disclosures and are applied consistently.
- **New Investment Adviser Marketing Rule**. Private fund advisers should understand how and when the new marketing rule applies differently to them than to other advisers. Also, in connection with the rule's adoption, certain no-action letters previously relied on by some private fund advisers have been withdrawn. One consequence is that placement agent arrangements generally must now comport with new requirements.
- **Use of Alternative Data**. Private fund advisers using alternative data in investment decision-making must adopt procedures for vetting these data providers to ensure the firm's sourcing and use of alternative data complies with applicable securities laws. (Alternative data is defined, generally, as data gathered from nontraditional sources such as satellite imagery, social media commentary, product reviews, credit card transactions, and geolocation information, among other sources.)
- **Compliance With Custody Rule**. Among other things, private fund advisers should be familiar (and, as applicable, comply) with SEC staff interpretations regarding special custody considerations for certain private funds. Private fund advisers should also monitor developments regarding the new rule that the SEC proposed earlier this year to replace the current custody rule. *See* "SEC Proposes to Remake Advisers Act Custody Rule for a Modern World."

In light of the rising regulatory temperature, private fund advisers risk of getting burned if they don't give careful consideration to the division's exam priorities that apply to them.

SEC Stirs Its Pot of Cybersecurity Preparedness and Response Proposals

BY JOSEPH SWANSON

The SEC remains laser-focused on cybersecurity, with the agency recently reopening the comment period on a sweeping rule for investment advisers and investment companies. In addition, the SEC issued proposed enhancements to Regulation S-P, the agency's existing regulation designed to protect the privacy of consumer financial information.

Last year, we reported on the SEC's proposed cybersecurity rule intended to increase regulation of advisers' and investment companies' cybersecurity preparedness. *See* "SEC Plants New Cybersecurity Regulations; Time Will Tell What Will Bloom." That proposed rule would have required, among other things, more detailed and well-documented cybersecurity programs, as well as cybersecurity disclosures to current and prospective clients and security holders and reports to the SEC within 48 hours of "significant cybersecurity incidents." Although the comment period for that rule closed in April 2022, the SEC announced on March 15, 2023, that it was reopening that period, such that it will receive additional comments until May 22, 2023.

Also on March 15, the SEC proposed amendments to Regulation S-P, with comments due June 5, 2023.

Adopted in 2000, Regulation S-P generally requires broker-dealers, investment companies, and registered investment advisers to adopt policies and procedures to safeguard customer records and information. The existing regulation, however, does not include a breach notification requirement.

The proposed amendments to Regulation S-P would change this and place greater emphasis on incident response by requiring the following from covered institutions:

- Written policies and procedures for an incident response program to address unauthorized access to, or use of, customer information.
  - That program must be reasonably designed to detect, respond to, and recover from unauthorized access to, or use of, customer information.
- Notice to individuals whose sensitive customer information was or is reasonably likely to have been accessed or used without authorization.
  - That notice would be required as soon as practicable but no later than 30 days after the institution becomes aware of the potential compromise of customer information.
- Procedures to address security risks involving service providers, through contractual provisions requiring the protection of customer information and prompt notification to the covered institution in the event of a breach.

In announcing the release of the proposed amendments, the SEC appeared focused on addressing the ever-increasing risk of customer information being compromised, given the many expansions in technology. The SEC also noted how, under the current patchwork approach to breach notification provided by varying standards under state law, the SEC's proposal would establish a federal minimum standard for breach notifications by covered institutions. Given the SEC's continued interest in cybersecurity, covered institutions should consider the following action items:

- Evaluate the extent to which existing cybersecurity programs can help satisfy the proposed new standards. Because many covered institutions may already have robust programs to comply with other regulatory regimes, such as the New York State Department of Financial Services' cybersecurity regulation, those institutions would be wise to leverage their existing programs and efficiently comply with any new standards formally adopted by the SEC.
- Emphasize incident preparation and response, particularly in light of potential new breach notification requirements under one or both of the SEC proposals. To meet those requirements, institutions will need to quickly detect, investigate, and respond to suspected incidents.

The proposals described above also come against the backdrop of the SEC also proposing on March 15 a new rule, form, and related amendments to require "market entities," including many broker-dealers, to address cybersecurity risks through the implementation of policies and procedures, regular reviews of those policies and procedures, and immediate notice to the SEC of any significant cybersecurity incident. Comments on this proposal are due by June 5, 2023.

Meanwhile, for its part, the National Association of Insurance Commissioners' Cybersecurity (H) Working Group is seeking input this spring on a plan to aid state insurance regulators in responding to cybersecurity events, which would include collecting information from companies regarding those events. This would be another regulatory development focused on cyber incident response. Covered institutions would be wise to plan accordingly.

