EXPECT FOCUS®

LEGAL ISSUES AND DEVELOPMENTS
FROM CARLTON FIELDS JORDEN BURT

CARLTON FIELDS
JORDEN BURT

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CONVENIENCE VS. CHANCE

Regulators Focus on Electronic Commerce

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NEWS & NOTES

California Passes Life and Annuity Electronic Transactions Law

BY DIANE DUHAIME & ANN BLACK

On January 1, 2016, Section 38.6 of the California Insurance Code will take effect permitting consumers to conduct certain life, disability, and annuity transactions electronically. The new law *attempts to* meet California consumers' increasing demand to conduct business electronically, and take advantage of the convenience of e-delivery and e-signatures in life insurance.

A closer look at Section 38.6, however, reveals that it contains several requirements not included in the laws of any other states, the Uniform Electronic Transactions Act (UETA), or the Electronic Signatures in Global and National Commerce Act (E-Sign). Section 38.6 also imposes some burdens on electronic life insurance transactions that are not applicable to paper transactions. Several of Section 38.6's most onerous requirements may actually impede the ability to conduct life insurance business electronically in California, as discussed below:

- If California insurance law requires transmission of a record by return receipt, registered mail, certified mail, signed written receipt of delivery, or other delivery method evidencing actual receipt by the person, to transmit the record electronically, the licensee must: (a) maintain a process or system that **demonstrates proof of delivery and actual receipt of the record** by the person, (b) document and retain information demonstrating delivery and actual receipt so that it is retrievable, upon request, by the department at least five years after the policy is no longer in force; and (c) if delivery and actual receipt of an electronic record cannot be demonstrated, the record must be resent to the person in the manner originally specified by the underlying California insurance law provision.

- When a licensee receives information that the record sent by electronic transmission was not received by the person, generally, the licensee shall, within five business days, either: (i) contact the person to confirm or update the person's email address, resend the record by electronic transmission, and demonstrate the transmission was received by the person; or (ii) resend the record by regular mail to the person at the address shown on the policy, or, if the underlying statute requires delivery in a specified manner, send the record in that manner.

- No discount or incentive may be provided to any person for opting into receiving electronic records, and no charge may be assessed against any person who declines to opt in to receive electronic records.

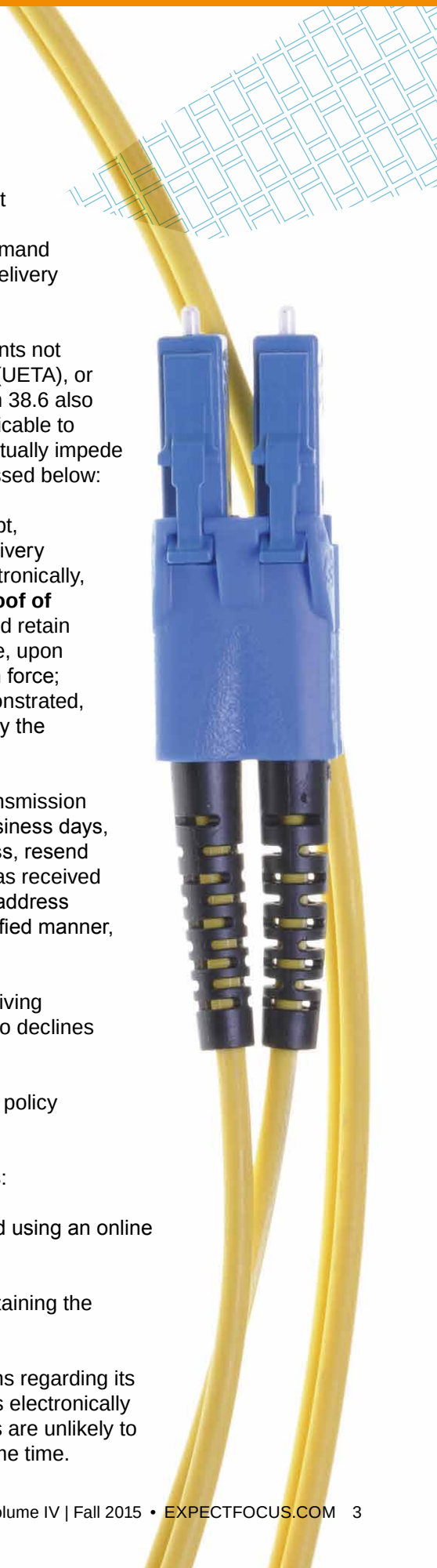
- A copy of the signed opt-in consent disclosure must be maintained with the policy information while the policy is in force and for five years thereafter.

Additionally, some Section 38.6 requirements require further clarification, such as:

- If a consumer's opt-in consent is acquired verbally, how may it be confirmed using an online or paper record?

- Does Section 38.6 require a person's opt-in consent be obtained before obtaining the electronic signature of the person on an application or other document?

Based on the onerous requirements of Section 38.6 and the outstanding questions regarding its implementation, many providers may decide to stop doing life insurance business electronically in California, or will not bother to begin doing so. Therefore, California consumers are unlikely to enjoy an increased ability to conduct electronic life insurance transactions for some time.



Under a Spotlight, "Shadow Insurance" Lawsuit Fails Scrutiny

BY PAUL WILLIAMS & JASON GOULD

One of several class actions that arose in the wake of a 2013 investigation by the New York Department of Financial Services (NYDFS) into so-called "shadow insurance," *Robainas v. Metropolitan Life Insurance Co.*, has been dismissed by a New York federal court for lack of a cognizable injury. "Shadow insurance" is a term used to describe an insurer's reinsurance of a portion of its risk through a subsidiary or affiliate, which reduces the assets the insurer must maintain in support of its reserves under state regulations. Though legal, the NYDFS characterized these activities as a "loophole" that puts policyholders at risk.

The *Robainas* plaintiffs' allegations were typical: that MetLife's letters of credit used by captive reinsurers were backed by contractual parental guarantees, meaning that less risk was transferred than regulatory filings suggested, and these "hollow assets" were not disclosed in annual filings which led to an artificially inflated risk-based capital ratio. Plaintiffs, MetLife policyholders, asserted a knowing misrepresentation in violation of New York Insurance Law Section 4226 and sought the penalty available for "aggrieved" persons.

The court's decision shines a light on the greatest weakness to any potential "shadow insurance" suit—that the alleged harms of "shadow insurance" are inherently conjectural.

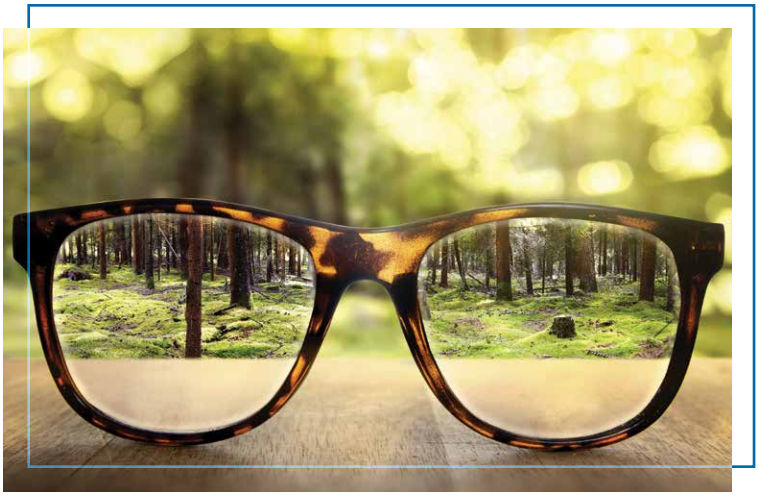
The court dismissed the plaintiffs' case for lack of a cognizable injury, rejecting each of plaintiffs' injury theories: that the policies were riskier than represented; that the "shadow insurance" inflated the premiums; that MetLife might be unable to pay insurance claims in the future; and that Section 4226 created a "right to be free from misrepresentation by the insurer." These theories failed to show the required "real or impending" injury for constitutional standing to sue, instead reflecting a conjectural or hypothetical injury. Section 4226 did not obviate this injury requirement but rather reinforced it—the word "aggrieved" suggesting an injury requirement coextensive with that of the Constitution.

The court's decision shines a light on the greatest weakness to any potential "shadow insurance" suit—that the alleged harms of "shadow insurance" are inherently conjectural. Nonetheless, insurers should take note of the court's suggestion that an injury might be shown if plaintiffs could prove their premiums were higher as a result of "shadow insurance" activities. The court rejected this argument because it was contradicted by a study showing that shadow insurance in fact *reduced* the cost of life insurance. That study may be important in future related litigation as well.

NAIC Evaluates Insurer's Use of Variable Annuity Captives, Price Optimization, and Big Data

BY ANN BLACK & WHITNEY FORE

At the National Association of Insurance Commissioners (NAIC) Fall National Meeting, regulators and consumer representatives continued to seek transparency on insurers' use of annuity captive reinsurance transactions (VA captives), big data, and price optimization. Regulators and consumer representatives are seeking to better understand why insurers use variable annuity captives and how big data and price optimization is used.



Working groups seek transparency.

Working groups within the NAIC continued to discuss the use of variable annuity captives. At the NAIC Center for Insurance Policy and Research's Regulation of Captives panel, panelists discussed the structure of VA captives. One panel relayed the concerns raised by the federal government as to the use of captives and noted that the Financial Stability Oversight Council's 2014 Annual Report identified variable annuity captive reinsurance transactions as priorities for state regulators to address. The Variable Annuities (E) Working Group (VAWG) was charged with addressing VA captives and received Oliver Wyman's report on why insurers engage in captive reinsurance transactions and ideas for improving the current AG43 and C3 Phase II Frameworks. Oliver Wyman was engaged to perform a quantitative impact study (QIS) to assess the efficacy and potential impact of its recommendations. In addition, the VAWG is seeking new disclosures in the financial statement blanks as to the valuation of the variable annuity and fixed annuity guarantees, how those guarantees can change in volatile market conditions, and how insurers manage those obligations.

Additionally, at the fall meeting, the Property and Casualty Insurance (C) Committee adopted the Casualty Actuarial and Statistical (C) Task Force's Price Optimization White Paper. The white paper seeks to provide information to state regulators on the potential benefits and drawbacks of using price optimization as states consider their regulatory responses to using price optimization in ratemaking. Finally, at the Market Regulation and Consumer Affairs (D) Committee meeting, Center for Economic Justice consumer representative Birny Birnbaum requested that the committee study insurer's use of big data as necessary to protect consumers. This request echoes similar requests Mr. Birnbaum made in the context of price optimization to the Casualty Actuarial and Statistical (C) Task Force.

