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The CFPB Takes First Enforcement Action Related to Data Security Practices

BY APRIL WALKER & KIMBERLY GUSTAFSON

The Consumer Financial Protection Bureau (CFPB) has taken its first UDAAP action against a consumer financial service provider related to data security practices. Since its launch in December 2009, Dwolla, Inc. ("Dwolla"), an online payment service company, has collected and stored consumers' sensitive personal information while providing a platform for online financial transactions.

The CFPB found that from 2010 to 2014, Dwolla misrepresented to consumers that its network and transactions were "safe" and "secure," in violation of the Consumer Financial Protection Act's prohibition on Unfair and Deceptive or Abusive Acts or Practices (UDAAP). Specifically, the CFPB found that Dwolla misrepresented on its website and in communications, that:

- **It employed "reasonable and appropriate measures to protect data obtained from consumers."** Dwolla did not adopt or implement data security policies and procedures, or a written data security plan, until 2012 and 2013 respectively and did not conduct its first comprehensive risk assessment until mid-2014.
- **"100%" of its consumers' information was "encrypted and stored securely."** Dwolla did not, in all instances, encrypt consumers' Social Security numbers, bank account information, names, addresses, 4-digit PINS, or digital images of driver's licenses and Social Security cards.
- **Its data security practices "exceed" or "surpass" industry security standards.** Dwolla did not conduct its first mandatory employee data security training until more than one year and a half after a penetration test demonstrated such training was needed.
- **Its transactions, servers and data centers were "safer than credit cards" and "PCI compliant."** Dwolla's transactions, servers and data centers were not compliant with standards issued by the Payment Card Industry (PCI) Security Standards Council.

A $100,000 civil money penalty was assessed against Dwolla and the company was ordered to stop misrepresenting its data security practices, fix those practices and train its employees. Dwolla consented to the order without admitting or denying the CFPB's findings of fact or conclusions of law. However, on the day the order issued, Dwolla announced in a blog post on its website that it never detected any evidence or indicators of a data breach, or received a notification or complaint of such an event.

CFPB Director: "With data breaches becoming commonplace and more consumers using these online payment systems, the risk to consumers is growing."

CFPB Director Richard Cordray said, "With data breaches becoming commonplace and more consumers using these online payment systems, the risk to consumers is growing. It is crucial that companies put systems in place to protect this information and accurately inform consumers about their data security practices." Considering the agency's aggressive action and heavy reliance on the UDAAP in its enforcement orders, the *Dwolla* action signifies representations about data security are now on the CFPB's radar as well.

Class Certified in Unique Fixed Indexed Annuity Case

BY JASON BROST

The creative theories of liability and damages on display in the recent certification of multiple classes suggest that the long run of annuity class actions is not over yet. Plaintiff in *Abbit v. ING USA Annuity and Life Insurance Company* offered multiple theories of liability, asserting 11 causes of action with respect to ING's marketing and administration of fixed index annuities (FIAs), including breaches of contractual and fiduciary duties, fraud, failure to supervise, and four statutory claims.

Plaintiff claimed that ING "surreptitiously embedded … structured financial derivatives" in its FIAs, without explaining whether this fact distinguishes ING's FIAs from other FIAs or, if not, how the "structured financial derivatives" were hidden. He further alleged that ING abused its discretion in the manner it adjusted caps on investment returns, which were allegedly set too low for the FIAs to perform as represented. Additionally, plaintiff contended that a premium bonus feature of certain FIAs makes them securities, because the bonus is "not included in the contract's guaranteed values," thus putting these products "in an unregulated 'no-man's land.'" Finally, plaintiff asserted that his FIA was worth only 73 cents per dollar of premium paid on the date of purchase and that other FIAs were similarly affected by ING, arguing that this purported ability to assess the "purchase date value" of the FIAs will allow damages to be calculated on a class-wide basis.

The California federal court recognized that treating FIAs as securities was a "novel theory" and expressed reservations about the methodology plaintiff used to calculate the value of these FIAs, but found enough common issues to certify some of plaintiff's claims.

In its opinion partially granting class certification, the California federal court recognized that treating FIAs as securities was a "novel theory" and expressed reservations about the methodology plaintiff used to calculate the value of these FIAs, but found enough common issues to certify some of plaintiff's claims. The Ninth Circuit has rejected ING's petition for permission to appeal this order, and briefing has begun on ING's motion for summary judgment on the class claims.

ALLEGED MISREPRESENTATIONS TO DFS WARRANT SLUSA PRECLUSION

BY WHITNEY FORE & DAWN WILLIAMS

The Southern District of New York recently granted defendant's motion to dismiss a putative class action claiming that AXA Equitable Life Insurance Company breached its contractual obligation by implementing a volatility management strategy for its variable annuities policies. The claims are similar to those that AXA settled with the New York Department of Financial Services (DFS) in 2014, including that AXA's "volatility management strategy could limit potential gains by holders of variable annuities during highly volatile markets thereby changing the nature of the products that these policyholders purchased."

In May 2009, AXA introduced this "volatility management strategy" for certain accounts without obtaining DFS approval. After an investigation, DFS determined that AXA's Plan of Operation "failed to adequately inform and adequately explain … that existing variable annuity policyholders (like Zweiman) who had not elected to participate in the volatility management strategy could nevertheless have this strategy applied to their policies." Applying this strategy, according to DFS, could limit potential gains by holders of variable annuities when the market was highly volatile. In an effort to avoid preemption, the named plaintiff in *Zweiman v. AXA Equitable Life Ins. Co.* argued that the misrepresentations did not induce her to buy, sell, or hold these securities. The district court found, however, that because plaintiff paid a premium for certain guaranteed benefits, her transaction had sufficient connection to the purchase or sale of a covered security, regardless of the passage of time and was thus preempted by the Securities Litigation Uniform Standard Act (SLUSA).

Further the court held that even if plaintiff was unaware of the misrepresentation, the defendant's alleged misrepresentations to DFS created sufficient connection to the purchase or sale of a covered security to warrant SLUSA preclusion. This is true, the court noted, because "[a]bsent DFS approval, AXA would not have been legally permitted to introduce the [] strategy to plaintiff's variable annuity policy."

Two federal appellate decisions highlight the potential criminal liability for rogue agents. First, in *United States v. Binday*, the Second Circuit Court of Appeals upheld mail and wire fraud convictions of three individuals for misrepresenting the financial status, reasons for buying, intentions of, and premium financing used by life insurance applicants. Defendants argued that the government failed to prove that defendants contemplated actual harm to their victims – the insurers – because STOLI and non-STOLI policies were economically identical.

