LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

Volume I, January 2025

EXPECTFOCUS®

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Clues TO THE FUTURE

DECODING INDUSTRY TRENDS

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Mr. Green				
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The Mysterious Boundary Beyond Which “Personal” Relationships Jeopardize a Director’s Independence

BY THOMAS LAUERMAN

In a recent enforcement action, the SEC concluded that the relationship between James Craigie and an officer of Church & Dwight Co. fatally undermined Craigie’s status as an “independent director” of the company under New York Stock Exchange rules. The SEC seems not to have needed a bloodhound to sniff out sufficient evidence for its case, particularly in light of some pretty expansive language in the relevant NYSE rule. Nevertheless, this case also merits some investigation by mutual funds and their independent directors.

Craigie had previously served as CEO and a non-independent director of Church & Dwight. After retiring from his CEO position, Craigie commenced a mentoring relationship, and a significant friendship, with a younger Church & Dwight executive being the mentee. Subsequently (after the expiration of a “cooling off” period), Craigie assumed the role of an independent director of the company. The SEC asserted that, while serving in that role:

i. Craigie paid more than $100,000 in travel and lodging expenses for the mentee and the mentee’s wife to vacation on multiple occasions with Craigie and Craigie’s wife.
ii. Craigie and the mentee both had ambitions for the mentee ultimately to become Church & Dwight’s CEO, but when Craigie’s successor as CEO planned to retire, it became apparent that someone other than the mentee would be chosen.
iii. Craigie, however, discussed the situation with the mentee, and the two of them reached out to a mutual friend who might be interested in the CEO position. This friend was an older executive who had been a colleague and supervisor of the mentee at a former company, and apparently also viewed the mentee favorably. Their apparent assumption was that, after some further seasoning, the mentee would be well positioned to become CEO following a relatively brief tenure by the friend in that position.
iv. Craigie then recommended the friend to the director heading Church & Dwight’s CEO search committee, and the friend subsequently became a strong candidate for the position.
v. Craigie improperly concealed the facts mentioned in (i)-(iii) from the company and/or its other directors.

Based on these and other facts, the SEC concluded that company proxy statements had misstated a material fact by identifying Craigie as an independent director and that he had violated the SEC’s proxy rules by causing or permitting that disclosure. Craigie settled the case without admitting or denying the SEC’s allegations.

The language of the relevant NYSE rule requires simply that an independent director have no material relationship with the listed company in question. Given that Craigie’s mentoring, befriending, and promoting of the mentee were not part of his specific duties as an independent director, and the fact that he concealed those things, it is understandable that he could be construed to have a material relationship with the company that was distinct from his relationship as an independent director, and not a purely personal relationship with the mentee.

Somewhat analogous language in the Investment Company Act of 1940 defines which mutual fund directors are considered independent (or, in the act’s parlance, not an “interested person”). Basically, that language requires that there be no SEC finding of a “material business or professional relationship” between the director and the investment adviser of the fund (or of another fund managed by that adviser) or the CEO or a controlling person of that adviser. The fact that this language refers only to “business” and “professional” relationships indicates that purely “personal relationships” are OK. But, even if the result in Craigie’s case seems pretty understandable, many (if not most) relationships entail a mix of personal and often subtle business/professional elements that leave the boundary between independence and non-independence shrouded in mist and subject to second-guessing.

Plotting a Course for Your 2025 Data Security Plan

BY PATRICIA CARREIRO

Trying to plot the course for a data security plan in 2025 requires piecing together the maps of various cartographers and decoding each map's legends and keys.

The cartographers:

- **Consumer Financial Protection Bureau**

  On November 12, the CFPB published a report warning about alleged gaps in consumer protection caused by Gramm-Leach-Bliley Act exemptions relied upon by insurers as keys to safe passage around the obstacles of most state comprehensive privacy laws. The report also added a legend urging lawmakers to address these gaps because financial institutions are allegedly increasingly collecting and using large quantities of consumers' financial data as a source of revenue.

  These actions may narrow the path for the use of consumer data by insurers navigating this perilous terrain.

- **Federal and State Privacy Regulators and Legislation**

  State privacy regulators have added caution signals to their maps that may result in insurers avoiding or slowing down on routes that could be interpreted as involving dark patterns (user interfaces that impact consumer choices), data brokers, and automated decision-making.

  In addition, to address the increased risk from cyberattacks, federal regulators and states continue to add important new features to their maps that reflect additional cybersecurity requirements: the latest NY DFS Part 500 requirements taking effect and recent amendments to the SEC's Regulation S-P, to name a few.

- **NAIC Privacy Protections Working Group**

  The NAIC Privacy Protections Working Group continues development of a model flight plan for insurers and has released drafts of the portion addressing service provider agreements, privacy notices, privacy rights, data sales, and the use and disclosure of sensitive personal information. The partial draft plan signals that the new draft model will incorporate new hazards in the form of additional obstructions on data use and disclosure, widened flight paths for enhanced customer privacy rights, and requirements on the use of service providers. The draft's symbology portends that insurers will need to enhance their due diligence and oversight of service providers.

- **Plaintiffs' Bar**

  The plaintiffs' bar continues to chart out new class actions that challenge the use of various website technologies. The plaintiffs' bar seeks to navigate toward statutory damages for alleged violations of common law privacy norms and wiretapping laws. A recent Northern District of California decision granting a motion for class certification against a large insurer in one such case appears to have marked out a channel for increasing demand letters to insurers.

To help decipher the work of these cartographers and plot a course that avoids obstacles:

- ✗ Review your data security program to ensure all required annual certification dates are understood (and prepare to meet them).
- ✗ Revisit existing and planned practices and associated notices and consents with an eye toward improvements to address changed business practices or technologies and the latest legal changes, regulatory enforcement priorities, industry trends, and private litigation risk.
- ✗ Document risk assessments, due diligence, oversight, and training activities.
- ✗ Consider enhancing due diligence and oversight of service providers' privacy and cyber commitments.
- ✗ Evaluate service provider contracts to determine necessary (or even merely advisable) provisions going forward. Consider developing a template, which can either be incorporated into agreements or used as a checklist when reviewing others' terms.
- ✗ Supplement employee training to address the latest threats.
- ✗ Refresh and rehearse your incident response plan, adjusting as needed to address changed business practices/technologies, compliance with the latest regulatory changes, and improvements deduced from recent tabletop exercises or data cybersecurity incidents.

Bon voyage!

The Case of Excessive Fees: Supreme Court to Investigate Pleading Standard in ERISA Excessive Fee Litigation

