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LEGAL ISSUES AND DEVELOPMENTS
FROM CARLTON FIELDS JORDEN BURT, P.A.

VOLUME IV, DECEMBER 2016

BACK TO THE FUTURE: 2017

Should Your Company Purchase Bitcoin to Pay a Cyber Ransom?

FINRA Focus on Cybersecurity Continues

Dodd-Frank in a Trump Administration

CARLTON FIELDS
JORDEN BURT

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Should Your Company Purchase Bitcoin to Pay a Cyber Ransom?

BY EDMUND J. ZAHAREWICZ & MATTHEW E. KOHEN

In recent years, businesses have witnessed the proliferation of cyber attacks, hacking, and other digital threats. One common threat is ransomware. In a ransomware attack, a company may lose access to critical systems and information until it pays a ransom or otherwise manages to defeat the malicious software affecting its operations. Due to their ability to help conceal the identities of the transacting parties, cryptocurrencies—and, in particular, bitcoin—have become a favorite medium of exchange for ransomware attackers.

Opinions differ as to whether it is advisable to pay the ransom in the event of such an attack. Recent FBI guidance suggests that implementing prevention efforts and creating a business continuity plan are preferable solutions. Nevertheless, companies insufficiently prepared for a ransomware attack may find themselves with no choice but to pay the ransom.

Companies at risk of a ransomware attack should understand how to obtain cryptocurrencies and how they work. Bitcoin, for example, may be purchased on numerous online exchanges such as Gemini (United States), GDAX (United States), Bitfinex (Hong Kong), Bitstamp (United States), Kraken (United States), Huobi (Hong Kong), and OKCoin (China). While exchanges are typically used by day traders, other sources of bitcoin such as Coinbase and Circle offer similar services, but are not designed for speculative trading. In addition, services such as LocalBitcoins offer users the ability to meet face to face to transact in bitcoin. Companies seeking to acquire cryptocurrency should carefully vet the purchase source before initiating a transaction.

Most cryptocurrencies are stored in a digital wallet. To send a transaction from a wallet, the owner of that wallet must control the wallet's private key. Private keys can be stored in a variety of ways, each with its own inherent risks. For instance, if the key is stored on a vulnerable system, there is a risk the wallet could become sequestered when the ransomware attack begins, preventing the company from accessing its bitcoin. Alternatively, if the bitcoin is stored on an online exchange, the company must entrust its private key to a third-party, in which case the company risks losing access to its bitcoins if the third-party is compromised.

Although such risks are generally less concerning to companies that intend to purchase bitcoin only as needed, given the ever-increasing threat of cyber attacks, companies may wish to include in their preparedness policies plans for acquiring bitcoin should the need arise. Companies that wish to implement such a plan should work carefully with their management, IT department, and attorneys to ensure that risks, such as those mentioned above, are considered.

NAIC Draws Line in CFPB Sandbox

BY SARAH AUCHTERLONIE

The National Association of Insurance Commissioners has taken a firm stance on the Consumer Financial Protection Bureau's proposed ban on "mandatory arbitration" clauses that make financial product consumers waive their right to join class actions.

Because consumer loans are generally financial products within the CFPB's purview, the CFPB stated that the proposed ban would extend to any such arbitration clauses used for whole life insurance policy loans if: (a) the insurance company is a "creditor" under the Equal Credit Opportunity Act (ECOA) and (b) the activity is not the "business of insurance" under the Dodd-Frank Act. In a comment letter, however, the NAIC urged the agency to remove altogether such policy loan features from the scope of the rule.

In drawing a line between insurance policy loans and consumer finance, the NAIC argued that whole life policy loans do not make insurance companies ECOA "creditors." The insurance companies do not extend, renew, or continue credit; nor do they arrange for such transactions. Rather, despite the use of the word "loan," a policy loan is in substance an advance payment of the policy's cash surrender value. It more closely resembles a structured temporary conversion from one type of asset into cash, particularly because if a policyholder does not repay the loan, the insurance company's recourse is simply to reduce the policy benefits by the outstanding balance of the loan.

Finally, the NAIC pointed to Dodd-Frank Act language that states the bureau lacks authority to alter, amend, or affect the authority of any state insurance regulator. Because states regulate the issuance of insurance policy loans, and none of the CFPB's enumerated statutes—like the Truth in Lending Act or Real Estate Settlement Procedures Act—expressly incorporates policy loans into their purview, the NAIC concluded that the CFPB's purported encroachment into this territory is "beyond the appropriate jurisdiction of the bureau."

For more analysis of this CFPB rule proposal, and the additional regulatory areas where it is prompting line-drawing controversies, see "CFPB Grabs for SEC/CFTC Turf," *Expect Focus* Vol. III 2016.

NAIC'S BIG DATA TASK FORCE SETS CHARGES FOR 2017

BY BEN V. SEESSEL

The NAIC's Market Regulation Committee recently adopted three broad charges developed by the Big Data Task Force. Formerly a "working group," the new "task force" designation reflects the entity's more formalized and enduring nature. The 2017 charges were preceded by a mission statement, which asserts that the duty of the task force is to "gather information to assist regulators in obtaining a clear understanding" of what data is being used by "insurers and third-parties in the context of marketing, rating, underwriting and claims." The mission statement also makes clear that both "potential concerns and benefits for consumers" will be explored.

Charge A is to review current regulatory frameworks and, "if appropriate," recommend changes to model laws and regulations "regarding marketing, rating, underwriting, and claims, regulation of data vendors and brokers, regulatory reporting requirements and consumer disclosure requirements." Charge B is to "[p]ropose a mechanism to provide resources and allow states" to collaborate to facilitate their ability to analyze the data and complex models insurers may be using. Charge C is to "[a]ssess data needs and required tools for regulators to appropriately monitor the marketplace and evaluate" insurers' practices.