Catching More Flies With Honey

Recent DOJ Policy Changes to Coax Cooperation From Corporate Defendants

BY NATALIE NAPIERALA AND DAVID WRIGHT

In March 2023, the Department of Justice announced two policy changes that attempt to incentivize self-disclosure to the federal government and self-imposed remedial measures by corporations charged with criminal wrongdoing.

Self-Disclosure Policy

The first policy — the U.S. Attorneys' Offices voluntary self-disclosure policy — seeks to reward self-disclosures of corporate misconduct by offering more favorable resolutions to corporations with the goal that such self-disclosure will enable the government to investigate and hold wrongdoers accountable more quickly and efficiently.

To meet the standards of the self-disclosure policy, a company's disclosure must:

1. Be voluntary, which requires that there be no preexisting obligation to disclose;
2. Be made (a) before an imminent threat of disclosure or government investigation; (b) before the alleged misconduct is publicly disclosed or otherwise known to the government; and (c) within a reasonably prompt time after the company becomes aware of the alleged misconduct, with the company having the burden to prove timeliness; and
3. Include all relevant facts concerning the alleged misconduct that are known to the company at the time of the disclosure.

If a company can satisfy the foregoing standards, and there are no aggravating factors, and the company fully cooperates, and the company timely and appropriately remediates, the USAO likely will not seek a guilty plea. Regardless of whether a guilty plea is sought, if the company has voluntarily self-disclosed, fully cooperated, and timely and appropriately remediated, the USAO will accord or recommend at least a 50% to 75% reduction from the low end of the applicable sentencing guidelines fine range or may offer a penalty benefit reduction from an alternate voluntary self-disclosure policy.

Moreover, an independent compliance monitor will not be required for a cooperating company that voluntarily self-discloses, and timely and appropriately remediates the criminal conduct, if the company demonstrates at the time of resolution that it has implemented and tested an effective compliance program.

Self-Imposed Remedial Measure Pilot Program

The second policy — the DOJ Criminal Division's pilot program on compensation incentives and clawbacks — takes a two-pronged approach.

Under the first prong, which is mandatory, every resolution entered into by the division must require the company to implement compliance-related criteria in its compensation and bonus systems. In other words, the pilot program is not optional; the division will apply the program's criteria to all corporate matters during the three-year effective period (ending March 15, 2026). The required criteria, which

are to be forward-looking changes to a company's compliance-related policies, may include, but are not limited to:

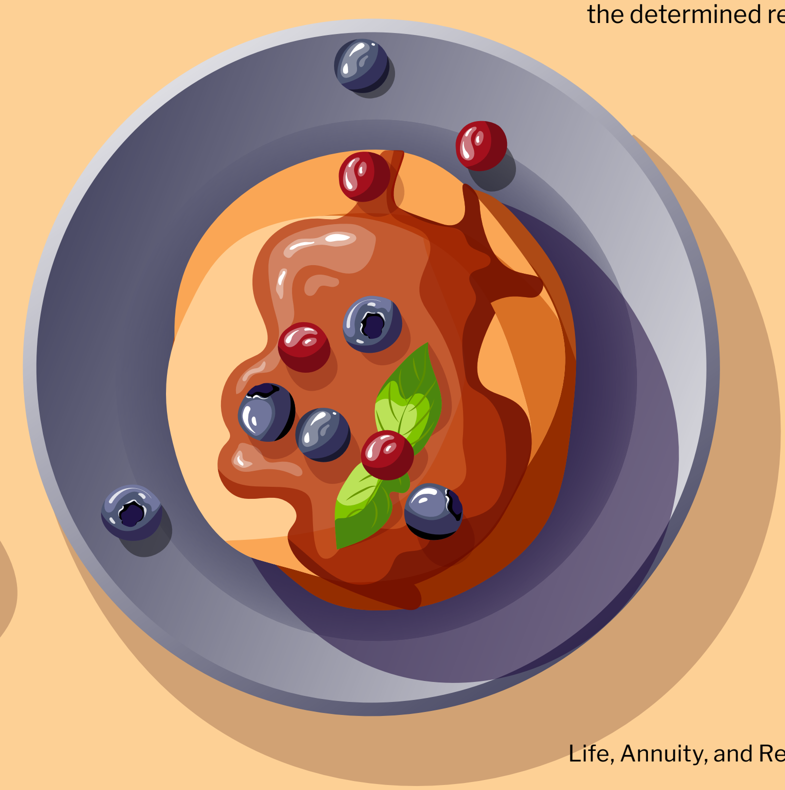
1. A prohibition on bonuses for employees who do not satisfy compliance performance requirements;
2. Disciplinary measures for employees who violate applicable law and others who both (a) had supervisory authority over the employee(s) or business arena engaged in the misconduct and (b) knew of, or were willfully blind to, the alleged misconduct; and
3. Incentives for employees who demonstrate full commitment to compliance processes.