BY IRMA SOLARES AND SEAN HUGHES

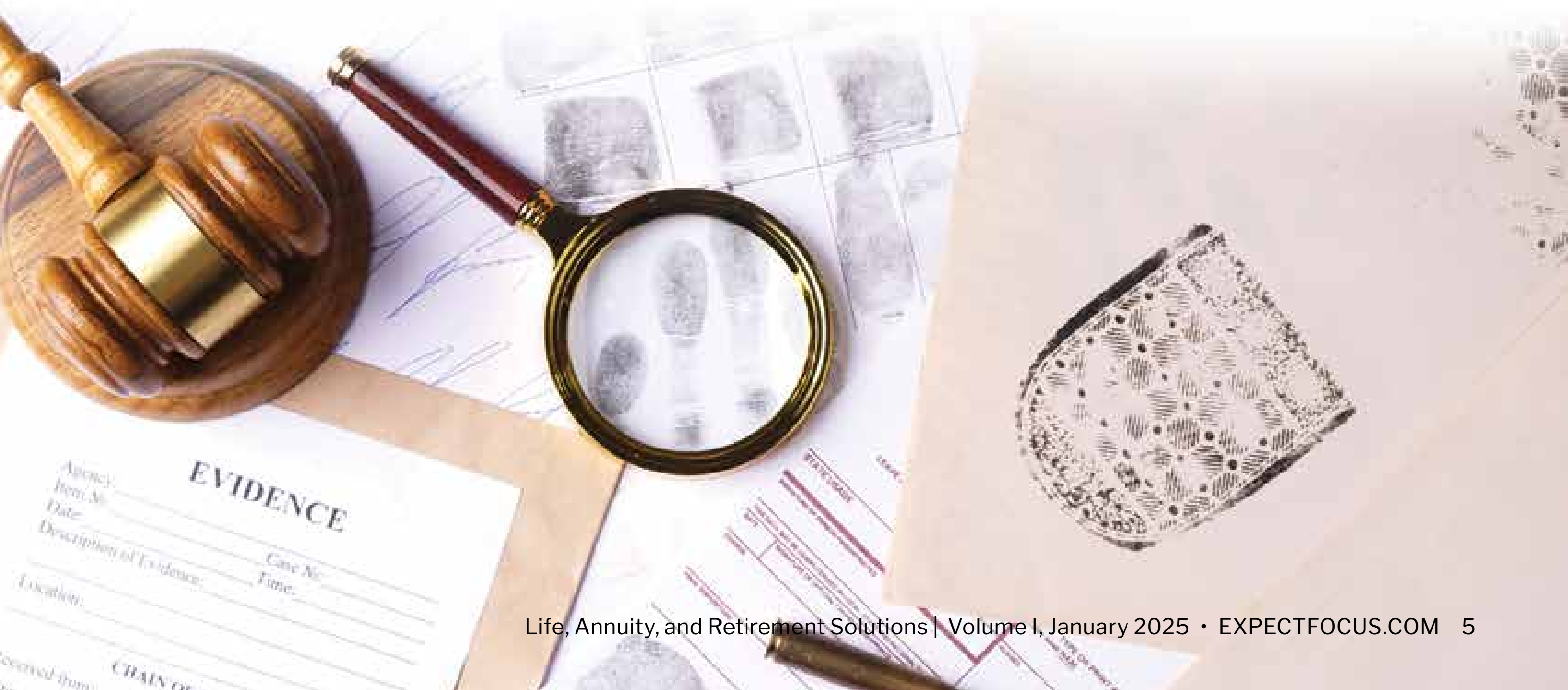
ERISA class action litigation against retirement plan fiduciaries remains a prominent feature of the legal landscape this year. These lawsuits typically involve allegations that plan fiduciaries acted imprudently in overseeing and managing retirement plans (such as 401(k) and 403(b) plans), leading to alleged “prohibited transactions” that result in excessive fees for investment options, record-keeping services, and administrative management services. The number of these cases began to rise significantly in 2016, with more than 450 excessive fee lawsuits filed between 2016 and 2023. So far in 2024, at least 25 excessive fee lawsuits have been filed against entities like Albertsons Companies, Bank of America, Coca-Cola Southwest Beverage, and Whataburger Restaurants.

Although the number of excessive fee lawsuits filed in 2024 has decreased by 23 cases compared to 2023, the plot thickens with the U.S. Supreme Court’s decision on October 4 to review the Second Circuit’s ruling in *Cunningham v. Cornell University*. The Second Circuit had affirmed the district court’s dismissal of the plaintiffs’ prohibited transactions claim and certain duty-of-prudence allegations for failure to state a claim. Importantly, the Second Circuit held as a matter of first impression that to state a claim for a prohibited transaction under 29 U.S.C. § 1106(a)(1)(C), it is not enough to allege that a fiduciary caused the plan to compensate a service provider for its services; rather, the complaint must plausibly allege that the services were unnecessary or involved unreasonable compensation.

The Eighth and Ninth Circuits have adhered to the plain text of section 1106(a)(1)(C), while the Second, Third, Seventh, and Tenth Circuits have required plaintiffs to allege additional elements to bring a claim because a “literal reading” of the statute would produce results inconsistent with ERISA’s purpose. These additional elements stem from the exemption outlined in 29 U.S.C. § 1108(b)(2)(A), which provides that “reasonable compensation” paid for “necessary” services to a “party in interest” is exempt from the prohibitions of section 1106(a). The Second Circuit held that this exemption is directly incorporated into section 1106(a)’s definition of prohibited transactions.

The Second Circuit has previously stated that when the exemptions are built into the relevant provision, plaintiffs must at the pleading stage allege that the plan services were unnecessary or involved unreasonable compensation. On December 2, in support of the plaintiff-appellants, the Department of Labor filed an amicus brief arguing that the burden of pleading and proving any exemption should fall on the defendant fiduciary.

The Supreme Court has scheduled oral arguments for *Cunningham* on January 22, 2025. The court’s decision could lead to a new wave of excessive fee litigation, particularly under section 1106(a)(1)(C), by providing uniform guidance on how courts should interpret these prohibited transaction rules.



SEC 2025 Examination Priorities Shine Light on AI

BY ELISHEVA KLESTZICK

Changes in available financial technology are changing the way the SEC's Division of Examinations will examine registered firms. The division's recently released 2025 examination priorities focus on the emerging risks posed by new financial technology in the capital markets and securities industry. The division aims to protect investors' interests by requiring registered firms that use such technology to provide more transparency and disclosure about their business practices.

AI Under the Microscope

One technology in the spotlight is generative artificial intelligence-based applications. The division plans to investigate registered firms' use of AI in their investment strategies and operations — specifically, their representations, policies and procedures, use of regulatory technology, and use of third-party products and services:

> With respect to AI, the Division will review registrant representations regarding their AI capabilities or AI use for accuracy. In addition, the Division will assess whether firms have implemented adequate policies and procedures to monitor and/or supervise their use of AI, including for tasks related to fraud prevention and detection, back-office operations, anti-money laundering (AML), and trading functions, as applicable. Reviews will also consider firm integration of regulatory technology to automate internal processes and optimize efficiencies. In addition, the Division will examine how registrants protect against loss or misuse of client records and information that may occur from the use of third-party AI models and tools.

Throughout its review of registered firms, the division will look for certain clues. Specifically, the division says:

> When conducting these reviews, assessments generally will include whether: (1) representations are fair and accurate; (2) operations and controls in place are consistent with disclosures made to investors; (3) algorithms produce advice or recommendations consistent with investors' investment profiles or stated strategies; and (4) controls to confirm that advice or recommendations resulting from digital engagement practices are consistent with regulatory obligations to investors, including older investors.

AI Washing

The securities industry has coined the term "AI washing" for misrepresentations and inaccuracies that registered firms may make about AI (similar to "greenwashing" in the ESG context). AI washing can manifest in many forms, including:

- Overstating a firm's AI capabilities;
- Giving an incomplete or inaccurate picture of certain AI practices;

- Using misleading high-tech buzzwords to attract investor attention when only basic algorithms, as opposed to sophisticated AI techniques, are being used; and
- Claiming that an AI function is fully autonomous when natural persons within the registered firm still play a role in the related activity.

Overall, AI washing is an act of deceit, and the division, in effect, wants a flashlight to reveal the true nature of AI use by registered firms. And instead of placing decoding responsibility on investors and consumers, the division places it in the hands of registered firms making AI claims and assertions.

Key Questions for Registered Firms

- Do you say what you do and do what you say?
- Does your business have a risk management framework that includes AI governance controls, testing protocols, and third-party oversight?
- Does your business have an established AI committee or AI governance group?
- When outsourcing AI work, is your clients' data properly handled and protected?
- When using AI tools, do you have policies in place to protect clients' confidential and personally identifiable information?

Addressing these key questions will light the way for registered firms to align their practices with ethical standards, risk management, and client trust in the use of AI.

Articles addressing other aspects of AI appear at pages 12 and 23 of this edition.

Will Insurers Be Required to Don a Deerstalker?

The Case of Third-Party Vendors in Insurance

BY ANN BLACK

Regulators are growing concerned about the delegation of various insurance company functions, prompting a closer examination of third-party vendors. Several groups within the National Association of Insurance Commissioners are leading the case:

- **Annuity Suitability (A) Working Group**

  The group is drafting a safe harbor guidance document to address requirements when recommendations and sales of annuities are made in compliance with comparable standards. The chair's draft stated that insurers availing themselves of the safe harbor must monitor the business conduct of the supervising third party. This would include investigating the third party at the outset of the contractual relationship and conducting ongoing audits using due diligence questionnaires and other monitoring techniques.

  During its November 17 meeting, the working group discussed comments on the chair's draft. Commentators and regulators debated how deeply insurers must delve into the policies and procedures of third-party distributors. Regulators were skeptical that relying on third-party certifications would constitute sufficient supervision.