At a recent American Academy of Actuaries meeting, Oregon Commissioner Lauri Cali, who chairs the task force, stated that, while development of a model law or regulation is "on the table," she does not expect the task force will develop such a model in the near future. Commissioner Cali also indicated that current law and regulation may be sufficient to appropriately govern. She further stated, consistent with the mission statement, that the primary focus of the task force is to better understand what data is being collected on consumers and how insurers are using this data.

Broker-Dealers Can Hold Customers' Initial Checks

BY TOM LAUERMAN

A recent SEC no-action letter gives broker-dealers more time to perform suitability and other reviews when opening certain customer accounts.

The firms requesting the letter were affiliated with three different insurance company complexes and were engaged in retail sales of mutual funds, variable annuity and variable life insurance contracts, Section 529 plans, and other securities. The firms sometimes served as "introducing" brokers, who would open accounts for their customers with the firms' "clearing" brokers.

Although, in order to fund the account, a customer might give an introducing broker a check made out to the clearing broker, the introducing firms did not want to be deemed to be carrying customer funds for purposes of broker-dealer net capital requirements. This meant that, under longstanding SEC interpretations, the checks had to be forwarded to the clearing broker by noon on the next business day following receipt.

This, however, did not allow enough time for the introducing firms' process of forwarding the relevant account opening documentation to their "offices of supervisory jurisdiction" (OSJs) to correct any inaccuracies or omissions and determine that regulatory requirements (such as suitability, "know your customer," and anti-money laundering) were satisfied, before opening the account and forwarding the check to the clearing broker.

Accordingly, under the no-action letter, the introducing broker need not forward the check to its clearing broker until noon on the day after a registered principal of the introducing broker approves opening the account, provided that: (a) the principal's review is completed within seven business days after the introducing broker has a complete application at its OSJ and (b) certain other conditions are met.

This is very similar to relief the SEC previously granted where a broker-dealer delays delivery of an initial check the customer has made payable to the issuer of a security (rather than, as here, to a clearing broker) that the customer is purchasing on a "subscription way" basis. *See* "'Promptly Transmit' Redefined for Some Customer Checks," *Expect Focus* Vol. III, 2015.

FINRA FINES FIRMS FOR NOT SUPERVISING L-SHARE ANNUITY SALES

BY ANN FURMAN

For two years FINRA has made sales and marketing of L-Share variable annuities (VAs) a regulatory and examination priority. Not surprisingly, FINRA in November announced settled actions against eight broker-dealers, alleging failure to supervise sales of L-Share VAs. Without admitting or denying FINRA's findings, the eight firms agreed to pay a collective total of $6.2 million in fines and more than $6 million to customers who purchased L-Share VAs.

L-Share VAs typically have a shorter surrender charge period (of three to five years) and higher ongoing mortality and expense risk (M&E) charges than a typical B-Share VA. Accordingly, L-Share VAs are generally more suitable for investors with short-term time horizons who want the optionality to be able to surrender the VA sooner than a B-Share VA.

On the other hand, certain VA guaranteed income benefit riders, which FINRA dubbed "long-term income riders," are designed primarily for investors with long-term time horizons. FINRA found "the potentially incompatible time horizons" of L-share VAs with long-term income riders "may present a red flag that the purchase may not be suitable for a customer's investment objective and time horizon."

Among other things, FINRA determined that the firms did not have and enforce adequate supervisory procedures regarding the sale of multiple-share class VAs, and did not provide adequate training or guidance to registered representatives about the types of customers for whom L-Share VAs would be suitable. Further, FINRA found that five of the firms did not identify or investigate "red flags" of potentially unsuitable sales of L-Share VAs.

FINRA's focus on L-Share VAs has contributed to some firms' decisions to cease offering L-share VAs or to ask insurers to redesign VAs to reduce the product's "mortality and expense risk" charge upon completion of the surrender charge period. In this regard, the FINRA actions exclude L-Share VAs with a "persistency credit" that reduces ongoing fees – to a B-Share VA level – after the VA is held for a period of time, generally seven to 10 years.

Complaint Against New York Life Dismissed in Action Testing Application of California's Usury Laws

BY VALERIE ESCALANTE TROESH

In a recent ruling, *Lujan v. New York Life Insurance Company*, a federal judge in the Northern District of California rejected the plaintiffs' claim that New York Life violated California's usury law by charging compound interest on their loans without a written agreement. At issue were two laws: (i) Section 2 of a 1918 California ballot initiative, which states that "interest shall not be compounded … unless an agreement to that effect is clearly expressed in writing and signed by the party to be charged" and (ii) the later enacted Article XV of California's Constitution, which exempts certain classes of lenders from Section 2 and gives the California Legislature authority to regulate them. The court, tracking the language of Article XV, concluded that because "compound interest is a 'charge' upon a loan and also 'compensation' received from a lender," Article XV regulated compound interest and, therefore, conflicted with and superseded Section 2. Since the insurer was exempt from Article XV, it was exempt from Section 2.

The *Lujan* court also agreed with New York Life's contention that, even if the compound interest provision of the Initiative applied, the plaintiffs' claims fail because the insurer was in compliance with Section 2's requirement that compound interest be clearly expressed and agreed upon in writing. The plaintiffs had argued that New York Life was not in compliance and therefore not authorized to charge compound interest because plaintiffs had signed only their respective life insurance applications—not the policies themselves, which plaintiffs admitted have language authorizing the compounding of interest upon premium and policy loans. The court, looking to the California Insurance Code and case law, recognized that an application and a policy constitute the entire contract if, as was the case here, the application is endorsed upon or attached to the policy. It was also key that the plaintiffs' policies stated that the policy and application were parts of a larger "entire contract." According to the court, "[p]laintiffs did sign an agreement when they signed the application that comprised the larger agreement for insurance."

Lujan is the most recent example of a court's view of the California usury law's impact on insurers' efforts to charge compound interest on loans.[1] As the plaintiffs have appealed the ruling, the industry might soon be able to look to a Ninth Circuit ruling for clarity on the issue.