The court disagreed, finding it sufficient "that the misrepresentations were relevant to the insurers' economic decision-making because they believed that the STOLI policies differed economically from non-STOLI policies." The court also found it unnecessary to prove actual harm or that the defendants intended a specific harm so long as they intended their misrepresentations to induce insurers to enter transactions without the relevant facts necessary to make an informed economic decision.

The second case, *United States v. Caramadre*, is more notable for the brazenness of the scheme, which the court referred to as "one of the most avaricious frauds in Rhode Island history," and the severity of the penalty imposed. The defendant was convicted of leading a conspiracy to purchase variable annuities and corporate bonds with death-benefit features in the name of terminally ill individuals who were not aware of these purchases. The First Circuit Court of Appeals rejected defendant's appeal of the trial court's refusal to let him withdraw his guilty plea and imposition of a six-year prison sentence and $46 million in restitution, finding that plea was knowing, intelligent, and voluntary, and that he had waived his right to appeal his sentence by the terms of his plea agreement.

Two Federal Courts Uphold Criminal Convictions for Insurance Brokers

BY JASON BROST

Junk Bond Fund Failure Challenges Industry

BY TOM LAUERMAN

The December failure and ongoing liquidation of the Third Avenue Focused Credit Fund (TAFCF) provides potential ammunition to significant financial services industry players who believe mutual funds and investment managers can present significant risks to the financial system and, in some cases, should be subject to special regulation by the Federal Reserve or more bank-like regulation by the SEC. *See* "FSOC Presses SEC on Money Managers' Systemic Risks," *Expect Focus,* Winter 2015.

Due to heavy redemption requests and insufficient liquidity in its portfolio of high-yield securities, TAFCF elected to suspend redemptions and liquidate. The SEC issued a temporary order on an emergency basis to facilitate that process, subject to certain conditions.

The SEC staff also immediately sent "sweep" requests to managers of other high-yield funds, requesting numerous types of information relevant to the funds' liquidity and related practices. The staff's sense of urgency was underscored by the unusually tight response deadline it set. In addition, the SEC's Office of Compliance Inspections and Examinations subsequently published its 2016 Examination Priorities that included scrutiny of liquidity controls of advisers to funds "that have exposure to potentially illiquid debt securities." Similarly, two major pending SEC rule proposals share the principal objective of reducing any possibility of inadequate fund liquidity: *see* "SEC Proposes New Limits on Funds' Use of Derivatives" on page 9 and "SEC Proposes Liquidity Risk Programs for Funds," *Expect Focus*, Fall 2015.

These strong responses by the SEC and its staff bolster the SEC's argument that it has the expertise and vigor to remain the primary regulator of the risks associated with funds and money managers, and that neither bank-like regulation nor much greater involvement by other regulators is necessary or desirable. The fund industry generally agrees with those arguments and, therefore, should hope that, as it seems, the circumstances leading to TAFCF's failure were aberrational.

Lack of liquidity alarms industry.

SEC Waivers with Strings Attached: the Wave of the Future?

BY JOSEPH SWANSON

The SEC recently attached potentially precedent-setting conditions to a waiver from certain automatic disqualifications under the federal securities laws.

Without such waivers, defendants that settle securities law charges may automatically be barred from engaging in certain activities or relying on certain advantageous provisions under the federal securities laws. We have previously reported on the SEC's increasing practice of granting such waivers and the criticism this practice has drawn from SEC Commissioner Kara M. Stein and others. *See* "Can 'Bad Actors' Wave Goodbye to SEC Waivers?" in the Spring 2015 issue of *Expect Focus*.

In December, however, the SEC and CFTC settled an action against a large bank over allegations that the bank failed to disclose material information about investment funds offered to its clients. The SEC also conditionally waived a disqualification from future reliance on the private offering exemption in Rule 506 of Regulation D that would otherwise have resulted.

The waiver's conditions included that:

- the bank retain an independent consultant to review and monitor its policies and procedures relating to compliance with the allegedly violated requirements;
- the consultant submit a written report annually for five years;
- the bank's management submit each year's report to the SEC for public dissemination, together with a certification that management reviewed the report; and
- the SEC may, for a period of five years, revoke or impose additional conditions on the waiver under certain circumstances.

In a publicly-released statement, Commissioner Stein wrote that the conditional waiver represented a "more outcome-focused approach" than the historically "binary nature of granting or denying waivers." She also touted the transparency that would come from the SEC making public the annual reports and certifications.

It will be interesting to see the extent to which conditions similar to those in this case will become the norm in waivers of this type.

Commissioner Stein wrote that the conditional waiver represented a "more outcome-focused approach" than the historically "binary nature of granting or denying waivers."

FAST Relief from Some Securities Law Requirements

BY RICHARD DENMON & NIKUL PATEL

The Fixing America's Surface Transportation Act (FAST Act), which became law in December 2015, contained important federal securities law changes.

Among other changes, it further reduced the burdens on emerging growth companies, as defined in the Jumpstart Our Business Startup Act of 2012 (EGCs), in conducting initial public offerings. As to such offerings, the FAST Act:

- Reduces the required waiting period between the public filing of the offering with the SEC and the commencement of any "road shows," or, if no road show, the pre-effectiveness filing period, from 21 to 15 days;
- Enables an issuer that qualified as an EGC at the commencement of the offering process to maintain that status for up to an additional year even though the issuer may subsequently during that process exceed the $1 billion maximum revenue threshold for EGCs; and
- Subject to specified conditions, it obviates the need for EGCs to file historical financial information for periods that would not be required to be included in the definitive prospectus as of the expected time of the offering.

The FAST Act also adds a new Section 4(a)(7) to the Securities Act of 1933 that could be viewed as codifying what has been referred to as the common law "Section 4(a)(1-1/2)" exemption. "Section 4(a)(1-1/2)" refers to the informal practice of relying on the Section 4(a)(2) private offering exemption for resales of securities by persons that have purchased them in private offerings, notwithstanding that the literal terms of Section 4(a)(2) apply only to offerings by the securities' issuer. To rely on Section 4(a)(7), several conditions must be carefully considered and satisfied. Nevertheless, in many cases Section 4(a)(7) will be a useful addition to the alternatives available for unregistered sales of securities by persons other than the issuer.

