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FROM CARLTON FIELDS JORDEN BURT, P.A.

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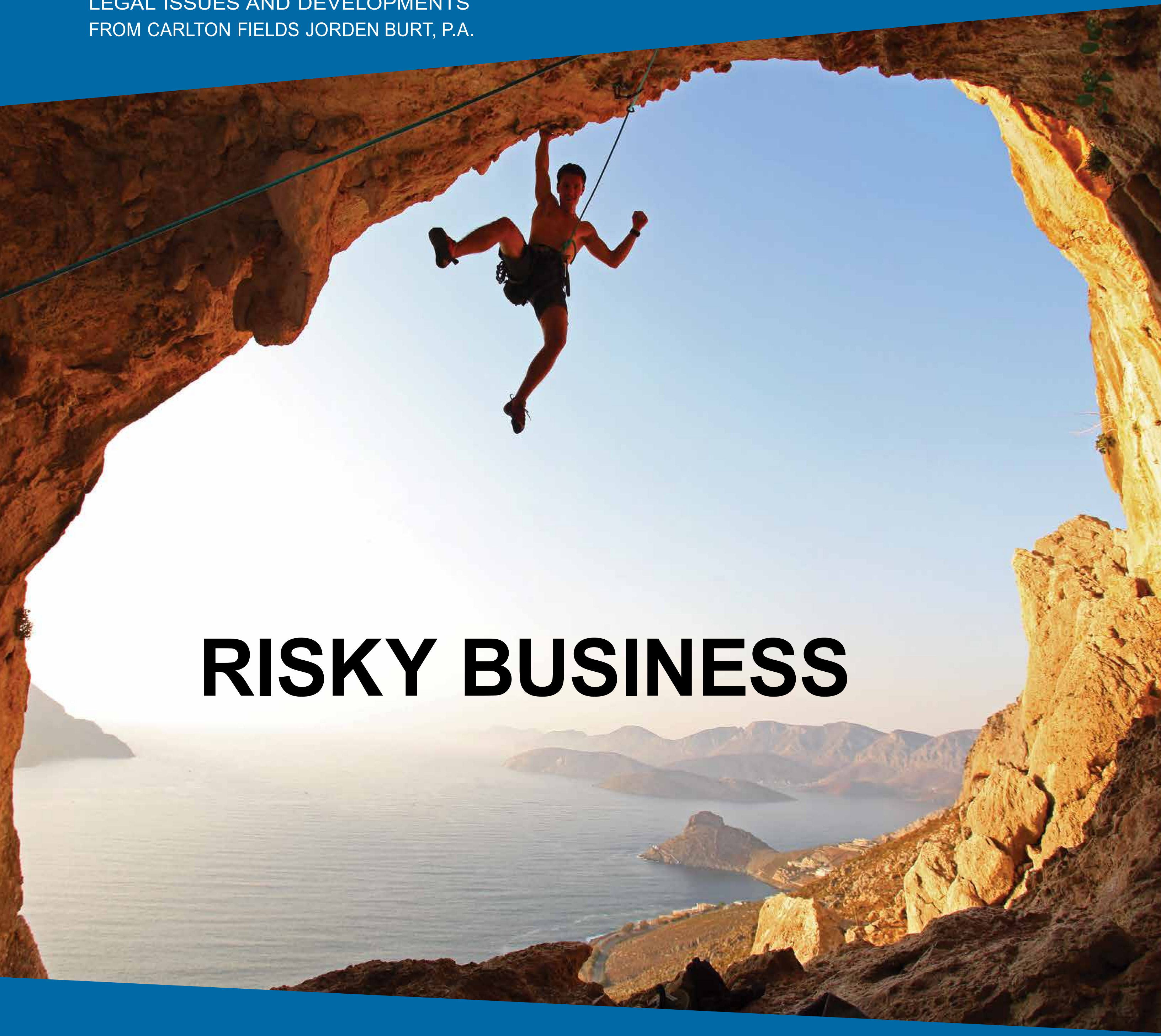

# RISKY BUSINESS

Regulators Demand Third-Party Risk Management

Signs of an Active 2017 for Laws Protecting Vulnerable Adults from Financial Exploitation

Will New Administration Speed VA Summary Prospectus?

CARLTON FIELDS
JORDEN BURT

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EXPECTFOCUS® is a quarterly review of developments in the insurance and financial services industry, provided on a complimentary basis to clients and friends of Carlton Fields Jorden Burt, P.A.





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# Regulators Demand Third-Party Risk Management

**BY JOSEPHINE CICCHETTI**

While third-party risk management has been a required component of an effective enterprise risk management program for many years, the topic is receiving elevated attention at insurance companies and related businesses.

The recently effective New York State Department of Financial Services (NYDFS) cybersecurity standards for NYDFS licensed financial institutions and the current proposed draft of the NAIC Insurance Data Security Model Law require licensees to implement specific policies and procedures designed to protect the security of company information systems and nonpublic information (including personally identifiable information of customers and policyholders) that are accessible to, or held by, outside service providers as part of an overall cybersecurity program.

The regulators recognize that an entity's cybersecurity program should start with, and be based on, the results of a risk assessment. The risk assessment should take into account factors specific to the entity, such as its size and complexity. However, regardless of specific regulatory mandates, every well-designed third-party risk management program should include the following:

- an analysis of the particular risks associated with the service organization and the services to be provided;
- baseline cybersecurity and other requirements to be eligible for hire;
- due diligence steps to be followed prior to contracting with a third-party;
- standard contractual provisions;
- mechanisms to monitor performance and compliance under the contract; and
- address termination and post-contractual procedures.

Implementing an appropriate third-party risk management program will require enterprise-wide engagement, including the participation of representatives from areas such as business units, procurement, sourcing, IT, risk, compliance, internal audit, legal, privacy, and the individual designated to manage the program.

# SEC Approves FINRA Efforts to Protect Seniors and Other Vulnerable Persons

**BY JOSHUA WIRTH**

The SEC recently approved an amendment to FINRA Rule 4512 that requires FINRA members to make reasonable efforts to obtain, from each customer for whom they maintain an account, specified information about a "trusted contact person." At the same time, the SEC approved new FINRA Rule 2165 that permits, but does not require, FINRA members to place temporary holds on disbursements from customer accounts if:

- the customer is at least age 65 or is a person age 18 or older with a mental or physical impairment preventing them from protecting their own interests, and
- the member reasonably believes that financial exploitation of the customer is occurring, has been attempted, or will be attempted. The rule broadly defines the term "financial exploitation," with the intention of permitting members to quickly respond and protect vulnerable customers from a wide range of abuses.

Such a temporary hold can last for no more than 15 business days plus one 10-day extension. If a hold is imposed, the broker-dealer must immediately initiate an internal review of the facts and circumstances and notify certain parties, including any trusted contact person, unless the firm reasonably believes that person is implicated in the exploitation.

FINRA has stated that the new rules do not apply to variable insurance products and mutual funds that are held directly through the issuer or its transfer agent, because such securities are not held in a customer account within the meaning of the rules. Moreover, even where investment company securities *are* held in a member firm's customer account, if the proceeds from a customer's redemption request are paid to the customer account within seven days, placing a temporary hold on distributing the proceeds to the customer (as permitted by the new rule) would not violate the Investment Company Act requirement that redemption proceeds be paid within seven days.

