SUTHERLAND

LEGAL ALERT

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NAIC Proposes Expansive New Governance, Risk Management and Reporting Duties on Insurance Holding Company Systems; A New Liability Profile Emerges for Directors and Senior Management

In an ambitious move to craft legislation that will override state case law on corporate governance, potentially challenge the federal securities laws as the primary source of the requirement to disclose corporate risk factors, and extend the extra-territorial reach of state insurance regulators to examine and control insurance holding companies and insurers beyond their state borders, a key committee of the National Association of Insurance Commissioners ("NAIC") has exposed amendments (the "Amendments") to the Insurance Holding Company System Model Act (#440) (the "Act") and changes to the supporting regulations[1] for a 30-day comment period **ending July 21, 2010**. The NAIC is seeking to focus the intellects and energies of directors on evolving risks facing insurers, such as those exemplified by the recent financial crisis and ensuing recessionary economy. To some, this process is seen as the effort, no doubt in good faith, of the executive branch (*i.e.*, insurance regulators) to compel the legislative branch to change existing law (through the NAIC accreditation requirements), while paying insufficient attention to the precedents set by the judicial branch (*e.g.*, case law regarding oversight duties of directors). In addition, issues of federalism are raised as the existing disclosure requirements of the federal securities laws do not dovetail with the disclosure requirements of the Amendments.

The Amendments would do the following:

- Impose on the directors and senior management of insurers and insurance holding companies new substantive duties, which may contradict existing process-driven case law on oversight liability, ignore judicially crafted culpability standards, and create a new plaintiff class;
- Require the ultimate controlling person of a regulated insurer to file with state regulators an annual report identifying the material risks, anywhere in the insurance holding company system, that could pose financial and/or reputational "contagion" to the insurer;
- Set forth other requirements for participating and sharing the expenses of supervisory colleges; and
- Add new requirements for transactions within the insurance holding company system that involve the insurer.

This Legal Alert has been written to help insurers consider the impact of the Amendments on their ultimate parent companies, other insurers in the holding company system, shareholders (if any), directors, senior management and the legal department. This is the time to identify changes that will need to be made in internal procedures and policies, to determine how to protect the board and management from their new liability profile, and to express to state insurance regulators detrimental outcomes from the proposed Amendments.

[1] The Insurance Holding Company System Model Regulation (#450) (the "Revised Regulation").

Procedural History

Before we analyze the substantive elements of the Amendments, we present a summary of their procedural history. Over the past year, the Group Solvency Issues Working Group ("GSIWG") of the NAIC's Solvency Modernization Initiative (EX) Task Force has held numerous public sessions to draft the Amendments, amid ongoing comments and objections from the industry. As with many recent NAIC initiatives, the Amendments appear crafted with an eye towards the financial regulatory reform debate currently concluding in Congress and are intended to demonstrate the adequacy and elasticity of state insurance regulations. In particular, the Amendments focus on strengthening the ability of each state insurance commissioner ("Commissioner") to supervise insurance groups using a system of windows and walls,[2] addressing a perceived weakness in the current U.S. insurance regulatory system.[3]

The GSIWG finished its work on June 18, 2010, referring the Amendments and Revised Regulation to the Financial Condition (E) Committee, which held its first call on the proposed changes three days later. At the end of the June 21 call, the full (E) Committee voted to expose the GSIWG's Amendments for public comment until July 21, 2010. The intent is for the (E) Committee to be in a position to approve the Amendments during the August 2010 Summer NAIC Meetings being held in Seattle and refer them to the Executive Committee and Plenary, for final adoption in October at the final NAIC Meetings for 2010.

It is expected that the Amendments will become part of the accreditation standards that the NAIC expects states to adopt as part of its efforts to promote sound, uniform financial solvency regulation for insurers nationwide.

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[2] In recent testimony before the U.S. House of Representatives, Ann M. Frohman, Director of Insurance from Nebraska and Chair of the GSIWG, explained that traditionally state insurance regulation of groups has focused on "ring fencing" the insurers. "Ring-fencing" is the legal walling off of certain assets or liability within the holding company system. See NAIC Consultative Paper on Regulatory Capital Requirements and Overarching/Valuation Issues for the Solvency Modernization Initiative, Dec. 2, 2009 at 26. According to Director Frohman, the GSIWG is recommending that the NAIC enhance its group supervisory efforts by "incorporat[ing] certain prudential benefits of group supervision into the solvency regime, providing a window into group operations, while building upon the existing walls that provide solvency protection. Ultimately, this 'windows and walls' approach should … increase understanding of the potential implications of group financial and reputational risks on an insurer within the group." Ann M. Frohman, Testimony Regarding Insurance Holding Company Group Supervision before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, March 18, 2010, at 9-10.