Other significant FAST Act provisions:

- Allows smaller reporting companies (SRCs) to incorporate by reference into Form S-1 their SEC filings made after the effective date of the Form S-1, a practice not previously permitted by SRCs and one that may prove useful for registered offerings by selling shareholders of SRCs;
- Directs the SEC, by June 1, 2016, to simplify and modify the disclosure requirements of Regulation S-K; and
- Amends Sections 12(g) and 15(d) of the Securities Exchange Act of 1934 to provide for savings and loan holding companies to be treated in a manner similar to bank holding companies for purposes of registration, termination of registration, or suspension of reporting requirements under that act.

SEC Proposes New Limits on Funds' Use of Derivatives

BY CHIP LUNDE

The SEC recently proposed a new rule (Rule 18f-4) to govern the use of derivatives by mutual funds, ETFs, and closed-end funds (including BDCs). The proposed rule would subject funds that use derivatives to new leverage limits, asset segregation requirements, and risk management procedures.

Leverage Limits

A fund that uses derivatives would be required to limit its exposure to derivatives, financial commitments, and other senior securities transactions to either:

- 150 percent of its net assets, or
- 300 percent of its net assets, if the derivatives lower the fund's overall risk (e.g., derivatives used for hedging).

Importantly, these exposures would be based on the notional amounts of the derivatives transactions. However, the amounts would be calculated differently for different types of derivatives transactions.

Asset Segregation Requirements

Asset segregation requirements would apply to a fund's use of derivatives and financial commitment transactions. For derivatives, a fund would be required to segregate qualifying assets equal to:

- a mark-to-market amount equal to the amount needed to unwind the derivatives position, plus
- a risk-based amount equal to the reasonably estimated amount required to exit the position under stressed conditions.

However, the coverage amounts would be reduced by (i) derivatives covered by netting agreements and (ii) margin posted by the fund.

For financial commitment transactions, a fund would be required to segregate assets equal to 100 percent of its obligations under those transactions.

Perhaps most significantly, qualifying coverage assets would be limited to cash, cash equivalents, and other narrow categories of assets specified in the rule.

Risk Management Program

Under the proposed rule, a fund that either (i) has over 50 percent of its net assets exposed to derivatives or (ii) uses complex derivatives must implement a risk management program designed to address risks associated with derivatives.

The program would provide for quarterly updates to the board and be subject to annual board approval. The proposed rule also calls for the appointment of a derivatives risk manager (such as the fund's CCO) that must be independent of the fund's portfolio managers.

The comment period for the proposal concluded March 28.

WILL SEC HEED ITS OWN COMPLIANCE OUTSOURCING ADVICE?

BY SCOTT SHINE

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently issued a compliance alert warning financial advisers about the dangers of outsourcing compliance functions to third-party providers. The alert, which identifies compliance outsourcing as a growing trend, raised concerns that third-party providers are often not familiar enough with the adviser's business and may insufficiently tailor their approach to each adviser they service. **OCIE also recommended that advisers with outsourced compliance functions review the third-party providers' business practices to ensure they comport with applicable compliance requirements.**

Ironically, just two weeks before the OCIE alert, the Director of the SEC's Division of Investment Management testified before Congress that the SEC staff is developing a somewhat analogous proposal: i.e., for third-party providers to conduct compliance reviews of investment advisers to supplement the SEC's own inspection program. This confirmed previous indications from SEC Chairman Mary Jo White and other officials that such an approach was being considered as a partial response to a chronic insufficiency of SEC resources to inspect investment advisers as frequently as many consider advisable.

The developing proposal, however, was immediately criticized in an op-ed by the division's immediate past director, who argued that certain previous attempts by the SEC to rely on third parties have not served the SEC or the public well. Rather, he pointed to more effective use of the SEC's own resources as the primary issue to be addressed.

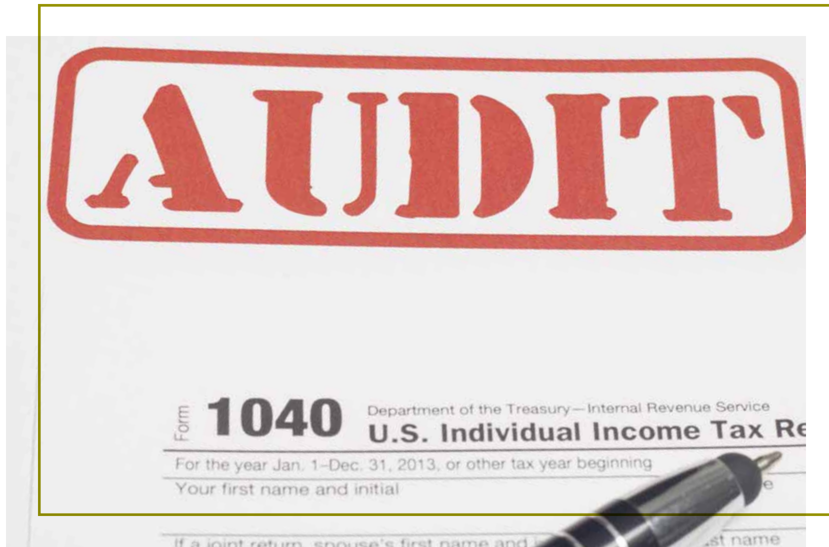
It will be interesting to see what measures the SEC puts in place to mitigate the dangers of relying on third parties to help it review investment advisers and how such measures compare to those followed—or recommended by SEC staff—when financial advisers retain other types of third-party compliance service providers.

Partnerships Must Respond to New Audit Rules

BY DAVID BURKE & JORDAN AUGUST

The recently-enacted Bipartisan Budget Act of 2015 includes a far-reaching overhaul of the rules applicable to IRS partnership audits and tax adjustments. This will be significant for partnerships and limited liability companies taxed as partnerships (collectively, "Tax Partnerships"), as well as for firms that sponsor, advise, or market Tax Partnerships to investors.

Although the changes generally take effect beginning in 2018, and Treasury regulations will be issued that contain the specifics of the law's operation, it is important to act now to evaluate how the new rules will impact both existing and newly-formed Tax Partnerships and to take responsive actions. Such actions may include amending existing partnership and LLC operating agreements, and planning whether to now make certain elections further discussed below.



