WILLKIE FARR & GALLAGHER LLP

NEW YORK WASHINGTON HOUSTON PARIS LONDON FRANKFURT BRUSSELS MILAN ROME

Recent Developments and Current Trends in

Insurance Transactions and Regulation

YEAR IN REVIEW 2014

January 2015

To Our Clients and Friends:

We are pleased to present our annual Insurance Transactions and Regulation **Year in Review – 2014**. In it we cover the year's most important developments in insurance transactions and regulation, including, among other topics, developments relating to mergers and acquisitions, insurance-linked securities, alternative capital, traditional capital markets transactions, corporate governance and shareholder activism, and the regulation and taxation of insurance companies, both in the United States and internationally.

2014 was an eventful year for the insurance industry, and many of the developments of the last year could be viewed as harbingers of additional changes to the state of the industry in 2015 and future periods. The year was also an exciting one for Willkie, as we were honored and fortunate to have been able to advise on transactions that placed us **#1 for insurance M&A** as ranked by *SNL* (based on both deal value and number of deals) and **#1 issuer's counsel for insurance capital markets offerings** as ranked by *Thomson Reuters*. Willkie was also ranked **Band 1 for "Insurance – Transactional and Regulatory"** by *Chambers*.

We hope that you find this Year in Review – 2014 informative. Please contact us if you would like further information about any of the topics covered in this report.

Sincerely,

The Willkie Farr & Gallagher LLP Corporate Insurance and Regulatory Group

Table of Contents

I. Review of M&A Activity in 2014

A. By the Numbers

Powered by a late-year surge in M&A activity in the non-life insurance sector, 2014 saw an increase in M&A activity in North America and Bermuda, both in terms of the number of deals announced and in total transaction value. A total of 75 life and property casualty ("P&C") insurance M&A transactions in North America and Bermuda were announced in 2014, representing over $21 billion in aggregate transaction value,[1] up from 62 transactions representing an aggregate of approximately $7 billion in transaction value announced in 2013. Twenty life insurance M&A transactions in North America and Bermuda were announced in 2014 ($12.6 billion transaction value), compared to 16 transactions announced in 2013 ($2.9 billion transaction value). Fifty-five P&C insurance M&A transactions were announced in 2014 ($8.4 billion transaction value), compared to 46 transactions announced in 2013 ($4.14 billion transaction value). Nearly half of the aggregate transaction value relating to P&C insurance M&A transactions in North America and Bermuda is attributable to transactions announced in the fourth quarter of 2014.

The largest transaction in the industry in 2014 occurred in Europe, where U.K. insurers Aviva and Friends Life agreed to a £5.6 billion ($8.8 billion) business combination that will create the largest life insurer in the United Kingdom. The general insurance sector saw less activity in Europe in 2014, although early 2015 provided the most significant deal in the Lloyd's of London listed sector in many years, with Irish domiciled XL Group plc announcing an agreement to acquire Catlin Group Limited.

1 Deal volume and value amounts in this report are from *SNL*'s database.

B. Market Trends – North America

1. Inbound Investment from Asia

Over the last several years, the direction of insurance transactions between Western companies and companies in Asia have largely flowed one-way, with Western companies diversifying by investing in Asian insurance assets. While this trend continued in 2014,[2] transactions between the two regions have also begun to flow in the opposite direction, as several insurance companies based in the Asia-Pacific region have emerged as buyers of insurance company assets in mature markets, including North America.

The most significant of these transactions—and indeed the largest and most significant life insurance transaction in North America in 2014—is Dai-ichi Life Insurance Company's $5.7 billion acquisition of Protective Life Corporation.* Dai-ichi, which is the second largest private life insurance company in Japan and one of the top 20 global life insurers, has stated that it plans for Protective Life to serve as its platform for future growth in the United States. This transaction represents Dai-ichi's initial entrance into the United States market. The Dai-ichi deal follows the acquisition in 2014 by another Japanese insurer, Sompo Japan Insurance Inc., of Guernsey-based Canopius Group Ltd.

Chinese insurers appear to have similar aspirations. In August, Fosun International entered into a definitive agreement to acquire a 20% stake in United States P&C insurer Ironshore Inc. for $464 million, and promptly followed that with an announcement in December that it had entered into a definitive agreement to buy Meadowbrook Insurance Group Inc. for about $433 million. These transactions followed closely on the heels of Fosun's first overseas purchase of an insurance asset, when in May it completed its acquisition of a Portuguese insurer for approximately $1.4 billion. In addition to Fosun, Chinese

2 See, for example, Allied World's acquisition of the Hong Kong and Singapore operations of Royal & Sun Alliance and Swiss Re's acquisition of RSA Insurance Group's Chinese operations, in addition to the several transactions where North American and European insurers acquired assets in Southeast Asia, particularly in Malaysia, Thailand and Singapore.

* Willkie Farr & Gallagher advised on this transaction.

insurer Anbang Insurance Group announced in October that it had entered into an agreement to acquire Belgian insurer Fidea from J.C. Flowers & Co.

We see a number of potential drivers of this increased attention on North American and European insurance assets from Asian insurers. In the case of the Japanese insurers, a desire to deploy their significant capital base and pressure on rates and profitability in the domestic Japanese market are driving a push toward conservative diversification into stable, mature markets. While Chinese firms may also be motivated by a desire to diversify and deploy capital, their acquiring assets in mature markets, together with the related infrastructure, business organization and personnel who are experienced in the growth and operation of insurance companies, could be part of a strategy to import that infrastructure, organization and experience into, and to spur growth in, the burgeoning and potentially large Chinese market. We expect these and other insurance and financial services firms based in the Asia-Pacific region to continue to be active in considering the acquisition of such insurance assets in the near term.

2. The Life Insurance Sector

As noted above, the largest transaction in the life insurance sector in North America in 2014 was Dai-ichi's acquisition of Protective Life. Other notable life insurance transactions in North America during 2014 were:

(i) Manulife Financial Corp.'s $4 billion acquisition of the Canadian life insurance, retirement and investment management business of Standard Life plc;

(ii) the $1.8 billion acquisition by the Canada Pension Plan Investment Board ("CPPIB") of Wilton Re Holdings Limited;

(iii) Wilton Re's C$600 million acquisition of AEGON's Canadian life insurance business;

(iv) GreyCastle Holdings Ltd.'s $570 million acquisition of a majority of XL Group plc's life reinsurance business; and

(v) the two-part transaction between New York Life and John Hancock Financial in which John Hancock has agreed to acquire New York Life's Retirement Plan Services ("RPS") business and New York Life has agreed to acquire 60% of John Hancock's demutualization-related closed block of individual participating policies.*

The Manulife transactions represent a return of Manulife to active participation in the M&A marketplace. Through the Standard Life and RPS transactions, Manulife has indicated a desire to become a major player in the pensions business in Canada, the United States and elsewhere.

The CPPIB and GreyCastle transactions are examples of the continuing trend of direct investment in the insurance industry by financial firms and providers of alternative capital. We discussed this trend in detail in our Year in Review – 2013, where we described M&A activity led by private equity firms, hedge funds and other financial firms as a positive for the industry. We continue to see these institutions as active players in insurance M&A, both in the life insurance sector, as these two transactions (along with Blackstone's acquisition of Philadelphia Financial Group for $165 million) demonstrate, and in the P&C insurance sector, as noted below. Both of these transactions also highlight the role that run-off consolidators continue to play in the industry. CPPIB's acquisition of Wilton Re allows the pension fund to be a direct player in the acquisition of in-force life insurance business, as Wilton Re has been operating in the run-off space for over a decade and was particularly active in 2014 with its acquisitions of run-off blocks from both CNO ($235 million acquisition of Conseco Life Insurance Company)* and CNA ($198 million acquisition of Continental Assurance Company), in addition to its acquisition of AEGON's Canadian life insurance business referenced above. The XL life reinsurance business that GreyCastle acquired has been in run-off since 2009.

* Willkie Farr & Gallagher advised on this transaction.

Overall, we expect that 2015 will see U.S. strategic players continue to focus on opportunities outside the United States, while insurers in the Asia-Pacific region will simultaneously be investigating investment opportunities in the life insurance sector in the United States. By and large, the Asian insurers are looking for trophy properties in the United States. Whether those properties can be found at the right price, whether their management teams are interested in a sale and thus whether this interest by Asian insurers in such properties will translate into announced M&A activity remains to be seen. We also expect that run-off consolidators will continue to be major participants in life insurance M&A in the United States as run-off properties become available. Such opportunities will come primarily from industry participants who will be looking to redeploy capital released in these transactions as well as the occasional company that, driven by ratings and capital pressures, has "thrown in the towel" and realized it will not find salvation through the capital markets or a strategic buyer. Finally, while the pace of private equity acquisitions slowed in 2014, we expect private equity and other financial buyers to continue to be active participants in the M&A market.

3. The Non-Life Insurance Sector

a) The Bermuda Reinsurance Market

For years we and other commentators have predicted that shifting dynamics in the market for reinsurance and retrocessional coverage would drive M&A activity among Bermuda companies with significant reinsurance operations. The pressures resulting from such shifting dynamics may have reached critical mass in 2014. The ILS market, the state of which we describe in greater detail below, has grown substantially in recent years, and this growth, among other factors, has caused the supply of reinsurance and retrocessional capacity to cover natural catastrophe and other risks to outpace demand significantly. This capacity surplus, along with generally favorable loss experience in the industry in recent periods, has caused some commentators to predict that the prevailing soft rate environment, and the resulting competitiveness among reinsurance providers to write new business, will last for the foreseeable future. As a result, Bermuda companies with significant reinsurance operations have been looking to consolidate in order to increase scale, thereby creating more efficient platforms with larger capital bases from which to compete for business, and to diversify operations into the primary insurance sector, into different geographic regions and into risks other than natural catastrophe risk.

Driven in part by these market realities, in the spring of 2014 Endurance Specialty Holdings Ltd. launched a $3.2 billion hostile takeover bid for Aspen Insurance Holdings Ltd.* After several months of public announcements from both companies throughout the summer aimed at swaying Aspen's shareholders on the merits of the proposed transaction, Aspen was ultimately successful in repelling the unwanted bid. We discuss this hostile takeover attempt and its defense in greater detail in Section V.E below. In general, hostile takeovers in the insurance industry remain rare, and the need to obtain insurance regulatory approvals prior to obtaining or acquiring "control" of an insurance holding company (particularly one with an admitted U.S. carrier) significantly complicates the ultimate execution of hostile takeover transactions in the industry. Nevertheless, the market pressures that are driving the need for consolidation may ultimately lead to additional hostile takeover activity or shareholder activism as a tool to bring parties to the negotiating table.

Other Bermuda reinsurers also acted to consolidate or diversify their operations in 2014. In November, RenaissanceRe Holdings Ltd. agreed to buy Platinum Underwriters Holdings Ltd. for about $1.9 billion.* RenRe has been diversifying away from its core property catastrophe reinsurance business in recent periods, and this transaction will allow RenRe to gain additional scale and to accelerate the growth of its U.S. specialty and casualty reinsurance platform. Another Bermuda reinsurer, Validus Holdings, Ltd., also announced plans to diversify its operations into the primary insurance sector by acquiring Western World Insurance Group, Inc., a direct

* Willkie Farr & Gallagher advised on this transaction.

writer of specialty insurance products in the United States, for $690 million. In December, news reports emerged that Montpelier Re Holdings Ltd. had put itself up for sale and hired a financial adviser to help it assess strategic options.[3] In January 2015, fellow Bermuda reinsurers Axis Capital Holdings Ltd. and PartnerRe Ltd. agreed to combine their operations in a "merger of equals" that would create a company with a combined market value of approximately $11 billion. The Axis/PartnerRe transaction was announced shortly after XL Group plc announced that it had agreed to purchase Catlin Group Limited. Both XL and Catlin have significant Bermuda reinsurance operations. We discuss that transaction in greater detail in Section I.C below.

2014 also saw an inbound investment in the Bermuda P&C reinsurance sector from new players, when a joint venture vehicle owned by Grupo BTG Pactual SA, a publicly traded Brazilian investment bank, and the Abu Dhabi Investment Council announced an agreement to acquire Ariel Re from Global Atlantic Financial Group Limited. The sale represents an exit by Global Atlantic from the Bermuda P&C reinsurance market. Global Atlantic has stated that it now intends to focus on its life insurance and annuities businesses.

b) North American Activity

A number of notable transactions took place in the non-life insurance sector in the United States and Canada in 2014.

In the personal lines segment, Canadian cooperative insurer Desjardins Group acquired the Canadian P&C insurance operations of State Farm, The Progressive Corporation announced an agreement to acquire a majority stake in ARX Holding Corp., a Florida-based provider of homeowners insurance, flood insurance and related lines, from a group of shareholders including a subsidiary of XL Group plc for $875 million,* and ACE Limited entered into a renewal rights agreement to acquire Fireman's Fund's high-net-worth personal lines P&C insurance business from Allianz SE for $365 million.*

The trend of acquisitions of P&C insurance and related assets by private equity firms also continued in 2014, with the $1.5 billion acquisition by TPG of The Warranty Group, Inc. from Canadian private equity firm Onex Corporation, the $2.4 billion acquisition by KKR of a majority stake in Sedgwick Claims Management Services, Inc. from a consortium of private equity investors, including Hellman & Friedman LLC and Stone Point Capital LLC, and the $138 million acquisition by The Westaim Corporation, a Canadian investment firm, and other buyers, including Catlin and Everest Re, of a majority stake in Houston International Insurance Group, Ltd.*

Regulatory changes also spurred M&A activity in the sector. In December, Radian Group, Inc. agreed to sell Radian Asset Assurance Inc., its financial guaranty subsidiary, to a subsidiary of Assured Guaranty Ltd. for $810 million.* Radian pursued the transaction in order to free up capital as it prepares for tighter oversight of its core mortgage insurance operations resulting from the private mortgage insurance eligibility requirements that were proposed by the Federal Housing Finance Agency earlier in the year. In addition, the highly regulated crop insurance industry in the United States saw two transactions in 2014, as HCC Insurance Holdings, Inc. acquired Producers Ag Insurance Group, Inc. from CUNA Mutual Group for $110 million, and Farmers Mutual Hail Insurance Company of Iowa announced an agreement to acquire John Deere Insurance Company from Deere & Company.

Run-off consolidators were also active in the P&C insurance sector in 2014. Enstar Group Limited and Catalina Holdings (Bermuda) Ltd. were each involved in a number of transactions. The most significant of these transactions are Catalina's acquisition of SPARTA Insurance Holdings, Inc.* and Enstar's $218 million acquisition of Companion Property and Casualty Insurance Company from Blue Cross and Blue Shield of South Carolina.*

3 Montpelier has not publicly confirmed these reports.

* Willkie Farr & Gallagher advised on this transaction.

Finally, 2014 saw the merger of Tower Group International, Ltd. into a subsidiary of ACP Re, Ltd., an affiliate of AmTrust Financial Services, Inc.* The transaction followed months of speculation after Tower had publicly announced significant reserve charges relating to certain of its commercial business lines.

This onshore activity in 2014 was consistent in terms of volume, type and scope with activity in recent years, and we generally expect this trend to continue in the near term. As stated above, however, attention from Asian insurers looking to expand into mature markets and Bermuda companies with significant reinsurance operations looking to diversify into primary lines of insurance business could prove to be catalysts of additional M&A activity over the next 12-18 months. The prevailing low interest rate environment, along with stronger securities markets in general, could also factor into decisions by established P&C insurance players to consider growth strategies that include increased M&A activity in future periods.

C. Market Trends – Europe

In one of the largest deals announced in 2014, U.K.-based Aviva plc and Friends Life Group Limited reached agreement in December on the terms of a recommended all-share acquisition by Aviva of Friends Life Group Limited. The announcements noted that the proposed acquisition is based on a financial and strategic rationale that would accelerate Aviva's transformation in line with its investment thesis, "cash flow plus growth." Shareholders of both companies will vote on the proposed deal at general meetings in late March 2015. The transaction takes the form of a court-sanctioned scheme of arrangement under Guernsey law requiring 75% approval of Friends shareholders (representing a majority in number) and, under the UKLA class tests for Aviva's London Stock Exchange listing, a simple majority vote of Aviva shareholders. Although Aviva has American depository receipts (ADRs) listed on the NYSE, the transaction and issuance of ordinary shares to Friends shareholders does not require SEC registration under the section 3(a)(10) exemption, as such court-sanctioned scheme of arrangement transactions can fit the conditions of such exemption. The deal announcements noted the expectation of higher cash flows enhanced by deal synergies gained principally through operating efficiencies in the combined back books and overlapping expenses. The deal is expected to increase the enlarged company's financial and strategic flexibility and support further growth of Aviva's dividends.

Following a deal leak announcement around the sensitive year-end reinsurance renewal period, Irish-domiciled XL Group plc announced that it had agreed to purchase Catlin Group Limited, a U.K.-listed group with significant syndicates and managing agency operations within Lloyd's of London and with other well-regarded international underwriting platforms. As a result of the leak announcement, the markets were not surprised when the deal was formally announced in early 2015. Following a news leak or related unusual share trading activity, there is generally very little flexibility for U.K.-listed groups such as Catlin to issue a "no comment" statement, which U.S.-listed groups might be able to do.

The XL/Catlin deal is structured as a cash and share deal worth approximately £2.8 billion ($4.2 billion). The transaction does not require the approval of XL shareholders, as XL will not be issuing more than 20% of its outstanding shares (doing so would have required a shareholder vote under applicable NYSE rules). In commenting on the XL transaction, Catlin's CEO suggested that the move was a preemptive one intended to get in front of what he and XL's CEO view as inevitable consolidation in the industry.[4] According to XL, the Catlin transaction will add immediate scale in specialty insurance, create a more efficient and more capable global network by bringing the two infrastructures together, accelerate each company's strategy and address the structural changes the parties see shaping the P&C sector. The transaction is set to close in mid-2015, with Catlin shareholders due to vote on the deal in the second quarter.

4 "XL-Catlin 'front foot' tie-up gets cautious investor welcome." *Insurance Insider*, 13 January 2015. Web. 29 January 2015.

* Willkie Farr & Gallagher advised on this transaction.

As compared to 2013, which saw seven Lloyd's businesses changing hands, the Lloyd's of London sector was less active in 2014. In addition to the Catlin deal, several of the other large transactions and offers involved targets with significant Lloyd's of London and other U.K. operations. For example, in Endurance's proxy statement appeal expressing its view of the benefits of a deal with Aspen,* Endurance noted that Aspen's "core strengths in the London insurance markets – including through Lloyd's – is an attractive area…"

The most significant stand-alone deal involving a Lloyd's business saw Qatar Insurance Company SAQ ("QIC"), the largest insurance company in the Middle East, complete its acquisition of Antares Holdings Limited, a specialist insurance and reinsurance group operating within Lloyd's and writing a range of property, casualty, marine and aviation risks and providing underwriting and claims services on a worldwide basis in mid-2014. The acquisition expanded QIC's global footprint through access to Lloyd's Syndicate 1274 and Antares's own managing agency, as well as a Bermudian platform with a Class 3 reinsurance license, accelerating QIC's plan to become a global insurance group.

Looking forward through 2015, among other strategic imperatives such as capital management and premium and investment asset growth initiatives, we anticipate that insurance groups with significant European operations will remain keenly focused on their preparations for the implementation of Solvency II in January 2016. The expected consequences of Solvency II, including higher than anticipated capital charges and higher compliance and reporting costs, may cause businesses in run-off and smaller companies (including mutual insurers) to seek a partner. Rating agencies have also noted that larger insurers are likely to benefit from their diversified lines of business under the capital charges calculated under the Solvency II regime. (*See* Section VI.L.1 below).

D. Market Trends – Latin America

Latin America continues to represent a significant growth opportunity for the insurance industry. This is evident in the significant level of insurance M&A activity experienced by the region in recent periods. This activity includes the transactions set forth below.

- ACE Group acquired the large corporate property and casualty business of Itaú Seguros, S.A. from Itaú Unibanco S.A., a transaction that will make ACE the largest commercial P&C insurer in Brazil. The acquisition is valued at approximately $630 million at current exchange rates. The parties have obtained regulatory approval and the transaction is expected to be completed in the first quarter of 2015.

- Swiss Re Corporate Solutions completed the 51% acquisition of Compañía Aseguradora de Fianzas S.A. Confianza for an undisclosed sum.* With this majority-share acquisition, Swiss Re Corporate Solutions expanded its presence in the Latin American P&C market. Confianza is the leading surety franchise in the Colombian insurance industry.

- In 2013 Swiss Re acquired an 11.1% stake in Sul América SA from ING Group N.V. and a 3.8% stake in SulAmérica from members of the Larragoiti family. The aggregate value of the acquisitions was $334 million. SulAmérica is the largest independent insurance group in Brazil and a leading provider of health and auto insurance.

- Marsh acquired a majority stake of Seguros Morrice y Urrutia S.A. (Semusa), a Panama-based insurance broker and adviser, to strengthen its position in Central America and the Caribbean. Also, Marsh recently acquired other companies in the Dominican Republic and Peru. Semusa is a leading insurance broker in Panama and has been Marsh's local correspondent for 15 years. The value of the transaction was not disclosed.

* Willkie Farr & Gallagher advised on this transaction.

- As noted above, Brazil's Grupo BTG Pactual SA, the largest independent investment bank in Latin America, agreed to acquire a 50% stake in reinsurer Ariel Re for an undisclosed sum, thereby expanding into P&C reinsurance.
- Brazil's Banco Panamericano SA agreed to sell its insurance division, Pan Seguros, to Banco BTG Pactual. The deal value is approximately R$580 million ($254 million).
- Panama City-based Capital Bank acquired insurer Optima Compañía de Seguros as part of its "expansion plan" in Panama's financial market.
- Bain Capital acquired Grupo Notre Dame Intermedica, a market leading provider of health and dental plans in Brazil.
- Howden's Broking Group acquired NMB Colombia Corredores de Reaseguros S.A., a reinsurance broker located in Bogota.
- Transatlantic Re acquired a 45% stake in El Sol del Paraguay Compañía de Seguros y Reaseguros.

We see several reasons for this increased M&A activity. Over the past four years, Latin America has experienced insurance premium growth of 90%, the highest of all regions (Asia/Pacific 62%, Africa 38%, Europe 12% and North America 4%). Latin American insurance premiums have grown from approximately $154.3 billion in 2011 to $184 billion in 2013. Latin American life insurance premium growth was the strongest of all regions in 2013. Brazil remains Latin American's primary growth engine accounting for approximately 63% of total Latin American life insurance premiums.

This premium growth has come from both life insurance and non-life insurance sectors across the region, and this has increased penetration and insurance density throughout Latin America. It has been fuelled by a number of favorable macroeconomic and demographic factors including, among other things:

(i) strong GDP growth;

(ii) growing population and consumption;

(iii) the continuing emergence of a middle class;

(iv) significant infrastructure development and industrialization initiatives (mainly transportation); and

(v) a supportive and strengthened regulatory framework in many countries.

Despite the steep growth experienced in the region in the last decade, the insurance and reinsurance sectors remain underdeveloped. Insurance penetration rates (*i.e.*, premiums to GDP) remain low in many Latin American countries – 1.4% average insurance penetration compared to the world average of 3.5% in 2013. Despite significant growth and M&A interest in Brazil, it still experienced only 2.5% penetration in 2013. Chile has the highest penetration rate in the region, notwithstanding the fact that it is perceived as being most exposed to natural disaster risks. In 2013, Colombia and Panama surpassed the 3% penetration rate and Costa Rica, El Salvador and Uruguay surpassed the 2% penetration rate. This expansion has been fuelled by mandatory insurance, credit-related coverage, tax-advantaged retirement plans and the introduction of private, specialized companies covering death, disability and retirement benefits associated with social security plans.

