LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

Volume II, May 2024

EXPECTFOCUS®

LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS

A DAY AT THE RACES

REGULATORS POUR ON THE SPEED

CARLTON FIELDS

v II INSIDE

3 Last Lap in SEC RILA Rulemaking

4 Litigation Lineup

6 Can Government Use Criminal Fraud Statute to Get Around "Personal Benefit" Requirement for Insider Trading?

7 Cinch Up! AI Enforcement Starts With Washing Charges

8 Racing Ahead: Privacy, Cybersecurity, and AI Heats for the Life Insurance Industry

11 Current Standings of AI Guidance and Requirements by State

12 Regulators Seek to Saddle Industry With New Obligations

13 Proxy Advisers Win by a Nose, Eclipse Conflict Disclosure Requirement

14 Courts May Call "Lane Violation" on Recent SEC Actions

16 SEC and CFTC Amend Form PF ... Again

18 Fifth Circuit Flags False Start in Challenge to SEC Gag Rule

19 SEC Seriously Limits Dealer/ Trader Distinction

20 NAIC Groups Carve Up the Mountain at the Winter Meeting

21 Cybersecurity Certification – Time Cuts

21 AI Certification – Gear Check

22 Sen. Wyden Sets Sights on Private Placement Life Insurance

23 Insurer Must Consider "Expectations of Future Mortality Experience" When Reassessing, Redetermining, and Changing COI Rates

24 Auto-Portability Providers Racing to Close Retirement Plan Gap

25 SEC Penalizes Anti-Whistleblower Provision in Customer Settlement Agreements

26 NAIC Takes Dive Start on Investment Management Agreements With New Guidance for Insurers

27 Insurers and Underlying Funds Sprint to Finalize Delivery Procedures for Tailored Shareholder Reports

28 News and Notes

EXPECTFOCUS®

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS MAY 2024

Executive Editor Thomas Lauerman
Assistant Editors Stephanie Fichera
Todd Fuller
Production Manager Jessica Bennett
Art Director & Designer Amy Chytka

EXPECTFOCUS® is a review of developments in the life, annuity, and retirement solutions industry, provided on a complimentary basis to clients and friends of Carlton Fields.

The content of EXPECTFOCUS® is for informational purposes only and is not legal advice or opinion. EXPECTFOCUS® does not create an attorney-client relationship with Carlton Fields or any of its lawyers.

SUBSCRIPTIONS: Changes in address or requests for subscription information should be submitted to communications@carltonfields.com.

Copyright © 2024 Carlton Fields. All rights reserved. No part of this publication may be reproduced by any means, electronic or mechanical, including photocopying, imaging, facsimile transmission, recording, or through any information storage and retrieval system, without permission in writing from Carlton Fields. EXPECTFOCUS® is a registered trademark of Carlton Fields.

Last Lap in SEC RILA Rulemaking

Critical Unresolved Issues

BY W. THOMAS CONNER AND HARRY EISENSTEIN

Congress directed the SEC to adopt a new registration statement for registered indexed annuities (RILAs) by the end of June. Several months ago, the SEC published its proposed registration statement and related rules. As we write this, the SEC seems on track to meet Congress' deadline.

The SEC's proposals would relieve significant existing regulatory burdens, and they were generally well received. Nonetheless, as the SEC approaches the finish line, commenters remain concerned about several collateral but critical questions and concerns. We have been following these closely, including:

- Unlike sales materials for variable annuities, RILA sales materials would have to be accompanied or preceded by a statutory prospectus. For the most part, this effectively would prohibit anything but electronic sales materials.
- The SEC proposes permitting RILA issuers to present their financial statements in accordance with the "statutory" accounting principles commonly used by insurance companies. This would not apply, however, to issuers of other non-variable products, such as market-value adjusted annuities (MVAs), contingent deferred annuities, and registered life insurance products, although the SEC suggested it might make the new registration framework available to MVAs as well. Otherwise, the issuers of these other non-variable products would still have the burden of having to present their financial statements in accordance with generally accepted accounting principles, absent individual relief.
- Under existing rules, RILA issuers may publish certain current crediting and other rates on their websites without filing the rates with the SEC. The SEC has proposed requiring these rates to be filed with the SEC. This would impose significant additional burdens on issuers, because they can and do change such rates frequently as market conditions evolve.
- The SEC is taking the view that interim account value adjustments resulting from market performance are *costs* that must be disclosed as such. We believe this approach mischaracterizes the nature of these adjustments, which are not amounts deducted to reflect any fee or cost but rather are adjustments to reflect changes in valuation based on the market and, as such, can be positive as well as negative.

We will be watching these and other RILA developments closely and provide detailed analyses when the final rules are adopted.

Litigation Lineup: Recent Decisions in Life and Disability Insurance Run into Policy Lapse, COVID-19, and Conflict of Interest Issues

BY STEPHANIE FICHERA AND JOHN GIBBONS

Life Policy Lapse Shortly Before Insured's Death

In *Simon v. USAA Life Insurance Co.* (Mar. 29, 2024), the insurer denied death benefits under a term life insurance policy, which had lapsed for nonpayment of premium two days before the insured's death. The district court granted the insurer's motion to dismiss, and the Eleventh Circuit Court of Appeals affirmed. The insured passed away in October 2021, after a period of illness and incapacitation. In December 2021, the insured's wife and beneficiary found letters from the insurer advising of the premium due and lapse, and she mailed full payment of the missed premium. The insurer received the payment and deposited the funds, but approximately 45 days later notified the beneficiary that the policy had lapsed, refunded the premium payment, and advised that death benefits would not be provided.

The policy included a 31-day grace period and stated that, "[i]f a premium is not paid when due, the policy will terminate except as indicated elsewhere in the policy." The policy allowed for reinstatement after lapse due to nonpayment of premium upon receipt of the unpaid premium and with satisfactory evidence that the insured was still insurable.

Applying Alabama state law, the Eleventh Circuit agreed with the district court's conclusion that waiver or estoppel did not prevent the insurer from denying coverage. The insurer's retention of the late premium payment for approximately 45 days did not suggest the insurer had acted with unreasonable delay or had treated the policy as in force or in a manner inconsistent with its rejection of the claim.

The Eleventh Circuit also agreed that the doctrine of equitable tolling did not apply to excuse the insured's failure to make a timely premium payment during a period of incapacity, explaining that the insurance contract was unambiguous and contained no provision for tolling of the due date for payments.

No Disability Payments for Alleged Brain Fog

In *McClendon v. United of Omaha Life Insurance Co.* (Mar. 15, 2024), the Eastern District of Arkansas entered summary judgment for the claims administrator after it denied the plaintiff's claim for long-term disability benefits for "long-COVID."

The plaintiff, a pizza cook for a college, had not worked since he was diagnosed with COVID-19 in July 2020, claiming that he had long-COVID and was enduring brain fog. He received short-term disability benefits under his employer's plan, but the administrator denied his application for long-term disability benefits under the policy's "own occupation" provision, concluding that his medical records did not show he was unable to perform the material duties of his regular occupation.

After a de novo review, the court agreed with the administrator's conclusion that the plaintiff "did not provide enough information for the company to determine the extent of any disability," noting that the "medical records submitted show uncertainty rather than clarity." Although the plaintiff's reports of brain fog were "consistent and long-standing," his extensive test results largely came back normal, and the testing and evaluations done by various specialists did not provide an objective basis for any disabling condition. Moreover, none of his doctors indicated that the plaintiff's "brain fog made him unable to do any important task required of a pizza cook on a full-time or part-time basis."

Disability Denial Not Tainted by ERISA Conflict

In *Harmon v. Unum Life Insurance Company of America* (Mar. 12, 2024), the Sixth Circuit Court of Appeals affirmed the district court's judgment upholding a plan administrator's termination of long-term disability benefits.

Due to a back injury, the plaintiff was approved for long-term disability benefits due to his restriction by a treating physician to lifting only five pounds, and the inability of his former employer (a fitness facility) to accommodate that restriction. After 24 months of payments, he was determined by the administrator to be unable to perform "any gainful occupation" based on its vocational consultant's review of job prospects in his labor market (Memphis, Tennessee) and finding that the jobs he could perform with his skill set and physical restrictions paid less than a gainful wage.

Shortly after the administrator approved the plaintiff's claim, the Social Security Administration independently determined that he was not disabled and could perform sedentary work and some light work, such as the work of a cashier, ticket seller, or assembler.

The plaintiff subsequently disclosed that he was living in Miami, Florida, and "lifting 10–15 pounds as part of his regular exercise regimen." The administrator had its clinical consultant and in-house physician review his medical records, and they determined he was capable of light work. The administrator also "conducted a new vocational assessment, focusing on the Miami labor market and including the light work it and SSA determined [the plaintiff] could handle," which identified alternative occupations that paid a gainful wage. As a result, the plaintiff was "cleared for light work," and the administrator terminated his benefits.

The plaintiff brought an ERISA action, claiming that the termination of his long-term disability benefits was arbitrary and capricious and "tainted by a conflict of interest."

After a de novo review of the administrative record, the Sixth Circuit concluded that the decision to terminate benefits was the result of a deliberate, principled reasoning process and supported by substantial evidence. The court explained, among other things, that it was not unreasonable for the administrator to rely on its in-house physician's review to conclude that the plaintiff could do light work, particularly given his self-reported activity and the SSA's independent finding that he was not disabled.

The court also rejected the plaintiff's arguments, based on weekly tracking reports, that the director supervising his claim was "unduly motivated by financial targets." The director's weekly reports "track[ed] the opening and termination of claims under his purview," and the plaintiff "speculat[ed] that they impose[d] an undue pressure to terminate benefits." But the professionals in charge of reviewing his claim had no access to these reports, so they did not influence the decision process.

Can Government Use Criminal Fraud Statute to Get Around "Personal Benefit" Requirement for Insider Trading?

BY THOMAS SJOBLOM AND AUSTIN JACKSON

The government prosecutes insider trading against insiders who convey material nonpublic information ("tippers") and outsiders who acquire material nonpublic information ("tippees") through two avenues: civil proceedings under 15 U.S.C. § 10(b) and criminal prosecution under 18 U.S.C. § 1348. Traditionally, insider trading cases have been brought under Section 10(b), which requires proof that a tipper received a "personal benefit" for conveying information to a tippee in breach of fiduciary duties.

