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Developments and Trends in

Insurance Transactions and Regulation

2016 YEAR IN REVIEW

January 16, 2017

To Our Clients and Friends:

We are pleased to present our 2016 Year in Review. In it we review the year's most important developments in insurance transactions and regulation, including developments relating to mergers and acquisitions, corporate governance and shareholder activism, insurance-linked securities, alternative capital, traditional capital markets transactions, and the regulation and taxation of insurance companies, both in the United States and internationally.

We hope that you find this 2016 Year in Review informative. Please contact us if you would like further information about any of the topics covered in this report.

Sincerely,

Insurance Transactional and Regulatory Practice
Willkie Farr & Gallagher LLP

#1 Legal Adviser in Insurance Underwriter and Insurance Broker M&A

SNL Financial
2016, 2015 and 2014, based on the aggregate number of deals in each year

#1 Issuer's Counsel for U.S. Insurance Capital Markets Offerings

Thomson Reuters
2016, 2015 and 2014, based on market share

Band 1 for Insurance – Transactional and Regulatory

Chambers USA
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Insurance Practice Group of the Year

Law360
2015 and 2014

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I. Review of M&A Activity in 2016

A. Market Trends – North America

1. By the Numbers

The year 2016 made 2015 appear—at least for now—to be an outlier rather than a harbinger of increased big-dollar M&A transactions in the life and health and property casualty ("P&C") sectors of the North American insurance industry. Deal volume in 2015, measured in aggregate transaction value, was extraordinary, driven by a number of large transactions involving publicly traded life and P&C insurers. Activity in 2016, however, returned to levels generally comparable to years prior to 2015, although it took a series of relatively large transactions announced late in 2016 to recover from a slow start to the year.

A total of 83 life and health and P&C insurance M&A transactions in North America were announced in 2016, representing approximately $25.3 billion in aggregate transaction value.[1] These figures compare to a total of 68 transactions, representing over $58 billion in aggregate transaction value, announced in 2015, and 73 transactions, representing approximately $17 billion in aggregate transaction value, announced in 2014.

In 2015, seven transactions had an equity value in excess of $5 billion. For context, only four $5 billion-plus transactions were announced over the prior nine years. Only one transaction larger than $5 billion (Sompo Holdings Inc.'s $6.3 billion acquisition of Endurance Specialty Holdings Ltd.) was announced in 2016, although another (Fairfax Financial Holdings Limited's $4.9 billion acquisition of Allied World Assurance Company Holdings, AG) came very close in aggregate transaction value. It also is noteworthy that seven significant transactions announced in 2015 involved buyers based in the Asia-Pacific region, while only two transactions involving Asian buyers were announced in 2016.

M&A activity in 2016 started slow but finished strong. Transactions representing approximately 93.6% of the aggregate transaction value of all insurance M&A deals announced in 2016 were announced in the second half of the year. Six transactions, all announced in the second half of 2016, accounted for approximately 86% of that aggregate transaction value.

Below, we provide our perspective on factors that drove M&A activity in 2016, and might drive it in 2017.

2. The Life and Health Insurance Sector

a) Life Insurance, Annuities and Long-Term Care

M&A activity in the North America life insurance sector was subdued in 2016. The largest announced transaction is the $2.7 billion acquisition of Genworth Financial, Inc. by a subsidiary of China Oceanwide Holdings Group Co., Ltd. Genworth has a diversified mix of business that includes life insurance and annuities, long-term care insurance and mortgage insurance, and operates in various geographic locations in addition to the United States, including Canada, Australia and several other international jurisdictions. The acquisition is noteworthy for several reasons.

The Genworth transaction represents a continuation of the trend of in-bound M&A from buyers based in the Asia-Pacific region. We commented on this trend in our 2014 and 2015 Years in Review. As noted above, 2015 saw a boom in acquisitions by Asian buyers. Only two in-bound Asian transactions were announced in 2016, and only one of them (Genworth) involved the acquisition of a business that included a direct writer of life insurance and annuities. The other was the acquisition in the P&C sector of Endurance Specialty Holdings Ltd. by Sompo Holdings, Inc.

We do not believe the decrease in Asian buyers in 2016 relative to 2015 portends a reversal of the multi-year trend of growing interest from these buyers in the North American insurance market. Their interest in North America remains high, and the factors that caused them to look to North America have not fundamentally changed.

[1] Deal volume and transaction values in this report are from *SNL*'s database.

Japanese companies, typically large industry players in their domestic markets, focused on the North American insurance market as a result of pressure on rates and profitability and demographic challenges in the domestic Japanese market, as well as a desire to deploy their significant capital and diversify geographically. These factors have not changed. Almost all of the larger Japanese insurers have completed large acquisitions of North American insurers. We expect that many are now considering expanding their existing North American operations through additional acquisitions.

The Chinese companies that have been contemplating U.S. acquisitions are different from the Japanese buyers. While the Japanese comprised industry participants making strategic acquisitions, the Chinese have been global investment companies, largely in the real estate sector and sometimes highly leveraged, looking to make financial investments. Interest from these companies in North American insurance assets remains strong, but it has become increasingly more challenging for them to navigate the complex regulatory, rating agency and cultural considerations that accompany insurance M&A. Two transactions that were initially announced in 2015 demonstrate some of these challenges.

In May 2015, Fosun International Limited announced that it was acquiring the remaining 80% of the outstanding shares of Ironshore Inc. that it did not already own. The transaction closed in November 2015. In December 2015, representatives of the Committee on Foreign Investment in the United States ("CFIUS"), an inter-agency U.S. government entity that reviews foreign acquisitions to determine whether they may threaten U.S. national security, approached Fosun with concerns about how it would operate Ironshore's Wright USA business. Wright USA is an insurance agency and third-party administrator principally providing federal employee professional liability insurance, as well as disability, life, dental and other coverages, to U.S. government employees, including national security officials. Separately, in June 2016, A.M. Best Company, Inc. assigned a negative outlook to Ironshore, citing "the drag related to the credit profile and high debt leverage measures of Ironshore's ultimate parent, Fosun." In response to these developments, Fosun filed for an IPO of Ironshore in July 2016, but ultimately turned to the M&A market to exit its investment after only about one year of ownership. In September 2016, it sold the Wright USA business to Starr Companies, and in December 2016 it entered into an agreement to sell Ironshore to Liberty Mutual Holding Company, Inc.

In November 2015, Anbang Insurance Group Co., Ltd. announced it had entered into a merger agreement to acquire Fidelity & Guaranty Life. At the time, Anbang and Fidelity & Guaranty Life stated that, subject to the receipt of required regulatory approvals and the satisfaction of other closing conditions, they expected the transaction to close in the second quarter of 2016. In May 2016, Fidelity & Guaranty Life announced that Anbang had withdrawn its application to the New York Division of Financial Services (the "NYDFS") for approval of its acquisition of control of Fidelity & Guaranty Life's New York insurance company subsidiary, that it intended to re-file the application in the future, and that it continued to work with the Iowa Insurance Division to secure regulatory approval for the acquisition of control of Fidelity & Guaranty Life's Iowa insurance company subsidiary. Media reports have cited the failure of Anbang to deliver financial and other information requested by the NYDFS as having preceded Anbang's decision to withdraw its application. As of the date of this writing, the transaction has yet to receive all of the insurance regulatory approvals required to close, even though the initial deadline to receive such approvals has passed.

In addition to its statements following Fosun's acquisition of Ironshore, CFIUS has recently acted to prevent Chinese investment in the United States in other contexts, and there is reason to believe that Chinese firms making investments in the United States will be under additional scrutiny from U.S. regulators in future periods. In a rare move in December 2016, President Obama, acting on the recommendation of CFIUS, blocked a Chinese firm from acquiring Aixtron SE, a technology

company with U.S. operations. Moreover, President-elect Trump has suggested that his administration would further increase regulatory scrutiny of Chinese investment in the United States. As we discuss in greater detail in Section VII.A.11 below, we anticipate that CFIUS will continue to be aggressive in seeking to examine financial services acquisitions, particularly those involving Chinese buyers, if they involve sensitive relationships (including with policyholders who are government employees) or large databases.

Further complicating the picture, in November 2016, media reports suggested that, in an attempt to curb the continuing flow of capital out of China, the Chinese government would soon announce new regulations that would subject investments by Chinese firms in foreign markets to greater scrutiny by the Chinese government. The reports stated that all foreign acquisitions by Chinese companies valued at $10 billion or more, property investments by state-owned Chinese companies above $1 billion and investments of $1 billion or more by any Chinese company in an overseas entity unrelated to the investor's core business, would be targeted for particular scrutiny under the new regulations.

The Genworth transaction was negotiated in light of these developments. Notably, the merger agreement relating to the Genworth transaction was signed after Genworth and China Oceanwide approached certain of Genworth's regulators to discuss China Oceanwide's application to acquire Genworth and its prospects for obtaining regulatory approval for the acquisition. In addition, the merger agreement provides for China Oceanwide to pay Genworth a termination fee of $210 million (approximately 7.78% of the aggregate equity value of the transaction) if China Oceanwide materially breaches the merger agreement or fails to obtain required regulatory approval of the transaction from Chinese governmental authorities, or if Chinese governmental authorities otherwise block the transaction. To secure China Oceanwide's obligation to pay the termination fee when due, cash in the full amount of the termination fee was deposited into an escrow account maintained by a banking institution in the United States concurrently with the signing of the merger agreement.

Despite the challenges facing Chinese companies interested in investing the North American insurance industry, interest from Chinese entities in acquiring insurance assets in the United States and other markets remains strong. We expect Chinese companies to continue to be active participants in insurance M&A. Executing these transactions in the face of the increasingly complex regulatory, rating agency and other challenges will require careful planning and sound legal and financial advice, however.

Other than the Genworth transaction, life insurance M&A in 2016 involved mostly smaller transactions, the largest of which was the $286 million acquisition by PartnerRe Ltd. of Aurigen Capital Limited, a North American life reinsurance company.

Leaving aside the Asian acquisitions, there are a number of reasons for the generally low level of life M&A activity over the last several years. In particular, a mature market, weak growth in the general economy, the persistent low-interest-rate environment, demographic trends and other factors have combined to create a situation in which fewer domestic strategic participants have been seeking growth through acquisitions in North America, and instead have looked to markets and industry sectors with greater potential for growth. Notwithstanding, we believe that several factors may result in an increase in M&A activity in the life sector in coming years, including the following.

- While the largest life insurance companies in the region account for almost half of all industry surplus,[2] the remainder of the market remains fragmented with room for additional consolidation.
- The demand for life insurance and annuities assets remains strong, particularly among relatively new entrants to the market, including run-off consolidators, financial buyers such as hedge funds and private equity firms, and Asian buyers, particularly "second round" Japanese buyers.

[2] This statistic does not take into account the recently announced spin-off by MetLife of its retail operations, which is discussed below.

- Regulatory changes and continued regulatory pressure could be an impetus for additional activity.
  - In our 2015 Year in Review, we described the designation of three insurers (AIG, Prudential and MetLife) as non-bank "systemically important financial institutions" ("SIFIs") and the potential for that designation to lead to structural changes by the three affected entities, or by other entities seeking to avoid such designation in the future. MetLife challenged the SIFI designation and received a favorable ruling in the U.S. District Court. The case has been appealed to, and remains pending before, the United States Court of Appeals for the D.C. Circuit. Meanwhile, in January 2016, MetLife announced that it plans to pursue a separation of its retail business. In February 2016, MetLife announced the sale of its U.S. retail advisor force to Massachusetts Mutual Life Insurance Company. In October 2016, MetLife filed for an 80.1% spin-off of its U.S. retail business under the name Brighthouse Financial, Inc. AIG was also active in the M&A market in 2016, as we discuss in greater detail in Sections I.A.3., I.B. and II below. It sold its mortgage insurer, United Guaranty Corporation, to Arch Capital Group Ltd. for $3.4 billion, certain commercial and consumer insurance operations in several jurisdictions to Fairfax Financial Holdings Limited for $240 million, and AIG Advisor Group to Lightyear Capital LLC and PSP Investments.
  - As discussed in greater detail in Section VII.A.8.a below, the U.S. Department of Labor's new regulations regarding who would be considered a "fiduciary" of an employee benefit plan under ERISA has spurred activity. Notably, in addition to the sales of MetLife's U.S. retail adviser force and AIG Advisor Group mentioned above, activity in the market for the acquisition and sale of insurance brokers has increased since the U.S. Department of Labor issued its proposed regulations early in 2015, as transactions representing over $9 billion in aggregate transaction value involving insurance brokers have been announced over the last two years.
  - It remains unclear how the Trump administration and the new Congress will change regulation in the industry, but it is possible that significant regulatory and legislative changes will affect M&A activity. Notably, President-elect Trump and other politicians have suggested that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank," or the "Dodd-Frank Act") and the Patient Protection and Affordable Care Act of 2014 (the "Affordable Care Act") will be repealed or amended, that the U.S. corporate tax rate will be reduced and that changes will be made to the tax base. A significant decrease in corporate tax exposure may diminish the appeal of inversion transactions to U.S. companies.
- Technology and new business models continue to have the potential to effect change in the industry, although exactly how and to what extent that will happen in the life and health insurance sector remains to be seen. The population mix in the United States is changing rapidly as baby boomers age and the number of millennials increases,[3] while life insurance penetration has decreased to historic lows, with approximately 30% of all households remaining completely uninsured and only 44% of households owning individual life insurance policies. Meanwhile, the percentage of households that say they do not have enough life insurance has increased to a historic high.[4] Many will view those statistics as signs of opportunity for organic growth in the sector, and it is reasonable to expect insurers and entrepreneurs to explore new ways to market and sell life insurance and annuities products using technology and new businesses models to take advantage of that opportunity. That, in turn, may create opportunities for additional M&A activity in the sector. Indeed, many insurers have started internal venture capital and investment groups focused on financial technology. We discuss some of the regulatory challenges facing "InsurTech Companies" in Section VII.A.4.b below.