Perks, Prizes, and Loopholes: Sen. Warren's Report on Annuity Sales Practices

BY WHITNEY FORE

This past April, Sen. Elizabeth Warren (D-MA) opened an investigation into annuity sales practices by issuing surveys to 15 insurance companies responsible for 71 percent ($168 billion) of total 2014 industry sales. The goal of this inquiry was to determine the prevalence of awarding perks and prizes to advisers who sell high volumes of annuities, a practice that Sen. Warren claims creates a conflict of interest. According to Sen. Warren, these non-cash incentives cause advisers to be more interested in making the sale than in ensuring that the product sold is appropriate for the consumer.

In October, Sen. Warren published a report summarizing her "findings." Thirteen of the 15 companies offer such incentives directly to agents, indirectly through third party gift payments, or both. But, according to Sen. Warren, no company clearly describes the nature and types of rewards in their annuity prospectuses. Nor is any company required to—the companies always complied with the various federal, state, and industry rules that apply to annuity sales. Current legislation permits companies to provide non-cash compensation for sales of a broad array of a company's products. Thus, Sen. Warren concluded in her report that the award of perks and prizes is equally attributable to industry practice and to "loopholes" within the regulatory system.

Sen. Warren expressed her hope that the Department of Labor's proposed rule regarding the definition of the term "fiduciary" will close these "loopholes."

In the report, Sen. Warren expressed her hope that the Department of Labor's proposed rule regarding the definition of the term "fiduciary" will close these "loopholes." If enacted, this rule would require that all advisers who give retirement advice specifically directed to an individual investor act in the best interests of their clients, and not for personal gain.

Solicitors Argue to U.S. Supreme Court That Vermont Health Care Reporting Law Is Not Preempted By ERISA

BY BEN SEESSEL

The Supreme Court will soon consider whether, as applied to self-insured health benefit plans or their third-party administrators, ERISA preempts a Vermont law requiring health care payers to report claims and other data to a state agency charged with developing a database of information on health care provided to Vermont citizens. The Second Circuit held the Vermont law to be preempted, finding that it had an impermissible "connection with" ERISA plans, particularly, because it addressed the "core" ERISA issue of reporting.

At the invitation of the Supreme Court, the Solicitor General and Solicitor of Labor submitted an *amicus* brief in support of Vermont at the petition stage in *Gobeille v. Liberty Mutual Insurance Co.* and recently filed a further brief after *certiorari* was granted. Their brief argues that the Vermont law is not preempted because it does not make "reference to" or have an impermissible "connection with" an ERISA plan, but applies to many types of health care payers. They further argue that, while ERISA governs the design and administration of employee benefit plans, the Vermont law is aimed at improving the quality and cost of health care for citizens of Vermont. In support of the contention that the law is not concerned with ERISA plan administration, the brief also notes that the Vermont statute's implementing regulation does not require submission of data regarding denied claims.

The solicitors cite *De Buono v. NYSA-ILA Medical & Clinical Services*, in which the court determined that a gross-receipts tax on patient services provided by a hospital operated by an ERISA plan was not preempted, notwithstanding that the hospital was required to submit quarterly reports under the law. The brief also cites *California Division of Labor Standards Enforcement v. Dillingham Construction*, in which the court held that California's prevailing-wage law was not preempted as applied to an apprenticeship program established as an ERISA plan, even though state law recordkeeping and disclosure obligations are typically associated with such laws.

The Solicitor General and Solicitor of Labor also contend that the Vermont law is concerned with an area traditionally regulated by the states, the health and welfare of state citizens, and is thus entitled to a presumption of non-preemption and, furthermore, that the Vermont law would survive under traditional field and conflict preemption tests. They point out that, without the Vermont law and those like it in other states, federal programs (such as those being implemented under the Affordable Care Act) that would use the data will be frustrated.

Federal Court of Appeals Deems Policies STOLI, Refuses to Order Return of Premiums

BY ROLLIE GOSS

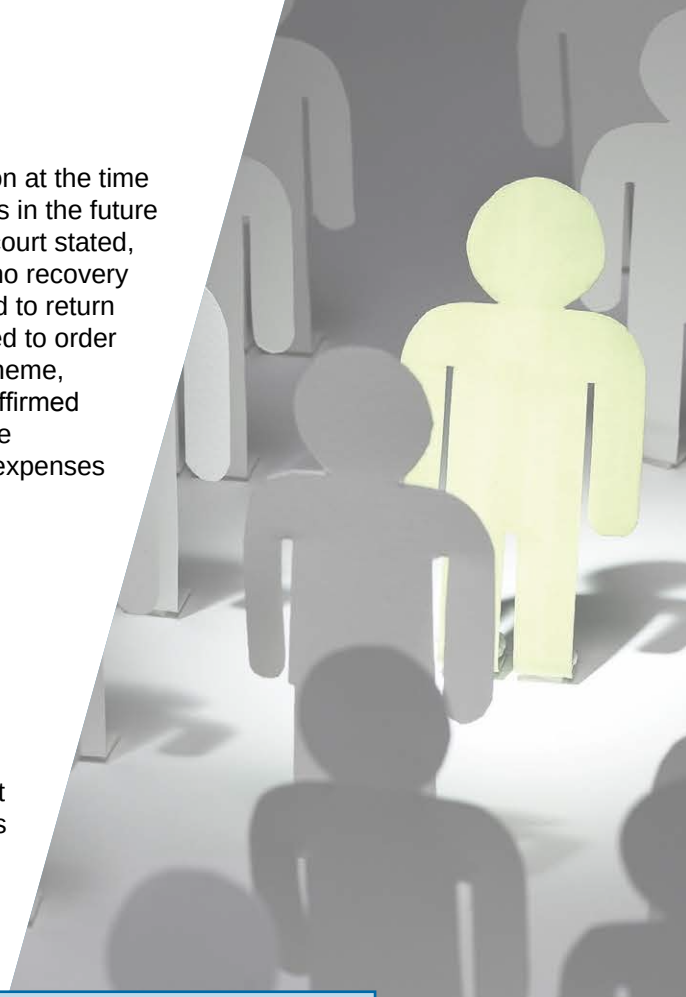
Upon determining that certain Ohio National life insurance policies were stranger originated life insurance (STOLI) under Illinois law, the Seventh Circuit Court of Appeals, in *Ohio National Life Assurance Corp. v. Davis*, affirmed the entry of summary judgment in favor of an insurer, holding that the policies at issue were void *ab initio*.

The five policies at issue were placed in trusts upon issuance for sale to investors, with the insureds receiving compensation for enrolling in "a program," frequently being unaware they were applying for insurance. The court held the policies to be STOLI because they were initiated, paid for, and controlled by someone who lacked

an insurable interest in the life of the insured and there was an intention at the time the policies were issued to transfer the formal ownership of the policies in the future to someone who lacked such an interest. In such circumstances, the court stated, parties normally "will be left where they have placed themselves with no recovery of the money paid for illegal services." Ohio National was thus required to return funds ($91,000) paid by one "innocent" defendant, but the court refused to order the return of funds paid by parties that were complicit in the STOLI scheme, whether or not they realized the scheme's illegality. Finally, the court affirmed an award of damages to Ohio National of $726,000—the amount of the commissions it paid to the complicit agent and its attorneys' fees and expenses paid in contesting the policies.

Individual Inquiries Predominate in 401(k) Litigation

BY WHITNEY FORE



In denying class certification in an action against Transamerica Life Insurance Company (TLIC), the Central District of California noted that the "sheer number of participants and plans" potentially involved in this litigation meant that "any difference in facts or legal posture among plans is potentially multiplied by a thousandfold[.]" The plaintiffs in *Santomenno v. Transamerica Life Ins. Co.* – three 401(k) plan participants from two different retirement plans – sought to represent a class of "about 300,000 participants in about 7,400 plans" serviced by TLIC. TLIC offers 401(k) products consisting of investment options and administrative services to small and midsize employers, operating about 15,500 such plans and managing approximately $19.5 billion in plan assets.

Individual questions regarding investment/ administrative management charges and lower-cost share classes defeated certification.

Plaintiffs alleged that TLIC's fees on its retirement accounts were excessive and constituted a breach of its fiduciary duty under ERISA. Specifically, plaintiffs alleged that "TLIC's fees on separate accounts that invest in publicly available mutual funds are excessive because TLIC provides no services on such accounts[.]" In addition, plaintiffs alleged that TLIC did not use its institutional leverage to invest their money in the lowest price share class of mutual funds, and that TLIC's affiliates made transactions prohibited under ERISA. The nail in the certification coffin turned out to be predominance: the court concluded that individual questions regarding the investment management/administrative management charges and lower-cost share classes would predominate over the common questions in this case.

Even though the Central District denied certification, it noted that its holding was limited and that "[i]f the question of evaluation of total plan expenses against total plan fees were more directly presented, or if the class more narrowly drawn (so that individualized inquiries, even if present, would not overwhelm common questions), the holding might well be different."

SEC Issues Proposed Changes to Administrative Proceedings

BY JOSEPH SWANSON

Amid controversy over its increased use of administrative proceedings to bring enforcement cases, the SEC has recently proposed several reforms. For instance, one change would ease the deadlines by which an initial decision must be rendered and provide a longer prehearing period. Additionally, rather than permitting depositions only where a witness is unable to testify at a hearing (as is currently the case), the SEC's proposal allows each side to depose up to three persons (and, in multiple-defendant cases, the defense could collectively depose up to five persons). The SEC also proposed requiring the parties to file electronically.

Do the proposed changes really fix anything?

The SEC appears to be responding directly to several recent legal challenges. *See* "Defendants Challenge SEC's Increased Use of Administrative Forum" and "SEC Administrative Law Judge Appointments Held Likely Unconstitutional" in the Winter 2015 and Summer 2015 issues of *Expect Focus*, respectively. In addition to seeking to improve the process afforded defendants in administrative proceedings, there is some recent evidence that the SEC has reduced the proportion of such proceedings it is bringing, relative to court cases. It is unclear whether that reduction is, at least partly, a response to the legal challenges being raised, or will persist.

As for the proposed reforms, although they are a step in the right direction, they raise other questions, including why the SEC settled on the seemingly arbitrary number of depositions per side. And, the fact remains that the Federal Rules of Evidence are inapplicable, there are no juries, and the proceedings are presided over by SEC employees, not federal judges. Accordingly, even if these changes are implemented, challenges by defendants will likely persist.

AML Requirements Proposed for Investment Advisers

BY MARISSEL DESCALZO

After more than a decade of delay, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) proposed new regulations that would extend mandatory anti-money laundering (AML) requirements to all investment advisers registered or required to be registered with the SEC under the Investment Advisers Act. **FinCEN proposes to include investment advisers in the general definition of "financial institution," and the regulations would generally extend to all advisory clients**, including hedge funds, private equity funds, and other private funds.

The proposed regulations, announced on August 25, would require investment advisers to develop and implement written AML programs tailored to address the specific risk posed by the services it provides and the clients it advises. The AML program would be required to provide for internal controls to ensure compliance, periodic testing to assess compliance, an AML officer to implement and monitor the program, and ongoing training for the adviser's employees, agents, and third-party service providers.