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1 *See Martin v. Metropolitan Life Ins. Co.*, 2016 WL1427556 (N.D. Cal. Apr. 12, 2016) (insurers were exempt from the compound interest provision); *Washburn v. Prudential Ins. Co. of Am.*, 2015 WL 7454039 (N.D. Cal. Nov. 24, 2015) (admitted insurers are exempt from restrictions on the charging of compound interest). *But see Wishnev v. Northwestern Mut. Life Ins. Co.*, 2016 WL 493221 (N.D. Cal. Feb. 9, 2016) (certain lenders were exempt from the maximum interest rate provisions of the Initiative, but not the compound interest provision).

Seventh Circuit Affirms Insurer's Duty to Pay Policy Proceeds Under Wisconsin Statute

BY GAIL JANKOWSKI

In *U.S. Bank Nat. Ass'n v. Sun Life Assur. Co. of Canada*, the Seventh Circuit, applying Wisconsin law, recently affirmed that an insurer may not void a life insurance policy solely on grounds that the policy's original owner did not have an insurable interest in the life of the insured when the policy was issued. (In 2010, Wisconsin enacted a more comprehensive statute governing the life settlement industry and STOLI, but the parties agreed that it did not apply retroactively to the policy at issue.)

The case involved a $6 million life insurance policy issued to an 81-year-old man in 2007. U.S. Bank was substituted as the owner and beneficiary on the policy and continued to pay premiums until the insured's death in 2014. After Sun Life refused to pay U.S. Bank the policy proceeds until it investigated the policy's validity, U.S. Bank brought suit under section 631.07(4) of the insurance code, which provides that "no insurance policy is invalid merely because the policyholder lacks insurable interest" but authorizes the court to order the death benefit payable to another person "equitably entitled thereto." The district court ultimately awarded U.S. Bank the proceeds, along with 12 percent statutory interest, and bad faith damages.

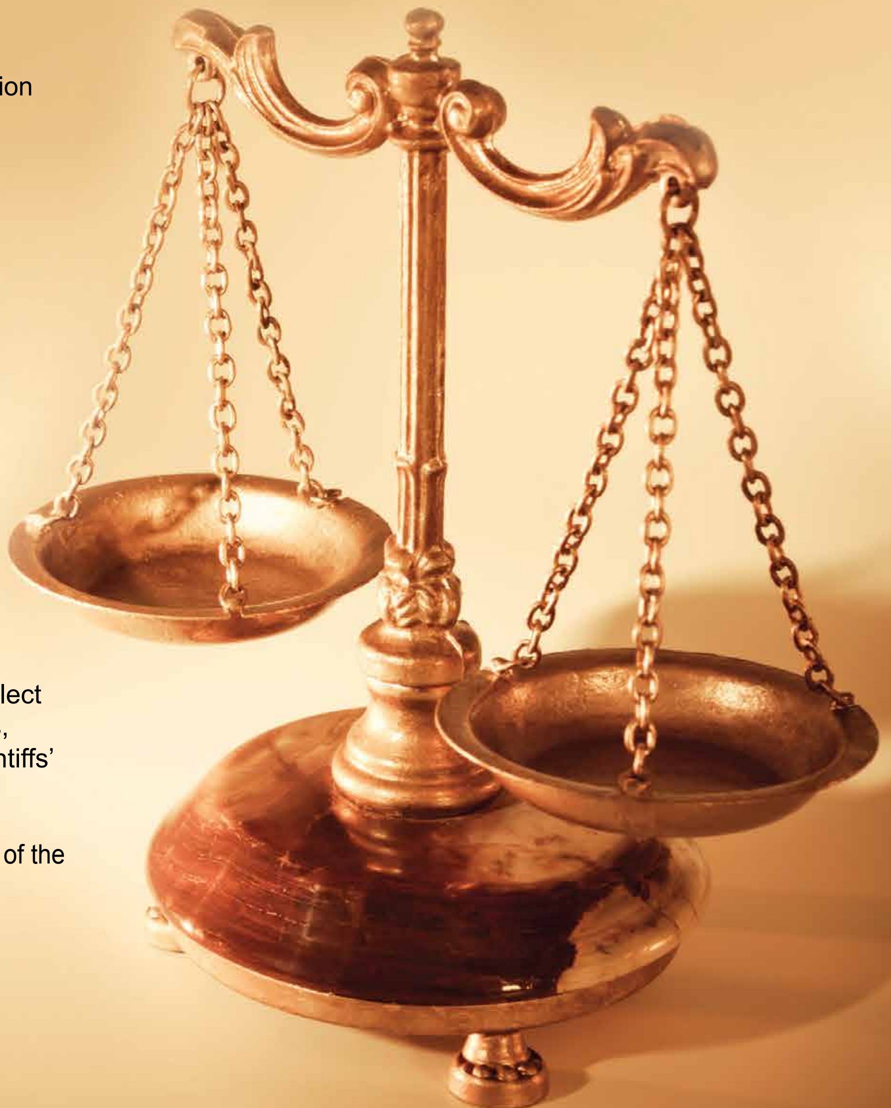
The Seventh Circuit affirmed. It rejected the insurer's argument that its refusal to pay the death benefits was permitted by another Wisconsin statute invalidating gambling contracts, pointing out that Wisconsin insurance code provisions trump other conflicting statutes. Similarly, the court found that Wisconsin's constitution, which prohibits the legislature from authorizing gambling contracts, did not invalidate section 631.07(4) because that provision did not authorize the contracts but merely changed the remedy for the violation.

Pennsylvania District Court Rejects Effort to Certify Retained Asset Account Claims Against Prudential

BY VALERIE ESCALANTE TROESH

In *Huffman v. Prudential*, a federal judge in the Eastern District of Pennsylvania recently rejected the plaintiffs' effort to certify for class adjudication a claim for alleged breach of ERISA (alternatively, state law) fiduciary duty related to Prudential's payment of claims under employer-sponsored life insurance policies through a retained asset account. The plaintiffs, beneficiaries of the life insurance policies, allege that Prudential's actions failed to comport with the language of the plan documents requiring payment of death benefits to be made in "one lump sum" and that, by investing funds in the accounts for its own benefit prior to withdrawal, Prudential was "not acting exclusively" to provide them their benefits. The plaintiffs also allege that Prudential's conduct triggered an ERISA prohibited transaction under Section 406(a)(1)(C), which, *inter alia*, prohibits fiduciaries from causing a plan to partake in a transaction involving the provision of services between a plan and a party in interest.

