LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY

Volume III, September 2023

EXPECTFOCUS®

LEGAL ISSUES AND DEVELOPMENTS FROM CARLTON FIELDS

FIGURING THE ODDS

IN SEARCH OF BETTER REGULATORY PAYOFFS

CARLTON FIELDS

vIII INSIDE

EXPECTFOCUS®

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS SEPTEMBER 2023

Executive Editor Thomas Lauerman

Assistant Editors Stephanie Fichera
Todd Fuller

Production Manager Jessica Bennett

Art Director & Designer Frances Liebold

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.

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

Regulators Hit Jackpot: Off-Channel Communications

BY ANN FURMAN

Several years before announcing the first "off-channel" communications enforcement action, the SEC and FINRA cautioned broker-dealers and investment advisers about problematic record-keeping practices involving the use of texting, messaging, and social media applications — such as WhatsApp, WeChat, Facebook, and Slack — for business-related communication. For example:

- In 2017, FINRA provided guidance on how FINRA and SEC record-keeping rules applied to digital communications "in light of emerging technologies and communications innovations."
- In 2018, the SEC noted its examination observations about the use of electronic messaging by investment advisers.
- In 2019, FINRA examinations uncovered that some broker-dealers did not maintain a process to reasonably identify and respond to "red flags that registered representatives were using impermissible personal digital channel communications in connection with firm business."

Apparently, these admonitions proved ineffective because, in September 2021, the SEC's Division of Enforcement commenced an initiative to investigate record preservation practices at financial firms. The division encouraged firms whose record preservation practices do not comply with the securities laws to contact the SEC.

In December 2021, the SEC and the Commodity Futures Trading Commission announced settled actions against the same firm for "widespread and longstanding failures" to maintain and preserve written communications. Since that time, a steady stream of settled actions has continued.

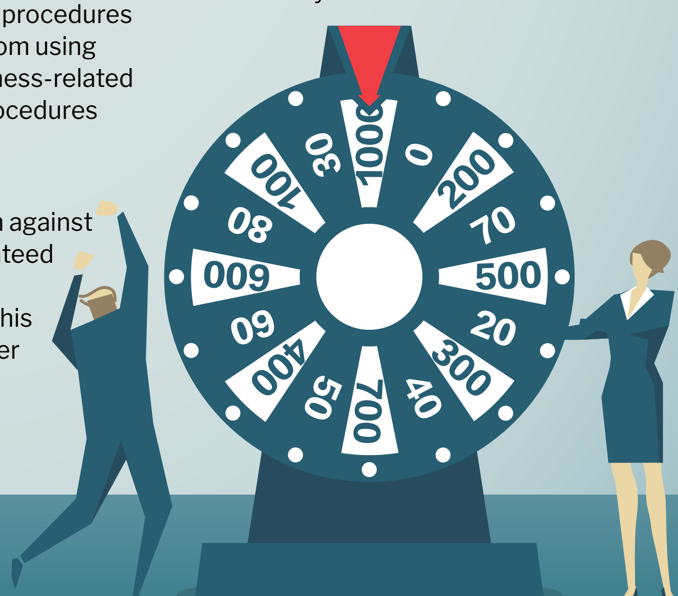
By August 8, 2023, when the SEC and the CFTC announced more settled actions involving off-channel communications, the SEC had brought over 30 enforcement actions and imposed over $1.5 billion in penalties against broker-dealers and investment advisers. The CFTC had brought over 18 enforcement actions against swap dealers and futures commission merchants and imposed more than $1 billion in penalties.

To add to the mix, earlier this year, a group of 10 financial industry trade associations, including the Investment Company Institute and the Securities Industry and Financial Markets Association, wrote to SEC Chair Gary Gensler addressing investment adviser record-keeping requirements. The letter noted that, unlike broker-dealers, investment advisers are not required to retain all business communications. These trade associations expressed concern that "the SEC is attempting to exceed its authority under the Advisers Act and engaging in rulemaking by enforcement through its current sweep regarding off-channel communications."

For its part, FINRA has brought enforcement actions against both firms and individuals for failing to retain business-related off-channel communications, including:

- A $1.5 million fine against a firm that did not preserve or reasonably supervise its employees' business-related text messages (even though firm written supervisory procedures prohibited employees from using text messaging for business-related communications, the procedures were not followed).
- A $10,000 penalty and a three-month suspension against an individual who guaranteed a customer against loss using text messages via his personal cellphone, rather than a firm-approved application (FINRA tacked on a books and records charge to allegations of prohibited messaging via off-channel communication).

With billions in penalties imposed to date, it is no surprise that both the SEC and FINRA have included in their 2023 examination priorities the inspection of broker-dealer compliance and supervisory programs for electronic communications related to firm business and the record-keeping for those electronic communications. To the extent the amount of penalties imposed is a measure of success of an examination program, regulators have struck gold. With such apparently favorable odds, regulators are likely to keep mining for registered personnel who engage in business-related digital communications with firm customers through channels not approved and controlled by the firm.



SEC Proposal Balances AI-Like Technology Use With Investor Best Interests

Has the Regulator Picked a Winner?

BY MEDERIC DAIGNEAULT

Like other savvy businesses, investment advisers and broker-dealers have increasingly embraced the use of predictive data analytics, artificial intelligence, and similar technologies (AI-like technologies) to help generate cost-savings, among other things. However, unlike other businesses, investment advisers are fiduciaries and are required to place their clients' interests ahead of their own. Similarly, broker-dealers are obligated to act in the best interests of their retail customers under the SEC's Regulation Best Interest. Therefore, while cost-savings and profitability can be a priority for firms, these aims cannot take precedence over the best interests of investors. To address potential conflicts that can arise with respect to a firm's use of AI-like technologies, which could intentionally or unintentionally place the firm's interests ahead of those of clients or customers, the SEC proposed new rules on July 26.

Proposal Overview

The proposed rules would require, among other things, that investment advisers and broker-dealers:

- Evaluate any use (or reasonably foreseeable potential use) of "**covered technology**" in any "**investor interaction**" to identify any conflicts of interest associated with that use.
- Determine whether any such conflict of interest places or results in placing the firm's (or its associated person's) interest ahead of investors' interests.
- Eliminate or neutralize the effect of any conflicts of interest that place the firm's (or its associated person's) interest ahead of investors' interests.

For these purposes, "**covered technology**" is defined to include an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes. "**Investor interaction**" generally includes engaging or communicating with an investor, including by exercising discretion regarding an investor's account, providing information to, or soliciting an investor.

A firm that engages in any investor interaction using covered technology would also be required to adopt written policies and procedures reasonably designed to achieve compliance with the proposed rules. As applicable, such procedures must include, among other things, a written description of the process for:

- Evaluating any use (or reasonably foreseeable potential use) of a covered technology in any investor interaction.
- Determining how to eliminate or neutralize the effect of any conflicts of interest determined pursuant to the proposed rules to result in an investor interaction that places the interest of the firm or an associated person ahead of the interest of investors.

Firms would also be obligated to conduct, at least annually, a review of the adequacy and effectiveness of policies and procedures adopted pursuant to the proposed rules and to retain certain records.

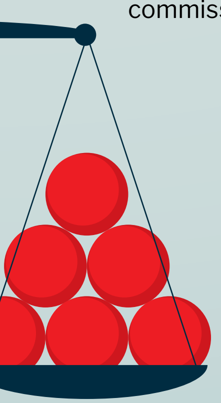
Some Serious Concerns

Few would argue that the use of AI-like technologies is risk-free. However, the proposed rules appear to be drafted more broadly than is reasonably necessary to accomplish the commission's stated goals. For instance, the commission claims that the proposed rules would "supplement, rather than supplant, existing regulatory obligations related to conflicts of interest." However, as fiduciaries, investment advisers are required to eliminate or make full and fair disclosure of conflicts of interest so that a client can provide informed consent. The proposed rules would effectively create a subcategory of conflicts, i.e., those associated with the firm's use of "covered technologies" in an "investor interaction," which must be treated differently. Full and fair disclosure, it seems, cannot cure such conflicts.

The rules also would appear to have the effect of altering the obligation of broker-dealers from one centered on investor best interests at the time of a recommendation to an ongoing obligation in connection with the firm's use of covered technologies.

As drafted, the proposed definition of "covered technology" would capture both sophisticated and simple tools commonly used by firms. These include, for example, investment analysis tools and models used to predict stock returns, as well as technology that makes use of lookup tables and historical or real-time data, such as spending behavior data, web browsing histories, and social media posts used to curate or target content and guide investor behavior.

In a joint comment letter submitted in August, 16 trade associations noted that the proposed rules "threaten to upend longstanding precedent." They also requested an extension of the 60-day comment period to allow market participants "sufficient time to thoroughly analyze and provide comment on the implications of the proposal." Unless extended in response to this or other requests, comments on the proposal must be submitted to the commission by October 10, 2023.