  Chair Doug Ommen stated that the working group would convene a small drafting group to revise the draft guidance.

- **Third-Party Data and Models (H) Task Force**

  The task force is investigating insurers' reliance on third-party vendors to develop AI systems, underlying models, and sources of consumer data. It is considering various regulatory models applicable to insurers' reliance on third parties.

  At its November 18 meeting, the New York State Department of Financial Services explained that under its Circular Letter No. 7, insurers must develop written standards, policies, and procedures concerning their use of external data and AI systems from third parties. This includes performing due diligence on third parties, ongoing monitoring, and terminating the relationship when necessary. The circular letter also advises insurers to seek audit rights whenever possible and require third-party cooperation with regulatory inquiries. Insurers are also responsible for detecting unfair or unlawful discrimination in third-party AI systems, models, or data.

  Task force members will be surveyed about risks in different markets to uncover potential issues. The task force will then probe into how to develop a robust plan for a regulatory framework governing third-party models, including whether to impose obligations on insurers to investigate potential issues or use other regulatory tools.

- **Privacy Protections (H) Working Group**

  This group also is addressing third-party vendor requirements, focusing on contractual obligations between insurers and vendors. It received comments suggesting that revisions to the NAIC's Privacy of Consumer Financial and Health Information model regulation (#672) should require insurers to perform due diligence on third-party vendors, including assessing vendors' capabilities to comply with contractual requirements under the model regulation and conducting ongoing audits of these vendors.

- **Big Data and Artificial Intelligence (H) Working Group**

  This group reported it is looking into the extent to which private passenger automobile insurers test third-party-provided AI systems.

It seems the inquest into third-party vendors will continue in 2025.

The Mystery Continues: IUL Proprietary Indices Challenged in RICO Suit

BY IRMA SOLARES

Since the enactment of the Racketeer Influenced and Corrupt Organizations (RICO) Act, it has been invoked in civil litigation with mixed results. Congress did not intend for RICO to become a surrogate for plaintiffs' state law fraud and breach of contract claims. As the Third Circuit Court of Appeals observed in *Annulli v. Panikkar*, "if garden-variety state law crimes, torts, and contract breaches were to constitute predicate acts of racketeering (along with mail and wire fraud), civil RICO law, which is already a behemoth, would swallow state civil and criminal law whole." For this reason, RICO claims are carefully scrutinized, and many courts have declined to apply RICO to consumer disputes, such as class actions alleging racketeering in the unfair, deceptive, or fraudulent sales and marketing of financial products. Although RICO claims are difficult to prove, their broad scope and the potential for treble damages and attorneys' fees continue to attract plaintiffs, who bring these claims in life insurance and annuity litigation despite limited success.

One such RICO complaint was recently filed in the U.S. District Court for the District of Vermont, alleging that the defendant life insurance companies and a parent company breached contracts and engaged in "racketeering through the use and control of an enterprise of marketing agencies that duped consumers" by including two index funds that "were not what was promised." The defendants are accused of operating a RICO enterprise involving independent marketing organizations, broker general agencies, and independent agents.

The two challenged indices are proprietary interest crediting strategies available to policyholders in three separate indexed universal life policies offered by the defendants. The plaintiff claims that the policy illustration contained misleading descriptions of the two indices and fraudulently misrepresented their "historical performance" and crediting rates.

The plaintiff seeks to certify a class of individuals who purchased any of the three indexed universal life policies and allocated some or all of the accumulated value under those policies to one of the two indices. However, since the plaintiff only purchased one of the policies and allocated 100% of her value to a single index, she may face procedural challenges to her standing as a representative of policyholders who purchased the other two policies or allocated funds to the second index, among other substantive defenses.

Time will tell whether the plaintiff's RICO claim survives or if the court determines that the claim is little more than a hyped-up version of the plaintiff's state law breach of contract claim.

Getting Clued In: How the SEC's RILA Rulemaking Affects Variable Annuities

BY HARRY EISENSTEIN

The recent rule and form amendments adopted by the SEC to facilitate the registration of registered index-linked annuities (RILAs) and market-value adjustment annuities (MVAs) on Form N-4 have been broadly welcomed by the insured investment products industry. Some changes to Form N-4 brought by the RILA/MVA rulemaking, however, will also apply to issuers of *variable annuities*, even if those variable annuity insurers do not offer any RILAs or MVAs. Variable annuity issuers *may* now file their annual updates in compliance with the new rule and form amendments, but they *must* submit such compliant filings for these products that are effective no later than May 1, 2026.

One of the most, if not the most, challenging new disclosure issues for variable annuities arises from a preexisting Form N-4 instruction requiring the disclosure of "all material … intermediary-specific variations (e.g., variations resulting from different brokerage channels) to the offering." These could include variations in underlying investment options as well as contract features.

Because registrants are not always aware of all changes a particular distributor may make, they have historically disclosed that such variations may exist and provided guidance on how investors could obtain specific details. Notwithstanding this practice, the SEC staff appears to have taken the position that this instruction requires a prospectus description of the contract features and investment options made available by each distributor.

For example, if an intermediary offers a version of a contract that excludes a material benefit described in the contract, the specifics of that version must be disclosed in the prospectus. This interpretation could present a considerable burden for many carriers, particularly given the relatively small benefit to investors, who are already given guidance on how to obtain more information. Bottom line: there will likely be more conversations between the industry and SEC staff on this issue.

Other Form N-4 disclosure changes for variable annuity registration filings are relatively straightforward. These consist primarily of additional risk disclosures for the prospectus cover page and principal risks section, with minor changes in the overview, key information table, and appendix sections.

In addition, there are new disclosure requirements affecting registration filings for variable annuities offered with unregistered fixed investment options. Among other things, the appendix must now include a table listing the name, term, and minimum guaranteed rate of each fixed option. These requirements extend to all fixed options, including unregistered fixed indexed options, which do not fit well with the prescribed table format. However, the instructions allow modifications and exclusions "as necessary to describe the material features" of a fixed option. Hopefully, staff will engage with registrants to clarify what modifications and exclusions should be made for these options.

Notwithstanding expected lengthy review periods for RILA and MVA registration filings, the SEC stated in the adopting release for the RILA/MVA rulemaking that filings to bring variable annuities without RILA or MVA options into compliance with amended Form N-4 can be submitted for immediate effectiveness, so long as there are no other material changes. SEC staff have also confirmed that this expedited filing process extends to filings for variable annuities offered with unregistered fixed options, including fixed indexed options.

Variable annuity issuers should keep in mind that, as registrants and SEC staff work through the complex process of compliance with the amendments adopted in the RILA/MVA rulemaking, questions and issues will inevitably arise (about some of which nobody now has even a clue). In the coming months, it is highly probable that SEC staff will take significant additional interpretive positions, some of which are likely to affect registration filings for variable annuities that do not offer RILA or MVA options.

Piecing *Alpine* Together

BY THOMAS LAUERMAN

Is FINRA constitutional? According to the D.C. Circuit's November 2024 opinion in *Alpine Securities Corp. v. FINRA*, FINRA proceedings may be unconstitutional in one narrow set of circumstances.