[3] Source: Pew Research Center, which reported recently that the number of millennials in the United States surpassed the number of baby boomers in 2015; each of those groups outnumbers Generation X by almost 10 million people.

[4] Source: LIMRA's 2016 Household Trends in Life Insurance Ownership Study.

b) Managed Care, Supplemental Health and Group Benefits

As we noted in our 2015 Year in Review, changes to the managed care insurance sector resulting from the implementation of the Affordable Care Act created a flurry of aggressive consolidation and caused some participants to exit the business completely. The most notable transactions in the sector were Anthem's $48 billion agreement to acquire Cigna, Aetna's $35.5 billion agreement to acquire Humana and Centene's $6.3 billion agreement to acquire Health Net. Of the three, only Centene's acquisition of Health Net has thus far received the required regulatory approvals to close. The United States Department of Justice has sued to prevent the completion of the other two transactions on antitrust grounds. As of this writing, the future of these proposed transactions remains unclear, and the industry waits to see how the Trump administration and the new Congress will act with respect to these transactions, the Affordable Care Act in general and the managed care insurance sector as a whole. One transaction worth noting in the industry in 2016 was the $600 million acquisition of Universal American Corp., a Medicare Advantage (Medicare "Part C") provider, by WellCare Health Plans, Inc.

There was considerable focus from industry participants in 2015 on group benefits businesses, which provide voluntary benefit products to insurable groups. Two noteworthy, although relatively small, transactions in this space occurred in 2016. Unum Group acquired dental and vision benefits provider H&J Capital LLC for $150 million, and Swiss Re Limited acquired IHC Risk Solutions LLC and the direct employer stop loss business written by its affiliates from Independence Holding Co. for $152.5 million. Interest in group benefits businesses appears to remain high, although there is considerable uncertainty regarding how such businesses might be impacted by new legislation involving the managed care insurance sector under the Trump administration and the new Congress.

3. The Non-Life/P&C Sector

Five large transactions accounted for a significant majority of the aggregate transaction value in the non-life/P&C sector in 2016. The largest of these transactions was the $6.3 billion announced acquisition by Sompo Holdings Inc. of Endurance Specialty Holdings Ltd., a transaction that highlights the continued interest in insurance assets by Asian buyers, which we discuss in greater detail in Section I.A.2.a above. The second largest was the announced acquisition by Fairfax Financial Holdings Ltd. of Allied World Assurance Co. for $4.9 billion. Fairfax, a financial holding company, owns a number of insurance and reinsurance companies. In addition, AIG entered into an agreement to sell its mortgage insurer, United Guaranty Corporation, to Arch Capital Group Ltd. for $3.4 billion, and Fosun announced an agreement to sell Ironshore Inc. to Liberty Mutual Holding Company Inc. for $3 billion. Finally, Medical Liability Mutual Insurance Company, a mutual insurance company that provides medical professional liability coverage, announced an agreement relating to its sponsored demutualization and sale to National Indemnity Company (a subsidiary of Berkshire Hathaway Inc.), for $1.5 billion.

Other transactions of note announced in 2016 include the $450 million acquisition by Assured Guaranty Ltd. of financial guaranty insurer CIFG Holding, Inc., American Financial Group's acquisition of the approximately 49% of the shares of National Interstate Corporation that it did not previously own for $313.5 million, the $310 million merger between United Insurance Holdings Corp. and the parent of American Coastal Insurance Company, and The Hartford's $160 million acquisition of Northern Homelands Company, the holding company of Maxum Specialty Insurance Group. National General Holdings Corporation also continued its acquisitive streak with a pair of middle market acquisitions: a $315 million acquisition of Century-National Insurance Company and Western General Agency Inc., and a $165 million acquisition of Elara Holdings, Inc. Finally, Enstar Group Limited announced the entry into an agreement with QBE Insurance Group Limited pursuant to which Enstar will reinsure U.S. multiline P&C business that is in run-off, including workers' compensation, construction defect and general liability policies.

While P&C insurers have enjoyed several years of benign loss experience and, with a few exceptions, solid financial performance, pricing pressure resulting from increased competition and excess capital throughout the industry (resulting from the historically soft reinsurance market, solid financial performance in recent years and other factors) have squeezed underwriting margins relative to recent years. Some market participants may be poised to execute M&A transactions to fuel growth and position themselves to compete for business from stronger platforms, but others appear to be approaching the market with caution as valuations remain high relative to book value.

Technological advancements, new business models and the desire to diversify may drive additional activity in the sector in coming years. Commercial lines providers may seek M&A opportunities in high-growth areas like cybersecurity, and personal lines providers may seek to diversify their operations as technological advancements affect the market for automobiles and consumer electronics and create new technology-based businesses models. Although it does not involve an insurance underwriter, a significant 2016 transaction that could be indicative of this coming trend is the $1.4 billion acquisition by The Allstate Corporation of SquareTrade Holding Company, Inc. SquareTrade is a provider of consumer electronics and appliance protection plans that insure mobile devices, laptops and tablets, and other consumer electronics and appliances, against malfunctions and accidental damage.

In addition, technology-based distribution platforms are starting to disrupt the way in which P&C insurance products are distributed, and "peer-to-peer" (P2P) startup models have begun to appear in the P&C industry. While some may note that the P2P insurers appear simply to be smaller, technology-based derivatives of the mutual insurance model that has existed in the industry for centuries, their direct-to-consumer marketing strategies and mobile-based technology platforms highlight the room for innovation in the way in which insurance products are distributed and sold to policyholders and claims are adjusted and paid. Many established personal lines insurers have already rolled out mobile applications to increase their direct interaction with policyholders and streamline the policyholder experience in many ways. We expect that market participants will continue to seek to enhance their technological capabilities in this regard, including potentially through M&A transactions.

We expect continued M&A activity involving Bermuda reinsurers in the near term, although perhaps at a slower pace than prior years. After several years of aggressive consolidation and acquisitions involving off-shore reinsurers with significant exposure to catastrophe risks, fewer stand-alone public Bermuda reinsurers remain. Despite much (perhaps hopeful) speculation among industry commentators that pricing of reinsurance and retrocessional coverage would harden, the market remains persistently soft, and many buyers of reinsurance are using increased negotiating leverage to lock in rates for longer periods. Total reinsurance capacity remains at historic highs, particularly due to the continued growth of the ILS market, the introduction of new entrants to the market and generally benign loss experience in recent years. These market dynamics will likely result in further M&A activity involving Bermuda reinsurers.

B. Market Trends – Europe

1. Demand to Simplify and Economize

Europe saw a record number of large insurance industry M&A deals in 2015 and, as we noted in our 2015 Year in Review, market commentators had heralded this as a return to large deal-making. However, in line with the experience in North America noted in Section I.A.1 above, this trend has not continued into 2016 within Europe.

The slowdown in Europe is generally attributed, particularly in the case of the U.K., to the run-up to the U.K.'s E.U. referendum and the ultimate vote for the withdrawal of the U.K. from the E.U. ("Brexit"). Many companies are waiting to see how the U.K.'s exit from the E.U. will affect the financial services market and, in particular, the future ability of U.K.-based insurers to conduct business and, elsewhere in the E.U., rely on "passporting" rights.

That being said, there has still been plenty of M&A activity to review in 2016. One theme that seems to have driven a number of this year's larger deals has been a desire to simplify large multinational firms, either in response to regulatory factors or to unlock value from companies with sub-optimal business structures.

A notable example is AIG, the activities of which have had implications in both the London market and the U.S. AIG's activist shareholder Carl Icahn has been applying consistent pressure to split the insurance group into three separate entities. As discussed in Section II below, AIG attempted throughout 2016 to resist this pressure by selling off parts of the group with the aim of becoming a leaner outfit that is more focused on its core insurance business. Most recently, AIG announced the sale of its interest in Ascot Underwriting Holdings Ltd, and its related Lloyd's of London ("Lloyd's") corporate member, Ascot Corporate Name Ltd, to the Canada Pension Plan Investment Board ("CPPIB"). This sale includes AIG's interest in Syndicate 1414 which, together with the managing agent, was set up by AIG and Ascot as a joint venture in 2001. CPPIB is an investment manager that invests the assets of the Canada Pension Plan. It will pay $1.1 billion for the Lloyd's platform, which includes the replacement of the Syndicate's funds at Lloyd's and the release of an AIG guaranteed letter of credit supporting those funds. AIG is due to receive around $240 million as consideration for the sale and has announced that it will keep its strategic partnership with Ascot Underwriting Bermuda Ltd., which it intends to expand.

The Ascot sale follows other AIG divestments including the sale of its Japan life insurance business, AIG Fuji Life Insurance Company, Ltd. to the Pacific Century Group, the sale of mortgage insurer United Guaranty to Arch Capital Group Ltd. for $3.4 billion ($2.2 billion in cash and $1.2 billion in Arch securities), the sale of certain commercial and consumer insurance operations in several jurisdictions to Fairfax Financial Holdings Limited for $240 million, the sale of AIG Advisor Group to Lightyear Capital LLC and PSP Investments, and the sale of AIG's remaining shares in Chinese insurer PICC Property and Casualty Co Ltd. for $192 million.

Other large financial institutions across Europe have also been feeling the pressure to streamline company structure, refocus on core business and free up capital. This has largely been in response to regulatory demands to hold more capital and changes in the way that available capital is determined.

By way of example, Deutsche Bank agreed in September to sell its Abbey Life Assurance business to Phoenix Life Holdings, which specializes in managing closed book life insurance funds in the U.K., for £935 million, following an auction process. While Deutsche Bank stated that the sale would have a net positive capital impact, it will lead to an expected pre-tax loss of approximately £800 million for the bank resulting mainly from impairment of goodwill and intangible assets. In order to fund the acquisition and associated costs, Phoenix announced that it would raise £735 million via a rights issuance and use £250 million from a new bank facility.

The auction process and sale to Phoenix continued despite the fact that the U.K.'s Financial Conduct Authority launched an investigation into Abbey Life in March 2016 to review its treatment of customers. One possible outcome of the investigation could be a request to pay compensation to policyholders or the assessment of regulatory fines, although Deutsche Bank has agreed to indemnify Pheonix for liabilities resulting from fines, fees and rectification charges that could arise following the investigation.

Phoenix also agreed with French insurer AXA to purchase Embassy, AXA Wealth's pension and protection business, including SunLife, which offers insurance, life cover and savings to the over-50s. This deal allows AXA to exit the U.K. life assurance market, which was announced as part of AXA's wider five-year plan to refocus its U.K. business towards P&C, health and asset management. As one of the final stages of this withdrawal, the sale of Embassy and SunLife will be concluded for £375 million and, much like the Abbey Life deal, will be funded by Phoenix through an equity placement and a short-term debt facility. The sale will generate a loss of €400 million for AXA, which will be absorbed as part of its wider consolidation agenda.

The sale of Embassy and SunLife followed quickly on the heels of Standard Life confirming that it would purchase AXA's Elevate, an investment platform for independent financial advisers, by acquiring AXA Portfolio Services, the company that houses the platform. Elevate handles nearly £10 billion of U.K. investments, which will be added to Standard Life's own platform business to give it a total of almost £36 billion of assets under administration, making it the largest U.K. platform of its kind. The price of the deal was not disclosed publicly; however, analysts have estimated that Elevate would have been worth around £50 million at the time of the sale.