Although FINRA's rules cover only broker-dealers, the SEC staff's 2017 Examination Priorities Guidance states that such priorities will include:

- evaluating the ability of broker-dealers and investment advisers to identify financial exploitation of seniors, and
- evaluating such firms' supervisory program and controls relating to products and services directed at seniors.

The staff, therefore, may expect investment advisers to be considering many of the same issues concerning seniors and other potentially vulnerable investors as broker-dealers will be considering as they implement FINRA's rules.

# Signs of an Active 2017 for Laws Protecting Vulnerable Adults from Financial Exploitation

**BY THADDEUS EWALD**

The North American Securities Administrators Association (NASAA)'s Model Legislation or Regulation to Protect Vulnerable Adults from Financial Exploitation (Model Act) gained traction in 2016 and appears poised for even more progress in 2017. The Model Act, adopted by NASAA in January 2016, aims to protect citizens over the age of 65 from being victimized by financial fraud by empowering financial services professionals to report on and prevent potential financial exploitation.

The hallmarks of the Model Act are: (i) mandatory reporting requirements for potential fraud applicable to certain financial professionals; (ii) notification to pre-approved third parties of potential financial exploitation; (iii) authority to temporarily delay disbursements of funds; (iv) immunity from civil and administrative liability for reporting, notification, and delays; and (v) mandatory record sharing of information related to exploitation with relevant state authorities. The Model Act was the basis of legislation or regulations adopted in four states in 2016. Alabama and Indiana adopted laws, and Vermont promulgated a regulation, which implement the Model Act's mandatory reporting requirements, immunity, and delayed disbursement provisions. Louisiana, on the other hand, passed a law that only provides for voluntary reporting, but maintains the Model Act's immunity and disbursement provisions. Several other states had previously adopted laws and regulations on the subject prior to the Model Act's promulgation last year. Some, like California, adopted the mandatory reporting requirements, while others, like Washington, enacted more robust statutory schemes nearly identical to the Model Act's full set of requirements.

All signs point to an even more active year for NASAA's Model Act or its variations. At the federal level, Sen. Susan Collins (R-ME) has re-introduced the Senior$afe Act of 2017, which passed the House in 2016 but stalled in the Senate. At the state level, dozens of legislators from across the country have introduced bills adopting wholesale or incorporating elements of the Model Act. Maryland, Mississippi, New Mexico, North Dakota, and Oregon, for instance, are all considering bills imposing mandatory reporting requirements in line with the Model Act. At least two other states, New York and Tennessee, are considering bills that would provide for voluntary reporting of suspected financial exploitation.

These bills, which regularly attract broad bipartisan support, are often co-sponsored by Democrats and Republicans, and pass state legislatures unanimously or with little opposition. While not every pending bill will become law, given the amount of legislation, this year should bring even more enactments than the four seen in 2016.

# FINRA Fines Firms for WORM Problems

**BY ANN FURMAN**

Broker-dealers, including principal underwriters of insurance products, may retain required records in electronic format, subject to satisfaction of longstanding conditions. One such condition is that the records must be preserved “exclusively in a non-rewritable, non-erasable format.” This condition is often referred to as “write once, read many” or “WORM.”

The WORM requirement was designed to ensure that electronic records are capable of being accurately reproduced for later reference, thus addressing, among other things, SEC enforcement concerns with unscrupulous broker-dealers who improperly alter or destroy records — such as order tickets and other transactional records — to conceal fraudulent activities.

In late 2016, FINRA announced that it fined 12 firms — including some prominent industry names — a total of $14.4 million for not maintaining electronic records in WORM format. In addition to finding that the 12 firms had WORM deficiencies that affected “millions of records,” FINRA found that each of the firms had procedural and supervisory deficiencies affecting the firm’s ability to adequately retain and preserve electronic records. In settling the actions, the firms neither admitted nor denied the charges, but consented to FINRA’s findings.

In its 2017 regulatory and examination priorities letter, FINRA also announced that it will continue to assess firms’ programs to mitigate risks related to cybersecurity and electronic recordkeeping, including compliance with WORM requirements by vendor-provided email review and retention services.

The recent fines levied by FINRA suggest more than isolated instances of non-compliance within the broker-dealer community, and other firms would be well advised to review their own WORM compliance, if they have not done so recently.

# Will New Administration Speed VA Summary Prospectus?

**BY GARY COHEN**

President Trump's nominee for SEC Chairman, Jay Clayton, could speed authorization of the variable annuity (VA) summary prospectus and related layered disclosure and shortened underlying fund report to shareholders. Doing so would be consistent with the President's stated objectives of relieving companies of regulatory burdens, reducing company costs, and benefiting investors.

It has been more than nine years since the SEC proposed summary prospectuses for mutual funds and more than eight years since it adopted an authorizing rule. It also has been more than seven years since then-SEC Chairman Mary Schapiro announced that the staff had begun developing a VA summary prospectus, and about four years since then-Director of the Division of Investment Management Norm Champ announced that the staff was working on the VA summary as a "regulatory priority."

The SEC, last fall, reported to the U.S. Office of Management and Budget that it expected to consider staff recommendations in October 2017. But such projected timetables for the VA summary prospectus have proved optimistic in the past and there is reason think this one will as well.

The Commission is in significant transition. The SEC Chairman nominee appears to have no particular experience in the variable insurance products area, and will need time to settle into his position and develop his agenda. President Trump will also be appointing two additional commissioners, one Republican and one Democrat, to fill existing vacancies. They too will need time to get up to speed.

On the other hand, William "Bill" Kotapish, a longtime staff official in this area, remains as head of the Division's Office of Insured Investments, providing continuity on the matter of the VA summary prospectus and related disclosure reforms.

# Sprouting Activity at the NAIC

**BY JOSEPHINE CICCHETTI, ANN BLACK, TOM LAUERMAN & JAMIE BIGAYER**

Various NAIC groups have planted seeds for a number of regulatory initiatives that impact life insurers.

- The Cybersecurity Task Force has been tilling the ground in preparation for a third draft of the NAIC Cybersecurity Model, which it hopes will be in full bloom by the Spring National Meeting.

- The Life Insurance and Annuities (A) Committee working groups are examining ways to improve the soil for consumers.

    - The Annuity Suitability (A) Working Group is starting at the ground level, convening for the first time at the Spring National Meeting, and opening the Suitability in Annuity Transactions Model for possible changes, including adding a best interest standard.

    - The Annuity Disclosure (A) Working Group is examining whether changes should be made to the illustration requirements to allow for illustrations of other varieties of annuities.

    - The Promoting Appropriate Sales Practices in Life Insurance and Annuities (A) Working Group will survey insurance regulators as to: (i) whether any misuse of senior or other designations are not adequately pruned by the NAIC Model Regulation on the Use of Senior Specific Certifications and Professional Designations, and (ii) any comments on the NAIC Model Consumer Alert on senior specialists and free lunch seminars.

    - The Life Insurance Buyer's Guide (A) Working Group is considering creating a decision tree to help consumers decide what variety of life insurance product to purchase and adding questions on whether the producer has a fiduciary duty to the consumers or is providing conflicted advice.

It also looks like the NAIC will prune some recent activities:

- Based in part on the recent impasses requiring a tie-breaking vote, the Unclaimed Life Insurance Benefits (A) Working Group may be clipped.

