EXPECT FOCUS®

LEGAL ISSUES AND DEVELOPMENTS
FROM CARLTON FIELDS JORDEN BURT

CARLTON FIELDS
JORDEN BURT

VOLUME III | SUMMER 2015

WHO OR WHAT IS IN CONTROL HERE?

The Shortcomings of Onboard Technology

INSIDE: LATEST NAIC CYBERSECURITY NEWS • DOL'S PROPOSED FIDUCIARY RULE LITIGATION PREDICTION • ACA LITIGATION CONTINUES • STATES CHALLENGE SEC REGULATION A+

EXPECTFOCUS®, Volume III, Summer 2015

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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NEWS & NOTES

Your Data Breach Collided With My Personal Injury Coverage

BY JOHN PITBLADO

Editors at *Wired* magazine recently engaged in a year-long project to develop a means to hack the onboard computer of a Jeep, and override the driver's control of several critical vehicle functions. According to a disturbing investigative article published this summer, they succeeded. "Their code," reports *Wired*, is an automaker's nightmare: software that lets hackers send commands through the Jeep's entertainment system to its dashboard functions, steering, brakes, and transmission, all from a laptop that may be across the country." As a result, the hackers were able to commandeer the vehicle and cause it to leave the roadway.

Days after the article published, Jeep recalled 1.4 million vehicles equipped with the entertainment system that was the point of entry for the hackers to ultimately access other computerized vehicle controls. Vehicle owners were not required to bring their vehicles to repair facilities; rather, a software fix was mailed to owners to plug in via USB port.

Query where Jeep looks for coverage. Presumably, it has specific products liability coverages (likely with add-ons to cover things like recalls and associated public relations) and cyber-liability (likely with specific data breach coverage). Depending on how its insurance package is constructed, inter-company disputes could arise as to which type of coverage is triggered.

But the Jeep incident raises the stakes on cyber-liability, which has generally, until now, been considered within the regime of property damage (like the destruction of hardware) and financial losses (associated with fines, penalties, and civil settlements and judgments for, e.g., data breach), but certainly not bodily or personal injury type coverage.

Technological advances are coming fast and furious, and this revolution is indeed televised.

While there was no bodily injury in the *Wired* experiment, surely that possibility is imminent. And when that happens, where will the coverage trail lead? Is a hacker a "motorist" once he takes the wheel of a vehicle remotely? Would coverage for injury be available under the hacker's auto liability policy, or the injured party's UM or PIP coverage? What happens when a misprogrammed robot kills a human co-worker? What if two self-driving cars collide?

Technological advances are coming fast and furious, and this revolution is indeed televised, albeit on Youtube. As noted in the *Wired* article, hackers' code is a nightmare for automakers, indeed, but we can be sure it's also keeping a few property-casualty underwriters up at night as the term "cybersecurity" continues to take on new meaning.

Phantom Injury Dooms "Shadow Insurance" Case

BY STEPHEN JORDEN

A recent federal district court decision dismissing a putative class action complaint against AXA Equitable Life Insurance Company may portend trouble for plaintiffs pursuing a number of similar so-called "shadow insurance" cases against New York insurers based on allegedly sham reinsurance transactions with affiliated (or "captive") reinsurers.

The plaintiffs in *Ross v. AXA Equitable Life Insurance Company*, alleged that AXA Equitable violated New York Insurance Law Section 4226 by failing to disclose or inadequately disclosing in its filed financial statements the details of transactions in which the insurer ceded billions of dollars in life insurance liabilities to captive reinsurers, purportedly without genuinely transferring the risks. Plaintiffs contended that these "shadow" insurance transactions artificially inflated AXA's surplus and risk-based capital ratio (a critical measure of an insurer's financial health for regulators and analysts), making the company appear more financially healthy than warranted. Plaintiffs asserted that they suffered injury by paying premiums for policies that were less financially secure than represented.

The district court dismissed the second amended complaint because plaintiffs failed to allege an "injury-in-fact" required for standing under Article III of the U.S. Constitution—"the invasion of a legally protected interest which is … concrete and particularized and actual or imminent, not conjectural or hypothetical." The court pointed out that the named plaintiffs did not allege that the challenged transactions caused them to pay higher premiums or that they relied on the company's annual filings in deciding to purchase the policies. And plaintiffs' allegation that the policies were less secure articulated a future risk of nonpayment that was "too hypothetical, speculative, and uncertain" to meet Article III's standing requirements.

The court also rejected plaintiffs' argument that an alleged violation of a statutory right under New York law to "truthful financial reporting" could alone confer standing in a federal court. The court observed that plaintiffs cited no authority that a state legislature could "confer Article III standing on a plaintiff who suffers no concrete harm merely by authorizing a private right of action based on a bare violation of a state statute," even accepting the soundness of arguably questionable authority that the U.S. Congress may do so.

Latest NAIC Cybersecurity News

BY JOSEPHINE CICCHETTI & MATTHEW KOHEN

The National Association of Insurance Commissioners has announced three initiatives in furtherance of its goal to address cybersecurity issues faced by insurance companies, their state regulators, and consumers, which it expects to adopt by the end of this summer. One such initiative saw the NAIC Cybersecurity Task Force release a draft of its Cybersecurity Bill of Rights for public comment.

The Cybersecurity Bill of Rights sets forth 12 general protections typically granted to consumers prior to, in prevention of, and after a regulated entity suffers a data breach.

The Cybersecurity Bill of Rights "is intended to set standards for helping consumers if their personal information is compromised." The Cybersecurity Bill of Rights sets forth 12 general protections typically granted to consumers prior to, in prevention of, and after a regulated entity suffers a data breach. Among other things, these protections include: the right to know what type of personally identifiable information is maintained by a regulated entity; the right to expect personally identifiable information will be adequately protected from unauthorized access; and the right to receive timely notice in the event a regulated entity suffers a data breach. The Cybersecurity Bill of Rights also invokes the Fair Credit Reporting Act by specifying any consumer affected by a data breach must receive a summary of the rights provided under the FCRA to victims of identity theft.

Besides informing consumers of their rights, the Cybersecurity Bill of Rights can help insurers and other regulated entities to minimize the impact posed by cybersecurity risks. Specifically, the Cybersecurity Bill of Rights should serve as a starting point for insurers to evaluate their cybersecurity incident response plan. However, thorough data breach preparation requires an understanding of, and compliance with, a myriad of state and federal laws. In some cases, these laws may conflict with the standards set forth in the consumer Cybersecurity Bill of Rights, but the proposed draft does not address the resolution of such conflicts.

In addition to the Cybersecurity Bill of Rights, the NAIC Cybersecurity Task Force has announced two other initiatives. First, the Task Force is coordinating with state insurance regulators to conduct examinations of regulated entities to ensure that the necessary steps are being taken to safeguard confidential information. Also, on September 10, the Task Force is co-sponsoring a forum with the Center for Strategic and International Studies entitled "Managing Cyber Risk and the Role of Insurance" to discuss best practices in managing the cybersecurity risks faced by both businesses and consumers.

The NAIC's release of the draft Cybersecurity Bill of Rights is yet another reminder of the serious cybersecurity risks faced by insurers today.

A Moral Victory But No Damages Awarded in AIG Bailout Litigation

BY WHITNEY FORE

The Court of Federal Claims recently held that the coercive terms of the government's $85 billion bailout of AIG were illegal. The victory, however, was merely a moral one because plaintiffs walked away with a $0 damage award.

The case, *Starr International v. United States*, turned on whether the government improperly overrode AIG shareholders' rights either in September 2008 when the AIG board approved the initial bailout or in June 2009 when a reverse stock split allowed the government to obtain the share of the company it was promised back in 2008. Starr International alleged that the government broke the law by requiring ownership of 80 percent of AIG and imposing 12 percent interest rate on the loan in its take-it-or-go-bankrupt bailout. The government countered that these demands were justified because the loan was high-risk.

The Federal Claims Judge Thomas Wheeler ruled that the government's rationalization for taking equity in AIG in exchange for a bailout loan was "entirely misplaced" and, further, suggested that the Federal Reserve Bank clearly overstepped its legal authority. **Judge Wheeler, however, awarded $0 in damages because without the government's bailout, AIG would have declared bankruptcy and "AIG's shareholders would most likely have lost 100% of their stock value."**

While Judge Wheeler's scathing criticisms of the government may give regulators pause when considering similar future bailouts, Judge Wheeler admitted that he found it "troubling" that the government was able to "avoid any damages notwithstanding its plain violations of the Federal Reserve Act."

A day after the court's ruling, Starr International announced that it would appeal the court's $0 damage award.

Rhode Island Supreme Court Decides STOA Case

BY GLENN MERTEN

The Supreme Court of Rhode Island recently considered two questions of first impression: (i) whether an insurable interest requirement applies to an annuity with a death benefit, and (ii) whether an immediate incontestability provision is enforceable as a matter of public policy.

In what the court characterized as a "rapacious investment scheme," the defendants in *Western Reserve Life Assurance Co. of Ohio v. ADM Associates* purchased and named themselves as beneficiaries of Freedom Premier III annuities with a Double Enhanced Death Benefit, which virtually guaranteed a risk-free investment. "The macabre *sine qua non* of the investment strategy" was that the defendants paid terminally ill individuals, identified through advertising to hospice patients, to serve as annuitants. Western Reserve's suits challenging the annuity purchases as void *ab initio* for lack of an insurable interest were dismissed, and on appeal the First Circuit certified the controlling questions to the Supreme Court of Rhode Island.

A divided court held that (i) neither Rhode Island's longstanding common law nor more recent statutory insurable interest law applied to annuities; (ii) the 2009 Life Settlements Act was silent as to annuities and stranger-originated annuity transactions, and therefore does not govern the scheme; and (iii) the transactions were not wagering contracts (a ruling disputed in the two-justice dissent).

The court also held the immediately-effective incontestability clause enforceable. **While the court recognized the ruling might "allow a perpetrator of fraud to profit from the fraudulent behavior," its precedents have long held that "an incontestability clause is effective even against a defense of fraud."**

The ruling raises questions regarding the application of insurable interest statutes and common law protections to annuity transactions, and additional legislative efforts may be required to extend to annuities the longstanding protections available to life insurance policies.

Insurer Victory in IUL Class Action

BY DAWN WILLIAMS

In a highly-anticipated opinion, a federal district court found for the insurer in a California class action involving alleged improprieties in the sale of indexed universal life insurance policies. Plaintiffs alleged that the insurer failed to disclose to the class in *Walker v. Life Ins. Co. of the Southwest* (1) the "volatility defect" of the IUL policies, that the interaction between the policy design and market volatility created a significant risk that the policy would lapse or suffer reduced value, and (2) the "tax defect," that policyholders would be required to pay substantial taxes if they had outstanding loans at the time of surrender. Plaintiffs claimed they were damaged because they would not have purchased the policies or would have paid less for them had they known the allegedly omitted facts.