Tippee Liability If the Tipper Is Not Guilty?

The Fluid Boundaries of Insider Trading

BY THOMAS LAUERMAN

Though "insider trading" has long been recognized as an illegal and abusive way to cheat in the securities trading game, new potential forms of this activity have recently emerged.

For example, we recently reported on an SEC action against an executive who used nonpublic information about his company's impending merger to trade options on a competitor company's shares. *See* "SEC Cultivates Shadow Trading Theory: Emerging Species of 10b-5 Violation?" *Expect Focus – Life, Annuity, and Retirement Solutions* (April 2022). Despite the competitor company not being directly involved in the transaction, the impending merger was likely to impact its value.

Recent studies have also shown that traders armed with nonpublic information about mergers or acquisitions involving specific companies are potentially profiting by trading in shares of exchange-traded funds based on indexes that include those companies' shares. Again, this type of gaming might be a violation, particularly in certain contexts. *See* "ETF Share Transactions Based on Nonpublic Information: An Illegal Secret Ingredient?" *Expect Focus – Life, Annuity, and Retirement Solutions* (May 2023).

More recently, the government is asserting that a jury may find a "tippee" guilty of insider trading under federal securities laws, even if the jury finds the "tipper" not guilty. A jury has done just that in *United States v. Klundt*, a case in the U.S. District Court for the Northern District of Illinois. This appears paradoxical considering the 1983 U.S. Supreme Court case, *Dirks v. SEC*, which is generally understood to establish a tippee's liability for trading on material nonpublic information as derivative of the tipper's liability. Specifically, under *Dirks*, tippee liability arises when a tipper (a) "has breached his fiduciary duty ... by disclosing the information to the tippee" and (b) "receives a personal benefit from the disclosure." The *Klundt* jury seems to have been instructed accordingly; hence, it's not immediately clear how they found the tippee guilty while exonerating the tipper.

Understandably, the tippee has filed a motion that he also be acquitted or, in the alternative, afforded a new trial. In contrast, the government maintains that the verdict should stand, pushing the boundaries of past interpretations of insider trading. At the time of this publication, the motion remains pending.

Given these recent developments, those responsible for compliance and other aspects of developing and implementing firms' insider trading compliance procedures would be wise to remain vigilant about the expanding range of potential violations.

SEC Deals New Cybersecurity Disclosure Requirements to Public Companies

BY JOHN CLABBY

On July 26, 2023, the SEC adopted new cybersecurity rules, which have two top-line impacts. First, registrants must disclose material cybersecurity incidents promptly on Form 8-K. Second, registrants must disclose new information regarding cyber risk management, strategy, and governance as part of their annual disclosures. These requirements apply to public company registrants with the SEC, including insurance companies (but not investment company registrants).

As to current disclosures, the rules add Item 1.05 to Form 8-K, requiring the disclosure of material cybersecurity incidents, including the nature, scope, and timing of the incident. The disclosure will be generally due four business days after the registrant determines materiality, which some registrants will think makes them disclose their hand prematurely. There is an exception to that disclosure timeframe, if the U.S. attorney general determines there is a substantial risk to national security or public safety and so notifies the SEC in writing. But such an exception will likely be difficult to obtain within the rules' four-day deadline.

As a practical matter, therefore, this disclosure might necessarily be high level and based on less-than-perfect information, because the investigation of such larger cybersecurity incidents often takes weeks or months. This is particularly true for events with multiple moving parts, such as a ransomware attack with data exfiltration and an extortion demand, where the impact on personal information may not even be known within the four-day period.

As to annual disclosures, the rules add Item 106 to Regulation S-K, requiring the following new disclosures in the registrant's annual report on Form 10-K:

- A description of the registrant's processes for assessing, identifying, and managing material cybersecurity risks.
- Disclosures as to the material effects of previous cybersecurity incidents.
- Disclosures as to management's role and expertise in managing cybersecurity risks and as to the board's oversight of those risks.

Registrants will need to start planning for compliance immediately, as the rules took effect on September 5. The Form 10-K disclosures start on annual reports for fiscal years ending on December 15, 2023. The Form 8-K requirements start on December 18, 2023, although smaller reporting companies have an extension to June 15, 2024.

Public companies should revisit their incident response plans, to see if they would benefit from additional processes to determine when a cyber incident could be material and, if so, who will be responsible for any necessary disclosures on Form 8-K within the four-business-day timeframe. Public companies should also work with their disclosure counsel to gather information for disclosure through new Item 106 on their annual reports.

NAIC Privacy Working Group Goes All-in on New Draft Privacy Model

BY ANN BLACK AND PATRICIA CARREIRO

The National Association of Insurance Commissioners' Privacy Working Group has been feverishly shuffling and re-dealing its new privacy model, but its luck may be running out.

After two full days of draws and calls on June 5 and 6, the working group dealt a revised draft of the privacy model on July 11. While the draft is an improvement over the initial version, it faced strong criticism, potentially indicating that the working group's odds of passing a new privacy model may be drawing thin.

Improvements From the Prior Draft

The July 11 draft took some definite "wins" from the play on June 5 and 6. For example:

- No longer prohibiting cross-border sharing of consumers' personal information.
- Removing the optional private right of action.
- Including a total HIPAA safe harbor.
- Permitting joint marketing agreements.
- Narrowing the circumstances requiring opt-in permissions for marketing and instances where an annual notice of privacy protection practices would be required.
- Extending the timeframe for insurers to transition personal information from legacy systems.

Remaining Issues

Despite this progress, many issues remain and the new model may still be a longshot. South Dakota and Nebraska have already stated that the current draft would be a bust in their states and stood no chance of passage. Criticism and concerns continued to be raised at the NAIC Summer National Meeting, prompting the working group to up the ante by promising to re-deal a new draft and request an extension. Will the next draft get sufficient buy-in to become a new model, or will the working group be forced to fold? We'll have to wait for the next draw.

Fifth Circuit Breaks From No-Action Pack

Becomes Better Bet for Letter Recipients?

BY THOMAS LAUERMAN

On July 21, 2023, a three-judge panel of the Fifth Circuit Court of Appeals issued an opinion asserting that the Commodity Futures Trading Commission's Division of Market Oversight likely acted arbitrarily and capriciously, potentially violating the Administrative Procedure Act, when it rescinded certain "no-action" relief that the division previously had granted. The court's reasoning, moreover, would seem also generally as applicable to SEC as to CFTC no-action letters.

A concurring opinion accompanying this decision notes that it puts the Fifth Circuit at odds with opinions from the Second, Third, and Seventh Circuits that have considered the status of agency no-action letters under the APA. Consequently, in the Fifth Circuit, beneficiaries of a no-action letter may find it somewhat easier to contest attempts by agencies to withdraw their letters. Further, the Fifth Circuit might, under certain circumstances, subject the terms and conditions of even a non-withdrawn no-action letter to scrutiny under APA standards.

If the rationale behind this Fifth Circuit decision gains traction, agencies may become more cautious about issuing no-action letters because of, among other things, (a) the additional care with which they may find it necessary or advisable to justify and articulate the agencies' rationales for the terms of those letters and (b) the additional types of legal proceedings to which the agencies may become enmeshed as a result of those letters.

The No-Action Letter

The no-action letter advised that the division would not recommend the CFTC take any enforcement action relating to specified activities, based on a university's representations in the letter that it would comply with certain terms. The letter (a) stated that it represented the views of the division only (and not necessarily the "positions or views of the Commission") and (b) purported to retain "the authority to condition further, modify, suspend, terminate or otherwise restrict the terms of the no-action relief ... in the division's discretion." Such no-action letters are issued by the division pursuant to CFTC regulations providing that the letter is binding only on the division and can be relied upon only by the "the [b]eneficiary" of the letter.

Nearly eight years after issuing the no-action letter, the division notified the university that it had not complied with the terms of the letter. Consequently, the division declared the no-action letter "withdrawn." Initially, the division did not explain which terms of the letter had been violated. This prompted certain parties (not including the university) asserting themselves as beneficiaries of the no-action letter (the "appellants") to contest the withdrawal.

Various legal wrangling ensued, during which the CFTC reversed its withdrawal of the no-action letter and issued a further letter asserting that the no-action letter was "void and should be withdrawn." This new letter did provide some explanation for rescinding the no-action relief and gave the university a chance to respond.