The denial turned on the court's finding that Federal Rule of Civil Procedure 23(b)(3)'s predominance requirement was not met. The court recognized that whether Prudential was acting as an ERISA fiduciary at the time it determined to pay the plaintiffs' benefits through the retained asset accounts and invest the remaining funds in those accounts for itself was "of critical importance." The court further recognized that resolution of that question depended on whether Prudential fulfilled its obligations under the documents of the 2,200 plans encompassed in the putative class. The court concluded, however, that there was no way to determine whether it did so on a class-wide basis where the terms relevant to claim settlement varied from plan to plan, and where the plans had different mechanisms for selecting payment methods.



Indeed, in some plans, an individual beneficiary could select the payment method of her liking; and, as the court explained, assessing whether an individual beneficiary may have in fact agreed to be paid through a retained asset account would only be further complicated by the lack of any uniform mechanism by which beneficiaries were to select payment methods. Individualized issues, thus, predominated, striking a fatal blow to the plaintiffs' class certification effort.

Note that the plaintiffs' motion for reconsideration of the ruling was still pending as of our publication date.

SEC and OCC Seek Accommodation with Fintech Firms

BY JOSHUA WIRTH

In November, industry participants and their regulators convened at the SEC for a special forum on the use of financial technology (fintech). In recent years, large amounts have been invested in fintech platforms such as automated investment advisers (robo-advisers), distributed ledger (blockchain) technology for trading, settlement and clearing processes, and online portals (including crowdfunding) for capital formation.

The SEC has balanced regulatory concerns that such platforms not be rushed to market to the detriment of investors with industry demands to accommodate for future growth and innovation. The forum focused on recent initiatives and trends to harmonize these advanced technologies/systems and the current regulatory landscape. The fintech industry does not want to be subject to an "antiquated" system that fails to address the unique features of these new technologies and regulatory concerns.

The most prevalent platform, robo-advisers, perhaps best encapsulates these concerns.

While robo-advisers generally are registered as investment advisers with the SEC, the SEC's current regulatory scheme is imperfectly equipped to handle the technologically nuanced advisory services. Among other things, robo-advisers may face unique challenges in tailoring compliance policies and procedures (including safeguarding client information and business continuity plans) to their own manner of operations. Nevertheless, it is encouraging to see regulators and robo-advisers discussing the growth and growing pains of emerging technologies in such a collaborative manner.

Similarly, in another late-breaking example of such collaboration, the Comptroller of the Currency confirmed on December 2nd that his office (the OCC) is planning to issue special purpose national bank charters to fintech companies that offer bank products and services. This option may allow some fintech companies to escape some of the numerous and complex state regulatory requirements that may otherwise apply to them, as well as, in some cases, Consumer Financial Protection Bureau requirements. These special purpose bank charters would effectively regulate the fintech company as a federal bank under the National Back Act. It is not yet clear what terms and conditions the OCC will impose in connection with such special purpose charters, and the OCC has asked for comments by January 15 on a related white paper that it released. However, the idea of special purpose national bank charters for fintech companies has already started to draw opposition from some quarters, including traditional community banks concerned about unfair competition and state regulators concerned about the impact on their prerogatives.

Insurable Interest Found in Life Insurance Policies Procured by Investors Through Fraudulent STOLI Scheme

BY THADDEUS EWALD

The Florida Supreme Court recently held that life insurance policies procured by investors through a STOLI scheme did not violate Florida's insurable interest statute and could not be challenged after the two-year contestability period expired.

In deciding *Wells Fargo Bank, N.A. v. Pruco Life Ins. Co.*, the court did not address the question of law certified to it by the U.S. Court of Appeals for the Eleventh Circuit: Whether a life insurance policy *without an insurable interest* can be challenged after the contestability period. The Eleventh Circuit had assumed that the underlying policies lacked an insurable interest, and the threshold question presented was whether the insurer could challenge the validity of the policies after the contestability period based on the absence of an insurable interest.

The Florida Supreme Court did not agree that an insurable interest was lacking. It acknowledged that the facts in the underlying cases showed that the policies were acquired as part of a fraudulent STOLI scheme. Notably, the transactions were orchestrated by sales representatives offering "free insurance" and monetary compensation to the insureds; the insureds did not need, or intend to retain, the policies or pay premiums; the applications contained false statements about the insureds; and the insureds understood that the beneficial interest in the policies would eventually be transferred to a third party after the contestability period.

Indeed, the Eleventh Circuit's statement of facts, incorporated in the Florida Supreme Court opinion, notes "[i]t was understood that [the insured's] daughter would not receive the death benefit from the policies and that any beneficial interest would eventually be sold to an investor with no insurable interest." The court nonetheless found that the policies satisfied Florida's insurable interest statute because, at inception, they named as beneficiaries individuals with an insurable interest (in both cases immediate family members). Having made that finding, the court held that Florida's incontestability statute—which had several exceptions, but none for STOLI schemes—prevented the insurer from challenging the policies' validity.

COURT UPHOLDS SEC ON "BACKTESTED" INVESTMENT STRATEGY ILLUSTRATIONS

BY GARY COHEN

An investment adviser seeking to show how a particular investment strategy would have performed during specified time periods would be well advised to:

- use only historical performance data and not a mix of historical data and hypothetical assumptions and
- reflect all aspects of the investment strategy and not omit the impact of any key aspect of the strategy.

These are the lessons of *Lucia v. SEC*, an August opinion of the D.C. Circuit Court of Appeals upholding an SEC decision that an adviser violated the anti-fraud provisions of Section 206 of the Investment Advisers Act and the SEC's advertising Rule 206(4)-1(a)(5) thereunder.