Under the Act, **a Tax Partnership will be liable for any additional tax, interest, and penalties imposed due to any partnership audit adjustment, under principles substantially different from those that have previously applied.** Among other things, any IRS adjustments generally will be taken into account at the Tax Partnership level, rather than allocated to its partners, in the year the audit or judicial review is completed, and the cost of any adjustment will flow to the partners/LLC members in that year, rather than to those partners who benefitted in the tax years under audit.

Nevertheless, the Act allows certain Tax Partnerships with 100 or fewer qualifying partners/members to opt out of the new audit rules by making an annual election on timely filed returns. The Act also permits Tax Partnerships to "push down" the audit adjustments to prior-year partners and prescribes how to make that election.

The Act further provides for audits to be handled by a "designated partnership representative," who can be a partner/LLC member or any other person with a substantial U.S. presence. This replaces the concept of a "tax matters partner" under current audit rules.

SEC PROBES RETIREMENT ADVICE

BY JEFFREY ROOD

The SEC has been sending lengthy sweep examination letters to many registered investment advisers (RIAs) and broker-dealers, requesting a broad variety of information regarding retirement plan advice.

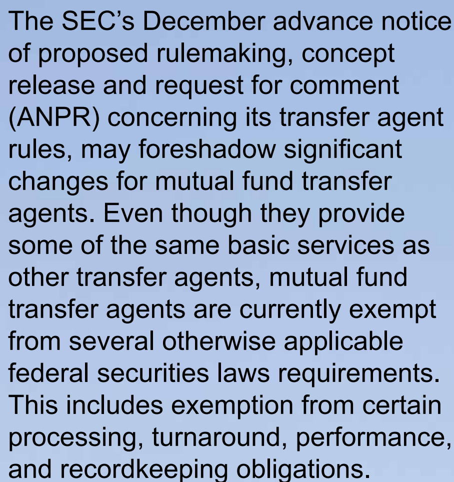
A form of the letter made public by the SEC includes 75 questions requesting information on advisory client accounts, fees, conflicts of interest, and supervision and compliance controls. For example, the letter requests copies of written disclosures and scripts regarding:

- distribution options (e.g., rolling assets over to an IRA);
- conflicts of interest when recommending a specific product or account type;
- account options available (e.g., IRA rollover) and applicable charges; and
- investment options available and applicable charges.

Interestingly, 25 questions pertain to products or services that are "qualified default investment alternatives" (QDIAs) under Department of Labor (DOL) rules, which include certain types of mutual funds and managed accounts. For example, registrants are asked to provide a "list of all retirement plans for which Registrant or an affiliate is the QDIA," the name of the product or service, and the amount of such plans' assets. If the registrant has "recommended that an RIA serve as a [plan's] QDIA," the letter asks for the RIA's name and the amount of such plan's assets. Further, if the plan participant pays the advisory fee, the letter requests extensive information about, among other things, disclosures to and contracts with plan sponsors, compliance reports, fees, and detailed plan data.

These requests are somewhat novel, as the DOL has historically been more active than the SEC in addressing regulatory concerns regarding QDIAs.

The DOL, of course, has pressed forward with its proposed fiduciary standards for retirement advice. (See a summary of Predicted Litigation under the DOL's Proposed Fiduciary Rule in the Summer 2015 edition of *Expect Focus*.) Against that backdrop, the SEC's recent focus on retirement seems to signal that the SEC intends to preserve, and perhaps increase, its own role in providing constructive regulation of such advice.



SEC Eyes Mutual Fund Transfer Agents

BY JOSHUA WIRTH

The SEC's December advance notice of proposed rulemaking, concept release and request for comment (ANPR) concerning its transfer agent rules, may foreshadow significant changes for mutual fund transfer agents. Even though they provide some of the same basic services as other transfer agents, mutual fund transfer agents are currently exempt from several otherwise applicable federal securities laws requirements. This includes exemption from certain processing, turnaround, performance, and recordkeeping obligations.

Mutual fund transfer agents typically present somewhat unique issues in servicing redeemable securities, the relationships that may exist between mutual funds and their transfer agents, and how the transfer agents are compensated. For example, mutual fund transfer agents often play a larger role in processing purchases or redemptions by shareholders than more conventional transfer agents. Their larger role might include determining the number of shares or the per share-price of an order and coordinating with administrators and other service providers of the fund.

The mutual fund industry's growth and increased complexity has led the SEC to question whether it should significantly revise the current transfer agent rules with respect to mutual funds.

The SEC did not propose any specific rule amendments. Among other things, however, the ANPR sought comment on whether:

- mutual fund transfer agents should be required to provide more detailed disclosures;
- exemptions currently afforded to mutual fund transfer agents should be eliminated; and
- the SEC should adjust its regulatory oversight of mutual fund transfer agents.

The ANPR specifically excludes from its scope questions about the relationship between mutual funds' 12b-1 plans and payments that are made for what are commonly referred to as "sub-transfer agent" services. Nevertheless, some information provided in response to the ANPR probably will be useful to the SEC as it continues to consider such questions. *See* "SEC Payments 'In Guise' Case Resolves Little" in the Fall 2015 *Expect Focus*.

Tenth Circuit Reverses UM/UIM Coverage Notification Class Certification

BY JOHN PITBLADO

The named plaintiff in *Soseeah v. Sentry Insurance* had a Sentry auto policy. She declined UM/UIM coverage when she initially purchased her policy, and renewed annually thereafter. In 2010, the New Mexico Supreme Court held, in *Progressive Northwestern Insurance Co. v. Weed Warrior Services*, that New Mexico's UM/UIM statute required UM/UIM policy limits must not be less than the policy's liability limits, unless the insured knowingly rejected UM/UIM coverage at that level. In a companion decision, *Jordan v. Allstate Insurance Co.*, the court provided guidance as to the process for such rejection:

> [I]nsurers must provide the insured with the premium charges corresponding to each available option for UM/UIM coverage so that the insured can make a knowing and intelligent decision to receive or reject the full amount of coverage to which the insured is statutorily entitled. If an insurer fails to obtain a valid rejection [for any reason], the policy will be reformed to provide UM/UIM coverage equal to the limits of liability.

According to the *Soseeah* complaint, in early 2011, Sentry sent form letters to all policyholders that had rejected UM/UIM coverage, which stated that: "[i]n ... 2010, the New Mexico Supreme Court issued a ruling requiring new information to be provided with Uninsured Motorist ... coverage selection forms" and that they "had to sign a new waiver or 'Your Premium Will Go Up.'" The letters also notified policyholders that "they may have UM/UIM coverage."