The Fifth Circuit Opinion

Nevertheless, the panel's July 21 opinion concluded, among other things, that:

- The no-action relief functioned as a form of permission to bypass administrative requirements, qualifying as an "agency action" akin to a "license" under the APA.
- Withdrawing or deeming void the no-action relief, therefore, constituted a withdrawal of a license that was subject to APA requirements applicable to agency actions.
- This agency action was deemed "final" for APA purposes, as it is unappealable and subjected impacted parties to enforcement proceedings.
- The initial revocation of the no-action letter was "likely arbitrary and capricious because the agency gave no reasons for it," and the agency's subsequent attempts to retroactively justify the revocation were likely deficient both substantively and procedurally.

For these and other reasons, the court found a substantial likelihood that the appellants would prevail on their claim that the agency's revocation of the no-action letter violated the APA and directed the lower court to preliminarily enjoin the revocation of the no-action letter pending a final determination of the appellants' claims.

NAFA Enters the Game, Files Amicus Brief in *SEC v. Cutter*

BY JUSTIN CHRETIEN AND RICHARD CHOI

On August 23, 2023, the National Association for Fixed Annuities (NAFA) filed an amicus brief in the case of *SEC v. Cutter Financial Group LLC* in federal district court in Boston. The brief followed the filing of an amended complaint by the SEC in June, in which the SEC made a number of allegations against Jeffrey Cutter and Cutter Financial Group that raise significant issues for the insurance industry generally and fixed indexed annuities in particular. Carlton Fields represented NAFA in connection with the amicus brief.

The SEC alleges that Cutter and Cutter Financial Group violated section 206, the antifraud provision of the Investment Advisers Act. Cutter is an investment adviser representative working for Cutter Financial Group, a registered investment adviser. Both are subject to SEC jurisdiction under section 206 for fraud. But Cutter is also a Massachusetts-licensed insurance agent with his own insurance agency. In other words, he is "dual-hatted" as both an investment adviser representative and a licensed insurance agent. Historically, securities have always been subject to federal regulation, while insurance products have always been subject to state regulation.

But here, the SEC alleges that Cutter and Cutter Financial Group engaged in fraudulent activities involving securities *and* insurance products (i.e., fixed indexed annuities) with advisory clients: i.e., that he advised clients to sell securities on the one hand and then advised them to purchase annuities on the other hand. In so doing, the SEC alleges, Cutter failed to make certain disclosures with respect to the sales of securities and, with respect to the purchase of annuities, that he failed to make certain disclosures and made certain misstatements to insurance companies about the annuity transactions. Thus, the SEC's allegations of section 206 fraud in the amended complaint cover activities involving both securities *and* fixed annuities.

The SEC currently accommodates dual-hatted investment adviser representatives who are also registered representatives for broker-dealers by separating, for jurisdictional purposes, recommendations made for a particular transaction on a commission basis while wearing the "hat" of a registered representative from investment advice provided on a fee basis while wearing the "hat" of an investment adviser representative, even if they involve the same client. The SEC's Regulation Best Interest applies to the former, the Advisers Act to the latter.

But the SEC apparently is not accepting the "dual-hat" premise when an investment adviser representative is also an insurance agent. This is, in our view, the incorrect approach. Just as transactions conducted for commissions under a best interest standard pursuant to Regulation Best Interest are beyond the reach of the Advisers Act, so too should transactions conducted under the best interest standards imposed by most states' insurance laws.

First, the plain language of the Advisers Act does not support its application to insurance products. Second, Supreme Court precedent and several acts of Congress, including the McCarran-Ferguson and Dodd-Frank acts, expressly preserve state regulation of insurance and fixed annuities. Third, this issue implicates the "major question doctrine" that suggests that agencies like the SEC cannot extend their jurisdictional reach with such significant consequences without clear congressional authorization to do so. Such congressional authorization is absent here.

Finally, the implications for the industry could be enormous. Should the SEC prevail, ad hoc application of the SEC's interpretations of the Advisers Act invariably would result in disparate treatment of consumers, as well as insurance producers, in respect of disclosures to be provided and the standard of conduct applicable to fixed annuity transactions, because they are not securities, and because not all insurance producers are investment adviser representatives. The foregoing is also contrary to the nationwide best interest standard sought by state insurance regulators and contrary to the best interests of the insurance industry and its customers. Stay tuned for updates.

SEC Folds on Swing Pricing for Money Market Funds

Odds Lengthen Against Swing Pricing for Other Funds

BY GARY COHEN AND THOMAS CONNER

On July 12, the SEC adopted, on a 3–2 party line vote, so-called money market fund reforms. The reforms substitute a *required* redemption ("liquidity") fee for proposed "swing pricing" for certain institutional money market funds.

More specifically, the SEC adopted requirements for institutional prime and institutional tax-exempt money market funds to impose liquidity fees when a fund has daily net redemptions that exceed 5% of net assets, except where the fund's liquidity costs are *de minimis*. The SEC also authorized any non-government money market fund, whether institutional or retail, to impose a discretionary liquidity fee, if the fund's board of directors determines that a fee is in the best interest of the fund.

The life insurance industry, along with the mutual fund industry, has strongly opposed swing pricing in the context of a November 2022 SEC proposal to mandate swing pricing for other types of funds, with comment letters from the American Council of Life Insurers, the Committee of Annuity Insurers, the Insured Retirement Institute, and the Teachers Insurance and Annuity Association of America. For background information about the nature of swing pricing and some of its pros and cons, see "SEC Would Mandate Swing Pricing: Badly Upending Most Funds' Procedures," *Expect Focus — Life, Annuity, and Retirement Solutions* (January 2023).

The SEC's July 12 action raises two questions:

- What does it mean for non-money market funds generally?
- What does it mean for money-market funds and non-money market funds underlying separate accounts?

The SEC did not provide answers to either question.

The SEC's action in connection with money market funds may reduce the likelihood of the SEC adopting a swing pricing requirement for non-money market funds. The odds seem good that the SEC will determine that the challenges of implementing swing pricing for non-money market funds are at least as great as implementing swing pricing for money market funds.

The SEC's July 12 action also reduces the possibility that an SEC proposal to exclude exchange-traded funds from the swing pricing mandate might give them a competitive advantage. Although the use of ETFs as underlying variable insurance product separate accounts currently is strictly limited by certain tax and operational considerations, steps are underway to alleviate these restrictions. *See* "ETFs in Variable Contracts: A New Marketing Opportunity," *Expect Focus — Life, Annuity, and Retirement Solutions* (May 2023).

The SEC did not discuss the impact of its swing pricing proposals on the life insurance industry in either its November 2022 proposing release or its July 12 adopting release. This inattention continues an administrative history where the SEC develops regulatory policy in the context of mutual funds and only later retrofits the policy for variable insurance products. For example, the SEC took 11 years to authorize summary prospectuses for variable insurance products after it did so for mutual funds.

SEC Chair Gary Gensler is widely respected for his broad and deep experience and expertise in the financial world. But he may have a blind spot for variable insurance products. He co-authored a book on investment products that stated, "There's no federal regulator … of the variable annuity industry." Now he heads the industry's federal regulator, whose regulatory role he thus mistakenly denied.

The SEC's adopting release states that "the Commission [had] expressed the view that swing pricing appeared to have operational benefits relative to liquidity fees." However, Gensler, in commenting on the SEC's action, stated his opposite opinion, saying "I believe that liquidity fees, compared with swing pricing, offer many of the same benefits and fewer of the operational burdens."

In its July 12 adopting release, the SEC took only one action regarding variable insurance products. It amended Rule 2a-7 under the Investment Company Act to provide that "a variable insurance contract issued by a registered separate account funding variable insurance contracts or the sponsoring insurance company of such separate account may apply a liquidity fee … to contract owners who allocate all or a portion of their contract value to a subaccount of the separate account that is either a money market fund or that invests all of its assets in shares of a money market fund." This accommodation was necessary, because, as a technical matter, deduction of any liquidity fee in connection with a registered separate account's redemption of underlying money market fund shares may mean that the registered separate account is (i) not paying redemption proceeds approximately equal to a variable contract owner's proportionate share of the separate account's current net assets and (ii) therefore not issuing contracts that are "redeemable securities" as required by section 27(i) of the Investment Company Act.

The SEC did not address any other challenges related to implementing a liquidity fee in the context of funds underlying separate accounts.

Robocalling into Florida: A Dicey Gamble in an Evolving Legal Landscape

BY CHARLES THROCKMORTON

No one likes receiving telemarketing calls or text messages from strangers. That's one reason Congress enacted the Telephone Consumer Protection Act more than 30 years ago. Initially designed, in part, to combat the scourge of telemarketers interrupting Americans during weeknight dinners, the TCPA has evolved to cover not only telemarketing calls but also unwanted spam text messages. And because the TCPA awards plaintiffs a *minimum* of $500 in statutory damages per call or text, the statute lends itself to class action lawsuits and has been the subject of widespread litigation across the country.