- Similarly, work on a continuum of actions chapter for the Market Regulation Handbook may be trimmed.

# SEC Facilitates Product Charge Variations

**BY TOM LAUERMAN**

SEC staff in December issued a Guidance Update that provides significant flexibility regarding how mutual funds and variable annuities (VAs) reflect multiple charge structures in their SEC registration statements.

Over time, such charge structures have proliferated. For example, to more easily comply with the fiduciary rules, promulgated by the Department of Labor last year, a broker (or other "intermediary") may want the sales charges and commissions to be the same for each mutual fund or VA that the intermediary offers its customers. Funds and VA issuers have therefore been under pressure to make available additional charge/compensation structures to meet the varied preferences of the intermediaries that sell these securities.

So-called "clean shares" (discussed in "SEC Staff Allows Brokers to Set Commissions for Mutual Fund 'Clean Shares'" on page 9) and "T-shares" can be useful for this purpose. For example, several funds and intermediaries have settled on T-shares – paying uniform commissions and typically having a 2.5 percent front-end load and a .25 percent per annum 12b-1 fee – as being broadly acceptable.

Additional charge structures, including clean shares or T-shares, often may be added to a fund's registration statement as sales load variations within a single class of shares. In that case, subject to certain conditions, the Guidance Update:

- permits the required information about the identity of, and charge structure applicable to, each intermediary to be contained in an appendix to the fund's prospectus; and permits such appendix to be delivered as a standalone accompanying document, rather than an attachment to the prospectus.

"Q&As" issued by the staff in February clarify that such prospectus appendixes also can be used to disclose VA sales load variations, provided the requirements of the Guidance Update are otherwise satisfied.

Whenever additional charge structures are added, the Guidance Update and Q&As also:

- encourage registrants, where appropriate, to request "selective review" or "template filing relief," which can avoid a full SEC review of the relevant filings, and
- provide practical advice about making such requests.

# SEC Staff Allows Brokers to Set Commissions for Mutual Fund "Clean Shares"

**BY CHIP LUNDE**

On January 11, the SEC staff issued an interpretive letter to the Capital Group (CG Letter) stating that Section 22(d) of the Investment Company Act does not prevent brokers from charging commissions for effecting transactions in so-called "clean shares."

The CG Letter effectively allows brokers to compete on commission rates for the sale of mutual funds, as they do for ETFs, subject to certain conditions. The conditions of the CG Letter include:

- the clean shares must not include any form of distribution-related payments to the broker;
- the broker must represent in the relevant selling agreement that it is acting solely on an agency basis for the sale of clean shares;
- the clean shares prospectus must disclose (in the fee table) that brokers may charge a commission on the sale of the shares and, if applicable, that other share classes are available;
- commissions collected by the broker must be consistent with FINRA rules and other applicable law; and
- purchases and redemptions of clean shares must be made at net asset value.

### SEC Staff Answers to Frequent Questions

On February 15, the SEC staff published answers to certain questions regarding the CG Letter. For example, a fund with an institutional class would not be required to make a Rule 485(a) filing to add required clean shares disclosure.

### Open Questions

The CG Letter clearly states clean shares may not be sold with sales loads or asset-based fees for sales or distribution. However, the CG Letter does not address whether a selling broker may receive service fees, such as sub-transfer agent or shareholder servicing fees, or revenue sharing payments from the fund's adviser.

In addition, some have wondered whether the legal premise of the CG Letter could be applied to the sale of variable insurance contracts. One potential issue to consider is that brokers selling variable insurance contracts may be deemed to be acting as agents of the issuing life company.

# Circuits Split Over Constitutionality of SEC's Administrative Law Judges

**BY NATALIE NAPIERALA & GABRIELLA PAGLIERI**

The Tenth Circuit Court of Appeals, in *Bandimere v. SEC*, recently held that the SEC's administrative law judges (ALJs) are "inferior officers" whose appointments violate the Appointments Clause of the U.S. Constitution because they are not appointed by the President, the chairman of the SEC, or a court of law.

This ruling squarely conflicts with that of the D.C. Circuit in *Lucia v. SEC*. *See* "D.C. Circuit: SEC's In-House Court is Constitutional," *Expect Focus*, Vol. III, 2016. In that case, the D.C. Circuit held that ALJs act as employees and not inferior officers because: (i) their decisions only become final after the SEC itself issues a final order; and (ii) the Commission retains discretion to review *de novo*. The Tenth Circuit opined that the D.C. Circuit improperly gave dispositive weight to the lack of finality of ALJs' decision-making power, which, the Tenth Circuit stated, was only one factor to be considered in deciding whether ALJs are inferior officers. The fact that ALJs "exercise significant discretion" led the Tenth Circuit to conclude that ALJs are inferior officers.

The circuit split may make this issue ripe for future U.S. Supreme Court review. Or, this split may resolve itself: the D.C. Circuit has agreed to vacate its decision in *Lucia* to rehear argument *en banc*, and has set oral arguments for May 24, 2017, while the SEC has petitioned the Tenth Circuit for a rehearing.

Whether the SEC may change its method of appointing ALJs, and how the Supreme Court will resolve this circuit split under the Trump administration are uncertain. For now, the Tenth Circuit's decision may lead to spates of litigation as petitioners who are subject to actions in the SEC's administrative forum will likely challenge that venue as unconstitutional.

# Court Applies "Fiduciary Exception" to Mutual Fund Trustees' Attorney-Client Privilege

**BY MICHAEL VALERIO**

In *Kenny v. Pacific Inv. Mgm't Co. LLC* (W.D. Wash.), a federal judge recently ruled that a mutual fund's independent trustees must produce certain documents that the trustees had redacted or withheld based on attorney-client privilege. A plaintiff shareholder had subpoenaed the documents in an "excessive fee" case brought under Section 36(b) of the Investment Company Act.

Calling the issue one of first impression, the district court based its ruling on the so-called "fiduciary exception" to the attorney-client privilege. The court accepted the plaintiff's position that this exception should apply when a beneficiary of a trust seeks information regarding a trustee's acquisition of legal advice to "guide the administration of the trust," as opposed to personal legal advice or advice sought in anticipation of litigation. As the district court noted, the Ninth Circuit has recognized the fiduciary exception in the ERISA context.

The court observed that the mutual fund in question is organized as a "Massachusetts business trust" and that, pursuant to the trust's administration agreement, the trust paid the fees for the independent trustees' legal counsel. As such, the court concluded that the fiduciary exception should apply, notwithstanding the independent trustees' and investment adviser's protests that the exception was never previously applied in the mutual fund governance context, and that doing so would discourage important communications between independent fund trustees and their retained counsel which, in turn, "would actually destabilize the mutual fund industry to the detriment of all shareholders."

The independent trustees have not sought interlocutory appellate review of this ruling. The industry should all keep an eye on other 36(b) cases still in the discovery phase to see if the decision emboldens other plaintiffs.

# SEC Adopts T+2 Securities Settlement Cycle

**BY TOM LAUERMAN**

On March 22, the SEC adopted a rule amendment that shortens the time by which most securities transactions effected by a broker-dealer are required to settle. Under the amendment, beginning September 5, 2017, most such settlements will be required to occur by the second business day after the trade date (T+2), rather than by the previously-required third business day after the trade date (T+3).