Additionally, the regulations would require investment advisers to

- report suspicious activities to U.S. authorities, which would impose obligations on them similar to those that the Bank Secrecy Act imposes on financial institutions such as mutual funds, broker-dealers in securities, banks, and insurance companies;
- file currency transaction reports and keep records regarding the transmittal of funds;
- respond to information requests from U.S. law enforcement pursuant to the USA Patriot Act; and
- comply with recordkeeping and travel rules that apply to transmittal of funds by non-bank financial institutions.

Under FinCEN's proposal, the SEC will have authority to examine investment advisers for compliance with these requirements. If the proposed regulations are adopted, an investment adviser that fails to comply may be at risk for civil or criminal liability.

SEC Proposes Liquidity Risk Programs for Funds

BY CHIP LUNDE

The SEC proposed rule reforms on September 22 designed to improve liquidity risk management by open-end funds.

Liquidity Risk Management Programs

Under the proposed reforms, mutual funds (excluding money market funds) and ETFs would be required to implement liquidity risk management programs. Liquidity risk is defined as the risk of not meeting redemption requests that are expected (or, in times of stress, that are reasonably foreseeable) without materially affecting NAV. Under the program, funds would be required to classify each portfolio investment into one of six categories (based on how long it would take to liquidate those investments) and maintain a three-day liquid asset minimum.

The program must be tailored to the characteristics of each fund and would be subject to periodic assessment and board oversight.

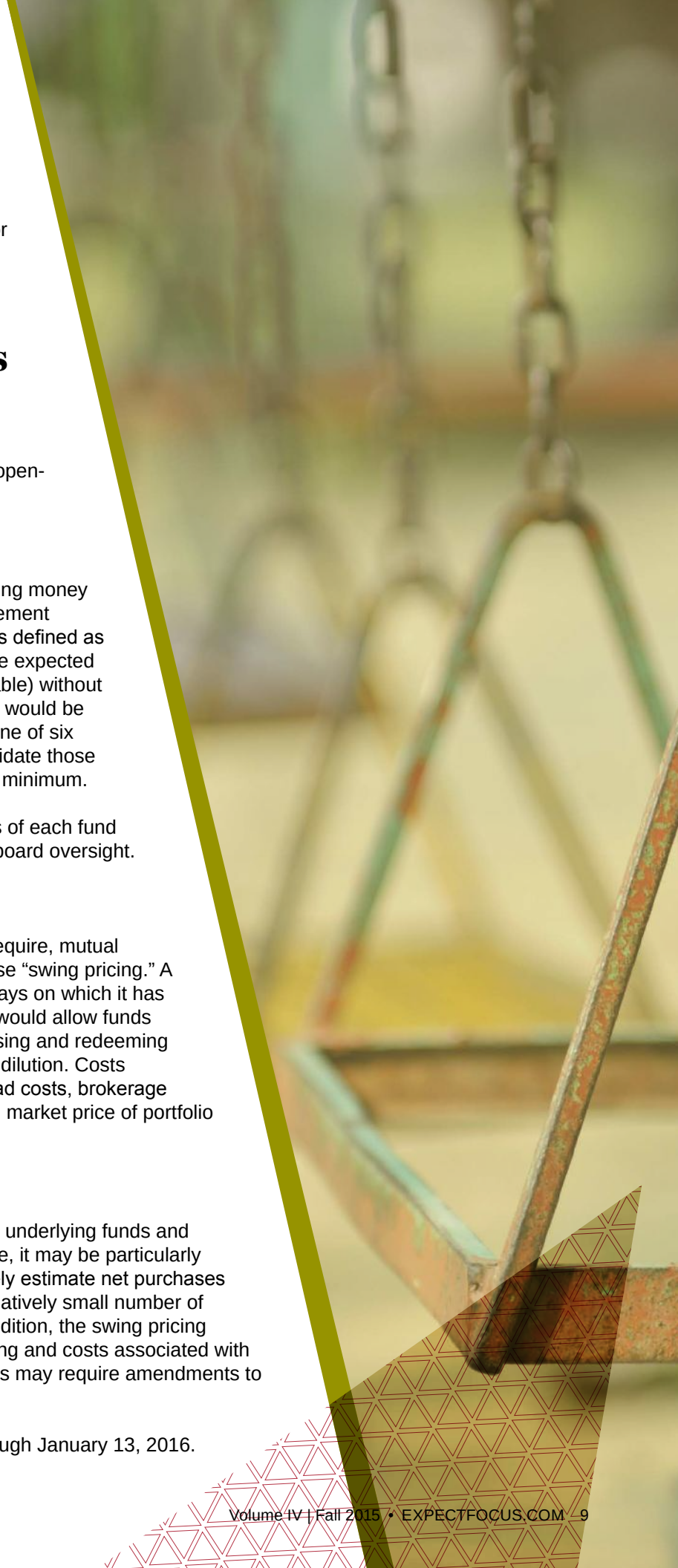
Swing Pricing

The proposed reforms would also permit, but not require, mutual funds (except money market funds and ETFs) to use "swing pricing." A fund using swing pricing would adjust its NAV for days on which it has large net purchase or net redemption orders. This would allow funds to pass on related portfolio trading costs to purchasing and redeeming shareholders, and protect other shareholders from dilution. Costs that may be reflected in swing pricing include spread costs, brokerage commissions and other transaction fees, change in market price of portfolio assets due to fund trading, and borrowing costs.

Unique Issues For Variable Insurance Products

The "swing pricing" proposal could uniquely impact underlying funds and issuers of variable insurance products. For example, it may be particularly difficult for unaffiliated underlying funds to accurately estimate net purchases and redemptions where they are submitted by a relatively small number of insurers after the close of business each day. In addition, the swing pricing option could present challenges related to the pricing and costs associated with fund substitutions. Addressing some of these issues may require amendments to fund participation agreements.

The comment period for the proposals is open through January 13, 2016.



Executives in Crosshairs for Corporate Violations

BY KEVIN NAPPER

A new U.S. Department of Justice policy expands expectations for corporate cooperation in white collar investigations in ways that have profound implications for SEC-regulated entities such as broker dealers, investment advisers, and others in the securities industry. This new policy:

- creates additional obstacles for any company attempting to resolve cases with the DOJ;
- places increased pressure on companies to develop and present evidence of wrongdoing by senior executives and other employees in order to get credit for cooperation; and
- puts additional pressure on prosecutors to charge individuals and thereby increase the exposure of corporate executives to government scrutiny.

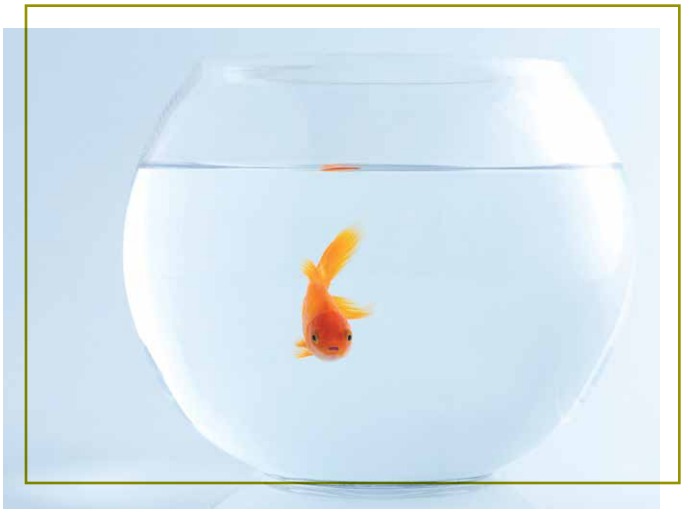
While it remains to be seen how this new policy, issued in memo form by Deputy Attorney General Sally Q. Yates on September 9, 2015, will play out, it is certain that SEC-regulated entities should be mindful of it and pay close attention to its application as the DOJ and the SEC implement it. Policy changes include the following:

- To be eligible for any cooperation credit, corporations must provide to the DOJ all relevant facts about the individuals involved in corporate misconduct.
- Both criminal and civil corporate investigations by the government should focus on individuals from the inception of the investigation.
- Criminal and civil attorneys handling corporate investigations for the government should be in routine communication with one another and in most cases should discuss civil referrals when a prosecutor decides not to pursue a criminal case.
- Absent extraordinary circumstances, no corporate resolution of alleged illegality will provide protection from criminal or civil liability for any individuals involved.
- Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires, and the reasons for any declinations to pursue individuals in such cases must be memorialized.

Feds Fish in Form PF

BY TOM LAUERMAN

Annual reports that the SEC must submit to Congress provide insight into how the agency is exploiting the wealth of information that private fund advisers are required to file with it on Form PF. The SEC developed Form PF over the past few years in response to requirements in the Dodd-Frank Act and other perceived regulatory imperatives.



Private fund advisers live in a regulatory fishbowl.

The following are some uses, as described in the SEC's August 2015 report, that may have the most direct impact on private fund advisers:

- Prior to examining a private fund adviser, SEC staff generally review the adviser's Form PF for any inconsistencies with other documents relating to the adviser, such as due diligence reports, pitch books, offering documents, operating agreements, books and records, the adviser's Form ADV and related brochure, and other information provided to investors, "particularly with respect to holdings, leverage, liquidity, derivatives, and counterparties."
- Such discrepancies can result in further staff inquiries or deficiency letters, or enforcement actions.
- The staff also uses a database containing certain information from Form PF to identify advisers engaging in activities implicating particular areas of examination focus, such as risk exposures, valuations, and high-frequency trading.
- SEC enforcement personnel also have accessed Form PF data to assist their ongoing program to identify hedge fund advisers whose investment returns are aberrational relative to certain

benchmarks and thus perhaps indicate improper conduct.

- As part of its monitoring of risks in the money market fund industry, the staff is also monitoring Form PF data reported for private money market ("liquidity") funds.

Multiple divisions, offices, and groups at the SEC are finding more ways to mine Form PF data to enhance the staff's ability to identify legal violations. Private fund advisers must be mindful, therefore, that they live in a regulatory fishbowl that is growing more transparent all the time.

SEC Judge Lenient Toward Compliance Employee

BY WHITNEY FORE

Previously, we described how some recent SEC officials' enforcement actions and statements could suggest a movement toward holding chief compliance officers (CCOs) strictly responsible for legal violations their compliance procedures fail to prevent. *See* "SEC Commissioners Making a Noisy Exit" in the Summer 2015 *Expect Focus*. Most SEC commissioners, however, maintain that the SEC only brings enforcement actions against CCOs who have engaged in egregious misconduct.

Recently, SEC administrative law judge Cameron Elliott entered the fray, dismissing the SEC Enforcement Division's case against an experienced, but relatively junior, Wells Fargo Advisers compliance employee. The Division alleged that the employee retroactively altered a document to make her review of an instance of insider trading appear more thorough, and then lied about it to the SEC.