Although the Latin American non-life insurance market is more mature than the life insurance market, it still provides significant growth prospects. Brazil, Colombia, Mexico and Chile are Latin America's main markets, growing at double-digit rates. Mexico's growth trend is expected to strengthen due to ongoing recovery in the U.S. and Canadian economies as well as the recent implementation of the country's infrastructure development plan.

Faced with slow growth in their home markets, life, general and composite insurers from North America and Europe have shown keen interest in increasing their exposure to Latin America. International groups benefit from potential advantages as market entrants due to their significant product experience. As the middle class in Latin America expands, demand for lifestyle products such as unemployment insurance and college savings plans is expected to grow. International groups may be well positioned to seize this opportunity by leveraging their product experience across distribution platforms in Latin America. International groups may also benefit from a lower cost of capital than local firms. Regulatory attitudes to reputable international buyers are typically neutral.

Notwithstanding these realities, the investing and growth landscape for international entrants is not without its complexities, because these markets are already dominated by local groups, many of which are state controlled or privately owned. Bancassurance also plays an important role in the sale of insurance products in the region, particularly in Chile, Brazil and Mexico, and most regional banks already have distribution partnerships with local insurers. This suggests that an opportunistic approach to acquisitions is likely to be the key to expansion in Latin America.

In general, attractive valuations continue to tempt local and international groups to sell businesses in the region, and the growth potential of the region (driven by many of the factors summarized above) continues to tempt other industry participants to expand into, or to increase their investments in, Latin America. We generally expect these growth and M&A trends to continue in 2015.

II. Insurance-Linked Securities

"Insurance-Linked Securities" or "ILS" is the name given to a group of structurally related alternative risk transfer products. This group includes catastrophe bonds ("Cat Bonds"), sidecars, industry loss warranties, collateralized reinsurance facilities, extreme mortality and longevity derivatives and bonds, XXX/AXXX excess reserve financing facilities, embedded value securitizations and dedicated funds and asset management vehicles. With $60 billion now committed to this sector by investors, the trends of favorable pricing (particularly in the Cat Bond market) for sponsoring ceding companies relative to more traditional reinsurance and retrocessional products, and increasing and broadening investor appetite for higher yielding, non-correlated asset classes resulted in robust transaction activity in 2014 in most segments of this increasingly important market.

The over-arching trend of convergence between traditional reinsurance and ILS continued in 2014. Several commentators noted a significant downward pull of the ILS market on the pricing of traditional reinsurance. Nowhere was this trend more in evidence than the continuing downward pressure on rates on line for traditional catastrophe reinsurance resulting from "inexpensive" Cat Bond alternatives.

Historically, one of the most profitable segments of the reinsurance market has been the reinsurance of natural catastrophe risks. As noted above, several industry commentators have suggested that the uptick in M&A activity among P&C writers with reinsurance books has in part been a consequence of the adverse pricing conditions in the traditional natural catastrophe market as reinsurers seek to reduce their reliance on this segment by diversifying into casualty and other lines and improving the efficiency of their operations through scale and rationalization.

We discuss these trends in more detail below.

A. Alternative Reinsurance Structures

2014 was another transformative year for the alternative reinsurance market, which continued to achieve record growth at historically low pricing spreads. This market includes an umbrella of capital markets-based products, including Cat Bonds, collateralized reinsurance, sidecars, ILWs and others. Building on the momentum initially generated in 2013, these ILS solutions have finally shed their "niche" moniker to become a mainstream source of insurance risk capital. With more than an estimated $60 billion in overall capacity at year-end, the impact of alternative reinsurance capital has rippled through the P&C space, both in terms of risk pricing and coverage. Driven in part by the continuing low interest rate environment and relatively light catastrophe activity, significant amounts of new capital have continued to flow from pension funds and family offices, among other sources, into ILS investment funds in search of non-correlated investment yield.

While we do not believe ILS will supplant traditional reinsurance as the primary form of risk transfer, each has a distinct comparative advantage depending on the nature, tenor and return profile of the particular risk. Some have argued that ILS capital is more efficient than traditional reinsurance at certain points along the risk spectrum. Conversely, traditional reinsurance can provide certain coverage terms that may be more difficult in a capital markets format. Both forms of protection are increasingly being used in tandem, and the competition between them has so far resulted in expanded coverage terms and cheaper risk transfer for property catastrophe risks. The impact is also crossing over into other markets, such as property non-catastrophe and casualty risks. Whether these changes are beneficial and sustainable over the medium and long run is a question for the prognosticators and pundits—but time will tell.

In order to harness the perceived comparative advantages from each of these formats, insurance and reinsurance companies have expanded their use of structured vehicles in 2014, such as Cat Bonds, collateralized reinsurance, sidecars, fund formations and asset management arrangements, alongside traditional reinsurance programs.

II. Insurance-Linked Securities

We expect these trends to deepen and grow in 2015 as primary insurance companies react more fully to the changing landscape and reinsurance companies continue to reposition their business strategies in response to recent and ongoing capital inflows.

1. Catastrophe Bond Market

The 144A Cat Bond market experienced record issuance in 2014 at historically low pricing, with approximately $8 billion in new issuances. Based on industry estimates, total outstanding volume was approximately $23 billion at year-end. In addition, there were approximately 20 different insurance and reinsurance sponsors in 2014, slightly less than half of which were new entrants to the market.

Large transactions have become increasingly popular, making the product potentially more attractive to primary insurance carriers in search of scalable protection. For instance, Florida Citizens sponsored the largest ever 144A Cat Bond transaction, closing Everglades Re III at $1.5 billion. Allstate has sponsored $1.3 billion in three separate transactions since 2013.* Two other transactions (Everest's Kilimanjaro* and AIG's Tradewynd) were $500 million each.

As spreads have fallen, sponsors have continued to push on coverage terms to further replicate traditional indemnity reinsurance protection. Almost two-thirds of 144A Cat Bonds in 2013-2014 utilized an indemnity trigger compared with less than 40% in 2009-2012. 2014 also saw the first non-U.S. indemnity 144A transaction, Gernerali's Lion I Re, which was exposed to Europe windstorm perils. Moreover, several transactions in 2014, including USAA's Res Re, were exposed to unmodeled perils for the first time, such as non-California wildfire, volcano and meteorite perils. The incorporation of unmodeled perils was buttressed by enhanced cedant disclosure, an approach meant to replicate reinsurance underwriting by investors rather than sole reliance on third party modeling.

Several Cat Bonds were structured with longer-dated maturities. Historically, most Cat Bonds have had tenors of three to four years. Over a billion dollars in 144A Cat Bonds issued in 2014 had a five-year tenor. Many more were structured with a four-year tenor. The longer maturity allows cedants to lock-in pricing and amortize transaction costs over a longer period thereby reducing the execution "friction" compared to traditional reinsurance.

The number and size of non-144A private placement transactions accelerated in 2014, particularly among smaller companies and first-time participants. Third party sources report almost $300 million aggregate principal amount of privately placed Cat Bonds in 2014. In addition, several market participants have recently established proprietary platforms to take advantage of the private placement market, including Aon Benfield Securities' CATstream, Horseshoe/JLT's Market Re, Kane's SAC program, independent start-up Rewire, Tokio Solution's Tokio Tensai platform and Willis' Resilience Re, among others. The goal of these new platforms is to reduce transaction costs and barriers to entry for new and smaller participants, including through streamlined disclosure and other efficiencies resulting from a private placement offering process.

On December 18, 2014, the U.S. Commodity Futures Trading Commission ("CFTC") issued a no-action letter providing relief from commodity pool operator registration for ILS issuers meeting certain enumerated conditions. The long awaited no-action letter helps to resolve uncertainty caused by the Dodd-Frank Act and related regulations surrounding several ILS structures, particularly Cat Bonds utilizing a derivative contract instead of reinsurance. The CFTC no-action letter was issued in response to an industry request by the Securities Industry and Financial Markets Association.

* Willkie Farr & Gallagher advised on this transaction.

We believe opportunities remain in the market for non-property catastrophe risks. Among other transactions completed in 2014, Aetna placed $200 million in medical benefit ratio coverage through their fifth Vitality Re transaction, RGA closed a $300 million embedded value securitization* and the California State Compensation Insurance Fund transferred $250 million of workers' compensation risk through Golden State Re II Ltd. Several extreme mortality bonds were also completed in prior years, including SCOR's Atlas IX transaction in 2013. As the ILS market has grown in size and sophistication, discussions about transferring non-traditional risks to the capital markets has accelerated. We would not be surprised to see a continued deepening of the market to other risk categories in 2015.

2. Hedge Fund Re

In the wake of Third Point Re's successful IPO in 2013, several transactions in 2014 were structured to combine insurance and investment returns in a hybrid strategy commonly (although perhaps mistakenly) referred to as "Hedge Fund Re." Although many variations exist, these transactions are typically structured in one of two principal ways: either as an independent start-up reinsurer with an experienced management team or paired with an established reinsurance company to underwrite the business. In either case, the reinsurer will enter into an asset management agreement with a third party to manage its investment portfolio in accordance with some pre-determined strategy.

The two most recent significant Hedge Fund Re transactions were the acquisition by Hamilton Insurance Group, Ltd. of an independently managed reinsurance company, now known as Hamilton Re, and the formation of Watford Re, managed in part by a subsidiary of Arch Capital.

- Hamilton Insurance Group, a Bermuda company led by former Marsh CEO Brian Duperreault and owned by a group of investors including Two Sigma Investments, completed its acquisition of S.A.C. Re at the end of 2013.* Now renamed Hamilton Re, the reinsurer seeks to combine an independent market-facing reinsurance underwriting strategy with the asset management expertise of Two Sigma.

- Bermuda-based Watford Re completed its $1.13 billion capital raise in March 2014 and combines the underwriting expertise of Arch Capital with the asset management expertise of Highbridge Capital. In addition to earning underwriting fees, Watford Re provides Arch with a multi-year and semi-dedicated source of reinsurance capacity.

Although we expect several additional transactions to be announced in 2015, Hedge Fund Re transactions have recently faced structural headwinds—in particular, A.M. Best has declined to assign an "A-" rating to a high profile vehicle, citing in part its inability to meet its "ramp-up" and other insurance underwriting goals. Consequently, we expect that forthcoming structures will be based on the Watford Re model in which the new reinsurer will partner with an established insurance or reinsurance company to assist in underwriting and generating appropriate business. (*See* Section VII.B below for a discussion of some of the tax implications relating to these structures).

3. Sidecars

Despite market softening, fully collateralized sources of reinsurance capacity continued to penetrate the global reinsurance market in 2014 as cedants increasingly added third party capital to their reinsurance programs, with a number of sidecars and collateralized vehicles deploying capital at the January 1 renewals. Collateralized reinsurance was the fastest-growing alternative segment in 2014, with alternative reinsurance capital reaching $60 billion by the end of the third quarter of 2014, up 25% from 2013, and collateralized reinsurance seeing the fastest expansion over the first three quarters of 2014, increasing by more than 25% to $29.4 billion.[5]

* Willkie Farr & Gallagher advised on this transaction.

5 "Collateralised reinsurance fastest-growing alternative segment in 2014." *Trading Risk*, 5 January 2015. Web. 29 January 2015.

The launch by Munich Re of its Eden Re II Ltd. sidecar, adding $290 million of third party capital and another $75 million with Eden Re I Ltd.,* as a renewal of its $63 million 2014 Eden Re vehicle, confirmed Munich Re's intention to make more use of alternative capital. In other renewals, Aspen Capital Markets, which is Aspen's unit that focuses on alternative capital management and ILS, renewed its Silverton Re collateralized reinsurance sidecar for 2015 with $85 million of capital.* Everest Re has continued to demonstrate that its third party capital backed, fully collateralized reinsurance sidecar Mt. Logan Re is core to its business, growing the sidecar again in the last quarter of 2014 to approximately $480 million. Montpelier Re added another $130 million to its Blue Capital platform, largely via private sidecar arrangements, and over the course of 2014 Scor Global Investments rose to $500 million of assets under management from $310 million, although its growth mostly occurred in the first half of the year.

As well as renewing vehicles, Brit plc, the global specialty insurer and reinsurer with a large presence at Lloyd's, was among the new sponsors for 2015. Joining the group of insurance and reinsurance firms that are leveraging third party capital from institutional investors to provide them with additional capacity in the currently challenging market environment, Brit launched a Bermuda domiciled special purpose reinsurer named Versutus Ltd., which has been fully collateralized with $75 million of funds from third party investors. In addition, AlphaCat Managers Ltd., the insurance-linked securities, Cat Bond and reinsurance linked investments arm of Bermuda based (re)insurance group Validus Holdings, added $155 million of new capital for deployment in 2015 through newly launched AlphaCat 2015 Ltd., a special purpose vehicle formed as a sidecar to invest in collateralized reinsurance and retrocessional contracts underwritten by AlphaCat Reinsurance Ltd.

With respect to the recent increase in consolidation and convergence among companies in the (re)insurance industry, Axis Capital has said that it expects a combined Axis-PartnerRe to be much more active in sharing its portfolio with third party capital providers.[6] While Axis Ventures Re has attracted capital from Stone Ridge Asset Management, ceding both property catastrophe and crop risk to its partner,* and PartnerRe has its Lorenz Re sidecar, neither carrier has been very active in managing third party capital. XL has also indicated that the proposed deal with Catlin will create a reinsurer with considerably expanded alternative capital capabilities.[7] In 2013, XL launched the New Ocean asset management platform with Stone Point,* while Catlin has partnerships with third party investors through Lloyd's special purpose syndicates and a non-Lloyd's sidecar launched last year.*

4. ILS Fund Formation

In 2014, we saw the continuing development of ILS/capital management ventures by traditional reinsurance companies. Firms that "went live" and deployed investor capital in 2014 include XL Group-backed New Ocean* and HiscoxRe's Kiskadee Investment Managers.* Kinesis Holdings also closed several fund offerings to investors in 2014, including at year-end, supported by Kinesis Capital Management, Lancashire Group's third party underwriting manager.* In addition, Securis Investment Partners in late 2014 launched its new Securis LCM Fund to support investments in a number of Lloyd's of London syndicates via a Securis Lloyd's corporate member.* Others established internally capitalized incubator funds designed to build up a marketable track record. In response to perceived investor appetite, some fund managers expanded their offerings in 2014 to include funds aimed at more remote layers of risk and lower expected returns.

We continue to see both open-end and closed-end fund structures, with many closed-end structures in particular utilizing segregated accounts of Bermuda segregated account companies to isolate portfolios of reinsurance risks as between different classes of investors or risk periods.

6 "PartnerRe-Axis to share more risk with third parties." *Trading Risk*, 26 January 2015. Web. 29 January 2015.

7 "Structural change pushes XL-Catlin merger." *Trading Risk*, 16 January 2015. Web. 29 January 2015.

* Willkie Farr & Gallagher advised on this transaction.

A continuing trend has been to enhance the traditional sidecar with a holding company structure or fund designed to facilitate the redeployment of investor capital from one underwriting period to the next. Some closed-end funds redeploy the available capital from one renewal period into the next available renewal period, whereas other funds require investors to commit a fixed amount to future renewal periods, which must then be funded with additional investor contributions if rollover proceeds are insufficient or not in time to collateralize new transactions. In either case, investors are typically given the opportunity to size up or size down their continuing investment in future renewal periods as they see fit.

In addition, open-end ILS funds continue to be organized. These funds generally allow for more frequent subscription and redemption activity into an existing portfolio of risks, subject to side pockets, slow-pay redemption shares (redeemable based on portfolio runoff rather than at net asset value) and other restrictions principally designed to maintain liquidity and protect new investors from pre-existing events affecting the portfolio. We saw several open-ended structures brought to market in 2014. Open-ended vehicles are being used both for funds with liquid portfolios comprising principally Cat Bonds, as well as for funds that invest almost exclusively in traditional reinsurance contracts.

Finally, the Alternative Investment Fund Managers Directive ("AIFMD") came into effect in July of 2014, forcing many managers to contemplate the burdens and potential benefits of marketing their funds in the European Union. AIFMD represents the most significant E.U. regulation of the alternative investment funds industry in recent times and directly impacts ILS Funds and collateralized insurance sidecars. AIFMD is broad in scope and covers the management, administration and marketing of a wide range of asset managers, whether they are based in the E.U. or outside. AIFMD will affect:

(i) alternative investment fund managers ("AIFMs") in the European Economic Area ("EEA") who manage alternative investment funds ("AIFs"), whether or not those AIFs are marketed in the EEA; and

(ii) non-EEA AIFMs who manage AIFs within the EEA, or who market AIFs within or into member states. As many ILS funds are managed by non-EEA AIFMs, the marketing and other activities of ILS Funds in the EEA is directly impacted by AIFMD.

Among other things, AIFMD includes requirements for the authorization or registration of AIFMs in order to perform the functions of portfolio management and risk management and for the marketing of AIFs to professional investors within the EEA. A short form registration is available in many member states, including the U.K., if the AIFM manages an AIF or AIFs with assets under management below certain thresholds.

One of the main changes under AIFMD is that a number of fund managers marketing in the U.K. will now need to be authorized or registered with the Financial Conduct Authority ("FCA") to operate as AIFMs, and those marketing in other EEA jurisdictions will now need to be authorized or registered with the appropriate regulator in each such jurisdiction, if so permitted, until pass-porting is adopted and available for non-EEA AIFMs on an EEA-wide basis. Unless an exemption is available, this requirement may apply to third party capital management initiatives in the alternative reinsurance and convergence market, including, for example, operators of sidecars or other collateralized reinsurance vehicles that are collective investment schemes that are not UCITS funds (retail mutual funds), and that carry out portfolio management or risk-management functions.

B. Excess Reserve Financings

2014 continued the previous year's trend where the number of new excess reserve financing transactions has been decreasing. Again, the likely cause was caution from both regulators and insurance companies in the life insurance reserve financing market as a result of the NAIC's activities. As was the case in 2013, the exceptions to this trend were transactions that occurred in connection with M&A activity in the life insurance industry. Buyers of life insurance companies with large term life and universal life reserves on their books often require that existing deals be either amended to their liking or replaced by new structures. Even with the slowdown, several life insurance companies completed new transactions in 2014, and several other existing transactions were restructured to take advantage of lower lending rates and the continued interest by reinsurance companies to act as credit providers.

1. Summary of Deal Activity

a) AXXX Market Remains Open

As was the case in 2013, many of the transactions for which we acted as deal counsel were designed to provide reserve financing for universal life policies subject to Regulation AXXX. The expansion of lenders willing to provide financing to fund AXXX reserves that started in 2012 continued in 2014. The size of the transactions ranged from a low of $100 million to $2 billion or more, as life insurance companies continued to take advantage of increased lender interest in financing redundant reserves. In most transactions in both the XXX and AXXX markets, commitments were for 10-20 years, although several transactions involved shorter terms intended to act as a financing bridge until other expected sources of funding become available.

b) Continuance of Non-Recourse Transactions as the Structure of Choice

Although we saw one or two XXX transactions in 2014 that utilized traditional letters of credit, the vast majority of deals were secured by non-recourse letters of credit or contingent notes, as those transactions have essentially replaced traditional letters of credit among lenders and reinsurance companies active in the reserve financing market. In the past, the obligation to reimburse the bank for any draw on the letter of credit was guaranteed by a parent holding company, thus being known as a "recourse" transaction. In a non-recourse transaction, no such guaranty is required. Rather, the ability to draw on the letter of credit or contingent note is subject to certain conditions precedent. These conditions usually include the reduction of the funds backing economic reserves to zero and a reduction in a prescribed amount of the captive's capital, and a draw limited to an amount necessary for the captive to pay claims then due. Because of these conditions, lenders and other funding sources have become more comfortable assuming the risk of relying for repayment on the long term cash flows from a block of universal life policies.

c) Choice of Domicile for Captives and Limited Purpose Subsidiaries

Vermont remained the preferred domiciliary jurisdiction for captive life insurers in 2014. However, with several states having adopted captive insurer laws or amending and expanding existing captive insurer laws over the past few years to facilitate reserve funding transactions, 2014 saw a continuation from last year of several other states—including Arizona, Delaware, Nebraska and Iowa—being utilized as captive insurer domiciliary jurisdictions. 2014 also saw the continued, although limited, use of the recently enacted "Limited Purpose Subsidiary" statutes in several states. The Limited Purpose Subsidiary statutes permit a ceding company to form a captive insurer, or "LPS," in the same domiciliary state as the ceding insurer. This has proven to provide for a more streamlined regulatory approval process for a transaction.

2. Utilized Structures

a) Limited Purpose Subsidiaries

As stated above, 2014 saw the continued, but limited, use of the LPS laws in XXX/AXXX transactions. Georgia, Indiana, Iowa and Texas have each promulgated an LPS statute. The advantage of an LPS over a captive insurer is that an LPS, once licensed, may provide its ceding company parent with full credit for reinsurance without posting any security in the form of a letter of credit or a credit for reinsurance trust. Under the LPS statutes, an LPS is permitted to take statutory financial statement credit for the face amount of letters of credit as well as parental guaranties by statutory authority; the LPS need not seek regulatory approval for a permitted practice or other dispensation to use this accounting treatment. Although this was a major development in the ability to finance Regulation XXX/AXXX reserves, we have not seen the use of the LPS statutes take off as expected, likely as a result of the generally lackluster market activity in the past two years brought on by general caution on the part of insurers and regulators alike.

b) Credit-Linked Notes vs. Letters of Credit

The use of contingent credit-linked notes in a role that may be analogous to a "synthetic letter of credit" continued to be the structure of choice for excess reserve financing transactions. In these non-recourse transactions, an SPV issues a puttable note to a captive insurer. The captive insurer's right to "put" a portion of the note back to the SPV in exchange for cash is contingent on the same types of conditions that would otherwise apply in a non-recourse contingent letter of credit transaction. The use of these notes, rather than letters of credit, has provided a means for reinsurance companies, which contractually agree to provide the funds to the SPV to satisfy the put, to enter a market that was once only available to banks.

c) Funding Sources Beyond Banks

Another means through which the market for funding sources in AXXX transactions has expanded beyond banks in recent years is the use of contingent credit-linked notes. Large reinsurance companies have shown a keen interest in participating in these transactions through support of the special purpose vehicles that issue the contingent notes. With the expansion of the group of potential funding sources for these transactions, life insurance companies can seek more competitive pricing and terms. 2014 saw a continuation of the trend started in 2012 of reinsurance companies surpassing banks as the primary "risk taker" in these transactions, with banks for the most part sitting on the sidelines.