A jury returned a verdict for the insurer after a three-week trial nearly a year ago on the common law fraudulent concealment claims. The California Unfair Competition Law claims were decided by the bench, however, and the court a few months ago issued a favorable 75-page opinion. Among the highlights of the decision were the court's findings that:

- the sales process was not uniform because each agent remained free to decide how to sell the products;
- the insurer had no duty to disclose that returns projected on an illustration might be more or less volatile, where the illustrations complied with state regulation;
- plaintiffs were not likely to be misled where there were significant disclosures on the illustrations regarding the numerical examples;
- plaintiffs suffered no actionable injury for a failure to receive returns above the guaranteed values; and
- plaintiffs could have avoided injury by reading their policies and returning them within the free look period.

Plaintiffs have filed an appeal.

Catching Up To Insurers' Use of Big Data

BY ANN BLACK & BEN SEESSEL

Various groups within the NAIC are beginning to study the way in which insurers are using big data. On the property and casualty front, the Market Regulation (D) (Market Reg) Committee is reviewing the use of big data in claims settlements and the Consumer Liaison Committee has been looking into the use of big data in price optimization tools. On the life side, the Life Actuarial Task Force (LATF) is going to examine the emerging trend of accelerated underwriting using big data.

At the Summer National Meeting, the Market Reg Committee held a hearing on the use of consumer data in settling property and casualty claims. The hearing was held at the request of NAIC consumer representatives who are concerned that consumer data is improperly being used to settle claims. An industry representative explained to the Committee how big data helps insurers gather facts to more accurately and quickly determine which claims to pay and which claims to investigate and identify potential fraudulent claims. A consumer representative acknowledged that big data holds great promise for consumers and industry, but warned that because the data collected and used includes information from social media on buying habits, hobbies, and interests, the databases may not be protected by the Fair Credit Reporting Act. Because the data was not free from defect, and consumers likely do not know about the type of data being used and how it is being used in settling claims, protection is critical. The representative also cautioned that the algorithms being used to process the data may not be accurate and do not eliminate bias.

Big data may reveal a person's buying habits. As a California regulator asked during the Consumer Liaison Committee's discussion of "Non Traditional Rating Factors" during the Summer National Meeting, if a person buys a lot of hot dogs, does it reflect that the person is unhealthy or, is buying them for a child's baseball team? Will this transaction be recorded and later impact this person's insurance rates?

Regulators, amazed at the level of data being accessed, raised questions about transparency to consumers. They sought information on how the use of big data in settling claims helps consumers and what happens if, based on the data, the insurer believes a claim is fraudulent. According to the regulators, the conversation will continue.

Regulators were amazed at the level of data being accessed and raised questions about transparency to consumers.

At a LATF Summer NAIC meeting, a representative from the Society of Actuaries (SOA) informed LATF on the growing use of accelerated underwriting and simplified issue by insurers. The representative explained that a variety of data is being used in complex predictive modeling algorithms as part of insurers' accelerated underwriting process. SOA raised concerns about the need for LATF to understand predictive analytics' ability to predict mortality and noted that mortality experience will not emerge for several years. SOA asked LATF to consider a charge to revisit VM-51 to collect data from insurers in order to understand how their accelerated underwriting processes work, including collecting information on the algorithms and data being used. The Experience Reporting Subgroup will further review accelerated underwriting.

A Summary of Predicted Litigation Under the DOL's Proposed Fiduciary Rule

BY JAMES F. JORDEN

The Department of Labor's recent Proposed Rule, which defines the term "fiduciary" as it applies to persons who provide "investment advice" to ERISA plans and IRAs, will impact the likelihood and severity of fiduciary litigation against life insurers and their agents. This article summarizes that potential impact, and will be supplemented periodically with updates focused on particular elements of the Proposed Rule not covered here.

As promulgated, the Proposed Rule would make significant changes to the two key fiduciary features of ERISA legislation: (1) fiduciary status; and, (2) fiduciary standards. The Proposed Rule creates a new and complex construct for the continued sale of variable and fixed annuities and mutual funds, among other products, particularly in the IRA plan market. **If enacted, it will require a costly "compliance" structure imposing new duties on insurance agents, brokers, and the insurers they represent.** From a litigation analysis perspective, it is most relevant that insurers face a serious potential increase in litigation or arbitration as a result of the Proposed Rule's new definition of "investment advice" coupled with a corresponding expansion of the definition of a "fiduciary," and a proposal, with respect to variable products (and potentially fixed as well) to effectively legislate a new cause of action for ERISA and IRA plans, participants, and owners.

The Proposed Rule

The Proposed Rule would sweep into the definition of an investment advisory fiduciary any person who, "in exchange for a fee," provides any of the four specified categories of advice:

1. Advisability of acquiring, holding, disposing of, or exchanging securities or other property, including a recommendation to take distribution or to take a rollover from the plan to an IRA or a recommendation regarding investments to be made with rollover monies;

2. Recommendations as to management of plan assets, including assets to be rolled over into an IRA;

3. Appraisals, fairness opinions or similar, if provided in connection with specific transactions involving plan or IRA assets; and,

4. Recommending someone else, for a fee, to provide any of the types of advice described in 1 or 2, above.

The Proposed Rule focuses largely, although not exclusively, on the advice and sales practices of parties in the IRA marketplace. The Proposed Rule defines "recommendation" as "a communication that, based on its content, context, and presentation would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."

Since it is clear that annuities or life insurance used to fund an IRA or other benefit plan will be treated as "other property" for purposes of the definition of "investment advice," we can therefore safely assume that many of what today are normal sales transactions between a plan or IRA owner, participant or trustee and an insurance agent, where neither likely would view the insurance agent as a fiduciary, will likely meet the definition of a transaction involving an "investment advisory fiduciary."

The Proposed Rule also contains an exemption, the "Best Interest Contract Exemption," pursuant to which agents and brokers will be permitted to receive compensation as a fiduciary. However, the contract itself will expand on the duties imposed on such agents and the "firms" they represent by creating certain contract obligations on persons who sell variable annuities or mutual funds they would not otherwise have.

The "Best Interest Contract Exemption" Under the Proposal

To meet the "principles" underlying the Best Interest Contract Exemption, the DOL requires a series of actions by the investment advisory fiduciary and the firm being represented by that fiduciary, including that they (1) contractually acknowledge fiduciary status, (2) commit to basic standards of impartial conduct, (3) warrant compliance with state and federal laws, and (4) provide disclosure and "mitigate" conflicts of interest. The DOL intends that this "contract" will enable IRA investors to "*hold their fiduciary advisers accountable if they violate basic obligations of prudence and loyalty.*"

The Change in Fiduciary Status

Under current case law applying either ERISA or the common law, the sale of an annuity to a prospective IRA purchaser or ERISA plan will not, absent unusual circumstances, constitute providing investment advice for a fee. Since adoption of the 1975 Rule, courts have held that fiduciary liability does not apply to insurance agents or the companies they represent merely when the conduct involves exclusively or primarily the sale of an insurance or annuity contract. Such results have been premised both on grounds of a failure to demonstrate that the salesperson had the requisite statutory discretion to be a fiduciary and also on the basis that the sales agent was not rendering "investment advice." As the Fifth Circuit Court of Appeals said in 1988:

> *Simply urging the purchase of its products does not make an insurance company an ERISA fiduciary with respect to those products.*

From a litigation perspective, this change to a fiduciary status for the sales agent is substantial and in many cases will afford litigants unhappy with investment results, or the ultimate characteristics of a particular form of annuity, the opportunity to second guess the original decision applying a significant range of issues. One potential saving grace, depending on one's view of the desirability of "arbitration," is that it is permissible to limit disputes under the contract to arbitration.

Assuming that the "firm" referenced in the "contract" required under the exemption signed with the IRA purchaser or ERISA plan is an insurer, then to comply with the terms of the exemption, the insurer will be required to meet the obligations set forth therein. This includes acknowledging fiduciary status, committing to basic standards of impartial conduct, warranting compliance with federal and state law, adopting policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclosing basic information on conflicts and costs of the advice.

Future Impact

Clearly the Proposed Rule will have a significant impact on the marketing of annuities and other investment products into ERISA plans and IRAs and the consequential potential litigation under fiduciary and other standards that will apply in those circumstances that qualify as rendering "investment advice." In addition, the development of a separate cause of action, both for fiduciary breaches and potential breach of contract claims, raises numerous unanswered questions.

Carlton Fields Jorden Burt Shareholder Jim Jorden will speak on this topic at ACLI's Annual Conference in Chicago, October 11-13, and at LIMRA's Annual Conference in Boston, October 25-27.

Navigating Derivative Lawsuits Against Mutual Funds After *Northstar*

BY JOHN CLABBY & VALERIE ESCALANTE

The Ninth Circuit Court of Appeals this spring held that mutual fund shareholders could maintain direct claims against the fund's trustees for breach of their common law fiduciary duties. Before *Northstar v. Schwab*, such claims had traditionally been classified as derivative claims and were the property of the fund itself.

The court found that the documents establishing the fund as a Massachusetts business trust supported a direct action, because they stated that the trustees will hold assets in trust "for the pro rata benefit of the holders." But this would seem to support, at most, investor suits for breach of contract and not breach of fiduciary duty.

The Ninth Circuit steers an unusual course.

The court also cited various authorities to the effect that trustees generally owe fiduciary duties to trust beneficiaries. On such meager grounds, the court concluded that investors in a mutual fund organized as a trust must be able to directly sue the trustees for traditionally "derivative" claims (i.e., for damages impacting the fund as a whole rather than an individual investor).

Finally, the court asserted, without citation, that the "distinction between direct and derivative actions has little meaning in the context of mutual funds." **The court reasoned that, because a mutual fund's sole objective is to increase net asset value, any decrease in the mutual fund's share price resulting from alleged wrongful conduct flows directly and immediately to shareholders.**

The court did not recognize the important role of a mutual fund's independent trustees in responding to investor demands relating to derivative claims. Nor did it explain why mutual funds organized as trusts should be treated differently from other businesses that pool equity for investment purposes and yet retain the distinction between derivative and direct claims.

The novel approach taken in this case may ultimately have limited reach, particularly because the Ninth Circuit was interpreting Massachusetts law. At least for now, however, mutual fund managers should be concerned about this new potential source of claims—and plaintiffs.

SEC Administrative Law Judge Appointments Held Likely Unconstitutional

BY MICHAEL VALERIO

Defendants in SEC administrative enforcement proceedings have increasingly been going to federal court to challenge the SEC's stepped-up use of its "in-house" tribunal. While the early results were not promising, more recent challenges have gained some traction. In *Hill v. SEC* and *Gray Financial Group, Inc. v. SEC*, a judge from the U.S. District Court for the Northern District of Georgia has issued preliminary injunctions halting SEC administrative proceedings, and a Manhattan federal district court judge has issued a comparable ruling in *Duka v. SEC*.

The Georgia court held in both actions that the "[enforcement defendants] have proved a substantial likelihood of success on the merits of their claim that the SEC has violated the Appointments Clause [under Article II of the U.S. Constitution]." In reaching this conclusion, the court accepted the enforcement defendants' position that SEC administrative law judges (ALJs) are "inferior officers" (rather than mere employees of the agency) and, as such, must be appointed by either the President alone, the SEC Commissioners, or the federal judiciary, which they are not. The New York court adopted the same rationale.