Although determining that the employee had thus aided, abetted, and caused securities law violations by Wells Fargo, the ALJ refused to impose any sanction on her. He noted that the testimony indicated that at least two levels of the employee's compliance department supervisors also "could have been charged with the same misconduct" and that imposing the sanction the Division requested could send a message to the industry that the Wells Fargo breach was one employee's fault, and not attributable to systemic problems. Further, the **ALJ concluded that excessive sanctioning of compliance personnel could discourage competent individuals from entering the field, especially since firms tend to compensate compliance personnel "relatively poorly."**

It would be a mistake, however, for CCOs to take much comfort from this opinion, as the ALJ clearly signaled a greater willingness to sanction more senior compliance personnel, particularly well-compensated ones.

Circuits Split on Scope of Dodd-Frank Whistleblower Protection

BY MICHAEL VALERIO

The so-called "whistleblower-protection" provision of the Dodd-Frank Act created a private right of action for a "whistleblower" who is subjected to retaliation by his or her employer. The statute elsewhere defines "whistleblower" to mean an individual who provides information about suspected securities law violations "to the Commission," which implicitly excludes individuals who provide information only to persons *other than* the SEC.

Not surprisingly, therefore, the Fifth Circuit Court of Appeals held, in *Asadi v. G.E. Energy (USA), L.L.C.*, that the plaintiff could not bring an anti-retaliation action against his former employer because the plaintiff admittedly never provided any information to the SEC. In *Berman v. Neo@Ogilvy LLC*, however, a two-one panel in the Second Circuit deferred to the SEC's broader interpretive rule, which extends the whistleblower-protection provision to certain individuals who do *not* qualify as whistleblowers under the statutory definition.

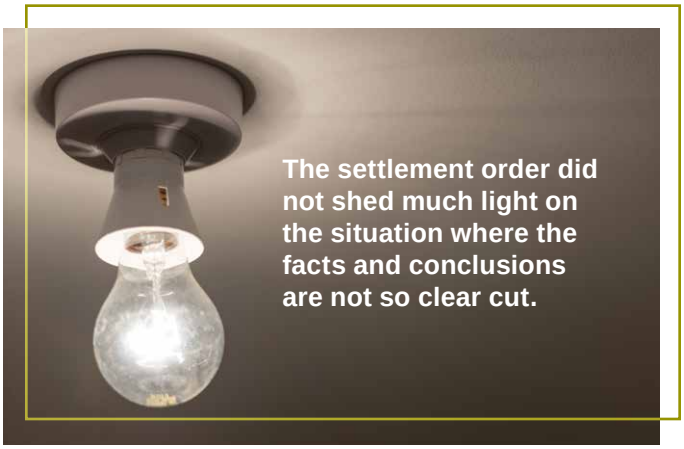
Specifically, based on certain language in a subsection of the whistleblower-protection provision, the SEC posits that employees who engage in disclosure activities protected under the Sarbanes-Oxley Act (SOX) and certain other laws are protected under the Dodd-Frank provision, even if they do not provide any information to the SEC. **This is potentially significant because the Dodd-Frank provision offers enhanced monetary remedies, no administrative exhaustion requirement, and a longer statute of limitations compared to the SOX provision.**

Declining to "definitively construe the statute," the Second Circuit majority instead found that "tension" between the statutory definition and the provision language on which the SEC's interpretation relies created an ambiguity that required *Chevron* deference to the SEC. Dissenting, Judge Jacobs observed that the majority's "alteration" of Dodd-Frank "creates a circuit split, and places us firmly on the wrong side of it." However, the defendants have notified the Second Circuit that they will not be pursuing a petition for Supreme Court review.

SEC Payments "in Guise" Case Resolves Little

BY JOSHUA WIRTH

The SEC has long considered whether mutual funds are making distribution payments "in guise"—*i.e.,* payments primarily intended to result in sales of fund shares but disguised as something else. *See* "Feds Dig for Disguised Fund Distribution Fees" in the Winter 2015 *Expect Focus.* Recently, the Commission brought its first enforcement action addressing this issue.



In September 2015, First Eagle Investment Management Company, LLC and its subsidiary, FEF Distributors, LLC settled SEC charges that they caused mutual funds advised by First Eagle to make illegal distribution payments to intermediaries outside of a Rule 12b-1 plan. The settlement order noted that the agreements pursuant to which the payments were made stated they were "generally for marketing and distribution" and the order did not include any facts to the contrary. According to the order, however, First Eagle characterized the distribution as being for "sub-transfer agent" services, rendering the mutual funds' prospectus disclosures about their distribution payments materially misleading. Sub-transfer agent services are shareholder services that are commonly paid out of fund assets, and not subject to Rule 12b-1.

Although First Eagle agreed to pay disgorgement of nearly $25 million, plus a $12.5 million civil penalty, the order did not shed much light on the dilemmas that can arise in cases where the conclusion is less clear, including (1) how to identify and value that portion of an intermediary's services that are primarily to promote sales, and (2) where the adviser or its affiliate pays for distribution outside the ambit of any Rule 12b-1 plan, how to ensure that those payments are not deemed to be made indirectly by a fund.

FINRA and NASAA Proposals to Protect Vulnerable Customers

BY ANN FURMAN

The Financial Industry Regulatory Authority (FINRA) is seeking comments on proposed rules addressing financial exploitation of (i) seniors (age 65 or older), and (ii) other adults with mental or physical impairments that prevent them from protecting their own interests (collectively, "vulnerable adults").

FINRA's proposal would (i) require member firms to make reasonable efforts to obtain information from their customers for a "trusted contact person" and (ii) permit, but not require, firm supervisory, compliance, or legal personnel to place temporary holds on disbursements from the accounts of vulnerable adults where there is a reasonable belief that financial exploitation is occurring, has been attempted, or will be attempted.

Imposing a temporary hold (15 business days maximum, plus one 15-day extension) would require the firm to immediately initiate an internal review of the facts and circumstances. It would also have to notify certain parties, including the trusted contact person, unless the firm reasonably believes that person is implicated in the exploitation.

The North American Securities Administrators Association, Inc. (NASAA) recently proposed similar model legislation. Among the differences: NASAA's proposal would (i) apply to investment adviser firms, as well as broker-dealers, and (ii) provide for notification of exploitation to be given to adult protective services authorities and to the state securities commissioner, rather than to a trusted contact person.

Both proposals address delaying "disbursements" from a vulnerable adult's "account" held by the firm. This terminology implies how the proposal could be consistent with the Investment Company Act requirement that registered investment companies pay redemption proceeds within seven days. Specifically, redemption proceeds could be paid within that period to the brokerage or advisory account, but held there temporarily in accordance with the proposal.

The language similarly seems to indicate that the proposals would not apply to variable products and mutual funds held directly though the issuer, because they are not held in a brokerage or advisory account.

FINRA Targets Stockbroker's Impermissible Transfer of Client Account Information

BY JO CICCHETTI & JOSHUA WIRTH

FINRA recently settled an action against a registered representative of a broker-dealer for alleged violations regarding the safeguarding and use of private consumer data. The broker accepted and consented to the settlement without admitting or denying FINRA's findings regarding the alleged violations.

The stockbroker was employed by Merrill Lynch for several years. In January 2014, he resigned from his position there to take a job with Edward Jones. Before resigning, he sent an email, titled "Vacation," from his Merrill Lynch account to his personal account, purportedly to conceal the transfer of Merrill Lynch clients' sensitive personal information. He knew this violated Merrill Lynch policy, and his email contained sensitive information regarding numerous Merrill Lynch customers and their accounts.

After starting at Edward Jones, the stockbroker attempted to access the information. Once Merrill Lynch learned of the transfer, it notified Edward Jones, which prohibited its registered representatives from bringing in information regarding their prior firms' customers. Upon receiving this notice, Edward Jones terminated the stockbroker's employment.

FINRA determined that the stockbroker caused Merrill Lynch to violate Regulation S-P and FINRA Rule 2010. Regulation S-P requires that firms establish policies and procedures to protect customer information and records. **FINRA Rule 2010 requires that members observe "high standards of commercial honor and just and equitable principles of trade."** FINRA fined the stockbroker $5,000 and suspended him for 10 business days.

This action should remind broker-dealers and associated persons that:

- Private consumer data compiled by a representative in the course of his employment and stored on a firm's system is subject to the supervision and care of that firm. Representatives have no right to freely transfer this data outside of firm policy.
- Access to clients' private personal information should be restricted to necessary employees.
- Upon receiving notice that an employee is resigning or leaving involuntarily, the employer should immediately restrict and terminate access to any customer information.
- Even if there is no direct pecuniary harm, broker-dealers and representatives can still be sanctioned for having improper policies and procedures.
- A written policy in accordance with Regulation S-P must be implemented and monitored. Having and appropriately enforcing written policies safeguarding information may potentially shield the entity from liability.
- Systems for monitoring and detecting the transfer of consumer information should be set up and reported to management.

This list is not exhaustive, but should serve as a reminder that FINRA, in accordance with the SEC, is adamant about implementing guidance and pursuing violations to better protect consumers from cyber-risks and data breaches.

NCCUSL Approves Uniform Commercial Real Estate Receivership Act

BY R. JEFFREY SMITH

The appointment of a receiver of real property is a common equitable judicial remedy available in all states. It is often sought by a foreclosing mortgagee or others who have, or claim, an interest in the real property. However, few states have comprehensive legislation regarding the appointment and powers of receivers for commercial real estate—case law provides primary guidance.

As a result, states' approaches to the appointment of receivers for commercial real estate vary greatly, not only from state to state, but even within states. Thus, the resolution of central issues, such as the standards for receiver appointment and the scope of a receiver's authority, range wildly from jurisdiction to jurisdiction. Many aspects of a receivership are left to the court's discretion. The inconsistencies among the states are particularly problematic because real estate mortgage loans are frequently secured by properties located in multiple states.

To remedy this, the National Conference of Commissioners on Uniform State Laws (NCCUSL) recently approved the Uniform Commercial Real Estate Receivership Act, and recommended it for enactment in all states.

The Act applies to the receivership for an interest in real property and any personal property related to or used in operating the real property, except that, with certain exceptions, it does not apply to property improved with one to four dwelling units. Also, it does not preempt other state laws that already provide for the appointment of a receiver, or laws providing for the appointment of a governmental unit or its representative as a receiver (such as an insurance commissioner).