In recent years, however, prosecutors have turned to the criminal fraud statute, Section 1348, to prosecute insider trading cases in order to avoid being blocked out by the need to prove a personal benefit. This approach, however, has been cast into doubt by Judge John M. Walker's concurring opinion in *United States v. Blaszczak* (2022). In that case, the defendants were charged under both Section 10(b) and Section 1348 but were initially convicted only under the latter. The Second Circuit affirmed those initial convictions in a 2019 decision upholding the government's use of Section 1348 to avoid proving that a tipper received a personal benefit.

However, the U.S. Supreme Court ultimately vacated the convictions for other reasons and remanded the case without addressing whether the government must prove a personal benefit for a Section 1348 conviction. Upon remand, the Second Circuit vacated the convictions but still did not address the personal benefit question.

This issue was instead addressed by the two majority judges in a separate concurring opinion authored by Judge Walker, where they found that "traditional notions of fair play are offended by the present incongruence in this circuit between civil and criminal deterrence." The judges noted that "[i]t should not require fewer elements to prove a criminal conviction than to impose civil penalties for the same conduct." Although this incongruence has not officially been decided by the courts, Judge Walker rightfully called upon the Second Circuit, the Supreme Court, and Congress to address the issue.

Thus, whether the government may continue to use Section 1348 to circumvent the personal benefit requirement under Section 10(b) remains in doubt.

Cinch Up! AI Enforcement Starts With Washing Charges

BY THOMAS SJOBLOM AND SARAH BARNEY

In March 2024, the SEC announced that it settled two cases against investment advisers Delphia (USA) Inc. and Global Predictions Inc. for making false and misleading statements about their purported use of artificial intelligence, when they were not using the AI as marketed. The firms agreed to settle the SEC's charges and pay $400,000 in civil penalties.

For months, SEC leadership has made repeated warnings about "AI washing," i.e., falsely claiming the use of AI or machine learning models or misrepresenting their application. The March enforcement actions are the first in which the SEC has charged companies with violating federal securities laws in connection with AI disclosures. We can expect many more.

The use of AI-driven tools by investment companies and professionals is not new. For more than a decade, algorithmic trading, high-frequency trading, AI-managed portfolios, and other AI-powered systems have started to eclipse traditional investment platforms. Recently developed AI, however, increases the speed around the track, because it can be trained on multiple types of data to understand how and why markets behave as they do, process enormous amounts of information in mere seconds, and predict market trends with sometimes impressive accuracy. On the other hand, AI is subject to error and bias from, among other things, the data inputs selected — sometimes called "GIGO" for "garbage in, garbage out."

SEC enforcement actions for misleading disclosures are not the only potential pitfall of AI use. Other potential AI abuses threatening to disrupt financial markets include:

- **Conflicts of Interest**. AI use by broker-dealers and investment advisers may pose increased conflicts of interest if used in a manner that results in the firm placing its own interests above its investors' interests. For example, one type of conflict may arise where an investment professional employs a proprietary AI algorithm to make investment decisions, which the investment professional has a financial interest in keeping confidential. Additionally, AI-powered tools are often a "black box" to the professionals that employ them, as such professionals are often unaware of *how* AI reached certain conclusions, thus resulting in a possible breach of fiduciary duty. If the algorithm is tainted, for example, by the use of corrupt or biased (GIGO) data, then the capacity to quickly scale information could become problematic as the transmission of any resulting recommendations could spread rapidly to many investors, causing unexpected market impact. The risk, among others, of such "algorithmic error amplification" prompted the SEC to propose a sweeping AI conflict of interest rule in July 2023, which has not yet been finalized. *See* "SEC Proposal Balances AI-Like Technology Use With Investor Best Interests – Has the SEC Picked a Winner?" *Expect Focus – Life, Annuity, and Retirement Solutions* (September 2023).
- **Market Manipulation**. Through various methods (i.e., deep learning or reinforcement learning), AI algorithms may learn how to manipulate and destabilize securities markets *and* avoid detection, when programmed with malicious intent. For example, a trader could deploy an AI-powered trading "bot" to create false market demand or supply, thus artificially inflating or deflating prices to the trader's advantage, and then avoid detection by mirroring non-threatening algorithmic trading systems.
- **Deception**. For quite some time, bad actors have used AI to clone voices, alter images, and even create fake videos to spread false or misleading information, also known as "deepfake" AI. Fraudsters can use these digital forgeries to impersonate a financial professional's customer or to disrupt financial markets by imitating powerful individuals in a multitude of schemes. For example, in "pump-and-dump" schemes, deepfake imagery or audio can drive up stock prices while fraudsters unload their shares before the ruse is uncovered. In 2023, a deepfake image of a billowing black cloud above the Pentagon caused the Dow Jones Industrial Average to fall approximately 80 points in four minutes, which illustrates how powerfully even unsophisticated spoofs can impact financial markets.

Public companies, investment advisers, and other investment professionals that use AI should prepare for enhanced SEC scrutiny, even in the absence of specific SEC AI rules. The track ahead is long, but the SEC has left the starting gate.

Racing Ahead: Privacy, Cybersecurity, and AI Heats for the Life Insurance Industry

BY ANN BLACK AND PATRICIA CARREIRO

Drivers, start your engines. It has been months of high speed for privacy, cybersecurity, and artificial intelligence.

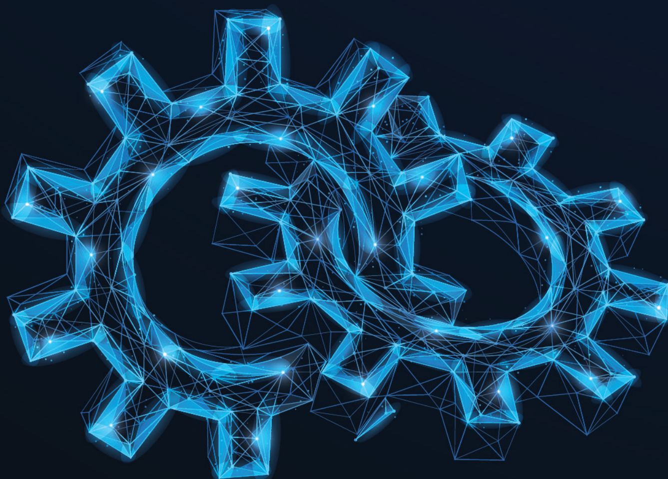
On the privacy circuit:

- **Heat 1:** The NAIC's New Privacy Model Stalls

  It might be a false start for the National Association of Insurance Commissioners' new privacy model, Insurance Consumer Privacy Protection Model Law #674. After years of effort, the team is regrouping its efforts. Whether it'll be a rain delay or a full rainout remains to be seen.

- **Heat 2:** GIPA Plaintiffs Search for Traction

  A series of putative class actions has been filed against life insurance companies by plaintiffs eager to expand the track for Illinois' Genetic Information Privacy Act (GIPA). *See* "Lawsuits Alleging Violations of Illinois' GIPA Are Piling Into Court Like Clowns Out of a Circus Car," *Expect Focus – Life, Annuity, and Retirement Solutions* (January 2024). In a recent filing, GIPA plaintiffs amended their complaint allegations to specifically plead family history as "protected health information that is genetic information" and add allegations highlighting the involvement of HIPAA-covered entities. The plaintiffs, however, have yet to address one of the largest speed bumps in their case: extensive legislative history reflecting Congress' intent to limit GIPA's application and exclude life insurers' underwriting practices from the race. Here's hoping this contest turns into a demolition derby of the plaintiffs' claims on the next lap.



On the cybersecurity circuit:

- **Heat 1:** The Change Healthcare Attack

  In late February 2024, health care technology provider Change Healthcare was struck with a devastating ransomware attack. The attack hit the brakes on the largest health care payment system in the United States, and the blowout has reverberated throughout the U.S. health care system for more than a month. A second attack was reported in April 2024. Even outside the health care industry, these attacks serve as a reminder of the importance of cyber readiness, vendor due diligence, auditing, and good contracting regarding obligations in case of a data incident.

- **Heat 2:** The NAIC's CERP

  The NAIC Cybersecurity Working Group's Cybersecurity Event Response Plan (CERP) finished its first lap and was adopted at the 2024 Spring National Meeting. The CERP builds on the NAIC's Insurance Data Security Model Law (#668) and, although it is intended to help insurance departments respond to cybersecurity event reports, it also serves as a yellow flag for insurers regarding departments' likely inquiries and approaches to investigating cybersecurity events. The CERP, however, is far from its finish line. As explained by the NAIC, the CERP is intended to be a living document, subject to changes as cybersecurity events and technology develop. With that in mind, the CERP is a valuable resource, but the pit crew is already planning adjustments.

On the artificial intelligence circuit, it's a burnout to regulate AI.

- **Heat 1:** Lawmakers and Regulators Off to the Races
  - **Lane 1:** State law and regulations concerning AI have continued their breakneck pace. From Utah's Artificial Intelligence Policy Act to California's Privacy Protection Agency releasing new draft AI regulations to the EU passing the EU AI Act, more and more jurisdictions are passing AI-specific legislation. Not to be outdone, the number of states adopting the NAIC's model bulletin on the use of AI systems by insurers, or otherwise issuing AI bulletins, has continued accelerating. *See* "Current Standings of AI Guidance and Requirements by States." Objects in the mirror may be closer than they appear.
  - **Lane 2:** The SEC put the pedal to the metal on its earlier warnings and settled its first two "AI washing" enforcement actions. In March 2024, the SEC announced settlements with two different investment advisers for allegedly misrepresenting that they "were using AI in certain ways when, in fact, they were not." *See* "Cinch Up! AI Enforcement Starts With Washing Charges."
  - **Lane 3:** The Federal Communications Commission announced its position that AI-generated voices are "artificial" for purposes of the Telephone Consumer Protection Act, and therefore require prior express written consent. Users of such AI-generated voices may want to consider updating their TCPA consents to specifically gather consent for the use of such voices.

- **Heat 2:** Eyes Up for Accelerating Litigation

  As companies implement AI in more use cases, AI adopters need to keep their eyes up for litigation that may litter the track. From insurers partnering with AI providers to streamline their review of medical records for underwriting purposes, or considering tools to assist agents, the potential use cases for AI are seemingly limitless. There are, however, certain “rules of the road” and risks to consider. The *Carlton Fields 2024 Class Action Survey* found that privacy litigation is the greatest area of anticipated risk arising from the use of generative AI, and this litigation has already begun. Either based on the alleged collection and processing of personal information without proper notice and consent or linked to particular use cases, plaintiffs have already begun burning rubber. Four significant litigation examples:

  - **Lane 1:** CIPA Claims

    A recently filed putative class action alleged violations of the California Invasion of Privacy Act (CIPA) based on a company’s use of AI to transcribe, monitor, and analyze customer service calls in real time and suggest potential responses to the agent speaking with the customer. The plaintiff alleges that callers were not told that their phone calls would be recorded or disclosed to service providers and that the tool was effectively an intentional wiretap, entitling him and all similarly situated class members to statutory damages of $5,000 per violation. CIPA allegations have been a recent favorite of plaintiffs’ firms, and there are many laps left to run.