The Georgia court noted that the constitutional defect "could easily be cured by having the SEC Commissioners issue an appointment or preside over the matter themselves." Instead, the SEC has appealed the Georgia and New York district court rulings to the Eleventh Circuit and Second Circuit, respectively.

As long as the government continues to litigate the constitutional issue, it is unlikely that the SEC will seek to "cure" the defect through a revised ALJ appointment

process. Doing so might be viewed as a government concession that calls into question ALJ appointment procedures in other agencies. Moreover, changes to the appointment process could require new legislation from Congress, could get mired in politics within the SEC, and would have to be reconciled with the already complex bureaucratic procedures associated with ALJ appointments.

SEC Commissioners Making a "Noisy Exit"

BY WHITNEY FORE

Securities and Exchange Commission members Daniel M. Gallagher and Luis A. Aguilar will soon leave the SEC, but neither is keeping quiet about the SEC's treatment of chief compliance officers (CCOs).

Gallagher recently issued a statement explaining his dissenting votes in two settled enforcement actions against CCOs of investment advisers. In both actions, the SEC's order states that the CCO was responsible for the "implementation" of the firms' compliance policies and procedures. **Gallagher criticized this as illustrating a disturbing Commission trend toward strict liability for CCOs for violation of the SEC's rule requiring investment advisers to "adopt and implement" policies** and procedures reasonably designed to prevent violations under the Investment Advisers Act.

Gallagher noted that the rule is "not a model of clarity" and offers no guidance on the distinction between the role of CCOs and management in carrying out the compliance function. Rather, the rule simply states that the CCO is "responsible for administering" the compliance policies and procedures adopted by the firm. Gallagher asked the SEC to examine the rule's language to determine if clarification is necessary.

Commissioner Aguilar responded with his own statement, asserting that the SEC has carefully struck a balance between encouraging CCOs to do their jobs well and bringing actions to punish those who engage in egregious misconduct. SEC Chair Mary Jo White has echoed such sentiments. Aguilar further stated, however, that CCOs "are responsible for making sure that their firms comply with the rules that apply to their operations," which does seem to put CCOs under a heavy burden.

Aguilar also noted that, over the past six years, the SEC charged CCOs in 80 of the 751 enforcement cases against investment companies and advisers. He also pointed out, however, that "the vast majority of these cases involved CCOs who 'wore more than one hat,' and many of their activities went outside the traditional work of CCOs."

States Challenge SEC Regulation A+

BY MATTHEW BURROWS

Massachusetts and Montana have taken the highly unusual step of suing the SEC over a recent amendment to Regulation A under the Securities Act of 1933.

The SEC adopted "Regulation A+" (as the amended regulation is commonly called) in reliance on new authority granted to it by the Jumpstart Our Business Startups Act (JOBS Act). Regulation A previously provided simplified filing procedures for offerings of not more than $5 million of a company's securities. Regulation A+ increased this threshold in a new two-tiered structure. Now, Tier 1 issuers may offer and sell up to $20 million of securities in a 12-month period, while Tier 2 issuers may offer and sell up to $50 million of securities in a 12-month period.

The JOBS Act also empowered the SEC to preempt state securities registration requirements for Regulation A+ offers to "qualified purchasers."

The JOBS Act also empowered the SEC to preempt state securities registration requirements for Regulation A+ offers to "qualified purchasers." In adopting Regulation A+, the SEC defined purchasers in Tier 2 Regulation A+ offerings to be "qualified purchasers" for this purpose, thus rendering state registration unnecessary for offerings to such purchasers.

The states' lawsuits, which have been consolidated in the United States Court of Appeals for the District of Columbia, seek vacatur of Regulation A+, and a permanent injunction to prevent its enforcement by the SEC. They allege, among other things, that the preemption of state securities laws for Tier 2 offerings is "inconsistent with the public interest and the protection of investors" and that the SEC did not sufficiently consider such matters.

They also allege that the SEC acted arbitrarily, capriciously, and in contravention of the Administrative Procedures Act. They challenge in particular the SEC's definition of "qualified purchaser," which was novel compared to the way similar terms are generally defined for securities law purposes.

SEC Proposes Major Disclosure Changes for Funds and Advisers

BY EDMUND ZAHAREWICZ

The SEC recently published two rule proposals to address concerns over the Commission's ability to gauge and monitor any risks that the asset management industry poses to the financial system and investors. This includes the impact of new fund products and investment management practices, such as exchange-traded funds and the use of derivatives, securities lending, and repurchase agreements. The SEC also hopes to enhance the quality of information available to investors.

Among other things, the proposals would:

- require funds to report monthly information about their portfolio holdings to the SEC on new Form N-Port, which would replace Form N-Q;
- require funds annually to report certain other types of information to the SEC on new Form N-CEN, which would replace Form N-SAR;
- amend Regulation S-X to require standardized, enhanced disclosure about derivatives in fund financial statements;
- add a new rule to permit funds to fulfill their obligation to transmit periodic reports to their shareholders by making the reports accessible on a website; and
- require advisers to report additional information on Form ADV about their "separately managed account" business and to maintain records of performance calculations and performance-related communications.

Information provided on Forms N-Port and N-CEN would be in a structured data format to improve the ability of the SEC and the public to aggregate and analyze information across funds and to link the reported information with information from other sources.

These SEC proposals are partly a response to continued pressure by other financial regulators to better address the possibility of risks to the financial system. (See "Global Regulators Evolve on Money Manager Systemic Risks" on page 13.) As such, **it is not too early for registrants to evaluate the proposed changes in light of their own operations**. There is, for example, already speculation that the proposals could cause some funds to halt their securities lending programs due to compliance costs.

"Promptly Transmit" Redefined for Some Customer Checks

BY ANN FURMAN

The SEC and FINRA recently extended relief originally granted to accommodate suitability reviews of deferred variable annuities, so that the relief is now also available for mutual funds, Section 529 plans, and other securities issued in subscription-way transactions.

"Subscription-way" is a common procedure whereby the check used to purchase securities is made payable to the issuer (or other third party) and is forwarded by the selling broker-dealer to the issuer or the issuer's agent. The new relief expands the types of securities for which broker-dealers may hold subscription-way checks for up to seven business days to complete the principal suitability review required by FINRA rules.

A broker-dealer is not deemed to be carrying customer funds for purposes of broker-dealer regulatory net capital requirements if it promptly transmits checks to third parties. For this purpose, the SEC generally interprets "promptly" to mean no later than noon of the next business day after receipt. Similarly, a FINRA rule generally requires broker-dealers to transmit payments for investment company shares no later than the end of the first business day following receipt (or, if later, the end of the third business day following receipt of the customer's purchase order). But broker-dealers often need to hold checks for longer periods of time to complete the principal suitability review.

Accordingly, the SEC staff recently issued a no-action letter that allows up to seven business days for such reviews of subscription-way transactions. Although the SEC previously issued an exemptive order granting comparable relief, *NYLIFE Securities LLC* extended that relief in March to any broker-dealer not covered by the order whose circumstances are similar. Following the SEC staff's lead, FINRA then issued Regulatory Notice 15-23 in June, granting comparable relief from FINRA prompt payment transmittal requirements.

These welcome regulatory actions place mutual fund, Section 529 plan, and other subscription-way transactions on the same suitability review playing field as deferred variable annuities.

Global Regulators Evolve on Money Manager Systemic Risks

BY TOM LAUERMAN

The Board of the International Organization of Securities Commissions (IOSCO) in June made an important recommendation concerning any risks that investment funds and advisors present to the global financial system. Specifically, it concluded that a full review of asset management activities and products in a broad global context should be the immediate focus of international efforts to address such "systemic" risks.

IOSCO also plays a role in the ongoing systemic risk initiatives of the Financial Stability Board, an international standards-setting body established by the G20 countries. Indeed, in July the FSB's chairman signaled a move toward IOSCO's position, saying, "The thinking of the FSB is that we will address issues around activities first and then take an assessment if there's any residual risk."

Previously, the FSB has focused more on developing standards for designating certain individual funds

and advisers as presenting global systemic risks and subjecting them to additional, potentially bank-like regulation. **Many in the United States have strenuously criticized this concept of imposing systemic risk designations on funds or advisers, arguing that any such risks would be much better addressed through industry-wide measures developed by the entities' primary regulators.** That, for example, has been the SEC's view. Indeed, the SEC proposals discussed in "SEC Proposes Major Disclosure Changes for Funds and Advisers" on page 12 aim to identify and monitor for such risks. Accordingly, the SEC, which is a member of both IOSCO and the FSB, may be an influence on those organizations' developing positions.

Likewise, Federal Reserve Board Governor Daniel Tarullo may have an impact in his capacity as Chairman of the FSB's Standing Committee on Supervisory and Regulatory Cooperation. Recently, Tarullo reportedly expressed a preference for an approach similar to what the FSB now espouses.

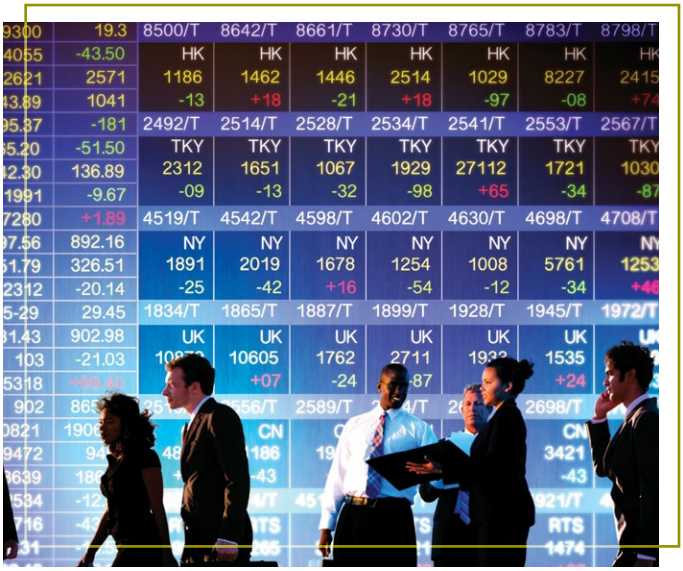
The developing thinking of the FSB may, in turn, have at least some influence on the approach that its U.S. counterpart (the Financial Stability Oversight Council) develops for identifying and addressing any risks that investment funds or advisers present to the U.S. financial system.

SEC Charges EB-5 Brokers For Not Registering

BY SCOTT SHINE

Multiple firms involved in the solicitation of investment capital for the Immigrant Investor Program (also known as "EB-5") have recently been charged by the SEC with acting as unregistered brokers. Neither *In re Ireeco, LLC,* nor *SEC v. Luca Int'l Group, LLC*, the first cases of this type, comes as a complete surprise (see "Immigrant Investor Program Raises SEC Broker Registration Issues" in the Summer 2014 *Expect Focus*).