Appointment Standards

The Act provides that a court *may* appoint a receiver, before a judgment in favor of the moving party, if the party has an apparent interest in the property and demonstrates that the property is in danger of waste, loss, or similar impairment or may be subject to a voidable transaction. After judgment, the court *may* appoint a receiver to enforce the judgment, or preserve non-exempt property pending appeal or during the post-foreclosure redemption period (for those states with such a right in favor of the mortgagor). In addition, the Act contains alternative provisions regarding a receiver's appointment in conjunction with a foreclosure when the mortgagor has consented, either before or after a default, in writing to such an appointment, or where the mortgagee demonstrates waste, loss or similar impairment. One alternative provides that such appointment is a matter of right, while the other makes such appointment permissive. Note that the Uniform Assignment of Rents Act, promulgated in 2005 by NCCUSL, provides that, if the mortgagor has consented to the appointment of a receiver, either before or after default, a mortgagee is entitled to the appointment of a receiver as a matter of right.

Appointment = Stay

The Act provides that, similar to a bankruptcy filing, the appointment of a receiver operates as a stay of any action or proceeding to obtain possession or control over receivership property, or enforce a lien securing a pre-appointment claim against the property owner.

Certain exceptions are provided, including enforcement of a mortgage by the person seeking the receiver's appointment, commencement or continuation of criminal proceedings, enforcement of non-monetary judgments by a governmental unit in furtherance of its police or regulatory powers, and actions to perfect or maintain the perfection of a security interest in the receivership property. Sanctions may be imposed for violating the stay, including civil contempt, an award of damages, and voiding of the prohibited action.

Powers of Receiver

One of the Act's most important features concerns the receiver's powers. **Unless ordered otherwise, the receiver may operate the business of the receivership property in the ordinary course**, including incurring unsecured debt, paying expenses, and asserting claims and other rights as to receivership property.

With court approval, the receiver may incur debt and operate the receivership property out of the ordinary course and make improvements to receivership property. Also with court approval, the receiver may sell, license, lease, or otherwise dispose of receivership property out of the ordinary course. In the case of a sale, the receivership property is sold free and clear of the lien of the party that obtained the receiver, any subordinate liens and any right of redemption, unless the sale agreement provides otherwise (liens senior to the lien of the moving party remain in place).

The liens on the receivership property that are extinguished attach to the proceeds of the sale with the same priority they had on the sold property. This provides a viable alternative to foreclosure for the mortgagee that sought the receivership, and is intended to achieve a greater sales price than is usually produced by a distressed foreclosure sale. It also provides greater flexibility for real estate mortgage investment conduits (REMICs) in commercial mortgage-backed securities transactions, as such sales can be structured to include an assumption and modification of the REMIC-held mortgage.

Receivers are also permitted to adopt or reject executory contracts, including unexpired leases, of the owner of the receivership property. Certain types of executory contracts are excluded, however. For example, a lease under which the tenant occupies the leased premises as its primary residence may not be rejected. The Act recognizes the enforceability of non-disturbance agreements, and prescribes the rights and claims that a party to an executory contract may assert due to a rejection.

Other Provisions

The Act also addresses such issues as the powers of the court, commencement of ancillary receivership proceedings in another jurisdiction, disqualification of a potential receiver, the posting of the receiver's bond, the receiver's engagement and compensation of professionals, and the obligation of parties to turn over receivership property and cooperate with the receiver. It sets forth a receiver's defenses and immunities, the receiver's periodic (and final) reporting obligations, and standards with respect to the removal and replacement of a receiver and the termination of the receivership and receiver discharge. The Act also expressly provides that seeking a receivership is not an election of remedies by the mortgagee, a receivership does not make the mortgagee a mortgagee in possession, and the appointment of the receiver is not an "action" for purposes of a state's "one-action" laws.

A copy of the Act, including the Prefatory Note and Comments, may be found at uniformlaws.org.

Avoiding the Bull's-Eye

BY LINDA FLEMING

The federal government collected over $200 million from three settlements based on health care fraud and abuse allegations this past September. This staggering amount excludes fees paid to attorneys, consultants and expert witnesses, and the value of lost executive and staff time spent investigating and defending these claims. To avoid becoming the next target, hospitals and health systems should consider developing best practices regarding physician compensation.

Develop a Risk Profile. Fraud and abuse laws comprise a dull rainbow of some black, much gray, and a little white. Providers should always avoid the black: Never base physician compensation on the volume or value of referrals. Risk tolerance factors into the gray area. Providers should develop a policy for physician compensation setting forth the acceptable compensation range and outlining factors to consider when setting physician compensation.

Assemble a Trusted Physician Compensation Team. This should include staff members and outside professionals. The chief medical officer, a medical staff representative, and a human resource officer know the market and can help determine need and comparable compensation packages in your area. Round out the team with an experienced health care attorney and a valuation expert. Together, the team can craft physician recruitment strategies, physician employment and recruitment agreements, and medical director agreements, and test all arrangements for fair market value.

Use Attorneys and Consultants Thoughtfully. Providers asking an attorney for a legal opinion should be prepared to accept the attorney's conclusion and act accordingly. Obtaining a second opinion after receiving an unfavorable one creates an easy-to-follow paper trail for whistleblowers and regulators. Conflicting legal opinions may confirm suspicions that an organization knew the risks but proceeded anyway.

Empower the Corporate Compliance Team. Complaints regarding physician arrangements should be taken seriously by investigating and then by engaging the physician compensation team. As recent settlements show, nearly anyone can be a whistleblower and there are significant financial rewards for those who succeed. *See* "Record Mega-Settlements May Attract More Whistleblowers" in this issue of *Expect Focus*.

Compliance with the myriad laws, rules, and regulations regarding physician compensation has never been more difficult. As the government's focus on health care becomes sharper, the potential for astronomical penalties to providers continues to grow, as does the temptation for potential whistleblowers. Hospital and health systems should consider what physician compensation best practices to employ to minimize the risk of finding themselves in the bull's-eye.

Could Your Medical Device Be a Hacker's Gateway into a Hospital Network?

BY ERICA MALLON

This has been a big year for health care data breaches. In January, the data of 80 million Anthem members was compromised; in March, a cyberattack exposed the data of 11.2 million Premera BlueCross BlueShield members and business affiliates; and in May, the data of 1.1 million CareFirst BlueCross BlueShield members met the same fate. Hackers' methods of accessing health care networks are becoming more creative, and include infiltration through medical devices.

Six years ago, for the first time, the number of "things" connected to the Internet surpassed the number of people, according to a January 2015 Federal Trade Commission report, "Internet of Things: Privacy & Security in a Connected World." Experts estimate that by the end of 2015, there will be 25 billion connected devices—and that by 2020, there will be 50 billion. While these devices can significantly improve the lives and health of consumers worldwide, they also pose sizable risks.

Hospital networks are prime targets for hackers because many contain vast amounts of highly personalized and confidential data, and **hackers have developed new methods of breaching hospital networks through hospital patients' medical devices.** In June 2015, TrapX, a firm specializing in deception-based cybersecurity defense, released a report that found attackers targeted and compromised radiology picture archive and communications systems and blood gas analyzers to gain access to the hospital networks. The TrapX report even suggested that an attacker could remotely hack a hospital drug pump and modify the amount of medication to a fatal dose.

Both the Food and Drug Administration and the FTC have provided guidance on cybersecurity in medical devices. In late 2014, the FDA issued final guidance calling for manufacturers to consider cybersecurity risks in designing and developing medical devices. Shortly thereafter, the FTC issued guidance on best practices for privacy and security protection, including guidance on the design, deployment, and management of medical devices.

Everyone involved in the development and maintenance of medical devices must be aware of the applicable cybersecurity risks, and take appropriate safeguards to ensure patient safety and privacy. These include the device developers, the providers who maintain them, and the consumers who use them. Compliance with the non-mandatory guidance and best practices issued by the FTC and FDA offer a good starting point.

Record Mega-Settlements May Attract More Whistleblowers

BY RADHA BACHMAN

September was a record-setting month for the United States Department of Justice, which entered into major health care fraud settlements with two large Florida-based hospital systems. The settlements were made in the face of two whistleblower lawsuits filed against the North Broward Hospital District (NBHD) and Adventist Health System (AHS), alleging violations of the Stark Law, the Anti-Kickback Statute, and the Federal False Claims Act.

Under the Stark Law and the Anti-Kickback Statue, it is illegal for health care providers and physicians to knowingly accept bribes or other forms of compensation in return for making referrals that result in bills to federal health care programs, such as Medicare, Medicaid, and TRICARE. The federal health care regulatory scheme was implemented to protect patients and the Medicare trust fund from corrupt decision-making by health care providers. Likewise, the Federal False Claims Act provides a mechanism for private citizens to file lawsuits, on behalf of the government, against entities they believe are defrauding the government. Whistleblowers under the False Claims Act could be entitled to up to 25 percent of recoveries.

The complaint against NBHD, filed by a Fort Lauderdale-based orthopedic surgeon, claimed that NBHD violated the Stark Law by overcompensating its physicians in exchange for the physicians' referrals to its health care facilities. The complaint alleged NBHD kept detailed records of money paid to physicians and amounts generated from the same physicians' referrals by way of "margin reports," and that physicians in deficit were pressured to increase referrals. The physician who filed the NBHD whistleblower suit is reported to have received an estimated $12 million from the settlement.

The first AHS complaint was filed by three former longtime employees of the organization, and alleged that AHS paid improper bonuses to physicians for referring patients to AHS facilities in Florida, North Carolina, Tennessee, and Texas. A second whistleblower suit was filed by a former AHS vice president. Additionally, AHS was accused of using improper coding modifiers for services billed to the Medicare program. These alleged acts, if proven, would constitute violations of the Stark Law and the False Claims Act. The complaints set forth specific examples of alleged violations including that AHS had leased, on behalf of one physician, a BMW and a Mustang and had paid total compensation exceeding $700,000 to a dermatologist who only worked three days a week. The amount of the whistleblowers' rewards in the AHS settlement have not yet been determined.

The $118.7 million AHS settlement, announced on September 21, is the largest health care fraud settlement ever made involving physicians' referrals to hospitals. NBHD's settlement, announced on September 15, was a close second at $69.5 million.

The fact that neither of these cases was litigated seems to suggest the federal government is able to locate "insider" whistleblowers with firsthand information and reliable evidence of fraud. As would-be whistleblowers become aware of the potential financial upside of rooting out potential fraud in their organizations, there will likely be an uptick in cases brought and settlements made. For hospitals and health care systems, now is the time to ensure compliance programs are functioning at a high level.

For Whom the Contractual Suit Limitation Period Tolls

BY JOHN PITBLADO

Virginia's Supreme Court recently addressed an issue of statutory interpretation that affects whether or under what circumstances a contractual suit limitation provision in an insurance policy may be tolled. In *Allstate Prop. and Cas. Ins. Co. v. Ploutis*, the court reviewed an insurance coverage action filed against a homeowner's carrier by a homeowner whose home and certain contents were damaged after water pipes burst on March 19, 2010. While the insurer provided an initial payment, the parties could not agree on the cost of remaining repairs. The homeowner ultimately filed suit on March 16, 2012, alleging breach of contract. For reasons not discussed in the opinion, "[u]pon the request of [the plaintiff homeowner], an order of nonsuit was entered on February 22, 2013." The plaintiff homeowner then re-filed the action on August 21, 2013, more than two years after the loss.

