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COMMENTARY

The New York State Department of Financial Services' Recent Enforcement Efforts

As we have previously noted, the New York State Department of Financial Services ("DFS") has emerged as an aggressive watchdog of financial institutions and insurers doing business in New York since its inception in October 2011.[1] In the past year, DFS continued to investigate and regulate emerging financial and insurance issues and did not hesitate to pursue enforcement actions and penalties. Because DFS sees its approach as a model for other states and regulators to foster nationwide change, it is worthwhile for legal and compliance professionals at financial institutions and insurers, located within and outside of New York, to continue to monitor DFS's activities.

DFS's Enforcement Philosophy

DFS's aggressive approach to enforcement is exemplified by its head, Superintendent Benjamin W. Lawsky, a former federal prosecutor. In a March 2014 speech, Lawsky articulated how he believes DFS and financial regulators should approach enforcement. In Lawsky's view, financial regulators should not focus exclusively on corporate accountability for misconduct but must increasingly address individual accountability.[2] Indeed, Lawsky said that a financial regulator fails in its enforcement mission if it cannot find "some person to hold accountable" for corporate misconduct. Lawsky called on regulators to employ "real deterrents" against individual misconduct. Such deterrents include "publicly exposing, in great detail, the actual, specific misconduct that individual employees engaged in" and imposing penalties against individuals who break the rules, such as suspension, termination, and clawing back bonuses. In a recent application of this approach, DFS banned billionaire investor Philip Falcone from having any role running an insurance company licensed by New York for seven years in the wake of his civil settlement with the Securities and Exchange Commission.[3]

In the same March 2014 speech, Lawsky urged imposing, in appropriate circumstances, corporate penalties that go beyond fines, which in his view may not effectively deter misconduct. Lawsky believes an appropriate penalty may include banning a company from conducting the type of business that was at the heart of its misconduct for an extended period. DFS recently imposed such a penalty on an accounting firm, which agreed to a one-year suspension from consulting work at financial institutions regulated by DFS as a result of alleged misconduct in its consulting work.

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DFS's Focus in the Past Year

In the past year, DFS pursued investigations or enforcement initiatives on many fronts, including ownership of insurance companies by private equity firms, captive insurance companies, monitors, force-placed insurance, virtual currencies, cybersecurity, conduct involving countries subject to sanctions, nonbank mortgage servicing, and consumer protection. We review these matters in turn.

Ownership of Insurance Companies by Private Equity Firms. As a result of concerns surrounding what DFS perceived to be a growing trend of private equity firms investing in the annuity business, DFS began an investigation into such activity in 2013. One of DFS's primary concerns was that private equity firms—which may seek comparatively short-term returns on investments—might be at odds with the annuity business, which typically focuses on ensuring long-term security for policyholders. Because of such concerns, DFS threatened to halt two private equity firms' plans to acquire annuity companies.[4] DFS later blessed the acquisitions only after the investment firms agreed to DFS's request to implement increased policyholder protections as part of the acquisition plans.[5] The increased protections consisted of heightened capital standards, the establishment of an additional "backstop" trust account dedicated to further safeguarding policyholder claims, and the private equity firms agreeing to enhanced regulatory scrutiny by DFS of their investments, operations, dividends, and reinsurance.

Captive Insurance Companies. Captive insurance arrangements involve a non-insurance parent company that creates and owns a "captive" to insure the parent's risk. DFS's investigations into captive insurance companies resulted from concerns surrounding the increased use of offshore and out-of-state special purpose vehicles to act as captives. DFS believes these arrangements were pursued to benefit from other jurisdictions' looser reserve and oversight requirements. In June 2013, DFS released a report claiming that New York-based insurers and their affiliates had put at least $48 billion in captive insurance transactions through shell companies located in other states or offshore.[6] The report recommended that DFS require New York-based insurers and their affiliates to disclose in detail their use of captive insurance transactions. The report also recommended that (i) the National Association of Insurance Commissioners ("NAIC") develop enhanced disclosure requirements for captive insurance companies around the country in the interest of national uniformity, and (ii) federal and other state agencies investigate the use of captive insurance nationwide. NAIC later announced it was investigating the controversy concerning captive entities, the resolution of which could take several years.[7] In response, Lawsky criticized as inadequate NAIC's proposal to monitor captive insurance companies.[8]

Monitors. Monitors or consultants are periodically placed in a bank or insurer to ensure compliance with a regulatory or prosecutorial order or agreement. Lawsky has stated that regulators place special reliance on monitors because of regulators' limited resources.[9] DFS is concerned, however, with monitors' independence, particularly in circumstances where they are hired by banks, embedded physically at banks, paid by banks, and depend on banks for future business. DFS's investigation into the monitoring and consulting industry alleged that no one was regulating monitors or consultants.[10] To oversee monitors, DFS has relied on a century-old New York banking statute requiring DFS approval for monitors or consultants to access confidential banking information. This statute allows DFS to determine whether monitors or consultants can work for particular banks. DFS is using this statute as a basis to suspend and penalize monitors or consultants who work for banks under DFS.[11] DFS intends to continue to pursue this approach, which it believes could serve as a national model for changes that should be implemented in the monitoring and consulting business.