The shortened settlement cycle will impact many securities transactions by both retail and institutional investors. For example, transactions in the shares of investment companies that are traded on exchanges (e.g., ETFs and closed-end funds), which heretofore have generally settled on T+3, will have to settle by T+2. The same is true of some non-exchange traded mutual funds, although most already settle on an even shorter T+1 basis.

### Benefits of Shortened Settlement Cycle

The Commission believes that shortening the standard settlement cycle will reduce certain credit, market, and liquidity risks, thus reducing systemic risk for central counterparties and other market participants in the United States. The Commission expects reduced risks and quicker access to funds and securities following trade executions to benefit market participants in various ways, including by lowering their capital, financing, and other costs. Insurance companies, investment companies, and other investors whose portfolios include securities that will be subject to a shorter settlement cycle under the amendment may derive some of these benefits, directly or indirectly.

This rule amendment may provide a particular benefit to mutual funds whose shares already are issued and redeemed on a T+1 settlement cycle. Such funds may be able to more efficiently and precisely manage their cash flows and liquidity requirements, to the extent the amendment makes the settlement cycle for their portfolio transactions closer to that for issuances and redemptions of their own shares. The Commission also believes that investors and other market participants may benefit from the fact that the amendment “harmonizes” the standard U.S. settlement cycle with the T+2 standard that already applies to many transactions outside the United States.

### Exemption for Insurance Products

The Commission left in place an order it issued in 1995 to exempt most insurance products (including variable annuities, variable life insurance, and certain other insurance contracts that are considered to be securities) from the T+3 requirement that was adopted at that time. As a result, sales and surrenders/redemptions of such insurance products will be exempt from the new T+2 requirement to the full extent they have been exempt from T+3.

This exemption reflects the fact that transactions in insurance products are subject to numerous requirements and considerations (including under state insurance law and Commission regulatory requirements) that make a T+2 or T+3 settlement mandate inapposite and unnecessary. For example, many such transactions remain subject to pricing and processing requirements under the Investment Company Act of 1940 and/or Financial Industry Regulatory Authority rules, although the regulators have shown some flexibility in administering such requirements, in recognition of the unique aspects of some of these transactions.

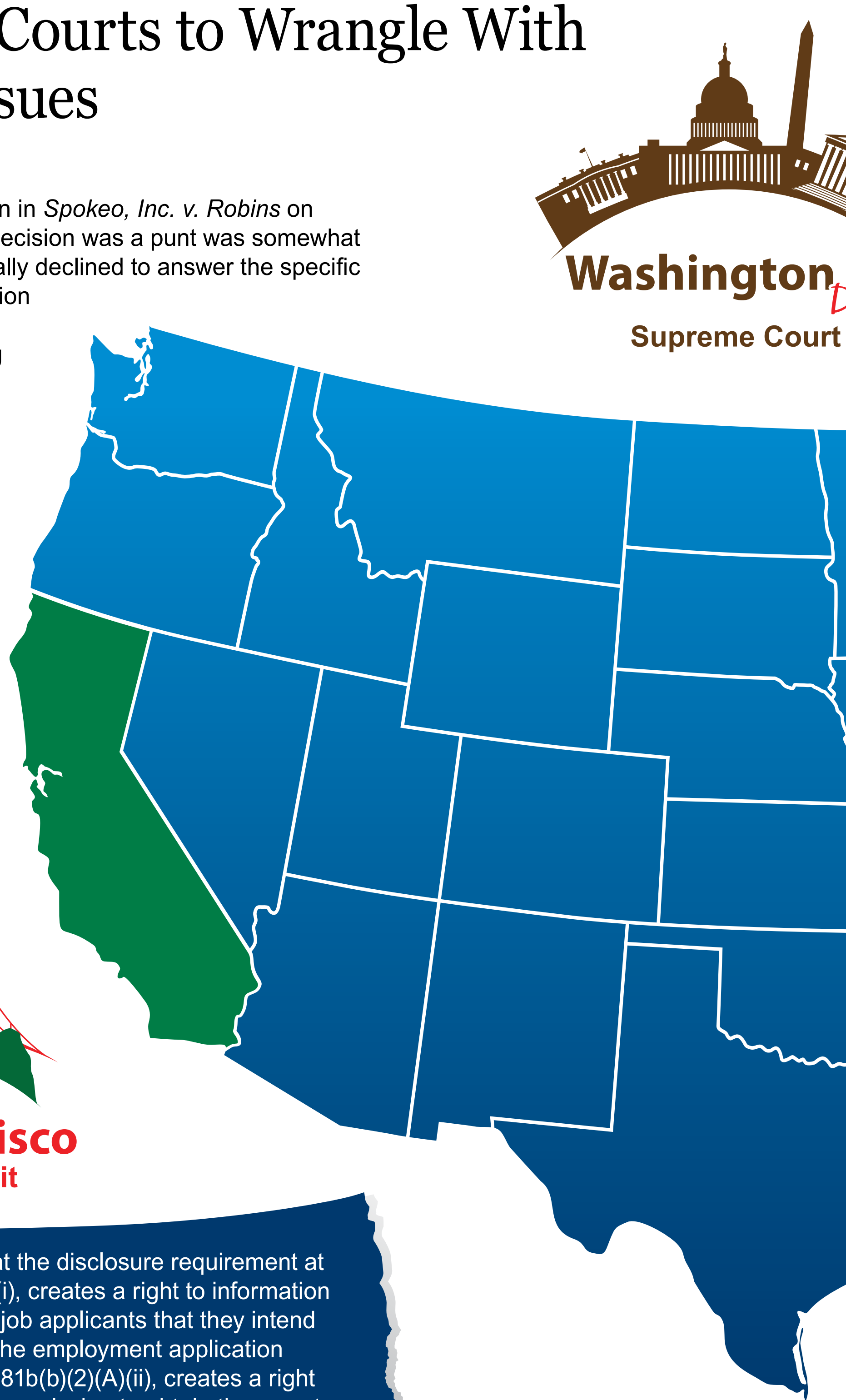
### Implementation of T+2

The Commission recognized that certain types of market participants (or their service providers) will need to incur significant costs in order to adapt to a T+2 standard settlement cycle. While the circumstances of different market participants vary widely, these costs are likely to fall most heavily on financial market utilities (such as central clearing agencies and central depositories) and certain broker-dealers. The Commission judged the additional costs for investors (or their investment managers) to be less, but still significant. For example, the Commission estimated additional costs of between $74,000 and $2,320,000 per institutional investor.

Nevertheless, the Commission concluded that the benefits resulting from a shortened settlement cycle will outweigh the costs. Moreover, the Commission concluded that the efforts of market participants to make the adjustments necessary for a standard T+2 settlement cycle are already sufficiently underway that the September 5 implementation date for T+2 is appropriate.