Under the second prong, the division will offer a fine reduction to companies that fully cooperate, timely and appropriately remediate, and demonstrate an implemented program to recoup compensation from employees who are under investigation for alleged wrongdoing or other employees who (a) had supervisory authority over such employees or the business arena engaged in the misconduct and (b) knew of, or were willfully blind to, the alleged misconduct.

A company will be required to pay the full amount of the original fine minus 100% of the amount of compensation the company is attempting to claw back ("possible clawback reduction"). Although not clear from the pilot program, each resolution will include a "resolution term," during which a company would attempt to remediate and implement changes to its compliance programs. At the end of the term, if the company has not recovered the full amount it sought to claw back, the company must pay the possible clawback reduction minus 100% of the compensation actually recovered. If the company's good faith attempt to recoup compensation is unsuccessful, prosecutors have the discretion to offer a maximum of a 25% reduction of the amount of compensation the company attempted to claw back such that the company must, after the resolution term, make an additional fine payment of the possible clawback reduction less the determined reduction percentage of the compensation sought. Such reductions may be warranted where, for example, a company incurred significant litigation costs on behalf of shareholders or can demonstrate it is highly likely that it will successfully recoup the compensation.

***

Both the self-disclosure policy and the pilot program are subject to uncertainties and varying interpretations. And both of these new policies are subject to a large degree of prosecutorial discretion. It therefore remains uncertain how any given prosecutor will apply either of the policies to a given set of facts, which makes it difficult for companies to conduct an informed cost-benefit or other analysis in determining whether to seek the advantages under either policy.



ETFs in Variable Contracts: A New Marketing Opportunity?

BY THOMAS CONNER

The Secure Act of 2022, in order to facilitate the use of exchange-traded funds (ETFs) as investment options under variable contracts, directs the Treasury Department to amend the governing look-through rules under applicable tax regulations to provide for insurance-dedicated ETFs. The department would be allowed up to seven years to update its regulations. Amendments could be adopted much sooner, however, as we understand that the extended adoption period was provided for certain revenue and cost "scoring" purposes. Another timing factor is that SEC rules governing ETFs may also need to be amended.

What You Need to Know

Market and economic factors will drive decision-making by ETF sponsors and insurance companies considering partnerships to create and offer insurance-dedicated ETFs in variable products. Some pros and cons will need to be analyzed and weighed carefully.

- Some ETFs have lower costs than mutual funds. A primary reason is that ETFs are bought and sold in the secondary market through brokerage houses so that the ETF does not bear the costs of maintaining shareholder accounts. However, mutual funds underlying variable contracts (underlying funds) enjoy this same advantage because their only direct shareholders are insurance company separate accounts. Some underlying funds reimburse insurers for maintaining contract owner accounts (sometimes referred to as "sub-transfer agency expenses"). Insurance-dedicated ETFs will need to consider the extent to which they can modify typical retail ETF cost structures as well as whether insurers will show flexibility in negotiating sub-transfer agency agreements.
- Retail ETFs also have lower cost structures because they often sell or redeem their shares in "in-kind" transactions with broker-dealers, so the ETF avoids the brokerage and other expenses associated with buying and selling portfolio investments through intermediaries. Query whether insurance companies will be willing to do the same.
- ETFs generally do not have sales loads or 12b-1 fees.
- Mutual fund families that do not currently offer ETFs will incur the considerable expenses associated with either registering new ETFs or converting existing funds to ETFs.
- Insurance-dedicated ETF sponsors may be challenged to transform fluctuating intraday ETF share prices into a defined, repeatable, formulaic, and nondiscretionary process required for a separate account to qualify as a unit investment trust under the Investment Company Act of 1940.

In conclusion, weighing the pros and cons will certainly be important. The most significant factor, however, may be that insurers and ETF sponsors conclude that product offerings with ETFs offered as investment options is simply too fertile ground not to be plowed.

ETF Share Transactions Based on Nonpublic Information

An Illegal Secret Ingredient?

BY THOMAS LAUERMAN

Those with nonpublic information about a merger or acquisition involving a company appear to be profiting by trading in shares of exchange-traded funds based on indexes that include such companies' shares, according to a recent study by Swedish and Australian researchers.

Securities law liability could very well be simmering in the background for people engaging in this type of activity. The SEC, for example, is known to have recently expanded the range of circumstances in which it has alleged insider trading violations. In this connection, we have previously reported on an SEC action against an executive who used nonpublic information about his company's impending merger to trade options on the shares of a competitor company. *See* "SEC Cultivates Shadow Trading Theory," *Expect Focus – Life, Annuity, and Retirement Solutions* (April 2022). The competitor company's value was likely to be affected by the merger, even though the company wasn't involved in the transaction.