The EB-5 program allows foreign investors to qualify for U.S. residency by investing in new commercial enterprises that create U.S. jobs. Because these investments frequently take the form of securities, firms that receive fees for facilitating the transactions may be required to register as brokers under the Securities Exchange Act of 1934.



In a recent press release, the SEC stated that it will "vigorously enforce compliance" with the broker registration requirements in the EB-5 area. Moreover, **FINRA's 2015 Regulatory and Examination Priorities Letter raised concerns about the adequacy of the due diligence and suitability analysis performed by some FINRA members that are involved in EB-5 private placement offerings**.

Given the increased attention from the SEC and FINRA, firms operating as EB-5 brokers should carefully examine the state of their compliance with all applicable federal securities law requirements.

The Chill is Gone: SEC Wants Unfettered Whistleblowers

BY JOSEPH SWANSON

The SEC continues its efforts to support whistleblowers.

The whistleblower program promulgated by the Commission under the Dodd-Frank Act offers rewards to individuals who report securities law violations. As we have reported ("Employers Warned: Hands Off Whistleblowers" in the Summer 2013 *Expect Focus*), the SEC has instructed companies to eschew employment agreements that could inhibit the reporting of corporate misconduct.

In April, the SEC went a step further, bringing its first enforcement action based on restrictive language in confidentiality agreements. In settling the case, KBR, Inc. agreed to a $130,000 penalty and committed to revise its agreements to make clear that employees may report misconduct without prior approval or retaliation.

The company had required witnesses in internal investigations to sign statements containing language threatening discipline, including termination, if the witnesses discussed the matters with third parties without prior approval. Because the SEC's investigations covered potential securities law violations, the agreements violated Rule 21F-17, which bars companies from hindering employees from reporting such violations. The SEC cited no evidence that KBR actually prevented any employees from contacting the SEC. Andrew Ceresney, the SEC's Director of Enforcement, explained that the agreements at issue "potentially discouraged employees from reporting securities violations to us." He added, "We will vigorously enforce this provision."

Clearly, companies may need to review their existing and historical employment and severance agreements to ensure they do not chill whistleblowing. Comparable concerns apply when companies make written or oral confidentiality requests as part of internal investigations.

At the same time, we hope the SEC will allow companies to continue to prohibit unauthorized disclosure of privileged information, trade secrets, and other confidential information that is not necessary to substantiate a reported securities violation. Protecting such interests will require careful work by companies and their counsel seeking to avoid KBR's fate.

SEC Reconsiders Exchange-Traded Products

BY TOM LAUERMAN

The SEC recently published myriad questions about the listing, trading, and marketing (especially to retail investors) of "new, novel, or complex" exchange-traded products (ETPs). Such ETPs include exchange-traded funds (ETFs), certain pooled investment vehicles that do not invest primarily in securities, and exchange-traded notes.

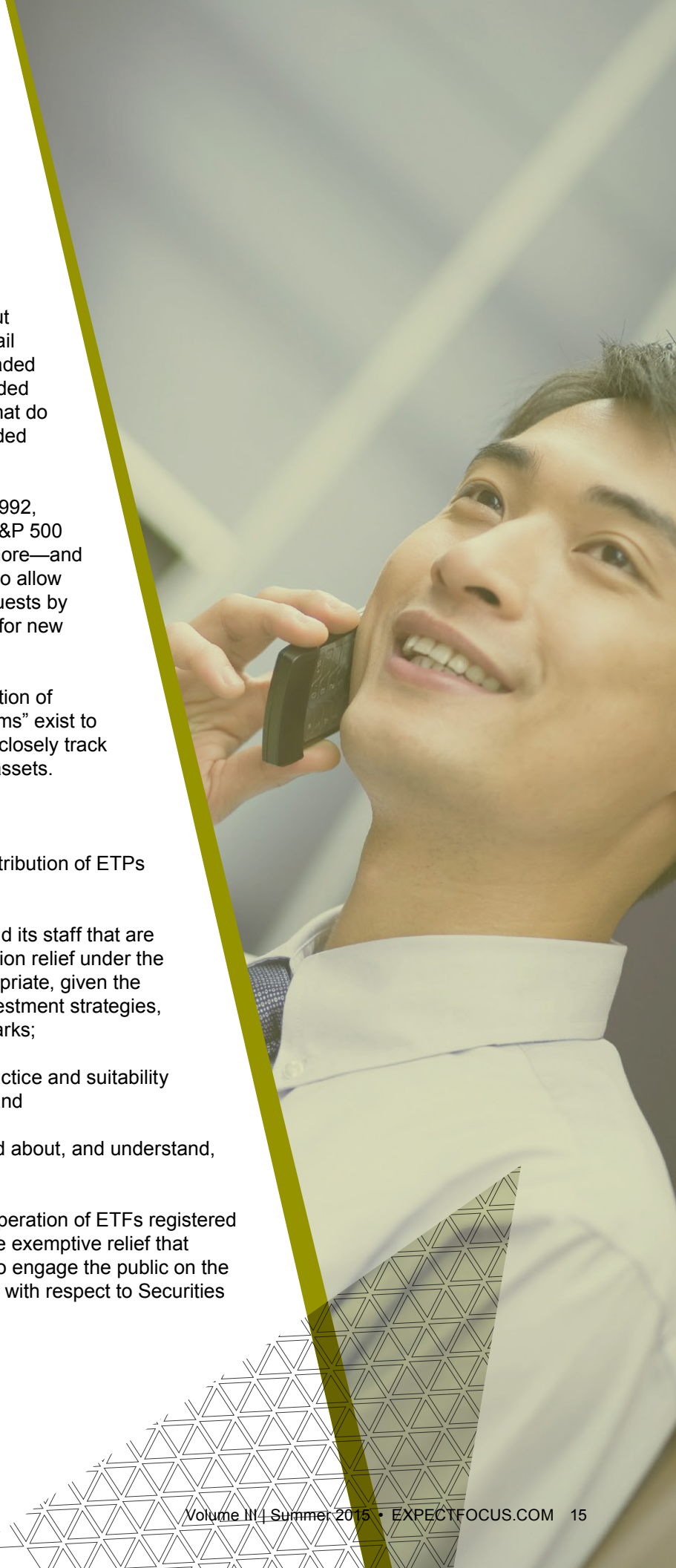
ETPs have grown and evolved enormously since 1992, when the SEC approved the first ETP, the SPDR S&P 500 ETF. Not surprisingly, the SEC also has received more—and more complex—requests by ETP issuers for relief to allow ETPs to be listed on securities exchanges and requests by securities exchanges to establish listing standards for new types of ETPs.

Now, however, the SEC is revisiting the basic question of whether effective and efficient "arbitrage mechanisms" exist to help ensure that secondary market prices of ETPs closely track the value of their underlying portfolio or reference assets.

The SEC also is making inquiries concerning:

- how potentially manipulative conduct in the distribution of ETPs can best be prevented;
- the extent to which the positions of the SEC and its staff that are reflected in existing ETP exemptive and no-action relief under the Securities Exchange Act of 1934 remain appropriate, given the increasing complexity and diversity of ETP investment strategies, underlying and reference assets, and benchmarks;
- how retail broker-dealers satisfy their sales practice and suitability obligations to investors with respect to ETPs; and
- the extent to which retail investors are informed about, and understand, the nature and operation of ETPs.

Prior SEC concept releases have focused on the operation of ETFs registered under the Investment Company Act of 1940 and the exemptive relief that ETFs require under that act. The SEC now seeks to engage the public on the treatment of all ETPs, a broader group of products, with respect to Securities Exchange Act regulation.



Connecticut Supreme Court Delivers $35 Million Body Blow to Body Shops

BY JOHN HERRINGTON

Auto insurers control the cost of collision repairs through the use of direct repair programs. The programs feature networks of auto body repair shops that enter into contracts agreeing to discount labor rates and other charges in exchange for a steady stream of customer referrals and streamlined adjustment procedures. As insurer referrals constitute the vast majority of business for most auto body repair shops, direct repair programs effectively set the market for labor rates at a level much lower than the "posted" rates auto body repair shops would otherwise charge. In an effort to realize higher rates, auto body repair shops throughout the country continue to mount legal challenges to the labor rates associated with such direct repair programs.

Collision shops fail to make a dent in insurers' right to negotiate rates.

Recently, a longstanding challenge to the "artificially low" labor rates insurers pay for auto repairs through the use of direct repair programs recently came to a crashing halt. In *Artie's Auto Body, Inc. et al v. The Hartford Fire Insurance Company*, the Connecticut Supreme Court reversed a $34.7 million judgment against the insurer in a class action suit initiated by a group of more than 1,500 Connecticut collision shops.

The plaintiffs filed suit in 2003 in an attempt to circumvent the contracts the body shops entered into through The Harford's direct repair program. The plaintiffs initially prevailed at trial on their theory that the insurer violated the Connecticut Unfair Trade Practices Act (CUTPA) by requiring its staff appraisers to use the negotiated hourly labor rates set forth in the contracts the body shops agreed to enter, instead of rates that the plaintiffs contended more accurately reflected the actual value of their repair services. According to the plaintiffs, the insurer's conduct constituted an unfair trade practice because it offended the public policy set forth in Connecticut regulation §38a-790–8 which governs the ethics of appraisers and requires them to "approach the appraisal of damaged property without prejudice against, or favoritism toward, any party involved in order to make fair and impartial appraisals...." Following a trial, the jury awarded plaintiffs $14,765,556.27 in compensatory damages, and the trial court awarded the plaintiffs $20,000,000 in punitive damages.

On appeal, the Hartford argued that §38a-790–8 did not apply to labor rates or the conduct at issue in this case and that the Connecticut insurance department had "consistently" interpreted §38a-790–8's "favoritism" prohibition to allow for the company's quid pro quo rate program.

The Connecticut Supreme Court agreed that insurance companies in Connecticut "have the right to negotiate the hourly labor rate that they are willing to pay for auto body repairs and to refuse to give their business to an auto body repair shop with which they are unable to agree on such a rate." In determining that The Hartford's use of staff appraisers through its direct repair program did not violate §38a-790–8 or otherwise constitute a CUTPA violation, the court noted:

"**Indeed, we are unable to discern why appraisers, when negotiating for the cost of auto repairs on behalf of their employers, would ever owe a duty of impartiality to the auto body repair shops with whom they are negotiating.** Under our regulatory provisions, those businesses are deemed to be capable of representing their own interests, and certainly are under no obligation to accept insurance related work that is not sufficiently remunerative."

The court therefore agreed with the defendant that the trial court incorrectly concluded that §38a-790-8 supports the plaintiffs' CUTPA claim alleging unfair labor rate practices, and accordingly, reversed.

When is a Vehicle *Not* a "Vehicle"?

BY JEFFREY MICHAEL COHEN

Two police officers were riding in a police car that was struck by an intoxicated underinsured driver. The officer in the passenger seat suffered serious injuries that were inadequately compensated by the tortfeasor's liability limits. The police car did not carry uninsured/underinsured coverage, nor did the injured officer have that insurance on his personal automobile. However, the officer driving the police car carried supplementary underinsured motorist coverage (SUM) from State Farm on his personal vehicle. The injured officer sought to arbitrate a SUM claim with State Farm because the State Farm policy provided underinsured motorist benefits to any person occupying the covered driver's personal vehicle or any "*motor vehicle" that the insured was driving*. The State Farm policy did not define "motor vehicle."