[3] In May 2010, the International Monetary Fund ("IMF") released its report providing a detailed assessment of how the U.S. insurance sector complies with the Insurance Core Principles of the International Association of Insurance Supervisors ("IAIS"). In that report, the IMF found that, while insurance regulation in the U.S. is generally "thorough and effective," the approach among U.S. insurance regulators to "supervision of groups needs significant development. The U.S. supervisors do not currently make a comprehensive and consistent assessment of the financial condition of the whole group of which a licensed insurance company is a member." "Risk-focused examinations are not yet generally focusing on group issues; and supervisory colleges are not meeting for all U.S.-based international groups." Financial Sector Assessment Program, United States of America, IAIS Insurance Core Principles Detailed Assessment of Observance, IMF, May 2010 at 15, 18 ("FSAP Report").

I. Corporate Governance

The Amendments will expand the oversight duties of directors of insurers and holding companies of insurers.[4] In addition, insurers will be obligated to comply with new composition requirements for the insurer's board and certain board committees.

A. Statement of the board's and senior management's responsibilities. Over strenuous industry objections, the Amendments would require every insurer that is a member of an insurance holding company system and that is subject to registration under the Act to include the following statement ("Statement") in its Form B registration statement:

> The insurer's board of directors is responsible for and oversees corporate governance and internal controls and … the insurer's officers or senior management have approved, implemented, and continue to maintain and monitor corporate governance and internal control procedures.[5]

Significance of the Statement for corporate governance. In order to understand its potential significance, the Statement must be considered in light of other corporate governance initiatives of the NAIC, as well as existing corporate governance regulations, case law and state statutes.

In efforts to improve the capital strength of insurers, the NAIC has begun an initiative, the Solvency Modernization Initiative ("SMI"), based on European regulation, to modernize solvency and capitalization regulation of insurers. Among other things, it is expected that the SMI will call for the board to create a formal risk tolerance statement and to quantify elements of risk. In addition, strategic decisions such as acquisitions must be consistent with the corporation's risk management policy. Further, the Own Risk and Solvency Assessment ("ORSA"), an internal model for risk management that is expected to be proposed under the SMI, effectively mandates a substantive approach to managing a company's risk.

The NAIC has also established the Risk Focused Examination Approach to regulatory regulations. Under this approach, regulatory examiners are directed to: (1) identify key activities of the insurer they are examining; (2) identify and assess risks in those activities (*e.g.*, credit, market, pricing, reserving, liquidity, operational, legal, strategic and reputational risks); (3) evaluate risk mitigation strategies; and (4) determine residual risk (*i.e.*, what's left over after mitigation).

As discussed in the next section, the Amendments would require the ultimate controlling person to disclose in the Annual Report various material risks to the insurer.

New actuarial-related oversight responsibilities will be imposed on insurance boards as a result of the NAIC's "principles-based reserving" initiative ("PBR").[6] As adopted by the Principles-Based Reserving

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[4] The FSAP Report notes that, as of May 2010, there are "no NAIC model laws or regulations that address corporate governance directly." FSAP Report at 41. In drafting the new provisions on corporate governance, the GSIWG asked for comment from the NAIC's new Corporate Governance (EX) Working Group ("CGWG") to ensure consistency with the Model Audit Rule's corporate governance provisions and with other solvency modernization initiatives at the NAIC. In the first meetings of CGWG, it became clear that corporate governance has not been a traditional area of expertise of state insurance regulators.

[5] See Amendments at § 4.B.(7).

[6] See generally *Principles-Based Reserving (EX) Working Group*, NAT'L ASS'N OF INS. COMM'RS, (last visited July 7, 2010).