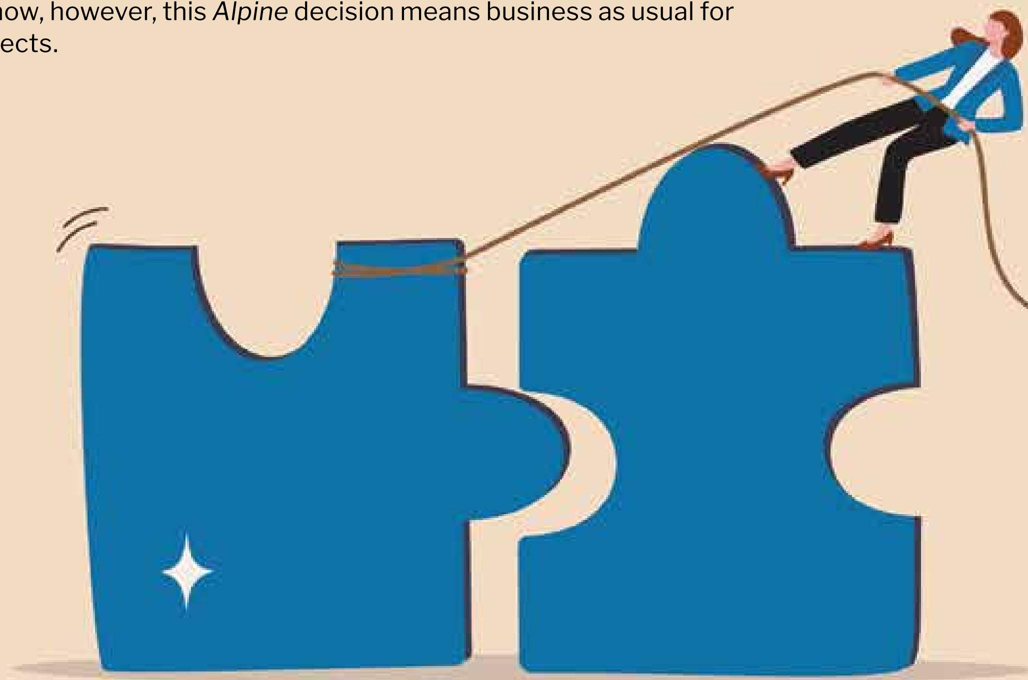
Alpine, a broker-dealer firm alleged to have broken FINRA rules, is the subject of expedited proceedings in which FINRA hopes to expel Alpine from membership. Alpine asked the district court and then the D.C. Circuit to halt the proceedings, arguing that either (1) FINRA is a private entity wielding too much government power (the private nondelegation argument) or (2) FINRA is a government entity whose officers were not properly appointed (the appointments clause argument). For additional details about *Alpine* and another case bearing on FINRA's constitutionality that also is currently pending in the D.C. Circuit, please see "FINRA's Sky Isn't Falling (Just Yet)," *Expect Focus – Life, Annuity, and Retirement Solutions* (September 2024).

After argument, the majority opinion (written by Judge Millett and joined by Chief Judge Srinivasan) agreed with Alpine on a single substantive piece of the nondelegation point: FINRA may not expel Alpine until either "full review by the SEC of the merits of any expulsion decision" or the time to seek SEC review runs out. With that one limitation, FINRA's expedited proceedings against Alpine may, for now, move forward.

Judge Walker, who would have invalidated FINRA's activities wholesale, partially concurred and partially dissented. His principal disagreement with the majority dealt with the quantum of SEC oversight necessary to avoid constitutional issues. In the majority's eyes, the SEC's eventual de novo review of FINRA actions was usually enough to satisfy the private nondelegation doctrine. "That is because many types of sanctions imposed by FINRA, short of expulsion, can be undone later. Censures can be rescinded, fines can be returned, and cease-and-desist orders can be lifted." And unlike the dissent, the majority did not believe that merely having to participate in FINRA proceedings would inflict any injury that could not later be remedied should Alpine prevail. An injunction was therefore warranted only to prevent FINRA from expelling Alpine before the SEC weighed in.

To the dissent, on the other hand, it was problematic that FINRA's "enforcement powers require[] no contemporaneous oversight by the SEC," meaning that the "SEC does not control FINRA's investigations, its prosecutions, or its initial adjudications." So "[u]ntil the SEC accepts an appeal from a final FINRA decision, FINRA wields its enforcement powers unilaterally." (An ironic assertion given Judge Walker's previous writing in this same case that FINRA's activities were "controlled by the government" "from start to finish ... with little to no room for private control.")

A more complete picture will probably emerge in time, and the Supreme Court may ultimately decide to wade in. For now, however, this *Alpine* decision means business as usual for FINRA in nearly all respects.



2 Across: Changing Financial Product Recommendations

BY CLIFFORD PEREZ

Artificial intelligence (**AI**) can and is already changing how firms and registered representatives recommend financial products to customers. AI has the potential to enhance recommendations that registered representatives give, by providing them with comprehensive real-time information about their customers. But AI recommendations can contain errors that firms and registered representatives need to recognize.

12 Down: *Positive Impacts of AI*

Firms are already filling in the spaces for **enhancements** AI can provide for financial product recommendations. AI is being developed to use clues about customers from traditional sources like their assets, spending patterns, and debt balances and nontraditional sources like social media posts, browsing histories, and prior communications made through email, chat messages, and meeting notes. AI incorporates this broad range of data into its output, which can provide registered representatives with a comprehensive, real-time, and tailored view of their customers. As such, registered representatives can use this information to enhance their existing skills and knowledge to provide customers with bespoke recommendations for relevant financial products. But firms have been cautious about allowing AI to provide customers with direct recommendations.

6 Across: *Dangers of AI*

Firms should be aware of potential **errors** in AI recommendations. AI can make flawed recommendations based on "hallucinated," i.e., made-up, data. AI also has the potential to provide recommendations not in the best interest of customers, for example, by prioritizing lower-quality products with higher costs where lower-cost, higher-quality products are available. Further, since AI uses historical data, it is susceptible to perpetuating or amplifying existing demographic-related biases reflected in the dataset.

These problems can be amplified by the complex nature of AI models, which often makes it hard to understand or explain how the recommendations are created. In some cases, AI models can generate different recommendations based on the same input without an explanation. So, making sure recommendations are reliable and free of bias can be difficult. But in-line citations providing the source of the data for recommendations could counter this problem.

3 Down: *Interested in AI Recommendations*

Most importantly, firms need to understand that using AI does not relieve them of their obligations to their customers or the **SEC**. The SEC maintains that AI does not relieve firms, or registered representatives, from complying with all applicable securities laws, rules, and regulations. Accordingly, firms and registered representatives are responsible for any recommendations made with AI, regardless of their knowledge of how AI finished the puzzle.

Articles addressing other aspects of AI appear at pages 6 and 23 of this edition.

SEC Commissioners on the Hunt for Materiality

Disagree on Cybersecurity Enforcement Actions

BY ELLIOTT SIEBERS

On October 22, 2024, Republican SEC Commissioners Hester Peirce and Mark Uyeda issued a joint dissent sharply criticizing charges brought against four companies for allegedly making materially misleading disclosures regarding cybersecurity. The charges stemmed from the SEC's investigation into public companies impacted by the widespread 2019–2020 compromise of SolarWinds' Orion software. The companies agreed to pay civil penalties ranging from $900,000 to $4 million.

According to the SEC's orders against the four companies — Unisys Corp., Avaya Holdings Corp., Check Point Software Technologies Ltd., and Mimecast Ltd. — each was aware that a threat actor had accessed their systems as a result of the SolarWinds Orion hack but negligently minimized these cybersecurity incidents in public disclosures filed with the SEC. The dissent characterizes the enforcement allegations as being of two types:

(1) Failing to disclose material information (in the cases of Avaya and Mimecast); and
(2) Failing to update an existing risk factor in response to a cyberattack (in the cases of Check Point and Unisys).

However, Peirce and Uyeda accused the majority commissioners of "playing Monday morning quarterback" and giving insufficient attention to whether the omitted disclosures would truly be material to investors in light of all the other information available to them.

Reviewing the Avaya order, the dissent took issue with the majority's view that not disclosing the identity of the threat actor constituted a material omission. As such attribution was never mentioned as being material in any comment letters to the SEC during its "cybersecurity rule" rulemaking, the dissent believes it highly unlikely that investors would view attribution as material. Furthermore, at the time of Avaya's disclosure, the attribution of the SolarWinds attack was already widely reported in the media. This, the dissenters say, is an example of the majority's focus on immaterial "details regarding the incident itself" rather than its overall "impact."

With respect to Mimecast, the majority took issue with its failure to disclose the number or percentage of encrypted customer credentials that were accessed by the threat actor, and the failure to state the amount of source code downloaded by the threat actor. On both topics, the dissent argues that the majority failed to assess Mimecast's disclosure "as a whole." The dissent highlights that Mimecast's disclosure stated that the credentials were reset, and there was no evidence of any access to its customers' email or archive content. Mimecast also disclosed that it believed that the downloaded source code was "insufficient to build and run any aspect of the Mimecast service."