The case, which involved an adviser's free seminars on retirement planning, clarifies what is required for so-called "backtesting" illustrations. The adviser purported to show prospective clients that the adviser's investment strategy was superior to others in allowing retirees to live comfortably off their investment income while also leaving a large inheritance.

The adviser showed slides that it claimed "backtested" the strategy. But the SEC found they overstated the strategy's success by understating historical inflation rates, overstating historical investment return rates, and, contrary to the strategy, using an artificially high percentage of assets invested in stocks during a period of favorable stock market performance.

The SEC concluded that had the adviser used only historical data and reallocated assets as the strategy required, the illustrations would have revealed the strategy had run out of assets, not grown as advertised.

The court upheld the SEC in rejecting the adviser's defense that the slides contained disclaimers disclosing that the "backtesting" illustrations were based on certain assumptions. Rather, such disclaimers did not alter the erroneous "overall impression" conveyed by the adviser that the "backtests" showed how the strategy would have performed.

FINRA Focus on Cybersecurity Continues

BY JOSEPHINE CICCHETTI & CHRISTINE STODDARD

On November 14, the Financial Industry Regulatory Authority (FINRA) imposed a $650,000 fine against Lincoln Financial Securities Corporation (Lincoln Financial) for its failure to implement adequate data security measures to protect confidential customer information. Specifically, FINRA found that, between 2011 and 2015, Lincoln Financial failed to adopt and maintain supervisory procedures, including written policies, to ensure the security of customer information stored electronically at its branch offices. FINRA took issue with both the firm's policy regarding the use of cloud-based systems as well as its failure to ensure its registered representatives and third party vendors were appropriately applying these procedures.[1]

This action follows a February 2011 FINRA action that resulted in the imposition of a $450,000 fine for similar data security failures, including enabling employees to access customer data online using shared login credentials without instituting procedures to safeguard the information or monitoring access to the accounts. The data, which included personal and financial information such as names, birthdates, addresses, Social Security numbers, email addresses, account numbers and balances, and transaction information, could be accessed from any Internet browser using the shared credentials. In total, the firm's failure to adequately secure its login details placed more than 260,000 customer records at risk. Moreover, because the firm did not institute procedures to monitor the distribution of the login information or access to the website, it had no way to determine who was accessing the information and when. The firm further failed to require brokers to install security software on their personal computers that would protect customer data when they worked remotely on firm business. FINRA alleged Lincoln Financial's conduct violated Rule 30 of Regulation S-P, requiring broker-dealers to adopt written policies to safeguard customer records and protect against unauthorized access; NASD Rule 3010, requiring supervision of registered persons to ensure compliance with applicable regulations; as well as NASD Rule 2110 and FINRA Rule 2010, requiring firms to maintain high standards in business.

Lincoln Financial's failure to implement sufficient cybersecurity procedures contributed to a 2012 data breach in which foreign hackers stole the records of more than 5,000 customers. The breach occurred after Lincoln Financial began using a cloud-based server to store customer information without requiring the third party vendor involved in the set-up to install security software on its computers.

1 FINRA additionally found that Lincoln Financial failed to implement a supervisory system to ensure the preservation of consolidated reports by third party vendors and to retain such reports.

FINRA specifically stated that the security policy adopted post-breach was inadequate, as it provided insufficient guidance regarding what security measures were required or how to implement them, instead leaving it up to the representatives themselves. Moreover, FINRA found the firm had failed to supervise both its registered representatives and their third party vendors to ensure they were following the proper guidelines and protecting customer information, including by not monitoring or auditing the third parties to ensure compliance.

Lincoln Financial consented to the $650,000 fine pursuant to a Letter of Acceptance, Waiver, and Consent without admitting or denying FINRA's findings. A Corrective Action Statement submitted by the firm stated it had taken measures to improve. These included hiring additional data security personnel and enhancing its training for representatives, hiring experts to evaluate its cybersecurity policies, implementing improved audit procedures at its branch locations, and holding regular meetings to assess the security of its data.

Takeaways

Though the landscape has changed significantly since 2011, increased regulation related to data security and the threat of breaches are now the norm. Adopting advanced security measures is no longer optional. In particular, both FINRA and the Securities and Exchange Commission require broker-dealers to adopt written data security policies and procedures. Firms must take steps to not only implement but continuously monitor and maintain adequate procedures to stay ahead of cybersecurity threats and business developments. Because technology and procedures change—for example, a firm may adopt cloud-based storage—the policies must be reviewed and revised as appropriate to maintain effective security.

1. **Details Matter**

   In adopting these policies and procedures, general guidance is not enough. Even after a firm adopts written procedures, FINRA may determine those procedures lack specificity and fall short of what applicable regulations require. For example, a firm's written policy should not simply state that representatives must use security measures like firewalls and anti-virus software to prevent unauthorized access to customer records. Instead, it should include specifics, such as what type of firewall should be used and how it should be installed. Firms can no longer rely on representatives to interpret and implement specific policies based on general best practices, as they may not have the requisite technical

knowledge to do so. Rather, firms are required to develop specific and adequate security plans and ensure their representatives are able to properly implement them. Where firms lack the ability to do so themselves, they must bring in experts to advise on potential risks and appropriate procedures.

2. Branch Supervision is Vital

More generally, firms are responsible for the information security practices of branch offices, and ongoing supervision is essential to ensure data protection. In addition to adopting written procedures and overseeing their implementation, firms must take an active role in monitoring branches for compliance. Firms should engage in regular audits of these locations to ensure security measures are effective and up to date. In addition, firms must implement procedures to monitor the security of the systems used at branch offices on an ongoing basis. In this way, firms will be able to act quickly if necessary to avert a threat or respond in case of unauthorized access. Ultimately, ongoing supervision is not only required by applicable laws and regulations, it can significantly help minimize a data breach's effects.