  - **Lane 2:** Data Scraping

    A recent decision found that scraping data from social media websites for use in training large language models (LLM) was not a violation of the platforms’ terms when not logged into such sites. This could trigger social media platforms to shift more of their data behind account login screens or modify their terms to clarify the scope of their application; but until then, entities looking for datasets to train their LLMs may have a closing window to pass the competition.

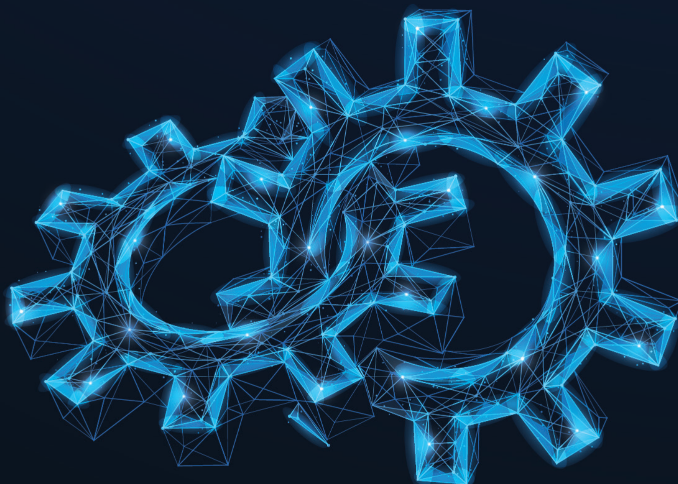
  - **Lane 3:** Illegal Passing

    Litigation has also arisen regarding the sharing of driving information with large data brokers, such as LexisNexis. A recent lawsuit alleged that LexisNexis received information on drivers’ driving behaviors from their cars and shared such information with car insurers evaluating such drivers’ risks. The case could have significant reverberations for those in the industry who rely on LexisNexis risk scores.

  - **Lane 4:** AI as a Nonstarter

    A putative class action lawsuit alleges that an insurer using a software tool to facilitate claims processing was impermissibly using AI to violate individuals’ rights. The parties do not appear to agree even upon what race they are in, strongly disagreeing on whether the tool involved is AI at all (versus simple automation) and whether individuals were harmed by its use or simply received the same result they would have received without the tool’s use.

Unfortunately, the racers show no signs of throttling down, so buckle up and prepare for the long race ahead. Ready, set, go!



CURRENT STANDINGS OF AI GUIDANCE AND REQUIREMENTS BY STATE

As of April 24, 2024

States have been off to the races to place in the artificial intelligence insurance regulatory Grand Prix. The NAIC adopted the Model Bulletin on the Use of AI Systems by Insurers, which some states have drafted on to adopt bulletins or requirements of their own. Below is a list of the top AI-state racers.

NAIC AI MODEL BULLETIN ADOPTED STATES

Finish Place	State
1	ALASKA
2	NEW HAMPSHIRE
3	NEVADA
4	CONNECTICUT*
5	VERMONT
6	ILLINOIS
7	RHODE ISLAND
8	PENNSYLVANIA
9	KENTUCKY
10	MARYLAND
10	WASHINGTON

*There is an Artificial Intelligence Certification filing due on September 1, 2024, and annually thereafter.

OTHER STATES WITH AI REQUIREMENTS

COLORADO – adopted AI insurance regulations, which took effect late 2023

CALIFORNIA –

- issued a bulletin reminding insurers to avoid discrimination that may result from the use of AI
- adopted a bill requiring that property and casualty insurers disclose AI use to applicants and insureds

PIT STOP – ENGINES REVVING UP

WASHINGTON, D.C. –

- issued a draft AI bulletin based on the NAIC AI Model Bulletin
- issued a data call to identify bias in auto insurance

NEW YORK – in the process of passing an AI circular letter for insurers that use external consumer data and information sources (ECDIS) and/or AI

WASHINGTON – AI task force formed

Regulators Seek to Saddle Industry With New Obligations

Firms Bridle and Stir Up Opposition

BY GARY COHEN

The Financial Crimes Enforcement Network (FinCEN), the Commodity Futures Trading Commission (CFTC), and the SEC have adopted or are proposing substantial increases in regulation of industry participants, primarily investment advisers including advisers to private funds, but also broker-dealers, publicly held companies, and proxy solicitation firms.

FinCEN seeks to close "regulatory gaps" that allow "thousands of investment advisers overseeing the investment of tens of trillions of dollars into the U.S. economy [to] currently operate without legally binding [anti-money laundering and counter-terrorism financing] obligations."

Banks, broker-dealers, and investment advisers to mutual funds are already subject to anti-money laundering and counter-terrorism financing obligations. Now FinCEN proposes also to include investment advisers that are:

- Registered with the SEC because they have more than $110 million in assets under management (RIAs); or
- Unregistered with the SEC but report to the SEC as exempt reporting investment advisers (ERAs), including investment advisers that advise only private funds and have less than $150 million in assets under management.

Broadly speaking, the proposed rule would require RIAs and ERAs to:

- Implement an anti-money laundering and counter-terrorism financing program;
- File certain reports, such as "suspicious activity reports," with FinCEN; and
- Keep records such as those relating to the transmittal of funds.

FinCEN proposes to delegate examination authority for the rule to the SEC, given the SEC's expertise in regulating investment advisers and experience in examining other financial institutions for carrying out anti-money laundering and counter-terrorism financing responsibilities.

FinCEN, a bureau of the U.S. Department of the Treasury that administers the Bank Secrecy Act, issued its rule proposal on February 13, and the public comment period closed on April 15. The rule would take effect 12 months from the final rule's effective date.

This FinCEN proposal is but one among many examples of major increased regulatory burdens that regulators seek to impose on investment advisers, including advisers to private funds, and other industry participants.

For example, SEC Chair Gary Gensler continues to push his active agenda. More rules will pour out of the SEC pipeline. The two Republican commissioners have opposed the three Democratic commissioners in many cases and will probably continue to do so.

The industry is increasingly fighting back by seeking relief from courts. For instance, last December, the Fifth Circuit vacated an SEC rule requiring companies to make certain disclosures about buybacks of their stock. If enacted as proposed, FinCEN's above-discussed regulation of investment advisers also may draw a court challenge, as it has already drawn strong fire from the industry.

The articles that follow on pages 13–19 discuss other examples of:

- The **increasing regulation** of investment advisers (including advisers to private funds) and other registrants; and
- **Serious industry pushback**, including litigation, as industry participants are emboldened by their increasingly frequent victories in court.

Proxy Advisers Win by a Nose, Eclipse Conflict Disclosure Requirement

BY THOMAS LAUERMAN

In February, a federal district judge in the District of Columbia awarded proxy advisers a victory by vacating an SEC rule provision that they opposed.

Money managers (such as investment advisers, mutual funds, and pension funds) commonly retain proxy advisers to help decide how to vote shares of publicly held companies that are included in investment portfolios run by the money managers.

Under the terms of the Securities Exchange Act of 1934 (Exchange Act), the SEC's proxy rules apply only to persons who "solicit" or participate in a "solicitation" of proxies to vote securities. The SEC, for many decades, has interpreted the concept of "soliciting" very broadly — broadly enough to encompass the activities of proxy advisory firms. But the SEC also historically allowed proxy advisory firms to avoid being covered by the proxy rules, subject to certain conditions that were not very burdensome.

In recent decades, the SEC and other interested observers became increasingly concerned about the very significant and growing influence that proxy advisory firms were having on the shareholder voting process, as well as the manner in which proxy advisory firms were operating.

To cut to the chase, the SEC adopted rule amendments in 2020 to specifically provide that proxy advisory firms were considered to be engaged in soliciting proxies and that they would be subject to the SEC's proxy rules unless they complied with certain conditions that were much more onerous than the historical conditions that had applied.

Much jostling followed, and along the way, Institutional Shareholder Services Inc. (ISS) filed this suit challenging the SEC's revised positions. The National Association of Manufacturers (whose members include many publicly held companies) intervened in the suit as a co-defendant with the SEC in support of its positions.

In response to the controversy, the SEC in 2022 adopted further amendments that removed all but one of the significant conditions that the SEC's 2020 amendments had imposed on proxy advisers. The one remaining condition was that a proxy adviser must disclose all conflicts of interest that are material to its objectivity. But ISS continued to press its case.

In February of this year, the U.S. district judge granted summary judgment in favor of ISS. The judge held that the history and purpose of the Exchange Act did not support the SEC's interpretation and that the ordinary meanings of "solicit" and "solicitation" when Congress enacted that statute did not encompass voting advice delivered by a person or firm (such as a proxy advisory firm) that has no interest in the outcome of the vote.

The judge saw so little ambiguity on this point that he thought the question did not even satisfy the first prong of what is commonly known as the *Chevron* test, and it was therefore unnecessary even to consider deferring to the SEC's judgment on the matter.

To the judge, then, this was not a closely run affair. On the other hand, it is unclear how significant this victory is for proxy advisers. ISS, for example, is a registered investment adviser. As such, it will continue to be subject to significant conflict of interest disclosure obligations under the Investment Advisers Act of 1940, including any further such requirements that the SEC may decide in the future to impose.

For that and other reasons, proxy advisers may turn out merely to have nosed out the SEC temporarily with this summary judgment.

Indeed, both the SEC and the National Association of Manufacturers have filed appeals to the district court's decision in this case.

Courts May Call “Lane Violation” on Recent SEC Actions

BY THOMAS LAUERMAN

With increasing frequency, petitioners representing the securities industry are asking courts to decide that rules adopted by the SEC exceed the agency’s authority, even when the rules have barely left the starting blocks.

SEC Expansion of Private Fund Adviser Regulation

For example, the National Association of Private Fund Managers and several other trade associations have filed a petition challenging the recent massive expansion of regulation over private fund investment advisers (and, by extension, of private funds). This expansion was adopted in 2023 by a split (3–2) vote of the SEC commissioners and is further discussed in “SEC and CFTC Amend Form PF … Again.”

The petitioners in this case, which is pending before a three-judge panel in the Fifth Circuit Court of Appeals, make numerous arguments.

Underlying many of these, however, is the idea that the SEC has committed something like a regulatory lane violation:

- Congress specifically prescribed different and distinct regulatory schemes for investment advisers, broker-dealers, registered investment companies, and private funds; and
- The SEC has impermissibly distorted and blurred the differences and distinctions, based on its own current judgment and preferences.