In *State Farm Mut. Auto. Ins. Co. v. Fitzgerald,* State Farm sued to stay arbitration alleging that the injured officer was not entitled to SUM coverage. The New York trial court ruled in favor of State Farm but the intermediate appellate court reversed. The Court of Appeals of New York reinstated the trial court's judgment and determined that, under New York insurance law, a police vehicle was not a "motor vehicle" under the SUM endorsement.

The court's ruling was based on *State Farm Mut. Auto. Ins. Co. v. Amato* where the court of appeals held that police cars were not included in the New York insurance law mandating that all motor vehicle policies must contain uninsured motorist coverage. The *Amato* decision did not apply to SUM coverage according to the intermediate appellate court. The court of appeals disagreed because "there is no material distinction between the uninsured motorist coverage in *Amato* and the disputed SUM coverage" in the case at issue. A principal insured can receive SUM benefits under *his or her own* insurance while occupying a police vehicle but a person cannot recover under a SUM endorsement in *someone else's* policy.

Ambiguities in insurance policies are generally construed against the insurer, according to the court of appeals, however, "a policy provision mandated by statute must be interpreted in a neutral manner consistently with the intent … of the legislation." The court concluded that the insurance statute restricted SUM coverage to a "motor vehicle" and the statute excluded fire and police vehicles from the term "motor vehicle." Thus, both uninsured motorist coverage and SUM coverage did not apply to police vehicles.

The court relied heavily on the doctrine of *stare decises* to support its conclusion stating that "common-law decisions should stand as precedents for guidance in cases arising in the future" and "generally be followed in subsequent cases presenting the same legal problem." Moreover, the court noted that the legislature had repeatedly amended the insurance law following *Amato* and made no effort to change that decision.

Three judges dissented, also relying on *Amato*. According to the dissent, *Amato* stood for the rule that the city, which owned the police vehicle, need not provide uninsured motorist protection to its officers. However, the *Amato* decision recognized that officers "may make a claim against *their own uninsured motorist policy.*" Thus, according to the dissent, *Amato* justified the injured officer's SUM claim against the policy of the police officer driving the police vehicle.

CFPB Continues to Target Add-On Credit Products

BY ELIZABETH BOHN

The Consumer Financial Protection Bureau (CFPB) has stepped up its enforcement actions alleging deceptive and unfair practices in marketing and billing for add-on credit protection products. Add-on products have been one of the most frequent targets of CFPB enforcement actions, with the vast majority of those actions directed at the credit card banks and auto finance lenders offering such products either directly or through their third-party contractors. In July alone, the CFPB filed three more actions, two of which were against the add-on product vendors themselves, Affinion Group Holding, Inc, and Intersections Inc.

The first complaints accepted by the CFPB after it opened for business related to credit cards, and its earliest enforcement orders, were against credit card issuers. Several early orders found unfair or deceptive practices in the marketing of and/or billing for add-on payment protection, credit protection, credit monitoring, identity theft, and other similar products, in violation of the prohibition against deceptive or unfair acts or practices in Title X of Dodd-Frank, i.e., the Consumer Financial Protection Act (CFPA). Indeed, the Bureau's very first enforcement order against a credit card issuer involved add-on products marketed by third-party vendors and a guidance bulletin it issued in April 2012 warned that banks and other supervised entities would be held responsible for the activities of their third-party service providers. The CFPB has also pursued auto finance lenders for deceptive practices in marketing add-on GAP, warranty and service contract products.

As of July, **CFPB enforcement orders based on claims for deceptive or unfair practices in marketing add-on products have collectively assessed over $1.7 billion in remediation and penalties against credit card and auto finance lenders**. The complaints filed against Affinion and Intersection alleged these companies are covered by the CFPA because they offer "consumer financial products or services," are "service providers" to the financial institutions with whom they partnered, and that they unfairly billed consumers for credit card and deposit account add-on benefits which were not received.

Recent enforcement actions and sizable penalties imposed reflect the Bureau's continued focus on remediating and penalizing deceptive or unfair practices in offering or charging for add-on payment and credit protection products, as well as its continued expansion of claims against ervice providers to the consumer financial product and service industry.

U.S. Supreme Court Allows Disparate-Impact Claims Under Fair Housing Act

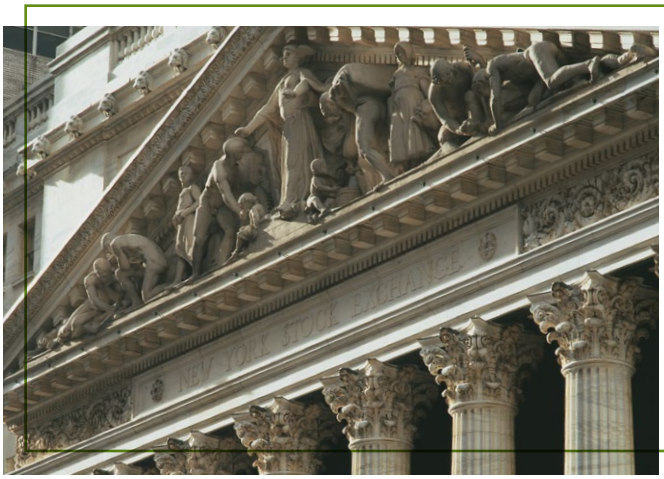
BY TENIKKA JONES & DENISE ROSENTHAL

In a recent holding, the U.S. Supreme Court determined that discrimination claims under the Fair Housing Act (FHA) may be premised on "disparate impact," meaning that a plaintiff may challenge a practice even if it was not intended to discriminate if it has a disproportionate impact on minorities and other protected classes.

The Inclusive Communities Project, Inc. (ICP), a Texas-based non-profit corporation that helps low-income families obtain affordable housing, sued the Texas Department of Housing and Community Affairs for violation of the FHA related to the Department's distribution of federally funded low income housing tax credits to developers based on certain selection criteria. In T*exas Department of Housing and Community Affairs, et al. v. Inclusive Communities Project, Inc., et al.*,the ICP alleged that the Department and its officers allocated too many tax credits to

housing in predominantly black inner city areas—and too few tax credits in predominantly white suburban neighborhoods—thereby perpetuating segregated housing patterns in Texas.

In its analysis, the Court considered instructive its earlier decisions upholding the viability of disparate-impact claims under Title VII of the Civil Rights Act of 1964, which was enacted four years before the FHA; and the Age Discrimination in Employment Act of 1967 (ADEA), enacted four months before the FHA. In those earlier cases, the court found that the language of Title VII and the ADEA went beyond merely focusing on the actors' intent or motivation (i.e., disparate treatment) and also encompassed the action's consequences (i.e., disparate impact). Because the FHA contains language similar in function and purpose to that contained in those statutes, the court concluded that it likewise permits disparate-impact claims.



The court also considered significant the FHA's 1988 amendments, would have been superfluous if Congress had assumed that only disparate-treatment claims were cognizable. Significantly, at the time of these amendments, all nine courts of appeals that addressed the issue uniformly concluded that the FHA encompassed disparate-impact claims. Congress thus made a "considered judgment" not to amend the operative language of the statute, thereby ratifying and accepting the appellate courts' view.

Although disparate-impact claims are now recognized under the FHA, the plaintiff has the initial burden of establishing that the challenged practice caused or will cause a discriminatory effect. Once a *prima facie* showing of disparate impact has been made, the burden then shifts to the defendant to demonstrate that the challenged practice is needed to accomplish "one or more substantial, legitimate, non-discriminatory interests." Once established, the burden shifts back to the plaintiff to prove that the defendant's "substantial, legitimate, nondiscriminatory interests" can be achieved by another less discriminatory practice.

Florida Court Confirms Substantial Compliance Standard Concerning Foreclosures

BY CHRISTOPHER SMART

The Florida Second District Court of Appeal recently issued a long-awaited opinion in *Green Tree Servicing v. Milam.* Until this decision, the district courts in Florida had not spoken directly on the issue of whether strict compliance or substantial compliance applied to evaluating contractual conditions precedent in the mortgage foreclosure context.

In *Milam*, the court held that mortgages are to be interpreted and applied just like other contracts. Because contractual conditions precedent are evaluated by a substantial compliance standard, the court held that standard applied equally to mortgages and, particularly, the notice requirements in paragraph 22 of the standard residential mortgage at issue.

The court held that the right to reinstate and assert defenses are contingent rights, and that the letter adequately informed the borrowers of those rights by saying they "may" have them. The court also held that notifying the borrowers that their November monthly payment had been missed was sufficiently explicit to comply with paragraph 22. It held that inclusion of a payment that had not yet come due but would come due within the required 30-day notice period was an immaterial variation from the requirement of paragraph 22. Finally, the court rejected the argument that the absence of an address where payment could be sent constituted a failure to provide notice of the action required to cure the default.

The *Milam* opinion brings significant clarity, reason, and cohesion to the line of paragraph 22 cases of which it is the latest to this aspect of the mortgage foreclosure debate. Once it is final, it will provide a useful tool in effecting the prompt adjudication of foreclosure cases on the merits rather than technicalities, and, importantly, restore to borrowers the important responsibilities of being free and reasonable agents capable of understanding basic notice letters.

CFPB Reports Continued Mortgage Servicing and Other Violations of Consumer Financial Law

BY ELIZABETH BOHN

In its Supervisory Highlights released earlier this summer, the CFPB reported its examination observations in consumer reporting, debt collection, mortgage origination and servicing, fair lending, and student loan servicing. The report cited violations of mortgage servicing loan modification regulations, including dual tracking, lack of quality control by credit reporting agencies in generating accurate consumer reports, fair lending violations, and improper handling of complaints by debt collection companies. Specific violations identified included:

Mortgage Servicing Violations

The CFPB's new RESPA loss mitigation rules include detailed requirements for soliciting and evaluating loss mitigation applications (LMAs) from borrowers. Violations of loss mitigation rules mentioned in the report included failing to send required LMA acknowledgements five days after receipt, requesting additional documents from borrowers which had either been previously submitted, or were inapplicable, disclosing payment plan terms in a deceptive manner, and failing to honor trial modifications after servicing transfers, causing delays in converting trial modifications to permanent modifications and resulting harm to borrowers.

Dual Tracking/Foreclosure Process

"Unfair and deceptive practices" found in the foreclosure process included sending notices of intent to foreclose to borrowers previously approved for trial modification before the first payment under the trial modification was due, termed "dual tracking," by the Bureau, which "could mislead consumers to believe the servicer had abandoned the trial modification," and therefore found to be a deceptive practice.

Fair Lending Violations

Lenders who denied or discouraged mortgage applications from consumers because they would have relied on public assistance income in order to repay the loan, were identified as violating the Equal Credit Opportunity Act. Those institutions were required to change their policies and provide remediation to applicants.