AXA's final move in 2016 was to announce the sale of its insurance brokerage Bluefin to rival broker Marsh for £295 million. While Bluefin made a pre-tax profit of £1.2 million in 2015, this was considered to be a welcome relief since AXA has struggled for some time to achieve any growth from the business and sustained losses in previous years. The deal will reduce AXA's profits by £56 million, but again has been seen as a positive step towards implementing its longer-term plans. AXA continues to offer car and other personal lines insurance in the U.K.

Old Mutual has also begun the process of splitting its Anglo-South African business into four separate units following a strategic review that highlighted the costs and inefficiencies in its current structure. The company plans to separate into Old Mutual Emerging Markets (Asia, Africa and Latin America), Old Mutual Wealth (UK), Nedbank Group (South Africa) and OM Asset Management (US). The announced timetable aims to complete the divisions by the end of 2018, although no indication has been given to date as to whether the U.K. wealth business will be separated by way of an IPO or takeover. It is understood that potential interest in acquiring these businesses include some of the private equity funds that are looking to expand further into the insurance industry.

2. Private Equity Maintains Its Interest

The inclusion of private equity investors as potential suitors for Old Mutual's U.K. business is demonstrative of another recent theme in insurance M&A in the U.K. Along with acquisitions by traditional insurance players, 2016 has seen more private equity groups making moves to acquire insurance firms across Europe. Meager investment returns in more conventional equity markets have made private equity firms think further outside the box in the hunt for better yield. While historically private equity might have avoided the insurance industry because of the added complication of gaining regulatory approval for acquisitions, we are seeing more and more firms take up the challenge in the pursuit of more favorable results. Regulators have, over time, become more comfortable with private equity firms as the custodian of regulated business, provided appropriate checks and balances are put in place in the context of individual acquisitions.

The Carlyle Group L.P. has been particularly busy in this space. In 2016, Carlyle Cardinal Ireland, a joint venture between the Carlyle Group and Irish investment company Cardinal Capital Group, made its seventh acquisition in Ireland, buying AA Ireland. The purchase was made for €156.6 million, which includes consideration for cash left on the balance sheet. The AA Ireland acts as a car and home insurance broker, provides servicing, motoring advice and breakdown cover, and has recently confirmed that it will be expanding its product offering into the life market. This assortment of products clearly illustrates private equity groups' interest in an increasingly wider market offering.

Aquiline Capital Partners LLC also added to this trend in early 2016, acquiring Simply Business from another private equity group, AnaCap. Simply Business is a leading online business insurance intermediary, using technology and a customer-centric approach to provide innovative insurance solutions to small businesses in the U.K. The company was launched in 2005 and now has more than 350,000 customers, with revenues having risen from £23 million in 2012 to £40 million in 2015.

The U.K. private equity group Cinven also publicized its intention to enter the German life insurance market and buy up available books of business. Cinven already owns a life insurer in Germany, Heidelberger Leben, which specializes in unit-linked policies, but expressed a willingness to expand its operations to more traditional life insurance product providers.

3. Continued Activity in the Run-off Market

Consolidation also appears to be the goal in the run-off market, which continues to see regular acquisitions, whether by way of entire companies and groups or discrete portfolios.

While AXA has been pulling out of some market segments in the U.K., it has continued to look for other opportunities in Europe. In April 2016, AXA Liabilities Managers purchased GLOBALE Rückversicherungs-AG, the remaining part of German run-off company Global Re. This acquisition was made through AXA DBIO, a vehicle that invests specifically in run-off acquisitions. The Global Re group was previously one of the ten largest reinsurance groups in the world, with subsidiaries in the U.S., Switzerland and Canada, and chiefly reinsured non-life risks in the U.S., U.K. and Europe. The group was put into run-off in 2002 and complements AXA DBIO's existing portfolio of non-life reinsurance business.

R&Q, another significant player in the run-off space, also announced a further acquisition: the purchase of The Royal London General Insurance Company Limited ("RLGI") from The Royal London Mutual Insurance Society Limited for £11.9 million. This was one of a number of deals where the business will ultimately be transferred internally to R&Q's Maltese based run-off specialist, R&Q Insurance (Malta) Limited, under Part VII of the Financial Services and Markets Act 2000. RLGI underwrote non-life insurance from 1985 to 1999 and this book will complement R&Q Insurance (Malta) Limited's existing portfolio, as the remaining liabilities relate mainly to employers' liability from cover provided to SMEs. The purchase price represented a small discount to RLGI's net assets of £13.5 million as at year-end 2015, most likely because of RLGI's exposure to long-tail disease claims, in respect of which firms have traditionally under-reserved.

Catalina Holdings U.K. Limited, the U.K. subsidiary of Catalina Holdings (Bermuda) Ltd, also announced this year that it had agreed to acquire AGF Insurance Limited from AGF Holdings (UK) Limited, a subsidiary of Allianz SE. AGF Insurance Limited wrote employers and public liability insurance in the U.K. and went into run-off in 1999. While the terms of the deal were not made public, AGF had £270 million ($381.7 million) in total assets, undiscounted gross reserves of £185 million ($266 million), and pro-forma shareholder equity of £79 million ($113 million) at the end of 2015.

4. Continued International Interest and Innovation at Lloyd's

Lloyd's carriers remain highly attractive to both strategic and financial potential purchasers, and have drawn significant interest from international investors. The sustained interest over several years in Lloyd's carriers has caused the pool of potential targets to decrease. As a consequence, we predict that any Lloyd's operations that come to market in 2017 will continue to be the subject of increasingly competitive auctions that could yield valuations calculated using ever higher multiples of book value.

By way of example, as discussed in Section I.A.3 above, the Canadian investment and insurance company Fairfax Financial Holdings Ltd., agreed in December 2016 to buy Allied World Assurance Co. for $4.9 billion in cash and stock. Switzerland-based Allied World has a significant Lloyd's presence, which will add to Fairfax's current Lloyd's operations through Brit.

In addition, Argo Group agreed in late 2016 to purchase Ariel Re for an estimated purchase price of $235 million. The agreement was reached following an auction process that reportedly involved a number of interested parties. Ariel Re operates across London, Bermuda and the United States, with risks also being underwritten through its Lloyd's Syndicate 1910. Argo considers this to be a complementary fit with its existing Lloyd's operation in terms of achieving diversification and scale.

Given the increasingly limited M&A opportunities to buy a Lloyd's vehicle, potential entrants to the market continue to explore special purpose syndicates ("SPS") as an alternative means of accessing Lloyd's. SPSs are also popular vehicles for routing third party capital into the Lloyd's market. In 2016, five new start-ups began writing business, with three of these operating as SPSs. The Mexican group, Patria Re, established SPS 6125, managed by Pembroke Managing Agency, which wrote a whole account quota share of Pembroke Syndicate 4000. Novae Group plc, a U.K.-listed Lloyd's insurer, and Securis Investment Partners LLP, an ILS fund manager, launched SPS 6129 with a stamp capacity of £40 million to write U.S. property excess and surplus lines business. It was capitalized by funds managed by Securis. Finally, the "Agora" SPS 6126, led by Mike Pritchard and managed by Asta, was established to support Skuld Syndicate 1897 and was backed predominantly by emerging market capital. Agora targets direct and facultative non-marine business, with stamp capacity of £40 million.

Other large managers of alternative capital have gone further and established their own syndicates. Credit Suisse Asset Management began trading through its Arcus Syndicate 1856 on January 1, 2016 with £90 million stamp capacity backed by CSAM's ILS funds and managed by Barbican Managing Agent Limited. This marks an evolution of CSAM and Barbican's special purpose syndicate by which the former took a quota share of the latter's portfolio across several classes.

Overall, we expect that an increasing number of market entrants and capital providers will continue to use SPSs and partnerships with other market participants as a first step into Lloyd's prior to the establishment of full syndicates and integrated Lloyd's vehicles.

5. The Rise of Demergers and Listings on the London Stock Exchange

In addition to the merger activity that we have seen in Europe this year, and continuing with the trend of simplifying large multinational businesses, there have been some significant demergers announced in 2016 in the financial services sector. These spin-offs have often involved listings on the London Stock Exchange, either to unlock the value in the spin-off group or to divest the group entirely.

Early in 2016, National Australia Bank sold off its interest in the Clydesdale and Yorkshire Bank Group, by floating 25% of Clydesdale's shares on the London Stock Exchange, with the rest of the shares being distributed to National Australia Bank shareholders. This spin-off concluded National Australia Bank's exit from the U.K. market, which had been muted for some time prior to the IPO. The Australian company's desire to pull back from the U.K. has been attributed to the slump in the local property market and fines levied on Clydesdale by the U.K. Financial Conduct Authority for mis-selling payment protection insurance.

In September 2016, the insurance group esure announced that it would demerge the Gocompare.com price comparison website (purchased by the group in late 2015) and list it on the London Stock Exchange. Sir Peter Wood, chairman of esure Group, stated that the reason for this move was to allow the two businesses to concentrate on their own separate strategies and align senior management incentives. The demerger was approved by 99% of esure's shareholders at its general meeting on November 1, 2016, and Gocompare.com began trading on November 3, 2016 with an estimated value

of around £400 million, with the deal costing £19 million to complete. Prior to the demerger, Gocompare.com drew down on a new £75 million debt facility to pay esure a £63 million dividend.

Gocompare.com will join another high-profile comparison website on the London Stock Exchange, Comparethemarket, whose owner, the BGL Group, is reported to be preparing for a £2 billion listing in early 2017. This adds to the recent trend of price comparison sites seeking exposure to the London stock market with Moneysupermarket, Confused.com and USwitch all taking this step.

We will wait to hear whether Old Mutual Wealth will join the ranks of these spin-offs by listing on the London Stock Exchange when Old Mutual is finally split. If so, Old Mutual Wealth could become a FTSE 100 company in its own right following an IPO.

6. Future M&A Trends and Drivers in Europe

While we expect the desire to simplify and economize to continue to drive M&A activity in 2017, future M&A trends and drivers in Europe over the next five years will ultimately be dominated by the fallout from the U.K.'s exit from the E.U. There are many competing theories as to how this will impact the market in the long and short term, making planning for the future extremely difficult for all participants in the European insurance market. This is exacerbated by the lack of clarity from the U.K. government as to how it might negotiate inclusion in, or the replacement of, the current passporting regime, or how the wider process of exiting the E.U. will be managed over the next few years. Brexit is further analyzed from a regulatory perspective in Section VII.B below.

The short term may see a rise in M&A and restructuring activity as insurers and intermediaries seek to relocate their centers of business away from the U.K. or supplement them with additional European carriers, in order to protect their wider European interests. We have already seen a glimpse of this in the banking sector, with the British Banker's Association warning that the larger banks are poised to relocate to mainland Europe if Brexit unfolds in an unfavorable manner. Lloyd's has also announced that it is planning to establish a subsidiary within the remaining E.U. should the U.K. government not secure passporting rights as part of the Brexit negotiations. Similar responses may become widespread among financial services companies and intermediaries based in the U.K. that wish to continue to provide products within the E.U. if this ability is not secured as part of the U.K.'s Brexit package. That being said, whether international firms do in fact leave the U.K. entirely will ultimately depend upon the costs of relocation compared to any loss of business as a result of any regulatory changes. Anecdotally, we have heard that some insurers have already begun to analyze these costs and have decided to keep their centers in the U.K., at least for the next few years, not least because of the costs of human capital. Nonetheless, this analysis will be sensitive to the model and exposures of each individual business and so, while this anecdotal confirmation is reassuring, it may not represent accurately the sentiments of the wider market.

Multinational insurers with pockets deep enough to spread the inevitable risk may take advantage of the weak pound to seize the opportunity to enter the U.K. market at this time. Kengo Sakurada, the chief executive of Sompo (which, as discussed in Section I.A above, entered into an agreement in 2016 to acquire Endurance, which is active in the Lloyd's market through Syndicate 5151), has said that London, and the Lloyd's market especially, are still appealing even taking into account the risks associated with Brexit. He confirmed that Sompo will continue to place resources and capital into Lloyd's because it opens access to other developed markets outside the E.U. However, whether these intentions ultimately lead to investment in the U.K. will likely depend on how easy it is to value U.K. assets and whether investors can see any potential growth opportunities. If the U.K. continues to suffer from

volatility in the value of the pound sterling, valuation and growth potential will be made more obscure and therefore investment more unlikely.