3. Regulatory Environment

a) NAIC

As discussed in more detail in Section VI.H.1 below, a very important development in the world of reserve financing transactions was the NAIC's adoption of the XXX/AXXX Reinsurance Framework and Actuarial Guideline 48 ("AG 48"), which are parts of the NAIC action plan to develop further regulatory requirements with respect to XXX and AXXX transactions. Importantly, the XXX/AXXX Framework and AG 48 aim to set standards applicable to XXX and AXXX transactions, instead of restricting them outright. Although certain insurance regulators, such as the New York State Department of Financial Services ("NYDFS") and the California Department of Insurance (the "CA Department"), are not satisfied with this approach and have continued to call for a nationwide moratorium on these types of transactions, the adoption of AG 48 by the NAIC is a significant development that provides guidance regarding how these transactions should be structured.

b) New York

As discussed in more detail in Section VI.H.1 below, the steps taken by the NAIC to address XXX transactions and AXXX transactions have by no means received uniform support from state regulators. Indeed, the regulators of several commercially important states—including California and New York—have voiced vehement opposition. Superintendent Benjamin Lawsky of the NYDFS in particular has criticized XXX/AXXX financing transactions, calling them a "shadow insurance" industry because of what he perceives to be a lack of regulatory oversight. In the wake of the NYDFS's year long investigation of XXX and AXXX captive transactions (which culminated in June 2013 with a report entitled "Shining a Light on Shadow Insurance – a Little-Known Loophole that Puts Insurance Policyholders and Taxpayers at Greater Risk"), the NYDFS had urged other state regulators to adopt a national moratorium with regard to future XXX and AXXX transactions. The CA Department has likewise urged the adoption of a nationwide moratorium on XXX transactions and AXXX transactions. However, the NAIC so far has not adopted a nationwide moratorium.

C. Embedded Value Securitization

2014 saw the return of a life insurance embedded value securitization, the first transaction of its type to come to market since Aurigen Capital Limited ("ACL") sponsored the Vecta I transaction in late 2011, which securitized the future flows from a block of Canadian dollar life insurance policies,* and early 2015 saw a second embedded value transaction close from Aurigen Capital Limited. Embedded value securitizations take advantage of the capital markets to monetize the future expected profits from a defined block of life insurance policies and can be an attractive way for both insurance companies and reinsurance companies to manage their capital and mortality risk efficiently.

Reinsurance Group of America, Incorporated ("RGA") announced in mid-December that its subsidiary, Chesterfield Financial Holdings LLC, completed an offering of $300 million of 4.50% asset-backed notes, a securitization of U.S. life insurance embedded value.* The transaction covers a closed block of policies assumed by RGA Reinsurance Company, a wholly owned indirect subsidiary of RGA, between 2006 and 2010. Credit Agricole Securities (USA) Inc. acted as initial purchaser and sole bookrunner.

Following closely on the heels of the RGA transaction, ACL announced in mid-January 2015 the private placement of C$210 million of asset-backed notes issued by Valins I Limited,* marking the second life insurance policy embedded value transaction to close in a four week period, and the first Canadian Dollar embedded value transaction since ACL's "Vecta I" transaction in late 2011. The transaction covers a closed block of Canadian life insurance policies reinsured by Aurigen Reinsurance Limited, a subsidiary of ACL, between 2008 and 2013 and consists of twenty-six life reinsurance treaties from 12 life insurance companies. A unique feature of the offering structure is that it allows for the increase and extension of the notes, providing flexibility to add future new life insurance business and access to capital funding. BNP Paribas Securities Corp. acted as structuring and placement agent.

With the apparent rise in investor appetite for this type of offering, we would not be surprised to see more embedded value transactions hit the market in 2015.

* Willkie Farr & Gallagher advised on this transaction.

III. Developments and Trends in Longevity, Pension Close-outs and De-risking Transactions

The U.K. longevity risk and buy-out markets experienced another record-breaking year in 2014 as deal volume exceeded £30 billion—nearly double the 2013 level of £16 billion. The market's expanded capacity was characterized by the participation of several new entrants, innovative transaction structures, and an increase in deal size at the market's high end, where typical deals now approach £1 billion.

The highlight of this year's longevity market was the transaction between BT Pension Scheme and The Prudential Insurance Company of America, under which BT transferred £16 billion in pension liabilities to Prudential.* The transaction is significant not only for its size— which distinguishes it as the largest longevity risk transfer transaction to date—but also for its novel structure. BT ceded its pension risk to a Guernsey-based captive that it created, and the captive then reinsured 25% of the scheme's total liabilities with Prudential. This pass-through structure enabled BT to deal directly with Prudential, and thereby to eliminate intermediary counterparty risk, decrease transaction costs and gain broader access to the reinsurance market. In employing this novel pass-through structure in a transaction of unprecedented size, the BT transaction sent a clear message to the market that both endorsed longevity reinsurance as an effective risk mitigation tool and provided a template for others—particularly large pension funds. In addition to the BT transaction, between July and December Prudential entered into longevity deals with Legal & General and Rothesay Life, involving the transfer of £1.35 billion and £1.28 billion of longevity risk, respectively.*

The robust U.K. market included several other noteworthy transactions and participants. In March, Legal & General and Prudential Retirement Income Limited executed separate buy-in transactions with AkzoNobel's ICI Pension Fund.* That transaction provides the ICI Pension Fund with an aggregate £3.6 billion protection of its pensioner liabilities. AzkoNoble reported that the deals collectively reinsure approximately one-quarter of AzkoNobel's pension liabilities and one-third of the ICI Pension Fund liabilities. Legal & General was responsible for £3 billion while Prudential handled £600 million. The transaction was unusual as it involved two insurers; buy-in transactions typically use only one. In June, Pension Insurance Corporation ("PIC") and Hannover Re entered into a "back-to-back" buy-in and longevity reinsurance transaction, which involved PIC's £1.6 billion buy-in for the Total Pension Scheme followed by the reinsurance of longevity risk with Hannover Re. Two deals followed the lead of the BT transaction and utilized wholly owned insurers or captive vehicles. In August, Phoenix Group executed a £900 million longevity swap with its own insurer, Phoenix Life Limited, that simultaneously reinsured longevity risk on a quota share basis. Earlier in the year, SCOR and Swiss Re participated in a £5 billion reinsurance swap for Aviva plc. In that transaction, a sponsor-owned insurance vehicle acted as intermediary between Aviva and the two reinsurers. Deutsche Bank also closed its first longevity experience option ("LEO") deal, a structure it developed to enable companies to hedge risk positions after entering bespoke transactions. The LEO instrument standardizes out-of-the money options with a trigger linked to 10-year index-based survival rates.

New entrants to the U.K. market included French insurer AXA S.A. and Dutch life insurer Delta Lloyd, both of which concluded deals in August. AXA S.A.'s €750 million longevity swap with Hannover Re made it the first French participant in the U.K. market. Delta Lloyd's €12 billion longevity swap transaction with RGA was the largest index-linked transaction in the market's history.

* Willkie Farr & Gallagher advised on this transaction.

III. Developments and Trends in Longevity, Pension Close-outs and De-risking Transactions

Commentators have noted that in 2014 the longevity market has become more appealing to smaller pension funds as transaction turnaround time has decreased from 12 months to six-to-nine months. As a result, the market is now attractive to funds with as little as £50 million in liabilities. By comparison, the smallest transaction participants in 2013 had £200 million to £300 million in liabilities.

Although not as robust as the U.K. market, the U.S. market saw an uptick in activity in the fourth quarter of 2014 as Prudential entered into pension-risk transfer transactions with Motorola* and Bristol-Myers Squibb* in September. Under the terms of the Motorola transaction, Prudential has agreed to assume responsibility for the administration and payment of an estimated $4.2 billion of retirement benefits to the approximately 30,000 Motorola Solutions retirees covered by the deal. In the Bristol-Myers transaction, by comparison, Prudential assumed responsibility for the administration and payment of $1.4 billion of retirement benefits to approximately 8,000 Bristol-Myers Squibb retirees.

In 2015, we expect to see a continuing increase in the level of activity in both the longevity-only and the broader pension risk transfer market as a whole. As noted in *The Economist* in August, the market has tremendous room for growth as only a small fraction of the $23 trillion of private defined benefit plan liabilities worldwide have been protected by longevity reinsurance or other risk-transfer arrangements.

* Willkie Farr & Gallagher advised on this transaction.

IV. Capital Markets

A. Equity Offerings

Initial public offering activity declined in 2014, in comparison to 2013, which witnessed several significant transactions. Pet insurer Trupanion, Inc. raised approximately $71 million in its public debut as a listed company. Heritage Insurance Holdings, Inc., a property and casualty insurance holding company, raised $66 million in its May 2014 IPO. Most significantly, James River Group Holdings Ltd., a specialty insurer for small and mid-size businesses backed by hedge fund D.E. Shaw, raised $231 million in an IPO that closed in December of 2014.* D.E. Shaw continues to own about half of James River following the offering. As of early January, Heritage and James River were trading higher than their respective IPO prices.

Following its successful IPO in 2013, which raised $335 million, Essent Group offered an additional 12 million common shares in a follow-on offering in November of 2014, raising approximately $128 million for itself and approximately $128 million for certain selling shareholders.*

In addition, as part of ING Group's divestment of its U.S. life insurance business, Voya Financial (formerly ING US), ING sold additional shares of Voya in a series of follow-on offerings in March, September and November of 2014 totaling nearly $3.0 billion. ING also entered into a share repurchase agreement with Voya under which Voya will repurchase $175 million of its shares of common stock from ING. As a result of these sales, ING has reduced its stake in Voya to 19%. In order to receive state aid from the Netherlands during the financial crisis, in 2009 ING Group agreed to divest its insurance and asset management businesses, including ING US, over a period of years. ING Group ultimately commenced the sale process for ING US through an IPO in 2013, in which all the shares sold were owned by ING Group.

The most significant equity offerings in the U.K. of insurance groups in 2014 were the IPO of Brit plc, a Lloyd's of London insurer, which raised approximately £240 million for Apollo Global Management and CVC Capital Partners, and the underwritten, discounted rights issue by RSA Insurance Group plc, which raised approximately £750 million.

B. Surplus Notes

2014 saw a resurgence in syndicated Rule 144A surplus note offerings. Several issuers that had been active in 2009/2010 returned to the market to take advantage of investors' search for yield in the current low interest rate environment.

Surplus notes, which are issued by insurance operating companies under Rule 144A and Regulation S, are subordinate in right of payment to the insurance company's indebtedness and to policyholder claims. Similar to a standard debt security, surplus notes include a stated maturity and have periodic interest payments; however, principal, interest and redemptions of the surplus notes are subject to the prior approval of the insurance regulator of the issuer's state of domicile. If the regulator decides that the insurance company has insufficient funds to make a payment on the surplus notes without putting the insurance company or policyholders at risk, the regulator can cause the company to defer the scheduled payment.

The year began with a $400 million issuance of surplus notes due 2044 by Nationwide Mutual Insurance Company, the proceeds of which were used for general corporate purposes, including the redemption of the company's outstanding surplus notes due 2034.

In June, The Guardian Life Insurance Company of America completed an offering of $450 million of surplus notes due 2064.* These notes were the first 50-year bullet notes issued by a financial institution following the financial crisis and the first 50-year surplus note offering since 1998. The notes also priced with the lowest ever coupon for a surplus note with a maturity of 30 years or more.

* Willkie Farr & Gallagher advised on this transaction.

Guardian's offering in June was followed in July by a $300 million offering by Mutual of Omaha Insurance Company of fixed-to-floating rate surplus notes due 2054.* The proceeds from the offering were used to finance a concurrent waterfall tender offer made by Mutual of Omaha for its outstanding surplus notes due 2036 and surplus notes due 2040.*

In September, Teachers Insurance and Annuity Association of America completed an offering of $1.65 billion of surplus notes due 2044 and $350 million of fixed-to-floating rate surplus notes due 2054.* TIAA used the $2 billion of proceeds partially to fund its $6.25 billion acquisition of Nuveen Investments, a leading provider of investment management and related services to individual and institutional investors.

Finally, in October, Farmers Exchange Capital III issued $500 million in trust surplus note securities due 2054 backed by an equivalent aggregate amount of surplus notes with a corresponding maturity from Farmers Insurance Exchange, Fire Insurance Exchange and Truck Insurance Exchange. The proceeds are intended to be used to repay outstanding amounts under certificates of contribution due 2021 issued by Farmers Insurance Exchange and Truck Insurance Exchange and for general corporate purposes. Pending that repayment, the Farmers Exchanges intend to use the funds to reduce temporarily their all-lines quota share reinsurance program.

C. Preferred Equity

Allstate accessed the market in February 2014 with a $750 million standalone issuance of fixed rate noncumulative perpetual preferred stock, represented by depositary shares.* Allstate followed the standalone issuance with a June offering of similar preferred equity under the Incapital LEOPARDSTM program.* This program, which was originally developed by Allstate and Incapital in December 2013, generally involves a one week marketing period for the depositary shares, and each series has the flexibility to reopen multiple times, similar to that of traditional retail medium term notes. In each case, the depositary shares were marketed to retail investors and listed on the New York Stock Exchange. This type of preferred stock was the first hybrid security issued by the insurance industry with a mandatory deferral distribution trigger since 2009, and because of the structure it received "Basket D" equity treatment from Moody's and "High" equity treatment from Standard & Poor's.

AmTrust and National General also conducted issuances of fixed rate noncumulative preferred stock in the form of exchange-listed depositary shares, totaling $200 million and $55 million, respectively. These preferred shares, like those of Allstate, featured a dividend stopper, but unlike Allstate they did not also include a mandatory deferral distribution trigger.

D. Investment Grade Debt

With interest rates staying at traditionally low levels during 2014, the year saw a healthy number of investment grade debt deals from the insurance industry. In particular, companies took the opportunity presented by low spreads and investor interest to repurchase or redeem outstanding debt with high coupons and replace it with debt with lower coupons.

Throughout the year, AIG redeemed a total of four series of its senior notes, with an aggregate of $4.77 billion in principal amount outstanding, in accordance with their terms. During the summer of 2014, AIG conducted simultaneous cash tender offers for eight series of junior subordinated debentures and nine series of senior notes, in each case that it had either issued or guaranteed, and, as a result, repurchased nearly $2.0 billion in aggregate principal amount of these outstanding debt securities. AIG also replaced some of the debt that it had repurchased during the year with total issuances of $3.25 billion of new senior notes.

MetLife completed its final remarketing of senior debt securities in two tranches in October 2014, with approximately $500 million senior component debentures

* Willkie Farr & Gallagher advised on this transaction.

due 2018 and approximately $500 million of senior component debentures due 2044.* These senior notes were originally issued in November 2010 as $1 billion aggregate principal amount of senior debentures due 2045, which formed part of MetLife's common equity units, with an aggregate stated amount at issuance of $3 billion. The common equity units formed part of the consideration for MetLife's acquisition of American Life Insurance Company and Delaware American Life Insurance Company from AIG in 2010. AIG subsequently resold the common equity units to investors in a public offering in 2011. The proceeds of the remarketing, plus an additional cash amount from holders of common equity units who elected cash settlement were used to satisfy the common equity unit holders' obligations under the related stock purchase contracts, under which MetLife delivered approximately 22.9 million shares of common stock to such holders. MetLife had earlier sold a new issue of $1.0 billion of senior notes due 2024 in April 2014, part of the proceeds of which were used to redeem at par $200 million of its senior notes due 2033 and repay $350 million of its senior notes at their June 2014 maturity.*

Following the October 2014 closing of TIAA's acquisition of Nuveen Investments, TIAA Asset Management Finance Company completed a Rule 144A offering of $1.0 billion of senior notes due 2019 and $1.0 billion of senior notes due 2024.* TAMF was established by TIAA to act as an intermediate holding company for Nuveen Investments and TIAA's existing asset management business. TAMF used the proceeds of this investment grade issuance to redeem three series of outstanding high-yield bonds of Nuveen Investments and repay an intercompany loan from TIAA.

In May 2014, Radian Group completed its concurrent public offerings of $260 million shares of common stock and $300 million principal amount of senior notes due 2019.* Radian and the underwriters in the transaction wall-crossed certain debt investors over the weekend prior to the launch to "test the waters" and were then able to sell the non-investment grade senior notes without any restrictive covenants on Radian in its first public debt deal since 2005. The proceeds of the offerings were used to finance Radian's acquisition of Clayton Holdings, a provider of mortgage-backed securities due diligence services.

Four Bermuda insurance companies sought debt financing in the first half of the year, with issuances of guaranteed senior notes by ACE ($700 million), Assured Guaranty ($500 million)* and Axis Capital ($500 million), and a standalone senior notes deal by the U.S. intermediate holding company for Everest ($400 million).*

There were a number of other debt issuances during the year including by Prudential ($1.9 billion), Marsh & McLennan ($1.4 billion),* Aon plc ($1.7 billion), Liberty Mutual ($1.0 billion), Aflac ($750 million), CNA Financial ($550 million), Nationwide Financial ($400 million), Old Republic ($400 million), USAA Capital ($400 million), W. R. Berkley ($350 million),* Unum ($350 million), Progressive ($350 million), Alleghany ($300 million),* Fairfax ($300 million), First American Financial ($300 million), Symetra ($250 million), American Financial ($150 million) and Kemper Corporation ($150 million).

E. Funding Agreement-Backed Notes

Funding agreement-backed notes are designed to generate regular cash flows to service the debt on short- or medium-term notes issued through a securitization vehicle, and transfer credit quality of a policyholder claim at the insurance company to the notes of that vehicle.

In 2014, the funding agreement-backed notes market continued to recover steadily following the financial crisis, and the year saw the addition of two new entrants, AIG and Tokio Marine. Most of the activity was concentrated in the first nine months of 2014, with a mix of domestic and foreign currency denominated issuances (Euro, Sterling, Japanese Yen, Swiss Francs, Norwegian Krone, Canadian Dollars and Australian Dollars).

* Willkie Farr & Gallagher advised on this transaction.

AIG returned to the funding agreement-backed notes market with the formation of, and first issuance ($450 million) from, AIG Global Funding, backed by funding agreements issued by American General Life Insurance Company. Reliance Standard Life Insurance Company, an operating entity of Tokio Marine & Nichido Fire Insurance Co., established a new program in April 2014 coupled with an initial issuance of $500 million. The market was still led by MetLife ($9.8 billion)* and New York Life ($3.3 billion),* but did witness increased issuances from Prudential ($1.2 billion),* Principal Financial ($1.2 billion), Jackson National ($800 million)* and Mass Mutual ($750 million). MetLife has been the leading issuer of funding agreements in each of the last six years, with New York Life the next largest.

Capacity may now exist for additional issuances by the industry based on a stronger balance sheet position, a reduction in operating leverage and a strengthening of statutory capital.

F. SEC Disclosures

Throughout 2014, the SEC's Division of Corporation Finance (the "Division") has continued to discuss its Disclosure Effectiveness agenda, with the goal of recommending changes to Regulation S-K and Regulation S-X to update and modernize specific disclosure requirements, to eliminate duplicative disclosures and to continue to provide material information. The Division is considering whether the SEC should adopt a more principles-based approach to provide companies with more flexibility to provide disclosures that it believes are material to investors, and is examining redundancies in filings, such as overlapping disclosure requirements in Regulation S-K and GAAP, which address similar information regarding legal proceedings, off-balance sheet arrangements, market risk sensitive derivative instruments and share repurchases. This project is clearly a priority of the Division, and we expect that its recommendations will become clearer during 2015.

The SEC is also assessing whether its comment letter practices have contributed to excessive disclosure. It has asked companies to evaluate regularly whether their disclosure continues to be material to investors as facts and circumstances change and to remove immaterial disclosures even if they were included in prior filings in response to comments from the SEC.

Two main areas of focus for insurance companies in SEC comment letters were the use of captive reinsurance arrangements and their potential impact on a company's financial statements, and statutory disclosures and dividend restrictions under ASC 944-505-40 and Rule 4-08(e) of Regulation S-K.

1. Captive Reinsurance Arrangements

As has been recently highlighted by the press, the NAIC and the NYDFS, many insurance companies use captive reinsurers to reinsure certain risks and reduce the amount of regulatory reserves in their statutory financial statements. The SEC has been requesting additional information on these captive reinsurance companies and additional MD&A disclosure of significant risks or uncertainties that could affect the insurance company as a result. The additional information requests have tended to concentrate on the business purpose of captives, and the existence of any arrangements with third parties and how those benefit the insurance company. Perhaps given the increased scrutiny on the use of captives, the SEC has also asked companies to provide information and disclosure on how using captives affects their financial statements and the potential consequences on the business if the use of captives were discontinued.

2. Statutory Disclosures and Dividend Restrictions

SEC comments have requested that companies disclose the nature of dividend restrictions on insurance company subsidiaries and the amount of retained earnings or net income restricted or unrestricted for payment of dividends. Rule 4-08(e) of Regulation S-K requires additional disclosure of the nature of the restrictions and the amount of restricted net assets when restricted net assets exceed 25% of consolidated net assets.

The SEC has emphasized the importance of disclosing minimum capital requirements for all jurisdictions with significant operations, including those of non-regulated, non-U.S.-domiciled subsidiaries and foreign insurance operations.

Under ASC 944-505-50-1b, the SEC has noted that it is not sufficient to state only that total adjusted capital is in excess of the risk-based capital for all insurance entities. SEC comments have required companies to disclose the amount of statutory capital and surplus necessary to satisfy state and, if applicable, foreign regulatory requirements if it is significant in relation to actual statutory capital and surplus. In the event that statutory capital and surplus is not significant, companies must explain why in the notes to their financial statements. The SEC has also commented that statutory capital and surplus disclosures must be audited.

V. Developments in Corporate Governance and Shareholder Activism

A. Overview

2014 saw a continued decline in the number of corporate governance-directed shareholder proposals at the annual meetings of U.S. public companies, as well as no significant increase in the success of those proposals that came to a vote. Similarly, companies continued successfully to pass their say on pay votes at high rates and, notwithstanding the ever-increasing prevalence of majority vote standards for directors, it continues to be the case that only very few directors do not obtain a majority vote in favor of their election. We believe 2015 will see the continuation of these trends, but for the New York City Comptroller's Boardroom Accountability Project, which, as discussed below, is making proxy access proposals at 75 large-cap companies.

At the same time, however, proxy fight activity is increasing, with several important fights tied to M&A transactions. Activist Pershing Square's tie-up with Valeant Pharmaceuticals in the joint pursuit of Allergan, Inc. broke new (and controversial) ground in collaboration between an activist and a strategic party. In the insurance arena, Endurance's takeover bid for Aspen ended once Aspen shareholders rejected Endurance's proxy proposals.

In the U.K., 2014 saw the introduction of revisions to the U.K. Corporate Governance Code (the "U.K. Code"), which sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. All companies, including insurance groups, with a premium listing of equity shares in the U.K. with reporting periods beginning before October 1, 2014 should continue to report against the September 2012 edition, although they are encouraged to adopt some or all of the new provisions in the revised U.K. Code earlier than formally expected. We detail the changes to the U.K. Code in Section V.F below.