Since the SEC has been willing to pursue that type of "shadow trading" activity, it likely also would pursue insider trading in ETF shares, although the exact parameters of such insider trading liability are far from clear. Presumably, any such liability would not be limited to M&A but would extend to other types of material nonpublic information as well.

The study's authors found that ETFs focusing on the industry or sector that include the companies involved in an M&A transaction were most likely to be used for trading on the basis of the M&A information. This is not surprising, as the shares of the companies involved in the transaction would be most likely to comprise a significant proportion of that type of index. However, at least in theory, insider traders also could seek to use other types of ETFs or even non-ETF mutual funds.

Accordingly, those responsible for developing and implementing firms' insider trading compliance procedures would be well advised to continue to be alert to the expanding range of possible violations.

Social Media Influencers Take Center Stage

BY EDMUND ZAHAREWICZ

Securities products and social media don't always mix. Just ask any of the celebrities who in recent years have faced SEC charges for unlawfully touting crypto asset securities. In March, the SEC settled charges against six well-known personalities, including the likes of actress Lindsay Lohan and rapper Lil Yachty, for promoting on their social media certain crypto asset securities without telling their followers that they were being paid to do so in violation of section 17(b) of the Securities Act of 1933. NBA Hall of Famer Paul Pierce, in February, and social media maven Kim Kardashian, last October, settled similar SEC charges involving other crypto asset securities.

Section 17(b) makes it unlawful for any person to promote a security without fully disclosing the receipt and amount of any compensation from an issuer. It is now more than five years since the SEC and its staff first publicly warned that digital tokens or coins may be securities and that "any celebrity or other individual who promotes a virtual token or coin that is a security must disclose the nature, scope, and amount of compensation received in exchange for the promotion."

Anti-touting cases are relatively easy to charge because the SEC is not required to show an intent to defraud. Paid influencers who, whether knowingly or negligently, make false or misleading statements while promoting a security may face additional charges. Paul Pierce, for example, was also charged with violating section 17(a)(2) of the Securities Act, which prohibits obtaining money or property through false or misleading statements made in the offer or sale of securities, for allegedly making statements "indicating that he was holding — and intended to increase — his investment in the crypto asset security while contemporaneously selling the securities."

Paid influencers have not been the only targets of the SEC's attention. In a more egregious matter, the SEC charged eight individual social media influencers at the end of 2022 in a $100 million stock manipulation scheme on Discord and Twitter. The defendants allegedly used social media to amass a large following of novice investors and then took advantage of them by repeatedly feeding them "a steady diet of misinformation."

As if on cue, in February, FINRA issued an update on its ongoing targeted exam sweep, launched in September 2021, of firm practices related to, among other things, the use of social media influencer and referral programs to promote products and services and recruit new customers. The update summarizes selected practices in this area that firms are encouraged to consider to ensure their compliance arrangements are reasonably designed to achieve compliance with relevant regulatory obligations. Among the practices noted:

- Maintaining focused written supervisory procedures, including:
  - Additional controls for social media influencers with a relatively large social media presence;
  - Updating written supervisory procedures regularly and in response to program developments, regulatory changes, or industry trends; and
  - Addressing program participants' compensation.
- Evaluating potential social media influencers' backgrounds and prior social media activities to identify any compliance and reputational risks before admitting them into social media influencer programs.
- Providing training, and defining permitted and prohibited conduct, for social media influencers.
- Maintaining records of social media influencer and referral program communications with the public, consistent with applicable SEC and FINRA record-keeping obligations.

With the SEC and FINRA's heightened focus on the activities of social media influencers and their relationships with market participants, there would seem to be no time like the present for securities firms of all stripes to dust off their compliance policies and procedures in this area for a thorough review.

SEC Places Short Order for T+1

But Insurance Products Mostly Off the Menu

BY THOMAS LAUERMAN

In February 2023, the SEC adopted rule amendments that require most securities transactions effected by broker-dealers to be settled within one business day (T+1), rather than the currently required two business days. The SEC proposed this change last year, as we previously reported. *See* "Shortened Settlement Cycle Sprouts at SEC," *Expect Focus – Life, Annuity, and Retirement Solutions* (April 2022).

These amendments will require numerous entities — which may include broker-dealers, clearing organizations, investment companies, and investment advisers — to make various changes to their methods of operation, systems, relevant agreements and disclosures, and/or certain SEC filings. For some firms, these changes will require substantial time and resources, and concerns are being expressed that some firms may not be ready by the May 28, 2024, deadline by which the SEC is requiring that T+1 be implemented. Indeed, the SEC's two Republican commissioners dissented from the SEC's adoption of these amendments, fearing that not all required operational changes could be adequately implemented in time. Instead, they, like some industry commenters on the proposal, argued (unsuccessfully) for an effective date of September 3, 2024.