Notwithstanding the above, while there is uncertainty as to how the regulatory landscape in the U.K. and Europe may change in the near future, many companies may simply wait to see the outcome of the U.K. government's negotiations and then react accordingly. We may therefore see a continued and more significant slowdown in M&A activity of companies with a U.K. base. This effect will most likely occur at the more modest end of the market, where companies do not have the resources or multinational reach to allow them to consider relocation.

The repercussions of the Brexit vote are likely to go well beyond the U.K.'s negotiations to leave the E.U. Many eyes are now focused on the elections scheduled for 2017 in France and Germany and the continuing political instability in Italy. The result of any of these could potentially have a significant effect on the direction of the E.U. which, in turn, may have implications for the insurance industry that are currently hard to predict.

There are, of course, some up-sides to the weak value of the pound sterling where investors are purchasing businesses using other currencies. Investors with U.S. dollars or Swiss francs to spend will find U.K. businesses keenly priced while the slump in the pound continues, and this may be a good opportunity for them to invest in the talent and expertise that continues to exist in the U.K. insurance market. It remains to be seen whether this temptation, when balanced against the uncertainty that will inevitably continue to exist over Brexit, will be sufficiently significant to drive M&A activity in 2017.

Despite the competing theories, the common sentiment around the insurance market is clear: hope that clarity quickly emerges regarding the likely terms that will apply to the insurance industry following the U.K.'s exit from the E.U. A prolonged period of uncertainty caused by on-going Brexit negotiations will, in all probability, have a negative impact on all companies operating in the market during this period, and this is something virtually all participants in the insurance industry would prefer to be clarified as quickly as possible.

II. Developments in Corporate Governance and Shareholder Activism

It may be chance, or it may be the beginning of a trend, but 2016 saw an increase in shareholder activism at insurance holding companies compared to prior years. Notable highlights include efforts to elect directors nominated by activists at three companies. 2016 was also a busy year for proxy access issues, although other types of shareholder proposals declined. We discuss these topics and more below.

A. Contested Board Situations

Contests to elect a dissident director have historically been rare occurrences for insurance holding companies. We believe this is in part due to activists' concern that such companies, operating under the heavy yoke of insurance company regulation, might be hard places to gain representation and even harder places to effect major, share price-moving change.

Beginning with John Paulson's Valentine's Day 2012 break-up proposal to The Hartford, however, the pace has begun to quicken, and in 2016 there were three. First, Stewart Information Services, a P&C insurer and one of the U.S.'s three largest title insurers, came under fire from activist investors Starboard Value LP and Foundation Asset Management, the owners of 9.9% and 5.6% of Stewart's stock respectively. Starboard acquired much of its stake in the summer of 2016, believing that Stewart was undervalued and ripe for improvement if governance changes could be achieved. Starboard strategically kept its holdings under 10% in connection with its push, reducing the chance that Stewart could successfully use the "insurance regulatory defense" against Starboard's moves. Foundation is a longer-term holder of Stewart's stock and had advocated for corporate changes in 2014 as well. In August, Foundation began a stockholder consent solicitation to gain support for holding a special meeting to replace two incumbent directors with independents nominated by Foundation. The two incumbent directors, Malcolm Morris and Stewart Morris, are cousins who are descended from the company's founders and were co-CEOs until 2011. They are the father and uncle, respectively, of the company's current CEO, Matthew Morris. Foundation's consent solicitation statement cited the weak operating performance of Stewart compared to the other big title companies, the relationship between these directors and the CEO, and various payments by the company to the Morris family, including for "horse expenses." In the meantime, Starboard began working in the background with Stewart to replace the Morris cousins as directors. In October, Stewart reached a deal with the activists—the Morris cousins would step down and be replaced by Matthew Morris and an independent named by Starboard; two additional incumbent directors would step down and be replaced by two new independents; and Foundation would drop its consent solicitation. To date, the stock price has held relatively steady; as noted above, it often takes time to bring change to an insurer.

The second situation involved financial guaranty insurer Ambac Financial Group. Following its emergence from bankruptcy in 2013, Ambac has been in runoff, although it remains open to the possibility of selectively growing and diversifying, through the development or acquisition of financial services businesses such as advisory, asset servicing, asset management, and insurance. Over the past year, its reported results have improved and its stock price has approximately doubled. Early in 2016, asset manager Canyon Capital filed materials with the SEC to start an election contest. It initially proposed three independent nominees for election to the board at the annual meeting to be held in May 2016, at which time all six members would be up for election. Eventually, Canyon retreated somewhat, putting forth a single candidate for the slot held by Ambac's board chairman. Ambac fought back hard. It made hay out of the fact that Canyon Capital was also the holder of a large amount of obligations insured by Ambac's principal financial guaranty subsidiary, with a value that far exceeded that of the Ambac shares Canyon held. It also pointed out that Canyon was pushing for faster resolution of insured claims, which would not necessarily favor

the interests of shareholders. Although Canyon raised issues about management compensation at Ambac and the CEO's relevant experience, it faced resistance from other stockholders, who didn't share its interest in speedy resolution. Shortly before the annual meeting, Canyon dropped its proxy fight. According to Ambac, to that date Canyon's candidate had received less than 5% of the total vote. Canyon's battle appears to have been poorly thought out and unsuccessful, although Canyon put out a final press release touting the changes that it claimed its efforts had engendered.

Finally, 2016 witnessed the resolution of Carl Icahn's battle with AIG, which began in 2015 and which we covered extensively in last year's edition of this publication. Icahn's initial push was to try to cause AIG to separate its P&C, life and mortgage guaranty businesses into three separate companies. AIG management rejected the call for a breakup and in January 2016 responded with a strategic plan to return $25 billion to shareholders over two years, with as much as $7 billion generated from divestitures. Following that announcement, Icahn declared his dissatisfaction with the plan, and said that he intended to nominate candidates for election to the board. AIG and Icahn then worked out a settlement, under which an Icahn deputy and John Paulson (whose firm had separately supported a break-up of the insurer) were appointed to the board of AIG.

Following the settlement, pundits speculated how much longer AIG CEO Peter Hancock would continue to serve in his role with Icahn and Paulson under the tent. However, at present Mr. Hancock appears to be thriving. Following AIG's announcement of the sale of its mortgage insurer, United Guaranty, in August for $3.4 billion, Icahn was quoted as saying that he and Hancock saw "eye to eye" on how to manage AIG. Notably, calls for a break-up of the life and P&C businesses, and of efforts to shed AIG's SIFI status, have not been repeated publically.

B. 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 proposed proxy access regulations were vacated by the Federal courts. The SEC's proposed rule would have permitted holders of more than 3% of the company's stock, who had held such stock for at least 3 years, to elect up to 25% of the company's board (a "3/3%/25%" formula). 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. Although activist interest in this topic was initially limited, in 2015 proxy access proposals boomed. Led by the NYC Comptroller's office, activists submitted a total of 110 proxy access proposals to the S&P 1500 in 2015, of which 88 came to a vote.

In 2016, the pace of proxy access proposals accelerated. According to Georgeson Inc., there were approximately 200 such proposals presented to S&P 1500 companies this past year. However, a much smaller number actually came to a vote. In 2015, the SEC first suspended the use of, and then announced guidance on, Rule 14a-8(i)(9) of the proxy rules under the Exchange Act (the "Directly Conflicts" rule), which made it essentially impossible to avoid including a proxy access proposal on the basis that it was in conflict with a competing management proposal. In the proxy access context, the SEC Staff had previously permitted companies to exclude, for example, a 3/3%/25% proposal if the company itself was proposing proxy access requiring 5% ownership for at least 5 years, with a right of such holders to elect up to 10% of the board. Issuers

regrouped in 2016; a popular strategy emerged of adopting the company's own proxy access bylaw ahead of the annual meeting, and excluding the shareholder proposal under Rule 14a-8(i)(10), which permits exclusion on the basis that the proposal has already been "substantially implemented" by the issuer. Although this requires companies to adopt a market standard proxy access formulation (generally 3/3%/20%), it permits them to include ancillary provisions that are different from or in addition to those proposed by activists. Further, even where the shareholder proposal was not excluded from the proxy statement, issuers that adopted their own form of proxy access prior to the meeting saw much lower rates of votes in favor of the shareholder's proposal at the meeting than those that did not have a version in place. In this regard, the results mirrored those in connection with shareholder proposals that directors be elected by a majority vote of all shareholders, rather than by a plurality. For many years now, companies that have adopted their own majority vote provisions (often so-called "majority vote-lite" provisions) have been able to defeat more robust majority vote proposals.

In 2016, an additional contested insurance company election involved a proxy access proposal made by the institutional investor CalPRS in respect of Old Republic International Corporation, another large P&C and title insurance group. Rather than merely contenting itself with having its Rule 14a-8 shareholder proposal appear in Old Republic's proxy statement, CalPRS also filed its own exempt solicitation statement with the SEC. CalPRS's solicitation did not request a proxy from stockholders, and merely asked them to vote in favor of its proposal on management's proxy card. (Although undoubtedly not the intended reason for taking this approach, this "exempt solicitation" under SEC rules had the additional benefit that it avoided CalPRS's holding proxies on more than 10% of the stock of Old Republic, which might have triggered the need to file a disclaimer or even a Form A.) At the meeting, CalPRS's proposal received a favorable vote of nearly 74%, one of the highest vote totals in favor of all the proxy access proposals presented in 2016.

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 to effectively "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. (And as mentioned above, in some states merely holding proxies covering more than 10% of the outstanding shares of an insurance holding company creates a presumption of control.) Insurers moving towards proxy access would be well-advised to require that any nominee have obtained all necessary regulatory approvals for board service, and to build such a requirement into their relevant bylaw. Of course, issuers should also require that to be eligible to use proxy access, the shareholder have acquired its shares without the intent to change or influence control of the company, and that it not presently have such intent. This requirement is common in company-adopted proxy access provisions, and is based on a provision included in the SEC's abandoned proxy access rule.

In fact, a "lack of control intent" provision came into play in what appears to be the only instance to date of a shareholder actually proposing a candidate using proxy access provisions. (Although almost 200 companies in the Fortune 500 have adopted them, none had ever received an actual candidate.) In late 2016, GAMCO Asset Management, an entity affiliated with activist investor Mario Gabelli, proposed a candidate for election at the annual meeting of National Fuel Gas Company, an NYSE-listed diversified natural gas company. NFG quickly rejected the bid to include the candidate in its proxy statement, on the basis that GAMCO had been pushing for the break-up of the company, a move consistent with a control intent as defined under the Exchange Act. GAMCO then withdrew its proposal. Although GAMCO's move may look like an avoidable blunder, it seems at least possible that it made the low-budget approach to draw attention to its break-up proposal rather than to actually get a director onto the board.

C. Say on Pay and Director Elections

As in the four prior years, in 2016 shareholders once again overwhelmingly voted in favor of executive compensation in companies' annual "say-on-pay" votes. According to Georgeson, even at companies that received a negative recommendation on the topic from Institutional Shareholder Services ("ISS"), votes in favor averaged 68%, up from 65% in 2015. Adverse recommendations by ISS and Glass, Lewis & Co., the two biggest proxy advisory firms, once again greatly outnumbered failed votes. In the U.K., "mandatory say on pay" came into force in 2014. Listed issuers have since been required to submit their pay policies for vote by shareholders at their Annual General Meetings, and further may not pay any amounts outside the parameters of the adopted policies. In the U.K., FTSE 100 companies had a bruising 2016. 13 FTSE 100 companies submitted their remuneration policies for approval (which must be done every three years, or sooner if the company needs to change the policy, or fails to obtain shareholder approval of its annual remuneration report), of which two companies' policies failed to receive the support of a majority of shareholders and a further two companies had votes against of more than 20%. In addition to the results on pay policies, the shareholders of two companies rejected their annual remuneration report with a further company receiving only 51% in favor. In total, 10% of FTSE 100 companies received votes against their annual remuneration report of more than 30%, compared with only 4% of FTSE 100 companies in 2015. In 2017, more than two thirds of FTSE 100 companies will be seeking shareholder approval for their remuneration policies (the largest since the creation of this requirement in 2014), and if the 2016 trend continues, some FTSE 100 companies may find themselves in conflict with their shareholders.

In addition, the number of directors at U.S. companies who received more than a majority of "no" or "abstain" votes with respect to their election in 2016 was less than in 2015, again according to Georgeson. In 2016, 22 directors (at 14 companies) fit into that category, compared to 27 in 2015. Such votes often result in so-called "zombie directors" when the candidates' boards of directors do not accept resignations offered by the directors whose support from shareholders was lacking. Further, shareholder proposals regarding board composition issues, principally focused on diversity and length of tenure, are receiving greater attention than in prior years at U.S. corporations. Refreshing boards with new perspectives is seen as both a corporate and societal good by many.

