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Recent Developments and Current Trends in

Insurance Transactions and Regulation

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I. Developments in Mergers and Acquisitions

Insurance M&A deal volume measured by announced deals in 2011 was consistent with 2010, although aggregate deal value across the sector was down. Volume in 2010 was driven in large measure by AIG's divestiture program, which resulted in the announcement of some of the largest M&A deals in industry history. No such blockbuster transactions occurred in 2011. Nevertheless, several large property/casualty transactions announced towards the end of 2011 may portend a more active M&A market in 2012. It is also worth noting that Europe's share of M&A activity relative to other markets decreased substantially in 2011, as a result of continued economic uncertainty stemming from the EU sovereign and fiscal crisis, although this uncertainty has created opportunities as a result of divestments. We believe that insurers with global ambitions increasingly are focusing their attention on Latin America and Asia for acquisition opportunities promising top line growth.

A. Life Insurance Mergers and Acquisitions

According to SNL, the total dollar value of life insurance M&A transactions was down sharply in 2011 ($5.1 billion) compared to 2010 ($22.3 billion), while the number of deals was about the same (34 in 2011 compared to 32 in 2010). As in 2010, the largest transactions were driven by insurers' need to divest properties in connection with the repayment of financial aid received from government entities during the 2008 financial crisis. This time, however, the sellers were Dutch financial service giants Aegon and ING, not AIG.

In April 2011, Aegon announced the sale of its Transamerica life reinsurance arm to the French reinsurer SCOR for consideration of $900 million. The deal, which also allowed Aegon to release $500 million in capital from the reinsurance units, makes SCOR the second largest life reinsurer in the world. Aegon announced that it planned to use the proceeds in the transaction to repay obligations owed to the Dutch state.

In July 2011, ING announced the sale of its Latin American pensions, life insurance and investment management operations for total consideration of €2.7 billion to Grupo Sura, a Colombian financial services holding company. This transaction resulted from the European Commission's demand that ING divest its insurance and investment management operations as a condition of receiving Dutch state aid. The sale process generated worldwide interest, and several major US and Latin American insurers were reported to be involved.

The European Commission's mandate to ING means that some additional large life insurance properties will come on the market in the near future. In particular, ING has announced that it is preparing to sell its US life operations in an initial public offering in 2012. We expect ING will conduct a parallel M&A process in addition to preparing for the IPO. Also, press reports indicate that ING's Asian life insurance operations will be auctioned in 2012. We expect this transaction to attract significant interest from US, Canadian and European insurers.

Finally, The Hartford has announced plans to sell its individual life insurance, retirement services and possibly individual annuity business in 2012.

B. Property/Casualty Mergers and Acquisitions

According to SNL, the 81 property/casualty M&A transactions in 2011 roughly equaled the number in 2010 (82 deals) but the total dollar value was up sharply ($13.5 billion vs. $9.1 billion). The increase in dollar volume was largely attributable to two significant transactions announced in the fourth quarter of 2011: Alleghany's acquisition of Transatlantic Holdings and Tokio Marine's acquisition of Delphi Financial. Soft pricing markets for property/casualty products, low equity valuations for property/casualty insurers and a slow economy generally have suppressed deal activity in recent years, with a greater proportion of deals in the property/casualty sector being about movement into niche markets and the acquisition of discrete lines and books of business. We expect improvements in the industry's outlook to stimulate

additional deal flow in 2012, particularly as reinsurers feel the need to have a critical mass of surplus in order to be perceived as serious players. The most notable property/casualty transactions of 2011 are discussed below.

1. Alleghany/Transatlantic Holdings

Alleghany's November 2011 announcement that it would acquire Transatlantic Holdings for $3.4 billion brought to a close a months-long saga involving the New York-headquartered reinsurer. The process began in June 2011 when Transatlantic announced that it had entered into an agreement for an all-stock "merger-of-equals" with Switzerland-based reinsurer Allied World Assurance. The deal was valued at $3.2 billion, or $51.10 per share, and would have given Transatlantic's shareholders 58% of the combined company. Shortly after the merger was announced, Transatlantic's largest shareholder indicated that it had serious concerns about the proposed transaction and may oppose the proposed transaction, and, in mid-July, Bermuda reinsurer Validus Holdings made an unsolicited cash-and-stock offer for Transatlantic, valued at $3.5 billion or $55.95 per share. Thereafter, in early August, National Indemnity, a unit of Berkshire Hathaway, made an unsolicited all cash offer for Transatlantic at $52 per share. Both the Validus and National Indemnity bids were well below Transatlantic's book value, which was approximately $68 per share as of June 30, 2011. In September 2011, influential proxy advisory firm Institutional Shareholder Service Inc. (ISS) issued a recommendation to Transatlantic's shareholders to vote against the Allied World deal.

Confronted with the likelihood of shareholder disapproval by Transatlantic's shareholders, Transatlantic and Allied World terminated their merger agreement. As a result, Transatlantic incurred an obligation to pay Allied World a $35 million break-up fee, $13 million of expense reimbursement and a further $67 million in the event Transatlantic agreed to be acquired by another party (which eventually happened). Thereafter, National Indemnity's offer expired and Transatlantic entered into talks with Validus, Alleghany and two other consortiums of investors. Ultimately, Transatlantic's board accepted Alleghany's offer in November 2011. The transaction closed in early March 2012.

2. Tokio Marine/Delphi Financial

In December 2011, Tokio Marine announced that it had agreed to acquire Delphi Financial, a writer of workers compensation and group life insurance, for $2.8 billion. Delphi has two classes of common equity: Class A common shares, which are publicly traded; and Class B common shares, which have ten votes each and are owned by Delphi's chairman and CEO. Holders of Class A shares will receive $43.88 per share (a 73% premium over market) and holders of Class B shares will receive $52.88 per share. All shareholders will receive a special dividend of $1.00 per share at closing. The transaction was negotiated and approved by an independent committee of Delphi's directors.

Delphi would represent Tokio Marine's fourth overseas acquisition in recent years. Tokio Marine acquired Philadelphia Consolidated in 2008 for $4.7 billion, Lloyd's of London underwriter Kiln Group in 2008 for $898 million and First Insurance Company of Hawaii in 2011 for $165 million. The company has been more aggressive than other Japanese insurers in using M&A to expand beyond its mature domestic market. We expect that other Japanese insurers, as well as some in Korea, may follow suit in coming years.

3. Allstate/Esurance

A third notable transaction was Allstate's $1 billion acquisition of on-line automobile insurer Esurance from White Mountains. The transaction, which closed in October 2011, provides Allstate with the platform to serve consumers who prefer internet-based distribution to a more traditional agency model, demonstrating the continuing power of distribution as a driving force in insurance M&A.

4. Nationwide/Harleysville

The September 2011 announcement of a combination between Nationwide Mutual Insurance Company and Harleysville also deserves mention. Under the terms of the acquisition agreement, Harleysville Mutual Insurance Company will merge with (and its policyholders will become policyholders of) Nationwide Mutual Insurance Company. In addition, Nationwide will acquire all of the publicly held shares of common stock of Harleysville Group Inc., Harleysville Mutual's 54% owned, NASDAQ-listed subsidiary, for $60 per share in cash, a premium of almost 100% when the deal was announced. No payment will be made to Harleysville Mutual's policyholders. The entities have a common CEO and most directors serve on the boards of both mutual companies. The transaction has sparked litigation in Philadelphia Common Pleas Court by Harleysville's policyholders who claim it is unfair to policyholders and constitutes self-dealing by officers and directors who own shares of the public subsidiary and stand to receive substantial cash consideration upon the closing of the transaction.

C. Outlook for 2012

We are optimistic that the pace of insurance M&A activity will accelerate in 2012. We are mindful, however, that a number of uncertainties could affect deal flow in the coming year. For example:

- *Will improving stock market valuations of property/casualty insurers generate increased M&A activity?*
  A soft rate environment and a poor economy have caused property/casualty insurers to trade at significant discounts to book value in recent years. These low valuations have suppressed industry consolidation, particularly among reinsurers. In our view, buyers are reluctant to dilute shareholder value by issuing stock (whether as consideration or to finance a transaction) at prices below book value, and sellers are hesitant to sell their companies at below-book-value prices, particularly when the consideration is cash. While book-value based stock-for-stock transactions are possible in this kind of environment, these transactions can be hard to accomplish for social reasons, among others. The projected hardening of certain segments of the property/casualty rate market in 2012 should, in certain cases, narrow the gap between stock market valuations and book value, which may facilitate increased activity.

- *How will ISS's statements with respect to the Transatlantic/Allied World transaction affect "merger of equals"?*
  The property/casualty reinsurers, in particular, also have been trading at significant discounts to book value in recent years. As a result, some industry participants have believed that the best way to get a deal done is through a stock-based, book-value priced, merger of equals that retains upside for all shareholders. M&A professionals generally have been of the view that merger of equals transactions do not require the validation of a sales process because they do not implicate Revlon or similar fiduciary duties. ISS's comments suggest that its policy might be to recommend a "no" vote on a merger of equals transaction that has not been tested with a sales process. If true, this would represent a departure from existing M&A practice and could inhibit the announcement of transactions by managements that do not want to risk the complications and uncertain outcomes of such a process. Alternatively, it could result in lower break-up fees, increased "window" shopping and the greater use of "go-shop" clauses in merger agreements.

- *Will any of the reinsurers attempt a hostile acquisition in 2012?*
  Industry participants have been predicting the consolidation of the property/casualty reinsurance industry for a number of years. Several deals have been announced, both in the Bermuda and Lloyd's listed sectors, but the anticipated wave of consolidations has yet to materialize. All Bermuda reinsurer acquisitions announced to date have started as negotiated transactions, which also has been the case with the recent Lloyd's reinsurers who have put themselves in play. While Validus has shown a willingness to make unsolicited bids after deals are announced, the open question is whether a reinsurer will attempt a hostile acquisition in the absence of an announced deal. The commencement of a hostile transaction could have the effect of putting the industry in play.

I. Developments in Mergers and Acquisitions

- ***Will any of the reinsurers go into run-off in 2012?***
  After several years of low returns on equity and stock market valuations, some of the smaller reinsurers may conclude in 2012 that they can deliver more value to shareholders by ceasing operations and making a liquidating distribution rather than continuing to write business. Such a decision may result from a variety of facts, including pressure from restive shareholders, downgrades or threatened downgrades from rating agencies and directors who have concluded that an improvement in prospects is unlikely in the foreseeable future. A decision to go into run-off will likely result in the sale of renewal rights, and perhaps the sale, through reinsurance, of some or all of the business to run-off specialists or industry consolidators. Ariel Re's recent asset sale to Goldman Sachs is one example in this vein.

- ***What effect will proxy access have on insurance M&A?***
  Activist funds typically make an investment in a company and then seek to persuade its board to follow a course of action they believe will enhance shareholder value, such as the sale of a business. If the board demurs, the activist may take its proposal directly to shareholders by engaging in a proxy solicitation to elect one or more directors who are allied with the activist's agenda. State insurance holding company acts generally require prior regulatory approval for the acquisition of control of an insurer and presume in virtually all states that control exists if a person holds proxies representing more than 10% of the voting stock of an insurer. An activist investor that proposes to engage in a proxy contest therefore must consider whether it needs regulatory approval both to hold proxies and to seat its directors. Beginning in the 2012 proxy season, shareholder groups have been demanding that companies include proxy access proposals in their annual meeting proxy statements. These proposals require a company to include dissident nominees on its ballot. As a result, if there is a proxy access provision, an activist would not need to hold proxies in order to elect a director (the proxies would instead be held by the company), and this approach could avoid the technical application of the insurance holding company act to the solicitation. Of course, the question of whether having one or more allied directors on a board constitutes control by the activist will depend on the circumstances, and so the holding company act may still apply. Nevertheless, proxy access may ease, at least to a certain extent, the hurdles to waging a proxy contest under the insurance holding company acts, which could stimulate additional M&A activity. For further discussion of proxy access and related matters as they affect insurance companies see "Developments in Corporate Governance, Public Company Regulation and Shareholder Activism" in Section II below. Although not the result of proxy access, Paulson & Co.'s recent pressure on The Hartford may be an inspiration to other activists looking to unlock value through structural changes.

- ***Will the European debt crisis stimulate or inhibit M&A?***
  The uncertainty resulting from the European sovereign debt crisis raises a number of questions for M&A professionals. For example: will holders of sovereign debt feel the need to sell operating assets to offset losses in their investment portfolios? Will insurers with sovereign debt exposure be downgraded and with what effect? How will insurers comply with mark-to-market accounting requirements? To what extent will regulators allow a different approach? Which insurers have written credit default swaps on European sovereign debt and how significant is their exposure? Will European insurers with significant debt exposures come under political pressure to act in a particular way in relation to such debt? It is possible that the need to generate capital to shore up balance sheets and ratings may cause European insurers to consider restructuring their organizations, which may result in the need to sell businesses. Alternatively, European insurers in particular may find themselves so distracted by the crisis that M&A is moved down the list of management's priorities.

- ***When will Solvency II be implemented and in what form?***
  Industry observers have long predicted that Solvency II will stimulate insurance M&A activity. The directive has been subject to significant change and delay over the years, and as of this writing uncertainty remains as to when Solvency II will be implemented, although a spokesperson for the European Commission has denied recent press reports that the full implementation

deadline of January 1, 2014 would be delayed until 2015 or 2016 and has indicated that the Commission remained committed to the 2014 deadline. Continued uncertainty as to Solvency II's provisions and the timing of its implementation could prompt European insurers to reconsider the value of holding non-core or capital-intensive businesses, particularly sub-scale operations in the United States. In addition, the Bermuda Monetary Authority has announced a group supervision regime that is similar to that of the EU and is, in part, designed to ensure that Bermuda will obtain "equivalency" status under Solvency II. This could prompt Bermuda reinsurers with operations in both Europe and Bermuda to structure their operations to achieve the greatest operational efficiency.

- *Will financial investors continue to play a role in insurance M&A?*

  Financial investors including Athene Re/Apollo, Guggenheim and Harbinger have all completed life acquisitions in recent years. In 2011, ProSight Specialty Insurance Holdings, whose shareholders include affiliates of TPG Capital and GS Capital Partners, acquired NYMAGIC, funds associated with GS Capital Partners announced a significant investment in Enstar, and Aquiline acquired Fidelity National's flood insurance business. We expect that private equity and hedge funds will continue to be active in the smaller end of the life M&A market, particularly as insurers look to shed non-core assets and shore up capital and the perception remains that under- or conservatively managed assets in the insurance industry present opportunity. In addition, we expect that private equity will participate in larger transactions by financing acquisitions by industry consolidators. We also anticipate interest on the part of financial investors in specialty lines property/casualty insurance and reinsurance, particularly at current valuations, and other niche markets. Of course, financial investors have to finance their transactions, and so their ability to get deals done will depend on the availability of financing on attractive terms as well as their ability to leverage their investments to generate returns — none of which is a given in the current environment.