Working Group on September 22, 2009, the Valuation Manual for PBR will require boards of insurers to establish a process for "general oversight of the principle-based reserves actuarial function."[7] PBR specifies actions the board must take, such as having discussions with senior management, requesting additional information, resolving questions, and monitoring the "process undertaken by senior management to correct any material weakness in the internal controls of the insurance company or group of insurance companies with respect to a principle-based reserve valuation if any material weakness in such internal controls is identified."[8] Further, PBR requires the establishment of "an infrastructure" to implement and oversee principle-based reserve processes, which will require the development of "policies, procedures, controls and resources."[9] Under PBR, the actions taken by the board in establishing the actuarial oversight process should be "[c]ommensurate with the materiality of principle-based reserves in relationship to the overall risks borne by the insurance company."[10]

Contrast the NAIC's approach with corporate case law. The oversight responsibilities of directors under Delaware case law depend upon process rather than outcome. The oversight duty imposed on directors is to "attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[11] The legal threshold for a plaintiff to establish the liability of a board for a breach of its oversight responsibilities is a failure to act in good faith. Such a failure is evidenced by any "sustained or systematic failure,"[12] or "where the fiduciary. . . intentionally fails to act in the face of a known duty to act."[13] Liability arises if there has been a conscious disregard of the "obligation to be reasonably informed about the business and its risks."[14] A failure to act in good faith can result in oversight liability as a breach of the duty of loyalty of directors. Oversight liability has been related to legal and compliance risks. Courts have avoided imposing liability for failing to oversee business risks, acknowledging that risk-taking is part and parcel of doing business.

Implications of the requirement to file the Statement on corporate governance. Examining the NAIC's approach in light of established corporate case law raises the following questions for consideration:

1. How does the Statement fit with directors' duty of care and the duty of loyalty?

2. Is the standard for compliance with the Statement consistent with and subject to traditional thresholds for bringing a claim of breach of fiduciary duties of directors, as well as exculpation provisions in a certificate of incorporation?

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[7] Principles-Based Reserving Working Group, *Corporate Governance Guidance for Principle-Based Reserves, VM-G,* NAT'L ASS'N OF INS. COMM'RS, 1 (Sept. 22, 2009), http://www.naic.org/documents/committees_ex_isftf_pbr_wg_corporate_governance_guide_pbr.pdf.

[8] Id.

[9] Id.

[10] Id.

[11] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996); see also, generally Stone v. Ritter, 911 A.2d 362 (Del. 2006); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009); *In re* Am. Int'l Group, Inc., 965 A.2d 763 (Del. Ch. 2009).

[12] *Caremark*, 698 A.2d at 971.

[13] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).

[14] *Citigroup*, 964 A.2d at 125.

3. Does that Statement impose substantive requirements for the risk management programs that insurance boards must establish and oversee?

4. Does the Statement impose substantive requirements for mitigating business risks such as those identified in the Annual Statement, a Risk Focused Examination, an ORSA, or in the PBR process?

5. Does the Statement effectively add another "plaintiff" who can bring actions against directors for a breach of oversight responsibility (*i.e.*, insurance regulators)?

6. Will it will be easier for shareholder plaintiffs to establish a failure to act in good faith?

7. Will Directors find it more difficult to rely upon the advice of experts?

B. Board Composition. The provisions of the Amendments that deal with Board composition for all insurers [15] are based, in part, upon Section 1202(b) of the New York Insurance Law, which applies to domestic life insurance companies. The Amendments require:

- **Independent board membership; quorum.** At least one-third of the board of directors of each domestic insurer must be persons who are independent. To be considered independent in this context, one must not be: (1) an officer or employee of the insurer or any entity controlling, controlled by, or under common control with the insurer; or (2) a beneficial owner of a controlling interest in the voting stock of the insurer or controlling entity. At least one independent director must be included in the quorum for the board.

- **Independent board committees.** At least one-third of the members of each board committee must be independent, and at least one such person must be included in any quorum for the committee.

- **Fully independent Nominating and Compensation Committees.** Board committee(s) that perform the following functions must be composed entirely of independent members of the board: (i) nominating candidates for director to be elected by shareholders or policyholders; (ii) evaluating the performance of officers deemed to be principal officers of the insurers; and (iii) recommending to the board the selection and compensation of the principal officers.

- **Exception.** The provisions on board composition do not apply if the person controlling the insurer, such as a mutual insurance holding company or a public company, has a board of directors and committees that meet these requirements with respect to the controlling entity.