D. Other Shareholder Proposals in 2016

The number of shareholder proposals in the 2016 proxy season was lower than in 2015, consistent with a multiyear trend that was interrupted in 2015. According to information compiled by Georgeson, the number of shareholder proposals received by companies in the S&P 1500 decreased by 9.5% overall. The number of proposals actually voted on decreased even more dramatically, by approximately 20%, to 266 proposals. These numbers are more striking considering that they include proxy access proposals that came to a vote, which were roughly equivalent in number in 2016 and 2015.

As in the past, shareholder proposals fall into two broad categories: those relating to corporate governance, and those relating to social or political goals. The former category includes proposals to require companies to have a board chairman independent from the chief executive officer, the most common governance proposal after proxy access. In 2016, 43 such proposals came to a vote,

compared to 58 such proposals that were voted on in 2015. Average support for these proposals was approximately 29%, not enough to bring about change but continuing to show 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. However, the number of such proposals remained low, likely reflecting the extent to which these governance changes have already been adopted by the S&P 1500, or perhaps reflecting activist focus on other issues, particularly proxy access.

Environmental and social proposals were also active in 2016. There were approximately 90 proposals submitted on issues related to climate change, including many that asked companies to report on how increases in global temperatures would impact their operations. Some of these may have been inspired by coverage of the questions raised about ExxonMobil's disclosures regarding its assets, and the impact that climate change may have on their ultimate recoverability. Nearly all of these resolutions failed to get majority support. As in 2015, political contributions and lobbying continued to be the leading social issues presented to shareholders. In 2016, 69 such proposals were voted on, compared to 63 in 2015. Somewhat surprisingly in a U.S. Presidential election year, the level of support for these proposals declined in 2016 compared to 2015. It will be very interesting to follow trends in regard to this topic in 2017.

III. Insurance-Linked Securities

A. Overview

Insurance-Linked Securities, or ILS for short, is the name given to a broad group of risk-transfer products through which insurance and reinsurance risk is ceded to the capital markets. This group of products is continually evolving to meet market demand, and includes catastrophe bonds, sidecars, industry loss warranties, collateralized reinsurance facilities, extreme mortality derivatives and bonds, embedded value securitizations and insurance-based asset management vehicles.

Drawn by non-correlated asset returns, particularly in a low interest rate environment, the amount of capital supporting the ILS market has grown considerably over the last several years, as international pension funds, endowments, family offices and other large pools of capital have increased their investment allocation to ILS-dedicated asset managers.

Once a niche alternative to traditional reinsurance, ILS has developed into a mainstream component of insurance risk-taking capacity, often competing directly in or alongside traditional reinsurance catastrophe programs, in addition to more liquid securities products, such as cat bonds. This overarching trend of capital convergence deepened in 2016, as the distinction between ILS and traditional reinsurance capacity has grown increasingly less cognizable.

The influx of efficient ILS capital is having a profound impact on the overall capital structure of the insurance and reinsurance industries, as Ricardo's theory of comparative advantage plays out in real time. This is not to imply that ILS is necessarily a more efficient form of capital than traditional reinsurance, but that different sources and forms of capital are more efficient at taking particular risks. For instance, a rated reinsurer with an equity shareholder base can assume certain types of risk that would be inefficient for an ILS fund, and vice versa.

These trends continued in 2016 as ILS structures evolved to match capital and risk more efficiently, including through the growth of collateralized reinsurance, the rising popularity of private placement cat bonds and sidecars, ILS involvement in senior note offerings, such as offerings from Heritage Insurance and UPC Insurance, and the creation of MGA and Lloyd's facilities, among others. We discuss many of these developments in more detail below.

- Although ILS grew overall in 2016, the Rule 144A catastrophe bond market experienced its first decline in new issuances since the financial crisis, decreasing from approximately $8 billion of new issuances in 2015 to approximately $6 billion in 2016 (with an overall market size still in excess of $25 billion). This decrease has occurred despite a greater than $1 billion cat bond issuance from XL Catlin through its Galilei Re vehicle in the fourth quarter of 2016. Rule 144A catastrophe bonds have long been the principal market for ILS because of their broad syndication, liquidity and transparency of pricing. While it is difficult to extrapolate cause and effect from one year of data, the trend seems to have been driven by favorable traditional reinsurance pricing and terms, as well as the ease of execution and lower frictional costs for sponsors. In addition, ILS investors have been increasingly willing in this "soft" market to assume risk through less liquid and transparent collateralized reinsurance and fronting structures.
- As spreads have remained near historic lows, cedents have continued to push on ILS coverage terms to further replicate traditional indemnity reinsurance protection. Several cedents have sought coverage for unmodeled perils such as U.S. wildfire outside

of California, volcanic eruption, meteorite impact and other natural perils. We believe that it is only a matter of time before the first "all natural perils" catastrophe bond emerges, which will further narrow the difference in coverage terms between ILS and traditional reinsurance.

- As the sophistication and modeling expertise of ILS investors has grown in recent years, interest in private placement cat bonds and other ILS structures under Section 4(a)(2) of the Securities Act has increased. While cat bonds are (and will remain) principally offered pursuant to Rule 144A, the popularity of private placements under Section 4(a)(2) as a streamlined alternative is beginning to take hold. This includes approximately $150 million of issuances through Rewire Holdings's private placement platform; over $200 million through JLT's Market Re platform; and over $360 million through Willis's Resilience Re platform. As an alternative to more traditional Rule 144A transactions, private placement cat bonds offer sponsors the benefits of a streamlined structure, modeling and subject business disclosure, as well as decreased transaction costs. This is especially important for first time sponsors, particularly smaller insurance companies who may not have adequate internal resources to undertake a full Rule 144A offering process, or for whom traditional reinsurance may be competitively priced on an "all-in" basis. Consequently, we expect these private placement structures to continue to increase in 2017 as a mid-point between Rule 144A bonds and collateralized reinsurance.

- Sidecars remained a popular risk transfer vehicle in 2016 despite the slowdown in cat bond market activity, with established sidecar vehicles either maintaining their size or growing. Representative offerings include those from Validus (AlphaCat), Brit (Versutus), Lancashire (Kinesis), Munich Re (Eden Re II) and a first-time issuance by RenaissanceRe's Fibonacci Re vehicle. Of particular note was the $160 million Limestone Re sidecar by Liberty Mutual that includes risks from U.S. property catastrophe, U.S. homeowners and London Market specialty insurance. The Limestone Re transaction represents the first sidecar issued by a primary insurance company in several years. Aspen Re's sidecar, Silverton Re, expanded to $130 million for the 2017 cycle, doubling in size since its inception in 2014.

- In 2016, ILS technologies developed primarily for property catastrophe risk have been utilized to protect against other forms of insurance, such as operational risk insurance and mortgage insurance. If the trend proves successful in future years, this expansion will represent an important step in broadening the ILS market to other forms of insurance risk.

    - In May 2016, Credit Suisse sponsored a CHF 220 million offering of operational risk-linked notes by Bermuda special purpose insurer Operational Re. The issuance was a first-of-its-kind transaction whereby Credit Suisse transferred a portion of its prospective operational risk (such as rogue trader events and litigation) in bond format to hedge funds and other investors. As a result of the offering, Credit Suisse was able to release regulatory capital and protect against these kinds of remote risks. This was a high-profile transaction, generating numerous articles in the mainstream financial press, as well as in specialized insurance publications. The Operational Re offering represents an important milestone for ILS, as the transaction utilized technologies developed primarily for property catastrophe risk to other forms of risk.

    - In May 2016, United Guaranty sponsored a $300 million Rule 144A mortgage insurance catastrophe bond tied to the risk of defaults on mortgage loans underwritten prior to 2009. The offering, which combines diverse structural features from both

the catastrophe bond and RMBS markets, enabled United Guaranty to access the capital markets for up to ten years of collateralized reinsurance protection for pre-crisis mortgage insurance policies.

- As the supply of Rule 144A catastrophe bonds waned in 2016, several ILS funds have invested in private placement senior note offerings by catastrophe exposed Florida insurance holding companies. Two such offerings that were publicly announced, among several others, include an $80 million issuance of senior notes to Fermat and Hudson Structured and a $30 million issuance of senior notes by UPC Insurance to Twelve Capital. The notes were issued in book-entry format, and are eligible for resale under Rule 144A and Regulation S.

B. M&A in the ILS Market

M&A activity in the ILS market increased significantly with four deals in 2016, compared with just one in 2015. As ILS matures as an asset class, ILS funds are looking to scale their operations and access a broader, more diverse investor base. Asset managers continue to look on ILS investments favorably as a relatively non-correlated yield for investors.

- In July 2016, Schroders, the global asset management group, increased its stake in Secquaero Advisors (a Swiss-based ILS manager) from 30% to 50.1%.

- In October 2016, Mitsui & Co, hoping to introduce Japanese institutional investors to ILS investments, bought a 15% stake in New Ocean Capital Management Limited (the asset manager founded by XL Group Ltd and Stone Point Capital). In addition, Mitsui committed an initial $100 million of capital to New Ocean's private fund platform on a multi-year basis and intends to increase that by a further $200 million by attracting its customers' investment to ILS.

- In November 2016, Elliott Management Corporation, the American hedge fund management firm, announced that it will acquire a controlling stake in Aeolus Capital Management. Elliott had been investing with Aeolus since 2012 and Aeolus hopes that it will be able to leverage Elliott's scale, access to investors and expertise in both marketing and managing alternative asset classes, while Elliott is likely to benefit from Aeolus's expertise in the ILS sector.

- In December 2016, Amundi, an asset management company jointly owned by Crédit Agricole and Société Générale, agreed to acquire Pioneer Investments from UniCredit. Pioneer is an active investor in ILS and offers specific ILS-focused investment vehicles (the Pioneer ILS Interval Fund). This is another example of an asset manager seeking to widen its offering through ILS investments and another strategic partnership between an ILS fund and a traditional asset manager seeking a wider group of investors and access to ILS, respectively.

C. U.K. ILS Legislation

We reported in our 2015 Year in Review that the U.K. government had commenced the legislative process for implementing a legal framework to facilitate ILS and collateralized reinsurance business in the U.K. In March 2016, HM Treasury issued a consultation paper, asking the industry to comment on what it considered should be the regulatory, tax and corporate structure for ILS business and how ILS vehicles should be authorized and supervised. Guided by the responses to the March consultation, in November 2016, HM Treasury released draft regulations for the operation of an ILS regime in the U.K. and issued a second consultation paper soliciting input on the proposed regulations by early 2017. The framework proposed by the draft regulations and some of the key open issues that will require further clarification are discussed in detail in our Client

Alert titled "Proposed ILS Regime for the U.K." dated December 1, 2016. One of the open issues is whether the U.K. regime will be able to authorize ILS vehicles in as competitive a timescale as other ILS jurisdictions. For example, as of January 1, 2017, Guernsey typically allows ILS vehicles to be authorized within one business day, while Bermuda's initial authorization process typically takes one to two weeks. The U.K. ILS initiative, once implemented, will mean that the U.K. can leverage its trusted and robust regulatory environment and wealth of existing (re)insurance know-how and specialist expertise to offer ILS sponsors and managers another jurisdiction to choose from in the area of alternative risk transfer.

D. Marketing ILS to E.U. Investors – AIFMD

As described in our 2015 Year in Review, the Alternative Investment Fund Managers Directive ("AIFMD") continues to impact investor marketing and fund-raising by ILS structures in Europe.

Without passporting rights for non-EEA alternative investment fund managers ("AIFMs") or non-EEA alternative investment funds ("AIFs"), ILS structures captured by AIFMD must continue to observe the private placement regime on a country-by-country basis and by considering exemptions from AIFMD.

Under the original plans, the AIFMD third country passport was to replace the country-by-country private placement regime, which was due to be phased out in 2018. However, many industry figures had expected the European Commission to make a decision in October 2016 about whether to allow managers from outside of Europe a passport under AIFMD, and that decision has not yet been announced.

The European Securities and Markets Authority ("ESMA") published its first set of advice on the application of the passport to six non-EEA countries (Guernsey, Hong Kong, Jersey, Switzerland, Singapore and the U.S.) in July 2015, where ESMA gave a positive assessment in respect of Guernsey, Jersey and (pending an amendment to local law) Switzerland, while recommending that any extension to the United States, Singapore and Hong Kong be delayed. ESMA's 2015 advice was sent for consideration by the European Commission, Parliament and Council as to whether to activate the passport provision for the eligible jurisdictions. The European Commission subsequently asked ESMA to assess a further six countries and provide more details on the capacity of non-EEA supervisory authorities and their track record in ensuring effective enforcement, including those non-EEA countries that ESMA assessed in its first set of advice.