B. Shareholder Proposals in 2014

The number of shareholder proposals in the 2014 proxy season was lower than in 2013, continuing a decline that now spans several years. According to information compiled by Georgeson Inc., the number of shareholder proposals received by companies in the S&P 1500 declined by 2.4% overall. As in the past, shareholder proposals fall into two broad categories: those relating to corporate governance; and those relating to social or political goals. In the former category, 59 proposals sought to require companies to have a board chairman independent of the chief executive officer. Of these, only four proposals received more than a majority of the votes cast, and only one proposal received the vote of a majority of the outstanding shares. Nonetheless, these proposals overall received an average of 38% of the vote, demonstrating the importance of this issue to a range of institutional investors. As in prior years, shareholder proposals to eliminate classified boards, adopt majority voting for directors and eliminate supermajority voting provisions were more successful. These are the only types of proposals that routinely receive a majority of votes cast. A few topical points to note—in December, the subject of repealing classified boards got an unexpected jolt from an article written by a sitting SEC commissioner (Commissioner Gallagher) and a Stanford Law School professor. The article, titled "Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors," challenged the research relied upon by Harvard professor Lucian Bebchuk in support of board declassification proposals that Bebchuk has championed at numerous companies over the past several years. While the research cited by Bebchuk purports to show that declassifying boards increases shareholder value, the article cites contradictory research showing that **classified** boards actually create greater value, at least at certain companies. The article goes on to propose that proponents of board declassification should be required to cite both sides of the research in their proxy proposals. We believe that the article raises good points about whether the rush to declassify boards has really been in the service of shareholders, vs. to serve unrelated interests (such as improving Institutional Shareholder Services ("ISS") governance scores, or increasing the public profiles of the advocates of declassification).

On another topic, although there were only 24 proposals on implementing majority voting for directors, they received higher levels of support than in 2013. Significantly, at companies that have already implemented some form of majority voting (typically, retaining a plurality vote standard for election, but adopting a majority vote policy that calls for directors to submit a resignation if they fail to receive a majority of the vote), these proposals received slightly over a majority of votes cast. In past years such proposals routinely failed at companies that had adopted such "majority voting-lite" protections. Although the practical difference of the two approaches is modest, these voting results may embolden shareholders to push for the somewhat more exacting requirements of a charter provision calling for majority voting.

Another important type of corporate governance proposal, on proxy access, showed little change in prevalence or results in 2014 compared to 2013. 2015 will be a more significant year, as further discussed below.

Social or political proposals have become ever more common in 2014. Typical examples include proposals to require issuers to make disclosures about political contributions or about environmental matters. These shareholder proposals almost never get majority support, although levels of support appear to have grown in 2014 over 2013.

C. Proxy Access

As our readers know, proxy access refers to the ability of shareholders to include their candidates for election to the board in the issuer's own proxy statement. Proxy access does not mean that insurgent candidates will necessarily be elected; rather, it is intended to reduce the costs of running a proxy fight by allowing proponents of board candidates to avoid the costs of printing and distributing their own proxy statements. In 2011, the SEC's own proxy access proposed regulations were vacated by the federal courts. However, in the wake of that proposal, shareholder activists began to seek so-called "private ordering" solutions to proxy access, in which issuers would adopt their own rules allowing access to the issuer's proxy statement, generally through a bylaw amendment. In 2012, nearly 30 stockholder proposals on the subject were submitted to issuers, of which 10 came to a vote. The subject has not yet taken off as an issue. According to Georgeson, the S&P 1500 saw 13 proxy access proposals submitted for a vote in 2014, as compared to 11 in 2013. Once again, success of the proposals depended greatly on how they were structured. The most restrictive version of commonly submitted proxy access proposal calls for a holder to have held at least 3% of the stock for at least three years. These "3/3%" proposals, which mirror the requirements that would have applied under the vacated SEC rules, garnered on average 56% of the vote cast. Other proposals, requiring lower ownership thresholds or shorter ownership periods, generally failed to pass. In addition, in 2014 three companies put forward management proposals to adopt proxy access.

For insurance holding companies, proxy access raises additional issues not present for many other types of issuers. Insurance holding company laws require persons who are presumed to have "control" of an insurer to file change of control approval filings or effectively to "disclaim" control before acquiring the rights that create a presumption of control. Although whether control actually exists is a question of facts and circumstances, having a representative on the board of directors of an insurance holding company is a significant fact for many insurance regulators. Insurers moving toward proxy access would be well-advised to require that any nominee have obtained all necessary regulatory approvals for board service.

In the latter half of 2014, the NYC Comptroller's office announced that it would make proxy access proposals following the 3/3% formulation at 75 large cap companies in 2015. These companies were selected by the Comptroller's office because of perceived concerns at the issuers related to one or more of three issues:

(i) the issuer's contribution to climate change;

(ii) a lack of board diversity, including gender and racial diversity; and

(iii) excessive CEO pay.

These proposals are precatory only—that is, they do not amount to a binding change, but request the submission to shareholders of a binding bylaw amendment that would require proxy access.

As of this writing, the proposals have been submitted to the issuers; it is unclear how many of them will come up for a vote or be adopted. One strategy for mitigating the issue, however, has recently been thwarted. In December, Whole Foods Market, Inc. obtained no-action relief from the SEC allowing it to exclude a 3/3% shareholder proposal on the grounds that it was inconsistent with a proposal being put forward by management under which holders of 9% of the stock for at least five years would be able to nominate directors. Many of the issuers that had received a proposal from the NYC Comptroller's Office considered putting forward their own proposals as well, to limit the likelihood of having to include shareholder nominees in the issuer's own proxy statement. Following an appeal by the proponent of the Whole Foods proposal, on January 16, 2015, the SEC reversed itself on the Whole Foods no-action letter. The SEC announced that it would not grant no-action relief on any proposals this year on the basis of "conflict" with a management proposal, and that it would be reviewing the whole question of when a conflict with a management proposal is sufficient to exclude a shareholder proposal. *The New York Times* reported that this reversal affected 18 pending no-action letter requests from issuers that had received the NYC Comptroller's proposal.

Finally, despite adoption of proxy access by a few companies to date, we are not aware of any issuers that have actually had a candidate proposed to be included in the issuer's proxy statement. This will undoubtedly be the next frontier in proxy access.

D. Say on Pay and Director Elections

As in the two prior years, in 2014 shareholders once again overwhelmingly approved the executive compensation of the S&P 1500 companies. Only 2.7% of companies failed to get a majority of votes cast in favor, compared to 1.5% in 2013 and 2.6% in 2012. Adverse recommendations by ISS and Glass, Lewis & Co., the two largest proxy advisory firms, once again greatly outnumbered failed votes. In the U.K., "mandatory say on pay" came into force in 2014. Listed issuers were required to submit their pay policies for vote by shareholders at their 2014 Annual General Meetings, and further may not pay any amounts outside the parameters of the adopted policies. No FTSE 100 company failed to get less than majority support for its remuneration policy at its 2014 annual general meeting, despite seven "no" or "abstain" recommendations from ISS.

In addition, the number of directors who received more than a majority of "no" or "abstain" votes with respect to their election in 2014 was comparable to 2013, according to Georgeson. In 2014, 28 directors fit into that category, compared to 26 in 2013. Three companies accounted for more than half of the elections in 2014 in which this occurred. Such votes result in so-called "zombie directors," in the colorful argot of the activists, when the candidates' boards of directors do not accept their subsequently proffered resignations from the board. One example in 2014 was Nabors Industries, where three members of the board were retained on the board despite receiving majority opposition. Retaining zombie directors is clearly to be avoided by issuers seeking shareholder goodwill.

E. Proxy Fights

The insurance M&A proxy fight that was on everyone's mind this year was the one relating to Endurance's takeover bid for Bermuda-based Aspen.* Endurance first publicly proposed a price for Aspen in April; Aspen adopted a poison pill shareholder rights plan in response. When it got no traction, in June, Endurance publicly increased its offer to approximately $3.2 billion in cash and stock. In addition, Endurance ran a proxy campaign soliciting Aspen shareholders to support a proposal to convene a special general meeting of shareholders at which the shareholders would consider a proposal to increase the size of the board of directors to a sufficient number to elect a majority of the board of directors at the next annual general meeting of shareholders notwithstanding Aspen's staggered board. Endurance also asked Aspen shareholders to consider a proposal to authorize a Bermuda court-ordered meeting of Aspen shareholders to vote on a scheme of arrangement.

* Willkie Farr & Gallagher advised on this transaction.

After a heated proxy fight, the two Endurance proposals were voted down by the Aspen shareholders. Shareholders holding more than 75% of the outstanding Aspen shares voted against the proposals. Aspen argued that the Endurance bid undervalued Aspen, and that the combination of the companies would create dis-synergies, including the loss of valued business. In addition, Aspen argued that the use of the scheme of arrangement without the consent of Aspen's board of directors would be an "unprecedented usurping of a board's judgment." An important factor in the outcome was the recommendations of proxy advisors ISS, Glass, Lewis & Co. and Egan-Jones against the Endurance proposals. The shareholder vote was final on July 28; Endurance abandoned its effort to acquire Aspen on July 30.

The insurance industry was otherwise quiet on the proxy fight front. In a few situations, activist investors sought seats on insurance company boards without a full proxy fight. In January 2014, Foundation Asset Management, which held 7% of title insurer Stewart Information Services, filed a Schedule 13D announcing that it planned to hold discussions with management of the company about getting representation on the company's board. Stewart quickly capitulated, agreeing in February to put two Foundation nominees up for election as part of management's slate. This sort of strong-arm "proxy access," now more than ever in favor with activist investors, is more effective than anything the NYC Comptroller's office has yet to cook up.

The insurance regulatory defense, in which the assistance of regulators is sought to defend against a proxy fight as potentially resulting in an unapproved change of control, did not play a significant part in any proxy fights this year. This defense remains potent in the right circumstances.

Activist tactics such as Foundation's are becoming relatively common. For an example of a new page in the activist playbook, one need look no further than the takeover battle between Allergan and Valeant. Not content merely to call for change at Botox-maker Allergan, activist Pershing Square (headed by William Ackman) teamed up with Canadian pharmaceutical company Valeant to bid for Allergan. Pershing Square owned nearly 10% of Allergan's stock, and agreed to support Valeant's cash and stock bid, including providing financing. When Allergan resisted, the bidders began a proxy fight to gain control of the board in order to get the offer accepted. Before the court-ordered special meeting could be held, however, Allergan agreed to be acquired by Actavis, another large pharmaceutical company. In an unusual arrangement, Pershing Square agreed to share its profits on its Allergan investment, which were in excess of $2.5 billion, with Valeant. The Allergan situation marks the first time that an activist and a strategic buyer have teamed up to attempt to acquire a target company. Undoubtedly both activists and aggressive strategic players will look for further opportunities for profitable collaboration in 2015.

F. U.K. Corporate Governance Code 2014

The main changes to the U.K. Code that are being phased-in relate to financial and business reporting (going concern), risk management and internal control, remuneration and shareholder engagement.

As with U.S.-listed companies as noted above, shareholder engagement is also a relevant governance concern for U.K.-listed companies. Under the revised U.K. Code, when publishing shareholder general meeting results, companies should explain how they intend to engage with shareholders when a significant percentage of shareholders have voted against any resolution. This requirement was originally intended to apply only to remuneration-related resolutions at the annual general meeting. It has now been extended to apply to any resolution at any general meeting.

Thus far little guidance has been provided on what is meant by a "significant" percentage of shareholders voting against a company proposal. However, an analogous provision can be found in the regulations governing the remuneration report segment of the annual report and accounts, which require that if a significant percentage votes against either the remuneration report or policy resolutions, then the annual remuneration report must set out, where known to the directors, the reasons for those votes and any actions taken by directors in response to investor concerns. Related remuneration guidance on this provision states that companies will need to use their judgment as to what they consider "significant," but as a guide, companies "may wish to consider" 20% as being significant, although there may be reasons why, for some companies, a higher or lower percentage might be more appropriate. The remuneration guidance also suggests that companies may wish to disclose in the annual remuneration report the level of votes they deem to be "significant."

The revised U.K. Code now requires confirmation in the annual report that a "robust assessment" of principal risks has been conducted at the level of the board of directors. Several commentators wanted the new guidance to clarify what is meant by a "robust assessment." While not an exhaustive list, the revised U.K. Code provides that this robust assessment must include risks that would threaten the company's business model, future performance and both solvency and liquidity risks. Under the revised U.K. Code, companies will also be required to monitor their risk management and internal control systems and, at least annually, review their effectiveness and report on that review in the annual report. For some companies with well-developed, ongoing board-level monitoring of their risk management and internal control systems, compliance with the revised U.K. Code will not require a radical departure from their current protocols. Others, however, may need to boost their ongoing monitoring and director engagement and also more closely assess the results of the annual review of effectiveness, taking action to address issues raised and thus being able to report on them in their relevant accounts.

Other key changes under the revised U.K. Code include the requirement for companies to state:

(i) whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so; and

(ii) whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks, and specifying the period covered by this statement and why they consider it appropriate.

It is expected that the period assessed will be significantly longer than 12 months. The second provision is an entirely new U.K. Code provision. These two provisions of the revised U.K. Code have caused the most discussion and debate and have gone through the most iterations. The end position is that companies will now make two separate statements, the statement on the going concern basis of accounting and this new, wider viability statement. All companies will need to consider carefully and well in advance what preparations, assurance and discussions will be needed to enable directors to feel confident to give each of the above statements and explanations.

Finally, a number of other key changes to the revised U.K. Code relate to the remuneration of directors. In general, greater emphasis must now be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and on acknowledging that the lead responsibility for doing so rests with the remuneration committee.

VI. Principal Regulatory Developments Affecting Insurance Companies

A. Overview

International and federal developments and the reaction of U.S. state regulators to these developments took center stage in 2014. The growing, and at times competing, influence and jurisdictional reach among the complex web of national and international regulators[8] came into clearer focus over the course of the year. These dynamics and their effect on U.S. and internationally active insurers made for a busy year in insurance regulation which included:

(i) the approval of changes to the interpretation of the Dodd-Frank Act which recognize the differences between banking capital requirements and requirements more appropriate for insurers designated as SIFIs;

(ii) IAIS field-testing of ComFrame and development of the BCR;

(iii) NAIC authorization (by amendment of the Model HCA) of state commissioners' group-wide supervisory authority;

(iv) the NAIC's decision to develop a U.S.-driven group solvency standard as an alternative to the BCR; and

(v) IMF assessment of whether the U.S. system of insurance regulation satisfies the standards set by the IAIS.

International matters did not, however, completely dominate U.S. insurance regulators' agenda in 2014. Much attention was also focused on life insurance company-owned captives; private-equity investors/owners of insurance companies; principle-based reserving; TRIA reauthorization and cyber risks.

A summary of these developments and forecasts for 2015 are set forth below.

8 A glossary briefly describing (i) the role of and acronym for the significant U.S. and non-U.S. insurance/financial regulators and (ii) several regulatory designations/initiatives is set out as **Appendix A** to this report. Please refer to the glossary for definitions of such acronyms and designations/initiatives that are used but not defined in this Section.

B. Federal Insurance Office

1. Insurance Modernization and Global Reinsurance Market Reports

a) FIO Modernization Report

In December 2013, FIO released its report on how to modernize and improve U.S. insurance regulation (the "FIO Report"). The FIO Report included various recommendations based on the idea that the U.S. system of insurance regulation "can be modernized and improved through a combination of steps taken by the states and by the federal government."[9] Examples of state action responsive to FIO criticisms are set forth below.

- Insurer Corporate Governance. The FIO Report noted the absence of an NAIC model law or regulation on insurer corporate governance in the context of the post-financial crisis world. The NAIC made great progress in this area in 2014 by adopting the Corporate Governance Model Act and corresponding regulation in November. The NAIC has already started to take action to make the adoption of this model law and regulation an accreditation standard. For more information, see Section VI.G.3 below.

- Group Supervision. The FIO Report recommended that states continue to develop approaches to group supervision in order to address the shortcomings of solo entity supervision. The NAIC was actively engaged in this area in 2014 through its revisions to the Model HCA that authorize state regulators to serve as GWS for certain international groups. Additionally, CDAWG is in the process of reviewing the IAIS's ComFrame as well as its international group capital developments to consider the extent to which they should be adopted by the NAIC and to coordinate any related responses or initiatives. For more information, see Section VI.D.2 below.

9 United States. Dept. of the Treasury, Federal Insurance Office. *Annual Report on the Insurance Industry*. Washington: Dept. of the Treasury, Federal Insurance Office, Sept. 2014. Web. 29 January 2015.

b) Covered Agreement on Reinsurance

Near the end of 2014, Director Michael McRaith of FIO disclosed that a covered agreement on reduced collateral for reinsurance is under development, and is expected to be based on the Amended Credit for Reinsurance Model Act. Under the Dodd-Frank Act, one of the specific authorities given to FIO is the power to assist the Secretary of the Treasury in negotiating covered agreements with international regulators on behalf of the United States that relate "to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation." It has been pointed out that the United States granted a concession to international reinsurers in allowing the reduced collateral concept to be added to the Amended Credit for Reinsurance Model Act, and that now a reciprocal recognition or concession of equal significance should be forthcoming from international regulators that benefited. It was not discussed which jurisdictions the draft covered agreement will be negotiated with. However, we note that earlier in 2014, the E.U.-U.S. Insurance Project—which builds on the established U.S.-E.U. bilateral dialogue and includes representatives from the NAIC, the European Commission, the European Insurance and Occupational Pensions Authority and FIO—proposed in its roadmap document that initial steps should be taken toward entering into a covered agreement between the E.U. and the U.S. federal government by the end of 2014.

c) FIO Reinsurance Report

FIO released a report in December 2014 that was also required under the Dodd-Frank Act, titled "The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States." This report confirms FIO's view that the reinsurance sector is "vitally important" to the United States, and that the global reinsurance market "provides an essential backstop and various risk and capital management mechanisms for insurance in the United States." The report noted that, as discussed above, Treasury and the U.S. Trade Representative are "considering a covered agreement with respect to collateral requirements for reinsurers."

2. 2015 Agenda

We note that one of the topics of interest for FIO, and therefore being considered by FACI, is cyber risk. Director McRaith has stated that Treasury Secretary Jacob Lew and Deputy Secretary Sarah Raskin have emphasized that cyber risk should be a priority for FIO. New York is also very interested in this topic. For more information regarding the emergence of cyber risk as a major insurance issue, see Section VI.G.5 below.

In 2014 a new chairman was appointed to FACI: Dan Glaser, CEO and Chair of Marsh & McLennan Companies. Glaser replaced Brian Duperreault, who previously held the role.

3. E.U./U.S. Dialogue

In 2014 the E.U./U.S. Dialogue Project changed its name to the E.U./U.S. Insurance Project. FIO was an initiator of this project and Director McRaith is a key member representing the interests of the United States with respect to this project. The E.U./U.S. Insurance Project released an update of its seminal document, "The Way Forward," in July of 2014 and its members thereby reaffirmed their continuing commitment to the project. Key goals include addressing GWS and group capital standards concepts, including various types of reviews, improving the flow of information between regulators, and developing a consistent approach to reinsurance and collateral requirements.

C. Federal Stability Oversight Council

The Dodd-Frank Act authorizes FSOC to designate a nonbank financial company, which could be an insurer, as a SIFI, thereby subjecting it to consolidated federal supervision under the Federal Reserve Board and enhanced regulatory standards. In 2013, FSOC made its first SIFI designations, three of which were insurance groups—AIG; General Electric Capital Corporation; and Prudential. The 2013 designation of Prudential was made over the objection of Roy Woodall, the voting insurance industry member of FSOC, who suggested that FSOC should rely on the recommendations of individuals with insurance expertise when determining whether an insurance group should be designated as a SIFI. In 2014 FSOC proposed the additional designation of MetLife as a SIFI, a proposal that was also contentious, with a number of insurance regulators publicly stating their belief that it should not be designated. MetLife challenged the designation, but FSOC confirmed its decision on December 18, 2014, with Woodall again providing the lone dissenting vote. MetLife then filed a lawsuit against FSOC on January 13, 2015 challenging the designation. FSOC has no voting members from the insurance industry besides Woodall, although Director McRaith and an NAIC representative (now Commissioner Adam Hamm of North Dakota) serve as non-voting members. It will be interesting to observe in the coming year whether the industry pushback and/or political power shifts in the Congress will have any effect on FSOC's designation process.

We note that, in addition to having authority to supervise SIFIs, under the Dodd-Frank Act the Federal Reserve Board is also responsible for the "consolidated supervision" of insurance groups that include federally chartered thrifts or banks.

On December 20, 2014, President Obama signed the Insurance Capital Standards Clarification Act of 2014, which gives the Federal Reserve Board flexibility in interpreting the "Collins Amendment," as Section 171 of the Dodd-Frank Act is commonly known. Pursuant to the legislation, insurance companies that are part of groups designated as SIFIs will not be subject to minimum capital standards that are designed for banks. Instead, the Federal Reserve Board is authorized to tailor capital standards for these insurance companies. This legislative development is significant because, prior to the adoption of this Act, while the Federal Reserve Board had recognized that the business models for banks and insurance companies differed, it took the position that it did not have statutory authority to adopt capital standards for insurance companies that recognized those differences. It is expected that the Federal Reserve Board will now develop and adopt rules on capital standards for insurance companies and it has been reported that the Federal Reserve Board has been consulting with state regulators about developing appropriate measures.

D. International Association of Insurance Supervisors

1. U.S. Representation at IAIS

The role of the U.S. regulators at the IAIS was also noteworthy in 2014. While a number of U.S. state and federal regulators and personnel (*i.e.*, state regulators, FIO and—as of 2013—the Federal Reserve Board) are members of the IAIS, the United States is far from having a controlling authority there. Director McRaith represents the United States at the IAIS, and serves on the IAIS Executive Committee and as Chair of its crucial Technical Committee, which is tasked with developing ComFrame. FIO's representation on these committees enables FIO to have an active role in the development of international insurance standards. There has been ongoing tension between state regulators and FIO as to how to approach international regulatory issues. State regulators hold seats on the IAIS Executive Committee and various other important committees. The Federal Reserve Board has joined the IAIS Technical Committee and IAIS Financial Stability Committee, having stated in mid-2014 the desire to get fully "staffed up" on IAIS committees.

The Federal Reserve Board's increased participation in the IAIS is one aspect of its growing and more visible involvement with insurance regulation and its apparent interest in allying with other U.S. regulators on the international front. As a result, some U.S. regulators began developing a "Team USA" approach to developing group capital standards that would not only be appropriate for use in the United States but also acceptable to the IAIS and potentially other international matters in general. Meanwhile, state regulators have continued to criticize the movement away from transparency at the IAIS.

2. Group Supervision

The IAIS is currently working on two major projects relating to group supervision:

(i) the development of ComFrame, which has been under development since 2010; and

(ii) the development of group-wide capital standards applicable to G-SIIs and IAIGs.

a) ComFrame

ComFrame is intended to provide basic standards for IAIGs and a process through which supervisors of IAIGs around the world may cooperate. The IAIS completed its third public consultation on a draft of ComFrame at the end of 2013 and began field testing it in March 2014. This testing began with the "quantitative phase" of field testing, which was followed in late 2014 by the beginning of the "qualitative phase" of field testing. Field testing of ComFrame consists of performing impact studies on all the ComFrame elements to see if each "leads to effective group-wide supervision of IAIGs, are of practical and substantive value and do not lead to excessive costs to IAIGs and their supervisory colleges." The current, qualitative phase of field testing includes studying governance, enterprise risk management, group structure and strategy, and it is expected that field testing will demonstrate how risks related to those areas are managed.

During field testing, ComFrame is being evaluated and will be modified if necessary before it is adopted in 2018 and implemented in 2019. Meanwhile, the NAIC has established CDAWG, which is tasked with reviewing ComFrame (as well as the international group capital developments discussed below), facilitating the participation of U.S. regulators in the ComFrame field testing processes, and communicating on these matters with the Federal Reserve Board and FIO.

b) Group Capital Standards

The IAIS has proposed a three-tiered group capital approach:

A. Basic Capital Requirements ("BCR"): A basic capital requirement applicable to G-SIIs on a consolidated, group-wide basis. The BCR was approved by the IAIS and went to the G-20 for approval in November 2014. The form of the BCR was therefore expected to be finalized by year-end, though not yet effective.