3. Security Does Not Stop at the Door

Firms are not just responsible for their employees and registered representatives, but for third party vendors—even where those vendors are retained by the representatives. NASD Rule 3010 (effective prior to December 1, 2014) and FINRA Rule 3110 (effective December 1, 2014), both require firms to maintain supervisory systems, including written policies, that enable them to oversee the activities of registered representatives and ensure they are in compliance with relevant laws and regulations. Information is placed at risk whenever it is shared, and firms are responsible for safeguarding customer information at each point of access. In essence, it is not the security of a firm's own system, but the security of the information generally that matters. Thus, firms must take an active role in guiding representatives and third parties and ensuring such policies are properly implemented.

4. Security is Ongoing

Moreover, it is not enough to simply institute such systems and mandate compliance by third parties; firms have a continuing obligation to ensure information is being protected. This involves ongoing testing and supervision. Also, firms must implement procedures that would enable them to track access to data and determine whether a server at any of their branches was breached. Personnel training can help keep data secure, but it is not enough. Regular meetings by those involved with data security and compliance, as well as the adoption of audit procedures to ensure the continued security of hardware and software are necessary.

5. Communication is Key

When information is placed at risk or a breach occurs, firms must be prepared to respond. In particular, communications with customers matter. Having proper procedures in place to deal with a security breach and assist affected customers will not only help minimize the damage but can affect the way in which regulators view a firm.

Ultimately, given increased enforcement of cybersecurity regulations, and a rise in data breaches themselves, firms must take their responsibility to safeguard customer data seriously. This obligation includes not only implementing proper procedures, but supervising third parties and engaging in ongoing monitoring to ensure these security measures are effective and up to date.

Complex Investment Product Training Materials Under Fire

BY NATALIE NAPIERALA & GABRIELLA PAGLIERI

In September 2016, the SEC imposed an approximately $15 million penalty and disgorgement (in total) against UBS Financial Services Inc. (UBS) as part of a settled action alleging that UBS failed to adequately train its registered representatives. The representatives had sold complex financial products to UBS's retail investors, many of whom had minimal investment experience and reported modest income and net worth.

The complex financial products at issue were risky, single stock-linked reverse convertible notes (RCNs), which contained embedded derivatives based on underlying stocks. To build its case, the SEC, along with its Enforcement Division's Complex Financial Instruments Unit, used, for the first time, "big data" analysis tools to identify "platform-wide" sales patterns rather than engage in the more customary investor-by-investor review.

Here, the SEC's data analytics ultimately led the SEC to conclude that UBS's training materials were inadequate mainly because such materials did not fully explain the risks associated with the volatility of the underlying stock's performance and the potential that the stock could close below the specified downside market protection level, or the availability of certain optionality features that could be exercised by the investor after the product's issuance. The SEC also found that, because of inadequate training, education and supervision, UBS's registered representatives did not fully comprehend the RCNs' risks and rewards thereby causing them, in certain instances, to make unsuitable recommendations to individual retail investors. This conduct, the SEC noted, constitutes a fraud or deceit upon the purchaser in the offer or sale of the products in violation of Section 15(b)(4)(E) of the Exchange Act.

The SEC's settled action against UBS enforces that broker-dealers who market complex and risky investment products to retail investors, particularly those with limited or no investment experience, must adequately train and supervise their sales staff on suitability determinations.

FINRA Seeks Clean Sweep of Abusive Cross-Selling Practices

BY GAIL JANKOWSKI

In late October, the Financial Industry Regulatory Authority (FINRA) announced a sweep examination of broker-dealers targeting cross-selling programs similar to those that recently resulted in Wells Fargo's payment of an $185 million settlement.

FINRA sent targeted exam letters to several broker-dealers, requesting extensive information for the period from January 1, 2011 through September 30, 2016. FINRA explained that the sweep aims to determine the incentives broker-dealer employees are given to:

- promote bank products of a parent or other affiliated company to broker-dealer retail customers;
- add features such as securities-based loans, credit or debit cards, or checking accounts to such customers' accounts; and
- open additional broker-dealer accounts for such customers.

The sweep letters request a strikingly broad range of information relating to cross-selling programs, including: employee compensation and discipline, metrics used to track and evaluate employee performance, revenues flowing from parents or other affiliates, training materials and seminars, and customer complaints. Accordingly, for the firms that received demand letters, these are burdensome requests. Overall, the breadth of the sweep seems to reflect FINRA's oft-repeated interest in the totality of firm "culture," as it relates to cross-selling practices. See "FINRA to Assess Member Firms' Cultures," *Expect Focus* Vol. II, 2016.

According to reports, a FINRA official declined to comment on the specific number or size of firms that received letters pursuant to the sweep, but did state that "[i]n light of recent issues related to cross-selling, FINRA is focused on the nature and scope of broker-dealers' cross-selling activities and whether they are adequately supervising these activities by their registered employees to protect investors."

Dodd-Frank in a Trump Administration

BY ROLLIE GOSS

During the recent campaign, President-elect Donald Trump pledged to repeal the Dodd-Frank Act (DFA) if elected, criticizing the regulatory burdens it imposed and contending that it discouraged lending by banks and impaired the growth of the U.S. economy. Mr. Trump stated he would dismantle most of the DFA if elected, because it "has made it impossible for bankers to function … It makes it very hard for bankers to loan money for people to create jobs, for people with businesses to create jobs. And that has to stop."

Shortly after the election, Mr. Trump's campaign adviser Anthony Scaramucci said "the worst anti-business parts of [the DFA] will be gutted." President-elect Trump's transition web page states he will replace the DFA with new policies to encourage economic growth and job creation.

Much of this criticism of the DFA has focused on its impact on the banking sector. Neither Mr. Trump nor his advisors have directed specific criticism at its impact on the business of insurance. This article examines one possible alternative Republican legislative approach, based on current policy proposals, focusing on possible DFA changes affecting the insurance sector.

The Financial CHOICE Act – A Possible Approach?