In July 2016 ESMA deemed there to be no significant obstacles impeding the application of the AIFMD passport to Guernsey, Jersey, Switzerland, Canada, Japan, and, subject to an amendment to local law, Australia. The United States, Hong Kong and Singapore have also all been granted some form of positive assessment, though with some limitations. For Bermuda and the Cayman Islands, ESMA cannot as yet offer definitive advice since both countries are in the process of implementing new regulatory regimes. In Bermuda, this depends on: (i) the publication of the final version of the new AIFMD-like regime being implemented in Bermuda and (ii) the completion of a review by the Bermuda Monetary Authority of the Bermudian investment funds and management framework. For the Isle of Man, ESMA found that the absence of an AIFMD-like regime makes it difficult to assess whether the investor protection criterion is met.

The European Commission has previously indicated that it would take a decision as to the activation of the third country passport once "a sufficient number of countries have been appropriately assessed." Now that some form of positive assessment has been given in respect of nine jurisdictions, it remains to be seen whether the European Commission will take this next step and draft a delegated act to activate the third country passport for these countries or whether it will wait to activate this provision until ESMA has cleared a larger number of countries for the passport.

E. Lloyd's Insurance Index

We reported last year that Lloyd's planned to launch its own insurance-based index, the Lloyd's Index, in the middle of 2016. However, following the U.K.'s vote to leave the European Union in June 2016, Lloyd's announced that it had put the Lloyd's Index on hold. While Lloyd's reaffirmed its commitment to the project, a spokesperson said that "the Corporation is conscious that [Lloyd's] must prioritize [its] resources appropriately and focus on [its] preparedness for a changing environment." Lloyd's has not given any indication of a new timeframe for launching the Lloyd's Index.

IV. Excess Reserve Financings

2016 ushered in an optimistic trend where the number of new excess reserve financing transactions increased significantly over the previous two years' lagging numbers. The slowdown in transactions in the past few years was caused by an abundance of caution from both regulators and insurance companies in the life insurance reserve financing market as a result of the NAIC's Captive's and Special Purpose Vehicle Use (E) Subgroup activities, and in particular the adoption by the NAIC of the XXX/AXXX Reinsurance Framework and Actuarial Guideline 48 ("AG 48") in late 2014, which applies to all policies issued after December 31, 2014 that fall under regulation XXX or AXXX. This was alleviated in 2016 by an increased level of certainty in what will be permitted in future financings. In addition to an increase in new transactions, companies continued the recent trend of restructuring existing transactions to take advantage of lower lending rates and the continued interest by reinsurance companies to act as financing providers. In addition, there was an interest in financing XXX and AXXX reserves without the use of a captive by adding admitted assets to the balance sheet of the insurer. Others have actively begun the process of addressing the complexities of AG 48 issues with a goal of closing new transactions involving AG 48 covered policies in 2017, or adding a block of AG 48 policies to an existing transaction.

1. Summary of Deal Activity

a) AXXX Market Remains Open

As was the case in 2015, several of the transactions 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 2016. In most transactions in both the XXX and AXXX markets, commitments were for 10-20 years, although it is still common to see shorter terms intended to act as a financing bridge until other expected sources of funding become available.

b) Non-Recourse Transactions Remain the Structure of Choice

In 2014, prior to the effective date of AG 48, the vast majority of deals were secured by non-recourse letters of credit, contingent notes or collateral notes, as those transactions had essentially replaced traditional letters of credit among lenders and reinsurance companies active in the AXXX/XXX market. In 2015 we saw a return, or at least a heightened interest, in traditional letters of credit. In 2016 we saw a return to the non-recourse contingent note structure. 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 typically include, among others, 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 became more comfortable assuming the risk of relying for repayment on the long term cash flows from a block of universal life policies. With the advent of AG 48, some regulators have approached a non-recourse transaction where the proposed "Other Security" is a conditional draw letter of credit or a contingent draw note with added caution. Although not expressly forbidden by the new rules, it remains to be seen how regulators will perceive these bespoke sources of contingent funding in the age of AG 48. Collateral notes (demand notes backed by pools of assets) may, but typically do not, contain these contingent features and therefore should remain acceptable for financing under AG 48, at least as "Other Security."

c) Choice of Domicile for Captives and Limited Purpose Subsidiaries

Vermont remained the preferred domiciliary jurisdiction for captive life insurers in 2016. Although several states have adopted captive insurer laws or have amended and expanded existing captive insurer laws over the past few years to facilitate reserve funding transactions, as was the case in 2015, 2016 saw a continuation in the trend of seeing fewer jurisdictions being utilized as captive insurer domiciliary jurisdictions. We would expect that once the market adapts to AG 48 and the related Credit for Reinsurance Model Law and the XXX/AXXX Regulation (as defined and further described in Section VII.A.3.c below), we will again see several other states—including Arizona, Delaware, Nebraska and Iowa—being utilized as captive insurer domiciliary jurisdictions. Although we are aware of at least one new transaction that closed in 2016 utilizing a Limited Purpose Subsidiary, we understand that the use of the recently enacted "Limited Purpose Subsidiary statutes" in several states have cooled off and may not currently be the captive of choice, at least for new AG 48 transactions. 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, which has proven to provide for a more streamlined regulatory approval process for a transaction.

2. Utilized Structures

a) Limited Purpose Subsidiaries

We are aware of at least one new transaction that closed in 2016 that employed the use of an LPS law in a reserve financing transaction. 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 few years brought on by general caution on the part of insurers and regulators alike.

b) Credit-Linked Notes and Collateral Notes vs. Letters of Credit

As mentioned above, recent activity in the marketplace implies that the use of contingent credit-linked notes in a role that may be analogous to a "synthetic letter of credit" will continue, along with collateral notes, to be the structure of choice for excess reserve financing transactions. In credit-linked note transactions, a special purchase vehicle ("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. In collateral note transactions, demand notes backed by pools of assets are issued by an SPV to a credit-for-reinsurance trust on behalf of the captive. Collateral notes are typically rated and qualify as admitted assets. The assets that back the collateral notes can be provided by banks, reinsurance companies or other providers of collateral.

c) Funding Sources Beyond Banks

As outlined above, the market for funding sources in AXXX transactions has expanded beyond banks in recent years through the use of contingent credit-linked notes and collateral notes. Large reinsurance companies have shown a keen interest in participating in these transactions through support of the SPVs that issue the contingent notes and collateral notes. With the expansion of the group

of potential funding sources for these transactions, life insurance companies can seek more competitive pricing and terms. With the increased activity in the market in 2016, it appears that the market will see a continuation of the trend started in 2012 of reinsurance companies surpassing banks as the primary "risk taker" in these transactions.

d) Alternative Approach to Funding

During 2015 several transactions were completed in which collateral notes were issued directly to insurers and held as admitted assets, thereby financing XXX/AXXX reserves directly on the balance sheet of such insurers. Given the regulatory attention to captives, this approach may become more common.

3. Regulatory Environment

a) NAIC

As discussed in more detail in Section VII.A.3.c below, a very important development in the world of reserve financing transactions was the NAIC's adoption in 2014 of AG 48, which is part 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 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, this was a significant development at the NAIC that provides guidelines on how these transactions should be structured.

As discussed in more detail in Section VII.A.3.c below, in December 2016, the NAIC finally adopted the Term and Universal Life Insurance Reserve Financing Model Regulation, which was originally planned for adoption at the NAIC's Spring 2016 National Meeting. For most states, the adoption of the XXX/AXXX Regulation will replace AG 48. At the same December meeting, the NAIC also adopted an amended version of AG 48.

b) New York and California

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. Former Superintendent Benjamin Lawsky of the NYDFS in particular has in the past 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 did not heed these calls for a nationwide moratorium and rather focused its attention on the Credit for Reinsurance Model Law and the XXX/AXXX Regulation.

4. Embedded Value Securitization

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. Although late 2014 saw the return of a life insurance embedded value securitization sponsored by Reinsurance Group of America, Incorporated ("RGA"), which announced in mid-December 2014 that its subsidiary, Chesterfield Financial Holdings LLC, completed an offering of $300 million of 4.50% asset-backed notes in a securitization of U.S. life insurance embedded value, the market for similar embedded value transactions has not materialized since.

Following closely on the heels of the RGA "Chesterfield Financial" U.S. dollar embedded value transaction, Aurigen Capital Limited 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 Aurigen Capital Limited'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 Aurigen Capital Limited, between 2008 and 2013 and consists of 26 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.

Although the market for embedded value transactions was not as robust as hoped in 2016, we would not be surprised to see more embedded value transactions hit the market in 2017.

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

Despite a number of predictions for strong European growth in 2016 in longevity, pension close-outs and de-risking transactions, the year seemed considerably less active than 2015, which was dominated by Dutch index-based longevity transactions. In February 2016, Delta Lloyd announced negative adjustments, imposed by the Dutch regulator, to capital relief from which it had previously benefitted through two of its index-linked longevity hedges. Market commentators are suggesting that index-linked transactions may now come under increasing regulatory scrutiny for the credibility of their risk transfer and risk margin relief. This has not yet been confirmed by any of the regulators. From the transactions in the public domain, it does not appear that any repeat index-based transactions have occurred in 2016. Turning to indemnity transactions, in November 2016, AXA France entered into its second transaction, ceding €1.3 billion of risk covering over 15,000 annuitants to RGA. AXA France first transferred €750 million of longevity risk covering 22,000 annuitants to Hannover Re in 2014.

The U.K. market witnessed a slow start in 2016, with buy-in and buy-out transactions in the first half of the year totalling £2.7 billion (compared against £4.4 billion on the first half of 2015). Deal activity accelerated in the second half of the year, with expectations that the year achieved in excess of £8.5 billion from buy-in and buy-out transactions.

In our 2015 Year in Review we announced that there were nine active insurers in the market. As a result of a merger between two insurers and one insurer withdrawing from the bulk annuities market, this number declined during 2016, to seven.

Solvency II has introduced a new dynamic to the market. With life insurers shouldering the weight of the new risk margin on their capital requirements for any longevity risk that has not been hedged, insurers are looking for new strategies to manage this capital strain. As a result, some insurers are reorganizing their balance sheet or selling their annuity portfolios. Aegon, for example, decided that annuities were no longer core to its business and sold its entire individual and bulk annuity portfolio, pursuant to a £3 billion sale to Rothesay Life in April 2016 and a further £3 billion sale to Legal & General Group Plc ("L&G") in May 2016. Prudential Plc announced its withdrawal from the bulk annuities market, citing the onerous capital requirements under Solvency II as its reason. We expect that, following suit of the Aegon disposition of its annuities business, we will see a number of other insurers with large or legacy books looking to move out of the market and to pass this risk to another insurer. It has been noted that these transactions are now competing with pension schemes for available insurer capital. For the majority of insurers, however, the new strategy is to ensure that longevity reinsurance and a matching portfolio of assets is in place quickly after the insurer has underwritten a bulk annuity, which would provide matching adjustment benefits and risk margin relief to the insurer.

This trend, following implementation of Solvency II, for insurers to hedge rather than hold longevity risk is already being felt in the reinsurance market by the surge of longevity-only reinsurance transactions that have occurred in 2016. We expect that most insurers are now reinsuring the majority of longevity risk in each buy-in and buy-out, either at the same time as the insurance transaction or very quickly thereafter. In April 2016, L&G and U.S. life insurer Prudential announced their first transaction of the year, followed by another two in close succession in August and October 2016 (one of which is the reinsurance of the ICI buy-in transaction referred to in the paragraph below). In June 2016 Pension Insurance Corporation

("PIC") transferred longevity risk associated with pension liabilities amounting to roughly $1.1 billion and covering approximately 2,900 pensioners across two sections of Aon's Retirement Scheme to Prudential. This followed two successful transactions between the pair in 2015.

Unlike the more gradual impact coming through on the market from Solvency II, the U.K.'s vote to leave the European Union had an immediate, but short-lived, lowering of insurer pricing (as a result of the fall in value of corporate bonds relative to the increase in value of gilts fuelled by interest rate cuts by the Bank of England), which resulted in a number of buy-in transactions occurring very quickly after the vote. One example of this is the ICI Pension Fund ("ICI"), which signed a £750 million buy-in with L&G on July 6, 2016, only eight business days after the vote. Highlighting the speed at which insurers sought to lock down reinsurance, Prudential entered into an agreement with L&G to reinsure the longevity risk of the pensioners covered pursuant to the ICI buy-in just two weeks later.