B. Higher Loss Absorbency ("HLA"): A higher standard also applicable to G-SIIs, building on BCR. The IAIS proposes that G-SIIs should face a higher loss absorption capacity, to reflect the greater risks that the failure of G-SIIs poses to the global financial system. An initial consultation paper is being drafted by the IAIS, with the finalization of the form expected in 2015.

C. Insurance Capital Standard ("ICS"): A capital standard to be applicable to IAIGs. An initial consultation paper was released in December with a comment due date of February 15, 2015, and the standard is to be developed in 2016. It is not yet clear as to which level of a holding company group the ICS will be applied to—whether it will be applicable to the ultimate parent or instead to an intermediate insurance holding company.

The effective date for G-SIIs and/or IAIGs to be subject to the three tiers is expected to be 2019 (alongside the implementation of ComFrame).

3. IAIS "Observer" Status

The IAIS has eliminated its "Observer" status, which previously allowed pre-cleared industry representatives and other persons to participate in its meetings. U.S. state regulators have voted against and strongly criticized the IAIS's move away from transparency. Commissioner Hamm, then President of the NAIC, stated that he was "extremely disappointed" with this change since "[s]hutting [observers] out of the official process in favor of 'invite only' participation deprives IAIS members and stakeholders alike and could diminish the credibility of decisions made at the IAIS." NAIC members also consistently re-affirmed their commitment to maintaining transparency in the NAIC.

However, Director McRaith did not vote against the IAIS's changing policy, and, further, defended the IAIS's decision at a November hearing of the Housing and Insurance Subcommittee of the House Committee on Financial Services, when he said that the IAIS is not trying to "shut out" state insurance regulators. Instead, McRaith told the House subcommittee that he believes the IAIS is trying to "improve the independence and transparency of its standard-setting activities," and he will work to ensure that U.S. stakeholders, including the NAIC, will have the opportunity to present their views to the IAIS.

At the NAIC's fall national meeting an IAIS representative announced that, as a means of allowing observers to have a continued role in developing IAIS standards, the IAIS expects to hold two public meetings in the United States in 2015 where interested parties will be able to speak. The meetings are being held on February 5, 2015 in Newport Beach, California and in May in New York City. The California meeting will focus on the development of ICS, as it will fall within the comment period for the ICS consultation paper.

E. Financial Stability Board

In November 2014 the FSB announced its determination that the nine G-SIIs designated in 2013—Allianz SE; AIG; Assicurazioni Generali S.p.A.; Aviva plc; AXA S.A.; MetLife; Ping An Insurance (Group) Company of China, Ltd.; Prudential; and Prudential plc—will remain the only designated insurer G-SIIs pursuant to the 2014 evaluation. Although it had been expected that the FSB would announce designation of reinsurer G-SIIs in 2014 for the first time, it was also reported in November that identification has been postponed in order to further develop the underlying methodology.

Although the IAIS has released recommendations on how regulators should evaluate and identify IAIGs, the IAIS itself does not designate IAIGs or keep a list of those designated by other regulators.

F. Financial Sector Assessment Program

The United States is currently undergoing an assessment by the IMF as part of the FSAP, which is conducted every five years by the IMF. The FSAP of the United States is well underway, as the United States has submitted its self-assessment and the IMF has made on-site visits to locations including NAIC offices. The IMF is now working on finalizing its report, which is expected to be delivered in 2015. This review will assess the strength and scope of U.S. insurance regulation against the Insurance Core Principles developed by the IAIS. In a previous FSAP report issued in 2010, the IMF was critical of the U.S. insurance regulatory system—saying, for example, that the NAIC had no model laws or regulations that directly addressed the corporate governance of U.S. insurers and that, while the state-based regulatory system was effective in assuring policyholder protection and the soundness of individual insurance companies, it "lacked a systemic focus and the capacity to exercise group-wide oversight." The FSAP also noted that federal regulators had limited regulatory authority over insurance companies, and recommended enhanced communication between state and federal agencies with respect to matters of insurance regulation. A number of these criticisms were subsequently reiterated in the FIO Report, as discussed in Section VI.B below.

G. Insurance Topics of General Interest

1. NAIC Internal Governance and New Federal Reserve Board Advisor

a) NAIC Governance Consultant

In response to criticisms of the NAIC's own governance by then-Connecticut Commissioner Tom Leonardi and others,[10] the NAIC created a new committee known as the Governance Review (EX) Task Force. The Task Force was authorized to receive applications from outside consultants to study and recommend changes to NAIC governance. Those applications were delivered in August; however, rather than permitting the Task Force to review and select a consultant as expected, a subcommittee of the NAIC's Executive Committee itself was formed and assumed that authority, a move that was challenged by Leonardi and others—albeit unsuccessfully. The selection of the NAIC governance consultant has not yet been announced. Once identified, the consultant will work with the Task Force in conducting its review.

b) Personnel Changes

In 2014 the President of the NAIC was Commissioner Hamm of North Dakota. He has been succeeded by Montana State Auditor and Commissioner of Securities and Insurance Monica Lindeen, who will serve as NAIC President for the term of 2015. Pennsylvania Insurance Commissioner Michael Consedine was to take the position of NAIC President-Elect; however, it was recently announced that Commissioner Consedine has been replaced as Pennsylvania Insurance Commissioner following the election of a new governor. The NAIC will hold a special election to replace Consedine and fill the office of President-Elect. Separately, Commissioner Hamm was selected to serve as the NAIC's new consultant to FSOC, taking over that role from Missouri Director Huff who had served the first two terms.

In late 2014 then-Commissioner Leonardi announced that he was resigning his position and returning to the private sector. Additionally, Kansas Insurance Commissioner (and former NAIC President) Sandy Praeger retired in January 2015. It has been widely rumored that the current NY Superintendent, Benjamin Lawsky, will be leaving his position, but as of this time no announcement has been made.

In June 2014 Thomas Sullivan, a former Connecticut insurance commissioner, became a senior adviser for insurance to the Federal Reserve Board. This appointment was widely praised by state insurance regulators as it seems to herald a closer working relationship between state regulators and the Federal Reserve Board. This will be particularly useful in light of the Federal Reserve Board's new authority to create and impose capital standards developed particularly for insurance groups. However, certain tensions continue between state insurance regulators and federal financial regulators, including FIO.

2. State Authority as Group Wide Supervisor

In 2014 the Model HCA was re-opened for amendment in light of international developments and the U.S. FSAP process. The NAIC drafted changes (the "HCA Revisions") to the Model HCA that focused primarily on U.S. regulators' authority to lead or participate in the group-wide supervision of certain international insurance groups. After much discussion among regulators and interested parties, the revisions were adopted by the NAIC in December 2014.

The HCA Revisions provide for a state insurance commissioner, in cooperation with other state, federal and international regulators, to determine whether the commissioner is the appropriate GWS for an IAIG with substantial insurance operations in the state. Factors considered in determining which regulator should assume the role of GWS include the domicile of the largest insurers in the IAIG, the domicile of the top-tiered insurer in the group, whether another jurisdiction seeks to act as GWS and whether another U.S. insurance regulator already

10For more information, see our NAIC Report: 2014 Fall National Meeting, dated December 5, 2014, Section I.F.2 – "NAIC Internal Governance Review Process Continues."

acts as the "lead state." The NAIC decided that the HCA Revisions should adhere as closely as possible to the "lead state" financial analysis process which is already working well in the United States, and almost all of the "lead state" identification criteria are included as criteria to be considered in determining the GWS. It was also decided that the HCA Revisions should include an explicit statement that each group can have only one GWS. Substantial debate occurred over whether the HCA Revisions should grant authority to commissioners to serve as GWS for all international insurance groups, or to limit the authority to IAIGs, a term which currently mirrors the IAIG concept used by the IAIS. The original Pennsylvania statute upon which the HCA Revisions were based provides authority over all international insurance groups. While the NAIC working group initially opted for GWS oversight of any international insurance group, after receiving feedback from its parent committee regulators, including Commissioner Consedine, they chose to limit the GWS authority to IAIGs. The NAIC and industry also included the possibility for non-IAIG groups to "opt in" to the GWS process if they want to have their GWS determined or recognized.

Under the HCA Revisions, the GWS is authorized to engage in various supervisory activities with respect to the IAIG, including: assessing enterprise risks within the IAIG; requesting from any member of the IAIG subject to the GWS's supervision any information necessary and appropriate to assess enterprise risk; communicating with other state, federal and international regulators and sharing relevant information with them (subject to confidentiality provisions); entering into agreements with or obtaining documentation from any member of the IAIG and any other regulators of the IAIGs; and other group-wide supervision activities "as considered necessary" by the GWS.

In the fall of 2014 a debate about the scope of the GWS's authority arose with respect to a provision in the HCA Revisions stating that the GWS is authorized to "compel development and implementation of reasonable measures" to ensure that the IAIG is able to mitigate enterprise risks to its members that are engaged in the business of insurance. Industry representatives urged that the role of the GWS should be "coordination and collaboration" among involved supervisors to facilitate a desired outcome, rather than "compelling" action on the part of group members over which the GWS does not have jurisdiction. In response, members of the NAIC working group argued that the proposed language was critical because it "gives teeth" to the GWS in the eyes of the international community. The NAIC working group chose to keep the "compel" language when describing the scope of the GWS's authority, but indicated that actions should be compelled through coordination with regulatory officials of the jurisdictions where members of IAIGs are domiciled. This resolution provides a more narrow authority than that provided by the Pennsylvania statute on which the HCA Revisions were based, which does not include the language on coordination.

3. Corporate Governance

In 2014, the NAIC completed two initiatives arising out of its Solvency Modernization Initiative (the "SMI") that focused on strengthening corporate governance standards applicable to U.S. insurers. The SMI was initiated in 2008 during the beginning of the global financial crisis. A number of its specific goals were identified following the IMF's 2010 FSAP Report wherein the IMF concluded that the NAIC had no model laws or regulations that directly addressed the corporate governance of U.S. insurers and made corporate governance recommendations, including:

(i) issuing more guidance on "good and bad practices" in corporate governance;

(ii) requiring insurers to have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling risks; and

(iii) formally requiring insurers to have an internal audit function.

As the SMI progressed, these three recommendations led to three NAIC model law and regulation developments: the development of the Corporate Governance Model Act and Corporate Governance Model Regulation, the development and adoption of the ORSA Model Act, and amendments to the Model Audit Rule.

VI. Principal Regulatory Developments Affecting Insurance Companies

a) The Corporate Governance Model Act and Corporate Governance Model Regulation

The NAIC adopted both the Corporate Governance Model Act and Corporate Governance Model Regulation in November 2014. Once enacted by the states, the Corporate Governance Model Act and Corporate Governance Model Regulation will require the filing of a CGAD, a confidential document that is intended to provide insurance regulators with a summary of corporate governance structure, policies and practices, so that regulators can gain and maintain an understanding of an insurer's corporate governance framework. The filing requirement will be imposed on all insurers, as defined under the applicable state's law, regardless of size or annual premiums. The provisions of the Corporate Governance Model Act will become effective on January 1, 2016, if adopted by the states.

The CGAD will include disclosure with respect to the items specified in the Corporate Governance Model Regulation, which can generally be categorized within four key elements of corporate governance:

(i) the insurer's or insurance group's corporate governance framework and structure;

(ii) the policies and practices of the insurer's or insurance group's most senior governing entity and significant committees;

(iii) the policies and practices for directing senior management; and

(iv) the processes by which the Board of Directors, its committees and senior management ensure an appropriate amount of oversight is applied to critical risk areas impacting the insurer's business activities.

The Corporate Governance Model Regulation identifies a number of sub-items within each of these elements, and the CGAD is expected to include a description of the listed items. The Corporate Governance Model Act and Corporate Governance Model Regulation were designed to provide insurers and insurance groups with flexibility in preparing the CGAD, as they can choose whether to make the disclosure at the insurer level, intermediate holding company level or ultimate controlling parent level. They also have the option of cross-referencing other insurance regulatory filings.

Beginning in 2016, the CGAD is to be prepared and submitted annually to the insurer's home state regulator by no later than June 1. However, if an insurer is a member of an insurance group, then the CGAD is to be submitted to the insurance group's lead state, rather than its home state regulator. The CGAD will be reviewed by regulators in order to obtain additional information regarding the corporate governance practices of their domestic insurers, or, if the regulator is the lead state regulator of an insurance group, of its domestic insurers and their affiliates. Due to the sensitive nature of the information contained in the CGAD, it will be protected by enhanced confidentiality provisions.

The NAIC has already begun taking action in order to make adoption of the Corporate Governance Model Act and Corporate Governance Model Regulation an accreditation standard. At the NAIC fall national meeting, the CGWG approved a recommendation to make adoption of the Corporate Governance Model Act and Corporate Governance Model Regulation's essential elements (including the requirement for an annual CGAD, prepared consistently with the Corporate Governance Model Regulation, and the enhanced confidentiality protection afforded to the CGAD) into accreditation standards. Thus, since the Corporate Governance Model Act and Corporate Governance Model Regulation will likely become accreditation standards, states will likely move quickly to adopt their requirements, and it would be prudent for insurers to begin internal preparations for this filing to be submitted in 2016.

b) Model Audit Rule

The Model Audit Rule, as currently adopted by the states, became effective in 2010. The 2010 revisions to the Model Audit Rule included a requirement that insurance companies have an audit committee whose sole responsibility is the appointment, compensation and oversight of the company's independent auditor (with additional requirements relating to the independence of committee members applicable to insurers over certain premium thresholds); and a requirement that insurers above certain thresholds file an annual report with respect to their assessment of internal control over financial reporting.

The Model Audit Rule, however, did not require that insurers maintain an internal audit function, and this absence was noted in the 2010 FSAP report. Accordingly, in August 2014, the NAIC adopted revisions to the Model Audit Rule (as revised, the "Amended MAR") to require that the following categories of insurers maintain an internal audit function:

(i) licensed or authorized insurers, as defined by applicable state law, with annual direct written and unaffiliated premium of at least $500 million; and

(ii) insurers that are members of a group of insurers with more than $1 billion in annual direct written and unaffiliated premium.

The internal audit function will review an insurer's corporate governance, risk management and internal controls and provide reasonable assurance to the insurer's audit committee with respect to such controls. Although small insurers are initially exempted from this requirement, the Amended MAR nonetheless recommends that such insurers conduct a self-review to determine whether an internal audit function should be maintained.

The Amended MAR provides that the internal audit function will be overseen by an insurer's audit committee, which will be responsible for granting authority and resources to those persons responsible for performing an internal audit. Additionally, the internal audit function should remain organizationally independent, with the persons in charge of the internal audit function being granted direct and unrestricted access to the insurer's board of directors. The head of the internal audit function must report to the audit committee regularly, and no less than annually, with respect to material findings from previous audits and factors that may adversely impact the internal audit function's independence or effectiveness.

The revisions to the Model Audit Rule are proposed to become effective on January 1, 2016. The Model Audit Rule is already an accreditation standard, and the CGWG recently approved a recommendation to make adoption of the Amended MAR an accreditation standard. As a result, states can be expected to adopt these revisions quickly, although they have not yet been adopted by any state.

c) States Continue Adopting the ORSA Model Act

When adopted by the NAIC, the ORSA Model Act had a proposed effective date of January 1, 2015, which would require insurers exceeding specified premium thresholds to maintain a risk management framework, regularly conduct an ORSA, and document the results of the ORSA in an "ORSA Summary Report." As of the end of 2014, only 21 states had adopted the ORSA Model Act.[11]

4. Credit for Reinsurance Model Law and Regulation

The end of 2014 saw the long-awaited addition of seven international supervisory authorities to the NAIC List of Qualified Jurisdictions, enabling states that have adopted the Amended Credit for Reinsurance Model Act to implement reduced collateral requirements with respect to qualified reinsurers domiciled in these seven jurisdictions. During the year, five more states adopted the Amended Credit for Reinsurance Model Act. In addition, a covered agreement on reduced collateral for reinsurance is being developed by FIO, the U.S. Trade Representative and the White House, although few details have been released to date.

In December 2014, the NAIC approved the international supervisory authorities of seven jurisdictions for addition to the NAIC List of Qualified Jurisdictions: Bermuda (Bermuda Monetary Authority ("BMA")); Germany (German Federal Financial Supervisory Authority ("BaFin")); France (Autorité de Contrôle Prudentiel et de Résolution ("ACPR")); Ireland (Central Bank of Ireland ("CBI")); Japan (the Financial Services Agency of Japan ("JFSA")); Switzerland (Financial Market Supervisory Authority

11 California, Connecticut, Delaware, Illinois, Indiana, Iowa, Kentucky, Maine, Minnesota, Nebraska, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, Wisconsin, and Wyoming.

("FINMA")); and the United Kingdom (Prudential Regulation Authority of the Bank of England ("PRA")). These are the first jurisdictions on the list. Those states that have adopted the Amended Credit for Reinsurance Model Act can now implement reduced collateral requirements with respect to qualified reinsurers domiciled in these seven jurisdictions. Absent any unexpected developments specific to a qualified jurisdiction, each of the seven jurisdictions will remain on the NAIC List of Qualified Jurisdictions for a period of five years.

With respect to each of the seven qualified jurisdictions, a single state will function as the "lead state" for purposes of regulatory cooperation and information sharing. Thus:

(i) the Florida Office of Insurance Regulation ("FLOIR") will be the lead state regulator with respect to the BMA, pursuant to an existing agreement between FLOIR and the BMA;

(ii) the CA Department will be the lead state regulator with respect to BaFin and the JFSA through a multilateral memorandum of understanding through the IAIS. It will also be the interim lead state regulator with respect to ACPR, pending the adoption of an amendment updating the bilateral agreement between ACPR and the NYDFS, at which point the NYDFS will become the lead state regulatory with respect to ACPR;

(iii) the NYDFS will be the lead state regulator with respect to the PRA;

(iv) the Connecticut Insurance Department will be the lead state regulator with respect to FINMA; and

(v) the Delaware Department of Insurance will be the lead state regulator with respect to CBI.

We note that Bermuda's status as a Qualified Jurisdiction is applicable only to (re)insurers of Class 3A, Class 3B, and Class 4, as well as to long-term insurers of Class C, Class D and Class E.

As 2014 came to a close, the Amended Credit for Reinsurance Model Act, which allows reduced reinsurance collateral requirements for unauthorized "certified" reinsurers, had been adopted by 25 jurisdictions.[12] In addition, we understand that further U.S. states including Arizona, Montana, Nebraska, Nevada, North Dakota and Washington are currently considering adopting the Amended Credit for Reinsurance Model Act. We note that a covered agreement on this topic could preempt individual states' decisions on whether to adopt reduced collateral legislation.

Under the Amended Credit for Reinsurance Model Act, reinsurers domiciled in countries found by the NAIC to have strong systems of domestic insurance regulations (*i.e.*, "qualified jurisdictions") are eligible to apply for "certified reinsurer" status in states that have adopted the amendments. In order to qualify as a "certified reinsurer," an applicant must also meet certain criteria as to financial strength and reliability as provided in the Amended Credit for Reinsurance Model Act. Certified reinsurers are permitted by regulators to post collateral at various reduced levels, and U.S. ceding insurers are permitted to take full financial statement credit for the reinsurance obligations of such certified reinsurers upon the posting of such reduced collateral.

5. Cyber Risk

Cyber risk emerged as a hot topic at the end of 2014. Cyber risk was addressed in several meetings at the NAIC's fall national meeting and it was also a major topic of discussion at the FACI meeting held on November 6. The discussions have covered the scope of the threat, the potential consequences of data breaches at insurance companies, and also the increased interest in and difficulty of writing coverage for cyber risk. In November, the NAIC's Executive Committee established the Cybersecurity (EX) Task Force, which has been tasked with monitoring and facilitating communication about this issue. The Cybersecurity (EX) Task Force has not yet been assigned any deliverables, such as a white paper or model guidance, but we expect it to get underway early in 2015.

12 Alabama, California, Colorado, Connecticut, Delaware, Florida, Georgia, Iowa, Indiana, Louisiana, Maryland, Missouri, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and Virginia have adopted both the Model Law and the Model Regulation. The District of Columbia, Hawaii, Maine, Massachusetts, New Mexico and Vermont have adopted only the Model Law.

H. Life Insurance Topics

1. Special Purpose Vehicles/Captives

Another important development in 2014 at the NAIC was the adoption of the Framework and AG 48, which are parts of the NAIC action plan to develop further regulatory requirements with respect to XXX and AXXX reserve financing transactions. The NAIC has now studied for a significant period of time reserve financing transactions associated with level premium term life insurance policies (*i.e.*, Regulation XXX reserves) and universal life insurance policies with secondary guarantees (*i.e.*, Regulation AXXX reserves).

Importantly, the Framework and AG 48 aim to set standards applicable to XXX and AXXX reserve financing transactions, instead of restricting them outright. Although certain insurance regulators, such as the NYDFS and the CA Department, are not satisfied with this approach and have continued to call for a nationwide moratorium on these types of transactions, the adoption of AG 48 is a significant development at the NAIC that provides guidance regarding how these transactions should be structured.

Previously, the PBR Task Force had hired Rector & Associates, Inc. to assist with certain of the PBR Task Force's charges, including analyzing life insurer-owned captive transactions and the potential regulatory treatment of these transactions in light of PBR, and assessing the level of resources needed for PBR implementation. Rector & Associates, Inc. issued the Rector Report during 2013 to address these charges. The analysis of the Rector Report by the PBR Task Force culminated in the general consensus at the NAIC that these XXX and AXXX reserve financing transactions should be permitted until PBR becomes effective, subject to a significant amount of regulatory oversight.

Significantly, the Rector Report recommended that the regulatory focus with respect to XXX/AXXX transactions ought to be on the ceding insurer and not the assuming captive reinsurer. The Rector Report suggested that this approach would minimize the ability of ceding insurers to move these transactions to offshore assuming entities in order to avoid regulatory oversight. Further, one of the key recommendations of the Rector Report was that the ceding company should be permitted to finance Regulation XXX and AXXX reserves only if the assets that back the "economic" portion of the XXX/AXXX reserves are comprised of certain "Primary Assets." The method for determining the required amount of such reserves would be a modified version of the PBR actuarial approach as set forth in the NAIC's Valuation Manual. The Rector Report recommended that assets used to support amounts in excess of the amount required to support these "economic" reserves could be in the form of non-admitted assets.

Based on the recommendations in the Rector Report, the NAIC developed in early 2014 and adopted during its summer national meeting the Framework, which aims to set standards applicable to XXX and AXXX transactions without restricting them outright. The Framework is also intended to provide an interim solution with respect to XXX and AXXX transactions, since many at the NAIC expect that XXX and AXXX transactions no longer will be needed after the full implementation of PBR.

In line with the recommendations in the Rector Report, the Framework does not change statutory reserve requirements applicable to a ceding insurer, but instead changes the types of assets necessary to back those reserve liabilities as follows:

(i) a portion of the total statutory reserve approximately equal to the PBR level is required to be collateralized with "hard assets" (e.g., cash and securities listed with the SVO); and

(ii) the remainder of the reserve could be collateralized with other assets identified as acceptable by regulators.