II. Developments in Corporate Governance, Public Company Regulation and Shareholder Activism

The year 2011 saw a slight drop-off overall in shareholder activism. However, continuing developments relating to proxy access, say-on-pay and shareholder/policyholder engagement in M&A situations made the year interesting.

A. Proxy Access

The SEC's proposed proxy access rule, which would have been Rule 14a-11 under the Securities Exchange Act, was vacated in July by the US Court of Appeals for the D.C. Circuit. The Court held that the SEC's actions in adopting the rule were "arbitrary and capricious" in part because it failed to adequately assess the economic effects of the rule. The SEC has not re-proposed Rule 14a-11, and by all accounts today the rule is low on the SEC's list of priorities.

However, proxy access is far from dead. In September 2011, amendments to Rule 14a-8 became effective that essentially permit shareholders to propose that companies adopt their own individual versions of proxy access. These amendments to Rule 14a-8 were proposed at the same time as new Rule 14a-11, but were not part of the case challenging Rule 14a-11 in the D.C. Circuit.

As a brief refresher, "proxy access" refers to the ability of shareholders to nominate candidates for the board of directors and have those candidates' names appear in the proxy statement and on the proxy card circulated by the company, along with management's proposed slate. Those who favor proxy access believe that the cost and difficulty of preparing and distributing a separate proxy statement is a major disincentive for shareholders who would otherwise prefer to see new faces on the board of directors. Rule 14a-11 would have permitted holders of 3% of the stock of a public company, who have held that stock at least three years, to include a limited number of nominees in the company's proxy statement. Candidates could be excluded if their candidacy, or board membership, would violate state law.

Although Rule 14a-11 is not available, as of early February shareholders had presented proposals to at least 18 companies to adopt, on a "private ordering" basis, a form of proxy access. These proposals themselves were split roughly evenly between proposals seeking a non-binding vote on whether proxy access should be adopted and proposals presenting a binding amendment to the by-laws that would mandate proxy access. All the proposals made public include minimum ownership thresholds and minimum holding periods, almost all of which are lower and/or shorter than Rule 14a-11's 3%/3 year cut-off.

Not all of the proposals made will come to a vote this year; in March, the SEC ruled on no-action requests that will allow some of them to be excluded from issuer proxy statements. Nonetheless, these 18 proposals may very well be the "thin edge of the wedge." If a number of them are approved by shareholders at 2012 annual meetings, we believe that companies can expect to see much more action on this front in the 2013 proxy season. With support from shareholders, over time proxy access could become a feature, like majority voting for directors or board declassification, that becomes the general rule among large companies rather than the exception.

B. Say-On-Pay

Although over 300 recipients of TARP funds were subject to say-on-pay votes as a condition to receipt of such funds, 2011 was the first year in which public companies generally had to hold such votes. Under SEC rules, a say-on-pay vote is a non-binding referendum on the compensation of a company's named executive officers and related disclosures.

Interestingly, voting results were overwhelmingly in favor of approval of such compensation. Fewer than 50 of the more than 2,300 of companies that held such votes received a majority of "no" votes on the item. Most

companies received approval votes in excess of 90%. The most significant predictor of a "no" vote appears to have been a negative recommendation from ISS, coupled with poor linkage between pay and performance. However, these factors were by no means dispositive; ISS made hundreds of negative recommendations in regard to companies that received majority "yes" votes. Dissatisfaction over executive pay seems, somewhat surprisingly, to be more of a concern for small shareholders and the popular press than for large institutional holders. However, it has been reported that some institutional investors had not yet fully settled their approach to say-on-pay as of the 2011 proxy season, so higher levels of negative votes are possible in 2012.

The consequences of a "no" say-on-pay vote are evolving. It appears likely that a failure to change pay practices following such a vote will result in a "withhold" or "against" recommendation from ISS in regard to directors up for election who serve on the company's compensation committee. In addition, if a company gets less than a 70% vote in favor, ISS will decide on a case-by-case basis whether to recommend against the election of the company's compensation committee members. Further, there have been a handful of lawsuits filed against companies that failed the say-on-pay vote. These lawsuits appear to be classic strikesuits, alleging breaches of fiduciary duty in connection with approving challenged compensation.

While several of these cases have been disposed of on a motion to dismiss, a case brought against Cincinnati Bell survived a motion to dismiss (as did an earlier case against KeyCorp, a TARP recipient). Much like an M&A strikesuit, the Cincinnati Bell case was eventually settled for non-monetary relief (principally, enhanced disclosure) plus attorneys' fees. The KeyCorp case came to a similar conclusion. However, subsequent cases seem to be moving away from the Cincinnati Bell court's decision and confirming that the business judgment rule offers directors protection for their actions following a negative say-on-pay vote. Some commentators and courts have even gone so far as to question the "viable legal authority" of Cincinnati Bell. We will have to wait and see how other pending cases are resolved and especially the results of any appeals before we have more certainty as to the real impact of "no" say-on-pay votes.

Finally, we are keeping an eye on developments in the UK relating to say-on-pay. UK-listed companies were required to hold advisory votes on pay a number of years before those votes were required in the United States. In the current UK uproar over compensation of executives at Royal Bank of Scotland, Barclays and elsewhere, the UK government has announced that it is considering giving shareholders a binding vote on future pay policy, beyond the current approval of the remuneration report, including the potential payouts officers could receive, and on exit payments in excess of one year's salary. The proposals being considered also include increasing the threshold for a successful vote on pay-related measures to 75% of votes cast. If such measures are adopted in the UK, it could be only a matter of time before they find their way to the United States.

C. Trends in Shareholder Activism

Unsurprisingly, the overall level of shareholder activism declined in 2011 compared to 2010. This decline resulted from mandatory say-on-pay voting, which removed a commonly sought proxy item, as well as the gradual adoption over time by many companies of measures like majority voting for directors and declassified boards, which have long been favorite requests of activists. According to information compiled by Georgeson, the number of corporate governance proposals voted on declined from 342 in 2010 to just 240 in 2011, or nearly 30%. Further, the number of directors receiving a withhold or against vote of greater than 15% declined from 748 in 2010 to 549 in 2011, while the number of US proxy fights (in which the dissidents distributed a separate proxy card) declined from 35 in 2010 to 20 in 2011.

According to Georgeson, the most common shareholder proposals in 2011 were those relating to board matters (such as majority voting and separating the CEO and board chairman roles), executive compensation (a wide variety of

issues, such as holding periods for equity and requiring equity awards to be performance-based), repealing classified boards, permitting shareholders to call a special meeting, and a relatively new subject of interest to the activists, permitting shareholder action by written consent.

Of these proposals, the only ones that consistently garner majority support are those requiring majority voting (but only at those companies where a plurality vote standard is not combined with a policy calling for directors who receive more "withhold" than "for" votes to submit their resignation) and those seeking boards to be declassified.

So is shareholder activism on the wane permanently? With the advent of mandatory say-on-pay voting and the spread of majority voting and single-class boards, the activists need to identify the next hot issue that will have traction with institutional investors. The right to call a special meeting and the right to act by written consent seem to be second-level issues for institutional investors. In fact, action by written consent could potentially lead to the voices of some shareholders not being heard. As discussed earlier, "private ordering" proxy access may become the next issue, though it is starting slowly. The next wave may be resolutions requiring disclosure of political contributions by corporations. Georgeson tracked 40 resolutions this year that related to political contributions (often seeking disclosure of contributions not just to candidates, but to political parties and organizations as well). ISS has recently announced that its policy will be to recommend a vote in favor of these resolutions. As the presidential election heats up in 2012, political contributions may become an even more lively issue.

D. Insurance Company Control Battles

Will 2012 be the year of multiple proxy fights for board seats (or even board control) at insurers? As 2011 drew to a close, several investors with reputations for not being shy about expressing dissatisfaction with management had amassed holdings exceeding 5% of the outstanding stock of a handful of insurers. Some Bermuda companies have been trading at a steep discount to book for a while; they may attract attention from activist shareholders seeking to unlock value one way or another. We also have our eyes on a couple of other situations where the 5% limit has not yet been crossed, but the investors involved appear poised to make a move to influence management. And following year end, Paulson & Co. pushed very publicly for structural changes at The Hartford.

In 2011, by contrast, there was limited action along these lines. Early in the year, Endurance Specialty Holdings repurchased a large block of its stock from one of its founding shareholders, Perry Corp. Perry had announced in 2010, in a Schedule 13D/A filing, that it intended to discuss with other shareholders the possibility of a merger of Endurance with another company, or the possibility of electing additional directors to the board who would be sympathetic to Perry's point of view about Endurance's future course.

The battle for control of Transatlantic (described in Part I of this Year in Review) also involved shareholder voting battles. First, Davis Advisors, a major Transatlantic shareholder, indicated that it had serious concerns about the proposed transaction and may oppose it. More interestingly, Validus attempted to use a consent solicitation in support of its attempt to break up the Allied World deal and engineer its own combination with Transatlantic. Validus sought to replace the Transatlantic board with its own representatives.

Any attempt to influence control of the board of the holding company for a US insurer operates in a gray zone unless the protagonist has filed and received approval of a Form A. The filing of a Schedule 13D, which in virtually all states is in effect an admission that the investor seeks to exert control over the company, is fundamentally inconsistent with not having an approved Form A on file. We have developed significant expertise in this intersection of federal and state law over the years.

E. UK Takeover Code Amendments

In the last quarter of 2011, key amendments to the UK Takeover Code were phased-in following a significant debate and consultation process. These 2011 amendments relate to fundamental issues impacting public company M&A in the UK, including the identification of potential bidders, the time period applicable to a named potential bidder to announce an offer or disavow an interest, the ability to use previously common deal protection devices and the disclosure requirements in relation to bid announcements. The UK Takeover Code generally applies to UK-listed companies also incorporated as public companies in the UK, but the Code also has indirect, voluntary application to UK-listed holding companies incorporated elsewhere, including many Bermuda-based insurance groups, but who have adopted look-alike bye-law provisions that mirror the UK Takeover Code.

The 2011 amendments seek to address the following perceived shortcomings in the prior takeover practice: (i) that UK takeovers were being influenced by short-term considerations; (ii) that bidders were able to gain tactical advantages in the takeover process by not clarifying their intentions in a timely manner and (iii) that disclosures to target shareholders needed to be improved.

One important 2011 amendment applies to the situation where a target must make an announcement following an approach by a potential bidder where, for example, the target is also the subject of rumor and speculation or the target's share price is the subject of volatile movements. As a result of the amendments, such an announcement by a target generally must identify any potential bidder with which the target is in talks and/or from which an offer has been received. Once the target makes such an announcement, the target does not have the ability to choose not to name any such potential bidder, regardless of whether or not such potential bidder is the one identified in any press rumor or speculation. Therefore, the need for confidentiality after an approach by any potential bidder is now far more important.

Once a potential bidder has been publicly named by a target, it has 28 days either to announce a firm intention to make an offer (in which case it is committed to doing so) or announce that it does not intend to make an offer (in which case it will not be able to make an offer for six months). The purpose of the 2011 amendments is to prevent a bidder continuing to force a target to engage for an extended period in a "virtual bid" without making an actual bid. The target may, however, ask the UK Takeover Panel for an extension of the 28-day period.

The 2011 amendments to the UK Takeover Code are likely to increase the amount of bid planning a potential bidder undertakes before approaching a target. For example, a potential bidder will wish to secure any necessary bid financing before approaching the target in the event that a target must make an announcement and identify the bidder, thereby commencing the 28-day period. It also could cause a potential bidder seeking to secure a target board recommendation before launching a bid to move to its best price more quickly or cause other potential bidders to be deterred from even approaching the target because they cannot "test the waters" with the target without the possibility of being named if there is a leak.

Another set of changes contained in the 2011 amendments significantly restricts or prohibits targets from entering into certain deal protection measures with bidders in offers subject to the UK Takeover Code. The following deal protection measures are now prohibited without the consent of the Panel:

- inducement/break fee arrangements, except a break fee of up to 1% of the value of the offer, which is permitted in favor of a white knight in a hostile situation or in favor of a successful bidder arising from a formal public auction process;
- undertakings not to solicit a competing proposal;
- matching rights, giving the first bidder an opportunity to match a later bid before the latter bid is recommended;

- restrictions on the target board changing its recommendation to shareholders; and
- restrictions on the provision of information to other bidders.

These 2011 amendments restricting deal protection measures could encourage the announcement of a formal auction by targets that are otherwise in play to permit them to use break fees with the successful bidder. In situations without a formal auction process, it could increase an initial bidder's costs where they secure a recommended bid but then a successful competing bidder emerges, in which case the initial bidder would not be reimbursed by inducement/break fees. Deal protections imposed only on the successful bidder, such as reverse break fees or standstill arrangements, are not impacted by the 2011 amendments.

Finally, the 2011 amendments enhanced the disclosure requirements in relation to announcements subject to the UK Takeover Code, including the following:

- bidders must set out detailed bidder financial information in the offer document, for cash bids as well as for share exchange offers, together with more detail about bid financing, including repayment terms, interest rates, security and key covenants;
- both bidder and target must disclose an estimate of the offer-related fees and expenses they expect to incur; and
- where statements of intention regarding any plans relating to, for example, the target's employees, locations of businesses and fixed assets are made, bidders are expected to honor these plans for at least 12 months, unless there is a material change of circumstances.

In light of the 2011 amendments, we understand that the UK Takeover Panel has been reviewing offer announcements and documentation to ensure that parties have been complying with the revised provisions of the UK Takeover Code.

III. Public Company Regulatory and Disclosure Developments

A. Significant SEC Rulemaking: Implementation of Dodd-Frank

1. Volcker Rule

On October 11, 2011, the SEC, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC) published a joint notice of the proposed framework for implementing the Volcker Rule.

As proposed, the Volcker Rule would restrict the ability of banks that receive government backstops like deposit insurance to make trades in securities, derivatives and other financial products with their own funds (i.e., proprietary trading). It would also prohibit banks from investing in or sponsoring, beyond a small amount, hedge funds or private equity funds. The rule likely will only apply to "banking entities," which, as proposed, include (i) any insured depository institution, (ii) any company that controls an insured depository institution, (iii) any company that is treated as a bank holding company for purposes of the International Banking Act and (iv) any affiliate or subsidiary of any of the foregoing.