A discussion of possible changes to the DFA affecting insurance or reinsurance should start with the basic Trump and Republican policy approaches to the regulation of insurance and reinsurance. Although the President-elect has issued no policy pronouncements concerning insurance or reinsurance regulation, the Republican approach historically, and specifically in response to the DFA, has been to strongly support the state-based regulation of the business of insurance in the United States, and President-elect Trump has made no statements indicating he disagrees with that approach.

Several bills introduced over the past two years would repeal or substantially modify all or part of the DFA. These include the Financial CHOICE Act of 2016 (The Financial CHOICE Act), introduced by House Financial Services Committee chair Rep. Jeb Hensarling, who was mentioned as a candidate for the position of Treasury Secretary in the Trump administration. This bill may provide a possible model for the Trump administration's approach to the DFA.

A published Executive Summary of the bill articulates its "Key Principles," which focus on simplicity and accountability of regulation, encouraging competition, consumer protection, avoiding government bailouts, and market management of systemic risk. The Executive Summary does not mention insurance, nor do any of the policy prescriptions laid out in that document relate directly to the business of insurance.

A published Comprehensive Summary of the bill begins with an outline of its provisions, which include "Improving Insurance Regulation by Reforming Dodd-Frank Title V." The insurance "improvement" discussion fills only two of the Comprehensive Summary's 126 pages, and addresses only one modest change: combining the positions of the Director of the Federal Insurance Office and the Financial Stability Oversight Counsel's (FSOC's) independent insurance representative into a single position. It also discusses the repeal of FSOC's Systemically Important Financial Institutions (SIFI) designation authority, which would impact some of the largest insurance companies.

The Financial CHOICE Act's approach would have only a modest impact on the business of insurance.

1. SIFI Designations

The SIFI designation process has been widely criticized for reasons that include: (1) the process is unnecessary or unwise; (2) the process violates principles of due process; (3) the process lacks transparency; and (4) the process is inappropriately applied to non-bank financial companies, such as insurance companies. The recent court opinion vacating Metlife's SIFI designation may provide further support for changing the SIFI process, at least as to insurance companies.

A concerted effort to change or eliminate the SIFI process seems likely. The Financial CHOICE Act

would eliminate the SIFI designation process entirely, legislatively rescinding the designation of AIG, Prudential, General Electric Capital, and MetLife as SIFIs, and removing them from prudential regulation by the Federal Reserve.

2. Covered Agreements

The Federal Insurance Office has been engaged in discussions with the European Union (EU) concerning a possible covered agreement on two issues: (1) a temporary declaration that the U.S. markets satisfy the equivalence requirements of the EU's Solvency II insurance regulatory directive; and (2) what is termed the "credit for reinsurance issue," which involves the level of collateral that alien reinsurers must post for reinsurance agreements in the United States.

There is widespread concern over Solvency II's potential impact absent some finding that the U.S. market satisfies its equivalence requirement. Beyond noting a lack of transparency, Republicans have not articulated opposition to a covered agreement addressing the equivalence issue.

The National Association of Insurance Commissioners (NAIC) may use the administration change as an opportunity to renew its opposition to a covered agreement encompassing the issue of collateral levels for credit for reinsurance provided by alien reinsurers. This issue has prompted complaints by alien reinsurers and foreign insurance regulators for many years, and the NAIC's effort to address it through a model act has not garnered sufficient support among the states, through the adoption of the model act, to resolve the issue uniformly throughout the United States.

The Financial CHOICE Act would leave in place the process for negotiating covered agreements concerning prudential insurance matters of international importance. There may be no changes to this area of the DFA.

3. The FSOC's Role

Republicans have criticized the extent to which the FSOC is involved in setting and implementing policy, and the lack of transparency in its operation. The FSOC's members have been criticized for their lack of insurance expertise and for applying "bank centric" rules to insurance companies. The Financial CHOICE Act would change the FSOC's role into that of, essentially, a monitoring and coordinating body.

4. The Federal Insurance Office (FIO)

The initial concern about the FIO was that it might morph into more of a regulatory office than a monitoring office, but its activities have focused on international issues while respecting the state-based regulation of insurance. We see no indication that a Trump administration would substantially change course in this area.

The Financial CHOICE Act would combine the positions of the Director of the FIO and the FSOC independent member with insurance expertise to reduce "fragmentation" and provide a single voice for the U.S. insurance industry at the domestic and international levels, including at the International Association of Insurance Supervisors, while preserving our traditional state-based system of insurance regulation.

5. The Nonadmitted and Reinsurance Reform Act (NRRA)

The NRRA portion of the DFA has been uncontroversial. The DFA encouraged the sharing of premium tax revenue for multi-state surplus lines placements among the states, and two mechanisms developed to share such revenues. However, both of these mechanisms have collapsed, resulting in no changes to that part of the market. The Financial CHOICE Act proposes no changes to the NRRA provisions of the DFA.

Conclusion

It is still early in the transition to a Trump administration, and little has been said about the DFA and insurance since the election. The development of the approach to the DFA and the issues discussed above will spark considerable interest. Whether the Trump administration will adopt the Financial CHOICE Act approach, or one similar, remains to be seen.

SEC Adopts Liquidity Risk Programs for Funds

BY CHIP LUNDE

On October 13, the SEC adopted rule reforms designed to improve liquidity risk management by open-end funds.

Liquidity Risk Management Programs

Under the reforms, mutual funds (excluding money market funds) and ETFs will be required to implement liquidity risk management programs.

Liquidity risk is defined as the risk that a fund could not meet redemption requests without significant dilution of remaining investors' interests in the fund. Under the program, funds will be required to:

- classify each portfolio investment into one of four categories (based on how long it would take to liquidate those investments);
- invest no more than 15 percent of their net assets in illiquid investments;
- set a highly liquid investment minimum; and
- implement procedures to address any shortfall in satisfying that minimum.

The program must be tailored to the characteristics of each fund and will be subject to periodic assessment and board oversight. Also, a fund must confidentially notify the SEC when its illiquid assets exceed 15 percent or its highly liquid assets fall below the fund's minimum.