Force-Placed Insurance Companies. In September 2013, DFS proposed rules to reform the force-placed insurance industry.[12] Force-placed insurance, or lender-placed insurance, is insurance that a bank, lender, or mortgage service places on a property that does not have the coverage required by the mortgage. Lenders typically obtain force-placed insurance to replace coverage that the borrower has allowed to lapse or to supplement coverage the bank or mortgage servicer determines is insufficient. According to DFS, its investigation into force-placed insurance companies revealed an alleged

"kickback culture" in the industry that resulted in "inflated premiums," which the proposed rules are designed to curb. DFS's new regulations will apply to the industry going forward and any new insurers that enter the market.

Virtual Currencies. As we have previously discussed,[13] since August 2013, DFS has been engaged in a fact-finding inquiry of virtual currencies, including Bitcoin, in an effort to develop a regulatory framework for such currencies. As part of this effort, in January 2014, DFS held two days of public hearings regarding virtual currencies.[14] At the hearings, Lawsky announced that DFS will put forward "a proposed regulatory framework for virtual currency firms operating in New York" in 2014, making New York the first state to create such a framework.[15] Lawsky has said the framework will require DFS to determine "the appropriate licensing, examination, and collateral requirements for the virtual currency industry."[16] With regard to licensing, DFS envisions adapting some of the rules for money transmitters and banks in order to issue a specially tailored "BitLicense," which would allow virtual currency exchanges to operate in New York.[17] More recently, in March of this year, DFS began accepting proposals and applications for BitLicenses.[18]

Cybersecurity. DFS also took an increased interest in issues related to cybersecurity after New York Governor Andrew Cuomo announced the formation of a Cyber Security Advisory Board and appointed Lawsky one of the co-chairs.[19] Soon after the formation of the Board, DFS sent so-called "308 Letters"—a request for information to which insurers are legally required to respond—to the largest insurance companies that DFS regulates, requesting information on the policies and procedures they have in place to protect against cyber attacks.[20] In May 2014, DFS released a report on cybersecurity based on the results of a year-long survey that DFS conducted of the banks it regulates.[21] As a result of what DFS perceives to be an increase in the frequency and sophistication of cyber attacks on financial institutions, the report announces that DFS will conduct new, regular, targeted cybersecurity preparedness assessments of New York banks as part of the regular examination process.

Conduct Involving Countries Subject to Sanctions. DFS pursued several investigations related to institutions that allegedly conducted transactions with countries and entities subject to U.S. and international sanctions, such as Iran and Sudan. In at least one of these investigations, DFS partnered with the U.S. Department of Treasury and the Federal Reserve. Lawsky has said that, in connection with one investigation, he is considering a deal that would temporarily suspend a financial institution's ability to transfer money through its New York branches on behalf of foreign clients as a penalty for the institution allegedly processing transactions for countries subject to sanctions. DFS also asked reinsurance companies for information about business in Iran, including measures they have taken to ensure they do not underwrite coverage for prohibited shipping.[22] Recently, DFS sent subpoenas to four U.S. insurers to determine if they have complied with U.S. laws against doing business with Iran.[23]

Nonbank Mortgage Servicing. In February 2014, Lawsky called on regulators to halt the expansion of nonbank mortgage servicers.[24] Mortgage servicers collect payments from homeowners and distribute the payments to investors who own the loans through mortgage securities. Nonbank mortgage servicers often focus on delinquent loans and those made to buyers with poor credit histories. Lawsky fears some nonbank mortgage servicers are getting too big too quickly and are not equipped to handle the amount of business they have assumed.

Consumer Protection. In April 2014, Lawsky brought a lawsuit against Condor Capital Corporation, a subprime auto lender based in Long Island, and its owner, for concerns related to the company's practices regarding customer loans and customer data.[25] DFS alleges that: (i) Condor stole millions of dollars from borrowers by deceiving them about the positive balances in their accounts, and (ii) the company did not properly safeguard customers' personal information. In pursuing the lawsuit, DFS is relying on a rarely used provision in the Dodd-Frank Act,[26] which gives state authorities power to enforce federal consumer protection law. Because DFS is among the first state regulators to take advantage of this provision, DFS's lawsuit may serve as a model for other state regulators to take similar action. Not long after the lawsuit was filed, the court granted DFS's temporary restraining order freezing Condor Capital Corporation's accounts and operations.

Conclusion

DFS's recent activity and initiatives suggest it will continue to pursue its interest in investigating emerging growth areas and trends, its desire to push its reforms and regulations as models for other jurisdictions, and its wide-ranging enforcement actions and remedies. Legal and compliance professionals at financial institutions and insurers, located in and outside of New York, should accordingly continue to keep informed of DFS and its activities.

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Endnotes

1 For a fuller discussion of the creation of DFS and its powers, please see our December 2011 *Jones Day Commentary*, "The Department of Financial Services: New York's Newest Financial Regulator" (*available at* http://www.jonesday.com/department__of__financial__services/). For a discussion of DFS's regulatory and enforcement activities in the first year following its inception, please see our May 2013 *Jones Day Commentary*, "The New York State Department of Financial Services at the One-Year Mark: A New Aggressive Regulator Worth Following" (*available at* http://www.jonesday.com/the-new-york-state-department-of-financial-services-at-the-one-year-mark-a-new-aggressive-regulator-worth-following-05-10-2013/).

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