The Framework also requires the cedent to disclose in its financial statements the assets used to support the reserves and hold an RBC cushion if the captive does not file RBC reports. In addition, as another enforcement tool, a note to the annual audited financial statement requires the cedent and its independent auditor to indicate whether the

Framework is being followed. Importantly, the Framework applies only prospectively as of January 1, 2015, and only to XXX transactions and AXXX transactions.

The Framework is expected to be codified via the creation of a new model regulation to establish requirements regarding the reinsurance of XXX and AXXX policies, which will be developed by the Reinsurance Task Force during 2015.

Pending the development of this new model regulation and its promulgation by the states, during a conference call in December 2014, the NAIC adopted AG 48 to ensure that the requirements of the Framework pertaining to XXX and AXXX transactions become effective as of January 1, 2015. AG 48 requires the opining actuary of the ceding insurer to issue a qualified opinion if the Framework has not been followed. The new model regulation to be developed by the Reinsurance Task Force will also be based in large part on the text of AG 48.

The steps taken by the NAIC to address XXX transactions and AXXX transactions have by no means received uniform support from state regulators. Indeed, the regulators of several commercially important states—including California and New York—have voiced vehement opposition. Superintendent Lawsky in particular has criticized XXX/AXXX financing transactions, calling them a "shadow insurance" industry because of what he perceives to be a lack of regulatory oversight. In the wake of the NYDFS's year-long investigation of XXX and AXXX captive transactions (which culminated in June 2013 with a report entitled "Shining a Light on Shadow Insurance – a Little-Known Loophole that Puts Insurance Policyholders and Taxpayers at Greater Risk"), the NYDFS had urged other state regulators to adopt a national moratorium with regard to future XXX and AXXX transactions. The CA Department has likewise urged the adoption of a nationwide moratorium on XXX transactions and AXXX transactions. However, the NAIC has so far not heeded these calls for a nationwide moratorium.

Not surprisingly, given the above developments, the Rector Report was met with swift criticism by Superintendent Lawsky, who characterized it as a "Trojan horse" that would advance the risky PBR approach that he had been warning his fellow regulators against adopting. During the 2014 meetings of the NAIC's Executive Committee, New York voted against the adoption of the Framework and AG 48 and voiced its opposition to the Framework in general, stating that the Framework would not fix the issue of insurers carrying inadequate reserves due to captive transactions, and that the NAIC would come to regret its decision to issue the Framework. The CA Department was not a member of the Executive Committee during 2014, but voted against the adoption of the Framework by the PBR Task Force.

During 2014, the NYDFS also proposed its own approach with respect to regulating XXX and AXXX reserves. On March 27, 2014, Superintendent Lawsky announced that New York had developed a revised formula for level term products (*i.e.*, those backed by XXX reserves). The revised reserving formula would be effective for new business written in New York after January 1, 2015 and, according to Lawsky, "reflects actuarially sound and evidence-based adjustments regarding mortality data and expenses" and will result in a 30-35% reduction in reserves for these products on a prospective basis. The NYDFS promulgated the applicable regulation to implement this formula on December 10, 2014. Superintendent Lawsky has also signaled that updated formulae for universal life insurance policies with secondary guarantees (*i.e.*, those backed by AXXX reserves) are to follow. By taking the lead on revising these reserving formulae, Lawsky is attempting to demonstrate to his fellow regulators and the life insurance industry that properly formulated traditional reserving can accommodate actual or perceived redundant reserve requirements without the need for either captive financing transactions or PBR.

2. Private Equity/Hedge Fund Investments in Life Insurers

In 2014 the Private Equity Issues (E) Working Group considered the recommendations of the NAIC's Financial Analysis Working Group with regard to best practices for acquisitions by private equity and hedge fund buyers, and heard a number of presentations including ones by the SEC and by rating agencies. The group is developing best practices guidance to be included in the NAIC's Financial Analysis Handbook, intended to help regulators during their review of acquisition of control applications. However, the group did not finalize a work product before the end of 2014 as was expected. Currently, a draft has been prepared and it is expected that it will be released for comment.

3. Principle-Based Reserving for Life Insurers

For over a decade, the NAIC has been working on developing a principle-based approach for life insurers' reserving methods, in which actuarial judgment and the risks faced by each life insurer would have greater weight on its reserves than the current formulaic approach. PBR comprises three principal components:

(i) the Model Standard Valuation Law (the "SVL"), which was revised by the NAIC in 2009;

(ii) the Standard Nonforfeiture Law for Life Insurance, which was amended by the NAIC in August 2012; and

(iii) a Valuation Manual, which was drafted and then adopted by a supermajority of NAIC members in December 2012, despite objections from key states such as California and New York.

At the NAIC's fall national meeting, the NAIC reported that 18 states[13] have adopted laws implementing PBR, with 12 additional states expected to introduce legislation implementing PBR during 2015. Prior to year-end, two further states (Michigan and New Jersey) adopted laws implementing PBR. If legislation adopting these amendments is adopted in the 12 states referenced by the NAIC at the national meeting, the combined total of the states that have adopted these amendments will represent at least 60% of total U.S. premium volume. In order for PBR to be implemented, at least 42 states representing 75% of total U.S. premium volume must adopt these amendments. At the NAIC fall national meeting, it was conceded that only a slight chance remains that PBR could become effective as of January 1, 2016, and that a more realistic effective date for PBR is January 1, 2017.

During 2014, with PBR edging closer to adoption, the NAIC became a veritable battleground between the opponents of PBR—including large commercial states like California and New York—and its proponents. At NAIC meetings, heated debates took place with respect to the proposed small company exemption from PBR—a proposal which the NYDFS's representative accused of being a politically engineered construct designed to entice the remaining hold-out states to adopt PBR. These heated discussions are expected to intensify as more states adopt PBR during 2015.

I. Property/Casualty Insurance Topics

1. Congress Fails to Reauthorize TRIA Prior to Its Expiration on December 31, 2014; New TRIA Authorization Passed in January 2015

In a bizarre turn of events, Congress failed to reauthorize TRIA prior to its expiration on December 31, 2014. After partisan back and forth throughout the latter half of 2014, each house of Congress had passed by a huge margin some version of a bill reauthorizing TRIA for multiple years. The bill that passed the House on December 10 was blocked by one retiring senator, Senator Tom Coburn of Oklahoma, for reasons unrelated to TRIA. Despite earlier claims that the Senate would stay in session as long as it takes, the bill was killed on December 16 and the Senate session closed.

The Senate ultimately passed the House's version of the bill on January 8, 2015, once the new session of the Senate was underway, and on January 12, 2015, President

13 Arizona, Connecticut, Florida, Hawaii, Indiana, Iowa, Louisiana, Maine, Mississippi, Nebraska, New Hampshire, New Mexico, Ohio, Oklahoma, Rhode Island, Tennessee, Virginia, and West Virginia. In addition, Texas has adopted the amendments to the Revised Standard Nonforfeiture Law for Life Insurance only.

Obama signed into law the Terrorism Risk Insurance Program Reauthorization Act of 2015 (the "2015 TRIA Authorization"), which extends TRIA for six years, until December 31, 2020.

Like the previous version of TRIA, the 2015 TRIA Authorization provides benefits in the event of certain acts of terrorism, subject to a deductible and to other limitations. The 2015 TRIA Authorization fixes the insurer deductible at 20% of an insurer's direct earned premium of the preceding calendar year and the federal share of compensation at 85% of insured losses that exceed insurer deductibles—the same percentages as the previous version of TRIA—but only until January 1, 2016, when the federal share will decrease by one percentage point per calendar year until equal to 80%.

Other notable changes from the previous version of TRIA include:

(i) an amendment to the program trigger to apply to certified acts of terrorism with insured losses exceeding $100 million for calendar year 2015, to be increased by $20 million per year until the trigger reaches $200 million for calendar year 2020 and any calendar year thereafter;

(ii) the mandatory recoupment of the federal share through policyholder surcharges increasing to 140% (from 133%) for terrorism loss risk-spreading premiums;

(iii) the insurance marketplace retention amount being the lesser of $27.5 billion, increasing by $2 billion until it equals $37.5 billion, and the aggregate amount of insured losses for the calendar year for all insurers; and

(iv) requiring insurers participating in the TRIA program to submit to the Secretary of Treasury (for purposes of a Congressional report to be submitted by June 30, 2016 and every June 30 thereafter) information regarding insurance coverage for terrorism losses in order to evaluate the effectiveness of the program.

We note that it is uncertain whether coverage under the 2015 TRIA Authorization will extend retroactively to December 31, 2014, or whether the period between December 31, 2014 and January 12, 2015, when the President signed the reauthorization, is left uncovered. While coverage is not clearly retroactive under the terms of the new legislation, we understand that Treasury may release guidance regarding this issue and are continuing to monitor any developments.

We also note that the 2015 TRIA Authorization legislation includes the National Association of Registered Agents and Brokers (NARAB II) Reform Act of 2015, which establishes NARAB II, a non-profit corporation intended to provide a mechanism through which licensing, continuing education and other nonresident insurance producer qualification requirements may be adopted and applied on a multi-state basis.

2. Mortgage Insurance

During 2014, the MGI WG continued to discuss the MGI Model and the numerous comments received with respect to the MGI Model from the industry.

The proposed revisions to the MGI Model that have been considered by the MGI WG principally relate to:

(i) capital and reserve standards, including increased minimum capital and surplus requirements, mortgage guaranty-specific risk-based capital standards, dividend restrictions and contingency and premium deficiency reserves;

(ii) limitations on the geographic concentration of mortgage guaranty risk, including state-based limitations;

(iii) restrictions on mortgage insurers' investments in notes secured by mortgages;

(iv) prudent underwriting standards and formal underwriting guidelines to be approved by the insurer's board;

(v) the establishment of formal, internal Mortgage Guaranty Quality Control Programs with respect to in-force business;

(vi) prohibitions on reinsurance with bank captive reinsurers; and

(vii) incorporation of an NAIC Mortgage Guaranty Insurance Standards Manual (the "MGI Manual").

The MGI WG's work during 2014 was spurred on by the FIO Report's recommendation that mortgage guaranty insurance should be overseen by federal regulators rather than state regulators, and it accomplished a significant amount of work on the draft MGI Model during the year. However, several major items in the draft MGI Model are yet to be finalized, including the proposed mortgage guaranty insurance capital model and the text of the MGI Manual. Another major item awaiting further discussion by the MGI WG during 2015 is the provision in the draft MGI Model with respect to reinsurance of mortgage guaranty obligations, including whether the current text of the proposed revisions needs to be revised to provide for less than 100% collateralization of mortgage guaranty by alien certified reinsurers (in line with the Amended Credit for Reinsurance Model Act) and whether a reinsurer of mortgage guaranty obligations that is not a mortgage guaranty insurance company should be required to establish a contingency reserve.

J. New York Corner

1. Holding Company Act/Regulations

In November 2014, NYDFS promulgated revisions to New York Insurance Regulation 52 to impose additional requirements on private equity firms that seek to acquire New York insurance companies. New York has made more progress on this topic than the NAIC has, and has publicly expressed particular concerns over the increased interest by private equity firms in owning life insurance companies. Notable revisions to Regulation 52 include that the acquirer must submit all plans for the insurer covering the next five years, and the insurer cannot deviate from these plans for the next five years without prior written approval of the NY Superintendent; the acquirer must submit five-year financial projections; under certain circumstances the NY Superintendent can require the insurer to obtain additional capital and, in the case of a life insurer, require a Regulation 114-type trust to be established as a source of capital for the insurance company; and background information must also be submitted by the acquirer's general partners, managers and managing members. The revisions were effective as of November 12, 2014.

2. Regulations on ERM and ORSA

a) New York's ERM Report Requirement

Under New York law, insurance companies licensed in New York must adopt a formal enterprise risk management function and they must file a confidential "Form F" ERM Report with the NYDFS each year. The first set of ERM Reports was due on April 30, 2014. NYDFS has stated that it expects the reports to be useful in the examination analytics area, that they should help the NYDFS determine how an insurance company's management is performing and that they will influence the level of testing that the NYDFS needs to conduct.

NYDFS representatives have provided the content suggestions set forth below for future Form F filings.

- The company should describe its non-insurance activities.
- The NYDFS wants the ERM Report to include a narrative description of the company's ERM function, even though this is not explicitly required by the applicable New York regulation.
- The NYDFS recommends that an ERM Report address cybersecurity risks, even though this disclosure is not required by the applicable New York regulation.
- With respect to filing documents as an attachment to the ERM Report, the report should contain specific references to the relevant information in each attachment, rather than referencing the attachment as a whole.
- If a question is not applicable to a particular company, the company should explain why and not just say "not applicable."

b) New York's ORSA Requirement

In 2011, through Circular Letter 2011-14, the NYDFS suggested that insurers should contemplate performing an ORSA as part of their ERM function. This requirement was finalized when, effective June 25, 2014, Regulation 203 became effective, requiring New York-domestic insurers to regularly conduct an ORSA consistent with the NAIC's ORSA Guidance Manual. Ultimate holding companies that directly or indirectly control New York insurers, as well as insurers that are not members of a holding company system, are required to adopt a formal ERM function. The ERM function is expected to be appropriate to the nature, scale and complexity of the holding company system or insurer, as the case may be, and shall include a written risk policy by the board of directors or governing body of the ultimate holding company or insurer, specifying the insurer or holding company system's risk/reward framework, risk tolerance levels and risk limits.

At the individual entity level, domestic insurers are required to submit an ORSA Summary Report electronically by no later than December 1 of each year, beginning in 2015. However, insurers may apply for an exemption from the requirement that a filing be made electronically. Additionally, one hard copy of the ORSA Summary Report must be submitted in 2015. New York's ORSA requirement differs in some ways from the requirements of the ORSA Model Act. For example, unlike other states, New York requires submission of an ORSA Summary Report for all domestic insurers, regardless of whether New York is the lead state regulator of the insurance holding company system. Additionally, the New York ORSA Summary Report must include the signature of an appropriate executive stating that the report has been provided to the domestic insurer's or member's board of directors or other applicable governing body or committee. Finally, the New York ORSA requirement does not incorporate the ORSA Model Act's specific confidentiality protections. Instead, the ORSA Summary Report will be protected under New York's existing confidentiality provisions for holding company filings.

3. New Force-Placed Insurance Regulation to Become Effective in February 2015

On October 15, 2014, the NYDFS published Proposed Regulation 202, which regulates force-placed insurance. Regulation 202 will become effective on February 7, 2015. Force-placed insurance is typically placed by a bank or other lender where a property owner's homeowner's insurance is cancelled or lapses and is not replaced in order to protect the lender's financial interest in the mortgaged property. The NYDFS has previously investigated the practices of a number of the largest force-placed insurers, resulting in three settlement agreements in 2013. Regulation 202 directly references the NYDFS investigation, while imposing rules on the rates for and placement of force-placed insurance and prohibiting certain practices in the force-placed insurance industry.

In addition to its consumer protection features, Regulation 202 would impose a number of obligations on insurers offering force-placed insurance with respect to rates charged for such coverage. In addition to specifying a minimum initial loss ratio of 62%, insurers will be required to submit annual reports to the NYDFS specifying, among other information, their actual loss ratio. Regulation 202 would require rates to be refiled at least every three years, as well as if actual loss ratios fall below 40%.

K. 2015 Forecasting

Looking to 2015, we believe the NAIC will continue to focus on developments at the international level, particularly since the U.S. FSAP report is to be released and the IAIS continues to work on establishing uniform global capital standards to be imposed on international insurance groups. In addition, with cyber attacks becoming serious threats to national security as well as to private companies, as demonstrated by the recent attack on Sony Pictures, we expect that cybersecurity will also be a main area of focus by the NAIC in 2015, along with addressing the rapid expansion of ride-share companies. The NAIC has created new subgroups to monitor and address each of these areas as they continue to develop.

On the federal front, with an additional major life insurer being designated as a SIFI by FSOC in 2014 and the passage of the Insurance Capital Standards Clarification Act, which allows the Federal Reserve Board to tailor capital standards for SIFIs (rather than subjecting SIFIs to minimum capital standards that were designed for banks), we expect the focus by the Federal Reserve Board to be on developing capital standards tailored to the insurance industry. FIO is also focused on cyber risk, at the request of Treasury. We also expect developments in reinsurance with the introduction of a covered agreement between the United States and another jurisdiction. Congress, meanwhile, unexpectedly failed to reauthorize TRIA, which expired on December 31, 2014, but a new version of TRIA was adopted on January 12, 2015 by the new Congress. It remains to be seen whether any consequences will ensue from what appears at this time to be a brief gap in coverage.

L. Other International Insurance Issues

1. Solvency II Developments

With the January 1, 2016 implementation date drawing closer, Solvency II continues to be the foremost regulatory issue in Europe. This issue has significance beyond Europe for a number of reasons. First, Solvency II affects international groups and how their group solvency is calculated and therefore affects the assessment of groups that have insurance companies within and outside of the E.U.; second, it affects reinsurers outside of the E.U. who wish to reinsure European insurance companies; and third, Solvency II has been held out as a new gold standard to which international insurance regulation should aspire.

Following on from a consensus reached between the European Parliament, the European Commission and European Council in late 2013 on formerly contentious fundamental issues relating to Solvency II, 2014 has seen the E.U. institutions and regulatory bodies make significant progress on preparing the delegated acts, technical standards and guidelines necessary to provide a fully fledged framework for the new regulatory regime. This momentum stands in stark contrast to the profusion of delays and setbacks that characterized much of the period following adoption of the Solvency II Directive in 2009. The general consensus now is that the January 2016 implementation date is likely to be achieved.

While the full suite of Solvency II delegated acts, technical standards and guidelines is still being developed and finalized, progress in 2014 has shed considerable light on a number of issues, including the issues of equivalence and group supervision, that are of particular interest to international groups.

a) Key 2014 Solvency II Updates

i. Omnibus II

In November 2013, a provisional agreement on key elements of the Omnibus II Directive was reached between the European Commission, the European Parliament and the Council of the E.U., thereby paving the way for the directive's adoption on April 16, 2014. Among other things, Omnibus II was required in order to amend Solvency II to:

(i) provide for transitional arrangements for the introduction of the new regime, which had not been adequately dealt with under the original Solvency II Directive; and

(ii) facilitate the adoption of subordinate rules that flesh out the higher principles set out in the Solvency II Directive.

A consolidated version of Solvency II, reflecting amendments made by Omnibus II, as well as a number of other Directives, has now been published in the Official Journal of the E.U.

Now that Omnibus II has been adopted, the European legislators and regulators have been able to focus on the development of the large number of Solvency II delegated acts, binding technical standards ("BTS") and guidelines necessary to create an effective regulatory regime. A number of developments on these points have occurred during 2014.

ii. The Delegated Regulation

On October 10, 2014, the European Commission adopted a Delegated Regulation (C(2014) 7230 final) (the "Delegated Regulation") containing a package of delegated acts to supplement Solvency II. The purpose of the rules contained in the Delegated Regulation is to set out more detailed requirements for firms and insurance groups, based on Solvency II provisions. These rules will form the foundation of a single prudential rulebook for European insurers. The Delegated Regulation covers a wide range of areas, including insurance groups and criteria for assessing third-country equivalence. Both the European Parliament and the Council of the E.U. have now also provided their backing for the Delegated Regulation, as required under the Solvency II Directive. The Delegated Regulation became laws on the day following its publication in the Official Journal of the E.U., which was January 17, 2015.

iii. Technical Standards

Solvency II requires the European Commission, with assistance from the European Insurance and Occupational Pensions Authority ("EIOPA"), to produce a large number of BTS. The purpose of the BTS is to supplement and/or implement Solvency II provisions, and to address issues that are of a highly technical nature. Over the course of 2014, EIOPA launched consultations on two sets of BTS, both of which, once finalized and endorsed by the European Commission, are expected to become legally binding in 2015.

iv. Guidelines

Solvency II requires EIOPA to produce guidelines on certain issues in order to enhance the convergence of supervisory practices. During 2014 EIOPA launched consultations on two draft sets of Solvency II guidelines on various issues, including equivalence, internal models, quantitative and qualitative requirements and reporting and disclosure requirements. Both sets of guidelines are intended to be published in all official E.U. languages in 2015, at which time a two-month "comply or explain" period will commence during which individual E.U. insurance supervisors will be expected to either comply with the guidelines or explain their non-compliance.

b) Equivalence and Group Supervision

Equivalence refers to the concept whereby the European Commission assesses under Solvency II whether the insurance regulatory regime of a non-E.U. country is equivalent to Solvency II for three purposes:

(i) reinsurance;

(ii) group solvency; and

(iii) group supervision.

The equivalence assessments could affect reinsurance collateral requirements for non-E.U. reinsurers that reinsure E.U. cedants, as well as group capital requirements and other compliance requirements generally for non-E.U. groups with E.U. subsidiaries and non-E.U. subsidiaries within E.U. groups. A finding of non-equivalence could affect the way international groups choose to organize themselves as well as affect the way international reinsurers consider capital requirements and how they provide security to their E.U. cedants. A number of countries are in the first "wave" of assessment for equivalence but some others, including the United States and Canada, have chosen not to engage in the formal equivalence assessment process.

i. EIOPA Reports on Bermuda, Switzerland and Japan

On December 19, 2014, EIOPA launched public consultations on three reports setting out its advice to the European Commission assessing the supervisory systems of the first three equivalence candidate countries: Bermuda, Switzerland and Japan.[14] The consultation period regarding the draft advice, which closed on January 23, 2015, was short, as the reports update previously consulted-upon 2011 analysis of the efforts made by the three jurisdictions to align their supervisory systems with Solvency II standards.

14 The European Commission has decided that there will be no further equivalence assessments beyond these three companies before Solvency II is implemented.

In its 2011 advice, EIOPA concluded that the three countries broadly met the equivalence criteria but with specific caveats for each of the three countries. The overall conclusion in the December 19, 2014 report is the same as it was in 2011, but the caveats set forth below were highlighted again.

- The 2014 report finds the Swiss system "equivalent" under all relevant principles except for one: public disclosure requirements are assessed as "largely equivalent." EIOPA expects this to be addressed through changes to Swiss legislation in 2015. This is a positive result for Switzerland, which has generally been seen to be at the forefront of the equivalence process.

- EIOPA's 2014 report finds Bermuda to be "equivalent" or "largely equivalent" for non-life insurance in all three relevant equivalence areas and EIOPA expects planned 2015 legislative changes to address a number of their concerns. As for life business, EIOPA finds Bermuda "partly equivalent" under some principles but notes that Bermuda is making changes to more fully align its life insurance regulatory framework with that of Solvency II. Therefore, Bermuda seems to be well positioned to obtain a positive equivalence decision at least for non-life business and group supervision.

- The 2014 report deems the Japanese system "equivalent" or "largely equivalent" with the exception of the solvency regime, which is deemed "partly equivalent." EIOPA expects that scheduled changes in Japanese law will improve this finding.

Once EIOPA has considered the feedback received, it will publish final reports on the consultations. Its final advice, once adopted by EIOPA's Board of Supervisors, will be sent to the Commission, which is expected to make the final decision in 2015 on whether the prudential regimes of Bermuda, Japan and Switzerland are equivalent to Solvency II.

ii. Omnibus II Equivalence Transitional Provisions

Omnibus II has provided a solution for the equivalence issue for countries outside of the formal assessment process. Omnibus II has amended Solvency II to include a set of criteria by which the European Commission can unilaterally determine whether the capital adequacy regime of a country is sufficiently equivalent to Solvency II. If it is, the jurisdiction will be granted provisional equivalence, thereby exempting multinational groups from having to operate in accordance with both local and European rules. A country will maintain provisional equivalence status for 10 years, which may be extended for additional 10 year periods an unlimited number of times. Therefore, even if a regulatory regime fails to achieve equivalence under the formal process, it may still be deemed equivalent for periods of 10 years under these transitional provisions. Market expectation is that the states of the United States will benefit from these transitional provisions.