The petitioners also allege procedural infirmities, including that the SEC did not allow enough time for public comment on, and did not provide an adequate cost-benefit analysis of, these reforms.

Controversies Around SEC Requirements for Consolidated Audit Trail Database

In another case, Citadel Securities and the American Securities Association have filed a petition challenging the SEC's recent action that reallocated to broker-dealer firms substantial costs of maintaining what is commonly known as the "consolidated audit trail" database.

As originally adopted, these costs were to be borne by FINRA and the securities exchanges. The costs are quite substantial, as the database must gather information about almost all broker-dealer transactions and be searchable by regulators for numerous purposes.

The petitioners are challenging this reallocation, which the SEC approved by a once-again split vote of its commissioners, in the Eleventh Circuit Court of Appeals. The petitioners allege that the reallocation violated the Administrative Procedure Act, because the SEC failed to consider the reallocation's impact on investors, despite the likelihood that at least some of the costs will be passed on (directly or indirectly) to broker-dealers' customers. The petitioners also allege that the database itself is legally flawed in various respects.

Moreover, another complaint challenging the consolidated audit trail database was filed in late April in the U.S. District Court for the Western District of Texas. That case is a putative class action on behalf of all investors whose personally identifiable information is held in the consolidated audit trail database. Among other things, the complaint alleges that the database violates such investors' federal constitutional rights.

SEC's Climate Change Disclosure Rules

Perhaps the most prominent, complicated, and potentially significant example of this trend occurred recently when multiple challenges to the SEC's final emissions reporting rules were filed commencing virtually immediately after the SEC's action (by a 3–2 vote of its commissioners) to adopt the rules. The U.S. Chamber of Congress, state attorneys general, and various other parties also filed challenges to these rules in the Fifth and several other circuits. However, all of these cases have been consolidated in the Eighth Circuit.

In light of this litigation, the SEC has issued an order that stays effectiveness of the rules, pending judicial resolution of the issues raised.

In the future, more challenges can be expected to assert that other SEC rules have strayed outside applicable boundary lines established by one or more governing statutory or constitutional provisions.

SEC and CFTC Amend Form PF … Again

Private Fund Advisers Should "Kick the Tires" Before Next Race to File

BY MEDERIC DAIGNEAULT

In February 2024, the SEC and the Commodity Futures Trading Commission (CFTC) adopted major amendments to Form PF to provide greater transparency into the operations and strategies of private funds, and to assist the commissions and the Financial Stability Oversight Council (FSOC) in identifying trends across the private funds industry.

Form PF, jointly adopted in 2011 by the commissions, requires private fund advisers to report extensive information regarding their firms, the funds they advise, and certain related persons. While the form was adopted primarily to help the then-newly formed FSOC identify and monitor systemic risk related to the private fund industry, it is also used by the commissions in their examination programs.

Since Form PF's adoption, the commissions have made several "pit stops" to keep it in what they consider to be racing shape, including amendments in 2014 in connection with money market fund reforms; again in May 2023 to require certain event reporting for large hedge fund advisers, private equity fund advisers, and to revise the reporting requirements of certain large private equity fund advisers; and again, in July of last year, in connection with money market fund reforms. The scope of the 2023 amendments is substantial, and they are currently under legal challenge as described in "Courts May Call 'Lane Violation' on Recent SEC Actions."

Among others, noteworthy amendments adopted in February include the following.

- **Master-Feeder and Parallel Fund Structures**. The commissions claim that allowing advisers discretion to report master-feeder and parallel fund structures, in the aggregate or separately, has obscured their risk profiles. Consequently, as amended, Form PF generally will require separate reporting of each private fund in such structures. By contrast, advisers will no longer be permitted to report parallel-managed accounts (as distinct from parallel funds) separately.
- **Reporting Fund of Funds**. To provide more clarity and uniformity for reporting purposes, the amendments will also require an adviser to include the value of a fund's investments in other private funds, internal or external, when determining whether certain thresholds or definitions are met (e.g., reporting as a large hedge fund adviser and whether a hedge fund is a qualifying hedge fund).

- **Reporting "Trading Vehicles."** The amendments will require advisers to report, on an aggregated basis for a reporting fund, all trading vehicles, whether fully or partially owned by the reporting fund. Currently, Form PF does not require advisers to identify trading vehicles, which are separate legal entities that may be used by a private fund for jurisdictional, tax, or other purposes.
- **Operations and Strategies**. The amendments will require additional identifying information regarding the private fund adviser, its related persons, and their private fund assets under management, as well as details regarding the private funds they manage and such funds' assets, financing, investor concentrations, and performance.
- **Digital Assets**. Amendments were also made to require reporting, as applicable, on a hedge fund's use of digital assets as an investment strategy.

Both the effective date and compliance date for these amendments is March 12, 2025. Like trying to rebuild an engine mid-race, the challenges, costs, and administrative burdens imposed on many advisers by the latest Form PF amendments are likely to be substantial. For that and other reasons, these amendments may very possibly come under legal challenge similar to that mentioned above as to the 2023 revisions (or at least be affected by the outcome of that challenge).

In any event, before test-driving the firm's data on the revised form, private fund advisers should use this time to:

- Determine which of the amendments will impact its Form PF filings.
- Assess whether changes need to be made as to how the firm collects, organizes, and reports required data for Form PF.
- Ascertain whether the firm maintains the information newly required by these amendments on a routine and organized basis, or if it can readily access it.
- Determine whether any new systems, vendors, or reports are required in order to comply.

Fifth Circuit Flags False Start in Challenge to SEC Gag Rule

BY NATALIE NAPIERALA AND NADER AMER

In January 2024, the SEC denied New Civil Liberties Alliance's petition to halt so-called gag orders. The SEC has a procedural rule that requires it to impose these orders on individuals and companies settling with the SEC on a "neither admit nor deny" basis. The gag orders are generally included in settlement agreements and, among other things, prohibit the settling party from making any future denial of the SEC's allegations.

The history of and challenges to the SEC's gag rule are more fully discussed in "The SEC's Compulsory Practice of Restraining Free Speech: 'You Signed It, So Live With It!'" *Expect Focus – Life, Annuity, and Retirement Solutions* (January 2024). Here, however, we discuss one procedural hurdle petitioners may face when challenging the SEC's gag rule.

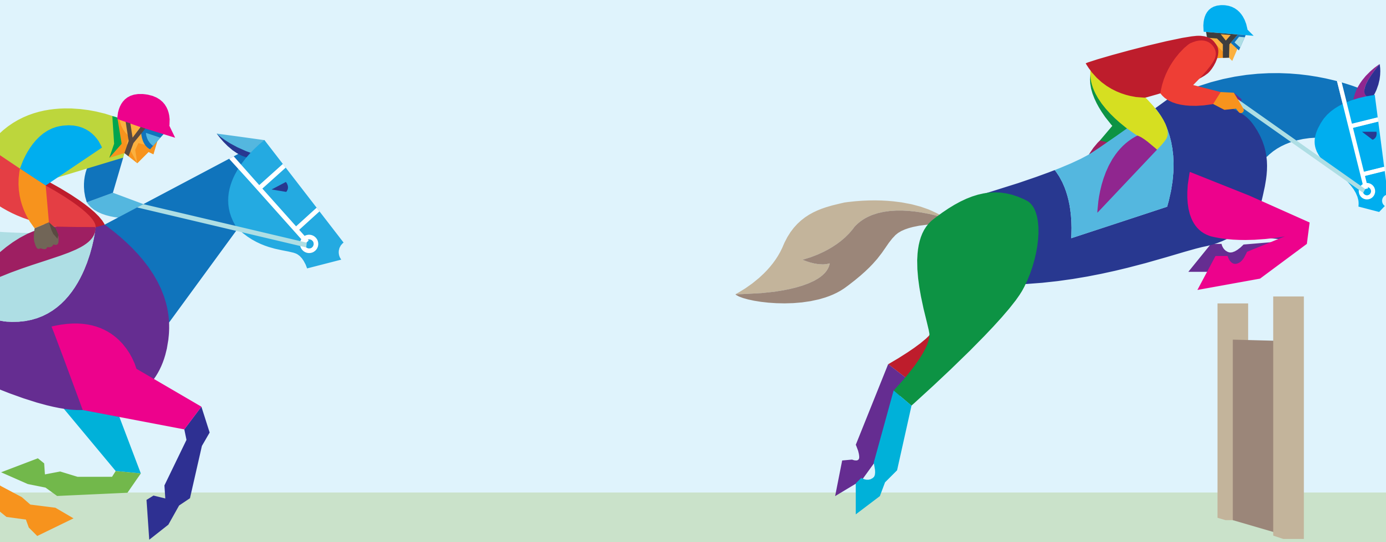
Specifically, in March 2024, the Fifth Circuit Court of Appeals, in a different matter, declined to entertain the appeal of a trial court's denial of a petitioner's motion for a declaratory judgment that would strike the SEC's gag rule language from his settlement agreement. The trial court had denied the motion to strike as procedurally improper because, it held, a party cannot seek declaratory relief by motion but instead must file a separate action for declaratory judgment.

On appeal, the Fifth Circuit held it lacked jurisdiction over the appeal because the trial court's denial of the declaratory judgment motion "did not dispose of [the petitioner's] entire claim but merely prevented [the petitioner] from pursuing a claim through the wrong procedural vehicle." Accordingly, the trial court's denial was not a final decision and an appellate court, therefore, could not address the propriety of the SEC's gag rule. Further, the appellate court noted that to exercise appellate jurisdiction in these circumstances would "dramatically undercut" the final judgment requirement and "erroneously establish that [the Fifth Circuit] is willing to consider future post-judgment orders on procedurally improper motions denied as such."

The Fifth Circuit also recognized that the Ninth and Eleventh Circuits have found that declaratory judgment requests are "not properly before the court if raised only" through a motion. Thus, the court declined "to open that Pandora's box of frivolous appeals."

Thus, any petitioner who seeks to challenge the SEC's gag rule must maneuver into a procedural posture that will allow a court to proceed with its review, such as filing a complaint challenging the gag rule. Notably, Elon Musk has done just that, positing the most recent challenge to the SEC's gag rule via a petition for certiorari to the U.S. Supreme Court seeking to lift his 2018 consent decree, which required Musk to obtain pre-approval for any Tesla-related tweets and prohibited Musk from publicly disagreeing with the SEC's allegations. The SEC has asked the Supreme Court to deny Musk's petition, arguing that Musk knowingly waived his rights.