The plaintiff was thereafter injured in a car accident and, when her UIM claim was denied because she had rejected UM/UIM coverage, she brought a class action complaint, alleging that her rejection of UM/UIM coverage was "legally insufficient" under *Weed Warrior* and *Jordan.*

The claim survived a motion to dismiss, and the trial court ultimately granted class certification. But the Tenth Circuit Court of Appeals reversed the class certification ruling, finding that the class as certified did not differentiate between those who had made claims, and those who simply sought reformation on the basis of an improper coverage rejection. The latter group, the court held, had no cognizable damages, and the trial court's ruling did not indicate that the smaller group alone could satisfy the requirements of Rule 23 to warrant class certification. It therefore remanded with instructions to decertify, and, if necessary, analyze whether any possible sub-group could be certified in light of the court's ruling.

Sloppy Claims Handling Exposes Insurer to Bad Faith Claims

BY JEFFREY MICHAEL COHEN

A Geico insured, with a $10,000/$20,000 liability policy, was involved in a three-car collision resulting in the death and serious injury of two occupants in one of the vehicles. The insured reported the accident to Geico the following day. Five days later, Geico notified the insured that the damages could exceed the policy limits and that the insured faced personal liability if the claims could not be settled. Seven days after the accident, Geico authorized payment of the policy limits and, for the next three days, Geico's claims handler attempted to reach the claimants' attorney, who did not return the calls. Accordingly, two weeks after the accident, Geico hand-delivered policy limit checks. The claimants' attorney was not in the office and no one would accept the checks. GEICO immediately sent the attorney a letter reflecting the failed delivery and again enclosed the checks.

The claimants' attorney wrote Geico rejecting the offer and returning the checks. He objected to the fact that the hospital's name was included on one of the checks, alleging that the hospital did not have a statutory lien right. His letter advised that the $20,000 offer would be accepted if Geico (1) sent another $10,000 for the property damage; (2) the insureds provided an affidavit that there was no other coverage; (3) the release did not have a hold harmless or indemnity agreement regarding potential liens; and (4) the release only released Geico's insureds.

The letter required strict compliance within 21 days. The claimants' attorney sent a similar letter to the insured of the other vehicle involved in the accident. That insurer complied and procured a release.

Four days before the deadline, Geico sent the claimants' attorney a proposed release which released Geico's insured and "all officers, directors, agents or employees and their heirs, executors, administrators and assignees." The release also provided that Geico would forward the checks 20 days after the release was returned. The next day, Geico sent the checks and release forms by overnight mail with a letter advising the claimants' attorney that he should call if the release was not correct or if changes were requested. Geico also sent affidavits of the insureds containing handwritten interlineations regarding insurance coverage that made the affidavits "vague and confusing." For the next two days, Geico tried to call the claimants' attorney, but the calls were not returned.

On the 21st day, the claimants' attorney returned the checks noting that the release did not conform to the demand and filed suit. The insured's counsel requested that Geico and the plaintiffs enter into a Cunningham agreement and resolve the bad faith issue before the liability trial. Geico refused and the claimants obtained a $4 million judgment. The insureds then sued Geico for bad faith.

After a thorough review of the foregoing facts, the U.S. District Court for the Middle District of Florida granted Geico's motion for summary judgment holding that, **although Geico's conduct could be described as "sloppy, bordering on negligent," it was not bad faith for Geico** to: (1) reject the request for a Cunningham agreement; (2) fail to send the claimants' settlement demand to the insureds; and, (3) even though the release did not faithfully adhere to the "hyper-technical" requirements of claimants' attorney, the attorney did not respond to Geico's request for comments on the release form and insurance affidavits until the 21-day deadline expired.

The trial court concluded the evidence demonstrated that Geico was not favoring its interest over the insured's interest and that the claimants' attorney appeared to be motivated to create a bad faith claim rather than settle the case, i.e., "**there is no reason to believe that a realistic possibility of settlement actually existed**." In *Moore v. Geico General Ins. Co.*, the Eleventh Circuit Court of Appeals rejected the District Court's analysis and remanded for a jury trial.

Geico petitioned for rehearing. The Eleventh Circuit issued a new opinion "to address Geico's concern" but reached the same result. The new opinion emphasized the following points:

a. Geico had a duty to manage the claim against the insured with "the same degree of care and diligence" it would have used in managing its own business.
b. Whether the insurer fulfilled that duty depends on "the totality of the circumstances."
c. The focus of a bad faith claim is on the actions of the insurer rather than the claimant.
d. Simple negligence by the insurer is not sufficient to establish bad faith but the insurer's "overall level of competence" is relevant to the question of good faith.
e. Where the record establishes factors contradicting and supporting the bad faith allegation, the totality of circumstances rule requires a trial. In this case, Geico's demand letter to the insured and its failure to make sure that the affidavits and releases met the claimants' demands required a jury to evaluate whether the insurer exercised the same degree of diligence and care that it would have used in managing its own business.

CFPB Director Offers Cold Comfort on TRID

BY CHRISTOPHER SMART

The Consumer Financial Protection Bureau's TILA-RESPA Integrated Disclosure (TRID) Rule took effect October 3, 2015. The TRID Rule requires two new forms – the Loan Estimate and Closing Disclosure – in connection with residential mortgage loans, replacing the old TILA disclosures, good faith estimate, and HUD-1 Settlement statement. It also establishes detailed requirements as to the timing, content, and furnishing of the new forms.

Despite months of industry preparation, the TRID rule's implementation has been fraught with uncertainty. While closings have not ground to a halt as some predicted, questions remain and reports of the lack of compliance – and perhaps the industry's inability to comply – with the rule abound.

Accordingly, on December 21, 2015, the Mortgage Bankers Association (MBA) wrote to CFPB to outline the issues, express the industry's concerns, and propose an interim solution.

The problem is that, in reviewing loans for compliance, due diligence companies have adopted an "extremely conservative interpretation" of the TRID rule, resulting in a 90 percent non-compliance rate. This could render loan originators unable to move loans to the secondary market, or force them to sell them at substantial discounts, ultimately leading to liquidity problems. It is also unknown how government-sponsored enterprises (GSEs) will interpret the TRID rule, and whether they will demand repurchase and indemnification for the lack of technical compliance. The MBA proposed written clarification on a lender's ability to correct a variety of these technical errors.