Given these concerns, firms are having to promptly determine what, if any, steps they must take to comply with these amendments and plan accordingly. Moreover, the SEC examination staff during the coming year will likely be asking questions about the status of firms' preparations in this regard.

Importantly, however, the SEC left in place a 1995 order that will exempt transactions in most variable annuities, variable life insurance, and other insurance products that are registered as securities from the new one-day requirement (as that order now exempts them from the current two-day requirement).

NAIC's New Privacy Protections Recipe

BY ANN BLACK AND PATRICIA CARREIRO

In April and May, the NAIC Privacy Protections Working Group held the first three of its biweekly calls to discuss its recipe for a new privacy model, "Insurance Consumer Privacy Protection Model Law #674." During the meetings, the working group considered whether the recipe needed to (a) include, as an ingredient, a private right of action; (b) clarify the HIPAA safe harbor; (c) leave more or less room for "secret sauce" (i.e., revise its confidentiality provisions); (d) revisit its kitchen cleanup processes (i.e., data retention and destruction requirements); and (e) locally source its ingredients (i.e., restrict cross-border data transfers).

Private Right of Action

The debate on whether to include a private right of action within the privacy model was similar to deciding whether a recipe should include cilantro — some love it, while for others it leaves a soapy aftertaste. As expected, consumer advocates sought to preserve a private right of action. They asserted that eliminating it would deprive consumers of any redress for the unwanted use of their personal information and make noncompliance a mere cost of doing business. The advocates alleged that this additional ingredient was necessary to counter insurers' increased data use and "surveillance economy," as regulators would not have the resources to enforce the draft model's protections. Those against its inclusion countered that the ingredient merely preserves the status quo; removing the language does not take away any existing causes of action.

HIPAA Safe Harbor

Discussions on the HIPAA safe harbor were less divisive. The commentators generally agreed that the recipe should include a HIPAA safe harbor. The question was how much to add and how to express that in the recipe (i.e., for the HIPAA safe harbor to apply, is it sufficient for entities to be subject to HIPAA or subject to and in compliance with HIPAA? And how should that apply to entities with varying lines of business, some of which are subject to HIPAA and others that are not?).

Confidentiality Provisions

Industry and consumer advocates debated the extent to which the model's recipe should protect secret sauce. Industry advocates requested that the optional contractual provisions between regulators and their contractors be made mandatory and expanded to protect all confidential data provided to regulators, even if not a part of a market conduct exam, stressing the importance of such protection to protect service providers' intellectual property. Consumer advocates, however, said that existing law provided sufficient confidentiality and that the model should not include any confidentiality provisions but rather require additional reporting and disclosures to help consumers "discipline insurers."

Document Retention and Deletion

Industry and consumer advocates also split on kitchen cleanup (i.e., the model's data retention and destruction provisions). Industry advocates explained that requiring deletion within 90 days of no longer needing personal information was a technical impossibility for legacy systems and would require years to implement, that individual confirmation of document deletion was unworkable, and that a risk-based (rather than the current one-size-fits-all 90-day proposal) was necessary. Regulators expressed openness to step up compliance or extended implementation deadlines and requested industry input regarding how long would be needed. Consumer advocates, however, requested the draft model be revised to lessen insurer discretion regarding the amount of time for which personal information would be retained. Regulators explained that their data minimization concerns were due to the risk of data breaches and that they were entirely unconcerned with de-identified data, with one regulator exclaiming: "If you can de-identify it, then go ahead and keep it forever."

Cross-Border Data Transfers

Consumer advocates appeared ambivalent as to whether their ingredients were locally sourced, but industry advocates raised sharp concerns over the draft model's proposal to require consent for all cross-border transfers, stating that such a requirement:

- Might offend, or be preempted by, international treaties;
- Is contrary to the increasingly global nature of business and is unduly burdensome for companies with global operations;

- Would exceed the protections put in place by state privacy laws; and
- Would harm consumers by increasing costs and decreasing the availability of 24-hour customer service without improving either security or consumer control over their data.

Instead, industry commentators encouraged the working group to explore vendor oversight and required contractual provisions when transferring data to service providers or vendors abroad (e.g., requiring international data processors to commit to certain cybersecurity practices and regular oversight and submit to the jurisdiction of U.S. regulators).

Next Steps

The working group made no final decisions but expressed its expectation to revise its recipe based on the feedback received. Next, the working group has invited regulators and other interested parties into the test kitchen for two full days of recipe development on June 5–6. Get your taste buds ready!