Though we cannot predict what the Supreme Court will do regarding Musk's petition, we can state with certainty that federal courts across the country will continue to examine defendants' constitutional rights with respect to the SEC's gag rule.



SEC Seriously Limits Dealer/Trader Distinction

Betting Window Open Re Federal Court Veto

BY ANN FURMAN

On February 6, 2024, the SEC adopted new rules under the Securities Exchange Act of 1934 (Exchange Act), to expand the scope of "dealers" and "government securities dealers" required to register under the Exchange Act, become members of FINRA, and comply with the federal securities laws and FINRA regulatory obligations.

Historically, Section 3(a)(5) of the Exchange Act has excluded traders from the definition of "dealer" unless trading was done "as a part of a regular business." Under the new rules, a person buying and selling securities for its own account could be deemed to do so "as part of a regular business" if that person engages in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants. For more detailed information about the background and effects of the new rules, see "SEC Wants More Securities Traders Under Its Dealer Big Top, Would Require Exchange Act Registration by More Regular Traders," *Expect Focus – Life, Annuity, and Retirement Solutions* (January 2024).

By thus narrowing the trader exemption, the new rules turn many traders into dealers, subjecting them to costly broker-dealer regulation and requiring significant operational changes. While the express purpose of the new rules is to regulate market participants that play a "significant liquidity-providing role in overall trading and market activity," the impact of the new rules may extend beyond the intended purpose. Market participants potentially covered by the new rules include proprietary trading firms that trade for their own account, also known as high-frequency trading firms, private investment funds, pension funds, and collective trust funds. However, registered investment companies and persons that have or control less than $50 million in total assets are excluded.

The SEC vote on the new rules was split 3–2. The dissenters, Commissioners Mark T. Uyeda and Hester M. Peirce, expressed concern about SEC overreach of claimed jurisdiction and creation of regulatory confusion.

Three trade associations for the private fund industry promptly filed a lawsuit against the SEC, asking a federal court to scrap the new dealer definition as arbitrary, capricious, and outside the agency's statutory authority to enact. Among other things, they say the SEC's estimate that the new rules would require fewer than 16 private funds to register as dealers "has no basis in the record" and "is wrong."

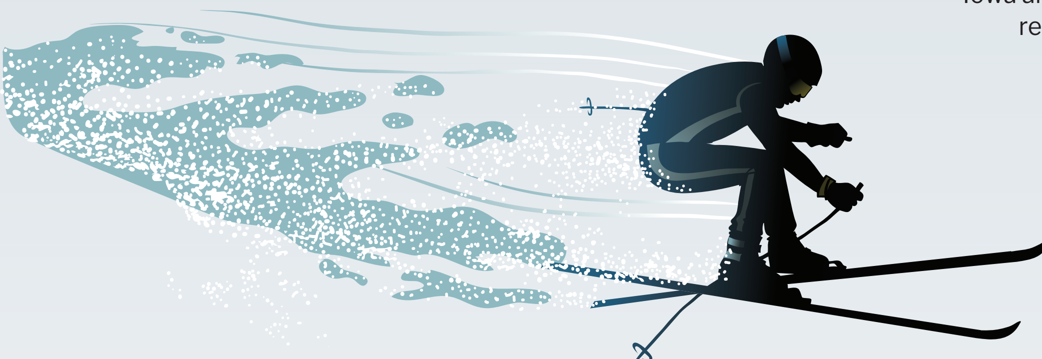
The rules became effective on April 29, 2024, and the compliance date is one year from that effective date.

NAIC Groups Carve Up the Mountain at the Winter Meeting

BY ANN BLACK AND ALEXANDRA BEGUIRISTAIN

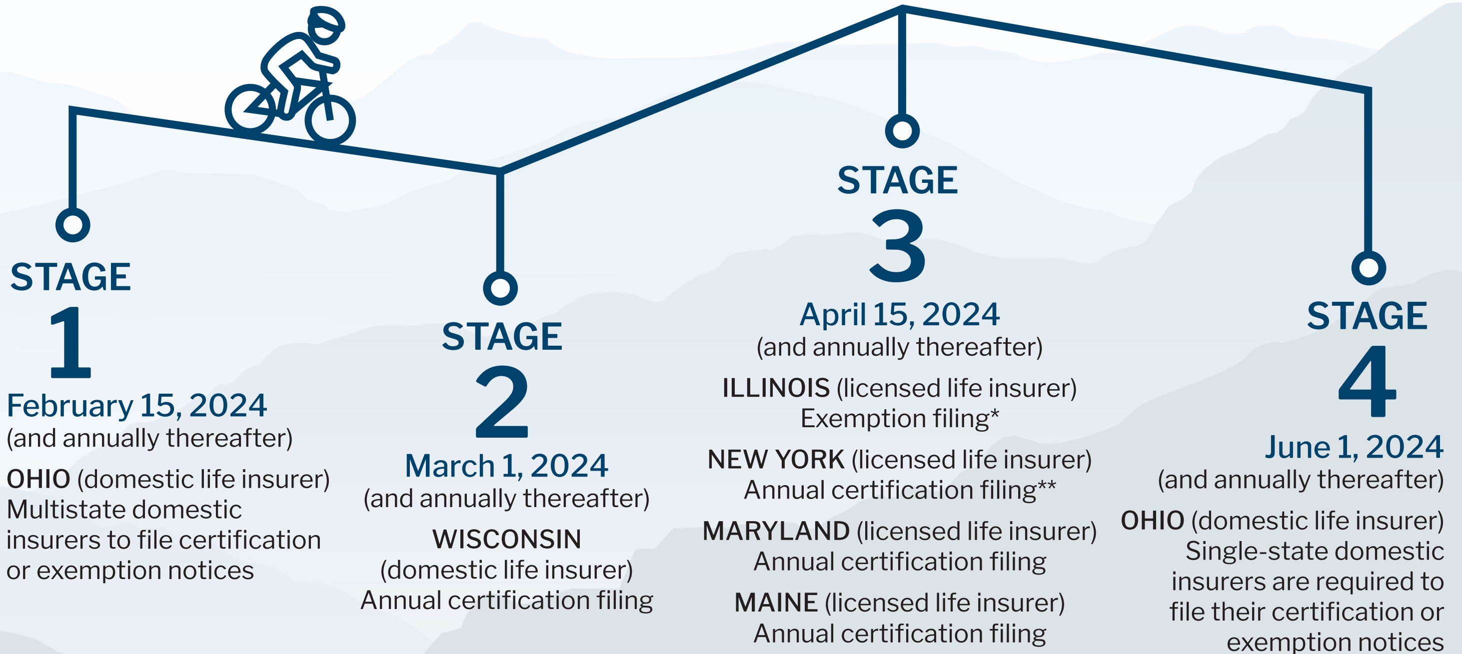
After strapping on their skis and riding up the lifts, the NAIC groups reported to their events. The results of the events of note for life insurers are as follows:

- The **Big Data and Artificial Intelligence (H) Working Group** continues its interval Nordic ski race. It completed three intervals of its artificial intelligence (AI) and machine learning (ML) surveys — home insurance, life insurance, and private passenger. For the fourth interval, the working group is moving on to development of the health insurance survey. The group is considering the types of health insurance coverages that would be covered by the upcoming survey, including supplemental and limited benefit coverages. Due to the evolving nature of big data and AI, the working group may repeat earlier intervals by conducting follow-on surveys. Chair Kevin Gaffney stated that the group will also continue tracking state adoption of the NAIC's model bulletin on the use of AI systems by insurers.
- The newly formed **Third-Party Data and Models (H) Task Force** charged out of the start ramp holding its first public meeting during the NAIC Winter National Meeting. As it continued downhill, the task force issued its proposed 2024 work plan, which will focus on evaluating existing frameworks for regulatory oversight of third-party data and predictive models, including those using AI and discussing the goals for a future regulatory oversight third-party framework.
- As reported in "Racing Ahead: Privacy, Cybersecurity, and AI Heats for the Life Insurance Industry," the **Cybersecurity (H) Working Group** finished the first of its combined events with a strong super-G finish by adopting the Cybersecurity Event Response Plan.
- At the finish line, the **Innovation, Cybersecurity, and Technology (H) Committee** cheered on its working groups and task forces, hearing the reports of those that met publicly at the NAIC Winter Meeting, as well as those who have met in regulator-only meetings since the start of the year.
  - The **E-Commerce (H) Working Group** finalized its E-Commerce Modernization Guide and work plan for 2024.
  - The **Technology, Innovation, and InsurTech (H) Working Group** chair will focus on education and will be receiving presentations from various insurtechs.
  - The **Privacy Protections (H) Working Group** had a false start and will be hearing first from subject matter experts and then from interested parties on privacy issues. Once the issues are identified, NAIC legal will create a matrix of the issues and how those issues are addressed by the current privacy models and the draft of Model #674.
  - Two collaboration forums will be reviewing data collection standardization and the assessing tools for regulators as they work with AI.
- Also applauding its working groups and task forces at the finish line, the **Life Insurance and Annuities (A) Committee** received the following reports of note:
  - The Life Actuarial (A) Task Force reported that the Indexed Universal Life (IUL) Illustration (A) Subgroup members have been reviewing company indexed universal life and other life insurance product illustrations, as well as annuity illustrations, to determine if the illustrations overpromise or understate the downside risks of products. The subgroup is considering whether changes to illustration guidelines are needed, although it has not determined whether these changes are needed in specific areas or if more comprehensive changes are needed.
  - Chair Doug Ommen reported that the Annuity Suitability (A) Working Group plans to discuss updating the FAQ document to add questions on the safe harbor/comparable standards provision in revised Model #275. He stated that Iowa and several states have conducted reviews of insurers' Model #275 policies and procedures and found them comprehensive except for those regarding oversight when insurers rely on the safe harbor. Rhode Island also identified lack of safe harbor oversight as a concern.



CYBERSECURITY CERTIFICATION – TIME CUTS

A “time cut” is a ruling within cycling to ensure that riders keep pace. Similarly, regulators have placed time cuts, or deadlines, for insurers to certify compliance with cybersecurity regulations. Some of the time cuts are listed below.