A number of smaller transactions have also been completed in 2016, evidencing a more buoyant market for small-to-medium sized schemes. The most recent small transaction, announced in October 2016, was the transfer from an unnamed pension fund to Zurich Insurance Group ("Zurich"), which covers £50m of pension longevity liabilities. Zurich retained 25% of the risk and transferred the balance to reinsurer Pacific Life Re. The transactions followed two similar transactions, written by the same providers with the same quota shares in August 2016, for two pension funds of the Pirelli group, between them covering £600m of pension longevity liabilities.

On the larger side of the transactions, L&G completed a £1.1 billion pension buyout for the Vickers Group Pension Scheme (part of the Rolls-Royce Group) covering over 11,000 members. This was the largest U.K. pension risk transfer transaction in 2016.

In our 2015 Year in Review, we commented on standardization of terms in the market, and we have witnessed this trend coming through in 2016. While bespoke longevity swap transactions, where risks are transferred by the scheme to the insurer and the reinsurer simultaneously, are more challenging and take longer to execute, we have witnessed, through the large number of repeat reinsurance transactions executed by a small group of counterparties, that preferred or master terms are developing, allowing these parties to move from pricing to execution in a matter of weeks. The speed at which pension plans can transact also depends on the documents in place. Umbrella agreements (which are typically in place with a panel of insurers) allow trustees to secure transactions on pre-agreed contractual terms and security arrangements. ICI is one of the most cited examples of a pension fund successfully harnessing such umbrella contracts. The fund has insured £8 billion of liabilities by way of 11 separate transactions since March 2014 (five of which were in 2016) using umbrella contracts with a panel of three insurers.

2016 saw many market participants engaged in discussions regarding future innovation. The market may be poised to explore capital markets solutions as an additional source of capacity alongside insurers and reinsurers. In particular, sidecars (typically utilized in the P&C (re)insurance space) are being presented as another means of hedging longevity risk. Sidecars enable a third-party co-investor (or co-investors), such as a hedge fund or private equity or sovereign wealth fund, to offer additional capacity alongside the reinsurer as a special purpose reinsurance vehicle when implementing a longevity risk transfer deal. The sidecar co-investor would then share with the reinsurer any profits or losses of that transaction. The hope is that 2017 will be a break-through year for adaption of such technology for use in the longevity risk transfer market.

On the other side of the Atlantic, the U.S. market saw a total of $9.0 billion in transaction volume through the third quarter. Industry professionals expected that strong performance to help the market equal 2015's total of $14 billion by year-end. The largest deal in the U.S. market in 2016 was the "jumbo" pension-risk transfer transaction between Prudential and WestRock Paper Company. Under the terms of the transaction agreement, which was executed in September, Prudential will assume responsibility for the payment and administration of $2.5 billion of WestRock's pension liabilities. The transfer will cover approximately 35,000 retirees and reduce WestRock's total U.S. pension obligations by 4 percent. Also noteworthy was the "split" transaction executed in June by MetLife, MassMutual and PPG Industries, Inc. This deal saw PPG transfer $1.6 billion in pension liabilities, covering about 13,400 retirees, to the two life insurers. MassMutual will act as lead administrator for approximately 11,000 of the retirees, while MetLife will have sole responsibility for the remaining 2,400.

The Canadian market observed a milestone in November with the execution of that market's first "streamlined" longevity swap. Under the terms of the swap, Canada Life Assurance Company will assume $35 million in longevity risk relating to just 200 pensioners of the Canadian Bank Note Company, Limited. Industry observers noted that the deal was among the smallest reported longevity swaps to date. It thus demonstrated the market's continuing adaptation to meet the needs of small participants.

Although the U.K. market continues to be the global leader, participants see considerable potential in the U.S. In August, L&G announced that it hoped to import to the U.S its pension-risk transfer strategy, which has enabled it to execute several longevity risk transfer transactions in the U.K. market with U.S. life insurer Prudential, among others, in recent years. As only about 5 percent of $3 trillion U.S. market has been de-risked to date, participants and observers remain bullish on the long-term prospects of the North American market and anticipate decades of future growth. As a result, continued development of the North American market in 2017 is expected.

VI. Capital Markets

A. United States Capital Market Activity

1. Equity Offerings

Consistent with the IPO market across all industries, 2016 was generally a quiet year in IPO activity involving insurance companies but experienced an increase in activity later in the year. Stock prices of financial companies in the S&P 500 rose 18% in the month following the U.S. presidential election, on investors' expectations of loosened regulation and higher interest rates under President-elect Trump. The broader S&P 500 index has risen 5% in that time.

The second-biggest U.S. listed company that debuted in 2016 was Athene Holding Ltd., which raised approximately $1.1 billion in December 2016 for its selling shareholders at a price within the IPO range. Athene is a leading retirement services company that issues, reinsures and acquires retirement savings products such as fixed annuities. Commencing operations in 2009 as a well-capitalized newcomer with an experienced management team, Athene was able to benefit from an environment in which the burdens of the financial crisis and resulting capital demands caused many existing companies to exit the retirement market. Athene acquired substantial blocks of long-duration liabilities, often at a discount to book value, and reinvested the related investments. Athene has a strategic relationship with Apollo Global Management, LLC, which co-founded the company, and this relationship allows Athene to leverage the scale of Apollo's asset management platform. Athene is based in Bermuda with its U.S. subsidiaries' headquarters located in Iowa. The shares have continued to perform well through the end of 2016.

Prior to the Athene IPO in December, 2016 was the biggest year ever for block-trading activity as a percentage of total activity in the equity markets involving companies in the insurance industry. Unlike an IPO or normal secondary offering, in a block trade, a bank buys shares from a public company or one of its large investors at a discount and then tries to resell it at a profit. If the share price falls before the bank can resell the shares, the bank faces a potential loss. This involves increased risk for the bank than traditional underwriting, but issuers and selling shareholders benefit from price certainty and minimal market risk. Through the first 11 months of 2016, block trades accounted for roughly 42% of equity-capital-market fees; substantially greater than any prior year. Many of the recent deals involve private-equity firms or hedge fund investors cashing out their investments. Before Thanksgiving, hedge fund D.E. Shaw Group sold approximately 3 million shares of James River Group Holdings Ltd. for aggregate proceeds of approximately $114 million in a block trade in which the bank intended to sell the shares before the market opened the following day. This transaction drew some attention on Wall Street and in the media because the number of shares the bank purchased was equivalent to more than 30 days of average trading volume in the James River Group stock. In a typical year, a bank would rarely buy more than 10 or 20 days' worth of shares of any one company's stock due to the risk of being unable to resell them without sustaining a loss.

Following on from its January 2016 announcement that it plans to pursue a separation of its retail business, MetLife, Inc. filed a registration statement on Form 10 for a potential 80.1% spin-off of Brighthouse Financial, Inc.

Kinsale Capital Group, Inc., an excess and surplus lines insurance company founded in 2009, priced an IPO in July 2016 raising proceeds of approximately $105 million for the selling shareholders, which included Moelis Capital Partners LLC. The selling shareholders sold another $92 million in shares after Thanksgiving.

In connection with its August 2016 agreement to acquire United Guaranty Corporation from American International Group for approximately $3.4 billion, Arch Capital Group Ltd. issued $450 million in non-cumulative preferred shares in the form of depositary shares. With the planned acquisition of United Guaranty, Arch continues to expand into the U.S. mortgage insurance marketplace.

Axis Capital Holdings Limited, AmTrust Financial Services, Inc., Aspen Insurance Holdings Limited, National General Holdings Corp. and Validus Holdings, Ltd. also conducted offerings of preferred stock in the form of depositary shares raising proceeds of approximately $550 million, $375 million, $225 million, $175 million and $150 million, respectively.

2. Surplus Notes

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.

Following a peak issuance in 2014, and a much reduced issuance in 2015 and 2016, we expect that 2017 will see some insurance companies return to the surplus note market and bid to reduce the interest expense on some of the existing series prior to any significant rates rises later in the year.

3. Debt

With interest rates only beginning to rise gradually at the tail-end of 2016 following uncertainty earlier in the year, 2016 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. This trend was accelerated in the fourth quarter of 2016, and we expect to see more companies take advantage of the low rates in 2017 in advance of any subsequent rate rises.

In connection with its financing for the proposed acquisition of United Guaranty, the new parent company for Arch's U.S. mortgage insurance business issued $950 million of senior notes guaranteed by the Arch public parent.

Allstate also issued $1.25 billion of senior notes in December 2016, the proceeds of which it partially used to finance the pending acquisition of SquareTrade Holding Company, Inc., a protection plan provider for mobile devices, laptops, tablets and other consumer electronics and appliances.

In connection with Willis Towers Watson's acquisition of additional interests in Gras Savoya Cie, in March and May 2016, Trinity Acquisition plc issued $1.0 billion and $600 million of senior notes.

AIG issued three series of senior notes totaling $3.8 billion in the aggregate in February, March and June. The proceeds of the $1.5 billion in senior notes sold in February were used, along with cash at the holding company, to purchase 11 series of senior notes and junior subordinated debentures of AIG and its subsidiaries maturing between 2018 and 2097.

There were a number of other debt issuances during the year, including by RGA ($800 million), Voya ($800 million), Aon ($750 million), Aflac ($700 million), Unum ($600 million), Principal Financial ($650 million), Old Republic ($550 million), Markel ($500 million), Progressive ($500 million), Travelers ($500 million), CNA Financial ($500 million), MGIC Investment Corporation ($425 million), Lincoln National ($400 million), Hanover ($350 million), Marsh & McLennan ($350 million), Radian ($350 million), American Financial Group ($300 million), Torchmark ($300 million), W.R. Berkley ($290 million) and Maiden Holdings ($110 million).

4. 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 2016, the market for funding agreement-backed notes continued to recover steadily following the financial crisis, and the year saw a new entrant to the market in the form of The Guardian Life Insurance Company. Guardian formed Guardian Life Global Funding and established its program in April, and conducted offerings in April and October.

The market was still led by MetLife and New York Life, but did witness increased issuances from Principal Financial, Jackson National, Mass Mutual, Prudential, AIG, Protective Life, Guardian and Reliance Standard. MetLife has been the leading issuer of funding agreements in each of the last eight years, with New York Life the next largest. The 2016 issuances concentrated on U.S. Dollar and Euro deals, but we have already started to see an increase in other currencies in January 2017, and we expect a variety of deals throughout the year as companies target different investor groups in their search for spread margin.

Capacity continues to exist for additional issuances by industry participants based on stronger balance sheet positions, a reduction in operating leverage and a strengthening of statutory capital.

B. SEC Disclosures

In 2016, the Securities and Exchange Commission Staff (the "SEC Staff") continued to concentrate its comments on insurance company Exchange Act disclosures on some of the topics we discussed in the 2015 Year in Review. These include disclosures regarding investments, compliance and regulatory matters, reserves, and acquisitions and dispositions. The SEC Staff also proposed major modifications to the disclosure requirements under Regulation S-K, which could take effect in 2017. We discuss each of these in more detail below.

1. Investments

Disclosures regarding investments were the most frequent topic of SEC Staff comments in 2016, and the SEC continues to focus on the disclosures surrounding unobservable inputs for level 2 and level 3 investments. The SEC Staff frequently asks companies to expand the level of fair value disclosures by class of assets and liabilities, and to support the determination of major security types and classes of fixed maturity securities. The SEC Staff has also focused its attention on disclosures surrounding valuation techniques, inputs and key assumptions used to determine fair values for each class of assets and liabilities presented in the disclosures.

2. Compliance and Regulatory Matters

The SEC Staff continues to focus on company contacts with countries designated by the U.S. Department of State as state sponsors of terrorism, most notably Syria and Sudan. The SEC Staff regularly asks insurance companies to describe their contacts with such countries, including any services, products, information or technology provided either directly or indirectly to such countries, as well as the materiality of any contacts with these countries, which it considers in both qualitative and quantitative terms. Any companies with global operations must also consider any foreign insurance regulatory restrictions on capital and surplus and compliance with such restrictions.