Debt Collection Complaints Disregarded

Debt collection companies were found to have inadequate compliance management systems because they did not properly train personnel or log, record, or categorize consumer complaints, including complaints that were resolved by agents, resulting in a failure to review or resolve the complaints. Debt collectors were also accused of failing to properly investigate disputes.

While the entities that committed the alleged violations of consumer financial laws are unnamed in the report, the violations cited have resulted in actual enforcement orders providing injunctive and monetary relief. The CFPB continues its heavy reliance on the Consumer Financial Protection Act's prohibitions on deceptive and unfair practices in its enforcement actions; enforcement orders based on violations of those prohibitions represent half the monetary relief awarded during the report's period.

D.C. Circuit Upholds Bank's Standing to Challenge Constitutionality of CFPB

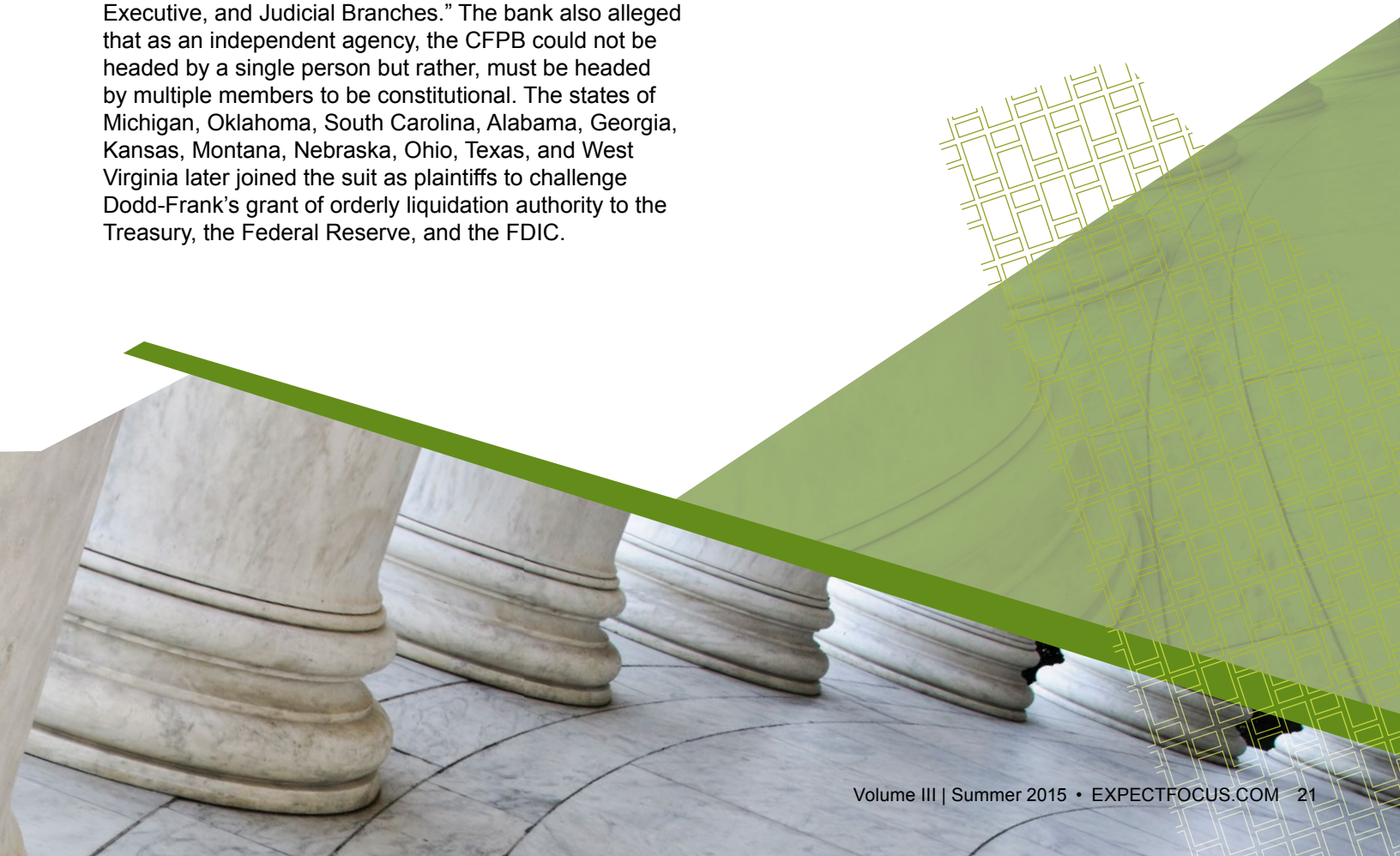
BY ELIZABETH BOHN & ZACHARY LUDENS

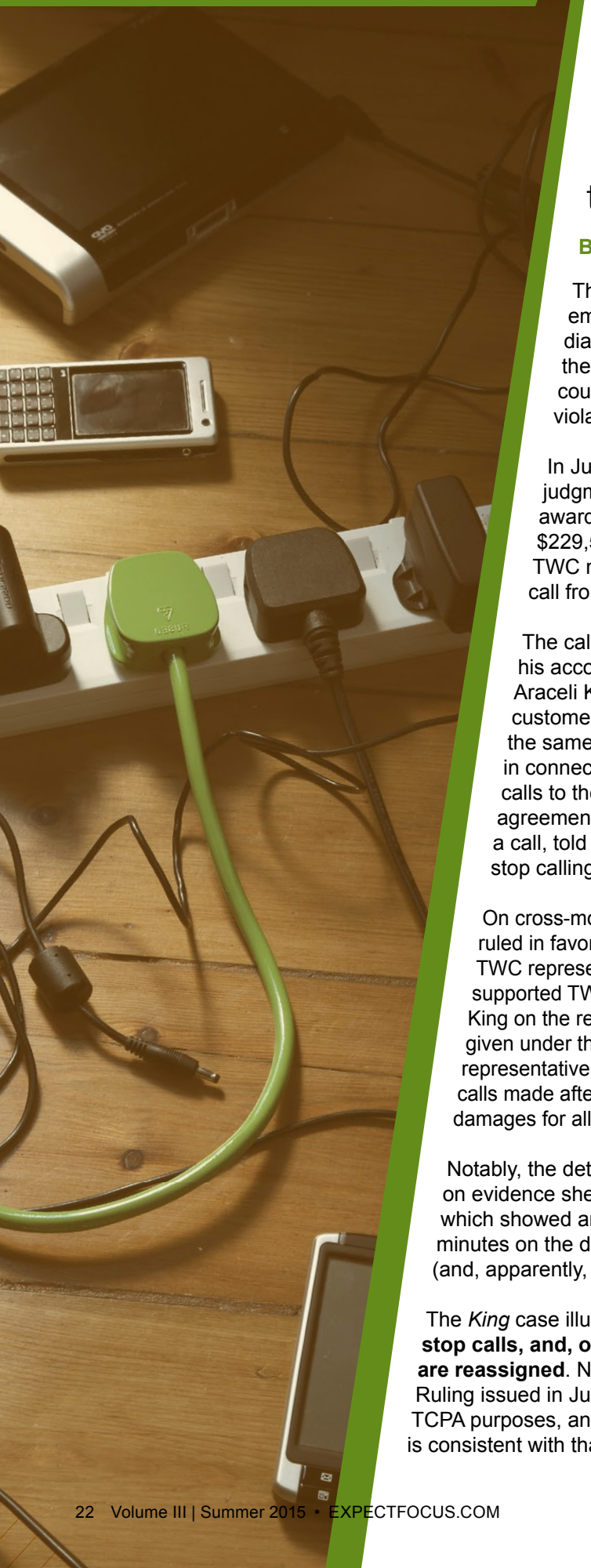
The D.C. Circuit Court of Appeals reversed a district court decision dismissing a bank's challenge to the constitutionality of the CFPB based on lack of standing. The district court had previously concluded that compliance costs were not an actual injury and, therefore, that the bank lacked standing and that the claims were not ripe.

State National Bank of Big Spring, a small Texas bank, joined by a number of states, filed suit challenging the constitutionality of the formation of the CFPB, the appointment of CFPB Director Richard Cordray, and the operation and creation of the Financial Stability Oversight Council (FSOC). State National offers checking accounts, savings accounts, certificates of deposit, and individual retirement accounts, all consumer financial products subject to CFPB regulation. The bank asserted that the Dodd-Frank Act's creation of the CFPB violated constitutional separation of powers because Congress "delegated effectively unbounded power to the CFPB, and coupled that power with provisions insulating the CFPB against meaningful checks by the Legislative, Executive, and Judicial Branches." The bank also alleged that as an independent agency, the CFPB could not be headed by a single person but rather, must be headed by multiple members to be constitutional. The states of Michigan, Oklahoma, South Carolina, Alabama, Georgia, Kansas, Montana, Nebraska, Ohio, Texas, and West Virginia later joined the suit as plaintiffs to challenge Dodd-Frank's grant of orderly liquidation authority to the Treasury, the Federal Reserve, and the FDIC.

State National alleged its injuries caused by the formation and operation of the CFPB included compliance costs, loss of profitability, loss of revenue in mortgage lending, and a discontinuation of mortgage lending as a result of revenue loss. The district court found these alleged injuries insufficient to establish standing to challenge the constitutionality of the CFPB, and held it was not enough to simply say that State National was "directly subject to the authority of the agency." The court also found that the claims were not ripe because the specific rules challenged were not applicable to the bank.

The D.C. Circuit found that the bank merely needed to show that it was regulated by the CFPB to have standing to challenge its constitutionality—which it found had been established. The court also noted that State National did not challenge the regulations *of* the CFPB, but rather regulation *by* the CFPB, thereby demonstrating ripeness. However, the court also found that State National did not have standing to challenge the FSOC, because State National was a small bank, not subject to FSOC regulations as a "too big to fail entity," thereby rejecting the bank's "competitor standing" theory, i.e. that it had standing because it competed with entities subject to FSOC regulation. The case was remanded to proceed on the merits.





Telecommunications Giant Hit With TCPA Treble Damages Award For Calls to Reassigned Cell Number

BY APRIL WALKER & ELIZABETH BOHN

The Telephone Consumer Protection Act (TCPA) prohibits non-emergency calls to cell phone numbers using automatic telephone dialing systems (ATDS) or prerecorded voice messages absent the called party's prior express consent. The statute authorizes a court to award $500 for each call violation or up to $1,500 per call violation if the defendant "willfully or knowingly" violated the statute.

In July, a federal district court in New York entered summary judgment against Time Warner Cable (TWC) under the TCPA, awarding the plaintiff a treble damages judgment in the amount of $229,500. *King vs. Time Warner Cable* involved 163 automated calls TWC made in 2013 and 2014 to a cell phone number it had consent to call from two unrelated customers.