- **Waiver available.** The Commissioner may waive the board composition requirements upon application by the insurers on the basis that either the insurer's annual direct written and assumed premium is less than $300 million, or on the basis of the insurer's unique circumstances, including the insurer's line of business, ownership structure and/or availability of qualified board members.

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[15] See Amendments at § 5.C.(1) – (6).

Implications of the Amendments' board composition requirements:

1. Unlike the Model Audit Rule, the exemption from the board and committee composition requirements does not require that the public company board or mutual insurance holding company board perform any oversight function for the statutory insurance company.

2. Generally public companies are subject to requirements to have independent nominating and compensation committees, so that their insurance company subsidiaries would qualify for the exception in the Amendments.[16]

3. The new provisions requiring independent directors for additional board committees will force substantial numbers of non-public insurers (and/or their parents) to recruit independent directors in a highly competitive market and to develop processes and procedures to verify their independence.

II. Annual Report on Material Risks of Financial and/or Reputational Contagion

A. The Annual Report. Before the Amendments, the NAIC Insurance Holding Company System Model Act seemed to have as a fundamental premise that the harm to be avoided was assets being unfairly taken from the insurer or the insurer being controlled by persons without the appropriate expertise and character. In contrast, for example, with the regulation of banks and their holding companies, state insurance regulators focused on insurers as self-contained units that would only transfer assets to affiliates in limited circumstances. The recent financial crisis, however, has caused the NAIC's thinking to evolve. The Amendments would require the ultimate controlling person of an insurer to file an annual report with the Commissioner identifying the material risks within the holding company system that could pose financial and/or reputational "contagion"[17] to the insurer (the "Annual Report").[18]

While the Amendments purport to give the insurance regulator authority over the controlling persons of insurers, Form A has been amended in part to address the possibility that such authority does not exist. Any controlling person filing a Form A would be required to agree to file the Annual Report for so long as control exists, and would be contractually required to acknowledge that the controlling person and all its subsidiaries in the insurance holding company system will provide information to the Commissioner upon request "as necessary to evaluate risk of financial and/or reputational contagion to the insurer." [19] The

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[16] The federal securities laws impose certain requirements on the board composition of companies whose securities are listed on national securities exchanges such as the New York Stock Exchange (a "listed company"). For instance, Section 10A(m)(2) of the Securities Exchange Act of 1934 directs national securities exchanges to prohibit the listing of a company not meeting the requirement that all audit committee members of a listed company's board be independent. The new Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Bill") will require that the SEC promulgate rules prohibiting the listing of companies unless all members of the compensation committee of a listed company's board are independent. There are also requirements that the nominating committee of the board of a listed company be independent**.**

[17] The Amendments define "contagion" as "an event or circumstance involving one or more affiliates within the insurance holding company system that can materially affect another insurer within the insurance holding company system or the insurance holding company system as a whole." "Material" includes any activity, circumstance, event or series of events that has the potential to affect in a significant adverse manner the core operations or liquidity of an insurer, to cause the insurer's risk-based capital to fall into company action level, or to cause an insurer to be in a hazardous financial condition. See Amendments at § 1(C) and 1(G).

[18] See Amendments at § 4.B.(8).

[19] See Amendments at § 3.B.(13).

Annual Report would be filed with the NAIC each year by the ultimate controlling person as a confidential supplement to Form B.

New Item 9 to Form B[20] provides instructions for the preparation of the Annual Report. Item 9 requires the ultimate controlling person to provide, to the best of its knowledge and belief, the following information (which is copied verbatim from the Amendments):

1. Any material developments regarding strategy, internal audit findings, compliance or risk management affecting the insurance holding company system;

2. Acquisition or disposal of insurance entities and reallocating of existing financial or insurance entities within the insurance holding company system;

3. Any changes of shareholders of the insurance holding company system exceeding ten percent (10%) or more of voting securities;

4. Developments in various investigations, regulatory activities or litigation that may have a significant bearing or impact on the insurance holding company system;

5. Business plan of the insurance holding company system and summarized strategies for the next 12 months;

6. Identification of material concerns of the insurance holding company system raised by supervisory colleges, if any, in the last year;

7. Identification of insurance holding company system capital resources and material distribution pattern;

8. Identification of any negative movement or discussion with rating agencies, which may have caused, or may cause, potential negative movement in the credit ratings and individual insurer financial strength ratings assessment of the insurance holding company system (including both the rating score and outlook);

9. Information on corporate or parental guarantees throughout the holding company and the expected source of liquidity should such guarantees be called upon; and

10. Identification of any material activity or development of the insurance holding company system that, in the opinion of senior management, could adversely affect the insurance holding company system.