# *Spokeo* Leaves Lower Courts to Wrangle With Article III Standing Issues

**BY AARON WEISS**

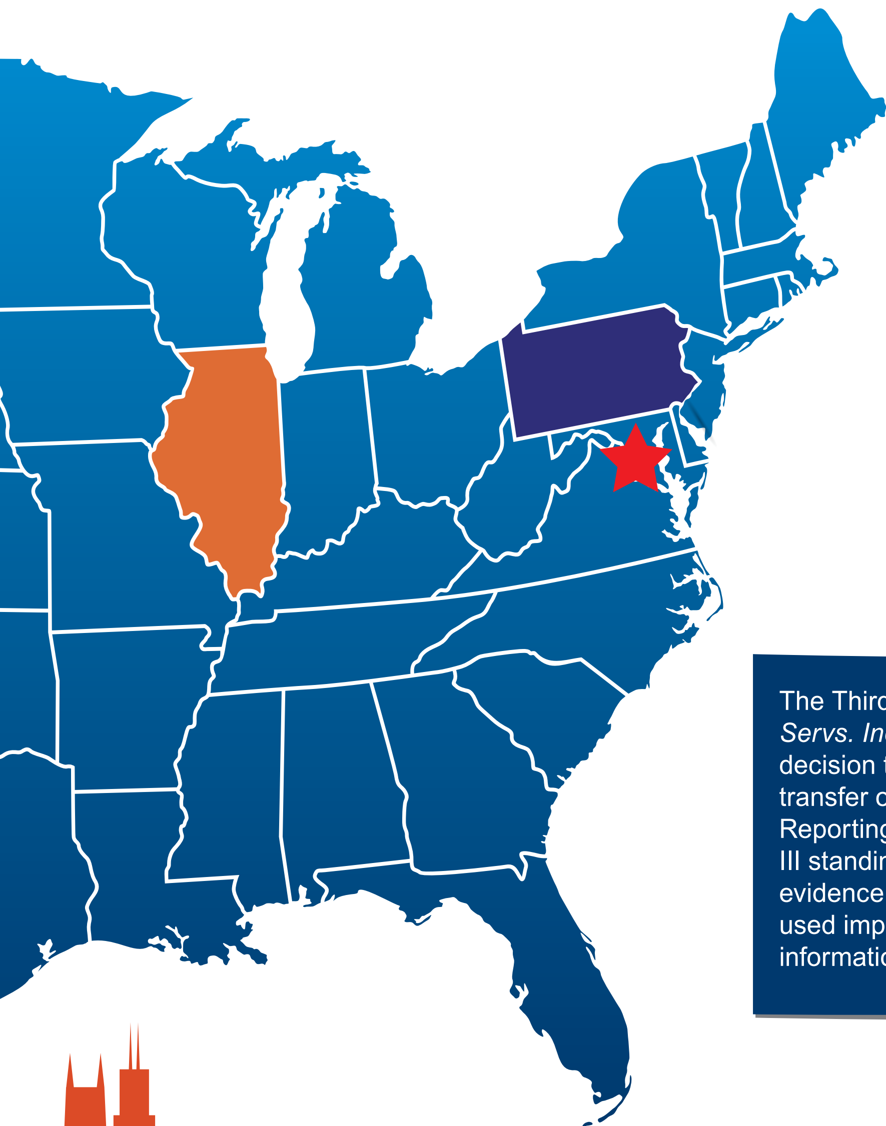



The United States Supreme Court issued its decision in *Spokeo, Inc. v. Robins* on May 16, 2016. At the time, the degree to which the decision was a punt was somewhat underreported. The five-judge majority opinion actually declined to answer the specific certified question: Whether a plaintiff suing for violation of a federal statute satisfied Article III's standing requirement by alleging no concrete injury stemming from the violation. Instead, the Court vacated and remanded the case to the Ninth Circuit to address whether the plaintiff satisfied the "concreteness" requirement for Article III standing. The oral argument on remand was conducted by the Ninth Circuit on December 13, 2016. That case will likely garner some attention when the Ninth Circuit panel opinion is issued. However, it is actually one of the less interesting cases making its way through the federal courts. In fact, the panel even entertained the idea of further remanding to the trial court to allow the plaintiff to replead the complaint in light of the appellate guidance on the issue.


The Ninth Circuit held in *Syed v. M-I, LLC* that the disclosure requirement at issue in the case, 15 U.S.C. § 1681b(b)(2)(A)(i), creates a right to information by requiring prospective employers to inform job applicants that they intend to procure their consumer reports as part of the employment application process. The authorization requirement, § 1681b(b)(2)(A)(ii), creates a right to privacy by enabling applicants to withhold permission to obtain the report from the prospective employer, and a concrete injury when applicants are deprived of their ability to meaningfully authorize the credit check. By providing a private cause of action for violations of Section 1681b(b)(2)(A), Congress has recognized the harm such violations cause, thereby articulating a "chain[ ] of causation that will give rise to a case or controversy."

The action in these cases has been mostly in the federal district courts, as hundreds of post-*Spokeo* opinions have been issued. But the federal circuit courts have also been busy. While some general principles appear to be developing, in many respects, these cases have become subject to statute-by-statute and circuit-by-circuit analyses.

So while much of the nation was transfixed on Washington, D.C., on January 20, the federal circuit courts were busy producing catnip for Article III standing aficionados. Three post-*Spokeo* opinions issued that day are memorialized within a few hundred pages of each other in volume 846 of the *Federal Reporter*, Third Edition.



**Philadelphia**
**Third Circuit**

The Third Circuit held in *In re Horizon Healthcare Servs. Inc. Data Breach Litig.* that "the congressional decision to create a remedy for the unauthorized transfer of personal information" under the Fair Credit Reporting Act "gives rise to an injury sufficient for Article III standing." The court thus held that, "[e]ven without evidence that the [p]laintiffs' information was in fact used improperly, the alleged disclosure of their personal information created a *de facto* injury."

**Chicago**
**Seventh Circuit**

The Seventh Circuit held in *Gubala v. Time Warner Cable, Inc.* that even if the defendant cable provider violated the Cable Communications Policy Act (47 U.S.C. § 551(e)) by failing to destroy plaintiff's personally identifying subscriber information for many years after plaintiff cancelled his cable subscription, the plaintiff nonetheless did not actually identify a plausible risk of substantial harm as a result of the violation. The court thus affirmed the lower court's dismissal of the case for lack of standing.

# Transparency Watch: Federal District Court Mandates Automatic Disclosure of Third-Party Funding Arrangements for Class Actions

**BY SHAUNDA PATTERSON-STRACHAN**

In January, the U.S. District Court for the Northern District of California announced a change that makes litigants in putative class action suits subject to requirements mandating automatic disclosure of third-party funding arrangements. The rule was introduced by amendment to a provision in the Standing Order For All Judges of the Northern District of California (Standing Order) regarding the contents of joint case management statements and relevant to disclosures of non-parties with interests in a lawsuit. The Standing Order now provides: "in any proposed class, collective or representative action, the required disclosure includes any person or entity that is funding the prosecution of any claim or counterclaim." The rule as announced is a scaled back version of what the district court's Civil Rules Committee initially proposed: a revision of the court's Civil Local Rule 3-15 (Disclosure of Non-party Interested Entities or Persons), which, by incorporating specific reference to "litigation funders," would have mandated automatic disclosure in the certifications by parties of funding arrangements in any matter before the court, not just putative class suits.

As we previously observed, while the practice of making loans to support litigation has existed in the United States since the 1990s, litigation finance has evolved substantially since then and, by all accounts, is on the rise. *See* "Litigation Finance on the Rise – But Questions Abound," *Expect Focus* Vol. II, Spring 2015. Indeed, whether focused on funding consumer or commercial litigants, investors of many stripes are taking chances on lawsuits, seeking shares of potentially lucrative recoveries, and making litigation finance a billion-dollar industry. In December 2016,

a relatively young but prominent Chicago-based investment firm and player in the market was acquired by litigation finance powerhouse Burford Capital for a reported $160 million. Reports state the combined entity has $1.2 billion invested in active commercial lawsuits.