The compliance deadline for the liquidity risk management program requirement is December 1, 2018 for large entities (June 1, 2019 for small entities).

Swing Pricing

The reforms also permit, but do not require, mutual funds (except money market funds and ETFs) to use "swing pricing." A fund using swing pricing would adjust its net asset value (NAV) for days on which it has net purchase or net redemption orders that exceed a specified percentage of the fund's net assets (a "swing threshold"). Swing pricing would allow funds to pass on related portfolio trading costs to purchasing and redeeming shareholders, and protect other shareholders from dilution.

For a fund using swing pricing, once the fund's net purchases or redemptions exceed a swing threshold, the fund must adjust its NAV by a swing factor determined according to the fund's policies and procedures. A fund may use investor flow information to reasonably estimate whether it has crossed a swing threshold with high confidence. The swing factor may consider only the near-term costs the fund is expected to incur as a result of the net purchases or redemptions on that day.

Funds may not engage in swing pricing until two years after the rule's publication in the Federal Register.

Unique Issues for Variable Insurance Products

The "swing pricing" proposal could uniquely impact underlying funds and issuers of variable insurance products. For example, it may be particularly difficult for unaffiliated underlying funds to reasonably estimate net purchases and redemptions where net purchase and redemption orders are submitted by intermediaries after the close of business each day. Even many non-insurance product funds are skeptical that they will be able to reasonably estimate early enough in the day whether a swing pricing threshold will be exceeded in order to have time to implement swing pricing for that day.

In addition, the swing pricing option could present challenges regarding the pricing and costs associated with fund substitutions. Addressing some of these issues may require amendments to fund participation agreements.

SEC Watchdog to Watch Watchdog

BY TOM LAUERMAN

The SEC's Office of Compliance Inspections and Examinations (OCIE) has established a dedicated team charged specifically with inspecting FINRA and other FINRA-related work.

This follows through on the SEC's previously-announced intention to step up its oversight of FINRA's broker-dealer inspection program. As we previously reported, the SEC is itself inspecting fewer broker-dealers in order to free up resources to inspect more investment advisers, and the SEC is relying on a ramp-up in FINRA's broker-dealer inspections to take up the slack. *See* "Regulatory Musical Chairs for Money," *Expect Focus* Vol. II, 2016.

In a speech this October, OCIE head Marc Wyatt stated that, historically, the SEC and FINRA have been examining about 50 percent of broker-dealers annually. This probably will not change much, except that broker-dealers can expect more of their examinations will be conducted by FINRA. On the other hand, investment advisers, overall, can expect somewhat more frequent SEC examinations.

The SEC and FINRA continue to improve their ability to use technology to make examinations more effective and to better target their examinations on firms where regulatory problems are likely to exist. The SEC is also increasingly able to make use of "whistleblower" tips to better target its examination and enforcement resources.

Thus, although the frequency of examinations will probably not change much for either broker-dealers or investment advisers, the regulators' increased use of technology and whistleblower tips should continue to make their examination programs more efficient and effective.

NEWS & NOTES

Carlton Fields was named in the 16th annual *BTI Client Service A-Team 2017* report, an honor limited to law firms that deliver unparalleled client service. This is the only law firm ranking that identifies top law firms for client service through a national survey of corporate counsel.

The Leadership Council on Legal Diversity (LCLD) recognized Carlton Fields for its efforts to promote diversity in the legal profession, naming the firm a 2016 Top Performer. The "Top Performer" designation is given to LCLD's most active and committed member corporations and law firms.

For the eighth consecutive year, Carlton Fields earned a perfect score of 100 on the Human Rights Campaign Foundation's Corporate Equality Index for its LGBT-inclusive policies, and was named a "Best Place to Work for LGBT Equality."

Carlton Fields recently earned ISO/IEC 27001:2013 Certification, the most widely adopted information security standard in the world and the highest level of security-related accreditation a business can achieve. ISO 27001 is an internationally accepted information security standard that specifies how to establish, maintain, and improve an organization's information security management system. These standards ensure that formal security and risk management controls are in place to protect sensitive company, client, and employee information. The firm achieved this certification for all of its offices and data centers throughout the United States.

Miami Shareholder **Julianna Thomas McCabe** was selected to receive the 2016 "Outstanding Contributor" award from Lawyers for Civil Justice (LCJ). The LCJ is a partnership of leading corporate and defense bar practitioners which focuses on reforming the U.S. litigation system to reduce the high cost of litigation and enable American companies to compete more effectively in the global marketplace. During the past two years, Ms. McCabe has actively voiced business community concerns regarding proposed amendments to Rule 23 governing class actions.

Carlton Fields sponsored the 5th Annual Insurance Market Summit, held November 10 in Hartford, Connecticut. Hartford Shareholder **Ben Seessel** moderated an industry response panel, which reacted to a presentation from IBM's Global Managing Partner, Cognitive and Analytics, Glenn F. Finch, on technology, strategy, disruptors, and new-frontier opportunity.

Shareholder **Richard Choi** co-chaired the 34th annual Advanced ALI CLE Conference on Life Insurance Company Products November 3-4 in Washington, D.C. The conference, co-founded by shareholder **Jim Jorden**, is the premier industry conference of its kind for life insurance companies, mutual funds, broker-dealers, and investment advisers. Miami office Shareholder **Ann Black** spoke on a panel that focused on the latest fixed and indexed product design and regulatory developments, and D.C. office Of Counsel **Gary Cohen**, who was on a panel with SEC staff, spoke on Rule 12b-1 fees.

Carlton Fields co-sponsored the American Bar Association Section of Litigation Appellate Practice Committee's CLE program, "The Trump Administration and the U.S. Supreme Court: What Does the Future Hold?" The November 17 program, held in Washington D.C., featured a bipartisan group of speakers and experts from the legal community. They discussed the role the Supreme Court vacancy played in the presidential campaign and how the nomination process is likely to play out. Miami Shareholder **Jason Kairalla**, co-chair of the programming subcommittee for the ABA's Appellate Practice Committee, was the event's organizing chair.

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