B. Related expansion of exam powers, of Commissioner's access to books and records, and Commissioner's powers to compel production of records and deny dividends. The Amendments expand the power of the Commissioner to examine the insurer's affiliates, based upon the Commissioner's obligation to determine the financial condition of the insurer. The financial condition of

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[20] We note that Form B is also being modified to remove the "de minimis" exemption from the organizational chart requirement. Now all affiliates in the insurance holding company system, not just those with total assets greater than ½ of 1% of total assets in the holding company, must be shown on the organizational chart required by Item 2 of Form A and Item 2 of Form B.

the insurer has an expanded meaning, which includes “the risk of financial contagion to the insurer by the ultimate controlling party, or by any entity or combination of entities within the insurance holding company system, or by the insurance holding company system on a consolidated basis.” The need and authority of state insurance regulators to examine affiliates flows arguably, but not conclusively, from this expanded definition of financial condition.

In the event that the requisite authority over the insurer’s affiliates does not exist, the Amendments offer remedies to state regulators by granting increased control over the insurer. The Commissioner may order the insurer to produce information not in the possession of the insurer if the insurer has access to the records contractually, or by statute or other means. If the insurer claims it cannot obtain the information, and “it appears” to the Commissioner that the claim is without merit, then the Commissioner would be able to require the insurer to pay a daily penalty or suspend the insurer’s license. Further, if “it appears” to the Commissioner that any person is “preventing full understanding of the risk of financial contagion to the insurer by affiliates or by its insurance holding company system,” then the Commissioner may disapprove dividends or distributions and place the insurer under an order of supervision.

The Commissioner also would have the power to compel production of records and to examine the records of the affiliates of the insurer using subpoena powers enforceable in court.

Implications of the Annual Report requirement:

1. Should insurers expect that insurance regulators will maintain the confidentiality of the information that is provided to them through the Annual Report and otherwise? Section 8 of the Amendments, titled “Confidential Treatment,” clearly contemplates that the information will be shared with members of any supervisory colleges, including foreign regulators.[21] Presumably, any information collected by the NAIC will also be shared with the new Federal Insurance Office at the U.S. Department of the Treasury, and also with the new systemic risk council, the Financial Stability Oversight Council (“FSOC”).[22] Since the U.S. Securities and Exchange Commission (“SEC”) is also a member of the FSOC, the SEC could potentially have full access to any confidential information provided to state insurance regulators by means of the Annual Report.

2. How will public companies and foreign private issuers reconcile their disclosure obligations under U.S. federal securities laws with their obligation to file an Annual Report? For example, Form 10-K or 20-F requires disclosure of the most significant risk factors for the holding company. The facts and circumstances of each holding company structure will determine the extent to which such 10-K/20-F risk factors overlap with the Annual Report disclosure, *i.e.*, material risks of financial contagion for each of its insurers in the holding company structure. Companies will have

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[21] See Amendments at § 7, “Supervisory Colleges.”

[22] The Dodd-Frank Bill creates the Federal Insurance Office (“FIO”) to be housed in the Department of Treasury. The FIO is charged with, among other things, monitoring all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in either the insurance industry or the United States financial system. To carry out its duties, the FIO is empowered to gather and analyze data and information on and from the insurance industry, as well as to enter into information-sharing agreements with state insurance regulators, individually or collectively. The FIO’s Director will serve in an advisory capacity on the FSOC. The FSOC consists of 10 voting members, including one independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise. The FSOC includes five non-voting members, including one state insurance commissioner. A primary duty of the FSOC is to identify risks and respond to threats to the financial stability of the United States by collecting information from member agencies and the FIO to assess and monitor risks.

to consider the extent to which the risks disclosed in the Annual Report must now be disclosed in their Forms 10-K or 20-F. A regulator, with 20/20 hindsight, could claim that certain risks from the Annual Report should have been included (or excluded) in the 10-K. This would place insurers in uncertain regulatory territory. For this reason, industry representatives have urged the NAIC to permit the ultimate controlling person to file its Form 10-K or 20-F to satisfy the Annual Report requirements.