Following a one-month extension, the comment period for the Volcker Rule closed on February 13, 2012. Due to the Volcker Rule's complexities and the broad impact it may have on a banking entity's ability to engage in proprietary trading, thousands of comment letters have been received thus far. It remains to be seen what form the final regulations implementing the Volcker Rule will take.

2. Whistleblower Program

Effective August 12, 2011, the SEC adopted the Securities Whistleblower Incentives and Protection Rule, which was implemented pursuant to Section 21F of the Exchange Act. Section 21F directs the SEC to pay awards of between 10% and 30% of the amount recovered to individuals who voluntarily provide the SEC with original information about a possible violation of the federal securities laws leading to an enforcement action resulting in monetary sanctions exceeding $1 million.

The new SEC rules define broadly the scope of potential whistleblower eligibility to include individuals outside of the United States. Also, there is no requirement that a whistleblower be an employee of the company with respect to which it is providing information. However, attorneys and others subject to the attorney-client privilege, as well as auditors, compliance personnel and investigators of possible violations of law, are generally excluded from eligibility. Under the rules, whistleblowers may also include individuals who use analysis of public information to produce qualifying "original information."

Most significantly, the new rules prohibit companies from taking actions to impede individuals from communicating with the SEC regarding possible securities law violations, including by enforcing or threatening to enforce a confidentiality agreement. Accordingly, confidentiality agreements or provisions and other contractual obligations cannot be used or relied upon to prevent individuals from acting as whistleblowers.

3. New Criteria to Replace Credit Ratings in Securities Act Forms and Rules

Section 939A of Dodd-Frank directed the SEC and other federal agencies to review regulations requiring "... the use of an assessment of the credit-worthiness of a security" and "any references to or requirements in such regulations regarding credit ratings." In response, the SEC proposed amendments in February 2011 and released a final rule on July 27, 2011 amending its rules and forms of registration statements under the Securities Act to remove and replace references to security ratings from nationally recognized statistical ratings organizations (NRSROs) and eligibility criteria based on such ratings. The amendments set forth

new standards that the SEC believes will enable widely followed issuers of non-convertible securities to access capital markets on terms similar to those available under the existing rules and forms. Most of the amended rules and forms became effective September 30, 2011 (though some will not go into effect until the end of 2012).

The amendments primarily affect the transaction eligibility requirements for Forms S-3 and F-3. To be eligible to use either of these short forms, an issuer must meet the form's registrant eligibility requirements (which generally pertain to reporting history under the Exchange Act) and at least one of the form's transaction eligibility requirements. For those issuers that did not meet applicable public float requirements, one such transaction requirement permitted such issuers to register primary offerings of non-convertible securities if such securities were rated investment grade by at least one NRSRO. The amendments replace this eligibility standard with four new standards for primary offerings of non-convertible securities (other than common equity). Under these standards, an offering of non-convertible securities is eligible to be registered on Forms S-3 and F-3, if the issuer:

- has issued at least $1 billion in non-convertible securities (other than common equity) in registered offerings for cash in the preceding three years;
- has outstanding at least $750 million of non-convertible securities (other than common equity) issued for cash in registered primary offerings;
- is a wholly owned subsidiary of a WKSI; or
- is a majority-owned operating partnership of a real estate investment trust (REIT) that qualifies as a WKSI.

In addition, any issuer of investment grade securities that does not qualify under the new standards may still use Form S-3 or Form F-3 if (1) it certifies its reasonable belief that it would have been eligible under the former investment grade rating standard and (2) it files such registration statement within three years of the effective date of the amendments (i.e., September 30, 2014). The separate eligibility standards (i) for primary offerings by issuers that meet public float and other requirements and (ii) for secondary offerings remain available.

The amendments also affect Forms S-4 and F-4 (used for the registration of securities issued in mergers and tender offers) and Schedule 14A (governing proxy solicitations), which permitted incorporation by reference of financial and other information concerning eligible issuers, including issuers of investment grade securities. Under the amendments these references are replaced by references to issuers eligible to register non-convertible securities under the revised Form S-3 and Form F-3 instructions.

Securities Act Rules 138, 139 and 168, which used investment grade ratings of an issuer's securities as an eligibility standard for safe-harbor protection for certain communications that would otherwise violate the prohibitions against offers prior to the filing of a registration statement and illegal prospectuses and for the publication of certain business information, were similarly amended to reference the revised Form S-3 and Form S-4 instructions.

Rule 134(a)(17), which permitted the content of offering announcements to include investment grade ratings, was also amended. The SEC modified the rule to remove the safe harbor for such communications in order to decrease reliance on credit ratings as mandated by Section 939A. However, the SEC noted that removal of the safe harbor did not mean that such a communication containing a securities rating would be a prospectus per se and that such determination should be made in light of all the circumstances of the communication.

4. Asset-Backed Securities Disclosure

Pursuant to Section 943 of Dodd-Frank, the SEC adopted rules, effective March 28, 2011, that established requirements for due diligence procedures and disclosures in ABS offerings. Under the new rules, issuers of publicly

offered ABS are required to perform a review of the pool assets underlying the securities and to disclose fulfilled and unfulfilled repurchase requests. In conjunction with the new rules, the SEC also amended Regulation AB to require that issuers disclose the nature of the review of the assets, the "findings and conclusions" of the review and information regarding the amount and characteristics of assets that deviate from the underwriting criteria. NRSROs are also required to include information regarding the representations, warranties and enforcement mechanisms available to investors in an ABS offering in any report accompanying a credit rating issued in connection with such offering, including a preliminary credit rating.

B. SEC Disclosure Comments

1. Loss Contingency

Throughout 2010 and 2011, the SEC has issued a number of publications and comment letters that focus on disclosure of litigation loss contingencies in periodic reports and financial statements of public companies. In particular, the SEC has urged, in speeches and "Dear CFO" letters, enhanced disclosure from companies in order to comply with Financial Accounting Standards Board (FASB) Accounting Standards Codification Subtopic 450-20. While the SEC initially focused its attention on the so-called "big banks," in the second half of 2011, reporting companies in the insurance industry have also received comment letters regarding this topic.

ASC Subtopic 450-20 requires a company to establish accruals for litigation and other contingencies when it is probable that a loss has been incurred and the amount of loss can reasonably be estimated. However, the SEC has indicated that a company is also required to disclose a contingency that does not meet this accrual standard if there is at least a "...reasonable possibility that a loss or an additional loss has been incurred." According to the SEC, in this case, disclosure should indicate the nature of such contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Accordingly, the SEC has issued comments in cases where a company discloses litigation or alludes to potential litigation without an estimate of possible loss or range of loss or a statement that such an estimate cannot be made. Furthermore, in instances in which a company states that a loss or range of loss associated with an unaccrued contingency is not estimable, the SEC has requested that a company disclose supplemental information about its process and efforts in reaching its conclusion. For example, the SEC has requested from such companies explanations of the procedures undertaken on a quarterly basis to attempt to develop a range of reasonably possible loss for disclosure and how the company determines whether to continue pursuing a litigation matter or to attempt to settle instead of litigate. In addition, when a company does report an accrued litigation loss, the SEC has indicated that it will examine prior loss contingency disclosures to determine whether such prior disclosure was sufficient and may request supplemental information in this respect as well.

These enhanced disclosure requirements present a challenge to reporting companies to balance compliance concerns with the risk that overly specific disclosure could reveal information to plaintiff's counsel that would be prejudicial to the defense of litigation and, thus, would not be in the best interests of shareholders. Certain companies have shown a willingness to disclose aggregate ranges of reasonably possible exposure between zero and very high estimated amounts, an approach that other companies are expected to follow to the extent feasible. However, it remains to be seen whether the SEC will find this approach satisfactory or whether a new round of SEC comments will demand more specific disclosure.

2. Euro Sovereign Debt Exposure

Throughout 2011, the SEC Division of Corporation Finance has commented on the disclosures of SEC-registered financial institutions, including insurance companies, relating to their exposures to certain European countries. Due to the recent uncertainties regarding European sovereign debt holdings, the SEC staff has been concerned

about the risks to financial institutions from direct and indirect exposures to these holdings. Many foreign private issuers and US financial institutions therefore received SEC staff comment letters on their existing disclosures. The SEC staff has stated that the current uncertainties arising in connection with European sovereign debt exposures, together with the lack of transparent, comparable information, raised concerns about the adequacy of SEC registrants' disclosures to investors.

To address these disclosure concerns, in early 2012, the Division of Corporation Finance issued CF Disclosure Guidance, Topic No. 4: European Sovereign Debt Exposures. The SEC staff noted that the current principles-based item requirements, such as in the MD&A and Market Risk sections of annual reports, do not adequately address the exposures. The SEC staff issued this guidance to suggest more detailed disclosures on European debt exposures.

In determining which countries are covered by the guidance, the SEC staff suggested that registrants should focus on those experiencing significant economic, fiscal and/or political strains such that the likelihood of default would be higher than would be anticipated when such factors do not exist. Acknowledging the fluid situation, the SEC staff stated that the European countries covered by this analysis would vary and thus the disclosures should be sufficiently flexible to capture those risks as they change over time.

In the guidance, the SEC staff noted that the additional disclosures should be provided separately by country, segregated between sovereign and non-sovereign exposures, and by financial statement category, to arrive at gross funded exposure. They also suggested that registrants should consider separately providing disclosure of the gross unfunded commitments made, as well as providing information regarding hedges in order to present an amount of net funded exposure.

This enhanced disclosure guidance has resulted in additional disclosures in 2011 annual reports for many SEC registrants. We understand that the SEC staff will continue to comment on disclosures of insurance companies in relation to European sovereign debt exposure throughout 2012.

C. Staff Legal Bulletins

1. Rule 14a-8 Shareholder Proposals

On October 18, 2011, the SEC issued Staff Legal Bulletin 14F to clarify and streamline the Rule 14a-8 shareholder proposal process. Under the new and old regimes, in order for a shareholder to submit a proposal for inclusion in the company's proxy materials, Rule 14a-8 requires that such shareholder must have held at least $2,000 in market value or 1% of the company's securities entitled to vote at the shareholder meeting for at least one year prior to the date the proposal is submitted. Beneficial owners, who hold their shares through an intermediary, can provide proof of share ownership by submitting a written statement from the "record" holder of the securities.

Most US brokers and banks deposit their customers' securities with, and hold securities through, The Depository Trust Company. Such brokers and banks are referred to as DTC "participants." The sole registered owner of the securities deposited with DTC is Cede & Co., DTC's nominee. Previously, the SEC took the position that certain brokers, typically introducing brokers, could be considered the "record" holder of securities held through DTC, even though they were not DTC participants and did not hold custody of the securities. As a result, in many cases, introducing brokers were permitted to certify the requisite ownership of shareholders' holdings through DTC, and companies were required to accept such certifications, even though they could not independently verify such ownership through DTC. To avoid this outcome, the bulletin revises the SEC's position and clarifies that going forward, only DTC participants will be viewed as "record" holders of securities that are deposited at DTC.

2. Legality and Tax Opinions in Registered Offerings

On October 18, 2011, the SEC issued Staff Legal Bulletin 19 to provide guidance on the legality and tax opinions required to be filed with registered offerings, which are commonly referred to as Exhibit 5 and Exhibit 8 opinions, respectively. The bulletin discusses the requirements for such opinions, the SEC's views regarding the permitted assumptions and

qualifications in these opinions and the filing of consents to include these opinions in registration statements.

a. Legality Opinions

Item 601(b)(5)(i) of Regulation S-K requires that all Securities Act filings include an opinion of counsel regarding the legality of the securities being offered and sold pursuant to the registration statement. Such opinion must state that the securities are validly issued, fully paid, non-assessable and, in the case of debt securities, binding obligations of the issuer.

The bulletin also confirms that the SEC will not accelerate the effectiveness of a registration statement if counsel does not opine that the securities will be legally issued. However, if counsel opines that the securities are not fully paid or are assessable, the effectiveness of the registration statement may still be accelerated with adequate disclosures regarding partial payment or assessability. In addition, the bulletin confirms that purchasers of securities in registered offerings are entitled to rely on such legality opinions, and that the SEC does not accept any limitation on reliance.

b. Tax Opinions

Item 601(b)(8) of Regulation S-K requires a tax opinion for filings on Form S-11, filings to which Securities Act Industry Guide 5 applies, roll-up transactions and other registered offerings where the tax consequences are material to an investor and a representation about the tax consequences is included in the filing. Legal counsel or an independent public or certified accountant can provide the tax opinion to support the tax matters and the consequences to shareholders described in the filing. A revenue ruling from the Internal Revenue Service also will satisfy the requirement.

The bulletin notes that tax opinions only have to address material federal tax consequences, and the registrant may recommend in the prospectus that investors seek the advice of their tax counsel or an advisor with respect to any state tax consequences. It also confirms that a tax opinion may be conditioned or qualified so long as the disclosure is adequate, and explains that counsel or an accountant may issue a "should" or "more likely than not" opinion if there is a lack of authority that directly addresses the tax consequence of the transaction or significant doubt about the tax consequences.

D. SEC Enforcement Actions and Notable Litigation

1. Foreign Corrupt Practices Act (FCPA)

The SEC and the Department of Justice (DOJ) maintained robust FCPA enforcement activity through 2011 and into 2012, initiating more actions than in any other year with the exception of 2010. The DOJ also successfully prosecuted its first corporate FCPA trial in May 2011, and regulators showed increased willingness to take actions to trial against both companies and individuals. In fact, a leading insurance broker recently settled SEC allegations that it violated the FCPA and entered into a non-prosecution agreement with the DOJ resulting in payments of more than $16.25 million to regulators.

The FCPA's anti-bribery provisions prohibit offering or providing money or anything of value to officials of foreign governments or foreign political parties with the intent to obtain or retain business. These provisions apply to "issuers," "domestic concerns," and "agents" acting on behalf of issuers and domestic concerns, as well as "any person" that violates the FCPA while in the territory of the United States. The FCPA also contains provisions requiring maintenance of accurate books and records and reasonable internal accounting controls aimed at preventing and detecting FCPA violations. Regulators have recently turned to these so-called accounting provisions when they cannot establish the elements for an anti-bribery prosecution and as a tool for compromise in settlement negotiations.

2. *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*

The Delaware Chancery Court's recent decision in *In re Southern Peru Copper Corporation Shareholder Derivative Litigation,* which resulted in a $1.26 billion judgment, focused on the role of special committees in assuring that directors meet the "entire fairness" test (i.e., fair price and fair process) in evaluating a proposed transaction.