In some ways, Florida has been the epicenter of robocall litigation over the last few years. After decades of TCPA litigation in Florida's federal courts, in July 2021, the Florida legislature passed the Florida Telephone Solicitation Act, often referred to as a "mini TCPA." Importantly, whereas the reach and breadth of the TCPA had been judicially narrowed over decades of litigation, the FTSA, as initially enacted, was very broad. This had the effect of putting thousands of previously compliant consumer-facing companies in the crosshairs of plaintiffs' lawyers in Florida. From July 2021 to July 2023, thousands of FTSA cases were filed and litigated.

In July 2023, perhaps in response to this flood of litigation, the Florida legislature passed an amendment to the FTSA. While this amendment curtailed the scope of the FTSA, particularly with respect to unwanted text messages, to the point that some commentators contend it no longer presents a real risk for texting cases, there remain several provisions that pose a risk for consumer-facing entities placing calls into Florida. The best indicator that this statute continues to have legs is the continuing routine filing of new FTSA cases in Florida courts.

Critically, shortly after the FTSA amendment, the Eleventh Circuit Court of Appeals issued a decision that broadened the text messaging risk in Florida under the TCPA. In July 2023, in *Drazen v. Pinto*, the Eleventh Circuit effectively reversed its prior 2019 decision in *Salcedo v. Hanna* and held that the receipt of a single unwanted text message is sufficient to create Article III standing. Following the *Salcedo* decision, federal TCPA text messaging case filings in the Eleventh Circuit had waned, because even in cases involving a high volume of text messages, it was evident that certifying a text message class would be challenging. With the *Drazen* decision, a major obstacle to class certification has now been removed. We expect the Eleventh Circuit to once again become a major hotbed for TCPA text messaging cases.

Under all the circumstances, it continues to be important for any consumer-facing companies that engage in outbound calling or texting into Florida — including insurance firms and securities firms — to examine their practices to ensure they comply with both the FTSA and the TCPA.

Carlton Fields played a role in Salcedo, *as well as numerous other precedent-setting decisions, and has defended hundreds of TCPA and FTSA cases in Florida and nationally.*

Mass. High Court Plays Wild Card

Upholds Broad Fiduciary Duty for Broker-Dealers

BY THOMAS LAUERMAN

On August 25, 2023, the Massachusetts Supreme Judicial Court upheld the validity of a rule promulgated in 2020 by the secretary of the commonwealth that imposes a broad fiduciary duty upon securities broker-dealers and their agents. Robinhood Financial LLC had challenged the validity of the Massachusetts rule as part of its defense against charges by the secretary that Robinhood had failed to comply with the rule and the Massachusetts Uniform Securities Act, pursuant to which the secretary had adopted the rule. The court's August 25 opinion reversed a previous lower court decision that had deemed the rule invalid.

The Massachusetts Rule

The Massachusetts rule, as now in force, omits language from the rule as proposed that would have extended its coverage to include investment advisers and advice regarding insurance and commodities. But broker-dealers and their agents, who are covered by the rule, will be subject to more extensive requirements in Massachusetts governing securities-related advice than otherwise would apply.

For example, while many requirements imposed by the Massachusetts rule are similar to those currently applicable to covered persons under the SEC's Regulation Best Interest, the Massachusetts rule imposes its requirements if a covered person provides any *advice* concerning securities investing, whereas Regulation Best Interest imposes such requirements more narrowly: i.e., only when such a person makes a *recommendation*. Similarly, although Regulation Best Interest applies only to recommendations made to "retail" customers and the Massachusetts rule does not apply to advice rendered to specified types of institutions, advice to other types of institutions may require compliance with the Massachusetts rule notwithstanding that they could be considered to be non-retail investors for purposes of Regulation Best Interest.

Although Regulation Best Interest does not impose a broad fiduciary duty on broker-dealers, it does impose very significant care, conflicts of interest, compliance, and disclosure obligations. Among other things, Regulation Best Interest requires a covered person to have a reasonable basis for believing a recommendation is in the best interest of the retail customer, without putting the covered person's financial interest ahead of the customer's.

In imposing a broad fiduciary duty on covered persons, however, the Massachusetts rule imposes a stricter requirement: i.e., the covered person must act without regard to the financial or any other interest of any party other than the customer.

The Massachusetts rule also treats investment recommendations made in connection with sales contests differently from Regulation Best Interest. For example, the Massachusetts rule creates a presumption that sales contests, *whether product-specific or not*, constitute a breach of a covered person's duty in connection with any securities recommendation relevant to the contest. In contrast, the prohibition on sales contests in Regulation Best Interest applies only to sales contests that are based on the sale of *specific* securities or *specific types* of securities within a limited timeframe.

The Court's Opinion

The court concluded that the secretary's promulgation of the Massachusetts rule was within the broad authority and deference afforded to the secretary to adopt regulations in furtherance of the objectives of the Massachusetts Uniform Securities Act. The court specifically rejected, among others, arguments that the rule is invalid because:

- It upsets the basic structure of the Massachusetts Uniform Securities Act, as well as historic industry norms, for regulating broker-dealers differently from investment advisers.
- It contradicts language in the statute stating that the act "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation."
- It abrogates relevant principles of common law.
- It constitutes a form of legislation whose enactment may not, under the Massachusetts Declaration of Rights, be delegated to the secretary.
- It has been preempted, inasmuch as the SEC intended Regulation Best Interest to establish a "ceiling" on the standard of conduct for broker-dealers.

Supreme Court Plays Its Cards on Constitutionality of SEC In-House Court Actions

BY NATALIE NAPIERALA AND NADER AMER

The U.S. Supreme Court's June 2023 decision to grant certiorari in *SEC v. Jarkesy* called into question the SEC's ability to pursue penalties and other legal remedies before the SEC's in-house administrative law judges. If successful, this appeal could severely limit the SEC's ability to quickly resolve enforcement actions — SEC rules require that such administrative proceedings conclude within at most 120 days after post-hearing or dispositive motion briefing.

In *Jarkesy*, the SEC brought suit before an ALJ in an administrative proceeding against George Jarkesy Jr. and his registered investment adviser, Patriot 28, for alleged securities fraud. Despite Jarkesy's demand for a jury trial (the rules for such proceedings do not provide for any jury trial), the ALJ continued with the action. Ultimately, the ALJ found Jarkesy liable and granted the SEC's request for equitable remedies and the imposition of civil penalties.

The Seventh Amendment provides for the right to a jury trial for actions at law, but not for equitable actions. Historically, courts of law, rather than courts in equity, have enforced civil penalties. Consequently, when a plaintiff seeks civil penalties, the action is considered an action at law, attendant to which is the Seventh Amendment right to a jury trial. Thus, in accordance with the above reasoning, the Fifth Circuit Court of Appeals held that it was a violation of the defendants' Seventh Amendment right for the ALJ not to have allowed for a trial by jury.

The SEC seeks to rely on the "public rights" exception to this general rule: when Congress, by statute, creates a "public right" and properly assigns the right to be adjudicated before ALJs, the Seventh Amendment does not require a trial by jury. This exception applies only where the use of a jury would disrupt the process Congress contemplated for resolution of the right, i.e., only if the right is so clearly integrated within a comprehensive regulatory scheme that the right is appropriately left for agency resolution.

The Fifth Circuit found the "public rights" doctrine inapplicable under the circumstances. This is because (1) securities fraud actions reflect common law fraud actions, which are focused on redressing *private* harms, (2) jury trials of securities fraud actions would not "go far to dismantle the statutory scheme," and (3) securities fraud enforcement actions are "not uniquely suited for agency adjudication," as shown by the many decades worth of federal court enforcement actions alleging violations of federal securities laws and regulations.

The grant of certiorari in *Jarkesy* comes on the heels of the Supreme Court's April 2023 decision in *SEC v. Cochran*, wherein the court held that defendants facing SEC claims in an administrative forum can challenge the ALJ's constitutional authority via an interlocutory appeal to the federal district courts. The highest court's decision is contrary to the long-standing policy of forcing defendants to wait until the conclusion of an administrative proceeding before a court may hear such an appeal on constitutional grounds. *Cochran* itself substantially undermined, as a practical matter, the SEC's ability to efficiently use administrative proceedings before ALJs. *Cochran*, moreover, may have tipped the Supreme Court's hand in *Jarkesy*, foreshadowing a constitutional limitation on the SEC's ability to use ALJs to swiftly resolve securities law claims.

The Supreme Court's ultimate decision on the constitutionality of ALJs could have a broad impact on many types of agency administrative proceedings throughout the United States. Stay tuned to see who has a winning hand.