In the case of Check Point, the dissent compared its disclosures to those made by SolarWinds. In the SolarWinds case brought by the SEC, the court rejected the argument that SolarWinds made "unacceptably boilerplate and generic" disclosures. Given the court's decision, and the substantial similarity of Check Point's disclosures to those of SolarWinds, the dissent was deeply skeptical about the case against Check Point.

The dissenters also discount the majority commissioners' claims that Unisys framed cybersecurity events as hypothetical, notwithstanding that a compromise of its network had already occurred. Rather the dissenters think that an enforcement action on this basis was unnecessary and that the majority failed to explain why any of the alleged omissions were material from a securities law perspective.

The dissent concludes that the majority failed to apply a "reasonable investor" standard in each of these orders. When adopting its cybersecurity rule, the SEC recognized that immaterial disclosure may "divert investor attention" and result in "mispricing of securities," and the dissenters foresee that the practical effect of these enforcement actions will be an increase in filings reporting on immaterial events.

Case Closed: Overview of Life, Disability, and Long-Term Care Insurance Litigation

BY STEPHANIE FICHERA, CLIFTON GRUHN, AND ANNICK RUNYON

Life Insurance – Cost of Insurance Increases

In a split decision, the Tenth Circuit Court of Appeals recently affirmed summary judgment in *PHT Holding I LLC v. Security Life of Denver Insurance Co.*, rejecting the plaintiff's claim that the defendant-insurer breached the nonparticipation provisions of universal life policies by increasing cost of insurance (COI) rates to recoup losses.

The plaintiff initially pursued three breach theories, arguing that the defendant: (1) considered factors outside the policy terms when raising COI rates; (2) increased COI rates to recover past losses, violating nonparticipation provisions that excluded policyholders from sharing in profits; and (3) raised COI rates non-uniformly among policyholders. The district court granted summary judgment on the first two theories, finding that the COI provisions granted the defendant substantial discretion in setting COI rates and that nonparticipation provisions addressed only sharing in profits, not COI rates. The parties reached a settlement with respect to the third theory.

The plaintiff appealed only the second theory regarding nonparticipation. The Tenth Circuit ruled that nonparticipation did not apply to COI rates and thus did not restrict the factors the insurer could consider when setting COI rates. The court emphasized that whether an insurer's losses are permitted to affect COI depends on how much discretion the policy provides for setting the rates, not whether the policy is participating or nonparticipating. As the plaintiff did not challenge the district court's finding that the COI provisions allowed the insurer to consider past losses, the court affirmed summary judgment for the defendant.

Life Insurance – ERISA Preemption

In *Figari v. United Parcel Service Inc.*, the U.S. District Court for the Southern District of Florida granted the employer's motion to dismiss, finding that the plaintiffs' state law contract and tort claims were preempted by ERISA.

The plaintiffs were the beneficiaries of a former employee who had participated in his employer's ERISA-covered benefits plan, which provided basic life insurance, along with supplemental insurance that he purchased through the plan. Upon his leaving the company, the former employee's plan was terminated, and thereafter the former employee died. The plaintiffs then filed a complaint in state court against the employer and life insurer, asserting claims for negligence, breach of contract, and breach of fiduciary duty and alleging that the employer was required to have notified them of their interest in the former employee's life insurance and to have continued the policies after his departure. The defendants removed the case to federal court, asserting that these state law claims were preempted by ERISA.

The plaintiffs argued that the plan fell within ERISA's safe harbor provisions — which exempt certain group insurance programs from ERISA's regulatory requirements — due to the supplemental insurance being "separate" from the basic insurance the employee received under the plan. The court disagreed, ruling that the supplemental insurance was "part and parcel with the whole insurance plan." The court reasoned that the employer subsidized the purchase of insurance by paying the full cost of the basic life insurance and endorsed the plan by purchasing the basic policy and serving as plan administrator. Under such circumstances, the plan was subject to ERISA even though the employee paid all premiums that went beyond the basic life insurance coverage.

Ultimately, the court found that ERISA defensively preempted the plaintiffs' claims, as they were based on the failure to pay benefits according to the terms of an ERISA plan. The court dismissed all of the state law claims, noting that the case should have been brought under ERISA and that the plaintiffs had not sought leave to amend.

Disability Insurance – Return to Part-Time Work

In *Raymond v. Unum Group*, the Fifth Circuit Court of Appeals affirmed the district court's denial of the policyholder's motion for summary judgment and sua sponte granted summary judgment in favor of the insurer in a disability insurance dispute.

The policyholder, a pharmacist, purchased disability insurance and, eight years later, was diagnosed with multiple sclerosis. She applied for benefits under her policy, which were approved, and the insurer began paying her monthly disability benefits and social insurance supplemental income. After the policyholder returned to work as a "pharmacy consultant" and "on-call floating pharmacist" on a part-time basis, the

insurer informed her that benefits would continue if she was not working in her "regular occupation" and was working in a "limited capacity." However, she later took a new position as a pharmacist with increased hours, duties, and pay. Upon investigation, the insurer discovered that the policyholder had underreported her hours and income.

The insurer terminated the disability benefits and sought repayment of more than $200,000 in overpaid benefits. The policyholder sued, claiming she remained eligible for total disability benefits. The insurer counterclaimed for the overpaid amounts. The district court granted summary judgment to the insurer, dismissing the policyholder's claims but allowing the insurer's counterclaim to proceed.

On appeal, the policyholder argued that the district court misinterpreted the definition of total disability. The court disagreed, finding that the policyholder, despite her reduced hours and inability to work full 12-hour shifts, was still able to perform the substantial and material duties of a pharmacist in her new role. The Fifth Circuit affirmed the district court's decision, agreeing that the insurer properly terminated benefits and that further discovery would not alter the outcome.

Disability Insurance – Interplay of Physical and Mental Health Policy Provisions

In *McEachin v. Reliance Standard Life Insurance Co.*, the Sixth Circuit Court of Appeals addressed "the interplay of the physical and mental-health components" of an ERISA-governed long-term disability insurance policy.

The insurer terminated the participant's total disability benefits in April 2021 after an independent review indicated significant improvement in her physical health, allowing her to perform her job. While the insurer acknowledged ongoing psychiatric issues that prevented her from working full time, it applied the policy's 24-month limitation on benefits for mental disorders that contributed to the total disability.

The Sixth Circuit affirmed the district court's decision, agreeing that the participant was no longer totally disabled due to her improved physical condition, and could work full time with appropriate limitations.

The court also applied its 2016 decision in *Okuno v. Reliance Standard Life Insurance Co.*, which held that a mental health disability does not "cause or contribute to" a total disability if physical disabilities alone are sufficient. The record indicated that the participant's physical condition alone prevented her from working until April 2021, making the 24-month limitation "irrelevant" until that point.

Finally, although the participant did not raise the argument below, the Sixth Circuit remanded the case to the district court to consider whether medical evidence post-dating the April 2021 denial could "toll the 24-month mental disability clock" and extend her eligibility for benefits.

Long-Term Care Insurance – Premium Rate Increases

The Eighth Circuit Court of Appeals affirmed a district court's decision to grant an insurer's motion to dismiss for failure to state a claim.

The plaintiffs purchased long-term care insurance policies with an inflation protection rider, which stated that premiums would not be expected to increase as a result of inflation-based benefit amount increases. However, after 10 years, the insurer raised annual premiums significantly.

The plaintiffs filed a putative class action, claiming fraud and a breach of the implied covenant of good faith and fair dealing. The insurer filed a motion to dismiss, which was later granted.

On appeal, the court rejected the plaintiffs' fraud claim based on the insurer's statement that premium increases would not correspond to benefit increases, noting that the insurer did not represent that it would never raise premiums, and the rider allowed for premium adjustments on a class basis.

Additionally, the court found no breach of the implied covenant of good faith and fair dealing because the rider expressly permitted premium increases. Accordingly, the court affirmed the dismissal of the case.

Blockchain: A Conundrum for Clearinghouses and Financial Institutions

BY GINA ALSDORF

Centralized financial intermediaries are a cornerstone for trading, settling, and clearing securities. Large institutions manage the individual accounts at the front end of these activities, while the Depository Trust & Clearing Corp. (DTCC) settles and clears most transactions. Though a puzzle to many, blockchain is a technology solution that could replace some of these functions, although for this to happen, changes in current legal requirements or interpretations will likely be required.