According to the litigation, Grupo Mexico, which controlled 63% of the voting power of Southern Peru Copper Corporation, wanted Southern Peru to acquire Grupo's subsidiary, Minera Mexico. The Board of Directors of Southern Peru established a special committee to effect this transaction, which retained an investment bank as its financial advisor to determine the value of Minera. Grupo had offered (and Southern Peru ultimately accepted Grupo's offer) to sell Minera in exchange for shares of Southern Peru stock with a market price of $3.1 billion at the time of signing and $3.7 billion at the time of closing. The investment bank initially concluded that the potential target was worth only $1.7 billion. However, the special committee directed the investment bank to adjust its valuation methods in order to maximize the estimated value of Minera and to minimize the market price of the stock of Southern Peru in its calculations.

According to the Chancery Court's decision, the special committee did not consider alternative transactions and did not have "real bargaining power" to negotiate at arms' length with the controlling shareholder. As a result, the board of directors of Southern Peru breached its duty of loyalty to its shareholders in approving this transaction. The court also found deficiencies in Southern Peru's proxy statement, which failed to disclose the stand-alone valuations by the investment bank and the fact that the equity value of Southern Peru's stock had been discounted. Furthermore, the court also criticized the fact that the transaction was only subject to approval by a vote of two-thirds of all shareholders rather than by a majority of the minority shareholders.

In addition to highlighting the importance of granting a special committee sufficient authority to explore alternative transactions and to negotiate in a meaningful "back-and-forth" with the controlling shareholder, this case also highlights the value of providing procedural protections such as a "majority of the minority vote" in demonstrating good faith.

3. Regulation FD

In November 2011, the SEC entered into a cease and desist order against Fifth Third Bancorp in connection with its redemption of trust preferred securities in May 2011. In its order, the SEC charged that Fifth Third, in violation of Section 13 of the Exchange Act and Regulation FD, "selectively disclosed," by way of a notice to preferred securities holders disseminated through DTC, that it would redeem a class of its trust preferred securities for approximately $25 per share when it provided its notice of redemption to DTC, which then made the information available to DTC participants. At the time of such disclosure, Fifth Third's trust preferred securities were trading at about $26.50 per share. Investors that appeared to have learned of the redemption through DTC immediately began selling the securities to buyers that were seemingly unaware of the redemption, which drove the price of the securities almost down to the redemption price within 24 hours of DTC's publication of the notice. As a result of these trades, the SEC initiated its cease and desist order proceeding, claiming that Fifth Third failed to issue a Form 8-K or other public notice of the redemption upon its transmittal of the notice to DTC so that all investors would be placed on equal footing for the planned redemption. According to the SEC, Fifth Third violated Regulation FD because it failed to consider how its decision to redeem the securities would affect investors in the market for those securities.

In connection with its settlement of the claim, Fifth Third compensated harmed investors and agreed to adopt and implement various additional policies and procedures with respect to future redemptions of its securities. In connection

therewith, the SEC agreed to settle the enforcement action without requiring Fifth Third to admit or deny the SEC's allegations. Because of Fifth Third's cooperation with the investigation, the SEC did not impose a civil penalty upon the company.

E. Other Areas of Interest

1. ISS Policy Updates for the 2012 Proxy Season

In November 2011, ISS released its 2012 proxy voting policies, which are applicable for shareholder meetings held on or after February 1, 2012. In addition to issuing guidance on pay-for-performance, say-on-pay and say-on-pay-frequency issues, ISS also issued guidance with respect to exclusive venue proposals and equity plans under Section 162(m) of the Internal Revenue Code.

Although ISS historically voted against exclusive venue proposals, in light of recent forum shopping cases arising in courts throughout the United States (and companies' responses thereto), ISS has shifted its policy slightly. Pursuant to its 2012 voting policies, ISS will now consider exclusive venue proposals on a case-by-case basis. In evaluating such proposals, among other things, ISS will take into account a company's litigation history (whether the company has suffered material harm from prior shareholder litigation in other jurisdictions) and corporate governance policies and procedures (including whether the company has in place an annually elected board, whether it relies on majority voting for uncontested director elections, and whether or not a non-shareholder approved poison pill is in place). ISS noted in its release that all exclusive venue proposals received thus far have sought to designate Delaware as the exclusive jurisdiction in which shareholder litigation may be brought. If a proposal to make another jurisdiction the exclusive venue arises in 2012, ISS may examine that jurisdiction's statutes, case law and judiciary as part of its evaluation.

ISS also announced that it will apply more scrutiny to votes on equity plans for newly public companies seeking favorable tax treatment under Section 162(m) of the Internal Revenue Code. Under the Code, this tax treatment is available for a plan in place at the time a company goes public if the plan is approved by public shareholders for such purposes within a set period after the IPO. Typically, ISS has recommended that shareholders vote for such equity plans due to the favorable tax deduction companies may take on performance-based compensation paid to named executive officers. Under the revised policy, however, ISS will subject equity plans presented for approval by newly public companies to a full equity plan evaluation, including consideration of total shareholder value transfer under the plan, burn rate, repricing and existence of liberal change in control policies.

2. D&O Clawback Insurance

In connection with the implementation of Dodd-Frank, the FDIC established in July 2011 new rules that permit clawbacks for up to two years of bonus and incentive pay from officers and directors. Pursuant to Section 954 of Dodd-Frank, the FDIC is permitted to require any senior executive or director "substantially responsible" for a financial institution's failure to pay back any compensation from the prior two years.

In response to these new rules, certain D&O insurance policies are beginning to offer coverage against compensation clawbacks. While it remains to be seen whether or not the FDIC and the SEC will argue that such policies are against public policy, Marsh, the first broker to offer such a product, has argued that these insurance policies should not be controversial, since they do not provide coverage to directors or officers for fraud or intentional wrongdoing, nor do they prevent shareholders from recouping such outlaid funds. To the extent that these policies are challenged, however, they ultimately may be deemed unenforceable. Nevertheless, many banks and other financial institutions have already purchased them.

3. Cyber Security

In October 2011, the Division of Corporation Finance of the SEC issued guidance regarding disclosure obligations relating to cyber security risks and cyber incidents of issuers. Such guidance may trigger disclosure for issuers with respect to any risks related to the costs of a potential cyber incident, the misappropriation of intellectual property or sensitive information, or the corruption of data resulting in operational disruption. Such disclosure may appear in various sections throughout Exchange Act reports and Securities Act offering documents, including risk factors, MD&A, legal proceedings, description of an issuer's business and disclosure controls and procedures.

4. Proposed Amendments to Promote Transparency in Audit Reports

On October 11, 2011, the Public Company Accounting Oversight Board (PCAOB) issued a proposed rule to promote transparency of audits, an issue that was first introduced by the PCAOB in a concept release in 2009. Pursuant to the proposed rule, (1) registered public accounting firms will be required to disclose the name of the applicable engagement partner in each audit report, (2) the PCAOB's Annual Report Form will be amended to require registered firms to disclose the name of the engagement partner for each audit report already required to be reported on the form, and (3) other independent public accounting firms and other persons that took part in the audit will need to be disclosed in the audit report.

The comment period with respect to the proposed rule expired on January 9, 2012. Issuers and auditors alike now await what final action will be taken by the PCAOB.

IV. Developments in Insurance Capital Markets

A. Equity

1. Common Stock Offerings

The first quarter of 2011 saw a carefully coordinated offering of MetLife equity securities by MetLife and AIG. Following the sale of ALICO to MetLife in 2010, AIG had received common stock, contingent convertible preferred stock and equity units consisting of senior debt securities and common stock forward purchase contracts from MetLife. Taking advantage of a favorable market, MetLife and AIG agreed to waive the requirements of the investor rights agreement and enter into transactions for all of the MetLife equity securities received in connection with the ALICO acquisition. MetLife raised approximately $3.0 billion from an offering of common stock and used the proceeds to repurchase the contingent convertible preferred stock from AIG, which it then cancelled. At the same time, AIG offered and sold $3.3 billion of MetLife's common stock and $3.3 billion of equity units. As a result of these offerings, AIG repaid in full the liquidation preference and accrued return of the preferred interests held by the United States Department of the Treasury in the ALICO SPV and paid approximately $5.5 billion to the Treasury to reduce the preferred interests in the AIA SPV. Following these transactions AIG no longer held any of the MetLife equity securities that it had received in the sale of ALICO.

AIG returned to the markets in May 2011, this time with its own securities. The Treasury and AIG offered and sold approximately $5.8 billion and $2.85 billion, respectively, of AIG common stock. Since AIG's recapitalization in January 2011, the Treasury had held approximately 92% of its outstanding common stock; this transaction resulted in that holding being reduced to 77%. Pursuant to the terms of a settlement with the lead plaintiffs in a securities fraud class action, AIG used $550 million of the proceeds from its offering to fund the remainder of the settlement amount. The additional proceeds were used for general corporate purposes.

Through two transactions in April and December of 2011, Citigroup sold down the remainder of its holding of Primerica. Primerica was spun-off from Citigroup in April 2010 with a private sale of approximately 29% of the common stock to private equity funds managed by Warburg Pincus and an initial public offering of approximately 30%. At the time, Citigroup maintained its interest in close to 40% of the company, but the two 2011 dispositions, which raised approximately $450 million, resulted in Citigroup's equity ownership being reduced to zero.

Another significant insurer equity deal in 2011 was the €900 million common stock offering in February by AEGON. The company's common stock is listed on Euronext Amsterdam and the proceeds were used to repay funds provided to AEGON by the Dutch state during the financial crisis.

2. Preferred Stock Offerings

The second quarter of 2011 saw a number of Bermuda reinsurers issue non-cumulative perpetual preferred stock, which is not callable for the first five years and includes a dividend stopper with respect to the companies' common stock. Following catastrophe losses in Australia, New Zealand and Japan, and significant property/casualty losses due to tornadoes and storms in the United States, the preferred stock issuances allowed the reinsurers to raise additional capital without a dilutive effect on their common stock holders. The terms generally are also structured so that the reinsurers also obtain equity credit from the rating agencies. This type of security was issued by Montpelier Re, Endurance Re and Partner Re in 2011 and by Aspen, Axis and Arch in early 2012. The securities of each issuer were directed to either institutional or retail investors, or both, and were listed on the NYSE.

B. Debt Capital Markets

1. Senior Notes

Insurance debt capital markets were somewhat quieter in 2011 compared to 2010, as many companies had already taken the opportunity to refinance in the historically low interest rate environment. Most issuances took place in the first half of the year, with insurance company yields bottoming out in July and then rising sharply along with financial-sector spreads in August as the Eurozone debt crisis gathered momentum; by early October broad-market spread levels had reached multi-year highs. There were, however, a number of both registered issuances and private placements of senior notes over the year, including AIG ($2.0 billion), Prudential Financial ($1.5 billion), Willis Group ($800 million), Liberty Mutual ($600 million), Nationwide ($600 million), Aon ($500 million), Fairfax ($500 million), Progressive ($500 million), CNA ($400 million), Genworth ($400 million), RGA ($400 million), XL Capital ($400 million), Lincoln Financial ($300 million), Ohio National ($250 million) and USAA Capital ($250 million).

2. Funding Agreement-Backed Notes

In 2011, the market for funding agreement-backed notes continued to regain traction following the decrease in activity witnessed in 2009. However, issuances remained below the levels seen prior to the financial crisis and a number of well-known names have yet to re-enter the marketplace. According to a press release, S&P rated $6.1 billion of funding agreement-backed notes over the first six months of 2011, $142 million more than for the same period in 2010, but a sharp decline compared to the record-high six-month total of nearly $23.0 billion in the first half of 2008.

Funding agreement-backed notes are generally described as annuity-like instruments that are designed to generate regular cash flows to service the debt on short- or medium-term notes issued through a securitization vehicle, such as a Delaware statutory trust, and that transfer credit quality of a policyholder claim at the insurance company to the notes of that vehicle.

Although issuances are down, a number of issuers have retained their programs, so that they have the option to access the markets if the opportunity presents itself. The dominant players at present are MetLife (with $6.12 billion of notes issued in 2011), New York Life ($1.7 billion) and MassMutual ($650 million).

The first few months of 2012 started off strongly in the funding agreement-backed medium term note space with MetLife accessing the market on a number of occasions with a mix of fixed-rate, floating-rate, extendible and maple bond offerings. If interest rates continue to remain low, this market may see the return of other names seeking to take advantage on behalf of their spread-based businesses.

3. Surplus Notes

After a busy 2009-2010, when no less than eight companies came to the market, 2011 saw no new issuances of surplus notes. However, perhaps signaling renewed activity this year, in January 2012 Mass Mutual issued $400 million of 30-year fixed rate surplus notes, the proceeds of which it will use for general corporate purposes and to strengthen its statutory capital position.

C. Hybrid Securities

Following changes to the ratings agencies' criteria for rating hybrid securities and the corresponding loss of equity credit associated with these securities, issuers have actively investigated potential restructurings, repurchases or redemptions of their outstanding hybrid securities. The main barrier such issuers face is the associated replacement capital covenants (RCCs) that were put in place for the benefit of senior note holders at the time the hybrid securities were issued, specifically to restrict such actions. If an issuer wants to repurchase or redeem its outstanding hybrid securities, the corresponding RCC will generally require it to use not less than a specified amount of proceeds from the issuance of junior or parity securities to do so.

Some issuers have sought to get around this by soliciting the required consents of their senior note holders in order to amend or terminate the RCCs, and in some instances couple that with a tender offer or redemption of their hybrid securities. However, there have been instances where the consent fee demanded by the senior note holders has been prohibitive to these transactions.

In February, Liberty Mutual terminated both a previously announced consent solicitation from holders of its senior notes to terminate an RCC and a linked cash tender offer from holders of the corresponding series C junior subordinated notes. However, the company went back to the senior note holders in March and successfully completed a cash tender offer to purchase the senior notes and, in conjunction with the tender offer, a consent solicitation to the senior note holders, including an exit consent, to terminate the RCC relating to the series C junior subordinated notes. As a result of these transactions and, most significantly, the removal of the RCC, Liberty Mutual has greater flexibility to manage its capital structure.