NAIC Innovation, Cybersecurity, and Technology (H) Committee Gets in on the Action

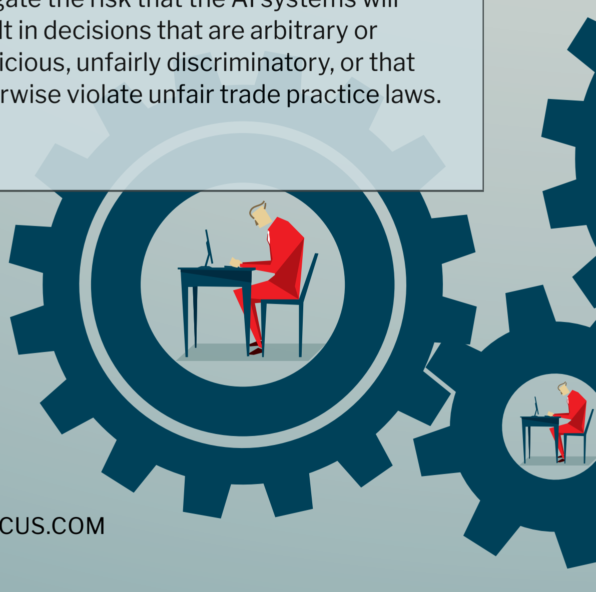
BY ANN BLACK, EDMUND ZAHAREWICZ, AND ERIN VANSICKLE

On July 17, the Innovation, Cybersecurity, and Technology (H) Committee of the National Association of Insurance Commissioners released its exposure draft of the NAIC's model bulletin on insurers' use of algorithms, predictive models, and artificial intelligence systems. The draft model bulletin takes a principles-based approach to how insurers should govern the development, acquisition, and use of artificial intelligence and big data-related resources (AI systems) in making or supporting decisions impacting consumers. It also advises insurers on what regulators may request during an investigation or examination. The committee's exposure coincides with Colorado's development of a proposed regulation on governance and risk management framework requirements for life insurers using external consumer data and information sources, algorithms, and predictive models (CO Life Governance Rule).

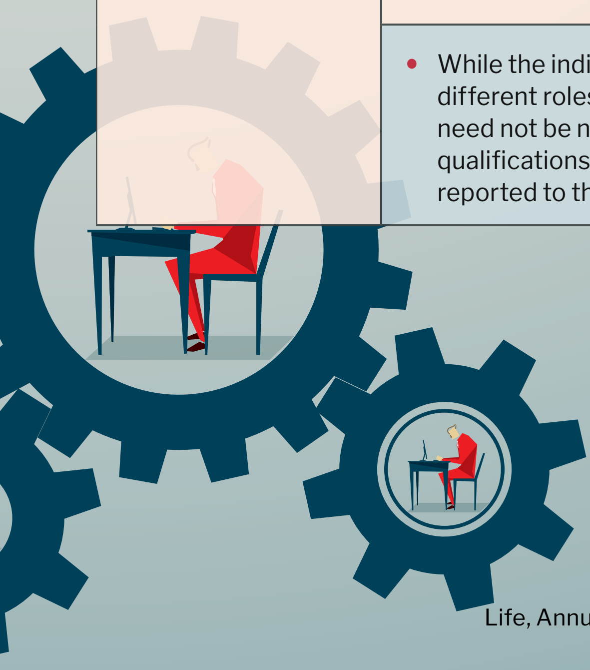
In contrast to the NAIC draft model bulletin, which sets forth regulator expectations and provides guidance to insurers, the CO Life Governance Rule bets on a more prescriptive approach to consumer protection.

Below are some of the key similarities and differences between the NAIC draft model bulletin and the CO Life Governance Rule:

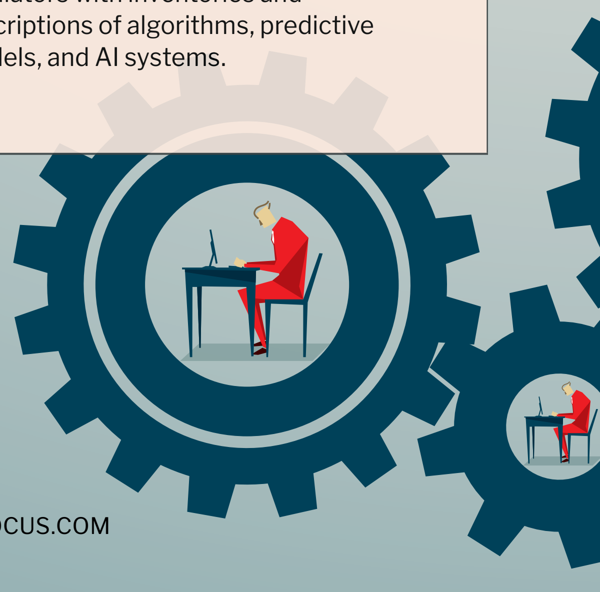
	CO LIFE GOVERNANCE RULE	NAIC DRAFT MODEL BULLETIN
Applicability	All ***life*** insurers doing business in Colorado.	All insurers doing business in the state where the bulletin is issued using AI systems to make or support decisions impacting consumers.
Governance	Life insurers using external consumer data and information sources, as well as algorithms and predictive models that use external consumer data and information sources (ECDIS/AI/PM), ***must establish*** a "risk-based" governance and risk management framework that ***addresses any insurance practices***.	Insurers are encouraged ***to develop, implement, and maintain*** a written program for the use of AI systems (AIS program). An AIS program should be reflective of, and commensurate with, the insurer's assessment of the risk posed by its use of an AI system.
Objective	The governance framework that facilitates and supports policies, procedures, systems, and controls ***must*** be designed to determine whether the use of such ECDIS, algorithms, and predictive models potentially results in unfair discrimination with respect to race and to remediate unfair discrimination, if detected.	The AIS program should be designed to mitigate the risk that the AI systems will result in decisions that are arbitrary or capricious, unfairly discriminatory, or that otherwise violate unfair trade practice laws.



	CO LIFE GOVERNANCE RULE	NAIC DRAFT MODEL BULLETIN
Principles	The risk management framework must include governing principles outlining the values and objectives of the insurer.	The *Principles of Artificial Intelligence* should guide insurers in their development and use of AI systems.
Responsibility	The risk management framework must be overseen by the board or a specified board committee.	The AIS program should vest responsibility with senior management reporting to the board or an appropriate committee of the board.
Roles	The required governance **must** set forth who within the insurer is responsible for the insurer's use of ECDIS/AI/PM, and it must:	The AIS program should address defined roles and responsibilities for key personnel charged with carrying out the AIS program generally and at each stage of an AI system life cycle, and should consider:
	• Include a cross-functional group from key functional areas including legal, compliance, risk management, product development, underwriting, actuarial, data science, marketing, and customer service, as applicable.	• Including a committee comprised of representatives from all disciplines and units within the insurer, such as business units, product specialists, actuarial, data science and analytics, compliance, and legal.
	• Set forth the clear lines of communication between the various committees, governance groups, and individuals and require regular reporting to senior management on the performance and potential risks of ECDIS/AI/PM.	• Coordination and communication between persons with roles and responsibilities with the committee and among themselves and escalation procedures and requirements.
		• The independence of decision-makers and lines of defense at successive stages of the AI system life cycle.
		• Scope of authority, chains of command, and decisional hierarchies.
	• While the individuals who are assigned different roles in the governance structure need not be named, the title and the qualifications of the individuals must be reported to the CO Division of Insurance.	• The qualifications of the persons serving in the roles identified.



	CO LIFE GOVERNANCE RULE	NAIC DRAFT MODEL BULLETIN
Policies, Processes, and Procedures	The required policies, processes, and procedures must address:	The AIS program should address policies, processes, and procedures:
	• The design, development, testing, deployment, use, and ongoing monitoring of ECDIS/AI/PM.	• For designing, developing, verifying, deploying, using, acquiring, and monitoring predictive models, including: (i) identification of constraints and controls on automation and design and (ii) data governance and controls, any practices related to data lineage, quality, integrity, bias analysis and minimization, suitability, and updating.
	• Consumer complaints and inquiries about the insurer's ECDIS/AI/PM, including how the insurer will ensure that consumers are provided with the information necessary to take meaningful action in the event of an adverse decision.	
	• A rubric for assessing and prioritizing risks associated with the deployment of ECDIS/AI/PM with reasonable consideration given to insurance practices' consumer impact(s).	• Risk management and internal controls, to be followed at each stage of an AI system life cycle.
	• Testing to detect unfair discrimination in insurance practices resulting from the use of ECDIS/AI/PM and, to the extent that unfairly discriminatory outcomes are found, how the insurer will address and remediate such outcomes.	• Methods used to detect and address errors or unfair discrimination in the insurance practices resulting from the use of the predictive model.
	• Ongoing monitoring regarding the performance of AI/PM including accounting for model drift.	• Management and oversight, including validation, testing, and auditing, including evaluation for drift.
Inventories	The framework must include documented up-to-date inventory of all utilized ECDIS/AI/PM, including version control. The inventory must also describe all utilized ECDIS/AI/PM, as well as their stated purpose(s) and the outputs generated through their use.	Insurers must be prepared to provide regulators with inventories and descriptions of algorithms, predictive models, and AI systems.