Disclosure, though, has been top of mind, both for advocates and critics of the practice. For example, during the comment period, Burford Capital told the district court the proposed revision of Local Rule 3-15 was "unnecessary and discriminatory." Burford argued, *inter alia*, that the court's rules "already have a much broader disclosure obligation than most U.S. federal courts," highlighting that Local Rule 3-15's requirements already mandated disclosure of "any persons …. known by the party to have … a financial interest (of any kind).…" The objections of Bentham IMF, an Australian-based litigation funder, included that the proposed requirement would "give defendants in all cases the unprecedented and unintended advantage of knowing which claimants lack the resources to weather a lengthy litigation campaign." On the other hand, as we previously reported, one of litigation financing's most vocal critics, the U.S. Chamber of Commerce Institute for Legal Reform, together with its allies, has urged an amendment to Federal Rule of Civil Procedure 26(a)(1)(A) that would require information about third-party funders of litigation to be added to the list of required "initial disclosures," as many such investors are "publicly traded companies or companies supported by investment funds whose individual shareholders may include judges or jurors."

Although more narrow in scope than the disclosure requirement initially proposed, the Northern District of California's third-party funding rule is the first of its kind by a federal district court. Litigation financing critics are sure to seek ways to build on this apparent advancement toward greater transparency in this area.

# The Ninth Circuit Finds California's Illustration Statutes Can Serve as the Predicate for UCL Liability

**BY DAWN WILLIAMS**

On March 3, the Ninth Circuit in *Walker v. Life Ins. Co. of the SW*, ruled that an alleged violation of California's life insurance illustration statutes could serve as a predicate for liability under the California Unfair Competition Law (UCL). The ruling reversed in part a U.S. District Court for the Central District of California decision in a 2010-filed action by a certified class of indexed universal life policyholders residing in California. The state's illustration statutes, Cal. Ins. Code § 10509.950 et seq., are substantially similar to NAIC Model 582, and apply to all individual life insurance policies sold in California, with a few exceptions. The statutes mandate the inclusion of certain information, and prohibit various practices. For example, an insurer may not "represent the policy as anything other than a life insurance policy."

Plaintiff alleged that the insurer violated California's statutes because it touted the policies as retirement or investment vehicles, "misrepresent[ed]" the costs, risks, safety and security of the policies, treated policy lapse "in a misleading matter," "deceptively present[ed] the guarantee values, fail[ed] to define key terms, and impl[ied] that nonguaranteed elements are annual guarantees." The district court dismissed those claims at the pleading stage.

In 2014, after the statewide class was certified, the case ultimately went to trial, resulting in a jury verdict for the insurer on the fraudulent concealment claim. The district court, nearly a year later, found for the insurer on the remaining UCL claims, which required resolution by a judge.

On appeal the California Department of Insurance filed an amicus brief supporting the plaintiff's position, and the panel spent a fair amount of time at the oral argument questioning all counsel about the statutory issue. The Ninth Circuit ultimately affirmed the district court in all respects, except on the narrow issue of whether UCL liability could be predicated on a violation of the illustration statutes. As to that issue, the Ninth Circuit found that even though the illustration statutes lack an express private cause of action, "private UCL claims are barred only when the underlying statute either actually bars private rights of action or provides a 'safe harbor' that renders the alleged conduct lawful."

The implications for the *Walker* case are unclear: the Ninth Circuit specifically affirmed the district court's finding "that the illustrations of the policy charges and interest rates were not unfair or deceptive." Even assuming there were technical violations of the statute, rendering the insurer's conduct "unlawful," the plaintiff would still need to prove that those violations caused her and the class damage, as another California federal court recently held in *Davis v. Riversource Life Ins. Co.* There, the court dismissed solely unlawful prong UCL violations because the plaintiff failed "to allege that his economic injuries were the 'result of' Defendants' alleged violations of" the statute.

The ruling suggests, though, that insurers selling individual life insurance policies in California may expect to see more lawsuits – individual and putative class actions – alleging violations in the illustration statutes. Given the Ninth Circuit's pronouncement about the UCL unlawful prong more generally, insurers might also be faced with other statutory violations serving as UCL predicates.

# Second Circuit Affirms Dismissal of "Shadow Insurance" Lawsuits

**BY ROLLIE GOSS**

In a summary order issued February 23, the United States Court of Appeals for the Second Circuit affirmed the dismissal of two so-called "shadow insurance" putative class action lawsuits — *Ross v. AXA Equitable Life Insurance Company* and *Robainas v. Metropolitan Life Insurance Company* — on the basis that the plaintiffs lacked standing under Article III of the United States Constitution to sue in the federal district court. The suits were two of several class actions that arose in the wake of a 2013 investigation by the New York Department of Financial Services into certain captive reinsurance transactions. Specifically, the complaints alleged that the insurance companies misused captive reinsurers domiciled in foreign jurisdictions to avoid higher reserve requirements of U.S. jurisdictions, resulting in the misstatement of their financial information and increased risks for plaintiffs. As reported in the Summer 2015 and Fall 2015 editions of *Expect Focus*, the district court dismissed the suits based on the plaintiffs' failure to establish Article III standing.