On December 29, 2015, Director Cordray responded, offering reassurances that the "first few months" of examinations would be corrective, not punitive. He also noted the GSEs' intent not to exercise remedies where good faith efforts are present. He downplayed the potential for civil liability, citing caps on statutory damages under TILA. Investors rejecting loans based on technical TRID rule violations, he concluded, would be doing so for reasons unrelated to potential TRID rule liability.

A good faith implementation period provides some comfort. However, the director's letter is not a compliance bulletin or supervisory memo and does not appear to be an official interpretation of the TRID rule. Moreover, his comments do not consider potential liability for actual damages and attorney's fees. As a result, the TRID rule's future enforcement, its impact on the secondary market, and the potential for civil liability remain uncertain.

BORROWERS MISUSE RESPA NOTICE OF ERROR LETTER

BY KRISTIN GORE & MICHAEL WINSTON

Effective January 10, 2014, the Consumer Financial Protection Bureau (CFPB) amended Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA). These provisions address, among other things, a servicer's obligations to respond to – and if appropriate, correct – errors asserted by borrowers regarding the servicing of their home mortgage loans.

As with many other consumer statutes however, borrowers have attempted to use the regulations as leverage for their otherwise futile claims against servicers. Because a servicer must respond to any Notice of Error/ Qualified Written Request (QWR) for up to one year after servicing is transferred or the loan is discharged (12 CFR §1024.35(f)(v)), the ability to misuse the statute is virtually limitless. From attempting to revive time-barred claims or avoid the fate of *res judicata*, to simply inundating servicers with requests for information already known and in many cases, already obtained through similar requests for discovery in foreclosure proceedings, consumer lawyers are attempting to use RESPA and Regulation X for purposes Congress never intended.

In many cases, borrowers use the regulations and provisions to manufacture the basis for a new lawsuit against a servicer, either in anticipation of, or in response to, the filing of a foreclosure action. For example, a borrower may send a QWR to a servicer, and regardless of the detailed responses and documentation provided, claim the response is insufficient and/or that the results of the servicer's investigation are incorrect.

But in one recent Southern District of Florida case granting final judgment for the servicer on claims it failed to respond sufficiently to the borrower's five QWRs, the court observed the statute's potential for abuse. Quoting another district court, the court in *Russell v. Nationstar Mortgage, LLC*, stated, "RESPA exists to prevent abuse of borrowers by servicers—not to enable abuse of servicers by borrowers." (S.D. Fla. Oct. 6, 2015) (quotations omitted).

The *Russell* court further observed that "good faith – not borrower satisfaction – is the relevant standard for loan servicers to meet the substance of RESPA. Congress could not have intended for [the statute] to operate in hindsight as a 'gotcha' ..." *Id.*

Therefore, while servicers should certainly be mindful of ensuring compliance with the requirements of RESPA and Regulation X, when faced with a Notice of Error or QWR, they can at least take comfort that the inevitably unsatisfied borrower is not the threshold for servicer liability under RESPA.

CFPB and DOJ Continue Enforcement Orders Against Indirect Auto Lenders Based on Discriminatory Loan Pricing Policies

BY ELIZABETH BOHN

In February the Consumer Financial Protection Bureau and Department of Justice announced entry of a consent order with Toyota Motor Credit, the U.S. financing arm of Toyota Motors' subsidiary Toyota Financial Services. The order culminated in an investigation begun in 2013, and is the third enforcement order entered this year against an indirect lender based on a finding that loan pricing policies resulted in discriminatory impact in violation of the Equal Credit Opportunity Act.

Indirect auto lenders such as TMC set interest rates at which they are willing to purchase auto consumer finance contracts based on the consumer credit scores and other risk criteria and provide these "buy rates" to the auto dealers. It has been a longstanding industry practice for lenders to permit dealers to mark up contract interest rates above the indirect lender's buy rate and receive a participation based on the interest revenue differential as additional compensation for originating the loan. In a bulletin issued in 2013, the CFPB advised indirect lenders that dealer markup policies which give dealers discretion to increase contract rates "create a risk of pricing disparities on prohibited bases such as race or national origin," warning that it would pursue lenders for ECOA violations. Shortly thereafter it entered its first enforcement order against an indirect auto lender bank, assessing nearly $100 million in remediation and penalties based on the discriminatory impact of dealer markup policies.

The CFPB and DOJ did not find that TMC intentionally discriminated against its customers, but rather, that its discretionary pricing and compensation policies resulted in discriminatory outcomes as to loans for which TMC did not reduce the loan prices through subsidies. Specifically, the enforcement order states that TMC permitted dealers to mark up contract rates on non-subsidized loans up to 250 basis points, a policy which resulted in minority borrowers paying higher interest rates than non-Hispanic white borrowers without regard to borrower creditworthiness. A similar order was entered against another major auto manufacturer's financing captive in July.

The order requires TMC to change its dealer pricing and compensation policies to reduce dealer discretion in setting interest rates and pay restitution of up to $21.9 million to minority borrowers whom the agencies found paid higher interest rates without regard to creditworthiness as a result of dealer markups permitted by TMC. This brings to $162 million the total remediation ordered in the four orders entered against indirect lenders since 2013.

According to the CFPB, auto loans are the third-largest source of outstanding household debt in the United States, after mortgages and student loans.

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Supreme Court Rules Against Using Settlement Offers to Moot Class Actions

BY AARON WEISS

In *Campbell-Ewald Co. v. Gomez*, a decision released in January, a majority of the United States Supreme Court held that an unaccepted Rule 68 offer of judgment by a defendant cannot moot a putative class action.

Campbell-Ewald arose in the context of a Telephone Consumer Protection Act (TCPA) lawsuit. The TCPA provides for a maximum of $1,500 in statutory damages per violation and does not provide for attorney's fees. Thus, the statutory damages this plaintiff could obtain were clear. The defendant offered to settle the case for $1,503, which was more than the plaintiff could receive as statutory damages for his claim. The plaintiff declined the offer.

The defendant then argued that the court lacked subject matter jurisdiction because the offer mooted the plaintiff's individual claim, and that because the plaintiff had not yet moved for class certification, the class claims were also mooted. The *Campbell-Ewald* majority adopted Justice Kagan's analysis from her dissent in the court's 2013 *Genesis HealthCare Corp. v. Symczyk* decision. There, Justice Kagan noted that an unaccepted offer cannot moot a case because "[a]s every first-year law student learns, the recipient's rejection of an offer 'leaves the matter as if no offer had ever been made.'"