	CO LIFE GOVERNANCE RULE	NAIC DRAFT MODEL BULLETIN
Training	The required policies, processes, and procedures must include an ongoing training program.	The AIS program should consider the development and implementation of ongoing training.
Third-Party Vendors	Requires insurers to have a process for selecting third-party vendors of ECDIS/AI/PM and places responsibility on insurers for ensuring the framework requirements are met even when the insurer's ECDIS/AI/PM is provided by a third-party vendor.	The AIS program should address the insurer's standards for the acquisition, use of, or reliance on AI systems developed or deployed by a third party, including policies and procedures related to: • Due diligence to assure that the third-party AI systems are designed to meet the legal standards imposed on the insurer itself. • Including in its third-party agreements requirements to maintain an AIS program consistent with what is required of the insurer, permit the insurer to audit the third party, provide the insurer with reports of the third party's compliance with standards, and comply with regulatory inquiries.
Reporting Requirements	Each insurer using ECDIS/AI/ML must submit: • By June 1, 2024, a narrative report summarizing its progress toward complying with the CO Life Governance Rule, areas under development, any difficulties encountered, and expected completion date. • By December 1, 2024, and annually thereafter, a narrative report of not more than 10 pages summarizing compliance with the CO Life Governance Rule.	

Colorado is looking to close the betting line on October 30, the proposed effective date for the CO Life Governance Rule. On August 31, the Colorado Division of Insurance held a hearing on the CO Life Governance Rule. According to the notice of hearing, stakeholders had until September 6 to submit written comments.

Sportsbooks still have time to set the betting line for the NAIC draft model bulletin. At the Summer National Meeting, the H Committee briefly heard comments on the NAIC draft model bulletin. A second draft of the model bulletin is expected at the end of September.

New York Department of Financial Services Plays Pit Boss for Consumer Protection

BY ANN BLACK AND EDMUND ZAHAREWICZ

Worried that the cards may be stacked against certain consumers and producers, the New York Department of Financial Services (DFS) released a circular letter and filing guidance note on July 17 to remind insurers of their obligations pertaining to unfair and unlawful discrimination in the sale of life insurance and annuities. The DFS is concerned that low-income consumers, consumers of color, and consumers living upstate, as well as small insurance producers, are being disadvantaged if insurers offer different versions of products within the same sales channels.

The DFS contends that "consumers with the same expectation of life and **with *identical* needs, goals, or personal or financial circumstances**" are "similarly situated consumers," and that if similarly situated consumers received "different terms, conditions, benefits, fees, or premiums for the same policies or contracts in the individual market" unfair discrimination has occurred.

As a result, the DFS states that it is a violation of New York Insurance Law sections 2606(a)(1) and 4224(a)(1) to:

- Have, at the request of a particular producer, a different version of a product or additional features that are offered **solely to** that producer's clients.
- Have a producer-developed product that is offered exclusively through that producer.
- Have different versions of a product offered through different producers as a marketing strategy.
- **Charge different** premiums or fees for identical policies or contracts or to sell different versions of a product with different rights, benefits, or fees **based solely** upon the level of **compensation paid to a producer.**

The filing guidance explains that the DFS:

> [H]as not objected to different versions of a product being sold in the markets or through the channels [specified in the filing guidance]. … [The DFS] does not object to the use of different policy forms in these markets or through these channels or deviation from the insurer's regular individual underwriting rules for the same policy form, such as levels of underwriting, pricing, and non-forfeiture values.

The guidance cautions, however, that:

> [W]ithin each market or channel, there can be no unfair discrimination between individuals of the same class and of equal expectation of life, in the amount of interest being credited, the amount or payment or return of premium, or rates charges, or dividends or other benefits or in any of the terms and conditions of the policy or contract.

And it explains that "similarly situated consumers with an equal expectation of life should receive the same version of the product regardless of which bank or financial institution sells it to them." The filing guidance notes that the DFS may allow exceptions on a case-by-case basis, but to do so, the insurer must show that "one product or version is not always better than the other versions

(suitability issue)" because the different versions address different consumer needs or goals. If the different versions are approved, all versions must be listed on the application.

Insurers must:

- Adhere to the circular letter and the filing guidance for all new life insurance and annuity policy form filings made after July 17; and
- Review their product portfolios "and take steps, as needed, to comply with [New York] Insurance Law section 4224(a)(1) and the guidance in [the] circular letter."

The circular letter states that the DFS expects to examine existing product portfolios for compliance with sections 2606(a)(1) and 4224(a)(1) during regular and targeted market conduct examinations beginning in 2025.

While its goals are admirable, the DFS may have overplayed its hand. For example:

- Does the guidance unnecessarily conflate unfair discrimination with suitability by classifying consumers with the same life expectancy by their "needs, goals, or personal or financial circumstances"? These factors are considered as part of Regulation 187's best interest obligations requiring the producer to believe that the insurance transaction is suitable. Given the robust nature of Regulation 187, it seems unnecessary to inject suitability factors into traditional unfair discrimination analysis.
- Will the guidance result in access to more products for consumers the DFS is intending to protect? An unintended consequence could be fewer and perhaps more expensive products. For instance, a financial institution may determine that its customers would benefit from a product with fewer riders or options and lower costs, while another financial institution may determine that its customers would benefit from a product with greater optionality and greater cost for such optionality. If an insurer must treat all consumers of such financial institutions as if they were "similarly situated," the insurer will have to choose between offering a simplified product over a more versatile but potentially more expensive product. Either way, there ultimately may be fewer products in the market if every insurer is confined to offering a single product version for a given "recognized" market. And fewer products may result in less competition and higher pricing, potentially making products less affordable overall.

While the DFS went all-in on its consumer protection goal, it's currently anyone's bet what impact this latest guidance on unfair discrimination may have on product design, pricing, and affordability.

Stakes Are High: Lawsuits Expose Deficient COBRA Notices

BY IRMA SOLARES AND SEAN HUGHES

Not many general counsels will tell you that their company's COBRA notice is what keeps them up at night. But recent class action litigation highlights challenges to COBRA notices and issues that can be easily addressed to avoid costly litigation. So if you haven't reviewed your COBRA notice form recently, now may be a good time to do so — or have a talk with your COBRA plan administrator.

What was initially believed to be a Florida-specific cottage industry of class action suits attacking allegedly deficient COBRA eligibility notices is now spreading to a multitude of states such as California, Georgia, Illinois, Michigan, Pennsylvania, Tennessee, and Texas.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) ensures that employees who lose health insurance coverage under their company's ERISA plan do not go without insurance before they can find replacement coverage. Employers that sponsor a group health insurance plan must offer employees and qualified beneficiaries continuation of coverage for at least 18 months after a "qualifying event." They must also inform employees and qualified beneficiaries of their right to enroll in continued health insurance coverage within a certain period of time after such an event, such as termination of employment, the death of the covered employee, or divorce.

What's the big deal, you wonder? The class actions allege that the employer or the designated COBRA administrator failed to provide COBRA-compliant notices because they are not written in a manner calculated to be understood by the average plan participant, or do not adequately inform the affected employee or beneficiary how to exercise rights to elect COBRA coverage, by failing to:

- Include a coverage election form.
- Include a date certain on which continuation of coverage ends.
- Include an address for payment of premiums.
- Identify the plan administrator.
- Provide all required information in a single notice rather than in multiple notices.

Other suits allege that the COBRA notice improperly contains language suggesting that failure to properly complete the coverage election, or forms that contain incomplete or incorrect information, may subject the plan participant to criminal or civil penalties. Recently, one such putative class action survived a motion to dismiss. In *Lites v. Amazon.com Services LLC*, the district court determined that the plaintiff sufficiently pleaded a COBRA violation and held that the plaintiff "plausibly alleged" that the COBRA notice was not "written in a manner calculated to be understood by the average plan participant given that the penalties included in the [COBRA notice] are not a strictly accurate statement of the law."

Companies, both large and small, have fallen prey to these actions. While many of these cases have settled with classes ranging from 1,700 to over 92,000 class members, a deficient COBRA notice can expose a company to statutory ERISA penalties of $110 per employee, per day that the COBRA notice is deficient. There's also an Internal Revenue Code excise tax penalty of $100 per day for each qualified participant or beneficiary for a COBRA notice violation. These penalties can add up quickly, in addition to attorneys' fees and costs.