2. The Proposed New U.K. Regulatory Framework on Holding Approved Persons Accountable

In the middle of 2014, directors and senior managers of insurance companies could be forgiven for being alarmed at what might be in store for them if proposals for regulating key individuals in the banking sector were to be applied to the insurance sector. On July 30, 2014, the FCA and the PRA published a joint consultation paper on strengthening accountability in banking.[15] The proposals, which focus on strengthening senior management responsibility and accountability, responded to the recommendations set out in the Parliamentary Commission's "Banking Standards Changing Banking for Good" report[16] and proposed to implement changes required by the Financial Services (Banking Reform) Act 2013. Among other things, the proposals for the banking sector included the introduction

15 United Kingdom. The Bank of England and the Prudential Regulation Authority. *Strengthening accountability in banking: a new regulatory framework for individuals.* (PRA CP14/14, FCA CP 14/13). July 2014. Web 29 January 2015. http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1414.pdf

16 United Kingdom. House of Lords, House of Commons. Changing banking for good; report of the Parliamentary Commission on Banking Standards. June 2013. Web 29 January 2015. http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf

of criminal penalties for individuals who were proven to have contributed to a bank's failure and a "reverse burden of proof," whereby it would be incumbent on individual senior managers to prove that they took reasonable steps to avoid any issue of regulatory misconduct that has occurred.

Anxiety levels among insurers' directors and senior managers are likely to have decreased, however, following a speech given by Mark Carney, governor of the Bank of England, to the Institute and Faculty of Actuaries on September 25, 2014. While Mr. Carney noted that the Bank of England was now working with other regulators to develop a similar regime for key people within the insurance industry, he further noted that they do not propose simply to extend the banking regime indiscriminately. He specifically noted that the "reverse burden of proof" feature of the proposed banking regime would not be applicable to insurers. Indeed, this approach was confirmed when the PRA issued a consultation paper on modifying the regulatory regime for individuals in the insurance sector.[17] The new proposed Senior Insurance Managers Regime ("SIMR") is intended in part to ensure proper implementation of requirements under Solvency II relating to governance and fitness and propriety and to include some aspects of the regime proposed for banks. The proposals contained in the consultation paper comprise the following main elements:

(i) the SIMR;

(ii) a "Governance Map;" and

(iii) a new set of conduct rules.

a) Senior Insurance Managers Regime

The proposals seek to develop an augmented regulatory framework aimed at ensuring that certain individuals working for insurers will behave with integrity, honesty and skill. The SIMR will require a narrower range of senior individuals in a firm to be pre-approved by the PRA as compared with the current Approved Persons Regime. Chief executive officers, chief financial officers, chief risk officers, heads of internal audit and chief actuaries will be included. For non-life insurance firms and Lloyd's managing agents, it is proposed also to include the chief underwriting officer.

Furthermore, in relation to insurance groups, individuals who take up functions within the scope of the SIMR along with holding company or other group company senior executives who have a significant influence on the management or conduct of the affairs of the insurer will be subject to pre-approval. Where a non-E.U. insurer has a branch in the U.K., an individual may combine a number of the key function roles but would still have to be pre-approved by the PRA.

b) Governance Map

As part of the implementation of the Solvency II requirement that there is appropriate and transparent allocation of oversight and management responsibilities within each firm, the PRA is proposing that insurers be required to compile and maintain a document, to be called a "Governance Map," recording the positions of those who effectively run the firm, along with the key functions within the firm, and the names of the individuals in each of these positions or with responsibility for a key function. This requirement will also apply to U.K. branches of non-E.U. insurers. It is not proposed, at this stage, that the Governance Map be made publicly available.

c) Set of Conduct Rules

Senior managers within the scope of the SIMR and employees within the scope of the FCA's regime for approved persons will be subject to a new set of conduct rules in place of the existing Statements of Principle and Code of Practice for Approved Persons ("APER"). These rules take the form of short statements of high-level principles and standards of behavior. Most employees of relevant firms who are based in the U.K. or who deal with customers in the U.K. will also be subject to application of these rules by the FCA. Three generic standards will apply to all such persons, namely: acting with integrity; acting with due skill, care and diligence; and dealing with the PRA and other regulators in an open and co-operative way.

17 United Kingdom. The Prudential Regulation Authority. Senior insurance managers regime: a new regulatory framework for individuals. (PRA CP26/14). November 28 2015. http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp2614.pdf

While the potentially worrisome features of the banking regime for key individuals such as criminal sanctions and a reverse burden of proof seem to have been avoided, senior managers in insurance firms will, in the course of 2015, have to come to grips with a new regime for personal supervision and understand their duties and responsibilities under that regime in readiness for its implementation on January 1, 2016.

3. EIOPA Report on Results of 2014 insurance Stress Test

On November 30, 2014, EIOPA published the results of its 2014 E.U.-wide insurance stress test, the aim of which was to test the overall resilience of the European insurance sector to market risk under a combination of hypothetical and historical scenarios so as to identify major vulnerabilities.[18]

The stress test comprised: first, a core stress module focused on adverse market scenarios covering financial asset price stresses as well as shocks to real estate asset prices and interest rate stresses; and second, a module run at the level of individual insurers, which considered the impact of a low interest environment.

A total of 167 insurance groups and individual insurers representing 55% of gross written premium for the E.U. market participated in the core stress test module and 225 companies representing 60% of gross technical provisions participated in the low yield module. Companies from all 28 E.U. member states, plus Norway, Switzerland and Iceland were involved. Participation in the stress test was sufficiently representative to enable EIOPA to draw inferences of a systemic nature. Individual insurance companies estimated a baseline scenario using the Solvency II regime, without internal models. In addition, companies tested a number of severe macro-economic and insurance specific shocks, including a prolonged period of low yields ("Japanese-like" scenario) and a sudden reverse in interest rates ("inverse" scenario).

The results of the baseline scenario indicated that, generally, the sector is sufficiently capitalized in Solvency II terms. Nevertheless, 14% of the companies (representing 3% of total assets), had a SCR ratio below 100%. Despite these generally positive findings the stress test results also showed that the sector is more vulnerable to a "double hit" stress scenario that combines decreases in asset values with a lower risk free rate. Nevertheless, 56% of the companies would have a sufficient level of capital under the most severe "double hit" stress scenario. The major vulnerabilities exposed by the insurance specific stresses were mass lapse, longevity and natural catastrophes.

The results of the low yield module indicated that 24% of companies would not meet their SCR under the "Japanese-like" scenario, while 20% would not meet this threshold under the "Inverse" scenario. A continuation of the current low yield conditions could result in some companies having difficulties in meeting their promises to policyholders in 8 to 11 years' time.

In connection with the 2014 stress test, EIOPA also issued a set of recommendations to National Supervisory Authorities ("NSAs") for the purposes of addressing identified vulnerabilities within the sector.[19] EIOPA has advised NSAs to engage actively with companies to assess their Solvency II preparedness and ensure they clearly understand their risk exposures and vulnerability to stress scenarios, and to ensure that they have the capacity to take corrective measures to deal with such vulnerabilities. European insurers can expect increased engagement with their NSAs as the January 1, 2016 Solvency II implementation date draws closer.

18 European Insurance and Occupational Pensions Authority. *EIOPA Insurance stress test 2014*. 28 November 2014 (EIOPA-BOS-14-203). Web 21 January 2015.

19 European Insurance and Occupational Pensions Authority. *Recommendations under Article 21(2)(b) of the EIOPA Regulation and Information Request under Article 35 of the EIOPA Regulation*. 27 November 27 2014 (EIOPA-BoS-14/209). Web. 29 January 2015. https://eiopa.europa.eu/Publications/Surveys/EIOPA%20Stress%20Test%20General%20Recommendations.pdf

VII. Tax

A. Corporate Inversions

The pace of corporate inversions accelerated in recent years, despite the 2004 enactment of Section 7874 of the Internal Revenue Code of 1986, as amended (the "Code") and subsequent Internal Revenue Service ("IRS") guidance intended to limit the tax benefits of such transactions. Recent completed or planned inversion transactions, where a U.S. corporation ("Domestic Corporation") restructures through, for example, a merger transaction to become a subsidiary of a foreign parent ("Foreign Parent"), have gained national prominence through the press and objections to such transactions voiced by the Obama administration, some members of Congress and activists. The Obama FY 2015 budget proposal and 2014 legislative proposals took aim at inversion transactions, but these proposals were stymied by a deadlocked Congress and Republican opposition to addressing corporate inversions in the absence of comprehensive corporate and international tax reform. As a result of Congressional inactivity, the Treasury Department ("Treasury") and the IRS issued Notice 2014-52, describing it as an important initial step in addressing inversions that close on or after September 22, 2014.

Under Section 7874, a Foreign Parent that acquires a Domestic Corporation, absent an applicable exception, will be treated as a U.S. corporation for U.S. federal income tax purposes if the former shareholders of a Domestic Corporation acquire 80% (by vote or value) of the stock of the Foreign Parent in the transaction (a "full" inversion). If the former shareholders of a Domestic Corporation acquired at least 60% but less than 80% of the shares of the Foreign Parent, the foreign status of the Foreign Parent would be retained in this so-called "limited" inversion, but certain U.S. federal income tax consequences could apply. The recent "wave" of inversions in the "limited" inversion band demonstrated that these tax consequences were an acceptable cost of the inversion.

For purposes of these anti-inversion ownership tests, Treasury regulations issued earlier this year (the "2014 Regulations") provided that stock issued by the Foreign Parent for, among other things, cash or marketable securities would be disregarded. The Notice, in an effort to expand cases where the acquisition of a Domestic Corporation by a Foreign Parent will result in the application of the anti-inversion rules, takes the approach of the 2014 Regulations one step further with a "cash box" rule. In cases where the passive assets (cash or marketable securities) of a Foreign Parent in an inversion transaction comprise more than 50% of the Foreign Parent group's assets, the "cash box" rule excludes shares of a Foreign Parent from the denominator of the inversion ownership fraction to the extent attributable to the Foreign Parent group's existing passive assets. As financial services companies, such as banks and insurance companies, have substantial passive asset holdings, the Treasury press release accompanying the Notice sensibly indicated that financial services companies should be exempted from the "cash box" rule. However, while applying a more flexible (although imprecise) carve-out for bank passive assets based on the passive foreign investment company ("PFIC") rules, the Notice provided a very limited carve-out for foreign insurance company passive assets by applying the more stringent requirements under the controlled foreign corporation ("CFC") rules, which, among other things, require a Foreign Parent insurer in an inversion transaction to earn at least 50% of its net written premiums from writing "home country" risks. As many Foreign Parent insurance groups (particularly Bermuda-based reinsurance groups) would not meet this 50% test, a significant portion of their assets will be treated as passive for purposes of the inversion ownership test.

The net impact is that foreign insurance groups that are considering acquiring a Domestic Corporation using Foreign Parent shares as part of the consideration will need to consider the application of the anti-inversion rules, even in cases where the foreign insurance group is much larger than the Domestic Corporation, as the limited exception to the "cash box" rule applicable to foreign insurance groups will meaningfully increase the inversion ownership fraction by skewing ownership in favor of the Domestic Corporation shareholder group. The seemingly inexplicable disparate treatment of foreign banks and foreign insurers has been brought to the attention of Treasury and the IRS, and consideration is being given to apply the more flexible PFIC exception to foreign insurers under the "cash box" rule. However, even if Treasury and the IRS decide to apply the more flexible PFIC exception to foreign insurers under the "cash box" rule, we note that issues and uncertainty will still arise in the context of foreign insurer acquisitions of U.S. companies, as the IRS has not provided any guidance on the PFIC active insurance exception to date.

B. Hedge Fund Re

In 2014, the hedge fund-sponsored reinsurer market seemed poised to shift from the "greenfield" model of Third Point Re, Hamilton Re and Greenlight Re to the sidecar-style model of Watford Re, a collaboration between Arch and Highbridge Capital. The sidecar-style model would allow the new venture to operate as a "pure" sidecar through quota shares with the reinsurer sponsor and/or as a "market facing" sidecar with business produced by an affiliate of the reinsurance sponsor to be written directly on the new venture's paper (either side-by-side with the sponsor or on its own). At one point early in the year, it was suggested that at least 20 of the top 50 hedge funds were exploring teaming up with a reinsurer to enter the reinsurance sector, with a new focus on casualty reinsurance. The hedge fund managers were attracted by the permanent or "sticky" capital provided by a reinsurance operation and the ability to provide investors with some uncorrelated risk while, in the case of U.S. taxable investors, potentially enjoying certain U.S. tax advantages offered by the Hedge Fund Re model in Bermuda (no entity-level tax coupled with potential deferral and long-term capital gain treatment). The reinsurer partner could benefit through fees on business that would not necessarily fit within the reinsurer partner's underwriting parameters, an equity stake in the new venture that could provide higher yielding investment returns and access to lower cost of capital to grow demand for business previously retained by the reinsurer partner.

The flurry of activity in early 2014 has not resulted in any significant launches other than Watford Re to date. Weak pricing in the reinsurance sector, concern over the current investment outlook, the challenges associated with launching Hedge Fund Re models (including securing a rating from A.M. Best) and the threat of increased U.S. tax scrutiny have contributed to the lack of successful launches in 2014 in the wake of Watford Re.

The threat of increased U.S. tax scrutiny came in a number of forms. A U.S. taxable investor in a Hedge Fund Re generally would be able to defer U.S. taxation until a sale of its shares and pay tax at long-term capital gain rates, provided that the Hedge Fund Re qualified for an exception to the PFIC rules by being treated as an insurance company for U.S. tax purposes and engaging in the active conduct of an insurance business. Legislative proposals introduced in 2014 sought to broaden the PFIC definition in an effort to catch insurers that were not writing enough insurance business. Further, Senator Ron Wyden (who was Chairman of the Senate Finance Committee in 2014 and is now its Ranking Member) has been pushing Treasury and the IRS to develop a new test that would distinguish between reinsurance companies that qualify for the "active insurance" exception to the PFIC rules and those companies that are functioning more like offshore investment vehicles. As it is not feasible to develop a single bright line test to make this distinction fairly, it has been suggested that a safe harbor test could be developed and coupled with a "facts and circumstances" approach which would allow a reinsurer that fails to qualify for the safe harbor to establish that it meets the "active conduct" exception to the PFIC rules. Despite Senator Wyden's loss of the chairmanship of the Senate Finance Committee, Treasury and IRS developments in this space may be forthcoming.

C. Captive Insurance Companies

In 2014, the Tax Court issued decisions in two captive insurance cases involving brother-sister premium payments, the first significant captive decisions since a 2001 IRS ruling in which the IRS described a facts and circumstances analysis that could apply for purposes of determining whether captive insurance arrangements should be respected as insurance for U.S. federal tax purposes. The treatment of the arrangement as insurance is critical to members of the captive's group seeking to deduct premiums paid to the captive for the coverage.

In *Rent-a-Center v. Commissioner*, 142 T.C. 1 (2014), the Tax Court ruled that premiums paid by a parent company to a subsidiary insurance company on behalf of other wholly owned subsidiaries were properly deductible as insurance premiums based on the criteria applied in prior case law. The Tax Court did not consider the captive a sham as it was: (1) established for legitimate non-tax business reasons based on a feasibility study prepared by the insurance broker; (2) adequately capitalized; and (3) operated in a commercially reasonable manner. The IRS conceded that the policies issued to its affiliates covering workers' compensation, automobile and general liability risks were insurance risks. The Tax Court found that risk was shifted from the insured affiliates to an independent entity not owned by the insureds that was financially capable of meeting its obligations, concluding that the parent's guarantees and the captive insurer's investment in the parent did not adversely impact risk shifting. The Tax Court also determined that risk distribution was satisfied by focusing on the thousands of store locations, employees and vehicles that were covered rather than the number of insured entities (which the IRS has focused on its prior guidance). Finally, the Tax Court considered the affiliate insurance as insurance in its commonly accepted sense based upon the captive insurer's capitalization, regulation and operation as an insurance company, including issuing valid binding policies, paying claims and charging and receiving actuarially determined premiums.

In *Securitas v. Commissioner*, T.C. Memo 2014-225 (2014), the Tax Court followed the Rent-a-Center opinion in holding that premiums paid by a parent company to its domestic insurance captive subsidiary (which were subsequently ceded to an Irish captive reinsurance subsidiary) on behalf of other wholly owned subsidiaries were properly deductible as insurance premiums. The captives were formed for legitimate business concerns: to reduce insurance risk; centralize costs; and allow for the calculation of the cost of risks in advance. The policies issued by the captives covered workers compensation, automobile, employment practice and general and fidelity liability risks, which the IRS conceded were insurance risks. The Tax Court held that risk was shifted to the adequately capitalized captives as the insured affiliates did not own an interest in the captives, and this risk shifting was not mitigated by the parental guaranty issued to the domestic captive (which was not drawn upon and was executed for reasons unrelated to the capitalization of the captive). The Tax Court also concluded that risk was distributed over hundreds of thousands of insured employees and thousands of insured vehicles and did not focus on the number of insured entities. Finally, the Tax Court determined the insurance arrangements of the captives constituted insurance in its commonly accepted sense, as each captive was adequately capitalized, organized, operated and regulated as an insurance company, issued valid and binding insurance policies, set and received reasonable premiums and paid losses.

In these 2014 cases, the IRS conceded that the arrangements involved insurance risk. However, in TAM 201149021, the IRS ruled that residual value insurance was not insurance for U.S. federal tax purposes, indicating that contractual protection against a protected party receiving less than its projected income from the protected asset at the end of a lease term is more akin to an investment risk than an insurance risk. The issues addressed in the TAM are currently the subject of litigation in the Tax Court. IRS personnel, in unofficial recent remarks, also have indicated that risks more akin to business risks rather than insurance risks, such as loss of a key customer or key supplier, will be carefully considered. Oral arguments on the treatment of residual value insurance as insurance for U.S. federal tax purposes were heard by the Tax Court in September of 2014, and the Tax Court's decision could have wide-ranging implications for the insurance industry and may help draw a clearer line between financial products and insurance products for U.S. federal tax purposes.

D. FATCA

The Foreign Account Tax Compliance Act ("FATCA") regime was enacted in 2010 to discourage U.S. persons from evading tax by investing in foreign accounts or entities and will usher in complex reporting and potential withholding requirements for all foreign entities, whether characterized as foreign financial institutions ("FFIs") or nonfinancial foreign entities ("NFFEs"). FFIs include depository and custodial institutions, mutual funds, certain investment entities and certain insurance companies that issue cash value insurance policies and annuity contracts. FFIs generally are subjected to a more comprehensive FATCA regime, which could including entering into an agreement with the IRS. The IRS provided additional guidance in 2014 and the United States has entered into a number of intergovernmental agreements with other countries ("IGAs") that clarified some issues as to the application of FATCA but left open many questions, a few of which are addressed below.

1. Catastrophe Bond Issuers

Despite recent extensive IRS guidance, it remains unclear whether Cat Bond issuers will be treated as FFIs or NFFEs. A Cat Bond issuer may qualify as an insurance company, but should not be characterized as an insurance company FFI for FATCA purposes as it does not issue cash value insurance contracts or annuities.

However, it would still be considered an FFI if it is characterized as an investment company (*i.e.*, an entity that invests in financial assets, including derivatives and insurance contracts). An issuer of Cat Bonds without an ultimate net loss trigger may be characterized as an investment company FFI. Even if the issuer's risk transfer agreement includes an ultimate net loss clause, the issuer may be considered to "invest" in insurance contracts – however, this interpretation appears strained as the insurance contract is better characterized as a liability rather than a financial asset.

As noted above, the FATCA reporting regime is generally more onerous for FFIs than for NFFEs; however, in the case of Cat Bonds held through a clearing organization, it appears that an issuer treated as an FFI would simply be required to report the clearing organization as the accountholder. By comparison, if the issuer of a bond with an ultimate net loss clause were viewed as an NFFE, it would likely be characterized as a passive NFFE. This could burden the issuer with a duty of reporting certain indirect owners of its notes, requiring it to look through any clearing organization involved for any U.S. owners holding greater than 10% of the issuance.

However, a consensus has emerged among legal practitioners in the ILS sector to treat all Cat Bond issuers as FFIs, regardless of the risk transfer trigger used, requiring the issuer to enter an FFI agreement with the IRS, unless an applicable IGA provides otherwise. Even though treating a Cat Bond issuer as an FFI rather than an NFFE may lessen its reporting burden, the IRS should not fault an issuer for taking this position, since the FFI regime is generally more comprehensive and treating a Cat Bond issuer as such may be viewed as conservative.

2. Section 953(d) Companies

A non-U.S. insurance company that is at least 25% owned by U.S. persons may elect to be treated as a domestic insurance company for U.S. federal tax purposes pursuant to Section 953(d) of the Code. Prior FATCA guidance had excluded any such Section 953(d) company from the definition of U.S. person, which clearly seemed wrong as a Section 953(d) company is considered a domestic company for all purposes of the Code (of which FATCA is a part). Treasury regulations issued in 2014 generally rectify this issue by treating a Section 953(d) company that is not licensed to do business in any state of the United States as a U.S. person, provided the company does not issue cash value contracts or annuities.

3. Protected Cells/Segregated Account Companies

The FATCA characterization of protected cells or segregated account companies and their respective cells or accounts is not clearly addressed by any of the recent guidance. However, the guidance does provide that the classification of an entity will be determined under general U.S. federal income tax principles, even in cases where an arrangement does not have a separate legal personality and is not a juridical person in its home country in cases where general U.S. federal income tax principles would characterize the arrangement as an entity. Proposed Treasury regulations issued in 2010 treat non-U.S. protected cells or segregated accounts that are characterized as insurance companies for U.S. federal tax purposes as separate entities (while grandfathering the treatment of some protected cell or segregated account companies as a single entity); however, these proposed regulations do not address non-insurance non-U.S. protected cells or segregated accounts.

E. FET

On February 5, 2014, the United States District Court for the District of Columbia, in *Validus Reinsurance, Ltd. v. U.S.*, granted the taxpayer's motion for summary judgment with respect to the IRS's application of a "cascading" theory to the U.S. federal insurance premiums excise tax ("FET") on retrocession premiums. The court analyzed the statutory provisions that impose the FET and concluded that the FET does not apply to premiums on retrocessions (*i.e.*, reinsurance of reinsurers). However, the court declined to address alternative arguments that were made.

The taxpayer in *Validus* was a Bermuda reinsurance corporation that entered into "retrocession" transactions whereby it bought reinsurance from other foreign reinsurers to protect itself in the event that it is required to pay claims under one or more reinsurance policies that it had issued to direct insurers. Based on the IRS's FET "cascading" theory (which imposes the FET on every insurance and reinsurance contract covering certain U.S. situs risks even if such risks were previously subject to the FET), the taxpayer paid the FET on certain retrocession contracts it entered into with other non-U.S. reinsurers. The court ruled that the plain language of both the FET active taxing provision and the definition of "policy of reinsurance" in the relevant sections of the Internal Revenue Code restricts the application of the FET to reinsurance transactions that cover certain insurance contracts, and not to retrocession transactions that cover reinsurance contracts.