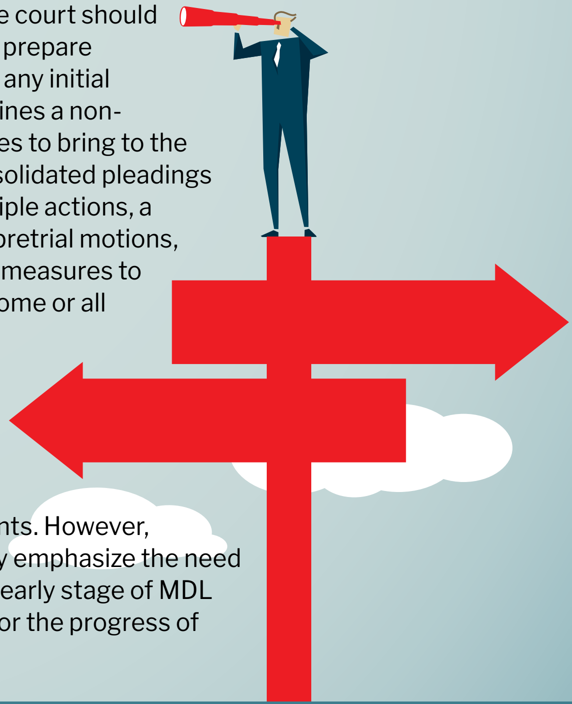
Proposed Rule Provides Guidance for Initial Case Management in MDLs

BY SEAN HUGHES

Multidistrict litigation (MDL) is a special federal legal procedure designed to efficiently process multiple civil cases involving one or more common questions of fact. These cases typically involve hundreds to thousands of plaintiffs in different district courts throughout the country. The U.S. Judicial Panel on Multidistrict Litigation may transfer these actions to any single district for coordinated or consolidated pretrial proceedings. In recent years, these actions have accounted for a substantial portion of the federal civil docket, with around 400,000 lawsuits currently part of MDL proceedings.

On March 28, 2023, the Advisory Committee on Civil Rules voted to publish for comment a new rule on initial case management in MDL actions, which could assist the transferee court (the court to which the case has been transferred) in addressing a variety of matters that often prove important in MDL proceedings.

Once an MDL action is transferred, proposed Rule 16.1 encourages the transferee court to schedule an initial MDL management conference to develop a management plan for orderly pretrial activity. While this initial management conference is not mandatory under proposed Rule 16.1(a), early attention to the matters identified in the rule may be of great value to the transferee judge and the parties. The draft rule further recommends that the transferee court designate coordinating counsel to ensure effective and coordinated discussion during a Rule 16.1(c) conference and provide an informative report for the court to use during an initial management conference under Rule 16.1(a). Under subsection (c) of the rule, the transferee court should order the parties to meet and confer to prepare and submit a report to the court before any initial management conference. The rule outlines a non-exhaustive list of 12 topics for the parties to bring to the court's attention, such as whether consolidated pleadings should be prepared to account for multiple actions, a proposed plan for discovery, any likely pretrial motions, and whether the court should consider measures to facilitate settlement by the parties of some or all actions before the court.

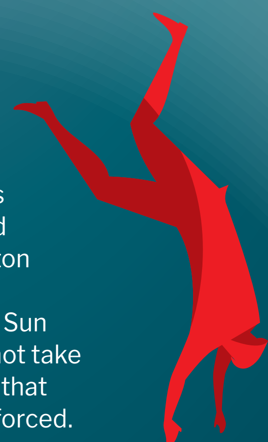


Ultimately, the proposed rule has prompted many concerns from both plaintiffs' and defendants' attorneys, as the rule does not set any mandatory requirements. However, codifying these topics would potentially emphasize the need for parties to address key issues at the early stage of MDL proceedings. We will continue to monitor the progress of proposed Rule 16.1.

STOLI Fallout: Stepping Into the Post-Void

BY KIRSTEN WOLFFORD

The phenomenon of void ab initio life insurance policies has "spawned a host of thorny questions regarding the appropriate remedial response to the identification of a policy as STOLI." The Supreme Court of Delaware succinctly identified the fundamental issue in its March 21 opinion in *Wilmington Trust, N.A. v. Sun Life Assurance Company of Canada*. Once a policy has been voided for lack of insurable interest, how will courts resolve the many questions that may result? The main questions in this case centered on the death benefit, the premiums paid, and any prejudgment interest on the premiums.



In an effort to avoid the use of stranger-originated life insurance policies for "human-life wagering," the Supreme Court readily affirmed the trial court's decision denying Wilmington Trust's bid to secure death benefits on two life insurance policies issued by Sun Life. The policies were initially funded by third parties and ultimately acquired by Wilmington Trust as part of a portfolio of life insurance policies. Although Wilmington Trust countered, alleging that Sun Life suspected the policies might be STOLI but did not take any action, the court held firm with recent decisions that STOLI policies are void ab initio and can never be enforced.

However, it was not all good news for Sun Life, which also sought to retain the premiums paid on the policies, claiming that returning the premiums to Wilmington Trust, which had purchased the policies subsequent to their issuance, would reward the buyer for involvement in "a knowing STOLI investment." The Supreme Court held that the trial court erred in applying the "automatic premium return" rule, under which premiums go back to the buyer once the policy is void, and remanded for the trial court to conduct a fault-based analysis in reconsidering its ruling on the premium return claim, including the claim for prejudgment interest.