In November, AIG closed an exchange offer of new senior notes denominated in Euros, Sterling and US Dollars for five outstanding series of its junior subordinated debentures denominated in the corresponding currencies. The exchange offer was made only to qualified institutional buyers pursuant to Rule 144A and non-US persons pursuant to Regulation S; however, AIG committed to entering into a registration rights agreement with respect to the new senior notes. AIG was able to terminate the offer before it expired as holders had exchanged junior subordinated debentures in excess of the $2.5 billion cap prior to the end of the offer's early participation period. Based on AIG's offering of common stock in May, the RCCs that AIG had in place permitted it to repurchase a certain amount of the junior subordinated notes during the next 180 days, which it duly did. The exchange offer was part of AIG's initiative to reduce debt costs and improve its financial flexibility going forward.

Finally, in November 2011 Aviva plc closed an innovative offering of $400 million principal amount of SEC-registered hybrid securities designed to provide surplus credit under Solvency II.

D. Insurance-Linked Securities

2011 was another solid year for insurance-linked securities (ILS), with approximately $4.6 billion of ILS issued in the Rule 144A market, including more than 40% of the annual total coming in the fourth quarter alone. There was a flurry of activity down-the-stretch as 2011 was brought to a close; a good harbinger of things to come as the market is off to a brisk start in 2012.

As in previous years, the catastrophe bond market was dominated by US hurricane risk, with approximately three of every four transactions having some US hurricane exposure. Nevertheless, the pipeline for bonds not linked to US hurricanes continues to be robust, including continued expansion into non-property and casualty perils.

Another positive sign was the issuance by Vecta I of C$120 million aggregate principal amount of debt securities in December. This was the first Rule 144A embedded value life insurance securitization since 2008 and the first to be structured without a financial guaranty. It was also the first ever Canadian life insurance securitization. The Vecta I transaction enabled Aurigen Reinsurance to monetize the cash flows associated with life insurance and mortality business it has reinsured.

As an enhancement of index-based catastrophe bond structures, Insurance Services Office Inc. (ISO), a subsidiary of Verisk Analytics, has recently started producing a county-level industry loss index for US hurricanes and earthquakes. In preparing the Verisk Catastrophe Index, ISO will work closely with its affiliate Property Claim Services (PCS), which currently produces state-level estimates based on industry surveys, and the modeling firm AIR Worldwide Corporation. In order to produce higher resolution loss estimates, AIR will employ a post event modeling process to disaggregate state-by-state PCS industry loss estimates to a county-level. The county-level loss estimates will then be reported by ISO in catastrophe bulletins similar to those currently produced by PCS. County-level loss estimates will enable insurance

company sponsors to modify industry losses estimates on a more granular level through the use of county payout factors. The new index, which had its ILS debut in early 2012, seeks to permit greater flexibility in managing basis risk in index-based transactions, which is an important concern for insurance company sponsors in accessing the ILS market.

We continue to monitor regulatory developments related to asset-backed securities, including insurance linked securities, such as the SEC's proposed Rule 127B under the Securities Act, which will implement the conflicts of interest provisions of Section 621 of the Dodd-Frank Act. The proposed rule would prohibit securitization participants from engaging in certain transactions that involve or result in a material conflict of interest with investors for one year from the closing date. The proposed rule also provides exceptions from this prohibition for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making.

While the proposal was directed at some of the more widely publicized abuses of the securitization market, particularly the shorting arrangement in connection with the now infamous Abacus transaction, the proposed Rule 127B could be interpreted broadly to cover other forms of asset-backed securities and other types of conflicts of interest. We expect the SEC to provide greater clarity on whether proposed Rule 127B will apply to less traditional forms of securitization, including ILS and similar structures, in the coming months. However, based upon the policy considerations underlying the proposal, we believe that ILS should not be covered by Rule 127B or, if covered, may fall under the rule's exemption for risk-mitigating hedging activities.

In addition, in early 2012 President Obama signed the Jumpstart Our Business Startups Act, or JOBS Act, which will eliminate the restrictions against general solicitation and general advertising in connection with certain private placements of securities to "accredited investors" or "qualified institutional buyers." As those involved in the ILS offering process know, the elimination of these restrictions could have a significant impact on how cat bonds and other related securities are marketed to investors, including by permitting expanded marketing efforts to non-core investors and creating greater transparency of the forthcoming deal pipeline.

V. Developments in the Swaps and Derivatives Markets

In 2011 the Commodities Futures Trading Commission (the CFTC) and the SEC proposed a number of rules to implement Title VII of Dodd-Frank that will impose regulation on the conduct of business in the over-the-counter derivatives market.

A. Potential Treatment of Certain Insurance Products as Swaps

In the summer of 2011, the Commissions issued their joint proposal further defining "swaps" and "security-based swaps". The definition of "swap" provided in Dodd-Frank is very broad and could be interpreted as capturing various consumer and commercial contracts as well as insurance products. To address this concern, the Commissions included proposed rules and interpretive guidance in their joint proposal regarding such types of contracts.

With respect to insurance products, the Commissions stated that they "do not interpret [the swap definition] to mean that products historically treated as insurance products should be included within the swap or security-based swap definition." The Commissions proposed a rule with a two-part test to identify what types of products would be considered insurance and not be considered a swap or security-based swap.

In particular, the insurance product would need to satisfy a product test and an entity test. Each element of the product test needs to be satisfied, including that (i) the beneficiary has an insurable interest that is the subject of the agreement and that it carry the risk of loss with respect to that interest continuously throughout the duration of the agreement; (ii) the loss occurs and is limited to the value of the insurable interest; (iii) the contract will not be traded separately from the insurable interest; and (iv) with respect to financial guaranty insurance, acceleration is at the sole discretion of the insurer. The Commissions differed on their opinion of whether insurance on a swap should itself be considered a swap and asked questions on that issue.

The entity test within the rule requires that the product must be provided by a company organized as an insurance company and subject to supervision by state or federal insurance regulators, or in the case of reinsurance only, by a person located outside the United States. With respect to reinsurance, the product being reinsured must meet the product test.

The Commissions further provided interpretive guidance that enumerated certain products that should be outside the scope of the swap and security-based swap definitions. These products included surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance and annuity products whose income is subject to Section 72 of the Internal Revenue Code. The SEC also noted that certain variable life insurance and annuity products, by virtue of being regulated as securities, would not be a swap or security-based swap.

Many commenters to the proposed rules noted that while the concepts in the product test may be appropriate for determining whether a product is property/casualty insurance, the concepts do not work for products such as annuity contracts, life insurance and long-term care and disability insurance. In addition, commenters were concerned that the entity test does not take into account the global nature of insurance and entities regulated as insurance companies in their home jurisdictions. Finally, commenters requested that the list of enumerated insurance products be included in the rules rather than the release to provide more certainty as to their exclusion and that, in particular, annuity products not be limited to ones whose income is subject to Section 72 of the Internal Revenue Code.

Another concern raised in the comment letters was that if an entity is looking to evade state insurance regulation, it would merely have to fail the entity test to have the product it is offering fall within the swap definition. This would be contrary to the established principle that, as provided in the McCarran-Ferguson Act, states are responsible for the regulation of insurance companies and insurance products.

B. Regulation of Swap and Security-based Dealers

As reported in our 2010 report, the Commissions proposed a definition of swap and security-based swap dealer as well as major swap and security-based swap participant in the fall of 2010. Although the comment period for the proposed rules expired in 2011, the Commissions have not yet issued final rules. Many of the comments received included concerns about whether interaffiliate trades will be used to determine whether an entity is a dealer and whether the level of unsecured exposure provided in the rules was sufficient to cause an entity to have to register as a major participant.

Pursuant to Dodd-Frank, entities that are registered as either a dealer or major participant with the CFTC or SEC, as applicable, are the entities tasked with complying with the bulk of the rules under Dodd-Frank, such as maintaining minimum capital requirements, collecting margin from their counterparties, recordkeeping rules, reporting trades to data repositories and business conduct standards.

C. Swap Execution and Clearing Requirements

It is unlawful for a person to engage in a swap if the swap is required to be cleared unless the swap is submitted to a clearing organization, or one of the counterparties to the swap is exempt from the clearing requirement (the commercial end-user exemption). The commercial end user exemption is not available for entities that are "financial entities." Insurance companies are classified as financial entities because the definition of "financial entity" includes persons predominantly engaged in activities financial in nature as defined in Section 4(k) of the Bank Holding Company Act, which definition includes insuring, guaranteeing or indemnifying against loss, harm, damage, illness, disability or death, or providing and issuing annuities and acting as a principal, agent or broker of the foregoing in any state.

The determination as to whether a swap or class of swaps is required to be cleared will be made by the relevant Commission either voluntarily or in response to a submitted request. Swaps that are subject to mandatory clearing must be executed on a designated contract market or registered swap execution facility (a new category of trading facility created by Dodd-Frank), unless no such platform makes such swaps available for trading.

D. Swap Data Recordkeeping and Reporting Requirements and Security-Based Swap Reporting Requirements

The CFTC adopted final rules with respect to recordkeeping and reporting requirements of swap data in December 2011. In general, compliance with the final rules is dependent on adoption of final rules further defining swaps and security-based swaps. The final rules set out the material terms that need to be reported to a data repository (which are quite extensive) as well as the ongoing reporting obligations during the life of a trade. Entities that are registered with the CFTC have primary reporting obligations; however, in circumstances where there is no registered entity, as between a financial entity and a non-financial entity, the financial entity is tasked with reporting the terms of the trade. This situation may apply in circumstances where a financial entity has entered into swaps with its affiliates that will be required to be reported to a data repository. In its final rules regarding the public reporting of swap data the CFTC did note, however, that certain inter-affiliate trades will not need to be publicly reported.

Parties to swaps, whether registered or not, will also be required to maintain full, complete and systematic records, including all pertinent data and memoranda, with respect to each swap to which they are a counterparty. The required records must be kept for the life of the swap plus five years. The records may be kept in either paper or electronic form, but must be retrievable within five business days.

Although the SEC has not yet adopted final rules, the proposed rules included material terms that needed to be reported to a data repository and specified the parties tasked with the obligation to report such terms. The SEC requested comment on the issue of how to treat inter-affiliate trades.

E. Implementation Schedule

Pursuant to Dodd-Frank, the provisions of Title VII were supposed to take effect on the later of the one-year anniversary of Dodd-Frank (July 2011) or, for provisions that required rulemaking, 60 days after publication of such final rules. The Commissions, however, both issued releases and exemptive orders in the summer of 2011 delaying the effective date of many of the provisions of Dodd-Frank and providing exemptive orders in certain cases where provisions would not otherwise be delayed due to rulemaking.

VI. Regulatory Developments Affecting Insurance Companies

A. Dodd-Frank

1. Implementation of the Nonadmitted and Reinsurance Reform Act

The Nonadmitted and Reinsurance Reform Act (NRRA), part of Dodd-Frank, became effective on July 21, 2011. The intent of the NRRA is to address inefficiencies in the regulation of surplus lines insurance and reinsurance. In addition, the NRRA created the Federal Insurance Office (FIO), a new office within the Treasury Department. The FIO is not granted general supervisory or regulatory authority over the insurance industry; however, it may have a significant effect on insurance regulation in general and certain insurers in particular. Specifically, the FIO may preempt state insurance measures that conflict with certain international agreements and disfavor non-US insurers. The NRRA also authorizes the Treasury Secretary and the United States Trade Representative to negotiate international agreements regarding prudential measures concerning insurance or reinsurance, subject to consultation with Congress.

a. Excess and Surplus Lines

State laws authorize policyholders to procure insurance coverage from unlicensed US or foreign insurers. The surplus lines procurement process involves specially licensed surplus lines brokers and surplus lines insurers designated "eligible" by insurance regulators to issue policies to US insureds. A signature feature of the surplus lines process is the broker's obligation to conduct a diligent search of the licensed insurance marketplace and receive coverage declinations by the admitted market prior to accessing the surplus lines market.

Historically a surplus lines broker's placement of multi-state risks triggered confusing, and often conflicting, state surplus lines rules. States in which a portion of an insured risk was located applied their own regulatory schemes to a multi-state risk, including surplus lines brokers licensing requirements, as well as state-specific surplus lines taxes, filing requirements, deadlines and compliance procedures. As a result, the surplus lines compliance requirements for a multi-state risk could be duplicative or mutually exclusive. The burden of compliance with conflicting regulatory requirements fell on surplus lines brokers.

The NRRA authorizes the policyholder's "home state" to regulate broker licensing, surplus lines tax payments and compliance filings; preempts certain state laws that are inconsistent with such "home state" focus; and maintains the role of state insurance regulators in the regulation of the surplus lines market place. Specifically, the NRRA provides that the home state of the insured will have exclusive authority to regulate the placement of nonadmitted surplus lines insurance and to collect premium taxes on nonadmitted reinsurance. The NRRA also establishes uniform standards for surplus lines eligibility criteria and preempts the diligent search requirements imposed on surplus lines brokers in connection with certain sophisticated commercial purchasers. With the implementation of the NRRA, the role of the NAIC's International Insurers Department (IID) has increased significantly because of its role under the NRRA as the sole gatekeeper for determining the eligibility of non-US insurers wishing to write excess and surplus lines insurance in the United States.

The exclusive home state authority to tax the surplus lines transaction is a hallmark of the NRRA. In addition to providing that no state other than the insured's home state may require any premium tax payment for non-admitted insurance, the NRRA also provides that the State may enter into a compact or otherwise establish procedures to allocate surplus lines premium tax among the states. The states have in various ways begun addressing the NRRA's authorization of their collaborative process to allocate premium tax with varying results.

The NAIC developed the Non-admitted Insurance Multi-State Agreement (NIMA) as a multi-state mechanism to allocate surplus lines tax. NIMA provides that participating states will share non-admitted insurance premium tax on multi-state risks. This includes allocation of casualty premium taxes for all casualty lines. Prior to the July 2011 effective date of the NRRA, for example, most surplus lines brokers did not allocate most forms of casualty insurance on multi-state risks, instead allocating 100% of that premium to the insured's home state.

NIMA also authorizes participating states to establish a clearinghouse for the receipt and dissemination of premium tax and transaction data related to non-admitted insurance of multi-state risks. NIMA's clearinghouse function as a tax-sharing mechanism has been delayed at least until July 1, 2012. Of most importance to brokers handling multi-state risks, 11 states and Puerto Rico have now signed on to NIMA. Nebraska, an initial signatory, subsequently withdrew from NIMA citing conflicts with Nebraska law.

NIMA's initial proposed allocation formulas applicable to all casualty insurance premiums were criticized as unduly burdensome and unworkable. The National Association of Professional Surplus Lines Offices, Ltd. (NAPSLO) has criticized this requirement, noting that most states did not previously require such allocation on casualty lines that "do not generate state-specific data in the normal course of business," such as products liability, D&O, E&O and others.[1] NAPSLO further commented that for such casualty lines, the

> vast majority of state laws require allocation of taxes on premium that is 'properly allocable' to a state. Most surplus lines brokers construed the term 'properly allocable' to mean that taxes on casualty premium should be allocated to the home state of the insured because that is where the exposure resides for a casualty risk. The corporate headquarters is intuitively where a liability exposure resides. There is no other more appropriate method of allocating casualty premium.