Present day, investors generally must maintain an account with a financial institution that is either registered as a broker-dealer or exempt from such registration, in order to trade securities. Financial institutions trade stocks, mutual funds, the securities underlying annuities, and other investments on an "omnibus" basis, meaning that all investor assets and trades are pooled into one "omnibus" account, under the name of a single financial institution that acts as custodian. The financial institution maintains records of the investors' interests in their respective individual accounts, and it holds an appropriate amount of securities in the omnibus account for their benefit. With omnibus trading, trades are netted out internally prior to the financial institution going into the market to purchase or sell securities. The financial institution receives a fee for maintaining the omnibus account and record-keeping of each investor's interest in the securities.

The clearing process validates the availability of purchase funds, records the transfer, and delivers the purchased security to the purchasing financial institution, which then allocates the security to the appropriate investor. Trades are typically settled one business day following the trade. Outsourcing settlement functions to a trusted third party, like the DTCC, is intended to minimize the risk of a seller not receiving payment and increase efficiency.

Are blockchains a possible replacement for the omnibus trading and clearing model?

Unlike the centralized trading process currently in use, a blockchain is a decentralized method of tracking ownership records that can be both secure and transparent. Envision a linked chain of blocks, each containing transaction data, a time stamp, and an identifier called a "hash." This chain, which is commonly referred to as a "distributed ledger," is akin to a list of transactions that would typically be stored on paper or digitally, except that each block contains a copy of all the previous trades, in addition to the most recent trades. Specialized computers, called "nodes," solve challenging puzzles to cryptographically validate all transactions on a blockchain, eliminating the need for a trusted third party.

Were securities to be tokenized (traded like cryptocurrency) on a blockchain, a clearing agency like the DTCC would in theory be unnecessary, because the cryptographic method used to validate transactions, and the immediate settlement, eliminates the need to use an intermediary to settle and clear trades. All the assets are shown continually on the distributed ledger. Nodes never take possession of an account holder's funds during any step of a transaction. Rather, the transaction happens between the buyer and seller and is immediately reflected by an updated account balance as represented on the blockchain.

Thus, the usual current one-day settlement delay would be eliminated. Also, with tokenized securities, anyone can in theory directly purchase or sell assets without an intermediary, which would lessen, or in some cases eliminate, any need for financial institutions that currently trade securities on an omnibus basis.

Financial institutions are already puzzling out how to respond. For example, on November 18, 2024, Goldman Sachs announced it would spin off its digital assets platform to create an industry-owned company. Large financial institutions and the government could use such a neutral platform to issue, trade, and settle tokenized assets. Under this model, financial institutions could retain their role as financial intermediaries, while still achieving efficiency advantages from adopting blockchain technology, which may very well become a mainstream part of securities trading.

This article was co-authored by Carlton Fields law clerk Jason Berkun.

SEC Action Builds Pressure for ETFs in Variable Contracts

BY THOMAS CONNER

On October 31, 2024, the SEC censured a major wirehouse for selling mutual funds to customers when lower-priced exchange-traded fund (ETF) "clones" of those funds were available. The SEC found that when recommending the mutual funds, the wirehouse and its registered representatives failed to consider the costs associated with the mutual funds as compared to the less expensive ETF clones and thereby failed to have a reasonable basis to believe that the recommendations were in the best interests of the wirehouse's customers. According to the SEC, this failure constituted a violation of the "care" obligation of the SEC's Regulation Best Interest.

For various economic and regulatory reasons, ETFs currently are not offered as options under variable annuity or variable life insurance contracts. Doing so will require assembling a puzzle, each piece of which will represent a solution for a different problem. Perhaps the single biggest challenge, though, is presented by Treasury Department regulations predating ETFs that have the effect of preventing the use of ETFs as investment options in variable contracts.

In 2022, however, Congress directed the Treasury to amend its regulations to permit ETF investment options in variable contracts. The Treasury was given seven years to amend its regulations, but such amendments could be adopted sooner. Indeed, the threat of enforcement actions such as those described above may give additional impetus to the general trend favoring ETFs over mutual funds, thereby increasing pressure for quicker action by the Treasury. On the other hand, for various reasons, it is not yet clear how much, if any, overall cost savings to investors would result if and when ETFs are available in variable contracts.

Nonetheless, it can be hoped that the recent SEC enforcement action will motivate Treasury staff to expedite the adoption of the necessary revisions to its rules to give investors at least the potential to experience lower costs from having ETF options in variable contracts.

Snap, Crackle, Remove: Gamesmanship or Winning Strategy? The What, When, and Where of Snap Removal

BY JULIANNA MCCABE

Snap removal is a rare but useful procedural device to remove an action from state to federal court under the diversity jurisdiction rules, even when the plaintiff's complaint names an in-state defendant as a party.

Snap removal is a potential solution to the "forum defendant" rule, designed by Congress to keep otherwise removable cases in state court if any defendant "properly joined and served" is a citizen of the forum state. 28 U.S.C. § 1441(b)(2). The rationale behind the forum defendant rule is that, presumably, an in-state defendant needs no protection from territorial bias in its home state. The "properly joined and served" language, however, limits the forum defendant restriction.

To date, four circuits (the Second, Third, Fifth, and Sixth) have recognized that naming a forum defendant in an action does not defeat an otherwise proper removal if the action is removed to federal court before the forum defendant is served. This is snap removal.

With the expansion of electronic filing in many state jurisdictions, notice of litigation before service of process is now quite common. Outside lawyers are often alerted to newly filed cases within days, or even hours, of their client's name appearing as the defendant in a state court lawsuit. Snap removals have become more commonplace as a result, and reaction by lower courts and commentators is mixed — with some referring to the procedure as "gamesmanship" or "forum shopping," while others note that snap removal is supported by the plain language of 28 U.S.C. § 1441 and that any litigant's choice of forum is, in effect, forum shopping. Some courts recognize that, although it seems unlikely Congress intended to create the snap removal device through the passage of section 1441, it is up to Congress to change the statutory language.

There are often legitimate reasons why a defendant may seek to remove an action to federal court, even when the plaintiff has named an in-state/forum defendant. The forum defendant, for example, may be a minor player in the dispute, whereas an out-of-state defendant bears the larger litigation risk. The forum defendant may also reasonably believe that parochialism is an issue despite its technical status as an "in-state" litigant.

Importantly, snap removal cannot be used to cure a lack of diversity — all defendants must be "diverse" from all plaintiffs, and the minimum amount in controversy must be met to remove a diversity case to federal court. Also, a removing party should carefully analyze the most recent authorities on snap removal in the relevant federal jurisdiction, as district court opinions in circuits without a bright-line rule on the issue can be inconsistent.

The snap removal strategy should be an arrow in counsel's quiver, ready for when and where it is available. However, the window for executing a snap removal closes immediately upon proper service of the in-state defendant, so get cracking!

Can Shareholders Rescind an Investment Company's Contracts Based on 1940 Act Violations?

BY THOMAS LAUERMAN

Section 47(b) of the Investment Company Act of 1940 provides that contracts that violate or "whose performance involves, a violation of" the act are not enforceable by "either party."

The majority of the business of mutual funds and other registered investment companies is conducted pursuant to investment management or other agreements with third parties. It potentially would be extremely disruptive if a fund's shareholders could sue under Section 47(b) to void such fund contracts. Specifically, plaintiffs' lawyers could bring troublesome lawsuits seeking to rescind one contract or another based on practically any alleged 1940 Act violation they could dream up.

Fortunately, holders of securities issued by a mutual fund (or other company registered under the 1940 Act) historically have not been considered "parties" to a contract with the fund. Therefore, except in the Second Circuit, courts generally have not permitted fund shareholders to maintain actions to rescind contracts under Section 47(b). Now, however, the U.S. Supreme Court is being asked to consider this question.