The calls at issue intended to notify TWC customer Luiz Perez that his account was past due, but were actually received by TCPA plaintiff, Araceli King. Perez and King were both TWC *and* Sprint cellular customers and Perez had signed up with TWC in September 2012 using the same number later assigned to King. King gave the number to TWC in connection with her cable service, and consented to receive automated calls to the cell number under the terms of her cable subscriber agreement. But after receiving 10 calls intended for Perez, King answered a call, told a TWC representative she was not Perez, and asked TWC to stop calling her cell number concerning the Perez account.

On cross-motions for summary judgment filed by the parties, the court ruled in favor of TWC on 10 calls made before King's conversation with the TWC representative, finding the broad consent in King's service agreement supported TWC's prior express consent defense. The court ruled in favor of King on the remaining 153 calls, finding that King orally revoked the consent given under the service agreement, and that TWC had knowledge through its representative that she did not consent to further robo-calls. The court found calls made after King filed suit to be "particularly egregious" but assessed treble damages for all 153 calls made after revocation of consent.

Notably, the determination that King orally revoked consent was based solely on evidence she presented—her sworn declaration and her Sprint call records which showed an incoming call from a TWC number that lasted over seven minutes on the date of her alleged oral revocation. TWC had no account notes (and, apparently, no call recording) to controvert King's evidence.

The *King* case illustrates **the risks involved in not honoring oral requests to stop calls, and, of reaching unintended recipients when cell phone numbers are reassigned**. Not surprisingly, the court mentioned the FCC's Declaratory TCPA Ruling issued in July, and the court's finding that King was the "called party" for TCPA purposes, and that she could and did orally revoke consent previously given is consistent with that ruling.

Market Allocation = Antitrust Consequences

BY CAYCEE HAMPTON

The U.S. Department of Justice and the State of Michigan recently initiated a civil antitrust action to enjoin certain marketing agreements between four south-central Michigan hospital systems alleging that the agreements unlawfully allocate territories for the marketing of health care services, thereby limiting competition among the hospitals.

In *United States v. Hillsdale Community Health Center,* Hillsdale and each of its three co-defendants, Allegiance Health, Community Health Center of Branch County, and ProMedica Health System, operate general acute-care hospitals in adjacent Michigan counties. Although all four defendants historically competed with each other to provide health care services to the residents of the surrounding area, Hillsdale developed "gentlemen's agreements" with each of the other three hospitals to restrict the marketing of competing health care services.

The Government characterized the hospitals' agreements as "naked restraints of trade that are *per se* unlawful under Section 1 of the Sherman Act" as well as state antitrust law.

The senior executives of the defendant hospitals created and enforced these agreements for several years. In the words of one ProMedica communications specialist: "The agreement is that they stay [out] of our market and we stay out of theirs unless we decide to collaborate with them on a particular project." The Government characterized the hospitals' agreements as "naked restraints of trade that are *per se* unlawful under Section 1 of the Sherman Act" as well as state antitrust law.

With the complaint, the Government filed a stipulation and proposed final judgment as to Hillsdale, Branch, and ProMedica. The final judgment enjoins the settling defendants from (1) agreeing with any health care provider to prohibit or limit marketing or to allocate geographic markets or territories, and (2) communicating with any other defendant about any defendant's marketing in its or the other defendant's county. The proposed settlement also requires each defendant to appoint an antitrust compliance officer within 30 days of the entry of final judgment. The action will continue against Allegiance, which declined the Government's settlement offer and issued a statement maintaining that "regulators have misinterpreted Allegiance's conduct."

This case is an important reminder that antitrust authorities may vigorously prosecute marketing agreements that disrupt the competitive process. Because marketing is a key component of competition between rival health systems, hospitals and other health care providers must be vigilant to avoid conduct that could be perceived as market allocation.

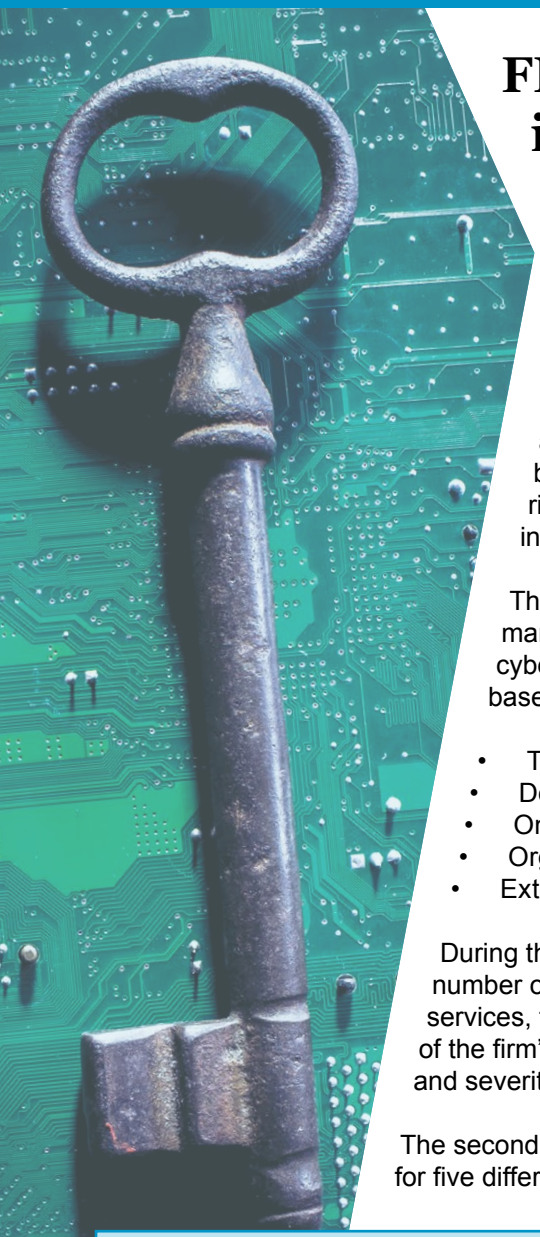
King v. Burwell & Beyond: ACA Litigation Continues

BY RICHARD OLIVER

The Supreme Court's ruling in *King v. Burwell* resolved what may be the last existential legal threat to Obamacare. The case upheld the extension of premium tax credits in states operating under federally created insurance exchanges pursuant to the Affordable Care Act. The statutory language authorizing the credits suggested that they would be available only to participants in state run exchanges. With only 16 states creating such exchanges, as many as 8 million people in 34 states were in jeopardy of losing access to affordable coverage had the challenge been successful. Some experts argued that this might result in the destabilization or collapse of the health insurance markets in those states. However, the Court found the statutory language ambiguous and relied on congressional intent as expressed though the overall structure of the ACA to uphold the credits.

While there are several challenges to the ACA working their way through the courts, most either have little chance of success or would not present serious obstacles to the Act's continued implementation. The most serious challenge is a suit by the House of Representatives seeking to stop federal payments to insurance companies of cost sharing subsidies designed to reduce out of pocket costs for lower income participants in state and federal insurance exchanges. The House argues that the administration cannot pay the subsidies without specific appropriations, even though the payments are authorized by the ACA. Administration requests for such appropriations were rebuffed by Congress in 2013 and 2014.

The suit faces several obstacles, not the least of which is a challenge to the standing of the House to bring the lawsuit in the first place. But, if successful, the suit could result in premium increases for lower income insureds and would give Republicans in Congress leverage in efforts to force changes to the ACA.



FFIEC Weighs in on Cybersecurity in Light of Unprecedented Risk of Cyber Threats

BY JOSEPHINE CICCHETTI & MATTHEW KOHEN

As financial institutions of all sizes continue to face unprecedented cybersecurity risk, the Federal Financial Institutions Examination Council (FFIEC) released its Cybersecurity Assessment Tool. The Assessment is consistent with the FFIEC IT Handbook and the National Institute of Standards and Technology Cybersecurity Framework (NIST), and provides a reliable benchmark to assist a financial institution's management in identifying applicable risks, assess preparedness for responding to a cyber incident, and provide institutional resilience.

The Assessment is designed to support financial institutions' upper-level management in the important task of analyzing the firm's vulnerability to various cybersecurity threats over time. The first part of the Assessment builds a risk profile based upon five main factors:

- Technologies and Connection Types
- Delivery Channels
- Online/Mobile Products and Technology Services
- Organizational Characteristics
- External Threats

During this stage of the analysis, the firm will assess a variety of factors, including the number of unsecured Internet connections, the use of externally hosted cloud computing services, the volume of ACH credit origination, the availability of trust services, the structure of the firm's IT department, the recency or possibility of a merger or acquisition, and number and severity of previously attempted cyber attacks.

The second phase of the analysis guides management in assessing the firm's maturity level for five different domains:

- Cyber Risk Management and Oversight
- Threat Intelligence and Collaboration
- Cybersecurity Controls
- External Dependency Management
- Cyber Incident Management and Resilience

This phase requires the firm to assess factors such as corporate governance and accountability in the event of a cybersecurity incident, risk management policies, cybersecurity training and culture, and threat monitoring and analysis.

Senior management and boards of directors must not only analyze their firm's cybersecurity vulnerabilities, but actively address and reform their risk management policies to keep up with the multitude of rapidly evolving cybersecurity threats.

This commentary by the FFIEC, which is comprised of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Consumer Financial Protection Bureau, and State Liaison Committee, underscores the sentiment that senior management and boards of directors must not only analyze their firm's cybersecurity vulnerabilities, but actively address and reform their risk management policies to keep up with the multitude of rapidly evolving cybersecurity threats. Tools like the Assessment provide valuable guidance to financial institutions seeking to stay one step ahead of the evolving cyber threat landscape.

Don't Get Locked Out: Is Ransomware a Threat to Your Business?

BY ZACHARY LUDENS

Ransomware is a type of malware that locks access to a computer and its drives. Many forms of ransomware take complete control of the computer system, encrypt all of the files, and deny access to the system and any files until a ransom is paid. If the ransom is not paid by the stated deadline, many ransomware programs will continue to raise the ransom. And, unfortunately, many ransomware programs require payment to be made in currencies such as bitcoin, making it very difficult to locate the wrongdoer or recover the funds.

In late June, the FBI issued an advisory regarding ransomware programs, particularly CryptoWall and its variants. Based on FBI reports, at least 992 ransomware incidents occurred between April 2014 and June 2015, costing victims a combined $18 million. The financial impact to each victim typically varied between $200 and $10,000.

The most sophisticated ransomware programs will spread beyond the initially targeted device to as many networked systems and servers as it can. Encrypting files as it goes, ransomware programs typically infiltrate systems when a user unknowingly installs or enables the ransomware program. Much like other viruses and malware programs, ransomware programs are typically placed as attachments to emails.

While the goal of most viruses and malware is to *obtain information* from systems, the goal of ransomware is to *stop the user from accessing information* on these systems. The programs charge users a premium to use their own systems. And, because the ransomware programs can encrypt files at a high-level bitrate, companies often find it more cost-effective and efficient to pay the ransom than to take actions against the ransomware in an effort to defeat it and/or prosecute the wrongdoers who originated it.