The Supreme Court also offered guidance on the question of when any prejudgment interest should begin to accrue, recognizing the role prejudgment interest plays in "incentivizing parties to potentially illegal agreements to behave in good faith." The court found that Wilmington Trust would not be entitled to prejudgment interest predating its purchase of the policies, because Sun Life should not be responsible for interest on premiums paid by former owners of the policies.

Medical Incapacity Does Not Toll Life Insurance Conversion Period

BY IRMA SOLARES

A plan administrator did not abuse its discretion in concluding that a former employee's surviving spouse was not entitled to life insurance benefits under an employee benefit plan. In *Hayes v. Prudential Insurance Company of America*, the plan participant's surviving spouse filed suit to recover benefits after her husband died. Several months before his death, her husband lost his job because of medical issues, which resulted in termination of his employer-provided life insurance policy. Although he had 31 days to convert the employer-provided coverage to individual coverage, he failed to make a timely election. Instead, the former employee waited 26 days after the conversion deadline passed to contact the plan administrator about converting his life insurance policy. The plan administrator denied his belated conversion request.

The employee passed away six months later and his surviving spouse submitted a claim for benefits under her husband's employer-provided life insurance policy. The plan denied her claim. During the administrative appeals process, the claim administrator noted that although the deceased was "incapacitated due to his medical conditions and symptoms during the time period he had to convert his coverage," the plan was required to administer claims under the plan in strict adherence to the policy provisions. The district court reviewed the plan denial of benefits for abuse of discretion and upheld the plan determination, and the Fourth Circuit Court of Appeals affirmed.

Both courts rejected the plaintiff's plea to apply the doctrine of equitable tolling to extend the conversion deadline because of the former plan participant's medical incapacity during the conversion period. The Fourth Circuit explained that because the decedent missed the conversion deadline, awarding benefits under 29 U.S.C. § 1132(a)(1)(B) would require modifying the plan's terms. The court also held that the doctrine of equitable tolling applies only to periods that operate like a statute of limitations, which a conversion period is not, because "it is not triggered by the violation giving rise to the action."

An interesting issue in the case was the Fourth Circuit's comments concerning the viability of 29 U.S.C. § 1132(a)(3) as a basis for courts to enforce contracts other than as written. Although the plaintiff did not assert a claim under subsection (a)(3), and expressly disavowed its application to the case, the Fourth Circuit recognized that subsection (a)(3) permits a plan participant or beneficiary to obtain equitable relief to redress violations of that subchapter. The court did not decide whether the plaintiff could have obtained relief under subsection (a)(3), thus laying the foundation for the possibility of equitable tolling relief under that provision for similar claims.

Carlton Fields Launches Digital and E-Commerce Engagement and Innovation Practice

Carlton Fields has launched a Digital and E-Commerce Engagement and Innovation Practice to help companies expand their online business. The group has a particular depth of expertise in advising insurance and other financial services and investment service businesses.

The group advises clients through all phases of development and implementation of:

- Digital marketing and engagement programs and practices, including the use of tools such as Google Analytics, Google Ads, Meta Pixel, and the LinkedIn Insight Tag
- Digital contracting/sales, including contracting for financial products with the use of electronic signatures, such as verbal and interactive voice response
- Algorithms, artificial intelligence, and machine learning
- Digital data management
- Biometric information programs, including for identity verification and fraud detection

From drafting requisite notices, policies, and consents, to designing new processes and contracting with third parties to implement new tools, to regulatory investigations and litigations, the Digital and E-Commerce Engagement and Innovation Practice is helping businesses innovate for the future.

NEWS & NOTES

Ann Black and **Richard Choi** were among eight Carlton Fields attorneys selected via client nomination to the *Reuters* 2023 "Stand-Out Lawyers" list, derived from *Reuters*' randomly sampled global Sharplegal survey. Lawyers on this list were recognized for their ability to offer proactive, business-savvy advice; deliver exceptional client service; and integrate well within the client's legal team.

JD Supra named **Ann Black** as the top author for insurance in its 2023 Readers' Choice Awards, which recognize top authors and firms read by C-suite executives, in-house counsel, media, and other professionals across the *JD Supra* platform.

Carlton Fields is recognized as a top law firm in the *BTI Client Service A-Team 2023* report, a designation limited to law firms that deliver unparalleled client service. The firm was ranked No. 25 in the nation for client service of the more than 600 law firms serving larger clients, earning a spot on the prestigious "BTI Client Service 30" list.