STAGE 1

February 15, 2024
(and annually thereafter)

OHIO (domestic life insurer)
Multistate domestic insurers to file certification or exemption notices

STAGE 2

March 1, 2024
(and annually thereafter)

WISCONSIN
(domestic life insurer)
Annual certification filing

STAGE 3

April 15, 2024
(and annually thereafter)

ILLINOIS (licensed life insurer)
Exemption filing*

NEW YORK (licensed life insurer)
Annual certification filing**

MARYLAND (licensed life insurer)
Annual certification filing

MAINE (licensed life insurer)
Annual certification filing

STAGE 4

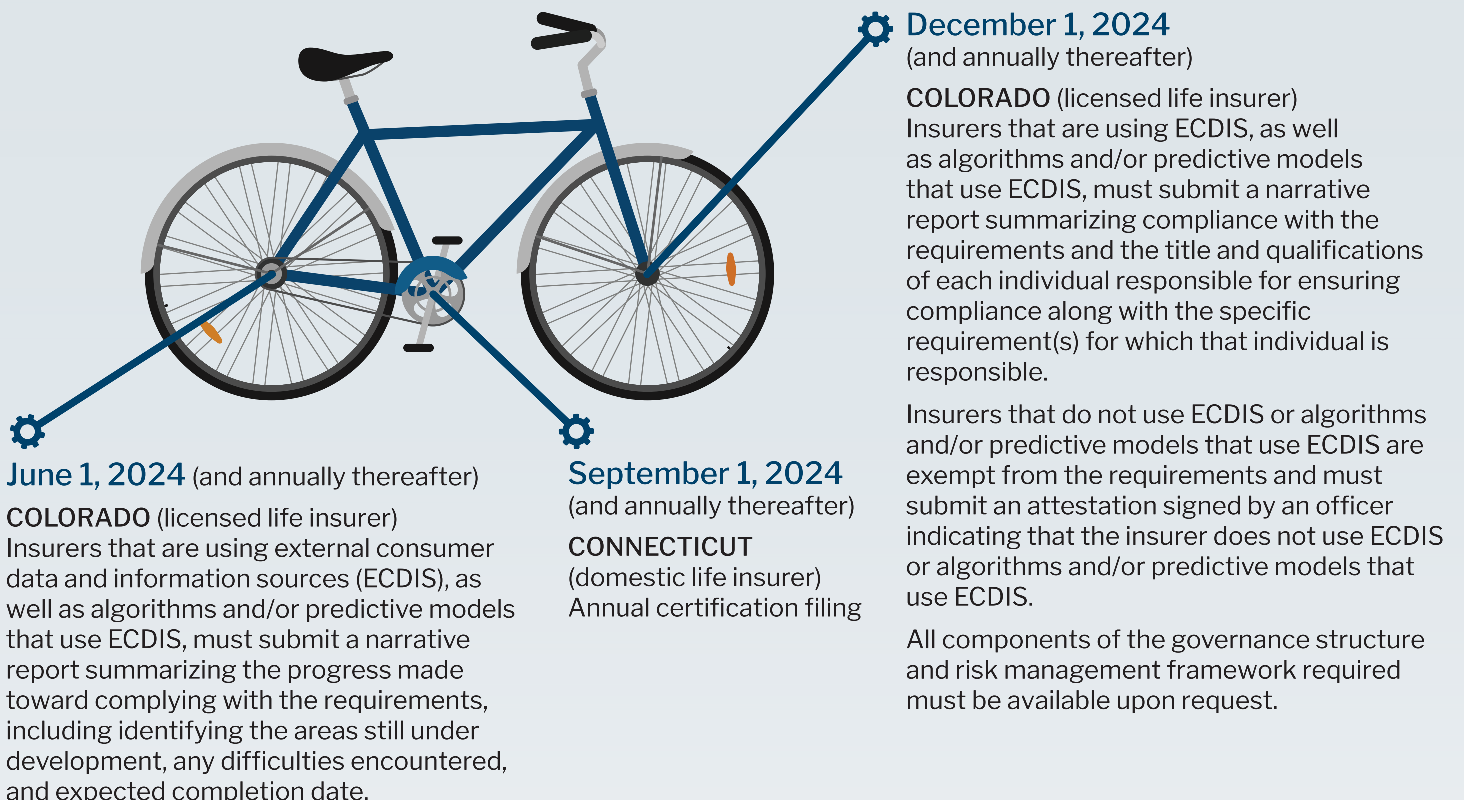
June 1, 2024
(and annually thereafter)

OHIO (domestic life insurer)
Single-state domestic insurers are required to file their certification or exemption notices

*Illinois certification filing to be due April 15, 2025, and annually thereafter.
**This filing is separate from the notice of exemption filing required within 30 days of determining that the insurer is exempt.

AI CERTIFICATION – GEAR CHECK

Both the Colorado Division of Insurance and the Connecticut Insurance Department have implemented gear checks to ensure that insurers are in compliance with their artificial intelligence regulations and guidance. Below are the dates of the gear checks.



June 1, 2024 (and annually thereafter)

COLORADO (licensed life insurer)
Insurers that are using external consumer data and information sources (ECDIS), as well as algorithms and/or predictive models that use ECDIS, must submit a narrative report summarizing the progress made toward complying with the requirements, including identifying the areas still under development, any difficulties encountered, and expected completion date.

September 1, 2024
(and annually thereafter)

CONNECTICUT
(domestic life insurer)
Annual certification filing

December 1, 2024
(and annually thereafter)

COLORADO (licensed life insurer)
Insurers that are using ECDIS, as well as algorithms and/or predictive models that use ECDIS, must submit a narrative report summarizing compliance with the requirements and the title and qualifications of each individual responsible for ensuring compliance along with the specific requirement(s) for which that individual is responsible.

Insurers that do not use ECDIS or algorithms and/or predictive models that use ECDIS are exempt from the requirements and must submit an attestation signed by an officer indicating that the insurer does not use ECDIS or algorithms and/or predictive models that use ECDIS.

All components of the governance structure and risk management framework required must be available upon request.

Sen. Wyden Sets Sights on Private Placement Life Insurance

BY TINO LISELLA AND EDMUND ZAHAREWICZ

On February 21, 2024, Senate Finance Committee Chairman Ron Wyden released a report on the findings from a self-styled "democratic staff investigation" into the use of private placement life insurance (PPLI) by "ultra-wealthy" investors. The report, which characterizes PPLI as a "buy, borrow, die" tax shelter, is highly critical of the uses and tax advantages afforded to the purchasers of such products that are not available to less affluent purchasers of life insurance. The report contains a framework for legislation purporting to curb the use of PPLI as a means of tax avoidance for the wealthy.

The committee received information from seven leading PPLI carriers on more than 3,000 in-force PPLI policies as of the end of 2022, representing $9.5 billion in assets under administration and face amounts totaling approximately $40 billion. The report singles out marketing materials promoting PPLI as tax-free investments in alternative investments, such as private equity and hedge funds, and as a means to avoid income, gift, and estate taxes. The report also takes issue with the ability of wealthy policyholders to borrow against such assets "at extremely favorable rates, and then pass[ ] the benefit to wealthy heirs upon the death of the policy owner tax-free."

According to the report, unlike traditional variable life insurance policies that allow policyholders to invest in basic equity and debt funds, PPLI policies offer highly customizable investment options, thus allowing wealthy policyholders to invest on a tax-advantaged basis in asset classes not typically available to middle-class policyholders. The report expresses concern that the Internal Revenue Service is largely unable to enforce existing "investor control rules" designed to curb abuse of PPLI policies due to a lack of reporting requirements.

The report's proposed legislation framework would, among other things, eliminate the present tax advantages for new and existing PPLI policies (as well as certain private placement annuity contracts to prevent the shifting of assets to such contracts) and require PPLI information to be reported to the IRS. Whether such legislation reaches the Senate floor, much less passes Congress, remains to be seen.

Insurer Must Consider "Expectations of Future Mortality Experience" When Reassessing, Redetermining, and Changing COI Rates

BY CLIFTON GRUHN

In *Advance Trust & Life Escrow Services, LTA v. Protective Life Insurance Co.* (Mar. 2, 2024), the Eleventh Circuit Court of Appeals affirmed in part and reversed in part the district court's dismissal of breach of contract claims regarding an insurer's cost of insurance (COI) determinations. In particular, the Eleventh Circuit rejected claims that the policy required the insurer to "reassess and redetermine" its COI rates at some unspecified interval(s) based exclusively on "expectations of future mortality experience." However, the court reversed dismissal of the plaintiff's alternative theory that the insurer ignored "expectations as to future mortality experience" when "reassess[ing], redetermin[ing], and chang[ing]" its COI rate scale.

The crux of the plaintiff's complaint concerned allegations of improving nationwide mortality rates since 2012. From that premise, the plaintiff alleged two theories against his insurer. First, the plaintiff claimed that the policy required his insurer to revisit COI rates considering only expectations regarding future mortality experience, but the insurer had never done so and continued using its initial rates, which included other factors, such as expenses and lapse rates. Second, the plaintiff claimed in the alternative that his insurer had in fact revisited and changed COI rates but, in so doing, ignored expectations of future mortality experience. The defendant moved for judgment on the pleadings, arguing that the policy language precluded the plaintiff's theories. The district court granted that motion.

On appeal, the Eleventh Circuit affirmed the dismissal of the plaintiff's first theory. The court surveyed a circuit split, dictionary definitions, and the policy as a whole, and, applying South Carolina law, determined that the policy neither required the insurer to revisit COI rates at monthly or other intervals nor to consider only expectations regarding future mortality experience.

Concerning the plaintiff's second theory, the court explained that, under the policy's language, the insurer's expectations regarding future mortality experience constituted the "main or principal ingredient" for redetermining COI rates. As a result, if the insurer undertook COI rate redeterminations, it was required to consider those expectations as part of the process. Thus, the court reversed to allow the plaintiff to pursue his second theory, noting: "While it remains to be seen what can be proven, at this pleading stage [the plaintiff's] complaint states a breach of contract claim to that extent."

Auto-Portability Providers Racing to Close Retirement Plan Gap

BY GINA ALSDORF AND STEPHEN KRAUS

For decades, both the federal and state governments have been working to tackle the coverage gaps in our retirement system. In the race for retirement readiness, dark horses like state plans with mandatory adoption requirements, automatic IRA arrangements, auto-enrollment, and auto-escalation of contributions have been central themes. One of the biggest remaining gaps, however, is "leakage" that occurs when people take their funds out of tax-favored retirement plans for purposes other than retirement. These funds are often not used for emergencies or taken out of the account because of need. Indeed, the most significant proportion of leakage occurs when people leave jobs and, because of "friction" (unfamiliar processes and procedures), fail to roll over funds to another tax-deferred plan or IRA.

Section 120 of the Secure 2.0 Act created a prohibited transaction exemption that allows compensation to be paid to "automatic portability providers" (APPs) to help stop such leakage. APPs can facilitate the automatic transfer to a new employer's plan of employee assets that have been forced into safe harbor IRAs following employee termination. The detailed conditions under which such force-outs into safe harbor IRAs may occur remain the same as prior to the Secure 2.0 Act and still must be satisfied.