3. What form of "due diligence" will be required in connection with the Annual Report?[23] Will preparers of the Annual Report be permitted to rely on experts, such as auditors and actuaries, in drafting the Annual Report? Should there be a scienter requirement for board liability for the annual Statement, as with Rule 10b-5 liability? How will the Annual Statement be relevant for securities and insurance product offerings under Forms S-1, S-3, N-4 and N-6, and private placements under 144A and Regulation D?

4. Currently the NAIC has issued no regulatory guidance on the form, scope and length of the Annual Report or the due diligence, materiality or depth of information that must be provided. Will the NAIC develop a robust mechanism for addressing insurer's and regulator's questions regarding the Annual Report on an ongoing basis, similar to those developed by the SEC?

III. Supervisory Colleges

Both the Amendments and the Revised Regulation expressly provide for state insurance regulator participation in, and certain reporting from, so-called supervisory colleges. Supervisory colleges are groups of regulators from different countries that work together to oversee large cross-border financial organizations. The supervisory colleges are designed to provide a forum to develop a more comprehensive view of all of the activities of a multi-faceted, multi-jurisdictional financial services enterprise that could pose a systemic risk to the enterprise and to the financial system as a whole. This approach has generally originated in the European Union with some modest level of success in the wake of its 2008 banking crisis.

Under the Amendments, Section 7 sets forth the framework and some general parameters for Commissioner participation in a supervisory college. As a general matter, during the drafting of the Amendments, interested parties leveled relatively significant criticism related to the lack of precision[24] and limits around the potential participation in the supervisory colleges.

Revised regulation. Under Section 7(A) of the Amendments, the Commissioner is granted the authority to participate in any supervisory college for any domestic insurer that is part of an insurance holding company system with international operations in order "to determine compliance by the Insurer with this Chapter." The powers of the Commissioner with respect to his or her participation in the supervisory college are enumerated as follows:

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[23] Section 11 of the Securities Act of 1933 imposes strict liability on a company, its board of directors and certain principal officers for any material facts that have been omitted from a registration statement or presented in such a way as to obscure or distort their significance. However, Section 11 also provides an affirmative defense of "due diligence," which is available to all parties, except the company, itself. Included within the "due diligence" defense is the ability of the board or principal officer to rely upon the opinion of an expert. See *In re* Worldcom, Inc. Securities Litigation, 2005 U.S. Dist. LEXIS 4193 (S.D.N.Y., Mar. 21, 2005).

[24] One prominent example of such lack of precision is the failure to provide a definition of the term "supervisory college" as used in the Revised Regulation and the Amendments.

- Initiating the establishment of a supervisory college;
- Clarifying the membership and participation of other supervisors in the supervisory college;
- Clarifying the functions of the supervisory college and the role of other regulators, including the establishment of a group-wide supervisor;
- Coordinating the activities, meetings, supervisory activities, and process for information gathering; and
- Establishing a crisis management plan.

Under Section 7(B) of the Amendments, the Commissioner is authorized to assess the “reasonable” expenses of the supervisory college to the relevant insurer, including any travel expenses.

Section 7(C) of the Amendments sets forth more parameters on the Commissioner when participating in supervisory college with other regulators (*e.g.*, this Section of the Amendments is focused more on participation in, rather than formation and taking a lead role in, the supervisory college). Under Section 7(C), the Commissioner can participate in a supervisory college “with other regulators” to assess the “business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance” of the applicable insurer. The Commissioner is permitted to enter into agreements with other regulators providing the basis for cooperation with such other regulators, consistent with confidentiality requirements under Section 8 of the Amendments.

The Annual Report and supervisory colleges. As noted above, under the Revised Regulation, the newly proposed confidential Annual Report to Form B must include information that derives from participation in a supervisory college. The Form B must include any concerns raised by a supervisory college about the insurance holding company system.

Implications of the supervisory college requirements:

1. What limits are there on a Commissioner’s participation in, or formation of, a supervisory college? Will the size and scope of the insurer’s domestic operations play a role in the Commissioner’s participation in the supervisory college?

2. What checks and balances will be placed on the amount of resources expended by the Commissioner in the participation in a supervisory college?

3. How sound are the confidentiality provisions with respect to the proceedings of the supervisory colleges and the required reports on the confidential supplement? Will the multiple jurisdictions of the participants and regulators in the supervisory colleges, and the possible role of the NAIC, diminish the ability to keep information about insurers confidential?