The trial court entered an addendum to the order of nonsuit providing that "the current action is 'merely an abatement of the original action, and the second filing is a reinstatement of the original action'" and thus, "'the present action is still the original action brought within the two year [contractual] limitation period.'" This referred to the subject insurance policy's contractual suit limitation provision, which is typically standard in a fire policy.

In fact, the court noted that a Virginia statute requires certain standard language in all fire policies, including a provision that "no suit or action on this policy for the recovery of any claim shall be sustainable in any court of law or equity … unless commenced within two years next after inception of the loss." The policy at issue contained a similar, but not identical, provision, stating that "no one may bring an action against us in any way related to the existence or amount of coverage … unless … the action is commenced within two years after the inception of loss or damage."

The court also noted that another Virginia statute provides, "if a plaintiff suffers a voluntary nonsuit … *the statute of limitations* with respect to such action shall be tolled by the commencement of the nonsuited action, and the plaintiff may recommence his action within six months." Relying on this statute, the homeowner argued, and the trial court agreed, that the policy's suit limitation provision—which was mandated by statute—was therefore tolled.

> **A contractual suit limitation provision is not a "statute of limitations" and neither is the code section mandating that all fire policies contain such a provision.**

The Virginia Supreme Court reversed in favor of the insurer, finding that while the "statute of limitations" may have been tolled—in this case, the five-year statute of limitations for bringing an action on a contract—nevertheless, a contractual suit limitation provision is not a "statute of limitations" and neither is the code section mandating that all fire policies contain such a provision. Thus, because the new suit was brought more than two years after inception of the loss, the high court held that the action was barred by the terms of the parties' contract, and reversed and entered judgment in favor of the defendant insurer.

To Stay or Not to Stay … That Is the Question

BY JEFFREY MICHAEL COHEN

In the insurance arena, courts are often confronted with simultaneous lawsuits involving the same, or almost the same, parties. In the "underlying case" a claimant seeks damages from an insured defendant. Simultaneously, the insured, the insurer, and often the damage case's claimant, are litigating a "coverage case" to obtain a declaratory judgment regarding the insurer's obligation to defend or indemnify the insured in the underlying case. In *Homeowners Property & Cas. Ins. Co. v. Hurchalla*, the court had to determine whether to stay the coverage case until the underlying case was resolved or allow the two cases to proceed simultaneously.The trial court stayed the coverage case; however, that decision was reversed by the appellate court.

In the underlying case, Lake Point, a property developer, sued Hurchalla for damages and an injunction alleging that she defamed the developer by making false statements that induced Martin County and others to void their contracts with the developer. Homeowners, Hurchalla's liability insurer, originally defended under a reservation of rights but later withdrew the defense and sued for a judgment declaring that Homeowners did not provide coverage for the underlying case.

Hurchalla moved to "abate" the coverage case until the underlying case was resolved. She argued that litigating the coverage case would prejudice her defense in the underlying case and force her to disclose her strategies to the developer. Homeowners opposed abatement arguing that the two lawsuits were mutually exclusive and that resolution of the coverage issues would facilitate resolution of the underlying case. The trial court abated the coverage case.

The district court of appeal granted certiorari and quashed the order, holding that it departed from the essential requirements of law.

The court discussed the distinction between a "stay" and an "abatement" of the underlying case. **Abatement requires "complete identity" of parties and causes of action. A stay requires "substantial similarity."** The propriety of abatement can be determined as a matter of law, but a stay is reviewed for abuse of discretion because it merely postpones the litigation. Conversely, abatement terminates one of the lawsuits because the suits are identical. So, the appellate court treated the order as a stay rather than abatement.

The court held that in evaluating stay of a coverage case pending resolution of the underlying case, three factors should be considered:

1. whether the two actions are mutually exclusive;

2. whether a decision on the indemnity issue will promote settlement of the underlying case and avoid collusion between the claimant and the insured to create coverage; and

3. whether the insured has independent resources so that the coverage issue would be immaterial to the claimant.

In *Hurchalla*, the court determined that denying a stay was an abuse of discretion, even though there was no evidence regarding Hurchalla's independent resources. A stay was indicated because the underlying case and the coverage case were mutually exclusive; the coverage issues related to Hurchalla's contention that Homeowners was estopped to deny coverage. Moreover, following the criteria set forth by the Florida Supreme Court in *Higgins v. State Farm Fire & Cas. Co.*,the court held that a determination regarding the insurer's duty to defend and indemnify its insured was likely to promote a settlement of the underlying case while reducing the potential for collusion between the claimant and the insured to create coverage where none exists. The court also discounted Hurchalla's contention that discovery in the coverage case would prejudice her defense in the underlying case because she retained the right to object to discovery that would reveal her defense strategies.

Consumer Bankers Association, Chamber of Commerce Join Challenge to FCC TCPA Ruling

BY ELIZABETH BOHN

The Consumer Bankers Association (CBA) and United States Chamber of Commerce (USCC) have joined the legal challenge to the Federal Communications Commission's July declaratory ruling and order. The Order responded to 21 petitions seeking clarification of or exemptions from Telephone Consumer Protection Act (TCPA) provisions relating to automatic telephone dialing systems, prior express consent, revocation of consent, reaching wrong numbers, and others. The FCC is authorized to issue implementing regulations and interpret the TCPA, which strictly regulates telemarketing calls, faxed advertisements, and calls (or text messages) to cell phones.

Calls and texts to cell phones using automatic telephone dialing systems (ATDS) or prerecorded voice messages are prohibited absent the "prior express consent" from the "called party." The statute provides for strict liability, and statutory damages of between $500 and $1,500 per call, text, or fax. The credit and collection industries, early adopters of predictive dialing equipment able to connect live representatives to called parties, have been targeted by TCPA plaintiffs' class action attorneys for several years. As other industries increasingly utilize technology to increase efficiency in group communications, the number of multimillion dollar class actions settlements and industries targeted have greatly expanded.

The Order increases the risk for business utilizing automated communications technology, now standard in many industries.

The Order increases the risk for businesses utilizing automated communications technology, now standard in many industries. First, the FCC denied a request to interpret the word "capacity" used in the TCPA's definition of an ATDS as meaning "present" capacity, ruling instead that the term includes equipment that generally has the capacity (to store or produce, and dial, random or sequential numbers), even if not presently used or capable of being used for that purpose. Thus "capacity" includes "potential ability," according to the FCC.

Businesses have also relied on prior express consent to call a number provided by a consumer to the business as a contact number, for example in a credit application, previously found by the FCC sufficient to establish consent. But in the Order, the FCC ruled that consumers can revoke consent "at any time and through any reasonable means," and, that callers "may not limit the manner in which revocation may occur," denying an industry request for permission to set procedures for revocation of consent.

These findings by the FCC are among those being challenged by ACA International, a trade association of credit and collection professionals; CBA, which represents the retail banking industry; the USCC and several other industry members. The petitions have been consolidated into a single case before the D.C. Court of Appeals for determination.

Federal Agencies File Action Against Bank for Discriminatory Redlining

BY TENIKKA L. JONES

The Consumer Financial Protection Bureau (CFPB) and the U.S. Department of Justice filed a complaint in New Jersey District Court against Hudson City Savings Bank, F.S.B., alleging it engaged in illegal redlining practices between 2009 and 2013. The agencies claim the Bank violated the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA) by engaging in a pattern or practice of unlawful, discriminatory redlining designed to avoid the credit needs of residents in majority black and Hispanic neighborhoods in New York, New Jersey, Connecticut, and Pennsylvania.

According to the complaint, the Bank "plac[ed] its branches and loan officers principally outside of majority black and Hispanic neighborhoods, exclud[ed] many majority Black and Hispanic neighborhoods from its Community Reinvestment Act [CRA] assessment area and one of its low-to-moderate income loan programs, select[ed] mortgage brokers that are mostly located outside of, and do not effectively serve, majority Black and Hispanic neighborhoods, and focus[ed] its limited marketing in neighborhoods with relatively few Black and Hispanic residents." The Bank also allegedly "failed to exercise adequate oversight or hire sufficient staff to ensure compliance with its fair lending obligations," had no "written policies or procedures to monitor for [fair lending] compliance," and its fair lending policy "consisted only of a statement asserting that it is an equal opportunity lender."

The Consent Order submitted for approval will require the Bank to provide $25 million in direct loan subsidies, invest over $1 million in targeted outreach and consumer education, and $750,000 on partnerships with community-based or governmental organizations, in

addition to imposing a $5.5 million civil penalty. **According to the CFPB, if approved, the Order will represent the largest redlining settlement in history to provide direct loan subsidies to qualified borrowers in affected neighborhoods.** Other obligations imposed on the Bank under the Order include using an independent consultant to monitor fair lending compliance; hiring/designating a fair lending officer; expanding CRA assessment areas; assessing and addressing the credit needs of majority black and Hispanic neighborhoods in the affected communities; and opening additional branches within the affected communities.

Institutions regulated by the CFPB should ensure fair lending policies and practices comply with, and provide continued training and education on, fair lending obligations. They should also monitor their own institutions and third-party service providers to ensure discriminatory redlining is not occurring.

