April 27, 2011

# New York Department of Financial Services to Have Authority Beyond Legacy Regulators; New Legal Risks Emerge for Insurers

*The merger of the New York Insurance and Banking Departments gives the combined Department heightened enforcement and regulatory powers over previously unregulated financial products and services. Sutherland suggests that insurers and reinsurers that are domiciled, licensed or accredited in New York be aware of the new legal risks arising from the formation of a new New York Department of Financial Services, and consider the actions discussed in this Legal Alert. This Legal Alert is applicable to accredited reinsurers, notwithstanding Dodd-Frank.*

It has been said that the lion shall lie down with the lamb, but the lamb won't get very much sleep.[1] There will be even less sleep for those responsible for overseeing and managing risks after the merger of New York State's Insurance Department and Banking Department into one entity called the Department of Financial Services (DFS). The legislation that effected this merger, known as the Financial Services Law (FSL), was signed by New York Governor Andrew Cuomo earlier this month and takes effect on October 3, 2011.[2]

Under the FSL, the Superintendent of Financial Services (Superintendent) will have the authority to enforce the New York Insurance Law and the New York Banking Law, which will both remain largely intact. The Insurance Division and the Banking Division will each be led by a Deputy Superintendent.

Nevertheless, the FSL will bring important changes to the regulation of insurers in New York State. The Superintendent will have expansive new rulemaking authority and enforcement powers over previously unregulated financial products and services and the entities providing them. Further, the Financial Frauds and Consumer Protection Unit (FFCPU)[3] of the DFS will have new powers to investigate financial fraud committed by insurers, banks and other entities and individuals (including insurance fraud committed by claimants). The Superintendent will be able to hold public hearings and levy civil penalties in amounts significantly greater than currently permitted under the New York Insurance Law. Any penalties levied as a result of a hearing may not be challenged in court. Instead, insurers will need to bring an Article 78 proceeding, which requires a showing that the Superintendent was arbitrary and capricious in his/her determination.[4]

The Superintendent is required to form a Working Group by June 30 of this year to examine ways to improve the efficiency and effectiveness of banking and insurance regulation. The working group must

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[1] Attributed to Woody Allen.

[2] Part A of S.2821C/A.4012C. This legislation is part of Governor Cuomo's 2011–2012 Executive Budget for New York State. It was originally proposed on February 1 and subsequently was significantly modified.

[3] The FFCPU will replace the Insurance Frauds Bureau of the Insurance Department.

[4] The Superintendent may assess insurers in order to pay for (i) costs of the DFS solely associated with regulating insurers and (ii) costs of the DFS not directly attributable to regulating insurers or banks. FSL § 206(a). The first type of assessment is allocated to all domestic insurers and all New York-domiciled branches of non-U.S. insurers pro rata based on gross direct written premiums and other considerations written or received by them in New York. The second type of assessment is to be allocated as the Superintendent decides is "just and reasonable." The amount of this second type of assessment is reduced by penalties paid to the DFS by an insurer. FSL § 408(b)

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consult with representatives of the insurance, banking and financial services industries and issue a report by January 1, 2012.[5]

## Expanded Authority over Financial Products and Services; Financial Fraud

The Superintendent will have broad new powers to regulate, investigate and levy civil penalties with respect to many products, services, entities and individuals not currently within the jurisdiction of the Insurance Department or Banking Department. The Superintendent is authorized to adopt rules and regulations and issue orders and guidance involving previously unregulated financial products and services so long as those regulations and orders are not inconsistent with the New York Insurance Law, New York Banking Law or FSL[6]. On the other hand, the Superintendent has the authority to limit his power by promulgating a list of financial products and services excluded from regulation by the DFS.[7] The list will not affect the Superintendent's financial fraud authority over these excluded financial products and services.