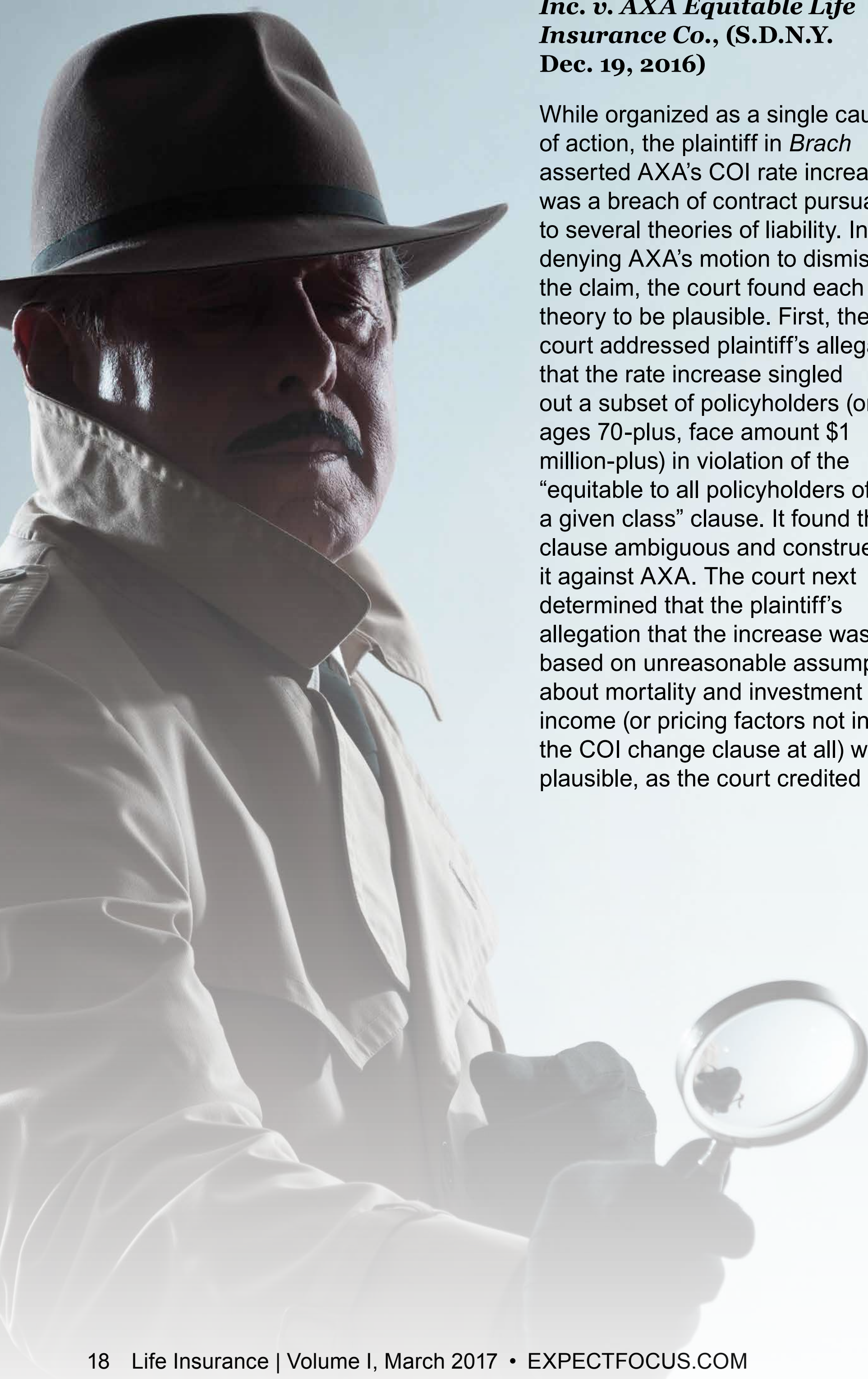
The court of appeals affirmed, and found the complaints failed adequately to allege that the plaintiffs had suffered injury-in-fact, a necessary element of Article III standing. First, the court rejected plaintiffs' argument that allegations that the insurance companies had violated New York Insurance Law section 4226 sufficiently alleged injury-in-fact because of injury "inherent in the statutory violation." The court held "[t]he mere fact that an insurer may make a misleading representation does not require or even lead to the necessary conclusion that the misleading representation is material or even likely to cause harm." Second, citing *Spokeo, Inc. v. Robbins*, (2016), the court held that, to establish standing, plaintiffs had to allege the injury-in-fact was concrete, particularized, and "actual or imminent, not conjectural or hypothetical." The court found the harm alleged in the complaints — an augmented risk that the insurers would be unable to pay death benefit claims in the event of an economic downturn and their policies' inferior status, relative to policies unaffected by shadow transactions, which plaintiffs claim they would have been able to buy for the same price — was speculative and hypothetical, and insufficient to establish standing.

While the Second Circuit's ruling is non-precedential, it reinforces that the alleged harms of "shadow insurance" are inherently conjectural, a fundamental flaw in this genre of litigation when pursued in federal court.

# Cost of Insurance Litigation Review

**BY STEPHEN JORDEN, SHAUNDA PATTERSON-STRACHAN & PAUL WILLIAMS**

As illustrated by the two examples here, recent decisions on preliminary motions seeking to dispose of or narrow the scope of claims challenging COI rate determinations suggest the industry may be enmeshed in litigation for some time. Additional clues will be revealed when motions pending in a string of other cases are decided.



### *Brach Family Foundation, Inc. v. AXA Equitable Life Insurance Co.*, (S.D.N.Y. Dec. 19, 2016)

While organized as a single cause of action, the plaintiff in *Brach* asserted AXA's COI rate increase was a breach of contract pursuant to several theories of liability. In denying AXA's motion to dismiss the claim, the court found each theory to be plausible. First, the court addressed plaintiff's allegation that the rate increase singled out a subset of policyholders (on ages 70-plus, face amount $1 million-plus) in violation of the "equitable to all policyholders of a given class" clause. It found the clause ambiguous and construed it against AXA. The court next determined that the plaintiff's allegation that the increase was based on unreasonable assumptions about mortality and investment income (or pricing factors not in the COI change clause at all) was plausible, as the court credited the plaintiff with providing some supporting evidence. Finally, pointing to an NAIC model law on unfair discrimination within a class as a "procedure" or "standard" on file, the court found plausible the plaintiff's allegation that the increase was not determined in accordance with procedures on file with the New York Department of Financial Services. However, the court dismissed the plaintiff's claim that AXA violated New York Insurance Law § 4226, which states it is "unlawful to misrepresent the terms, benefits, advantages, of any of contracts or misrepresent the financial condition of the insurer." Specifically, the plaintiff claimed that if AXA's justification for the COI rate increase were true, it had filed false information with the Department when it suggested there were no changes in experience factors. However, the court dismissed the claim, finding that the plaintiff had not identified any specific illustration, annual statement, or interrogatory that was misleading and, thus, failed the heightened pleading standard. The dismissal was without prejudice, however, and in mid-January, the plaintiff filed a second amended complaint, re-pleading the Section 4226 claim. AXA has since moved to dismiss the second amended complaint.

***Dickman v. Banner Life Insurance Co.*, (D. Md. Dec. 21, 2016)**

While the case involves somewhat less traditional assertions by the plaintiffs, Banner Life's motion to dismiss effort in *Dickman* generated a ruling with a more traditional result: a mixed bag for the insurer. As alleged in the complaint, Banner Life's policies provided guaranteed coverage for 20 years in exchange for a minimum premium, after which the policyholder could use excess cash value to extend coverage. Plaintiffs further alleged that, for years, they paid excess premiums to increase the cash value and ensure coverage beyond 20 years, but Banner Life's COI rate increase meant that the cash value was drained and the benefit of the excess premium payments was negated. Banner Life moved to dismiss the complaint's unjust enrichment, conversion and fraud claims (though not the breach of contract claim). The plaintiffs' unjust enrichment and conversion claims were dismissed for failure to state an actionable claim. However, the fraud claim, based on allegedly false financial and public statements regarding the company's financial health (which plaintiffs contend hid the eroding profitability of the policies) was allowed to stand. The court added, though, that no fraud claim could be based on the COI increase itself, since this was a matter of contract law; nor could it be based on the COI rate increase explanation letter sent to the plaintiffs, since this would not show reliance or causation. Notably, the *Dickman* complaint also asserts a pretext theory: that the COI rate increases were designed to funnel money to corporate parents as part of a so-called "shadow insurance" scheme. In the same ruling, the district court also denied Banner Life's motion to strike from the complaint (as false, and also immaterial to the plaintiffs' claims, prejudicial and scandalous) allegations regarding its captive reinsurance and dividends transactions, finding them "potentially relevant to both the contract and the fraud claim in that they provide an alternative reason for the COI increase other than the reason given by Banner."

# China Tightens Regulations on Investing Insurance Funds in Shares of Listed Companies

**BY JIN LIU & BARRY LEIGH WEISSMAN**

## Introduction

The entire Chinese economy, including its insurance industry, has experienced rapid growth in recent years. Speculative investments have become an inevitable byproduct of this growth. One of the most well-known examples of a risky insurance company investment was the bitter takeover battle by Evergrande and Baoneng for control of China Vanke Co. Ltd. (Vanke), China's biggest real property company (by sales). Since 2015, Baoneng has used its majority-owned insurance arm Foresea Life, and other of its units, to amass a 25 percent stake in Vanke. Baoneng is now the company's largest shareholder. Evergrande units have accumulated 14 percent in Vanke according to its November 2016 regulatory disclosure. Vanke's shares dropped 16 percent in 2016.