The majority reserved the question of whether the result would differ if the defendant had deposited the full amount of the plaintiff's individual claim into an account payable to the plaintiff and the trial court had entered judgment for the plaintiff in that amount. In the case before the court, that question was "hypothetical."

On its face, the opinion leaves an open question: Would an actual tender of payment by certified check to the court's registry, rather than a Rule 68 offer of judgment, moot the individual and class claims?

Congress Considers Changes to FCRA to Expand Consumer Credit Files and Limit Use of Credit Reports for Employment Decisions

BY ELIZABETH BOHN & JEFFREY ROOD

The Fair Credit Reporting Act (FCRA) regulates consumer reporting agencies (CRAs) and the use of consumer reports. The FCRA's stated purpose includes requiring CRAs to adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner that is fair and equitable to the consumer.[1]

The credit reporting industry has claimed that H.R. 4172 would improve credit histories of Americans deemed "credit invisibles." Sponsors estimate nearly 100 million Americans would establish or raise their credit scores. But consumer groups are concerned that supporters underestimate the amount and significance of additional negative payment history that would be reported.

Two purportedly consumer-oriented bills amending the FCRA are currently in committee in Congress. H.R. 4172, "The Credit Access and Inclusion Act of 2015," has bipartisan support, but is opposed by certain consumer groups. H.R. 3524, the "Equal Employment for All Act of 2015," is a Democratic-supported bill with less chance of passage, but reflects trends in state law.

H.R. 4172 permits "utility and telecom companies and landlords to report on-time payment data to CRAs," which, supporters claim, "helps those with little to no credit build their credit scores based on a full picture of their payment history." Now, utility and telecom companies report only negative information, or do not report at all, due in part to regulatory uncertainty. State laws in California, New Jersey, and Wisconsin that effectively prohibit "full-file" reporting would be preempted.

H.R. 3524 prohibits CRAs from furnishing consumer reports to an employer "if the employer seeks to use such information in a denial of employment." Currently, such use is a statutorily "permissible purpose." Sponsors argue consumer reports are "often inaccurate and bear little to no correlation to job performance." Opponents respond that their use is limited, and is especially important for employees in charge of financial assets, as financial difficulties are an indicator for employee fraud.

Sponsors claim 11 states and New York City already have laws similar to H.R. 3524. Therefore, employers and CRAs must take precautions to ensure their use of consumer reports in employment decisionmaking complies with their jurisdictions' laws.

1 15 U.S.C. § 1681(b).

Financial Institutions Spend More on Cybersecurity

BY KIMBERLY GUSTAFSON & APRIL WALKER

Financial institutions have been at the forefront of protecting their customers' personal information, including names, addresses, phone numbers, account numbers, Social Security numbers, income, and credit histories. The Gramm-Leach-Bliley (GLB) Act, which became law in 1999, requires financial institutions to ensure the security and confidentiality of this type of data.

Over the last decade and a half, cyber-crime has become more prevalent and sophisticated, prompting financial institutions' heightened response. In February 2016, the American Bankers Association Banking Journal reported that CEOs now rank concerns over cyber-related threats higher than those regarding fiscal crises, asset bubbles, and energy prices. The concern is legitimate. In 2014 alone, data breaches exposed over 85 million records in the United States.

In its 2015 Industry Drill Down Report, Raytheon-owned security vendor Websence claimed that the financial services sector faces security incidents a staggering 300 times more frequently than businesses in other industries.

Protecting customer information now comes at great cost. *Forbes* reported that JPMorgan Chase, Bank of America, Citibank, and Wells Fargo will spend roughly $1.5 billion on cybersecurity in 2016. JPMorgan Chase expects to spend $500 million on cybersecurity in 2016, double what it spent just two years ago. Notably, in 2015, Bank of America CEO Brian Moynihan told Bloomberg that cybersecurity is the only area in the bank that has no budget constraint.

According to the U.S. Financial Services:Cybersecurity Systems & Services Market – 2016-2020 report, the U.S. financial institutions cybersecurity market is the largest and fastest-growing private sector cybersecurity market. Its cumulative 2016-2020 size is forecasted to exceed $68 billion.

LEGAL CHALLENGE TO FCC'S TCPA OMNIBUS RULING READY FOR COURT DECISION

BY ELIZABETH BOHN

The FCC's July 2015 Omnibus Ruling ("the Ruling") interpreting certain provisions of the Telephone Consumer Protection Act (TCPA) has been widely denounced by business interests for its expansive interpretation of the statute's definition of an autodialer and edicts concerning revocation of prior express consent and reaching wrong or reassigned numbers. Specifically, the FCC ruled that the word "capacity," used in the TCPA definition of an autodialer, didn't mean "present" capacity, but rather includes "potential ability" (for example, by connection to additional software) so as to encompass equipment that "generally" may have the capacity to store or produce, and dial, random or sequential numbers, even if not presently used or capable of being used for that purpose.

The FCC also ruled that businesses could not set standards or procedures for customers to revoke prior express consent as long as the manner in which the consumer revoked consent was "reasonable." Additionally, the FCC provided a safe harbor for only one single call or text to a wrong number reached unintentionally, and only if this resulted from reassignment of a number for which prior express consent had been received.

Shortly after the Ruling issued, ACA International (ACA), a trade association of credit and collection professionals, joined by a large contingent of industry members, including the Consumer Bankers Association (CBA), Sirius XM Radio and others ("Petitioners") filed a petition challenging it in D.C. District Court and all of the petitions were subsequently consolidated in the D.C. District Court of Appeal. Petitioners argued, inter alia, that the agency's expansive interpretation of the TCPA's autodialer definition is arbitrary and capricious, that the Ruling unlawfully prevents callers from reasonably relying on the prior express consent of the called party by imposing liability for innocent calls to reassigned numbers, and that it unlawfully imposes an unworkable regime for handling revocation of consent. Nine entities intervened on the side of the Petitioners, and amicus briefs were filed by the American Bankers Association, Mortgage Bankers Association, National Retail Federation, and others.

The FCC response brief has been filed, and amicus briefs in support of its position were filed by the National Consumer Law Center and National Association of Consumer Advocates, both trade associations of attorneys heavily involved in filing TCPA class actions. All briefing has been completed, leaving the decision now in the hands of the D.C. Court of Appeal.