The Superintendent may investigate, hold a public hearing, and then impose civil penalties for "any intentional fraud or intentional misrepresentation of material fact" with respect to a financial product or service, or involving any person offering to provide or providing any financial products or services" (we refer to such intentional fraud or intentional misrepresentation as "financial fraud").[8] A "financial product or service" is defined as:

- any product or service offered or provided by any person regulated or required to be regulated by the Superintendent pursuant to the banking law or the insurance law, or
- any financial product or service offered or sold to consumers, with certain exceptions.[9]

The new penalty regime under the FSL and insurance law is as follows:

- $5,000 per violation for financial fraud;[10]
- $1,000 for other violations of the FSL or regulations under the FSL;[11]
- $1,000 per violation for general violations of the Insurance Law; and
- $500 per violation for acting as a producer without a license or aiding an unauthorized insurer in contravention of the insurance law.[12]

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[5] FSL § 205-a.

[6] FSL § 302(a)

[7] FSL § 302(b)

[8] FSL §§ 404 and 408(a). The FFCPU must have a "reasonable suspicion" before it may begin a financial fraud investigation on behalf of the Superintendent. FSL § 404(b).

[9] FSL § 104(a)(2). The exceptions are financial products or services (a) regulated under the ***exclusive*** jurisdiction of a federal agency or authority, (b) regulated for the purpose of consumer or investor protection by any other state agency, state department or state public authority, (c) where rules or regulations promulgated by the Superintendent on such financial product or service would be preempted by federal law. (Emphasis added.)

[10] FSL § 408(a)(1). Violations of state or federal fair debt collection practices or fair lending laws also come with a $5,000 per violation penalty.

[11] FSL § 408(a)(2)

[12] FSL §§ 55, 69 and 70 at the budget legislation.

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The $5,000 penalty appears to apply to an insurer only if it commits intentional fraud or intentional misrepresentation of a material fact that is not also a violation of the insurance law. This is because the FSL provides that "penalties for regulated persons under the insurance law shall be as provided for in the insurance law," and the Superintendent may not impose or collect a fine under the FSL that would be in addition to any penalty or fine for the same act or omission that is imposed under the Insurance Law.[13] Read together, this appears to mean that there is a maximum $1,000 per violation penalty for a financial fraud under the FSL that also violates the Insurance Law. When aggregated, these per violation penalties can become quite large.

## Examples

The following are examples of products, services, entities and individuals over which the Superintendent will now have regulatory or investigatory authority.[14]

- The Superintendent will have the authority to investigate financial fraud suspected on the part of an insurer, in addition to "insurance fraud" which focuses on fraud perpetrated against an insurer.[15]
- Further, the Superintendent will have the authority to investigate financial fraud suspected on the part of an insurer ***even if no insurance products or consumers are involved***. This includes investment activities for the general account, investment advisory services, and derivatives and hedging/replication activities.
- Persons other than claimants who perpetrate financial fraud against an insurer will be subject to investigation.
- The Superintendent will have the authority to investigate fraudulent acts even if a federal regime is implicated, unless the federal regime is exclusive. For example, certain investment products sold by or for the insurer would be covered.
- Sales and offerings of fixed and variable life insurance products supported by an insurer's general account or a separate account may be subject to the financial fraud provisions of the DFS.
- Sales of securities and other investment products in an insurer's general account, separate account or in Regulation 114 trusts may be under the Superintendent's financial fraud authority.
- In general, under the federal securities laws the person selling or offering to sell a security needs to be aware of and comply with the federal anti-fraud rules and other provisions. Purchasers of securities, absent someone holding inside information, generally are more focused on their investment decision and due diligence than the anti-fraud provisions of the federal and state securities laws. Nevertheless, purchasers would also be pulled into the Superintendent's financial fraud regime. For example, an intentional breach of a "big boy" representation by the purchaser may be financial fraud subject to investigation by the Superintendent.

[13] FSL § 408(a)(3)

[14] The FFCPU must have a "reasonable suspicion" before it may begin a financial fraud investigation on behalf of the Superintendent. FSL § 404(b).