[1] NAPSLO, Why NAPSLO Opposes the NAIC's Nonadmitted Insurance MultiState Agreement (NIMA), January 2011, available at http://www.napslo.org/imispublic/Content/NavigationMenu/Publications/Newsletters/January2011/NIMAJan11.htm.

The competing proposal for state coordination of multistate surplus lines tax allocation, the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT), offers a compromise position on the casualty allocation issue. SLIMPACT would require allocation of casualty premium in cases where the underwriter allocated premium according to risk exposures in various states when underwriting the risk, but would not otherwise require allocation of casualty business. That is, taxes will only be allocated to the home state unless the policy at issue is rated on a state-specific or location-specific basis. NAPSLO has commented that this allocation proposal, offered by Kentucky, "reflects common industry practice that allocates casualty premium on a general liability and medical practice premium when the policy is rated based on state specific data." So far, nine states have signed onto SLIMPACT. This issue will continue to be debated in 2012.

Still other states, such as New York, have amended their laws to require 100% payment of surplus lines premium tax to the state where it is the insured's home state without current provision for allocation with other states.

b. Reinsurance

The NRRA also addresses states' extraterritorial regulation of a US ceding insurer's ability to take credit for reinsurance, and the solvency regulation of US reinsurers.

The NRRA makes the US reinsurer's state of domicile the sole regulator of the reinsurer's financial solvency if the state of domicile is an NAIC-accredited state (or has substantially similar financial solvency requirements), and no other state may require the reinsurer to provide financial information other than that required by its state of domicile. This is intended to encourage single state regulation and reporting that will ultimately be shared among states where the reinsurer is licensed.

Notably, the NRRA prohibits a state in which a US ceding insurer is licensed, but not domiciled, from denying credit for reinsurance if the ceding insurer's domestic state recognizes credit for reinsurance for the insurer's ceded risk and is an NAIC-accredited state (or has

substantially similar financial solvency requirements). As noted in Section VI, B.1. below, the NAIC has addressed more specifically various aspects of a US ceding insurer's credit for reinsurance regulation through the adoption of amendments to the NAIC Credit For Reinsurance Model Act.

2. Dodd-Frank Staffing Updates

Dodd-Frank established three insurance-related positions in the federal government, all of which are now filled. The three positions are: (1) Director of the FIO; (2) a state insurance commissioner to serve in an advisory capacity as a nonvoting member of the Financial Stability Oversight Council (FSOC); and (3) a presidentially appointed insurance expert to serve as a voting member of the FSOC.

The FIO Director, former Illinois Insurance Director Michael McRaith, was appointed to the FIO by Treasury Secretary Geithner in March 2011 and assumed office in June 2011. Missouri Insurance Director John Huff was selected by the NAIC in September 2010 to serve as the nonvoting state insurance commissioner representative on the FSOC. Finally, President Obama appointed S. Roy Woodall, a former Kentucky Insurance Commissioner and Treasury Department official, as the FSOC's voting member with insurance expertise in June 2011. Mr. Woodall's nomination was confirmed by the Senate on September 26, 2011.

In 2011, the Department of Treasury established the Federal Advisory Committee on Insurance (FACI), intended to be a forum of state insurance regulators, members of the insurance industry, academics and consumers, to advise the FIO. FACI held its first meeting on March 30, 2012. Director McRaith appointed Brian Duperreault, president and CEO of Marsh & McLennan Cos. Inc., as chair of the committee.

The FIO was directed by the NRRA to conduct a study and submit a report to Congress by January 21, 2012 on how to modernize and improve insurance regulation in the United States. Considerations for development of the report contained in the NRRA include: systemic risk regulation for insurance; capital standards; consumer protection; existing national uniformity of state regulation; regulation of insurers and affiliates on a consolidated basis; international coordination of insurance regulation; costs and benefits of Federal regulation of insurance (except health insurance); feasibility of regulating only certain lines of insurance at the federal level; and the potential consequences of subjecting insurance companies to a federal resolution authority, including the effect such authority would have on the operation of the state insurance guaranty fund systems. That report has not yet been issued and is keenly anticipated.

Under Dodd-Frank, the FIO was also directed to submit two reports to Congress regarding reinsurance: by September 30, 2012 , the FIO must submit a report on the global reinsurance market and "the critical role it plays in supporting insurance in the United States," and, by January 1, 2013, the FIO must report to Congress on the impact of the reinsurance reforms included in the NRRA "on the ability of state regulators to access reinsurance information for companies regulated in their jurisdictions."

3. Financial Stability Oversight Council's Final Rule Regarding Designation of Nonbank Financial Companies

On April 3, 2012, the FSOC released a final rule (the Release) and interpretive guidance (the Guidance, and together with the Release, the Final Rule) implementing Section 113 of Dodd-Frank, for determining whether certain insurance companies, asset managers, investment advisers, private equity funds, hedge funds, nonbank lenders and other financial services companies will be deemed systemically important financial institutions (SIFI). Section 113 grants the FSOC the authority to subject certain US and foreign companies "predominantly engaged in financial activities"[2] (collectively, nonbank financial companies) to enhanced supervision by the Board of Governors of the Federal Reserve System (the Federal Reserve) and to prudential standards that, as currently proposed, include risk-based

[2] Section 102(a)(6) of Dodd-Frank generally defines a nonbank company as "predominantly engaged in financial activities" if 85 percent of its annual gross revenues or 85 percent of its total consolidated assets are derived from activities that are financial in nature.

capital and leverage requirements, liquidity standards, risk management requirements, single counterparty credit limits, stress testing requirements and debt-to-equity limits, among others.[3]

Dodd-Frank requires the Federal Reserve to issue regulations defining when a company is "predominantly engaged in financial activities."[4] In a notice of proposed rulemaking issued on April 2, 2012, the Federal Reserve proposed to define "financial activities" to mean all activities that are listed as permissible activities for bank holding companies under Section 4(k) of the Bank Holding Company Act and Regulation Y.[5] The proposed definition includes 34 enumerated activities identical to those described in Section 4(k) and implementing regulations, but without regard to the limiting conditions imposed on bank holding companies that do not define the activity itself. If adopted as proposed, the rule's very broad application would likely meet the Federal Reserve's stated goal of capturing as many companies as possible within the definition of "nonbank financial company," making them potentially subject to Section 113 of Dodd-Frank and implementing regulations, including the Final Rule.

The Final Rule incorporates the following: (1) a three-stage process for evaluating each nonbank financial company, culminating with the FSOC's identification and designation of certain nonbank financial companies that pose a threat to the financial stability of the United States; (2) applying quantitative metrics in Stage 1 and at other times during the process; (3) applying a six-category framework using a combination of quantitative metrics and qualitative analysis in Stage 2; (4) using in-depth analysis in Stage 3 to evaluate a nonbank financial company's potential to pose a threat to US financial stability; (5) adopting policies and procedures to govern the determination process, including timing, notice and information requirements; and (6) including significant detail, analytical criteria and interpretive explanation in the Guidance. The Final Rule adopts incremental changes and clarifications to the second notice of proposed rulemaking and interpretative guidance issued on October 18, 2011[6], including how certain evaluation criteria will be applied to particular industries, such as insurance companies, asset managers and investment advisers. The key elements of the three-stage evaluation process are summarized below.

Stage 1 – Quantitative Analysis.

Stage 1 identifies which companies will receive company-specific evaluation by evaluating whether they meet a size threshold of $50 billion in assets and any one of five other thresholds. Under the $50 billion threshold, (i) each US nonbank financial company will be evaluated using its global total consolidated assets and (ii) each foreign nonbank financial company will be evaluated using its total assets based solely on its US operations. If it meets the size threshold, a company will then be evaluated applying five additional thresholds: credit default swaps outstanding, derivative liabilities, total debt outstanding, leverage ratio and short-term debt ratio. If it meets any one of these five thresholds, the company will automatically qualify for further evaluation in Stage 2.

The Stage 1 quantitative metrics will be uniformly applied to all nonbank financial companies. The FSOC has identified specific industries for which the proposed metrics may not adequately identify the appropriate companies for continued review and has acknowledged that it will consider the relevant factors specific to each industry when applying the Stage 1 metrics.[7] In addition, the FSOC will periodically review and assess the quantitative thresholds as new data

[3] On January 5, 2012, the Federal Reserve released a notice of proposed rulemaking seeking public input regarding the development of enhanced prudential standards applicable to "covered companies" to implement Section 165 of Dodd-Frank. As proposed, "covered companies" includes all US and foreign nonbank financial companies designated by FSOC under Section 113 of Dodd-Frank and its implementing regulations contained in the Final Rule. The public comment period has been extended until April 30, 2012. 77 FR 594.

[4] Section 102(b) of Dodd-Frank.

[5] The Federal Reserve's April 2 release amends the original notice of proposed rulemaking issued by the Federal Reserve on February 11, 2011, which stopped short of including a specific definition of "financial activities."

[6] 76 FR 64264.

[7] These industries include financial guarantors, asset management companies, private equity firms and hedge funds.

becomes available over time, and may adjust thresholds.[8] Critically, if the FSOC determines that the quantitative thresholds in Stage 1 inadequately assess the ways in which a particular company might pose a threat to US financial stability, the FSOC may evaluate that company based on company-specific qualitative or quantitative factors.

Stage 2—Application of Six-Category Framework.
Stage 2 focuses on the potential threat each individual nonbank financial company could pose to US financial stability. The FSOC will apply a six-category framework using a combination of quantitative metrics and qualitative analysis to assess the impact of the nonbank financial company's material financial distress on the broader US ceconomy and the vulnerability of the nonbank financial company to financial distress. The Stage 2 analysis will be based solely on information available to the FSOC from public or regulatory sources, including information obtained from the company's primary financial regulatory agency or home country supervisor and information provided voluntarily by the company.

Stage 3—In-Depth Analysis and FSOC Determination.
At the conclusion of Stage 2, each company marked for evaluation in Stage 3 will receive notice that it is under consideration for a proposed determination. In that notice, the FSOC will likely include a request to the company to provide certain quantitative and qualitative information, including confidential business information, that the FSOC deems relevant to its evaluation. In the final stage of the three-stage evaluation process, the FSOC will conduct a detailed, in-depth review of each company, focusing on whether that company could pose a threat to US financial stability due to its material financial distress or the nature, scope, size, scale, concentration, interconnectedness or mix of its activities.

[8] For example, as more data becomes available in connection with additional regulations promulgated by the SEC and CFTC regarding swap transactions, FSOC will promulgate new quantitative metrics to more appropriately measure each company's derivative liabilities.

B. NAIC's Solvency Modernization Initiative

1. Reinsurance Collateral Reform

After more than 12 years of debate, in November, 2011, the NAIC finally adopted amendments to its Credit for Reinsurance Model Law and Regulation (the NAIC Credit for Reinsurance Model Act) to implement reinsurance collateral reform. In large part these changes follow the concepts embodied in the regulations adopted by New York last year (see Part 125 of Title 11 of the Official Compilation of Codes, Rules and Regulations of the State of New York (Regulation No. 20) (2010)), but unlike New York's regulations, which do not apply to credit for reinsurance of risks involving life insurance, the NAIC Credit for Reinsurance Model Act applies to property/casualty and life insurer alike.

A principal focus of the amended NAIC Credit for Reinsurance Model Act is the establishment of a mechanism under which a domestic ceding insurer may take full reinsurance credit when the reinsurer posts less than 100% collateral for reinsurance obligations. Under the amended NAIC Credit for Reinsurance Model Act, collateral requirements may be reduced for international reinsurers meeting certain criteria as to financial strength and reliability when such reinsurers are domiciled in countries that are found to have strong systems of domestic insurance regulation. Such reinsurers would be eligible to apply for "certified reinsurer" status in the states that have adopted the amendments to the NAIC Credit for Reinsurance Model Act and approved reinsurers would be permitted to post collateral at reduced levels.

While the amendments to the NAIC Credit for Reinsurance Model Act do not result in full mutual recognition between well-regulated countries, this process of mutual recognition is being enhanced by the NAIC's efforts to create a list of "qualified jurisdictions," which individual states will be required to consider when approving jurisdictions in this context. At the NAIC's national meeting in March 2012, the Reinsurance (E) Task Force established a drafting group that was charged with developing a process to review non-US jurisdictions, including consideration of budgetary and resource requirements.

It is important to note that any new collateral levels apply on a prospective basis only – existing liabilities must continue to be funded with 100% collateral. And, as noted above in connection with the NRRA, only the cedent's domestic state regulator may set the standards for such insurer's ability to take credit for reinsurance. In addition, these new standards can come into effect only on a state-by-state basis. Each state legislature must enact the amendments to the Credit for Reinsurance Model Act before the standards can become operative in that state. Prior to the adoption of the amendments to the Credit for Reinsurance Model Act, four states (Florida, Indiana, New York and New Jersey) enacted the necessary legislative amendments to their respective credit for reinsurance laws, building on proposals of the NAIC and the credit for reinsurance provisions in Dodd-Frank. Nevertheless, any immediate practical effect will be limited, because the substantial majority of the states have yet to act, and the changes are not mandatory – states have the option of retaining a 100% funding requirement if they choose to do so. It remains to be seen which states will introduce the amendments during the 2012 legislative session.

At the NAIC's national meeting in March 2012, the Reinsurance (E) Task Force also discussed the steps necessary to assist the states in implementing these provisions, including developing related accreditation standards. More specifically, the Reinsurance Task Force released an initial draft of proposed key elements of the models for the purpose of updating the standards for reinsurance ceded under the Financial Regulation Standards and Accreditation Program. For the time being, only Part A key elements for the reinsurance ceded standard under the NAIC accreditation program, which address state laws and regulations, have been developed. Recommendations regarding Part B standards, which address state practices and procedures in financial solvency regulation, are to be considered at a later date. The Reinsurance Task Force intends to again discuss these key elements during an open conference call to be held prior to the NAIC's 2012 summer national meeting in Atlanta. Following the ultimate adoption by the Reinsurance Task Force of the key elements, recommendations will be sent to the F-Committee for consideration. Typically, this would be followed by a one-year exposure period prior to consideration for adoption, with such standards ultimately becoming effective two years following their adoption by the NAIC. However, a more expedited implementation of these standards is expected.