The More the Merrier: Court Rejects Waiver Argument, Enforces Arbitration Clause in Consumer Contract

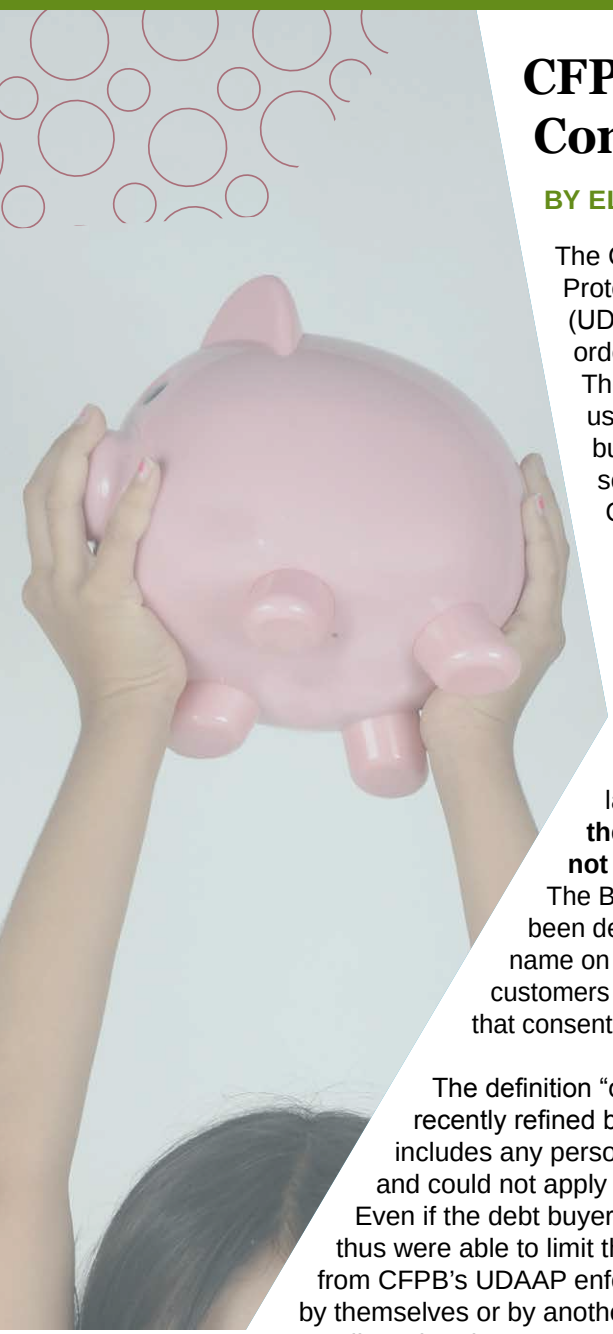
BY JULIANNA THOMAS MCCABE

A federal district court in Oklahoma recently rejected a defaulting borrower's attempt to argue that her lender's pursuit of foreclosure litigation waived the lender's right to insist on arbitration of the borrower's counterclaims, and also compelled arbitration of the borrower's third party claims against a lender-placed insurer, even though the insurer was not a signatory to the arbitration agreement.

After her mortgage lender initiated a foreclosure proceeding in an Oklahoma state court, the borrower in *Beneficial Financial I Inc. v. Cravens* removed the action to federal court and asserted a variety of counterclaims against the lender related to the servicing of the mortgage. She also filed a third party claim against the insurance company that had issued lender-placed insurance ("LPI") to protect the mortgaged property after the borrower allowed her homeowner's insurance policy to lapse, claiming that the insurance was unnecessary, excessively expensive, and accelerated her inability to bring the delinquent mortgage loan current, the borrower demanded substantial compensatory and extra-contractual damages as well as the total release of her loan obligation.

The lender and insurer jointly moved to compel arbitration pursuant to an arbitration clause in her loan agreement, which pre-dated the CFPB regulation banning arbitration provisions in home mortgage loans. The Court rejected the borrower's argument that her lender waived the right to compel arbitration by initially refusing to arbitrate the foreclosure dispute, and by filing the state court foreclosure action, finding that first, the arbitration rider included a carve-out for foreclosure actions and, thus, the filing of a foreclosure action was not inconsistent with the agreement. Additionally, although the court agreed that the loan servicer's initial refusal to arbitrate was inconsistent with its subsequent arbitration demand, it found that action insufficient to constitute a waiver. Given the strong federal policy in favor of arbitration, action inconsistent with the right to arbitrate is just one factor in making a waiver determination, and because other factors to establish a waiver were largely absent, the court found there was no waiver as a matter of law.

Although the LPI insurer was not a signatory to the loan agreement or arbitration clause, the court also granted the insurer's motion to compel arbitration under an equitable estoppel theory. Equitable estoppel can be used by a non-signatory to compel arbitration where the contracting party's claims against the non-signatory are related to the agreement that includes the arbitration clause, and where the claims allege interdependent or concerted conduct between the non-signatory and a signatory. Use of equitable estoppel to compel arbitration should be considered whenever a co-defendant's contract includes an arbitration clause.



CFPB Continues to Focus on Reforming Consumer Collection Practices

BY ELLEN LYONS

The CFPB has authority to enforce violations of the Consumer Financial Protection Act's prohibition on unfair, deceptive, and/or abusive practices (UDAAP). UDAAP violations have figured prominently in multiple enforcement orders covering what the CFPB deems "deceptive" debt collection practices. The magnitude of the penalties imposed demonstrates that the CFPB is using UDAAP enforcement actions to try to reform industry practices. Thus, businesses engaged in collection of consumer debt face mounting regulatory scrutiny in addition to existing civil litigation challenges under the Fair Debt Collection Practices Act (FDCPA).

In a recent enforcement action, the CFPB ordered the United States' two largest debt buyers to overhaul their "deceptive debt collection practices" and, collectively, pay $61 million in refunds, stop collecting $128 million, and pay $11 million in civil penalties. Among other things, the CFPB found that the debt buyers had knowingly purchased "approximate" debt from creditors where the current balances had not been confirmed, and then misrepresented their intention to prove the debts, by suing with "robo-signed" lawsuits that did not provide proof of the amounts owed. **In some instances, the debt buyers advised borrowers that they had to prove that the debt was not owed or that an attorney had reviewed the debt and a suit was imminent.** The Bureau found each of these practices deceptive. Other practices that have been deemed deceptive by the CFPB in recent orders include phone calls with a fake name on caller ID, false threats to immediately repossess collateral, and misleading customers into consenting to auto-dialer technology by making false misrepresentations that consenting to the auto-dialer is the only way to prevent early morning cell phone calls.

The definition "debt collector" under the Fair Debt Collection Practices Act (FDCPA) was recently refined by the Eleventh Circuit in Davidson v. Capital One to make it clear that it includes any person who regularly collects or attempts to collect debts owed or due to another and could not apply to a bank that collected debts bought from another, but owned by the bank. Even if the debt buyers sanctioned by the CFPB had collected only their own, owned-debts, and thus were able to limit their FDCPA civil liability, such a distinction did not protect the debt buyers from CFPB's UDAAP enforcement capabilities. Thus, businesses that collect debts – whether owned by themselves or by another – should carefully consider the CFPB's reach and the guidance provided regarding what the CFPB considers deceptive practices.

Furnisher Duties of Accuracy Under the Fair Credit Reporting Act

BY FENTRICE DRISKELL

The stated purpose of the Fair Credit Reporting Act (FCRA) 15 U.S.C. §§ 1681, et seq., is to require consumer reporting agencies (CRAs) to adopt reasonable procedures to meet the needs for consumer credit, personnel, insurance, and other information in a manner that is "fair and equitable" to the consumer with respect to the "confidentiality, accuracy, relevancy, and proper utilization" of such information. The FCRA protects both the privacy of consumer information and sets restrictions not only on CRAs, but also on furnishers and users of reported information to ensure such information is as accurate as possible.

The FCRA thus requires furnishers to report accurate and complete information to CRAs. More specifically, furnishers are prohibited from reporting information relating to a consumer that is known to be inaccurate, or that the furnisher has reasonable cause to believe is inaccurate. Nonetheless, furnishers who clearly and conspicuously provide an address for consumers to give notice of inaccuracies are exempt from this prohibition, unless the consumer has provided notice that information is inaccurate. And while the FCRA does not obligate furnishers to provide an address for the consumer to

notify it of inaccuracies in reported data, furnishers who do so cannot be held liable for inaccuracies in reported information if the consumer fails to notify the furnisher of the inaccuracies. Furnishers who regularly report information to CRAs about transactions with consumers also have an affirmative duty to notify the agencies of information the furnisher later determines is incomplete or inaccurate.

The duty of accuracy also extends to circumstances where a consumer disputes information. The FCRA expressly prohibits reporting disputed information unless the furnisher also reports that the information is disputed. Therefore, furnishers should promptly notify CRAs when a consumer disputes the completeness or accuracy of reported information. The willful failure to do so may subject a furnisher to any actual damages sustained by the consumer, or damages between $100 and $1,000, punitive damages as allowed by the court, reasonable attorney's fees, and court costs.

To help mitigate the risk of exposure to potential violations, furnishers of information should establish policies and procedures to insure compliance with FCRA duties, and should give consumers an address to use to dispute inaccuracies.

CFPB Proposes Banning Use of Pre-Dispute Arbitration Agreements in Consumer Class Actions

BY ELIZABETH BOHN

The CFPB has proposed prohibiting application of pre-dispute arbitration agreements to class litigation involving certain consumer financial products. Citing concerns that such agreements "effectively prohibit" class litigation and prevent consumers from obtaining remedies for harm caused by providers of consumer financial products or services, the proposal would apply to most products subject to Bureau oversight.

Dodd-Frank prohibited arbitration agreements in home mortgages, and authorized the Bureau to regulate the use of arbitration clauses in other consumer financial products, if it found based upon study that doing so would protect consumers and serve the public interest, and if any proposed rule included findings consistent with study results.

In March, the CFPB released the results of a three-year study of pre-dispute arbitration agreements, concluding that such agreements restricted consumer relief in disputes with financial service providers by limiting class actions. Specifically, the Bureau reported that arbitration agreements could be used to move class action lawsuits to arbitration, and typically prohibited class arbitration, thus blocking any form of class-wide relief for such claims. The study, which is available at consumerfinance.gov, focused on credit cards, prepaid cards, and deposit accounts, and excluded cases involving investors, securities, brokerage accounts, or investor services. Insurance cases not involving an add-on to a consumer financial product such as title or credit card insurance were also excluded.

The Bureau's proposal would prohibit inclusion of arbitration clauses that block class action claims in contracts with consumers for credit cards, checking and deposit accounts, prepaid cards, money transfer services, certain auto loans, auto title loans, small dollar or payday loans, private student loans, and installment loans. More specifically, any arbitration agreement in a contract for one of these products would be required to explicitly state that it is inapplicable to cases filed in court on behalf of a class unless and until class certification is denied or the class claims are dismissed.

The Bureau also proposed to require companies that choose to arbitrate individual disputes to submit arbitration claims and awards issued to the CFPB. Specifically, covered entities that use arbitration agreements in their contracts with consumers would be required to submit initial claim filings and written awards in consumer finance arbitration proceedings to the Bureau through a process it expects to establish as part of the rulemaking. It is also considering whether to publish the claims or awards to its website and make them available to the public.

Mortgage Servicing Complaints to CFPB Remain High

BY ELIZABETH BOHN

The CFPB's September "consumer complaints snapshot" highlighted mortgage servicing complaints, in particular those related to loss mitigation applications. As the mortgage market is the largest consumer financial market place in the United States it is not surprising that the CFPB reported that it has received more complaints concerning mortgages than about any other consumer financial product since it first began accepting consumer complaints in 2011.

The majority of mortgage servicing complaints discussed in the September 22 snapshot were from consumers unable to make mortgage payments; these include complaints alleging delays and lack of information in applying for loan modification, and that servicers moved forward with foreclosure while modification applications were still under review. Consumers also complained that companies did not accept payments of anything less than the full balance owed, and that payments were not credited in accordance with consumer instructions.