This February, however, the Department of Labor proposed regulations that, by way of implementing Section 120, would enable the additional transaction out of the safe harbor IRA to a new employer's plan, including compensation to the APP assisting an employee/IRA owner. Once a safe harbor IRA is funded, an APP would query other record-keepers continually to find any data matching that of the employee and thus locate the new employer's plan. When such data is found, and where the new employer has allowed, the APP can automatically roll existing safe harbor IRA funds into that employee's account at the new employer's plan.

Saddle Weights for APPs. Under the proposed rules, in addition to disclosure and operational requirements, APPs would need to acknowledge their fiduciary status in writing and would be subject to fiduciary duties. Unlike the existing rules for safe harbor IRAs, the proposed rules provide no fiduciary safe harbor for rollovers to a new employer's plan by an APP. If an APP doesn't meet its fiduciary responsibilities, there could be regulatory or civil action against the APP.

Plan Sponsors Also Weighed Down. Moreover, according to the DOL, the decision of an employer to participate in an APP program would constitute a fiduciary act. Where the current regulation for force-out rollovers to safe harbor IRAs provides fiduciary relief for a sponsor in the selection of an IRA provider and the selection of default investments for the IRA, no such safe harbor exists for APP selection by an employer or for the employee's new employer in allocating rollover dollars into the new plan. The new employer would also be required to disclose the program, including any fees and expenses, to employees in its summary plan description. Because of the lack of fiduciary relief, employers that allowed the transfer of assets into their plans via an APP transfer would also need to review the transaction to ensure the assets were correctly invested into the asset allocation selected by the participant or, if none exists, into the default investment option of the receiving plan.

Overall, the DOL had a real opportunity to encourage auto-portability. Instead of making it a fast track, however, the track is muddied with additional burdens and risks for both employers and APPs. The DOL could have created a safe harbor similar to the one for force-outs to safe harbor IRAs, thus allowing transfers into a new employer's plan based on "negative consent" by the employee and without subjecting employers and APPs to fiduciary scrutiny, so long as certain prescribed conditions were met. However, the regulation proposed has come up at least a furlong short of the finish line. Under the circumstances, it is unlikely that auto-portability will be widely adopted in this current incarnation.

SEC Penalizes Anti-Whistleblower Provision in Customer Settlement Agreements

BY JONATHAN STERLING AND BRENDAN GOOLEY

The SEC has opened a new track in the whistleblower litigation derby. While SEC enforcement actions concerning whistleblower violations are nothing new, they typically involve claims that companies precluded *employees* from reporting purported violations of securities laws to the SEC. *See* "Juggling Act: SEC Fines Three Employers for Potentially Discouraging Whistleblowers," *Expect Focus – Life, Annuity, and Retirement Solutions* (January 2024).

In the case discussed below, however, the SEC claimed that a company violated whistleblower rules by allegedly precluding *customers* from reporting alleged securities law violations to the SEC.

The SEC's action evidences its broad interpretation of whistleblower protections and comes on the heels of pro-whistleblower actions by other regulatory bodies, including the National Labor Relations Board. *See* "NLRB Stacks Deck in Favor of Employees: Employers Must Play Cards Defensively or Go Bust," *Expect Focus – Life, Annuity, and Retirement Solutions* (September 2023).

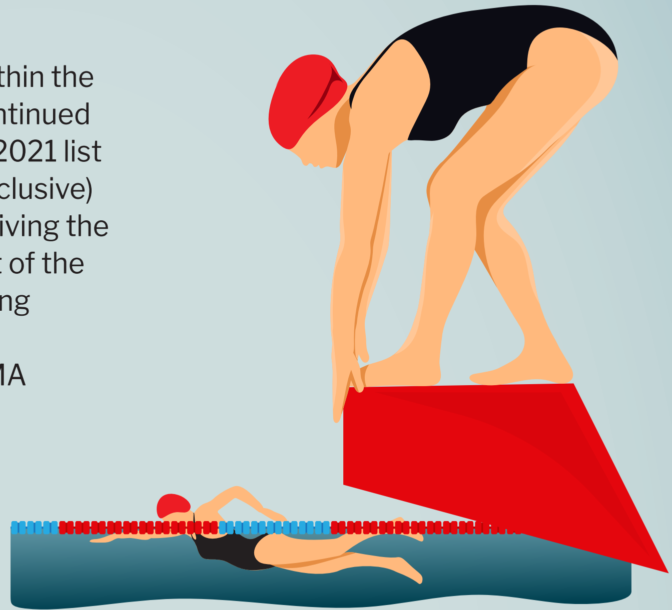
In January, a major bank agreed to pay $18 million to settle claims by the SEC that it violated federal whistleblower protection rules. The SEC alleged that the bank had required clients involved in disputes to sign confidential release agreements, prohibiting them from disclosing settlement details and precluding them from voluntarily contacting the SEC. At the time of the settlement, the director of the SEC's Division of Enforcement blew the SEC's own penalty whistle, saying that companies "cannot include provisions that prevent individuals from contacting the SEC with evidence of wrongdoing."

Broad SEC interpretations of whistleblower protections in settlement agreements with customers open a new field in whistleblower protection litigation. Companies now need to be concerned about agreements with all sorts of third parties rather than just focusing on their employers. They also need to scrutinize carefully what was previously thought of as standard and mundane settlement and confidentiality language.

NAIC Takes Dive Start on Investment Management Agreements With New Guidance for Insurers

BY ANN BLACK AND ERIN VANSICKLE

During its Winter National Meeting, various groups within the National Association of Insurance Commissioners continued addressing the Macroprudential (E) Working Group's 2021 list of "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity-Owned Insurers." This included receiving the Risk-Focused Surveillance (E) Working Group's report of the Affiliated Investment Management Agreement Drafting Group's work addressing the regulatory oversight of investment management agreements. In 2023, the IMA Drafting Group was tasked to consider affiliated investment management services and investment management agreements and ensure consistency between the NAIC's *Financial Analysis Handbook* and the NAIC's *Financial Condition Examiners Handbook*.



The IMA Drafting Group proposed enhancements to the *Financial Condition Examiners Handbook*'s current guidance to examiners in Section 1-III F regarding outsourcing of critical functions, which applies to the examination of **all** investment management agreements, including those with affiliates. In reviewing the *Financial Analysis Handbook*, the IMA Drafting Group determined that similar guidance would be desirable for the analysis of Form D filings for affiliated IMAs and proposed new language for two sections of the *Financial Analysis Handbook* – Section V.C. Domestic and/or Non-Lead State Analysis – Form D Procedures and Section V.F. Domestic and/or Non-Lead State Analysis – Analyst Reference Guide.

Under the IMA Drafting Group's proposed language, as part of the Form D filing or a financial examination, an IMA would be reviewed for the following:

- **Selection of Investments** – The specificity of the investment guidelines given to the investment adviser who will be making investments.
- **Authority for Transactions** – The level of authority that will be given to the investment adviser in executing transactions.
- **Conflicts of Interest** – The manner in which any known conflicts of interest will be considered.
- **Fiduciary Responsibility** – An acknowledgment by the investment adviser that it acts as a fiduciary in advising the insurer and a statement of the adviser's registration status. In this regard, the NAIC's *Financial Condition Examiners Handbook*'s language includes a statement that it would be advisable for the investment adviser to be registered with the SEC or, at a minimum, to acknowledge that it is subject to applicable guidance and requirements under the Investment Advisers Act of 1940.
- **Calculation of Fees** – The way fees are calculated and whether the fees appropriately reflect current market conditions, as well as the nature of the assets and type of asset management. Where the investment adviser is an affiliate of an insurer, care is needed to ensure that fees are not being used to impermissibly evade dividend restrictions.
- **Sub-Advisers** – The authority to engage sub-advisers, including the required consent by the insurer, and payment of sub-adviser fees in a manner that ensures the investment adviser is not being paid for services being provided by the sub-adviser.
- **Reporting** – The information required to be provided to the insurer as to compliance with applicable guidelines and as to performance and risk metrics, as well as to enable the insurer to comply with regulatory requirements.
- **Termination** – The rights of the insurer to terminate and to transition the investment advisory services to a successor adviser.

The deadline for public comment was April 30, 2024.

Insurers and Underlying Funds Sprint to Finalize Delivery Procedures for Tailored Shareholder Reports

BY W. THOMAS CONNER

Variable contract issuers and underlying funds are charging toward the finish line to finalize procedures for delivering upcoming semiannual "tailored" shareholder reports. The reports in this new format must be concise (e.g., three-page "trifold" brochures) and provide just the essential information about a **single portfolio** (or class of a portfolio). More detailed information must be provided online, and the reports themselves must be **mailed** (or emailed, if the contract owner consents).

Different procedural frameworks have emerged for delivering the tailored shareholder reports and fulfilling a series of website posting and other collateral requirements. Frameworks have differed depending on variables such as whether certain contracts have been "discontinued" or "Great-Wested" and how insurers and underlying funds have allocated their various relevant delivery and website posting responsibilities.

In January, the SEC staff issued FAQs on tailored shareholder reports, several of which are pertinent to variable contract issuers.

- As noted above, detailed fund information that historically has appeared in shareholder reports must instead now be posted online. The SEC staff advised that such information could appear on either a variable contract issuer's website or an underlying fund's website, but noted some important practical implementation issues to consider.
- The staff advised that, where a variable contract investor has allocated contract value to multiple underlying funds, the individual shareholder reports of each of these funds could be bound, stapled, or stitched together for transmission to the investor, subject to certain conditions.
- The staff outlined several practices for effective email delivery of tailored shareholder reports. While the staff did not specifically address email procedures for variable contract issuers, this guidance should be equally applicable to variable contract issuers.

Hopefully, all insurers and underlying funds will be able to take a final "victory lap" after developing effective tailored shareholder report compliance procedures. Funds, and to the extent applicable, insurance companies, generally must implement the new disclosure, transmission, website posting, and related requirements with respect to shareholder reports for the period ending June 30, 2024, which will be transmitted by the end of August 2024.

NEWS AND NOTES

Carlton Fields' insurance group was named one of *Law360*'s 2023 "Practice Groups of the Year." The award honors the attorney teams behind litigation wins and major deals that resonated throughout the legal industry this past year. The firm's insurance group was recognized for its work on behalf of some of the largest insurers in the world in class actions, complex commercial litigation, and regulatory matters.