IV. Affiliate Transactions Within a Holding Company System

The Amendments would require that new substantive provisions be added to any intercompany cost-sharing and management services agreement and would expand the list of transactions within the insurance holding company system that require pre-notification to, and approval by, the Commissioner.

A. Substantive provisions governing affiliate cost-sharing and management services agreements within the holding company system

The Amendments would require that agreements for cost sharing services and management services include those provisions "as would be required by rule and regulation issued by the commissioner."[25] Initially the revisions to the Act proposed in March 2010 had set forth 22 specific new requirements. The GSIWG ultimately elected not to codify these 22 specific requirements into the Act, but rather added 13 additional requirements to Section 19 of the Revised Regulation, including the requirements that all cost-sharing and management services agreements:

- Identify the person providing the services and the nature of such services;
- Set forth the methods to allocate costs;
- Require timely settlement, not less frequently than on a quarterly basis;
- Prohibit the advancement of funds by the insurer to the affiliate except to pay for services defined in the agreement;
- State that the insurer will maintain oversight for functions provided to the insurer by the affiliate and that the insurer will monitor services annually for quality assurance;
- Define books and records of the insurer to include all books and records developed or maintained under or related to the agreement;
- Specify that all books and records of the insurer are and remain the property of the insurer and are subject to the control of the insurer;
- State that all funds and invested assets of the insurer are the exclusive property of the insurer;
- Include standards for the termination of the agreement with and without cause;
- Include provisions for the indemnification of the insurer in the event of gross negligence or willful misconduct on the part of the affiliate providing the services; and
- Specify certain conditions with regard to the receivership of the insurer.

In addition, Item 6 of Form D would be amended with regard to cost-sharing and management services agreements to require that the insurer furnish:

- A brief statement as to the effect of the transaction upon the insurer's policyholder surplus;
- A statement regarding the cost allocation methods that specify whether proposed charges are based on "cost or market." If market based, the statement must include a rationale for using market instead of cost, including a justification for the company's determination that amounts charged are fair and reasonable; and
- A statement regarding compliance with the NAIC Accounting Practices and Procedures Manual regarding expense allocation.

B. Transactions that require notification and approval by the Commissioner

The Act currently requires that certain transactions within an insurance holding company system may not be entered into by the insurer unless the insurer has: (1) notified the Commissioner in writing of its intention to enter into the transaction at least 30 days prior thereto, and (2) the Commissioner has not disapproved the transaction within that period.

[25] See Amendments at § 5.A.(1)(b).

The Amendments would expand this requirement to include any amendments or modifications to, or termination of, previously approved intercompany agreements. In addition, the notice sent to the Commissioner must include information regarding the reasons for the change and the financial impact on the domestic insurer.

The Amendments would also expand the list of transactions that require advance notification to include: (1) reinsurance agreements or modifications thereto in which the reinsurance premium or a change in the insurer's liabilities, or the projected reinsurance premium or a change in the insurer's liabilities in any of the next three years, exceeds 5% of the insurer's surplus as regards policyholders; (2) all reinsurance pooling arrangements, including modifications thereto; and (3) all tax allocation agreements.

Considerations

The Amendments and the Revised Regulation are the first in a series of regulatory changes that will significantly impact insurance holding company systems, as U.S. and international regulators devise new measures intended to address the risks that are perceived as having led to the recent financial crisis. With a seat at the table of the new federal risk regulator, state insurance regulators can be expected to flex their muscle and assert increased jurisdiction over insurance holding company systems, requiring insurers to manage increased and potentially contradictory regulatory demands and corresponding regulatory uncertainties.

In this context, we suggest that you consider whether your enterprise has significant concerns and considerations that should be expressed to state insurance regulators during the comment period on the Amendments.

Beyond the comment period, we suggest that you evaluate which changes will need to be made in your internal procedures and policies. Your company, its board, and its management will have new liability exposures. Protections need to be put in place.

Sutherland's insurance regulatory practice is uniquely situated to help you address the challenges of the new insurance regulatory environment. Our attorneys have worked with insurers, as well as federal and state regulators, for more than fifty years in areas such as corporate governance, federal securities law compliance, derivatives, international, national and state tax issues, reinsurance and agency issues.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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