2016 Stark Law Updates

BY RYAN WIERENGA

Centers for Medicare and Medicaid Services (CMS) issued the 2016 Medicare Fee Schedule (the "Schedule") in an effort to facilitate compliance with the Physician Self-Referral Law (the "Stark Law"). Generally, absent an exception, the Stark Law prohibits a physician from making referrals for designated health services payable by Medicare to an entity with which the physician has a financial relationship. Among other changes, the Schedule clarified the writing requirements for exceptions to compensation arrangements, and provided two new exceptions.

The Schedule clarified that contemporaneous documents evidencing the course of conduct between the parties, instead of a single formal contract, could be sufficient for a compensation arrangement to meet an exception. Examples of such documents include board meeting minutes, timesheets, and written communication. These documents must clearly relate to one another and a signature is required on at least one of them. Finally, the documents must evidence the arrangement that was in place before any referrals were made between the parties.

The first new exception is for remuneration from a hospital to a physician to assist the physician with compensating a nonphysician practitioner (NPP) for furnishing services to patients of the physician's practice. Substantially all of the services furnished by the NPP must be primary care and/or mental health services. The remuneration from the hospital may not exceed 50 percent of the actual compensation, signing bonus, and benefits paid by the physician to the NPP during the first two years of the arrangement.

The second new exception is for timeshare arrangements that include the use of premises, equipment, personnel, items, supplies, or services. This exception covers "use" arrangements only and does not cover traditional office space leases. This exception is predominately for the provision of evaluation and management services to patients.

FALSE CLAIMS ACT LIABILITY BASED ON IMPLIED CERTIFICATION

BY CAYCEE HAMPTON

When the U.S. Supreme Court granted certiorari in *Universal Health Services v. United States ex rel. Escobar* in late 2015, health care providers began optimistically awaiting a decision. This case is expected to decide whether the False Claims Act (FCA) can be used as a sweeping enforcement mechanism for general regulatory compliance.

Escobar involves a subsidiary of Universal that operates a mental health clinic in Lawrence, Massachusetts, and receives governmental funds from the state Medicaid program. The respondents are the parents of a clinic patient who died of a seizure. They claim Universal, by submitting bills to the state Medicaid agency for services rendered by its staff members, fraudulently misrepresented that those staff members were licensed and supervised in accordance with Massachusetts law and consequently violated the FCA, relying on the liability theory of "implied certification."

Earlier this year, major organizations representing the health care industry offered arguments to dispute the implied certification theory. Those filing amicus briefs in favor of Universal included the American Hospital Association, Federation of American Hospitals, and Association of American Medical Colleges. These groups urged the court to consider that the implied certification theory "renders the complexity of the Medicare and Medicaid programs a potential gold mine for opportunistic relators." The American Medical Association quoted the court's previous warning, "expansive readings of the FCA can create 'almost boundless' liability."

Universal argues violations of regulatory requirements do not render a claim for payment false or fraudulent. Rather, liability for implied certification, if any, "must rest on noncompliance with an expressly stated condition of payment."

In March, **Carlton Fields** released the fifth annual Carlton Fields *Class Action Survey: Best Practices in Reducing Cost and Managing Risk in Class Action Litigation*. This year's survey reveals a marked increase in spending on class actions after four consecutive years of declines. It is an important turning point as legal departments now project further spending increases in 2016 even as they pursue efficient and innovative ways to manage class actions. Results of the 2016 edition were compiled from 391 in-depth interviews with general counsel, chief legal officers, and direct reports to general counsel in more than 25 industries. The survey can be viewed and downloaded at ClassActionSurvey.com.

"BTI Brand Elite 2016: Client Perceptions of the Best-Branded Law Firms" named **Carlton Fields** in the Top 10 of all law firms as the "Best of the Best Client Service Strategist" in the Client Service Strategist category. Overall, corporate counsel ranked the firm in the top 25 percent in the 2016 BTI Brand Elite.

Nine firm attorneys were elected shareholder during Carlton Fields' All-Attorney Meeting held on January 29-30, 2016: **Lauren E. Catoe** (Real Estate and Commercial Finance, Tampa), **Douglas J. Chumbley** (Products and Toxic Tort Liability, Miami), **John "Jack" E. Clabby** (Securities and Derivative Litigation, Tampa), **Richard D. Euliss** (Financial Services and Insurance Litigation, Washington, D.C.), **Kristin A. Gore** (Business Litigation, West Palm Beach), **J. Derek Kantaskas** (Construction, Tampa), **Anastasios G. Kastrinakis** (Business Transactions, Miami), **David L. Luck** (National Appellate Practice and Trial Support, Miami), and **Ilan A. Nieuchowicz** (Real Property Litigation, West Palm Beach).

Carlton Fields welcomes the following attorneys to the firm: of counsel **David W. Adams** (Real Estate and Commercial Finance, Atlanta) and **Cynthia Morales** (Real Property Litigation, Miami); and associates **Joanna B. Lardin** (Business Transactions, Miami) and **Jennifer A. Migliori** (Business Transactions, Miami).

Corporate Counsel named Carlton Fields Washington, D.C. and Miami shareholder, **James F. Jorden**, a "Client Service All-Star" in BTI Consulting Group's 2016 survey. Mr. Jorden was named to the BTI Client Service All-Star list in 2013.

Along with the IRI, Carlton Fields shareholders **James Jorden**, **Stephen Kraus**, and **Michael Valerio** hosted a webinar on March 8 titled "Proposed DOL Fiduciary Rule: Scope, Status & Potential Litigation Exposure." The webinar addressed the "Top Ten" key questions about the DOL Fiduciary Rule.

Shareholder **James Jorden** co-chaired the National Advanced Forum on Life Insurance Litigation, Regulatory Enforcement & ERM in New York, New York, on January 25-26, 2016. The Forum included, among others, the following sessions: Enterprise Risk Management and Cybersecurity Risk Mitigation; Litigation Forecast: The Department of Labor's Proposed Fiduciary Rule: Limitations, Requirements, and Additional Costs; Class Actions and Complex Litigation; Individual Product Litigation Roundup: Life Insurance, Annuities, Mutual Funds and More.

Miami shareholder **Christopher O. Aird** will serve as the firm's 2016 Leadership Council on Legal Diversity (LCLD) Fellow. The Fellows program was created by the LCLD to identify, train, and advance the next generation of leaders in the legal profession.

Washington, D.C., shareholder **Dawn Williams** served on a panel during the LIMRA Regulatory Compliance Exchange held March 30-April 1 in Baltimore, Maryland. She presented on "Insurance and Securities Litigation Trends."

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