Gina Alsdorf Joins Carlton Fields

Gina Alsdorf has joined Carlton Fields' Financial Services Regulatory Practice as a shareholder in Washington, D.C.

Gina has more than 15 years of experience in the financial services industry, working with regulators, plan fiduciaries, investment professionals, and business owners on complex issues involving ERISA, employee benefit plans, banking, securities, annuities, privacy, and related tax matters.

For more than a decade, she held various senior in-house roles counseling executives in the financial services industry, most recently at Lincoln Financial. Gina served as in-house counsel for a third-party administrator and as a former investigator for the Employee Benefits Security Administration, an agency within the U.S. Department of Labor.

Carlton Fields was recognized as a **leading law firm in BTI Consulting Group's "Leading Edge Law Firms 2024" report**. This inaugural report identifies firms deemed by clients to be best equipped to meet new leading-edge expectations and help them deal with their most critical issues.

The American Bar Association has published an updated *Fund Director's Guidebook*, the first since 2015. **Gary Cohen** served as a member of the task force that authored the updated guidebook, co-chaired by former SEC director Andrew "Buddy" Donohue.

Thomson Reuters named 12 Carlton Fields attorneys to its 2024 "Stand-Out Lawyers" list, including **Ann Black**, **Richard Choi**, and **Ann Furman**, who were recognized for their ability to offer proactive, business-savvy advice; deliver exceptional client service; and integrate well within the client's legal team.

JD Supra has named Carlton Fields as a top firm, and attorney **Ann Black** as a top author, in the insurance category in its 2024 Readers' Choice Awards. The firm and Ann were selected based on the consistently high readership and engagement of their thought leadership articles.

The firm is a sponsor of the NAFA Annuity Leadership Forum on June 24–25 in Washington, D.C. **Gina Alsdorf** and **Trish Carreiro** will serve as speakers at the forum.

Carlton Fields is ranked among the **top 5% of law firms in BTI Consulting Group's "Client Service A-Team 2024" report**. This is the only legal ranking that identifies leading law firms for client service through a national survey of corporate counsel.

Carlton Fields released its 13th annual Class Action Survey, which provides an overview of important issues and practices related to class action matters and management. The annual publication reports on historical trends captured since the inception of the survey and includes information related to emerging issues in class action litigation.

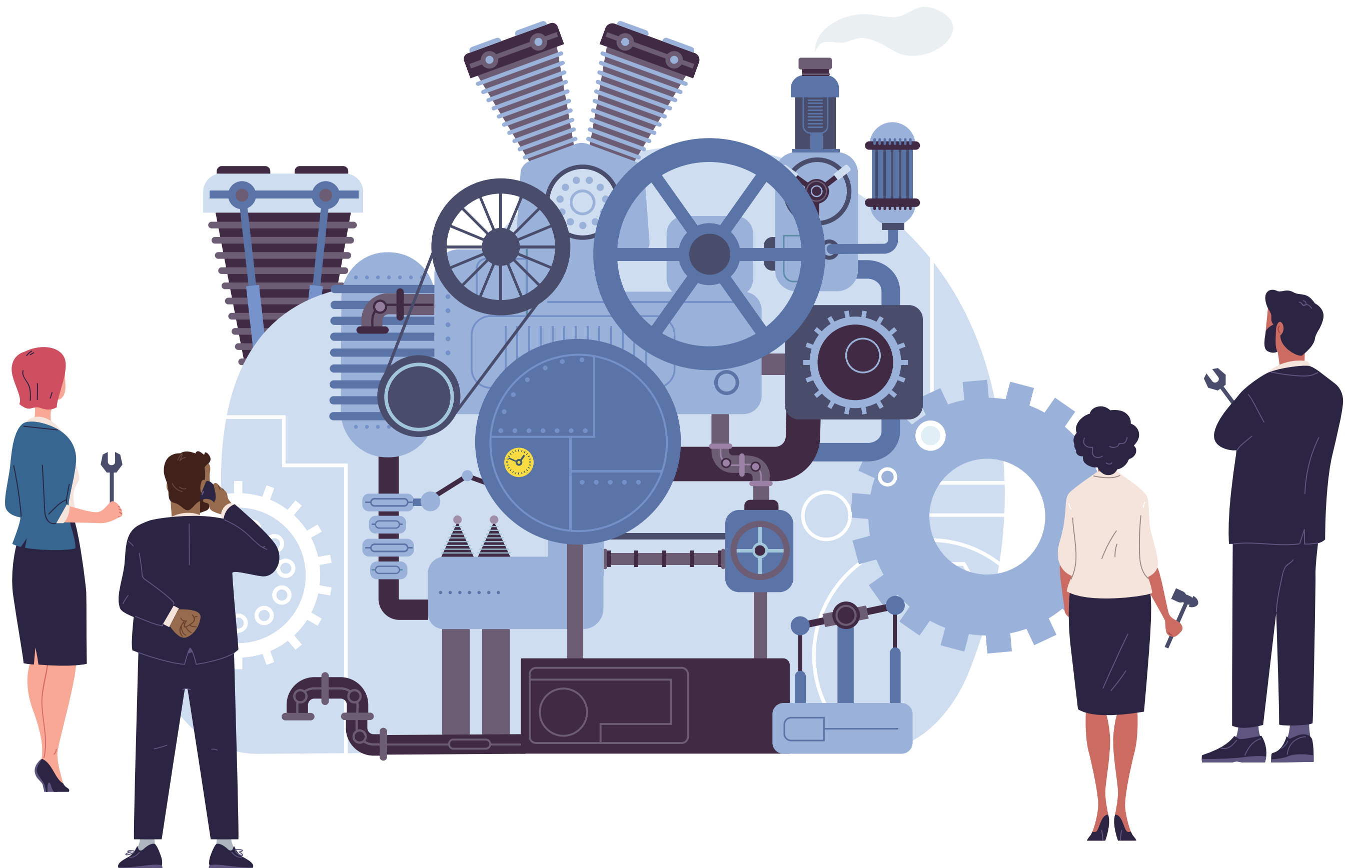
Carlton Fields is proud to serve as the executive partner of the ACLI Compliance & Legal Sections Annual Meeting on July 22–24 in Fort Lauderdale, Florida.

Carlton Fields welcomes the following attorneys to the firm: shareholders **Gina Alsdorf** (financial services regulatory, Washington, D.C.) and **Ricky Benjamin** (health care and life sciences, Atlanta); of counsel **Janet Goldberg McEnery** (labor and employment, Tampa); senior counsel **Stephen Beke** (mass tort and product liability, Los Angeles); and associates **Alexandra Beguiristain** (financial services regulatory, Miami), **Jillian Blumenthal** (business litigation, Miami), **Siena Carnevale** (business litigation, New Jersey), **Lauren Gandle** (health care, Tampa), **Julia Duffy** (property and casualty insurance, New Jersey), **John Gibbons** (life, annuity, and retirement litigation, Washington, D.C.), **Julie Levine** (business litigation, Miami), **Haroon Mian** (intellectual property, New York), **Oliver Phillipson** (property and casualty insurance, New York), and **Samuel Spinner** (appellate practice and trial support, Miami).

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY GROUP

Co-chairs, **Ann Y. Black** and **Markham R. Leventhal**

Scott Abeles
Enrique D. Arana
Gina Alsdorf
Alexandra Beguiristain
Scott E. Byers
Patricia M. Carreiro
Richard T. Choi
Justin L. Chretien
Gary O. Cohen
W. Thomas Conner
Mederic Daigneault
Robert W. DiUbaldo
Harry Eisenstein
Stephanie A. Fichera
Todd M. Fuller
Ann B. Furman
Brendan N. Gooley
Jason H. Gould
Clifton R. Gruhn
Sean W. Hughes
Jeanne M. Kohler
William J. Kotapish
Stephen W. Kraus
Thomas C. Lauerman
Julianna Thomas McCabe
Thomas F. Morante
Jason A. Morris
Mark A. Neubauer
Brooke Patterson
John C. Pitblado
Thomas V. Sjoblom
Robert B. Shapiro
R. Jeffrey Smith
Irma T. Solares
Erin J. VanSickle
Jeffrey L. Williams
Michael N. Wolgin
Edmund J. Zaharewicz



OUR FOOTPRINT

Atlanta
One Atlantic Center
1201 W. Peachtree Street NW | Suite 3000
Atlanta, Georgia 30309-3455
404.815.3400 | fax 404.815.3415

Hartford
One State Street | Suite 1800
Hartford, Connecticut 06103-3102
860.392.5000 | fax 860.392.5058

Los Angeles
2029 Century Park East | Suite 1200
Los Angeles, California 90067-2913
310.843.6300 | fax 310.843.6301

Miami
2 MiamiCentral
700 NW 1st Avenue | Suite 1200
Miami, Florida 33136-4118
305.530.0050 | fax 305.530.0055

New Jersey
180 Park Avenue | Suite 106
Florham Park, New Jersey 07932-1054
973.828.2600 | fax 973.828.2601

New York
Chrysler Building
405 Lexington Avenue | 36th Floor
New York, New York 10174-3699
212.785.2577 | fax 212.785.5203

Orlando
200 S. Orange Avenue | Suite 1000
Orlando, Florida 32801-3456
407.849.0300 | fax 407.648.9099

Tallahassee
215 S. Monroe Street | Suite 500
Tallahassee, Florida 32301-1866
850.224.1585 | fax 850.222.0398

Tampa
Corporate Center Three
at International Plaza
4221 W. Boy Scout Boulevard | Suite 1000
Tampa, Florida 33607-5780
813.223.7000 | fax 813.229.4133

Washington, DC
1025 Thomas Jefferson Street, NW
Suite 400 West
Washington, DC 20007-5208
202.965.8100 | fax 202.965.8104

West Palm Beach
CityPlace Tower
525 Okeechobee Boulevard | Suite 1200
West Palm Beach, Florida 33401-6350
561.659.7070 | fax 561.659.7368

CARLTON FIELDS

Carlton Fields serves business clients in key industries across the country and around the globe. Through our core practices, we help our clients grow their businesses and protect their vital interests. The firm serves clients in eight key industries:

- Life, Annuity, and Retirement Solutions
- Banking, Commercial, and Consumer Finance
- Construction
- Health Care
- Property and Casualty Insurance
- Real Estate
- Securities and Investment Companies
- Technology and Telecommunications

Atlanta • Hartford • Los Angeles • Miami • New Jersey • New York • Orlando
Tallahassee • Tampa • Washington, D.C. • West Palm Beach

For more information, visit our website at www.carltonfields.com.

Carlton Fields, P.A. practices law in California through Carlton Fields, LLP.