Given these activities, many industry experts believe the China Insurance Regulatory Commission's (CIRC) recent imposition of restrictions on stock investments by insurance institutions is an attempt to curtail speculative and risky investments. It is interesting to note that the circular "Further Strengthening the Regulation of Investment in Stocks in Insurance Funds" (the 2017 Circular) not only regulates future stock investment, but also does not seem to give any grandfather rights to insurance companies' existing investments. Instead, it requires them to adjust their investment proportions within two years or the time limit prescribed by the relevant regulatory body until the regulatory requirements are met.

## The 2017 Circular

On January 24, the CIRC issued the 2017 Circular. One of its effects was to nullify the section of a 2014 circular titled "Strengthening and Improving the Supervision and Administration of the Use of Insurance Funds" (the 2014 Circular).

The 2014 Circular discussed insurance company investments in listed company shares. This included the right to participate in the listed company's financial and operating policy decisions, or the ability to control the listed company. The 2014 Circular stated that this is subject to equity investment management and must comply with relevant regulations on equity investment with insurance funds.

In replacing those 2014 provisions, the 2017 Circular specifies additional requirements and restrictions on investing insurance funds in the stock of a listed company.

The 2017 Circular puts the investment in the shares of a listed company into three categories: (i) general stock investment; (ii) major stock investment; and (iii) listed company acquisition. It also establishes a comprehensive solvency adequacy ratio before an insurance company can invest in a listed company's stock. The categories are differentiated based on: (1) whether the stock investment in a listed company meets or exceeds 20 percent of the listed company's overall stock capital; and (2) whether such stock investment results in control or actual control over the listed company.

The term “ordinary stock investment” refers to a stock investment in a listed company by an insurance institution or by an insurance institution and a non-insurance person acting in concert, in which the stock investment is: (i) less than 20 percent of the total stock capital of the listed company; and (ii) the investment does not result in control of the listed company.

The term “significant stock investment” refers to a stock investment in a listed company by an insurance institution or by an insurance institution and a non-insurance person acting in concert in which the stock investment is: (i) equal to or more than 20 percent of the total stock capital of the listed company; and (ii) the investment does not result in control of the listed company.

The “acquisition of a listed company” includes becoming the controlling shareholder.

The insurance institution’s solvency ratio at the end of the previous quarter shall not be less than 100 percent when the insurance institution undertakes a general stock investment. When carrying out a major stock investment and acquisition of a listed company, the insurance institution’s solvency ratio at the end of the previous quarter shall not be lower than 150 percent, and the insurance institution must have completed filing of its stock investment management capability and must be in line with the internal control regulatory requirements for insurance fund use.

The 2017 Circular also provides that the insurance institution must use its own funds to acquire listed companies and that an insurance institution may not pledge the listed company’s stock that it is purchasing to finance such purchase.

Other restrictions include that an insurance institution shall apply to the CIRC for prior approval when it intends to purchase shares in a listed company. It also limits the industries in which an insurance institution may purchase shares in a listed company, insurance companies, non-insurance financial enterprises and industries related to insurance business. The key to any of these types of investments is that the company in which the insurance entity chooses to invest has stable cash flow return expectations.

As a general capital rule, the book balance of all equity investments of an insurance company shall not exceed 30 percent of the total assets of such company at the end of the immediately prior quarter.

The book value of a single stock investment by an insurance institution shall not exceed 5 percent of the total assets of the insurance institution at the end of the immediately prior quarter, except as otherwise provided for in the acquisition of listed companies or investment in stocks of commercial banks listed on the Stock Exchange. For insurance institutions that have already increased their blue-chip stock holdings pursuant to relevant policies, the proportion of investment should be adjusted within two years or within the time limit prescribed by the relevant regulatory body until the regulatory requirements are met.

Carlton Fields shareholder **James F. Jorden** will co-chair the ACI's National Forum on Life Insurance Litigation, Regulatory Enforcement & Enterprise Risk Management April 19-20, 2017 in New York. Topics will include Enterprise Risk Management and Regulatory Roundtable, Regulatory Priorities and Responses for 2017 and Beyond (with panelist **Edmund J. Zaharewicz** and moderated by **Josephine Cicchetti)**, Product and Sales Practice Class Actions and Complex Litigation (with panelist **Stephen J. Jorden)**, Individual Product Litigation Roundup: Life Insurance, Annuities, Mutual Funds and More (with panelist **Shaunda Patterson-Strachan)**, and Litigation Forecast: Status of The Department of Labor's Fiduciary Rule (with panelist **James F. Jorden)**.

Carlton Fields shareholder **Barry Leigh Weissman** was a panelist at the ABA's 43rd Annual TIPS Midwinter Symposium on Insurance and Employee Benefits in Coral Gables, FL in January 2017. The panel, Plenary Session No. 10: Brexit! What Happens Next?, discussed U.S. insurers' business in Britain and continental Europe after Brexit.

Washington, D.C. Shareholder, **Shaunda Patterson-Strachan**, was selected to join The Association of Life Insurance Counsel (ALIC). ALIC is considered to be the premier association for life insurance counsel. Since 1913, the focus of ALIC remains unchanged: to furnish scholarship on the legal issues challenging life insurance companies, combined with fellowship for our professional and personal growth. Membership is strictly on an individual basis. Those selected to join, serve life insurance companies and their stockholders, policy holders and broader constituencies.

Carlton Fields named six new office managing shareholders: **Frank A. Appicelli** (Hartford), **Jeanne M. Kohler** (New York), **Daniel L. DeCubellis** (Orlando), **Johanna W. Clark** (Orlando), **Christine Davis Graves** (Tallahassee), and **John R. Hart** (West Palm Beach).

Carlton Fields welcomed the following attorneys to the firm: shareholders **Neal McAliley** (national trial practice, Miami) and **J. Robert MacAneney** (insurance, New York), of counsels **Larry R. Kemm** (business transactions, Tampa), **Julia C. Mandell** (government law and consulting, Tampa), and **Michael D. Padula** (white collar crime and government investigations, Miami) and associate **Jillian R. Orticelli** (labor and employment, Hartford).

Carlton Fields shareholder and chair of its firmwide pro bono committee, **Kathleen S. McLeroy**, received the William Reece Smith Jr. Public Service Award, given by Stetson University College of Law. The award recognizes individuals who have provided outstanding service to the legal profession and community.

Carlton Fields shareholder **Robert W. DiUbaldo** was a presenter at the DRI Insurance Coverage and Practice Symposium in New York in December 2016. The presentation, An Insurer's Duty to Settle: Factors and Considerations, examined an insurer's obligations regarding settlement and, in particular, to initiate settlement discussions absent a demand.

The 2017 *Carlton Fields Class Action Survey: Best Practices in Reducing Cost and Managing Risk in Class Action Litigation* is now available. This year's survey — the sixth edition of our multi-industry annual survey — is the biggest yet, with powerful insights into class action litigation and trends, data on how companies manage and approach risk, and strategies for managing cost. The survey is available at www.ClassActionSurvey.com.

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