The good news is that these claims are largely avoidable. While many companies rely on their COBRA administrator to send compliant COBRA notices, many fail to follow the Department of Labor's model election notice, which the department introduced to assist employers and plan administrators in complying with the applicable notice requirements. While the use of the model notice is not required, the department views its use as a good faith compliance with COBRA's notice content requirements. Employers and plan administrators should look to closely follow the department's model COBRA notices in the future, as these provide guidance as to many of the notice content requirements. However, employers must also be aware that there are additional requirements under the statute that the model notice does not enumerate. Thus, adhering to the COBRA regulations, in addition to closely tracking the model notice, is a good way for employers to protect themselves against these high-stakes class action claims.

New California Lapse Statute Decision Highlights the Importance of Where Insurance Policies are "Issued or Delivered"

BY MICHAEL WOLGIN

This past May, the Ninth Circuit Court of Appeals affirmed a district court's order granting summary judgment in favor of a life insurance company, finding that California's lapse statute applies only to life insurance policies initially "issued or delivered" in California.

In *Elmore v. Hartford Life and Accident Insurance Co.*, the insured alleged that the company improperly terminated his policy under California's lapse statute, sections 10113.71 and 10113.72 of the California Insurance Code, which outlines procedural notice requirements that insurers must follow before they can terminate a policy. Despite receiving termination notices sent to his work address, which was the current address on file, the insured did not timely pay his premiums, and his policy lapsed in May 2017.

The insured, a California resident, filed suit alleging that the insurer violated California's lapse statute "by failing to notify him of his right to designate an additional party to receive lapse-of-payment notices and to send these notices to that designee before terminating his policy." The insurer moved for summary judgment, contending that the notice provisions of the 2013 statute did not apply retroactively and did not extend to the policy in question, which was originally issued in Illinois. The district court agreed and entered summary judgment for the insurer.

On appeal to the Ninth Circuit, the first ground for summary judgment (that California's lapse statute did not apply retroactively) was foreclosed by the ruling in *McHugh v. Protective Life Insurance Co.*, in which the California Supreme Court ruled in favor of retroactivity. Nonetheless, the insurer prevailed on the second point: that the California law did not apply. Although the policyholder had moved to California after buying the policy, California's lapse statute applies only to policies "issued or delivered" in California. The insured argued that the relevant provisions of the statute did not expressly include the condition that policies must be "issued or delivered in this state," suggesting that it should apply to his Illinois-issued policy. The Ninth Circuit, however, construed the statute and concluded that the plain language of the law limits its reach only to policies "issued or delivered" in California, and affirmed the district court's ruling.

Life insurers should take note of the new *Elmore* decision, which should limit *McHugh*'s expansion of the California lapse statute for a subset of policies not originally issued in California.

This article was co-authored by Carlton Fields summer associate Annick Runyon.

Texas Doubles Down on "Intent to Deceive" as Requirement to Void Insurance Policy

BY SEAN HUGHES

The Texas Supreme Court reinforced common law precedent that insurers cannot avoid liability under an insurance policy based on a misrepresentation in an insurance application unless the insurer can establish that the insured intended to deceive or induce the insurer to issue the policy, among other requirements.

In *American National Insurance Co. v. Arce*, the insured's response to medical history questions in his life insurance application was inaccurately recorded as "no" by the agent, despite disclosing some adverse medical history. Upon the insured's death shortly thereafter, his mother, the policy's beneficiary, submitted a claim that was later denied, prompting her to sue the insurer for breach of contract and violations of the Texas Insurance Code.

Section 705.051 of the Texas Insurance Code states that "[a] misrepresentation in an application for a life, accident, or health insurance policy does not defeat recovery under the policy unless the misrepresentation (1) is of a material fact and (2) affects the risks assumed."

Before section 705.051 was re-codified in 2003, the Texas Supreme Court had established a five-part common law test that required proof of "intent to deceive" in order to void a policy based on an insured's misrepresentation. In *Arce*, the insurer claimed that no benefits were owed under the policy due to material misstatements of fact in the insured's application that affected the risks the insurer assumed in issuing the policy. The insurer argued that the language in section 705.051 encompassed every element of the common law test *except* the intent to deceive, thus indicating that the statute did not require intent to deceive. However, the Texas Supreme Court rejected this argument, finding that under this interpretation, insurers could avoid paying on an insurance policy based on an innocent, unknowing, or careless misstatement in an insurance application, so long as the misstatement was of a material fact and either induced the policy's issuance or affected the premium charged.

The Texas Supreme Court analyzed the history of the 2003 re-codification of the statute, finding that the Texas legislature not only declared that the 2003 recodification was nonsubstantive, but it also left section 705.051's language materially unchanged. Thus, based on precedent, the lack of substantive change showed that the legislature's intent was *not* to eliminate the common law requirement. In analyzing the plain text of the statute, the court next rejected the insurer's argument that the language in the statute encompassed every element of the common law test *except* intent to deceive. The court focused on the statute's use of the word "unless," which implied that the two enumerated elements in the statute were merely necessary, not sufficient, to defeat recovery. The court further stated that, "as written, section 705.051 does not guarantee that the insurer can 'defeat recovery under the policy' if both of the stated conditions are satisfied; it only guarantees that recovery *cannot* be defeated if one or the other is not." The court further stated that even taking "unless" to mean "except if," as the insurer urged, did not alter the plain meaning of section 705.051 as establishing minimum conditions that did not guarantee denial of recovery. Thus, the court found that the statute did not inherently or necessarily conflict with settled law requiring pleading and proof of intent to deceive *in addition to* the statutorily mandated conditions.

Accordingly, the Texas Supreme Court held that insurers must plead and prove intent to deceive to avoid contractual liability based on a misrepresentation in an application for life insurance, regardless of whether the policy is contestable. Proof of a material inaccuracy is not enough.

SCOTUS Removes Burden Handicapping Appeals Seeking Arbitration

BY IRMA SOLARES, BRUCE BERMAN, AND ALEX BEIN

The U.S. Supreme Court's June 2023 decision in *Coinbase Inc. v. Bielski* requires that district court litigation in any matter remain in the starting gate while any appeal from a denial of a motion to compel arbitration in that matter runs its course. This will make arbitration a much more frequent winner in the sweepstakes for choosing the conflict resolution venue.

Many consumer financial products and services agreements include an arbitration clause allowing parties to require that disputes be resolved through arbitration instead of the court system. Class actions are generally precluded. While arbitration clauses are disfavored by consumer advocacy groups, they are an effective tool for stemming costly class actions when used properly.

In *Coinbase*, the plaintiff alleged that the online currency platform didn't replace funds fraudulently taken from users' accounts. Coinbase filed a motion to compel arbitration, relying on the arbitration provision in its user agreement. The district court denied the motion. Coinbase then filed an interlocutory appeal to the Ninth Circuit Court of Appeals under the Federal Arbitration Act, which expressly authorizes an interlocutory appeal from the denial of a motion to compel arbitration. Coinbase simultaneously moved the district court to stay all proceedings pending the resolution of the interlocutory appeal. Coinbase's request for a stay was denied by both the district and appellate court. Ninth Circuit precedent provided that such a stay is not automatic but may instead be granted at the trial court's discretion.

The Supreme Court, drawing a card from *Griggs v. Provident Consumer Discount Co.*, maintained that an appeal, including an interlocutory appeal, divests the district court of its control over those aspects of the case involved in the appeal. Because the question on appeal is whether the case belongs in arbitration or instead in the district court, the entire case is essentially "involved in the appeal." As such, the court concluded that an automatic stay during the pendency of an arbitrability appeal was necessary. In further support, the court reasoned that "it makes no sense for trial to go forward while the court of appeals cogitates on whether there should be one."

Among other things, the court noted that lower courts possess robust tools to prevent unwarranted delay and deter frivolous conduct that an automatic stay might encourage. It also found that the discretionary factors considered by courts in the Ninth Circuit, including irreparable injury absent a stay, were insufficient to protect parties' rights during an interlocutory appeal addressing arbitrability — even substantial and non-recoupable litigation expense. The court distinguished its holding in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.* to the effect that questions of arbitrability are severable from the merits of the underlying disputes, noting that here, by contrast, the issue was more broadly whether a court's authority to consider a case was "involved in the appeal" when the appellate court is considering an issue of arbitrability.

The court's decision aligns with decades of legislative and judicial support for alternative dispute resolution and arbitration agreements, and the concomitant growth in the use of arbitration domestically and around the world, particularly in the context of commercial disputes. As the court recognized in *Coinbase*: "Absent an automatic stay ... [the] right to an interlocutory appeal would be largely nullified ... [i]f the district court could move forward with pre-trial and trial proceedings while the appeal on arbitrability was ongoing." Indeed, "many of the asserted benefits of arbitration (efficiency, less expense, less intrusive discovery, and the like) would be irretrievably lost ... if the court of appeals later concluded that the case actually had belonged in arbitration all along."