The court's focus on the statutory language, and its conclusion that retrocessions are not subject to the FET, leave open a number of questions that could have been avoided had the court simply ruled that the FET does not apply to foreign-to-foreign reinsurance or retrocession transactions on the basis of Supreme Court precedent limiting the extraterritorial application of U.S. laws to purely foreign conduct or activities absent clear congressional intent to do so as well as the Tax Court's prior rejection of "cascading" withholding tax application in the context of U.S. source royalty payments. For example, if a Bermuda insurer insures a U.S. risk subject to a four percent FET and subsequently reinsures all or part of that risk to a Bermuda reinsurer, would a second FET be payable on the reinsurance transaction? The court expressly noted that it was not ruling on foreign-to-foreign reinsurance transactions. In addition, the decision implies that cessions from a U.S. reinsurer to a Bermuda retrocessionaire should not be subject to the FET, as the cession would be characterized as a retrocession. Does this mean that such premiums could be subject to a 30% U.S. withholding tax, as these premiums are not subject to the FET?

The decision clearly provides favorable guidance, and any foreign reinsurer that has paid the FET under the "cascading" theory should file protective claims for refund. However, the IRS has appealed the decision to the District of Columbia Circuit Court of Appeals. It is hoped that the Circuit Court will rule more broadly that the FET does not apply to a foreign-to-foreign reinsurance or retrocession transaction on the basis of the judicial precedent described above.

F. Increased United Kingdom Scrutiny of Cross-Border Tax Planning

1. Introduction

During the past year, international tax planning has been the subject of considerable public scrutiny in the United Kingdom by politicians, the tax authorities and the media. Disquiet over perceived tax avoidance by the likes of Google and Amazon has resulted in suggested reforms that are so broad that their impact will be felt by almost any international business, including in the insurance industry.

We focus here on two recent developments and their potential impact on the insurance sector: the Organisation for Economic Co-operation and Development's ("OECD") Base Erosion and Profit Shifting project (the "BEPS Project"); and the U.K. Diverted Profits Tax ("DPT").

Both are of potentially broad scope and could significantly affect the international insurance sector, including (re)insurance groups, ILS funds and other third party asset management businesses.

2. OECD BEPS Project

a) Action Plan

In February 2013, the OECD launched its BEPS initiative to coordinate multilateral action on international tax rules in order to tackle tax planning strategies that are seen to exploit tax law to shift profits artificially to low tax or no-tax jurisdictions in which very little economic activity takes place.

The BEPS Project has a 15 point Action Plan that includes, in particular:

(i) the definition of a permanent establishment ("PE") and the attribution of profits to a PE (Action 7);

(ii) assurance that transfer pricing outcomes are in line with value creation, noting that current rules may facilitate the transfer of risks or capital away from countries where the economic activity takes place (Actions 8 to 10); and

(iii) developing rules regarding transfer pricing documentation to enhance transparency for tax administrations (Action 13).

Action Plan deliverables are due in three phases, from September 2014 to December 2015.

b) Country-By-Country Reporting

The September 2014 deliverables included guidance on transfer pricing and intangibles, particularly in relation to the definition of 'intangibles' and the methodologies used to analyze transactions involving intangibles.

Guidance regarding revised transfer pricing documentation and country-by-country reporting was also released. The OECD takes a three-tiered approach, which is described below.

i. Local File

The local file is submitted to a taxpayer's local tax authority and provides detailed information on specific intercompany transactions that are material to the relevant jurisdiction's tax system, including a description of the transaction, copies of intercompany agreements and a detailed comparability and functional analysis.

ii. Master File

The master file provides a high level overview of the multinational enterprise ("MNE") group, including its global allocation of income and economic activity and its overall transfer pricing policies.

iii. Country-By-Country Reporting

This requires reporting of the MNE group's global allocation of income, the taxes paid and the economic activity of the group in the jurisdiction in which it operates. Economic activity is measured by certain indicators, such as total employees, capital and retained earnings in each tax jurisdiction. Furthermore, disclosures are required as to each entity's jurisdiction of tax residence and incorporation and a description of its business.

These additional reporting requirements are designed to assist tax authorities in gathering information to enable them to target their resources and efforts on corporate structures that may appear to result in a mismatch between profits that are reported for tax purposes and the location of the profit-generating activities. An example of this is the attribution by an MNE group of a large proportion of its global profits to a low tax jurisdiction while maintaining a significant physical presence (in the form of premises and employees) in one or more high tax jurisdictions.

The forthcoming Finance Bill 2015 is expected to authorize the U.K. government to implement country-by-country reporting.

c) Definition of a Dependent Agent Permanent Establishment

Although the deliverable on Action 7 is not due until September 2015, a discussion draft on the artificial avoidance of a PE was issued in October 2014 (the "Discussion Paper"). The proposals include changing the definition of a dependent agent permanent establishment from a person who "concludes contracts" to a person who "engages with specific persons in a way that results in the conclusion of contracts" or "negotiates the material elements of contracts." This change is intended to apply to situations where a contract is substantially negotiated in one state but is finalized in another state, or where a person sells products in one state on behalf of a foreign enterprise that "owns" those products.

The Discussion Paper specifically addresses insurance companies that may do large-scale business in a state without having a PE in that state. The document discusses the possibility of following the lead of the United Nations Model Double Tax Convention (already adopted by some OECD member countries) of deeming an insurance enterprise (except, maybe, in regard to reinsurance) to have a PE in a state if it collects premiums in that state or insures risk situated there through a person who is not an agent of independent status. The Discussion Paper invites comments as to whether reinsurance raises specific concerns related to the avoidance of PE status.

3. U.K. Diverted Profits Tax

a) A New Tax

Despite being one of the early proponents of the BEPS Project, the U.K. government has preempted the OECD by announcing the introduction of the DPT. The announcement in the Autumn Statement on December 3, 2014 came as a surprise to the business community. It was followed by the publication of draft legislation and guidance from Her Majesty's Revenue and Customs ("HMRC").

The DPT has been labeled the "Google Tax," which reflects its political origins. The past year or so has seen heated debate about large MNEs paying little to no tax in the jurisdictions in which they earn their revenues. The debate largely centered around international businesses selling products to (retail) customers in the U.K. without paying corporation tax in the U.K. However, the DPT legislation captures a much wider range of circumstances than the ones that seem to have prompted its introduction.

The DPT is targeted at supposed weaknesses in U.K. tax law regarding the definition of a PE and in the scope of the transfer pricing regime, as well as to accelerate full and early disclosure of information potentially relevant to a transfer pricing examination.

The DPT is a new tax intended to be separate from the existing U.K. corporation tax that is charged at a rate of 21% (due to fall to 20% on April 1, 2015). The DPT will be charged at the (apparently deterrent) rate of 25%. It will apply from and after April 1, 2015, with an apportionment of profits, on a just and reasonable basis, for any accounting period that straddles this date. The DPT is, therefore, capable of being charged on profits arising from business written before April 1, 2015 where the profits are not recognized until after that date.

b) Two Branches

There are two main branches of the DPT:

- a Section 2 charge, which applies where a foreign company with activities in the U.K. organizes its affairs in such a way as to avoid creating a taxable presence (in the form of a PE) in the U.K.; and
- a Section 3 charge, which applies to a company that is subject to tax in the U.K. that enters into a transaction or series of transactions with a connected person that causes a tax mismatch outcome between the entities.

c) Avoided PE – Section 2

The first branch is designed to address the same problem identified in Action 7 of the BEPS Project, namely activities that fall just short of a PE. In particular, the framing of the Section 2 branch turns on the fact that, under current law, a non-U.K. resident company is only liable for U.K. corporation tax if it carries on a trade in the U.K. through a PE in the U.K., with a "PE" being defined to include a dependent agent who habitually exercises authority to "do business" (or, under the slightly narrower terms of many U.K. double tax treaties, "conclude contracts") on behalf of the non-resident. While the BEPS Project proposes to tackle this through widening the definition of "PE," the DPT seeks directly to tax certain U.K. activities that stop short of the current understanding of a PE.

DPT applies where a person (the "Avoided PE") carries on activity in the U.K. in connection with supplies of goods or services made by a non-U.K. resident company to customers in the U.K. in circumstances where:

(i) the Avoided PE is not a U.K. permanent establishment;

(ii) it is reasonable to assume that any of the activity of the Avoided PE or non-U.K. resident company is designed (for example, by way of agreed limitations on their respective activity) to avoid the creation of a U.K. permanent establishment (whether or not it is also designed to secure any commercial or other objective); and

(iii) it is reasonable to assume that there is an "effective tax mismatch outcome" (as defined), or one of the main purposes of the arrangements is the avoidance of corporation tax.

HMRC has commented that the tax avoidance condition would be met if the arrangement would not have been carried out at all were it not for the opportunity to avoid a U.K. corporation tax charge or where any non-tax objective was secondary to the benefit of obtaining the tax advantage.

One scenario that may be vulnerable is a common feature of a multinational (re)insurance group whereby a U.K. business provides sales and marketing services to a foreign affiliated risk carrier. Typically, any useful contacts with potential insureds or their brokers, identified by the U.K. entity, will be immediately referred to the fellow group member to be handled by its foreign underwriting team. The U.K. activity would not usually go any way down the path of discussing the terms of a particular piece of business. It is unclear whether the DPT is intended to apply at all in that situation and, if so, what proportion of the non-U.K. insurer's profits would be taxed.

d) Freestanding Effective Tax Mismatch Outcome – Section 3

The second branch of the DPT applies where there is a transaction, or series of transactions, between a U.K. company (or U.K. branch of a non-resident company) and another person under common control, where the "effective tax mismatch outcome" and the "insufficient economic substance condition" are met.

The "effective tax mismatch outcome" condition looks at whether, in connection with the supply of goods or services, a transaction (other than a loan) between the non-resident company and a connected party reduces the overall tax liability by at least 20% and an economic substance test is failed. Any transactions between a U.K. business and a Bermudian affiliate will therefore need to be considered.

The "insufficient economic substance condition" is satisfied if either: (a) the financial benefit for both parties of the tax reduction is greater than any other financial benefit referable to the transactions and it is reasonable to assume the arrangements were designed to secure the tax reduction; or (b) the contribution of economic value to the transaction of the person, in terms of the functions or activities of its staff, is less than the financial benefit of the tax reduction, and it is reasonable to assume the person's involvement in the transaction was designed to secure the tax reduction. These provisions would capture transactions even where the non-tax financial benefits were significant or where a special purpose vehicle is involved.

There are some similarities here with the familiar "thin capitalization" question as to whether the intra-group financing would have been entered into at all in the absence of the relationship between the parties.

e) Geographical Scope of the Section 2 DPT Charge and the Sales Threshold Exemption

The Section 2 charge will apply where the avoided PE is "carrying on activity in the U.K. in connection with supplies of goods or services made by the foreign company to customers in the U.K.," subject to an exemption where the total sales revenue from all supplies made by that company, or a connected company, to customers in the U.K. in a 12 month accounting period does not exceed £10 million. It is not clear from the words of the draft legislation whether it is the supply activity or the customer that has to be "in the U.K." and, if the latter, what nexus is required in order for a customer to be "in the U.K."

HMRC has indicated that the aim is to identify where the customers are located, and that this could be determined in accordance with generally accepted accounting principles with respect to geographic reporting (that is, reporting of operating segments or reportable segments). HMRC sees the sales threshold exemption as a filter for cases that would not prevent a significant risk in terms of sales into the U.K. market. This may be of assistance to the London insurance market, given that many of the insureds and cedants seeking cover in the market are not based in the U.K.

For the purpose of the exemption, "sales revenue" is intended to mean gross income (*i.e.*, sales net of sales returns, allowances and discounts).

f) Investment Manager Exemption ("IME") and Independent Broker Exemption

The current corporation tax PE exception for an independent agent acting in the ordinary course of its business will also apply to the DPT under the first branch; provided (unless the agent is protected by the IME or the independent broker safe harbors) that the avoided PE and non-resident company are not connected with each other.

The IME is effectively a specific application, in the context of corporation tax, of the independent agent concept. This reflects the importance of the asset management industry to the U.K. economy and, as noted, is being carried across as an exemption from the DPT. There is a parallel corporation tax PE safe harbor (again mirrored by a DPT exemption) for an independent broker (as defined).

g) HMRC Guidance

HMRC has published guidance on the DPT, including examples of when the DPT would apply.

In terms of the first branch, draft HMRC guidance refers to "contrived arrangements used by large groups (typically multinational enterprises) that result in the erosion of the U.K. tax base." This reference includes arrangements involving significant sales activity in the U.K. that are designed to stop short of the conclusion of contracts.

One example in the draft guidance concerns a situation where a foreign company acquires widgets from a third party and sells them to customers in the U.K. and other markets. A U.K. company, which is a subsidiary of the foreign company, provides sales support services such as identifying new customers and undertaking all selling activities to the point just before the conclusion of the contract with the customer. This last step is done by the foreign company, which is in a low tax jurisdiction. There is no commercial reason why the contracts are not concluded in the U.K. except for the foreign company imposing a restriction on the U.K. company.

Regarding this situation, HMRC comments that there is a contrived separation of the conclusion of contracts from the selling activity and process of agreeing on terms and conditions. The requirement for the foreign company to conclude the contracts is deliberately intended to limit the activity that takes place in the U.K. On this basis, HMRC concludes that a Section 2 DPT charge arises because the activities of both companies are designed to ensure that the foreign company is not carrying on a trade in the U.K. through a PE and the arrangements have a main purpose of avoiding a corporation tax liability so the tax avoidance condition is met.

With regard to the second branch, HMRC sets out an example where a parent company owns two subsidiaries, one in the U.K. and the other in a no-tax territory. The U.K. company needs to invest in new expensive fixed plant and machinery to carry on its trade in the U.K. The parent company injects capital into its no-tax subsidiary to enable it to purchase the plant and machinery. This is then leased to the U.K. company so as to leave it with relatively small profits over a number of years. The no-tax territory company has no full time staff and the only functions it performs are the ownership of the plant and machinery and some routine administration actions relating to the leasing payments it receives.

With respect to this situation, HMRC comments that there is an effective tax mismatch outcome because the lease payments are allowable in the U.K. company's corporation tax computation but are not taxed in the hands of the no-tax territory company. HMRC goes on to say that the contribution by the offshore company's staff provides little economic value and that value is much less than the financial benefit of the associated tax reduction. Accordingly, HMRC concludes that it is reasonable to assume that the offshore company's involvement in the transaction was designed to secure the tax reduction. The DPT under the second branch would be calculated on the assumption that the U.K. company had instead acquired and owned the plant and machinery.

h) Critical Response

The DPT in its current draft form has been heavily criticized domestically in the U.K. Despite the widely-held view that the legislation is poorly drafted, HMRC has stated that it will consult only on the details and will not consider substantive changes.

The broad application of the legislation will be disappointing to the (re)insurance industry, given the U.K. government's assurance in the Autumn Statement that, building on the U.K.'s position as a world leader in the global insurance market, the government would explore options to ensure that the U.K.'s regulatory and tax regime is as competitive as possible to attract more reinsurance business to the U.K.

One can predict intense lobbying to clarify and refine the scope of the DPT, both in the (re)insurance industry context and more generally.

The DPT may also come under international pressure. It arguably undermines the current network of double tax treaties to which the U.K. is a party that prohibit the U.K. from taxing foreign residents that do not have a U.K. permanent establishment. The official view of the U.K. government and HMRC is that DPT is not "corporation tax" and so is outside the scope of the treaties. However, treaties are often broader and encompass income tax and other similar taxes. HMRC's supplementary argument is the general principle that tax treaties cannot be relied upon to facilitate tax avoidance (citing paragraphs 9.4 and 9.5 of the Commentary to Article 1 of the OECD Model Tax Convention).

It is also possible that the DPT infringes the E.U. freedoms.

4. Going Forward

There continues to be discussion and lobbying with respect to both the DPT and the BEPS Project. The (re)insurance industry, along with many other industries and multinational groups, will need to tread carefully and monitor these new developments in the coming year.

Appendix A

Insurance Regulatory Glossary

For purposes of Section VI of this Year in Review – 2014, the following terms have the following meanings:

"**AG 48**" means Actuarial Guideline 48, which was promulgated by the NAIC in 2014.

"**Amended Credit for Reinsurance Model Act**" means the NAIC's Credit for Reinsurance Model Law and Regulation.

"**BCR**" means a basic capital requirement being developed by the IAIS.

"**CA Department**" means the California Department of Insurance.

"**CDAWG**" means the NAIC's ComFrame Development and Analysis Working Group.

"**CGAD**" means the annual, confidential corporate governance disclosure required to be submitted by insurers pursuant to the Corporate Governance Model Act and Corporate Governance Model Regulation.

"**CGWG**" means the NAIC's Corporate Governance (E) Working Group.

"**ComFrame**" means the IAIS's Common Framework for the Supervision of Internationally Active Insurance Groups.

"**Corporate Governance Model Act**" means the NAIC's Corporate Governance Annual Disclosure Model Act.

"**Corporate Governance Model Regulation**" means the NAIC's Corporate Governance Annual Disclosure Model Regulation.

"**Dodd-Frank Act**" means the Dodd-Frank Wall Street Reform and Consumer Protection Act.

"**ERM**" means enterprise risk management.

"**FACI**" means the Federal Advisory Committee on Insurance, which provides advice and recommendations to FIO.

"**Federal Reserve Board**" means the Board of Governors of the Federal Reserve System.

"**FIO**" means the Federal Insurance Office.

"**Framework**" means the XXX/AXXX Reinsurance Framework adopted by the NAIC in 2014.

"**FSB**" means the Financial Stability Board.

"**FSAP**" means the Financial Sector Assessment Program, which is conducted every five years by the IMF.

"**FSOC**" means the Financial Stability Oversight Council.

"**G-SIIs**" means globally systemic important insurers designated by the FSB.

"**GWS**" means group-wide supervisor.

"**HLA**" means Higher Loss Absorbency, a capital requirement being developed by the IAIS.

"**IAIG**" means an internationally active insurance group.

"**IAIS**" means the International Association of Insurance Supervisors.

"**ICS**" means Insurance Capital Standard.

"**IMF**" means the International Monetary Fund.

"**MGI Model**" means the NAIC's Mortgage Guaranty Insurance Model Act.

"**MGI WG**" means the NAIC's Mortgage Guaranty Insurance (E) Working Group.

"**Model Audit Rule**" means the NAIC's Annual Financial Reporting Model Regulation.

"**Model HCA**" means the NAIC's Model Insurance Holding Company System Regulatory Act.

"**NAIC**" means the National Association of Insurance Commissioners.

"**NYDFS**" means the New York State Department of Financial Services.

"**NY Superintendent**" means the Superintendent of NYDFS.

"**ORSA Model Act**" means the NAIC's Risk Management and Own Risk and Solvency Assessment Model Act.

"**ORSA Summary Report**" means the annual, confidential report of an insurer's ORSA.

"**ORSA**" means the "own risk and solvency assessment" that certain insurers are required to conduct.

"**PBR**" means principle-based reserving.

"**PBR Task Force**" means the NAIC's Principle-Based Reserving Implementation Task Force.

"**RBC**" means risk-based capital.

"**Rector Report**" means the report issued by Rector & Associates, Inc. in 2013 to assist the PBR Task Force.

"**Reinsurance Task Force**" means the NAIC's Reinsurance (E) Task Force.

"**SIFI**" means a systemically important nonbank financial company, as designated by FSOC.

"**SVO**" means the NAIC's Securities Valuation Office.

"**Treasury**" means the U.S. Department of the Treasury.

"**TRIA**" means the Terrorism Risk Insurance Act.

"**U.S. Trade Representative**" means the Office of the United States Trade Representative.

Willkie's Corporate Insurance and Regulatory Group

Willkie's Corporate Insurance and Regulatory Group is one of the preeminent practices in the industry, representing insurance companies, investment banks, sponsors and other financial institutions in M&A, capital markets and regulatory matters in the U.S., London, Europe, Asia and Bermuda.

NEW YORK

Rajab Abbassi
Gregory Astrachan
Scott D. Avitabile
Elizabeth Bannigan
Serge Benchetrit
David Boston
Leah Campbell
Thomas Cerabino
Henry Cohn
Joseph Cunningham
Laura Delanoy
Alexander M. Dye
Mark Getachew
Michael Groll
William Gump
Donald B. Henderson, Jr.
Jeffrey Hochman
Arthur J. Lynch
Leslie Mazza
Vladimir Nicenko
Benjamin Nixon
Maria-Leticia Ossa-Daza
Jeffrey Poss
Christopher Peters
Robert S. Rachofsky
Richard Reinhold
John M. Schwolsky
Steven Seidman
Robert Stebbins
Allison J. Tam
Adam Turteltaub

LONDON

Nicholas Bugler
Joseph D. Ferraro
Judith Harger
Jon J. Lyman

WASHINGTON, D.C.

Christopher S. Petito

PARIS

Christophe Garaud
Daniel Hurstel
Paul Lombard
Daniel Payan
Annette Péron

FRANKFURT

Bettina Bokeloh
Andreas Hautkappe
Stefan Jörgens
Georg Linde
Patrick Meiisel
Mario Schmidt

BRUSSELS

Xavier Dieux

MILAN/ROME

Maurizio Delfino
Gianluca Cattani
Massimo Chiais

NEW YORK
787 Seventh Avenue
New York, N.Y. 10019-6099, U.S.A.
T 212-728-8000
F 212-728-8111

WASHINGTON
1875 K Street, N.W.
Washington, D.C. 20006-1238, U.S.A.
T 202-303-1000
F 202-303-2000

HOUSTON
600 Travis Street, Suite 2310
Houston, TX 77002
T 713-510-1700
F 713-510-1799

PARIS
21-23 rue de la Ville l'Evêque
75008 Paris, France
T +33 1 53 43 4500
F +33 1 40 06 9606

LONDON
CityPoint, 1 Ropemaker Street
London EC2Y 9AW, England
T +44 20 3580 4700
F +44 20 3580 4800

FRANKFURT
An der Welle 4
D-60322 Frankfurt am Main
T +49 69 79302 0
F +49 69 79302 222

BRUSSELS
Avenue Louise, 480 / 3B
1050 Bruxelles, Belgium
T +32 2 290 18 20
F +32 2 290 18 21

MILAN
Via Michele Barozzi, 2
20122 Milan, Italy
T +39 02 76363 1
F +39 02 76363 636

ROME
Via di Ripetta, 142
00186 Rome, Italy
T +39 06 68636 1
F +39 06 68636 363

This Year in Review 2014 is a publication of Willkie Farr & Gallagher LLP. It is provided for news and information purposes only and does not constitute legal advice. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. For additional information, please contact the Willkie Farr & Gallagher LLP attorney with whom you regularly work.

This publication may not be reproduced or disseminated in whole or in part, in any form, without the express permission of Willkie Farr & Gallagher LLP.

©2015 Willkie Farr & Gallagher LLP. All rights reserved.

For further information on Willkie Farr & Gallagher LLP, please visit www.willkie.com

Date of Publication: January 2015

WILLKIE FARR & GALLAGHER LLP

NEW YORK WASHINGTON HOUSTON PARIS LONDON FRANKFURT BRUSSELS MILAN ROME

in alliance with Dickson Minto W.S., London and Edinburgh

www.willkie.com