Several theories could support a shareholder's right, in some circumstances, to maintain actions under Section 47(b) to rescind a contract. These theories include:

- Because the courts of certain states have held that a fund's bylaws or other basic documents constitute "contracts" between the fund and its shareholders, the shareholders also should be considered "parties" to such contracts within the meaning of Section 47(b).
- Shareholders who properly bring a derivative action to rescind a contract that a fund has entered into should be considered "parties" to the contract within the meaning of Section 47(b), because the fund clearly is a party, and the derivative action is asserting the fund's rights as such.
- Shareholders should be considered third-party beneficiaries of certain contracts that a fund has entered into, in which case the shareholders also should be considered "parties" to the agreement within the meaning of Section 47(b), given the rights they have as beneficiaries.

To date, the Second Circuit is the only federal appellate court to have held that shareholders can maintain actions under Section 47(b), thus giving them a private right of action. This stance, however, conflicts with several other federal circuit courts that have denied such a right.

In a recent opinion, the Second Circuit reaffirmed its position by permitting an activist shareholder of closed-end funds (CEFs) to maintain an action under Section 47(b) to rescind certain board actions. The court treated the CEFs' bylaws as contracts with their shareholders. The board actions aimed to prevent the activist shareholder from leveraging its stake in ways that disadvantaged other CEF shareholders, but the activist alleged these actions violated another provision of the 1940 Act. For more information about the battles between CEFs and such activist investors, please refer to "Gone With the Wind? Closed-End Funds Risk Extinction," *Expect Focus – Life, Annuity, and Retirement Solutions* (September 2024).

The CEF defendants in this case have petitioned the U.S. Supreme Court for a writ of certiorari to resolve the conflict over whether a private right of action exists for Section 47(b). The Investment Company Institute and the Asset Management Group of the Securities Industry and Financial Markets Association have jointly filed an amicus brief supporting the petition, joined by a separate supporting brief from the U.S. Chamber of Commerce.

There are many strong arguments against affording fund shareholders a private right of action under Section 47(b). It is to be hoped, therefore, that the Supreme Court will grant certiorari and overrule the Second Circuit.

Jarkesy May Reshape SEC Enforcement Against Professionals

BY NATALIE NAPIERALA AND AUSTIN JACKSON

For decades, the SEC has relied on its in-house administrative proceedings to enforce alleged violations under the federal securities laws, including under its own rules of practice. These in-house proceedings offer significant advantages to the SEC, including, among other things, limited discovery and the lack of a jury trial. And studies have reported that the SEC's success rate in administrative proceedings is approximately 90%, compared to 69% in federal court enforcement actions. In *SEC v. Jarkesy*, the U.S. Supreme Court dealt a blow to the SEC when the court's majority held that such proceedings violate a respondent's Seventh Amendment right to a jury trial when the SEC uses this forum to adjudicate claims that are "legal in nature," i.e., fraud and other claims imposing civil penalties. For more details about *Jarkesy* and the changing constitutional law landscape that provides its context, please refer to "Breeze or Gale? Unanswered Questions at the Heart of the Supreme Court's Recent Administrative Law Decisions," *Expect Focus – Life, Annuity, and Retirement Solutions* (September 2024).

Emerging evidence shows that *Jarkesy* also may affect other types of in-house administrative actions, including, notably, proceedings under Rule 102(e) of the SEC Rules of Practice against accountants, attorneys, and other professionals appearing before the SEC who have allegedly engaged in unethical or otherwise improper behavior. In the months following the *Jarkesy* opinion, August through November 2024, the SEC dismissed seven Rule 102(e) proceedings against accountants pending in its in-house forum. Of these cases, four had sought civil penalties, thus falling within the purview of *Jarkesy*. But the three other SEC dismissals involved only remedial relief, which has raised questions about whether the SEC is applying *Jarkesy* more broadly.

While the SEC has not formally explained the dismissal of these three cases in its administrative forum, the timing suggests a strategic response to *Jarkesy*. By proactively dismissing these cases, the SEC may seek to preempt constitutional challenges to its in-house proceedings that, unlike *Jarkesy*, are not limited to fraud and civil penalties. Such challenges could draw, for example, on statements in Justice Gorsuch's concurring opinion in *Jarkesy* to the effect that the Fifth Amendment's due process clause requires any action involving potential deprivation of life, liberty, or property be adjudicated through traditional court proceedings.

In any event, professionals who appear before the SEC will be closely scrutinizing how the agency responds to *Jarkesy* as it reconsiders the balance between its enforcement authority and constitutional safeguards.

Insurer Allowed to Benefit From Foreign Tax Credits Distributed by Underlying Funds

BY STEPHEN KRAUS

The Eleventh Circuit Court of Appeals recently held that a life insurance company did not breach its fiduciary duties by retaining the benefits that it derived from foreign tax credits. The plaintiffs argued that, under ERISA, the insurer had a fiduciary duty to pass those benefits back to certain retirement plans.

Under a group annuity contract that the plaintiff's plan had purchased from the insurer, participants could allocate contributions among specific mutual funds selected by the plan sponsor from the insurer's broader menu of investment options. A number of these funds passed foreign tax credits through to the insurer as the owner of the fund shares, which were held in a "separate account" of the insurer pursuant to the terms of the group annuity contract.

After sleuthing hard to find a violation, the plaintiffs argued that (a) the insurer was a functional fiduciary under ERISA section 3(21)(A)(i) because it exercised "authority or control respecting management or disposition" of plan assets and (b) it engaged in a prohibited transaction under ERISA section 406(b)(1) by dealing with plan assets for its own interest or own account. The Eleventh Circuit held that, even though the insurer exercised authority over the foreign tax credits, under "ordinary notions of property rights under non-ERISA law," they were not plan assets because the plan had neither a legal nor beneficial interest in the foreign tax credits. The court noted that the separate account was established, administered, owned, and managed by the insurer and that the insurer was also the legal and taxable owner of the assets in the separate account.

The plaintiffs also argued that the insurer was a functional fiduciary because the distribution of the foreign tax credits to the insurer resulted from its "discretionary authority" over the management and administration of the separate account. The court rejected this argument as well, ruling that the insurer did not have control over the factors that gave rise to the foreign tax credits. Rather, the undisputed facts showed that the plaintiffs and plan participants chose the mutual funds in which to invest.

Amendments to N-PORT May Be OUT-Ported

New SEC Reporting Requirements Already Under Challenge

BY ANN FURMAN

Gary Gensler's tenure as SEC chair can be remembered for an impressive number of rule proposals, many of which encountered vehement industry opposition or were challenged in court, struck down, or stayed.

One of Gensler's more controversial and costly rule proposals would have mandated the use of "swing pricing" by mutual funds, imposed a "hard close" at 4 p.m. each day, and amended Rule 22e-4 under the Investment Company Act (the mutual fund liquidity rule). Following strong opposition to the proposal, the SEC determined in August 2024 not to move forward with its swing pricing and hard close proposal.

Instead, the SEC adopted amendments to Form N-PORT that require open-end funds, closed-end funds, and exchange-traded funds organized as unit investment trusts to report portfolio holdings to the SEC monthly (instead of quarterly). The amendments also require funds to make portfolio holding reports available to the public 60 days after the end of each month (instead of every third month). The effective date for the new N-PORT reporting requirements is November 17, 2025, or six months later, May 18, 2026, for entities with net assets of less than $1 billion.

The new portfolio holding reporting frequency rule has encountered opposition on both procedural and substantive grounds. Republican Commissioners Hester Peirce and Mark Uyeda opposed the N-PORT amendments, with Peirce dubbing them "too short to report," because the SEC gave "too little attention to the costs, perhaps because the Commission failed genuinely to seek needed public input on these changes."

The day after the SEC adopted N-PORT amendments, the Registered Funds Association (a trade group recently formed in Texas) sued the SEC in the Fifth Circuit seeking to overturn the new requirements. The complaint alleges that the "amendments would impose great harm by limiting an investment company's ability to benefit from the proprietary work product of its investment adviser. ... In effect, the amendments force funds to make their intellectual capital available to the public for free."

The case is tentatively scheduled for oral argument the week of March 31, 2025. Challenges to SEC rules have been having pretty good success in the Fifth Circuit lately. Moreover, the new Republican majorities in the SEC or in Congress may see fit to reverse these amendments, especially because their compliance dates are still a good ways off. Very possibly, therefore, the SEC's adoption of these new N-PORT reporting requirements will be reversed.