Carlton Fields and Chief Diversity Officer **Nancy Faggianelli** were selected as 2023 Florida Legal Award honorees in the diversity, equity, and inclusion category by the *Daily Business Review.*

The firm is sponsoring the NAFA Annuity Leadership Forum on June 20–21, 2023, in Washington, D.C. The forum is an opportunity to discuss the regulation, legislation, and other important issues facing industry organizations and business today. **Richard Choi** will serve as a legal panelist at the conference.

Carlton Fields is sponsoring the ACLI Compliance & Legal Sections Annual Meeting on July 17–19, 2023, in Las Vegas. The annual meeting will address topics relevant to both compliance and legal executives. **Tino Lisella** will speak on fraud and the use of chatbots fraud bots, and **Michael Yaeger** will speak on federal sentencing guidelines and DOJ guidance.

Carlton Fields welcomes the following attorneys to the firm: Shareholders **W. Thomas Conner** (financial services regulatory, Washington, D.C.), **Mederic Daigneault** (financial services regulatory, Hartford), and **Blair Hedges** (real property litigation, Orlando); Of Counsel **Joan Archer** (intellectual property, Los Angeles); and Associates **Jason Bullinger** (construction, Orlando), **Trevor Cardo** (real estate and commercial finance, New York), **Andres Cordova** (property and casualty insurance, Miami), **Olivia Dresevic** (health care, Tampa), **Sameer Hussain** (business litigation, Los Angeles), **Benjamin Mandel** (business litigation, Los Angeles), **Christopher Norris** (appellate practice and trial support, Miami), and **Amrit Singh** (business litigation, New York).

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY GROUP

Co-chairs, Ann Y. Black and Markham R. Leventhal

Scott Abeles
Enrique D. Arana
Scott E. Byers
Patricia M. Carreiro
Richard T. Choi
Justin L. Chretien
Gary O. Cohen
W. Thomas Conner
Mederic Daigneault
Robert W. DiUbaldo
Stephanie A. Fichera
Todd M. Fuller
Ann B. Furman
Brendan N. Gooley
Jason H. Gould
Clifton R. Gruhn
Sean W. Hughes
Jeanne M. Kohler
William J. Kotapish
Stephen W. Kraus
Thomas C. Lauerman
Jordan J. Luczaj
Julianna Thomas McCabe
Thomas F. Morante
Jason A. Morris
Mark A. Neubauer
Brooke Patterson
John C. Pitblado
Thomas V. Sjoblom
Robert B. Shapiro
R. Jeffrey Smith
Irma T. Solares
Erin J. VanSickle
Jeffrey L. Williams
Michael N. Wolgin
Kirsten N. Wolford
Edmund J. Zaharewicz

CARLTON FIELDS

Carlton Fields serves business clients in key industries across the country and around the globe. Through our core practices, we help our clients grow their businesses and protect their vital interests. The firm serves clients in eight key industries:

- Life, Annuity, and Retirement Solutions
- Banking, Commercial, and Consumer Finance
- Construction
- Health Care
- Property and Casualty Insurance
- Real Estate
- Securities and Investment Companies
- Technology and Telecommunications

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

Atlanta
One Atlantic Center
1201 W. Peachtree Street NW | Suite 3000
Atlanta, Georgia 30309-3455
404.815.3400 | fax 404.815.3415

Hartford
One State Street | Suite 1800
Hartford, Connecticut 06103-3102
860.392.5000 | fax 860.392.5058

Los Angeles
2029 Century Park East | Suite 1200
Los Angeles, California 90067-2913
310.843.6300 | fax 310.843.6301

Miami
2 MiamiCentral
700 NW 1st Avenue | Suite 1200
Miami, Florida 33136-4118
305.530.0050 | fax 305.530.0055

New Jersey
180 Park Avenue | Suite 106
Florham Park, New Jersey 07932-1054
973.828.2600 | fax 973.828.2601

New York
Chrysler Building
405 Lexington Avenue | 36th Floor
New York, New York 10174-3699
212.785.2577 | fax 212.785.5203

Orlando
200 S. Orange Avenue | Suite 1000
Orlando, Florida 32801-3456
407.849.0300 | fax 407.648.9099

Tallahassee
215 S. Monroe Street | Suite 500
Tallahassee, Florida 32301-1866
850.224.1585 | fax 850.222.0398

Tampa
Corporate Center Three
at International Plaza
4221 W. Boy Scout Boulevard | Suite 1000
Tampa, Florida 33607-5780
813.223.7000 | fax 813.229.4133

Washington, DC
1025 Thomas Jefferson Street, NW
Suite 400 West
Washington, DC 20007-5208
202.965.8100 | fax 202.965.8104

West Palm Beach
CityPlace Tower
525 Okeechobee Boulevard | Suite 1200
West Palm Beach, Florida 33401-6350
561.659.7070 | fax 561.659.7368

Carlton Fields, P.A. practices law in California through Carlton Fields, LLP.