The Reinsurance Task Force also established a drafting group to develop the processes applicable to an advisory group that will be formed to support and assist states in the review of reinsurance collateral reduction applications. Finally, the revised NAIC Credit for Reinsurance Model Act will impose new annual reporting requirements on certified reinsurers domiciled outside the US, which forms must be filed with the domiciliary state of the ceding insurer. The Reinsurance Task Force is currently working to develop reporting instructions with respect to these Forms CR-F (for property/casualty reinsurers) and CR-S (for life and health reinsurers).

2. Principles Based Reserving for Life Insurers

Since 2005, the NAIC has been working on replacing the current formulaic approach that life insurers are required to use in establishing reserves with a "principles based" approach, in which actuarial judgment and the economic risks faced by each insurer will have greater weight on a company's reserves than will formulas. There are two key aspects of this effort: amending the standard valuation model law (with the authority for insurers to use principles based reserving) and adopting a Valuation Manual, with the detailed guidance from regulators as to how insurers are to conduct principles based reserving.

The NAIC adopted an amended standard valuation law in 2009, but introduction of the amended law in state legislatures has been on hold while the Valuation Manual was completed. Efforts to complete the Valuation Manual continued throughout 2011.

In particular, during 2011 the NAIC conducted an "impact study" of the provisions of the Valuation Manual, which led to certain adjustments in the terms of the Valuation Manual. At the NAIC's national meeting in March 2012, the Life Actuarial Task Force adopted amendments to the Valuation Manual and exposed it for public comment. The objective of the Life Actuarial Task Force is to adopt the Valuation Manual in June 2012. If that occurs, it is possible that the Valuation Manual could be adopted by the NAIC's Plenary Committee during 2012, which would then allow the individual states to begin the process of implementing principles based reserving by introducing the amended standard valuation law in their legislatures by 2013.

However, while the NAIC clearly remains committed to adopting principles based reserving, new issues continue to arise. For example, the details of how insurers are to conduct principles based reserving that are reflected in the Valuation Manual may contain too many formulaic elements to attract the political support of the industry that will be needed to get state legislatures to adopt the amended standard valuation law. Although well-meaning regulators continue to work diligently on this issue, implementation of principles based reserving is still not likely to occur anytime soon.

3. Amendments to NAIC Model Insurance Holding Company System Regulatory Act and Regulation

In late 2010, the NAIC adopted amendments to the Model Insurance Holding Company System Regulatory Act and Regulation (the Model HCA Amendments) to respond to perceived gaps in the regulation of insurance holding company systems. These changes, which will become effective in each state as they are enacted by the state legislatures and insurance departments, will increase group-level reporting to state insurance regulators. It is currently anticipated that in order to obtain or maintain accreditation status, states will be required to implement the significant elements of the Model HCA Amendments by January 1, 2016, although states may act prior to this deadline.

The Model HCA Amendments are intended to strengthen the insurance regulator's review/access to group affiliate information and enhance regulation of individual entities to protect against enterprise risk. The Model HCA Amendments include the following key elements:

- additional information required for Form A (acquisition of control) filings (i.e., three-year financial projections of the domestic insurer, third party background checks for the directors, executive officers and 10% shareholders of the acquiring party);
- consolidated hearings permitted in connection with acquisitions of control requiring the approval of more than one insurance commissioner;
- 30-day deemer for disclaimer of affiliation requests and administrative hearings permitted upon request in the event of disallowance of a disclaimer request;
- prior notice required for the proposed divestiture of a controlling interest in a domestic insurer;
- annual representation from the domestic insurer's board of directors with respect to corporate governance and internal controls;
- prior approval required for additional types of affiliate transactions (e.g., reinsurance pooling agreements, tax allocation agreements) and notification following termination of previously filed affiliate agreements;
- filing of a Form E pre-acquisition statement with a domestic insurer's home state prior to filing of Form A; and
- enterprise risk report required to be filed annually by the ultimate controlling person of every insurer subject to registration, which report shall identify the material risks within the insurance holding company system that could pose enterprise risk to the insurer.

To date, five states (Indiana, Kentucky, Rhode Island, Texas and West Virginia) have enacted legislation adopting amendments to their respective holding company system acts that are substantially similar to the Model HCA Amendments. Additional states have introduced legislation in 2012 incorporating portions or all of the Model HCA Amendments, many of which are currently pending.

4. Enterprise Risk Management Framework and Own Risk and Solvency Assessment

As noted above, the Model HCA Amendments require the ultimate controlling person of an insurer to file an enterprise risk report identifying the material risks within the insurance holding company system that may pose enterprise risk to the insurer. As described below, state insurance regulators have been moving rapidly on requirements for insurers to establish and maintain an enterprise risk management (ERM) framework in order to establish processes at the insurer level to assess and report on the adequacy of its risk management and solvency position. The most notable action in 2011 was the NAIC's adoption of the Own Risk Solvency Guidance Manual (Guidance Manual) as a step towards formalizing a requirement for insurers meeting certain size thresholds to conduct an Own Risk and Solvency Assessment (ORSA) and provide reports to their domiciliary regulator. The NAIC's ORSA proposal would require each US insurer with premium exceeding the Guidance Manual's exemption threshold, or insurance group on behalf of its subsidiary insurers, to regularly conduct an ORSA to assess the adequacy of its risk management and current (and likely future) solvency position, internally document the process and results and provide a high-level summary report annually to the domiciliary regulator, if requested. Each insurer's ORSA process will be unique, reflecting its business, strategy and approach to ERM. State insurance regulators recognize this and plan to use insurers' reports to gain a high-level understanding of the ERM process, the prospective risks to each insurer's plan and the adequacy of capital for the risks identified. New York, for example, recently released a circular letter (Circular Letter 2011-14 (December 19, 2011)) defining "enterprise risk" as "any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole." This Circular Letter goes on to identify certain components that constitute an effective ERM system, including: an ERM function, headed by an appropriately experienced and authorized person with adequate resources and access to the board and senior management, sufficient to permit ongoing assessments of the insurer's risk profile to be delivered to the board and to senior management; a written policy delineating the insurer's risk/reward framework, risk tolerance levels and risk limits; a process for identifying and quantifying risks, supported by appropriately detailed documentation, including solvency assessments and stress testing; and the performance of an ORSA.

While insurers are required to complete the ORSA, the Guidance Manual provides both insurers and state regulators with guidance as to what an ORSA may entail. The Guidance Manual recommends that an insurer's ORSA filing include three distinct sections: (i) a description of its risk management policy; (ii) quantitative measurements of its risk exposure in normal and stressed environments; and (iii) a group economic capital and prospective solvency assessment that documents how the insurer combines qualitative elements of its risk management policy and the quantitative measures of risk exposure in determining the level of the financial resources needed to manage its business over the long-term business cycle (e.g., two to five years).

In addition, the Guidance Manual recommends that an insurer's ERM framework consider, at a minimum, the following key principles:

- A governance structure that clearly defines and articulates roles, responsibilities and accountabilities; and a risk culture that supports accountability in risk-based decision-making.

- A risk identification and prioritization process that is key to the organization; clear ownership of this activity; and a risk management function that is responsible for ensuring that the process is appropriate and functioning properly at all organizational levels.

- A formal risk appetite statement, and associated risk tolerances and limits that are foundational elements of the insurer's risk management; and board of directors understanding of the risk appetite statement, which ensures alignment with risk strategy.

- Risk management and controls that are an ongoing enterprise risk management activity, operating at many levels within the organization.

- Risk reporting that provides key constituents with transparency into the risk management processes and facilitates active, informal decisions on risk taking and management.

Most recently, at the NAIC's national meeting in March 2012, the NAIC approved a request to commence drafting of a stand-alone model law that would make ORSA a legal requirement (the ORSA Model Act). The Group Solvency Issues Working Group of the NAIC is working with the industry to review and consider public comments to the ORSA Model Act, which is currently contemplated to become effective in 2015.

5. Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)

The NAIC is also supporting the development of ComFrame with the involvement of its International Insurance Relations (G) Committee (IIRC). Among IIRC's charges for 2012 is the participation in the work of the International Association of Insurance Supervisors (IAIS), including ComFrame, by attending committee and task force meetings; assisting with the drafting of, and commenting on, papers; and attending IAIS conferences and meetings.

ComFrame is being developed by the IAIS as a way for insurance regulators around the world to cooperate in the supervision of internationally active insurance groups (IAIGs) and to holistically address risks arising in IAIGs. ComFrame is intended to take into account the businesses and structures of IAIGs from a risk management perspective and to impose both quantitative and qualitative requirements on IAIGs. The main goals of ComFrame are to develop methods of operating group-wide supervision of IAIGs in order to make group-wide supervision more effective, to establish a comprehensive framework for international regulators to address group-wide activities and risks, and to foster a global convergence on the issue. It is expected that ComFrame will be developed over a period of three years, after which time the IAIS will test the impact of its implementation and adjust accordingly. See further discussion of the IAIS and the globalization of insurance regulation below.

C. International Developments

While there were other developments in individual countries, the major European regulatory issue in 2011 was Solvency II and its implications for both EU and non-EU insurers.

1. Solvency II

Solvency II empowers the European Commission to assess whether the insurance regulatory regime of a non-EU country is equivalent to Solvency II for three purposes: (i) reinsurance, (ii) group solvency and (iii) group supervision. The intention is to ascertain whether the non-EU country's system of insurance regulation provides a similar level of policyholder and beneficiary protection as Solvency II. The equivalence assessments will affect reinsurance collateral requirements for non-EU reinsurers that reinsure EU cedents, as well as group capital requirements and other compliance requirements generally for non-EU groups with EU subsidiaries and non-EU subsidiaries of EU groups. However, a finding of non-equivalence of a non-EU jurisdiction could also potentially impact the corporate

structure and supervision of an insurance group headed there. In these cases, Solvency II would allow the insertion of a sub-holding company in a non-EU jurisdiction that is deemed equivalent, and for that equivalent regime to be applied in relation to the sub-group that results. Absent such a step, Solvency II provides for two possibilities. Either (i) the principles of group solvency and group supervision set out in Solvency II shall be applied to the entire group or (ii) the EU supervisors may apply "other methods" to ensure appropriate supervision of the insurers in the group. These "other methods" are not specified, but an example is given of a requirement to establish an EU insurance holding company and to create an EU sub-group that is subject to the group solvency and group supervision requirements contained in Solvency II, including the requirement for an EU group supervisor.

The Commission asked the European Insurance and Occupational Pensions Authority (EIOPA) to assess a first wave of countries – namely Bermuda and Switzerland (in all three areas) and Japan (reinsurance only) – for suitability to be granted equivalent treatment in the specified areas. EIOPA has duly provided the Commission with its final advice, advising that all three countries largely meet the requirements in the specified areas (although subject to qualifications and caveats in some regards). The timings for the Commission's final decision on equivalence for these first wave countries is uncertain but is expected in any event before Solvency II comes into force. EIOPA has stated that it will undertake equivalence assessments for the second wave of three countries (which have yet to be selected) from 2011 to 2012, and for the third wave of three countries from 2013 to 2015. The most noteworthy omission from the recommended first wave of countries to be assessed is the United States. EIOPA based its recommendation that the United States be excluded from the first wave of equivalence assessments on the fact that day to day regulation of the insurance industry remains at the individual state, rather than the federal, level.

Transitional arrangements for eligible countries not included in the first wave of equivalence assessments are expected to be adopted as part of the "Omnibus II" directive, which is expected to be adopted in 2012 (see below). Countries included in the transitional arrangements are expected to receive the same benefits as if a positive finding on equivalence had already been made. There is substantial debate and uncertainty over these transitional arrangements and it is unclear how long such arrangements will remain in place – some are advocating for five years; others for ten years.

While the United States has been considered to be a primary candidate for inclusion in the transitional arrangements, new questions have arisen over whether the United States will engage in the process by which the transitional rules are applied. Further, Solvency II has created significant friction between US and EU regulators. US regulators are concerned about the reliance on internal models, the equivalence assessment process, and the rules for group supervision, among other issues. US regulators have even referred to Solvency II as an experiment and have resisted embracing it as the new gold standard of solvency regulation, as some countries have done. US regulators are also concerned that the EU will attempt to export these new solvency rules to other markets.

Although Solvency II was originally stated to have become effective by October 31, 2012, a revised implementation date will be contained in the so called "Omnibus II" directive expected in 2012. There is a widely held belief that Omnibus II will introduce a two phase approach whereby Solvency II will come into effect on January 1, 2013, but firms will not be required to comply with it in full until January 1, 2014. In addition, Omnibus II is expected (among other things) to introduce a series of transitional provisions in specific areas that may extend beyond January 1, 2014. The detail of the Solvency II project will be set out in so-called "delegated acts" and binding technical standards that will be issued by the Commission and will be legally binding. Again, the timing for adoption of these measures has been subject to delays and is currently uncertain.

It is worth noting that Solvency II has been in process for more than ten years and the costs of implementation thus far have been quite substantial. The further delay in implementation has caused some to question when and how Solvency II will ultimately be implemented. There are ongoing concerns about the capital requirements that will be required by the standard model and whether European insurers and regulators will be ready to use internal models as an alternative.

2. United Kingdom – New Prudential Regulator

The UK coalition government has introduced detailed proposals for a radical restructuring of the regulatory regime for financial services in the UK. The current proposals are contained in a consultation paper issued by HM Treasury. This consultation paper attached a draft bill that would, if passed into law, have the effect of amending the Bank of England Act 1991, the Banking Act 2009 and the Financial Services and Markets Act 2000. These amendments are intended to become effective at the end of 2012, which would mean that they would coincide with the planned implementation of Solvency II. Seen as a response to the financial crisis, the proposals involve the abolition of the UK's Financial Services Authority (FSA) and the establishment in its place of a new system based on the following components: a new macro prudential regulator, the Financial Policy Committee (FPC), to be established within the Bank of England, responsible for setting macro financial services policy and monitoring systemic risks; a new prudential regulator, the Prudential Regulation Authority (PRA), to be established as a subsidiary of the Bank of England with the intention that it can draw on the financial sector expertise of the Bank but remain operationally independent; and a new conduct of business regulator, called the Financial Conduct Authority (FCA) to focus on ensuring confidence in the wholesale and retail financial markets with particular focus on protection of consumers and the creation of a new single agency responsible for tackling serious economic crime.