[15] Section 176.05(1) of the New York Penal Law defines "insurance fraud" as "A fraudulent insurance act is committed by any person who, knowingly and with intent to defraud presents, causes to be presented, or prepares with knowledge or belief that it will be presented to or by an insurer, self insurer, or purported insurer, or purported self insurer, or any agent thereof, any written statement as part of, or in support of, an application for the issuance of, or the rating of a commercial insurance policy, or certificate or evidence of self insurance for commercial insurance or commercial self insurance, or a claim for payment or other benefit pursuant to an insurance policy or self insurance program for commercial or personal insurance which he knows to: (i) contain materially false information concerning any fact material thereto; or (ii) conceal, for the purpose of misleading, information concerning any fact material thereto."

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- Sales of bundled financial products, such as certain premium financing arrangements, would be covered by the provisions of the DFS.
- Hedging transactions would be included. For example, if an insurer entered into a foreign exchange swap or an interest rate swap to hedge fixed-to-floating interest rate risk, any related financial fraud would be under the jurisdiction of the Superintendent.
- Contracts entered into by insurers on behalf of their separate accounts would be covered. This includes not only the variable life or annuity contract issued to the contract owner, but also stable value agreements and investment management agreements supporting those contracts.
- A borrowing by an insurance company from a bank or in the capital markets would be subject to the Superintendent's financial fraud regime.
- M&A transactions involving insurers and blocks of insurance business may also fall under the Superintendent's financial fraud regime.
- Reinsurance transactions, including trust agreements and letters of credit, may be covered under the Superintendent's financial fraud regime.

## *Preventive Measures*

In light of the above, insurers and their boards will need to be aware of the increased risks of enforcement activities presented by the FSL. We suggest that you consider taking the following preventive actions.

**Board of Directors**

- Senior management of New York insurers and reinsurers should make the Board of Directors aware of the Superintendent's new financial fraud regime and expanded powers to regulate financial products and services, as well as the related compliance and reputational risks. Senior management should determine how the company's risk management program should be updated, then update the program accordingly.
- In accordance with their fiduciary duties to monitor compliance risk (*i.e.*, directors' *Caremark*[16] duties), Board members will need to review the company's risk management program to assure themselves that the new risks associated with the expanded authority of the Superintendent under the FSL are addressed. The Board will need to monitor the ongoing effectiveness of the risk management program.

## Chief Compliance Officer, General Counsel and Chief Risk Officer

- The Sarbanes-Oxley compliance program will need to be reviewed to determine whether it needs to be amended to include compliance with the changes brought about by the FSL. Since senior officers of the holding company will need to sign the certification required by Section 404, they will need comfort that the breadth of the Superintendent's new regulatory and investigatory scope is addressed by compliance and internal control programs. The company's auditors may have a view on this.
- The insurer's ultimate holding company should consider the impact of the FSL on potential disclosure on its Enterprise Risk Report (*i.e.*, proposed Form F under the NAIC's recently adopted Insurance Holding Company Model Regulation, #450). The Compliance Officer/General Counsel of a stock insurance company will need to coordinate with the corresponding person at the holding company. Reputational risk from a public hearing held by the Superintendent,

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[16] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

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including where the insurer is the victim of financial fraud, would be included in the NAIC's definition of "enterprise risk."
- To the extent that a New York insurer has administrative or other services provided to it by a non-New York affiliate, the Superintendent could investigate the affiliated service provider if financial fraud is suspected.

## Chief Investment Officer

- The chief investment officer should examine controls not just for sales, but also for purchases of securities for its general account, separate accounts and any credit for reinsurance trusts. For example, purchase and sale agreements for securities normally contain representations by buyers. Investment personnel and other business people should be trained to be aware of the changes brought by the FSL.
- In the context of real estate investments by insurers, a limited liability company may be established and the insurer or a subsidiary may be the managing member of the LLC. These management activities could be interpreted to be "financial services" and regulated by the Superintendent because they are services performed by the insurer.
- When entering into investment transactions, New York insurers should consider a disclaimer that they are not offering a service to the seller or buyer and that the security being sold is not a "product" of the New York insurer.

## Head of Reinsurance, Chief Actuary

- The reinsurance program should be reviewed to determine whether existing controls are consistent with the new FSL regime. Any contractual representations and warranties should be reviewed for accuracy.

*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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