States Decode Their Expectations on Insurers' Use of AI

BY ANN BLACK, EDMUND ZAHAREWICZ, AND ERIN VANSICKLE

States continue to decode their expectations regarding insurers' use of artificial intelligence (AI) systems. Since our last report, the following states have issued bulletins based on the National Association of Insurance Commissioners' model bulletin on the use of AI systems.

1. Iowa (November 7, 2024), whose bulletin notes that the Iowa Insurance Division also anticipates providing supplementary guidance on the governance of third-party AI systems.
2. Oklahoma (November 14, 2024)
3. Massachusetts (December 9, 2024), whose bulletin notes that the Massachusetts Division of Insurance also intends to revisit the guidance provided in the bulletin on a periodic basis and make updates as warranted. It would consider any relevant recommendations made by the AI Strategic Task Force created pursuant to the Massachusetts governor's executive order No. 629. One objective of the task force is to recommend new policies, guidelines, or frameworks that promote responsible AI development and use, including issues related to bias, equity, privacy, security, and potential misuse of AI-generated content.
4. North Carolina (December 18, 2024)

The above-mentioned bulletins followed action by:

- The 17 jurisdictions that previously adopted the NAIC model bulletin (namely, Alaska, Arkansas, Connecticut, Illinois, Kentucky, Maryland, Michigan, Nebraska, Nevada, New Hampshire, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, Washington, D.C., and West Virginia).
- California, Colorado, and New York, which previously decrypted their separate AI requirements for insurers. (The NAIC also notes Texas as having relevant guidance, though it is not specific to AI systems.)

Also, on December 6, the Colorado Division of Insurance gave a decoder ring to private passenger automobile insurers and health benefit plans on its expectations on governance requirements by releasing for comment proposed amendments to Regulation 10-1-1. The proposed amendments would update requirements for life insurers and expand their applicability to private passenger automobile insurers and health benefit plan insurers.

Articles addressing other aspects of AI appear at pages 6 and 12 of this edition.

Deadline Approaches for RIAs to Adopt AML Programs

CIP Requirements Remain in Limbo

BY BRIAN MORRIS

On August 28, 2024, the Financial Crimes Enforcement Network (FinCEN) adopted a final rule that subjects investment advisers to the anti-money laundering (AML) compliance provisions of the Bank Secrecy Act (BSA). For additional information on that rule as proposed, please refer to "Regulators Seek to Saddle Industry With New Obligations: Firms Bridle and Stir Up Opposition," *Expect Focus – Life, Annuity, and Retirement Solutions* (May 2024).

According to FinCEN, the new rule is designed to address illicit finance risks in the investment adviser sector, as revealed in a recent Treasury Department risk assessment that highlighted cases in which sanctioned persons, corrupt officials, and other criminals exploited the investment adviser industry to access and launder funds through the U.S. financial system. It also seeks to bring the United States into compliance with international AML standards by addressing a long-standing gap identified by the global Financial Action Task Force (FATF).

As adopted, the new rule broadens the definition of "financial institution" covered by the BSA to include investment advisers that are registered with the SEC (RIAs) or that report information to the SEC as exempt reporting advisers (ERAs). The expansive new rule requires both RIAs and ERAs to:

- Implement a risk-based and reasonably designed AML program;
- File reports of suspicious transactions, known as suspicious activity reports (SARs), with FinCEN;
- Keep requisite records relating to the transmittal of funds; and
- Comply with special information-sharing procedures between and among FinCEN, law enforcement agencies, and financial institutions under the USA Patriot Act.

As expected, FinCEN delegated examination authority for ensuring compliance with the new rule to the SEC, as the federal functional regulator responsible for the oversight and regulation of investment advisers, in similar fashion to the SEC's examination of brokers and dealers in securities and mutual funds, which have been required to comply with AML provisions of the BSA for decades.

Notably, however, the new rule does not require investment advisers to adopt a customer identification program (CIP) or take steps to identify beneficial owners of customer entities, which are integral components of AML programs required for other financial institutions subject to the BSA. However, the extension of CIP requirements to investment advisers is part of another recent companion rule proposed jointly by FinCEN and the SEC. If adopted, this proposed rule would require both RIAs and ERAs to:

- Establish written CIPs appropriate for the RIA's size and lines of business, including risk-based procedures sufficient to verify and form a reasonable belief as to the identity of each customer; and
- Maintain records of information used to verify a customer's identity.

Federal agencies such as the Treasury and the SEC are likely to see broad changes in regulatory initiatives once leadership, including Treasury Secretary Janet Yellen and SEC Chair Gary Gensler, depart government service. As occurred in 2017, the incoming administration is expected to swiftly freeze any ongoing regulatory efforts by executive departments and independent agencies, including the SEC and FinCEN. Thus, while the January 1, 2026, deadline for investment advisers to comply with the new FinCEN rule is fast approaching, the fate of integral CIP requirements under the SEC and FinCEN's jointly proposed rule remains in limbo. For now, that leaves investment advisers with little choice but to take steps to design and implement effective AML programs, albeit without clarity as to whether and when fundamental CIP requirements might need to be incorporated into those programs.

Decode AML Jargon Trends: Word Search Challenge!

Think you're up to speed on the latest industry lingo?

See how quickly you can find the following terms hidden in the grid: AML, BSA, CIP, ERAs, FATF, FinCEN, RIAs, SARs, SEC, ACRO, and NYMS

Challenge your team to see who can complete it the fastest!

F	A	T	F	L	A	C	I	P	T
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N	B	S	A	I	E	A	R	A	S
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N	C	I	P	O	P	L	E	S	C
B	S	A	S	E	C	A	D	O	P
R	I	A	S	R	U	L	E	S	T
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news and notes

Carlton Fields earned national first-tier rankings for six of its practices in the 2025 edition of **Best Law Firms®**. In addition, the firm achieved 64 metropolitan first-tier rankings across nine of its offices.

Carlton Fields has relocated its Atlanta office to **Promenade Tower** located at 1230 Peachtree Street, NE, Suite 900, Atlanta, Georgia 30309. This move represents an important step for the strategic growth of Carlton Fields and the firm's continued commitment to the Atlanta community.

Carlton Fields is recognized as a **litigation powerhouse** in BTI Consulting Group's Litigation Outlook 2025 report. This is the only law firm litigation ranking based solely on unprompted, objective feedback from corporate counsel.

The Leadership Council on Legal Diversity has named Carlton Fields as a recipient of the **2024 Compass Award**. The award recognizes law firms and corporations that show a strong commitment to building a more inclusive legal profession. This recognition follows additional honors within the past year recognizing Carlton Fields' commitment to diversity, including ***The American Lawyer*'s 2024 Diversity Scorecard**, ***Law360*'s 2024 Diversity Snapshot**, ***Law360*'s 2024 Women in Law**, and ***Florida Trend*'s Legal Elite Notable – Women Leaders in Law**.

Carlton Fields and **John Pitblado** were recognized for pro bono work by Lawyers for Children America at the organization's Champions for Children event on November 7, each receiving an award for extraordinary commitment to improving the lives of vulnerable children through legal advocacy.

The firm sponsored the **ACLI Annual Conference** on September 25–27 in Chicago, Illinois.

The firm was proud to sponsor the **NAFA Annuity Distribution Summit** on October 2–3 in Dallas, Texas.

We were pleased to participate in the **ALIC Fly-In** on October 17 in New York, where **Trish Carreiro** and **Markham Leventhal** spoke on privacy class action claims impacting the life insurance industry.

Carlton Fields supported the **ALI CLE Conference on Life Insurance Company Products** on November 7–8 in Washington, D.C. **Richard Choi** once again served as co-chair of the conference and **Trish Carreiro**, **Justin Chretien**, **Tom Conner**, **Harry Eisenstein**, **Ann Furman**, and **Barry Weissman** served as speakers.

Carlton Fields is a sponsor of the **SIFMA C&L Annual Seminar** on March 23–26 in Austin, Texas.

The firm is a sponsor of the **IRI Annual Conference** on March 26–28 in Tampa, Florida.

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