The division of responsibilities between these new organizations has yet to be finalized and the HM Treasury will release further detail in 2012; however, it is expected that insurers and reinsurers will be regulated both by the PRA (for prudential issues) and the FCA (for conduct of business issues), whereas insurance intermediaries will be regulated by the FCA only. Consistent with this, it is expected that The Society of Lloyd's and Lloyd's managing agents will be regulated by both the PRA and the FCA whereas Lloyd's members' agents and Lloyd's brokers will be regulated by the FCA only. Insurers and reinsurers will therefore have to deal with multiple regulators, including the PRA for prudential matters such as solvency capital levels and new authorizations; the FCA for conduct of business issues; and the new financial crime agency. Further, while insurers may well argue that they do not pose the same level of systemic risk as the banking industry does, they should nonetheless monitor the work of the new FPC and assess the effects of macroeconomic policy on the industry.

An interim financial policy committee has already been established to begin monitoring systemic risk and advise the UK Government on potential macro-prudential tools. The FSA and Bank of England have begun the process of splitting out prudential from conduct of business regulation within the FSA as a precursor to the establishment of the new regulatory structures. It is intended that the FSA will continue to operate pending the implementation of the new regime, although internally it will move to a shadow PRA and shadow FCA structure in advance of implementation. The current CEO of the FSA, Hector Sants, will become a member of the FPC and CEO of the PRA, ensuring a degree of continuity between the old and the new regime.

3. The IAIS and the Globalization of Insurance Regulation

Global expansion of the insurance industry, the cross-border effects of the financial crisis and the natural affinity between insurance regulators has led to an increasingly interconnected world of insurance regulation. This is reflected most clearly in the agenda and actions of the IAIS.

VI. Regulatory Developments Affecting Insurance Companies

Established in 1994, the IAIS now has insurance regulators and supervisors from approximately 140 countries as members. Originally, the IAIS was established as a forum in which regulators could meet and exchange views and news. It was also intended to assist in the development of emerging regulatory regimes.

Today, the IAIS is flexing its regulatory muscle and has become one of the leading voices in the evolution of insurance regulation. Although this is partly a natural progression, the financial crisis and demands by the G-20 and other governmental entities for an institution to be the focal point for global insurance regulation has turbocharged the IAIS. The IAIS is now an active member in the Joint Forum (along with the Basel Committee on Banking Supervision and the International Organization of Securities Commissions) and is represented on the Financial Stability Board and many other international regulatory associations.

2011 was an active year for the IAIS. It issued a revised set of its Insurance Core Principles, issued an important ComFrame concept paper and launched a working group and data collection exercise focused on identifying systemically significant insurance groups.

The ComFrame concept paper, which was issued on July 1, 2011, identified five primary areas of focus, each of which is referred to as a "Module". These Modules are described as follows:

Module 1 – Scope of Application.
This Module is intended to establish criteria for the definition of "group", to identify IAIGs and to determine the scope of ComFrame supervision.

Module 2 – Group Structure and Business.
This Module is intended to assess, from a risk management perspective, IAIG legal and management structures, IAIG business and business mix, and intra-group transactions and exposures. This Module is also intended to address contingency planning for stress conditions of the IAIGs and approaches regarding policyholder protection schemes.

Module 3 – Qualitative and Quantitative Requirements.
This Module focuses on requirements relating to the corporate governance framework, ERM, assets and liabilities, valuation and capital adequacy.

Module 4 – Supervisory Cooperation and Interaction.
This Module involves the development of a principle of coordination and interaction among insurance supervisors, the identification of group-wide supervisors and their roles, as well as the use of supervisory colleges, the supervisory process and review, crisis management, supervisory reporting and public disclosure generally.

Module 5 – Jurisdictional Matters.
This Module relates primarily to the applicability of ComFrame to jurisdictions governed by the IAIS, and to the study of peer review and peer assistance mechanisms and a ComFrame data compilation mechanism.

In mid-2011, the IAIS also established a Supervisory Forum, which is intended to enhance cooperation among regulators and convergence of supervisory practices. The Supervisory Forum will focus on large insurers and insurance groups.

As to be expected, the expanding role and array of issues being addressed by the IAIS has not been without tensions and concerns. Issues such as regulatory convergence and regulation of international groups give rise to significant debates over preferred systems of regulation and the specter of loss of control and influence – for regulators and industry.

The role and influence of the US insurance regulators at the IAIS has also undergone its own evolution. The IAIS is run by a 24-member Executive Committee, on which the United States has three seats. In its early years, the United States was by far the most influential member country. Often, the NAIC president was also president of the IAIS. For many reasons, the balance of power and influence within the IAIS has migrated, in part, to Europe. Japan and certain other countries have also emerged as influential forces within the IAIS.

The establishment of the FIO has also added a new wrinkle to the IAIS. Pursuant to Dodd-Frank, the FIO was to be the US representative on international issues and specifically, the US representative at the IAIS. For reasons that are not entirely clear, at the IAIS annual meeting in Seoul, Korea this Fall, the FIO director, Michael McRaith, was not elected to the IAIS Executive Committee. Rather, the three seats on the IAIS Executive Committee reserved for the United States remained in the hands of state regulators and the NAIC. It will be interesting to see how this dynamic plays out in 2012.

In addition to activity within the IAIS, insurance regulators are increasingly working on a bilateral or multilateral basis. This is most clearly seen in the US/EU regulatory dialogue, the number of memoranda of understanding that have been entered into among US and EU regulators, and among other regulators. The net result is that echoes of regulatory developments in Brussels will be heard in New York, California or Japan and vice-versa and means that insurers must enhance their ability to monitor and participate in debates over regulatory developments in many forums.

D. New York Developments

1. New York Department of Financial Services

October 3, 2011 marked the official reorganization of the New York Insurance Department and Banking Department into a single state agency – the resulting body being the New York Department of Financial Services (NYDFS). Benjamin Lawsky is the Superintendent of the new agency. Robert Easton has returned to serve as Executive Deputy Superintendent of the Insurance Division and Joy Feigenbaum is serving as Executive Deputy Superintendent of the Financial Frauds and Consumer Protection Division. The reorganized New York Department is comprised of five main divisions:

- The Insurance Division carries on the core functions of regulating all insurance activities in New York, including life, property and health insurance.
- The Banking Division continues regulating state chartered banks, along with other financial services providers such as mortgage servicers and originators, check cashers, money transmitters and budget planners.
- The Financial Frauds and Consumer Protection Division brings together the fraud and consumer units of Banking and Insurance, but also adds important new powers, including the ability to conduct investigations, research, studies and analyses of issues affecting consumers of most financial products and services. The Division protects and educates consumers of financial products and services and fights financial fraud. In addition, the Division is empowered to pursue civil and criminal investigations and bring enforcement proceedings as appropriate.
- The Real Estate Finance Division focuses on all aspects of the mortgage industry to ensure that the lessons from the recent financial crisis are learned and new reforms are instituted.
- The Capital Markets Division actively monitors the latest developments and products and helps the New York Department better police systemic risk.

On December 30, 2011, Superintendent Lawsky issued a report to the Governor and New York State Legislature regarding the integration of the New York Department and identifying ways to improve the efficiency and effectiveness of regulation. The report details the establishment of the New York Department, actions to date and ongoing initiatives. These initiatives have included a campaign to require life insurance companies to regularly match their records against the Social Security Master Death File; an emphasis on increased transparency for many rates and rate changes; the deregulation of certain coverage procured for “large commercial insureds” (as further discussed below); and the NYDFS’ investigation of force-placed insurance, for which public hearings have been scheduled for May 2012.

2. Treatment of Derivatives in Insurer Insolvencies

Effective December 12, 2011, legislation was enacted to amend Article 74 of the New York Insurance Law to clarify the ability to close-out qualified financial contracts and netting agreements in the context of insurer insolvency proceedings.

A qualified financial contract is a commodity contract, forward contract, repurchase agreement, securities contract, swap agreement or any similar agreement as determined by the Superintendent by regulation. A netting agreement is a contract, including a master agreement, bridge agreement or security arrangement, that documents one or more transactions involving qualified financial contracts and provides for the netting, offset, liquidation, termination or close out of such qualified financial contracts. The amendments to Article 74 are largely consistent with the provisions of the NAIC's Insurer Receivership Model Act relating to the treatment of qualified financial contracts and netting agreements.

Under amended Article 74, "...no person shall be stayed or prohibited from exercising . . . a contractual right to cause the termination, liquidation, acceleration or close out of any obligation under a netting agreement or qualified financial contract with an insurer . . . because of . . . the insolvency, financial condition or default of the insurer at any time . . . [or] the commencement of any proceeding under [Article 74]." The amendments also provide that the Superintendent cannot avoid a transfer of money or other property arising under or in connection with such agreements made before the commencement of a proceeding, with the exception of transfers "...made with actual intent to hinder, delay or defraud the insurer."

Under prior law, if a New York insurer became insolvent, enforcement of contractual rights in qualified financial contracts and related netting agreements would be constrained by injunctions typically issued upon commencement of a delinquency proceeding (first-day injunctions) and pre-insolvency transfers of margin were subject to avoidance as preferences. As a result, insurers' counterparties and creditors faced uncertainty and/or delay in exercising remedies that would be permitted if the proceeding involved a non-insurer under federal bankruptcy law or a bank under federal or New York banking law. The ability to close-out qualified financial contracts and netting agreements without regard to the first-day injunctions and preference attacks for pre-insolvency margin transfers should result in an increased willingness on the part of counterparties to enter into derivatives with New York insurers and may improve pricing for such transactions.

Under Article 74, as amended, the date used to measure damages is the date of the enforcement of the netting provision (provided that the counterparty does not leave the contract open with the result that the Superintendent later exercises his option to reject the contract), and the amount of any claim for damages will be the "actual direct compensatory damages," defined as the normal and reasonable costs of cover or other reasonable measures of damages utilized in the derivatives, securities or other market for the contract and agreement claims, not including punitive or exemplary damages, damages for lost profit or lost opportunity, or damages for pain and suffering. The effect of the amendments is to render unenforceable provisions of walkaway or other provisions that provide that the nondefaulting party is relieved from payment upon termination of a qualified financial contract or netting agreement. If the counterparty does not immediately terminate the qualified financial contract or netting agreement, and instead leaves the transaction open, and the Superintendent later exercises his option to reject the qualified financial contract (or netting agreement, as the case may be), the counterparty's rejection damages would be treated as a pre-petition claim for "actual direct compensatory damages." Though no case law exists to determine the myriad issues that can result from rejection of a transaction, logic dictates that the counterparty's claim should be a net claim, rather than a pre-petition claim for damages in the amount due from the insurer and an obligation to pay the full amount due

to the insurer. If the Superintendent intends to transfer a qualified financial contract or netting agreement to another party, he must either transfer to one party all agreements between the insurer and a particular counterparty and its affiliates, including all related rights or obligations and all property securing the parties' claims, or transfer none of the agreements.

At the request of the New York Department, the amendments to Article 74 do not apply to financial guaranty insurers. As enacted, the amendments apply to liquidation, rehabilitation and conservation proceedings with respect to domestic, foreign and alien insurers that occur on or after the date of enactment.

3. Commercial Lines Deregulation

Effective November 15, 2011, legislation was enacted that amends Article 63 of the New York Insurance Law to broaden existing commercial lines deregulation (commonly known as the Free Trade Zone) to include policies issued to large commercial insureds that employ or retain a special risk manager to assist in the negotiation and purchase of the policy. A large commercial insured is an entity that generates annual commercial risk insurance premium in excess of $25,000 (other than for medical malpractice insurance) and meets at least one of seven specified criteria relating to net worth, gross assets, gross revenues and employees. A special risk manager is an employee of, or consultant retained by, the purchaser, who provides skilled services in loss prevention, loss reduction, or risk and insurance coverage analysis and assessment, and the purchase of insurance, who meets certain other educational and experience requirements and holds certain professional designations. The amendments also provide an exemption for insurers from filing requirements with respect to inland marine insurance policies, where by general custom of the business, the rates for such risks are not written according to manual rates or rating plans.

The amendments to Article 63 and the related regulations exempt, until June 30, 2013, policies issued through use of a special risk manager from rate and form filing requirements, other than medical malpractice insurance. Existing exemptions for risks producing premium in excess of $100,000, and for difficult to place risks as specified by the New York Superintendent of Insurance, remain in force.

In order for an insurer to avail itself of the exemptions in Article 63, it must obtain a special risk license. The amendments increase the minimum financial requirements (surplus to policyholders or trusteed surplus, as applicable) required for a special risk license (i) for authorized insurers or US branches, to 200% of authorized control level RBC, or 250% of authorized control level RBC for risks issued to large commercial insureds through use of a special risk manager, and (ii) until June 30, 2014, for domestic property-casualty insurers or reciprocal insurers (a) writing total direct premiums comprised of at least 90% medical malpractice insurance, (b) assuming reinsurance premiums in an amount that is less than 5% of total direct premiums written, and (c) writing 90% of their total direct premiums in New York, to at least twice the required minimum surplus to policyholders and at least the required minimum surplus as regards policyholders, respectively.

Notwithstanding the exemption from form and rate filing requirements, policies issued under Article 63 must otherwise comply with all applicable provisions, standards, laws and regulations. Additionally, policies must bear a legend stating that the rates and forms are not subject to filing and/or approval. The special risk manager may not be an employee of the insurer or its affiliates and, unless exempted, must be licensed as an insurance producer. Insurers must file a certificate of insurance evidencing the coverage with the Superintendent within one business day of binding coverage and a supplemental checklist and certificate form, along with a copy of the certificate of insurance previously filed, within 30 days after the inception date. Policy forms not previously filed must be filed with the Superintendent for informational purposes within three business days after first use, but no later than 60 days after the inception date.

While the broadening of commercial lines deregulation should increase the flexibility of insurers in meeting the needs of the market, they will want to pay particular attention to the operational issues associated with the new informational filing requirements.

E. National Flood Insurance Program Modernization/Extension

Both the House and the Senate acted on legislation that would reauthorize and reform the National Flood Insurance Program (NFIP), which has been operating on temporary extensions for the past several years. The House adopted a bill on July 12, 2011 that would extend the NFIP for five years while including various reforms aimed at making the program more financially sustainable. The Senate Banking Committee, meanwhile, has approved its own NFIP reform measure, which is now awaiting action on the Senate floor. Both bills include provisions requiring FEMA to examine the possibility of more private insurance market participation in the program, and specifically authorizing the NFIP to purchase private reinsurance.

Facing another pending expiration, late in the year Congress extended authorization for the NFIP temporarily through May 31, 2012. Key members of Congress have expressed optimism that the differences between the House and Senate versions of the broader reform bill can be worked out before then, thus putting an end to the series of short-term extensions of the program that have created much uncertainty in the market in recent years.

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