The Supreme Court decision aligns the circuits, offering uniformity on long-debated arbitrability issues, and represents a victory for the financial services industry, which relies significantly on arbitration clauses.

NLRB Stacks Deck in Favor of Employees

Employers Must Play Cards Defensively or Go Bust

BY JONATHAN STERLING AND BRENDAN GOOLEY

The National Labor Relations Board has made a series of employee-friendly moves over the past few months that have significant adverse implications for employers, including those in the insurance and securities industries. These moves include:

- Invalidating most confidentiality and non-disparagement provisions in employment agreements.
- Asserting that most noncompete agreements are illegal.
- Imposing stricter scrutiny on workplace rules in general.

In February, the NLRB held in *McLaren Macomb* that the National Labor Relations Act prohibits confidentiality and non-disparagement provisions in severance agreements when such provisions limit an employee's ability to discuss the agreement with co-workers or communicate about their employment. That decision reversed NLRB precedent and broadly limits two key tools that employers frequently use in severance agreements. Employers now will have to be extremely careful to tailor any such confidentiality and non-disparagement provisions narrowly.

Then, in May, the NLRB's general counsel issued an enforcement memorandum asserting that noncompete agreements with employees violate the NLRA when they "could reasonably be construed by employees to deny them the ability to quit or change jobs by cutting off their access to other employment opportunities that they are qualified for." While non-binding, the NLRB's memorandum followed on the heels of a rule proposed by the Federal Trade Commission that would ban the vast majority of noncompetes. That rule has yet to be finalized and is reportedly delayed until at least next year. Nevertheless, the NLRB's memorandum notifies employers of its intent to target noncompetes.

Three months later, in August, the NLRB, in *Stericyle Inc.*, reverted to an old rule that was formerly on the books that created a rebuttable presumption that workplace rules such as those found in employment handbooks are unlawful if they have a reasonable tendency to chill employees from exercising their right to engage in concerted activity. To rebut this presumption, employers must show that the workplace rule is narrowly tailored to advance legitimate and substantial business interests — a high standard. Employers must now carefully review handbooks and other policies and rules.

Collectively, the NLRB's actions establish its intent to adopt employee-friendly positions generally. It is virtually certain that the NLRB will continue to implement and perhaps even ratchet up this approach in its future regulatory and enforcement initiatives.

Therefore, employers need to reexamine their policies and agreements in light of the NLRB's actions and other indications that the federal government's pendulum is swinging away from employer-friendly policies. The days of cutting and pasting boilerplate confidentiality and non-disparagement language in severance agreements and using the same noncompete for every new hire are over. Employers need to consider why confidentiality and a noncompete are essential for a particular employee. Does the employee have access to trade secrets? Will the employee be instrumental in developing and implementing the company's growth plan?

Eventually, possibly with a new administration, the pendulum will likely swing back. But employers cannot assume they can wait it out. Prompt and decisive attention is necessary.

Against All Odds Alpine Wins Important Injunction Against FINRA

BY TINO LISELLA

On July 5, 2023, the D.C. Circuit Court of Appeals issued an injunction that raises a challenge to FINRA's authority to use FINRA-appointed hearing officers to conduct enforcement proceedings. The injunction enables Alpine Securities Corp., which FINRA had expelled from its membership, to nevertheless remain a member pending Alpine's appeal of its expulsion.

FINRA has enjoyed a long history of prevailing in federal court when broker-dealers or registered persons challenge its authority or claim that it is a "state actor." The refrain is largely the same: FINRA is not a government regulator; it is a self-regulatory organization (SRO), where membership is voluntary. Thus, expulsion from membership is not much different from being kicked out of a country club for dealing from the bottom of the deck during weekly poker games.

Not so fast, says Judge Walker in a concurring opinion attached to the injunctive order, which was issued by a three-judge panel. He explains that FINRA's hearing officers are near carbon copies of SEC administrative law judges, who the Supreme Court held in *Lucia v. SEC* must be appointed in accordance with the appointments clause of the U.S. Constitution. Judge Walker queries whether it makes a difference that FINRA hearing officers are employees of a nominally private corporation. He thinks that although FINRA is private, its enforcement activities are controlled by the government, positing that FINRA hearing officers execute government laws subject to a government plan, with little room for private control.

The Next Hand

Although arguments that FINRA is a state actor have generally been dismissed without serious consideration by courts, such arguments may now have a more receptive audience in the D.C. Circuit. Judge Walker's concurrence highlights the reality that securities brokers do not have a choice if they want to sell securities in the United States. FINRA membership is, in effect, mandatory. And FINRA enforces not only its own rules (which are generally vetted by the SEC) but also provisions of the Securities Exchange Act.

Although the injunction is a serious setback for FINRA, it is not "game over" as expulsion would be for Alpine. One judge on the panel would have denied the injunction, and the third judge, while granting it, did not join in Judge Walker's concurrence.

Two weeks after the injunction was issued, FINRA filed a motion for en banc reconsideration of the injunction. On August 22, 2023, the D.C. Circuit denied this request, which indicates that the greater court is perhaps sympathetic to Judge Walker's view of FINRA's authority. Regardless, we are not even mid-shoe in the cards that have been played. This case now needs to be played out on the merits.

If Alpine ultimately prevails, it could be a game-changer for FINRA enforcement. Would FINRA attempt to have its hearing officers appointed by the president under the appointments clause? Would FINRA disciplinary hearings be conducted by SEC ALJs, thus depriving FINRA of the ability to adjudicate its own rules? Time will tell, but this ruling will surely create sleepless nights for many within the SRO.

NEWS & NOTES

Carlton Fields is sponsoring the ACLI Annual Conference on September 27–29, 2023, in Washington, D.C. The conference will feature sessions addressing legal, investment/financial, reinsurance, compliance, retirement security, advocacy, and legislative and regulatory issues. **Irma Solares** will speak on a compliance and legal focus session on account takeover fraud at the conference.

Carlton Fields is a sponsor of the ALIC 2023 Fly-In on October 3, 2023, in Cincinnati, Ohio. **Trish Carreiro** will speak on the use of artificial intelligence in the life insurance industry.

The firm is sponsoring the NAFA Annuity Distribution Summit on October 4–5, 2023, in Nashville, Tennessee. The summit brings principals and executives from all arms of annuity distribution together to discuss the challenges and opportunities facing distributors and what's on the industry horizon. **Joe Swanson** will speak on a session on the future of privacy and cybersecurity.

Carlton Fields is pleased to participate in the ALI CLE Conference on Life Insurance Company Products on November 2–3, 2023, in Washington, D.C. **Richard Choi** will again co-chair the conference, and **Ann Black**, **Trish Carreiro**, **Tom Conner**, and **Ann Furman** will serve as speakers.

Carlton Fields earned national first-tier rankings for six of its practices in the 2023 *U.S. News & World Report* and *Best Lawyers*® "Best Law Firms" guide. Additionally, 179 Carlton Fields attorneys were included in *The Best Lawyers in America 2024*© and 12 firm attorneys were named to the 2024 "Lawyers of the Year" list, a designation given to only one lawyer in each specific practice area and geographic region.

Carlton Fields is pleased to announce that 12 of the firm's practices and 27 of its attorneys earned top rankings in *Chambers USA 2023*. The firm ranked in the top bands in Florida for insurance.

Carlton Fields continues to be recognized as one of the top law firms in the country for diversity, ranking in the top 50 in *The American Lawyer*'s 2023 Diversity Scorecard for the 16th consecutive year. The firm is also recognized as a top law firm in the nation for female and minority attorneys in *Law360*'s 2023 Women in Law and Diversity Snapshot reports.

Carlton Fields welcomes the following attorneys to the firm: shareholder **Jayashree Mitra** (intellectual property, New York); of counsel **Wendy Dowse** (mass tort and product liability, Los Angeles); senior counsel **Gwaina Wauldon** (labor and employment, Hartford) and **Alicia Whiting Bozich** (real property litigation, Tampa); and associates **Michael Bailey** (cybersecurity and privacy, Miami), **Alundai Benjamin** (labor and employment, Hartford), **Kevin Foreman** (business litigation, Washington, D.C.), and **Daniel Simonds** (real estate and commercial finance, Los Angeles).

LIFE, ANNUITY, AND RETIREMENT SOLUTIONS INDUSTRY GROUP

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

Scott Abeles
Enrique D. Arana
Scott E. Byers
Patricia M. Carreiro
Richard T. Choi
Justin L. Chretien
Gary O. Cohen
W. Thomas Conner
Mederic Daigneault
Robert W. DiUbaldo
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

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

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

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