Complaints about servicing transfers also remain high according to the report, with consumers complaining of not being properly informed about the date of transfers, confused about where to make payments after transfers, and, that payments increased unexpectedly after transfer. The new loan estimate form under the Bureau's TILA-RESPA Integrated Disclosure Rule rule, required to be used as of October 3, includes a disclosure as to the lender's intent to retain or transfer servicing, and replaces the initial servicing disclosure statement previously required by RESPA regulation 1024.33(a) for first lien home mortgages. Section 1024.33(b) of the servicing transfer regulation also requires written notices of servicing transfers of most federally-related mortgage loans be given not less than 15 days of a transfer.

Issues relating to servicing transfers have been high on the Bureau's radar since before 2013, when it issued, together with state attorneys general, an enforcement order requiring the nation's largest third-party mortgage servicer to provide $2 billion in principal reductions and issue $125 million in refunds based on post-transfer servicing practices including improper denial of loss mitigation applications which it found to constitute unfair and deceptive or abusive practices. Last October, the Bureau published a Compliance Bulletin/Policy Guidance on Servicing Transfers (Bulletin 2014-1), citing to practices included in the 2013 order, expressing heightened concern about transfer-related risks to consumers, advising that servicers may be required to submit plans for managing transfer-related consumer risks, and stating that it will continue monitoring the mortgage servicing market with further rulemaking and enforcement orders possible.

Bitcoin: Currency, Property, and Now, Commodity

BY EDMUND ZAHAREWICZ & MATTHEW KOHEN

In September 2015, the Commodity Futures Trading Commission (CFTC) issued an order filing and settling charges against a cryptocurrency company for conducting commodity options-related activity without complying with applicable regulations. The order finds that Coinflip, Inc., a San Francisco-based company, operated Derivabit, an online exchange offering to connect buyers and sellers of bitcoin option contracts, without maintaining the appropriate registrations. Although the ruling may not be particularly profound, it likely puts to rest the uncertainty over how bitcoins themselves (or any other virtual currency) should be classified under the Commodities Exchange Act (CEA) for regulatory purposes.

The order defines "virtual currencies" as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction" and confirms that all virtual currencies, at least insofar as they fall within that definition, are classified as commodities under the CEA. Based on this classification, the CFTC enforced certain CEA provisions and other regulations against Derivabit in the same manner as it would enforce those rules against an exchange dealing in run-of-the-mill commodity options or swaps.

The CFTC's order could have sweeping effects on the trade and use of virtual currencies. Under rules adopted by the CFTC pursuant to Dodd-Frank, it is unlawful for any person in connection with any "contract of sale of any commodity" to engage in fraud or manipulative behavior, regardless of whether such activities have a nexus to a commodities-based derivatives market. By classifying virtual currencies as commodities, the CFTC is thus allowing for the possibility that it could assert its anti-fraud authority over virtual currency transactions in the cash market, such as transactions on a bitcoin exchange, even where the transactions have no plausible connection to a derivatives market. The order also leaves open the possibility that the CFTC could attempt to assert its anti-fraud authority over 'blockchain 2.0' applications, which require the transmission of nominal amounts of virtual currency to facilitate a non-monetary goal, such as the creation and enforcement of a smart contract. It remains to seen, however, just how far the CFTC may seek to use its anti-fraud authority, if at all, to police users of virtual currencies.

By classifying virtual currencies as commodities, the CFTC is thus allowing for the possibility that it could assert its anti-fraud authority over virtual currency transactions in the cash market.

Although the future legal treatment of virtual currencies is ultimately unknown, one thing is certain: as virtual currency technology continues to develop at breakneck pace, virtual currency innovators must keep abreast of the rapidly developing legal landscape.

NIST IoT Framework Raises Interesting Cybersecurity and Data Privacy Challenges

BY: JOSEPHINE CICCHETTI & MATTHEW KOHEN

The National Institute of Standards and Technology (NIST) released the draft Framework for Cyber-Physical Systems, which is intended to provide an outline for the development and maintenance of secure, interoperable Internet of things (IoT) devices, also referred to as "CPS" devices. The Framework is designed to provide a common foundation for IoT applications across multiple industries, such as manufacturing, transportation, energy, and health care.

Today's IoT continues to grow, and now includes devices such as smart cars, residential HVAC systems, and wearable devices. The comprehensive Framework addresses a variety of challenges, some of which may forecast potential legal concerns for IoT stakeholders.

The Framework addresses the cybersecurity and privacy challenges that are inherent in all interconnected, data-driven systems. Because IoT devices connect cyberspace with the physical world, the Framework recognizes that "the mechanisms used to address IT challenges may not be viable in the world of CPS." The Framework further notes that the IoT presents significant privacy challenges.

NIST's insights are telling of the coming legal and regulatory challenges that IoT companies may face. **Because of the way IoT devices allow individuals to interact with the physical world, a "privacy violation can be quite different from that of an information privacy violation," such as a data breach.** Companies that are trailblazing a path through this budding industry need to be cognizant of laws and regulations that affect physical—rather than purely digital—privacy concerns.

In addition to new physical privacy concerns, IoT companies face increased exposure from typical cybersecurity risks. IoT data is "often collected for the sake of the management of the system, not for any user-driven purpose." Designers must consider what gains may be had in collecting and maintaining certain data versus the risks and compliance costs associated with that data collection.

Companies pioneering IoT development should be mindful of all privacy and cybersecurity risks associated with the interconnection of cyberspace and the physical world. As the industry develops, companies will need to employ cutting-edge legal and compliance strategies to go along with their cutting-edge CPS products.

"Let's [Not] Go Crazy" with Copyright Takedown Notifications

BY DIANE DUHAIME

Stephanie Lenz posted a short home video on YouTube in February 2007 of her two young children dancing to a barely audible recording of the Prince song "Let's Go Crazy." In June of the same year, YouTube received a takedown notice from Universal Music Corp. The notice complied with the Digital Millennium Copyright Act (DMCA) and included the statement "[w]e have a good faith belief that the [use of 'Let's Go Crazy'] is not authorized by the copyright owner, its agent, or the law." After obtaining pro bono counsel, Stephanie Lenz filed a lawsuit the following month against Universal which claimed, *inter alia*, Universal violated the DMCA by misrepresenting that Lenz's use of a portion of Prince's song constituted copyright infringement. The DMCA requires that the copyright holder consider whether another's use of their copyrighted work is authorized by law or by the copyright owner's permission. The DMCA further provides that any person who knowingly materially misrepresents that material or activity is infringing, shall be liable for any damages, including costs and attorneys' fees, incurred as the result of the service provider relying upon such misrepresentation.

Lenz argued that prior to sending the takedown notification, Universal did not first consider whether her use of the copyrighted song constituted fair use (i.e., whether her use was authorized under the law as contemplated by the DMCA). Universal argued that fair use is not a use authorized under the law, but rather is an affirmative defense to copyright infringement.

On September 14, 2015, the Ninth Circuit affirmed the district court's denial of the parties' cross motions for summary judgment, affirming the district court's holding that copyright owners must consider fair use before issuing DMCA takedown notices.

The holding in *Lenz v. Universal Music Corp.* sends a clear message to copyright owners regarding unauthorized uses of the copyright owner's work: **before sending a DMCA takedown notice, make a good faith determination that the unauthorized user does not have a valid fair use defense under the Copyright Act**. Interestingly, the Ninth Circuit stated that the "formation of a subjective good faith belief does not require investigation of the allegedly infringing content" and the court is "in no position to dispute the copyright holder's belief even if [the court] would have reached the opposite conclusion."

In the *BTI Litigation Outlook 2016* report, corporate counsel rank Carlton Fields Jorden Burt in the top 5 percent of all law firms for Complex Employment Litigation. They also included the firm on an "Honor Roll" for its class action and torts work.

Carlton Fields Jorden Burt is a recipient of the *Daily Business Review's* 2015 "Litigation Department of the Year" award for mid-sized law firms. The award recognizes the accomplishments of Florida-based litigators in 2014.

For the seventh consecutive year Carlton Fields Jorden Burt received a perfect score on the Human Rights Campaign 2016 Corporate Equality Index, and was named among the "Best Places to Work for LGBT Equality." Carlton Fields Jorden Burt is one of 95 law firms in the country that scored 100 percent.

Carlton Fields Jorden Burt received five national first-tier rankings in the 2016 *U.S. News and World Report* and *Best Lawyers* "Best Law Firms" guide. The firm also received high ranks in several key metropolitan areas.

The American Bar Association appointed shareholder **Marissel Descalzo** (Miami) to its Criminal Justice Section Council for a three-year term. The Council has the primary responsibility of approving and reviewing criminal justice policy recommendations before they are presented to the ABA House of Delegates for association-wide adoption.

The Beacon Council recently appointed Miami shareholders **Patricia H. Thompson** and **Andrew J. Markus** to one year terms, as, respectively, secretary and chair of the International Committee. The Beacon Council, Miami-Dade County's official economic development partnership, is a not-for-profit, public-private organization that focuses on job creation and economic growth by coordinating community-wide programs; promoting minority business and urban economic revitalization; helping local businesses to expand; and marketing Greater Miami throughout the world.

Over the past year, Carlton Fields Jorden Burt attorneys, led by shareholder **Mark Neubauer** (Los Angeles), worked with Public Counsel, the ACLU Foundation of Southern California, and Arnold & Porter on a pro bono lawsuit aimed at providing equal education to California students. The legal team successfully sought a temporary restraining order in *Cruz v. State of California* in October 2014, requiring the state to ensure that students who are academically behind or missing courses necessary for graduation or college entry not be placed into content-less "service classes," courses they have already passed, overcrowded classes, or sent home. On November 5, 2015, the State Board of Education approved a settlement with students from six of the high schools that sued, which will require state education officials to provide immediate assistance to the schools to ensure they comply with AB 1012, a new state law that limits the scheduling and course assignment practices that led to students losing valuable learning time. Together with AB 1012, the settlement will ensure that students at low-income schools are provided the same equal access to educational opportunities regardless of zip code or income.

Shareholders **John A. Camp** (Miami) and **Daniel C. Brown** (Tampa) and associate **David L. Luck** (Miami) were honored as finalists at the *Daily Business Review's* 2015 Most Effective Lawyers Awards luncheon on December 4 in Miami.

Shareholder **Jason P. Kairalla** (Miami) is a recipient of this year's Lawyers for Children America, Inc. John Edward Smith Child Advocacy Award. This is the second time Mr. Kairalla has received this award, which is presented annually to 10 to 12 attorneys and law firms to honor their outstanding work with children.

Carlton Fields Jorden Burt welcomes the following attorneys to the firm: shareholders **Jeanne M. Kohler** (insurance, New York) and **Robert W. DiUbaldo** (insurance, New York); special advisor **Greg Gilman** (digital media, entertainment, interactive gaming and technology, Los Angeles), associate **Nora Valenza-Frost** (insurance, New York), and associate **Benjamin E. Stearns** (government law and consulting, Tallahassee).

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