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Because no protection system can keep up with the breakneck speed at which ransomware programs develop, strong proactive policies are critical to protecting any company. An education policy to keep system users up to date helps strengthen the first line of defense. Critically, frequent and thorough backups—isolated from the potentially infected networked systems—allow companies to continue to access information and even recreate affected systems if they choose not to pay the ransom.

With the growing prevalence of ransomware, information security programs should include appropriate protections and planning to avoid potentially disastrous effects, such as massive system downtime and business losses, if ransomware finds its way in. Otherwise, you may find yourself locked out of your systems and having to decide whether to pay the ransom as it continues to increase.

Online Behavioral Advertising Guidelines Go Mobile

BY GAIL PODOLSKY & ZACHARY LUDENS

On September 1, the Digital Advertising Alliance (DAA) began enforcing its guidelines for online behavioral advertising regarding mobile advertising. The DAA, a not-for-profit independent body, develops industry-best practices to protect consumer choice in online behavioral advertising.

Any company engaged in mobile advertising should review any advertising and privacy practices, policies, and guidelines to ensure they comply with the DAA guidelines that are now being enforced. Online behavioral advertising refers to targeting ads to consumers based on their browsing history. The DAA's guidelines focus on any company that collects data about consumers' online browsing habits, uses that information, or permits third-parties to collect it.

Originally published in July 2009, the guidelines include various recommendations to advertisers, including one that advertisers give consumers notice that their data is being collected and that consumers can opt out. In 2013, the DAA released additional guidelines specific to online advertising in the mobile environment. The mobile guidelines include specific recommendations regarding cross-application data collection and location data collection. This includes instances in which websites are allowed to access your information regarding applications on your phone to tailor advertisements to your tastes.

However, when released in 2013, the DAA declined to enforce this guidance until appropriate tools were developed to allow consumers to opt out of online behavioral advertising in the mobile environment. Since there are now multiple opt-out tools available, including AppChoices, the DAA announced that it will begin enforcing these guidelines. The DAA guidelines include many potential safe harbors for companies where consumers receive proper notice and consent to the practices.

While the guidelines provide no specific penalties for non-compliance, the Federal Trade Commission (FTC) has enforcement authority in this area. The FTC's recent praise of the DAA's leadership in this area indicates that compliance with DAA guidelines may save a company from referral to the FTC by the DAA. Therefore, companies should review their advertising and privacy practices, particularly those applicable to mobile advertising, and consider complying with the DAA's guidelines.

States Continue To Grapple With Data Breach Notification Issues

BY DIANE DUHAIME

Connecticut's data breach notification law currently requires notification "without unreasonable delay." Effective October 1, 2015, Connecticut will (a) require notice of any breach of security not only "without unreasonable delay," but "not later than ninety days after the discovery of such breach, unless a shorter time is required under federal law"; and (b) require an offer of "appropriate identity theft prevention services and, if applicable, identity theft mitigation services" to each Connecticut resident whose Social Security number was breached or is reasonably believed to have been breached, such services to be provided for a period of not less than 12 months and at no cost to each such resident. Connecticut Attorney General George Jepsen stated that the amended law "sets a floor for the duration of the protection and does not state explicitly what features the free protection must include," and that he may "seek more than one year's protection – and to seek broader kinds of protection – where circumstances warrant."

As illustrated in Carlton Fields Jorden Burt's data breach notification survey (*Expect Focus*, Summer 2014), approximately 47 states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands have laws requiring entities to notify individuals of security breaches involving personally identifiable information. Many companies favor federal preemption of state data breach notification laws so they will no longer be faced with the daunting task of complying with so many different notification requirements. However, in a letter to Congress dated July 7, 2015, the National Association of Attorneys General observes there are many federal data breach notification and data security bills pending in Congress, and basically urges that any such federal laws not preempt state laws. The letter, signed by 47 state attorneys general, reasons that federal preemption will leave consumers less protected than they are today, and result in the states' inability to respond to consumer concerns. The letter provides many examples of how states have responded to data breaches, and explains that states need continued flexibility to amend their laws in response to technology and data collection changes.

Carlton Fields Jorden Burt was chosen as the top law firm in the country by the *Vault Guide to the Top 100 Law Firms* for "Overall Diversity," "Diversity for Women," "Diversity for Minorities," "Diversity for LGBT," and "Diversity for Disabilities." This is the sixth time in seven years that *Vault* named Carlton Fields Jorden Burt the best firm in the country for overall diversity and diversity for women and minorities.

Twelve of Carlton Fields Jorden Burt's practices and 40 attorneys earned top rankings nationally, and in California, Connecticut, Florida and Georgia in the *2015 Chambers USA Guide to America's Leading Business Lawyers*.

New York Shareholder **Ethan Horwitz** was named a top litigator in the country by *Law360* in its inaugural "Trial Aces" series. Horwitz is one of 50 attorneys selected for this list. According to *Law360*, Trial Aces were chosen based on the number of high-stakes trial they've worked on, the role they played at trial, and the trial outcome.

Miami Shareholder **Benjamine Reid** was appointed National Co-Chair of the American Bar Association Litigation Section Judicial Intern Opportunity Program. The program provides judicial internships to students who are members of racial and ethnic groups that are traditionally underrepresented in the legal profession.

The Florida Bar appointed West Palm Beach Shareholder **Sarah Cortvriend** to the Voluntary Bar Liaison Committee for the 2015-2016 term.

Tampa Shareholder **Fentrice Driskell** received the 2015 Leaders in Law award from the Florida Association for Women Lawyers (FAWL). This award honors FAWL members who have made a significant impact in their communities, made meaningful contributions to their communities through legal service or volunteer activities.

West Palm Beach Shareholder **Joseph Ianno, Jr.** was appointed to the Palm Beach County Criminal Justice Commission, which works to cultivate and enrich local criminal justice practice, policy, and program development.

Tampa Of Counsel, **C. Douglas McDonald, Jr**., was elected to be a Fellow of the American Bar Foundation. Membership is limited to less than one percent of lawyers licensed to practice in each jurisdiction in the United States.

Notable Matters

Carlton Fields Jorden Burt recently assisted Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund (FHCF) in securing a $300 million catastrophe (CAT) bond and nearly $3 billion in reinsurance. This is the fourth consecutive year the firm has served as counsel to Citizens in its issuance of a CAT bond as well as their traditional reinsurance. Last year, Citizens secured a $1.5 billion CAT bond: the largest issuance of its kind in CAT bonds' 20-plus-year-history. FHCF entered the reinsurance market for the first-time ever this year, securing $1 billion of reinsurance. These transactions provide additional liquidity for Citizens and FHCF following a catastrophic storm.

On the Move

Carlton Fields Jorden Burt welcomes **Brian Olasov,** Executive Director – Financial Services Consulting, to its Atlanta office. As a consultant, Mr. Olasov advises lawyer colleagues in mortgage loan issues, liability theories and damage analysis, and serves as an expert witness for other firms in structured finance disputes. He is a non-attorney professional member of the firm's Real Estate and Commercial Finance practice group.

Events

In June, Carlton Fields Jorden Burt sponsored the Cyber Security Forum, and co-sponsored the panel, "Latest Developments and Trends in Significant Annuity and Life Insurance Litigation" at the Insured Retirement Institute's Government Legal and Regulatory Conference in Washington, DC. **Jo Cicchetti** (Washington, DC) served as moderator for the Cyber Security Forum, and speakers during the forum and general conference included **Richard Choi** (Washington, DC), **Markham Leventhal** (Washington, DC), **Diane Duhaime** (Hartford), **Steve Jorden** (Hartford), **Joe Swanson** (Tampa), and **Walter Taché** (Miami).

Carlton Fields Jorden Burt sponsored the American Council of Life Insurers' Compliance and Legal Sections Annual Meeting that took place July 15-17 in Las Vegas, Nevada. **Jason Gould** (Washington, DC), **Steven Kass** (Miami), and **Shaunda Patterson-Strachan** (Washington, DC) spoke during a concurrent session on non-guaranteed elements in life and annuity products. Additionally, Carlton Fields Jorden Burt is a sponsor of the upcoming ACLI Annual Conference that will be held in Chicago October 11-13.

The 33rd Annual Advanced ALI CLE Conference on Life Insurance Company Products will be held November 2-3 at the Capital Hilton in Washington, DC. **Richard Choi** (Washington, DC) co-chairs the Conference, and **Ann Furman** (Washington, DC) and **Gary Cohen** (Washington, DC) will present, respectively, on recent developments affecting the distribution of insurance products and on how the SEC has fit insurance products under the federal securities laws on the 75th anniversary of the Investment Company Act of 1940.

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- Construction
- Telecommunications
- Securities
- Real Estate
- Manufacturing and Raw Materials

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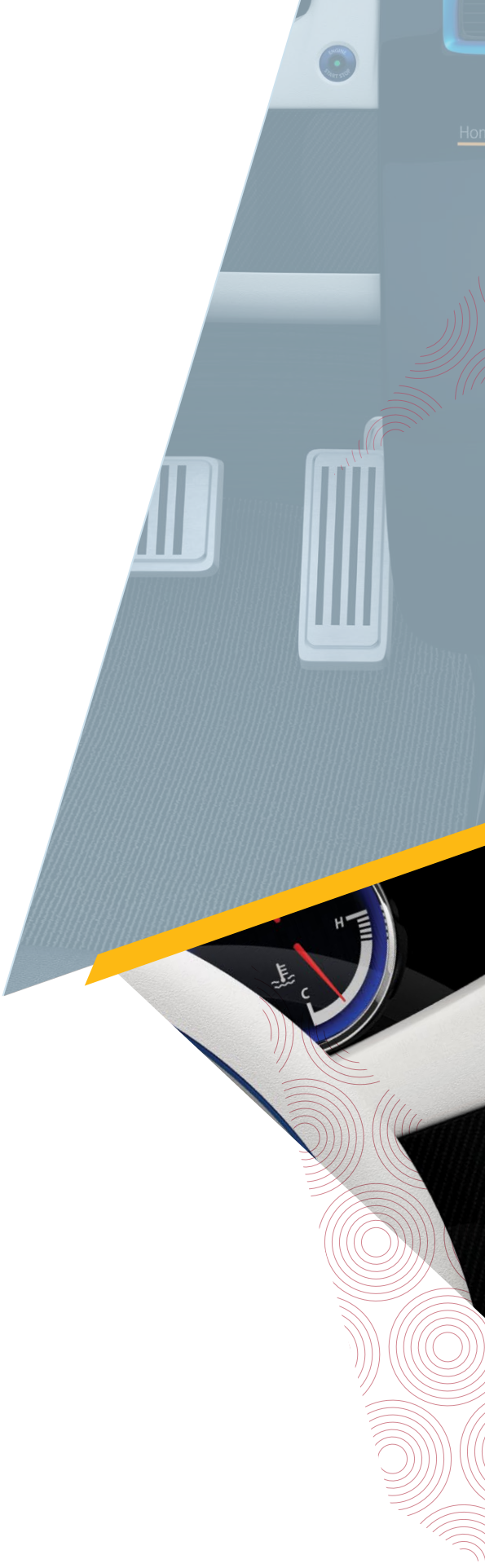

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