Additionally, the SEC Staff has indicated its intent to crack down on the misuse of non-GAAP financial measures. Specifically, the SEC Staff identified the use of misleading financial measures, per share non-GAAP liquidity measures, and inappropriate adjustments for tax expenses as potential bases for enforcement action. Actions that the SEC Staff considers misleading include excluding normal operating

expenses, inconsistent presentation of non-GAAP financial measures between periods, making adjustments for certain non-recurring, infrequent or unusual items, substituting individually tailored accounting principles, reconciling EBIT or EBITDA to operating income as opposed to net income, over-reliance on free cash flow, and presenting non-GAAP financial measures more prominently than GAAP financial measures. In determining whether a non-GAAP financial measure qualifies as a liquidity measure, the SEC Staff looks to the substance of the measure, not management's characterization. Non-GAAP liquidity measures for which per share presentation is inappropriate include EBIT, EBITDA and free cash flow. Finally, adjustments for income tax effects may be appropriate depending on the nature of the non-GAAP financial measures. For liquidity measures that include income taxes, it may be acceptable to adjust GAAP taxes to show taxes paid in cash. If the measure is a performance measure, the company should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented net of tax, but rather income taxes should be shown as a separate adjustment and clearly explained.

3. Reserves

The SEC Staff continues to focus on the level of detail provided by insurance companies regarding their reserving process. The SEC Staff has requested expanded disclosures to help investors understand the nature of assumptions, the extent of changes in reserve estimates, the use of industry data, the impact of events occurring or additional information obtained since the last reporting date, the actuarial methods used, and why recognition in earlier periods was not required.

4. Acquisitions and Dispositions

Following the 2015 issuance of Accounting Standards Codification 944 for short-duration insurance contracts, the SEC Staff provided informal feedback in 2016 for presenting the effects of acquisitions and dispositions in the required development tables. The SEC Staff advises that the acquiring company should use a retrospective approach to reflect the development information associated with the acquired business in the incurred and paid claims tables. Thus, the acquiring company should recast all periods presented in the tables so as to include the development activity associated with the acquired business as if it had always been owned by the acquiring company. In certain circumstances, it may be appropriate to present this information prospectively in separate development tables, where the development information of the acquired company is presented separately, by underlying accident year, both as of the acquisition date and subsequent to the acquisition date. In the case of a disposition, the SEC Staff notes that the selling company should reflect the disposition retrospectively, recasting all periods in the tables to remove the balances associated with the sold business. Additionally, the SEC Staff notes that when a company translates balances of its foreign operations to the reporting currency for inclusion in the incurred and paid claims development tables, it should use the foreign exchange rate in effect on the current-year balance sheet date to recast all periods presented in the tables. Alternatively, a company could show separate development tables using the foreign exchange rate in effect on the current-year balance sheet date to recast all periods presented in the tables.

5. Regulation S-K

In July, the SEC issued a proposed rule modifying existing disclosure requirements under Regulation S-K that have become duplicative, overlapping, outdated or superseded due to disclosure requirements required by the SEC, U.S. GAAP and International Financial Reporting Standards ("IFRS"), or due to technological or other developments. Specifically, the proposed rule would eliminate duplicative mandated disclosures such as significant debt following the latest balance sheet date, income tax reconciliations, information regarding warrants or other rights, related party transactions, material contingencies in interim financial statements, presentation of earnings per share, reasons

for material accounting changes in an interim period, and effects of discontinued operations in interim financial statements. The proposal also identifies overlapping requirements that are related to, but not the same as, other disclosure rules. The SEC is seeking comment on whether to delete these requirements entirely, integrate them with their respective counterparts, modify them or refer them to the Financial Accounting Standards Board ("FASB") for potential incorporation into U.S. GAAP. The disclosures proposed for deletion or integration include those relating to material events subsequent to the end of the fiscal year and changes in accounting principles reportable in interim filings, segment financial information, financial information by geographic area, seasonality, material research and development expenditures, the frequency and amount of cash dividends, tabular disclosure of changes to employee equity plans, ratios of earnings to fixed charges, invitations for competitive bids, foreign currency restrictions, and restrictions on dividends. The disclosures for which the SEC is seeking comment on whether to retain, modify, eliminate or refer to FASB include those related to assets subject to liens, uncured or waived defaults, changes in debt obligations, financing arrangements, income taxes, related party transactions, revenues from major products or services, major customers and loss contingencies and significant legal proceedings. Finally, the proposal identifies outdated and superseded disclosure requirements, such as the high and low sales prices for company's common stock, which is readily available elsewhere, and disclosing the availability of a company's filings at the SEC's Public Reference Room, which the SEC proposes to replace with an extended requirement to disclose the company's Internet address. Additionally, the SEC proposes revising the disclosure requirements in light of changes to U.S. GAAP, such as by making conforming changes to the statement of cash flows and statement of comprehensive income and information relating to consolidation, discontinued operations and pooling-of-interests. The comment period for this proposed rule closed on November 2, 2016.

C. European Capital Market Activity

In 2016, there were two important trends that were noticeable in the debt and equity issuances by European insurance groups: issuances related to acquisition financing; and issuances related to regulatory capital needs. We discuss these trends below:

1. Acquisition Financing

As we note above in Section I.B, there have been a number of large M&A transactions in 2016, and there were several secondary equity offerings to fund in part the issuers' acquisitions. In the U.K., Phoenix Group Holdings had two secondary issuances in 2016: (i) on May 27, it issued 22,542,000 ordinary shares to raise £190 million to partially fund its acquisition of AXA Wealth's pensions and protection businesses; and (ii) on October 25, it issued 144,722,989 ordinary shares to raise £718 million to partially fund the acquisition of Abbey Life. In addition, Arch Capital Group Ltd. used the proceeds from the sale of its 4.011% senior notes due 2026 and its 5.031% senior notes due 2046 to partially fund the acquisition of United Guaranty.

2. Solvency II Impact on Subordinated Notes and Preference Shares of Insurance Groups

In our 2015 Year in Review, we reported on the re-categorization of subordinated notes and preference shares as Tier 2 capital under Solvency II. Since the implementation of Solvency II on January 1, 2016, a number of issuers have sought to bolster their Tier 2 capital. The requirements for securities to be categorized as Tier 1 capital under Solvency II are stringent, and many issuers have issued securities in 2016 that fall below these levels; however, there has been a lot of activity with insurance groups issuing preference shares and subordinated notes, which then qualify for categorization as Tier 2 capital as follows:

- Aviva plc updated and revised its £7 billion euro note program. The program enables Aviva plc to issue senior notes and subordinated notes capable of qualifying as Tier 3 capital and Tier 2 capital for regulatory purposes.

- Allianz SE issued $1,500,000,000 of 3.875% undated subordinated notes intended to qualify as Tier 2 capital under Solvency II.

- L&G commenced a £4,000,000,000 euro note program that permits it to issue dated or undated subordinated notes with terms capable of qualifying as Tier 2 capital under Solvency II.

- Prudential plc increased the limit of its medium term note program from £5 billion to £6 billion at the end of 2015 and the program was updated in May 2016 for the issuance of senior notes as dated or undated subordinated obligations with terms capable of qualifying as Tier 2 capital under Solvency II.

- PGH Capital Public Limited Company commenced a £3 billion euro medium term note program (guaranteed by Phoenix Group Holdings) that permits it to issue dated or undated subordinated notes with terms capable of qualifying as Tier 3 capital and Tier 2 capital under Solvency II.

In addition to issuances related specifically to European solvency requirements under Solvency II, a number of insurance groups that are subject to the Bermuda regulatory regime (which, with effect from January 1, 2016, was granted full equivalence to Solvency II in respect of group solvency calculations (see Section VII.B.2.b below)), as administered by the Bermuda Monetary Authority ("BMA"), issued preference shares in 2016 to bolster their regulatory capital. These included the following:

- Axis Capital Holdings Limited issued $550,000,000 of 5.50% Series E Preferred Shares with terms capable of qualifying as Tier 1 and Tier 2 capital securities in accordance with the group insurance requirements of the BMA.

- Arch Capital Group Ltd. issued $450,000,000 of 5.25% Series E Non-Cumulative Preferred Shares with terms that are capable of qualifying as Tier 2 capital securities in accordance with the group insurance requirements of the BMA.

- Aspen Insurance Holdings Limited issued $225,000,000 of 5.625% Perpetual Non-Cumulative Preference Shares with terms capable of qualifying as Tier 1 capital in accordance with the group insurance requirements of the BMA.

3. Prospectus Regulation

The European Commission has continued to pursue its goal of creating a capital markets union within the E.U. This flagship initiative is intended to strengthen E.U. capital markets, addressing concerns that capital markets-based financing in the E.U. is relatively underdeveloped and businesses in the E.U. remain reliant on banks as a source of funding. As part of its review of the regulatory framework for creating the capital markets union, the European Commission intends to implement a new prospectus regulation (the "Prospectus Regulation") that will repeal and replace the existing public offering regime in the E.U.

The final compromise text of the Prospectus Regulation was published on December 16, 2016 and, subject to proofing amendments, is expected to enter into force in the first half of 2017. At least three developments are potentially relevant to insurance groups. They are described below.

If an issuer has a universal registration document approved by an E.U. competent authority (the FCA in the U.K.) every financial year for two consecutive years, subsequent registration documents or amendments may be filed without the prior approval of an E.U. competent authority. This is akin to the U.S. shelf registration document and will be useful for frequent issuers in European markets, allowing them faster and cheaper access to the European capital markets.

In an effort to make risk factors easier to digest for investors and reduce the large number of boilerplate risk factors included in European offerings, the Prospectus Regulation will introduce a requirement to differentiate risk factors by relative materiality based on the issuer's assessment of the probability of their occurrence and the expected magnitude of their negative impact. The changes to the risk factor regime are expected to make risk factors more investor-friendly and more targeted towards the issuer (as is already

the case in U.S. offerings); however, commentators have expressed concerns that such categorization will be an impossible task for issuers and may lead to increased litigation, *i.e.*, whether a company will be deemed to have engaged in misrepresentation if a "low" risk occurs and has a material adverse effect on the issuer or the securities.

The European Commission has confirmed that there will be a "prospectus lite" regime available for wholesale issuances of debt securities. There will be two ways to qualify for the lighter wholesale regime: either an offer of debt securities to be traded only on a regulated market (or a specific segment thereof) to which only qualified investors can have access for the purposes of trading in such securities; or an offer of debt securities with a minimum denomination of EUR 100,000. A differentiated wholesale regime will be useful to issuers as it means that there will be fewer requirements for wholesale debt offerings, such as surplus notes or funding agreement-backed notes (as described above).

The Prospectus Regulation is expected to be published in the official journal of the E.U. in the first half of 2017 and will have a 24-month implementation period. It is possible that the U.K. will leave the E.U. prior to the conclusion of the implementation period and so the implementation of the Prospectus Regulation in the U.K. may not be completed. However, until the U.K. leaves the E.U., the FCA has confirmed that it will continue to work towards implementing E.U. legislation. If the U.K. remains a member of the EEA it will continue to be bound by the Prospectus Regulation and will retain its passporting rights.

VII. Principal Regulatory Developments Affecting Insurance Companies

A. U.S. Regulatory Developments

1. Overview

The development of group capital standards and enhancement of group supervision were a key focus of insurance regulators in 2016, with state, national and international regulators all working on separate initiatives. In particular, 2016 saw the Federal Reserve Board's[5] introduction of proposed prudential and capital standards for certain insurance groups under Dodd-Frank, the IAIS's continued work on a global Insurance Capital Standard, and the NAIC making progress toward a group capital calculation tool for state regulators. In addition, cooperation between the U.S. and the E.U. was a focus in 2016, with progress in negotiations of a covered agreement between the U.S. and the E.U., culminating in the announcement on January 13, 2017 of the successful conclusion of negotiations regarding a covered agreement. Progress was also made in developments related to Solvency II. Further, in a significant development for the life insurance industry, the Valuation Manual operative threshold was reached during 2016, resulting in principle-based reserving becoming available effective as of January 1, 2017. Another significant development was the long-awaited adoption by the NAIC of the XXX/AXXX Model Regulation, which follows the previously adopted AG 48 in prescribing the regulatory requirements for captive reserve financing transactions. Finally, insurance regulators, lawmakers and the industry prioritized cybersecurity regulation and cybersecurity coverage issues in 2016, along with considering other ways that technology is affecting the industry.

As discussed herein, the results of the 2016 election have cast significant uncertainty over the outcomes for existing regulations and new regulatory initiatives in 2017.

[5] A glossary of relevant regulatory bodies that are referenced but not otherwise defined in this Year in Review is attached as Annex A.

2. State, Federal and International Group Capital and Supervision Standards

a) Overlapping Group Capital Initiatives

i. Federal Reserve Board Proposed Rules Affecting Insurance Groups

In June 2016, the Federal Reserve Board invited public comment on an Advance Notice of Proposed Rulemaking ("ANPR") regarding group capital requirements for supervised institutions significantly engaged in insurance activities (*i.e.*, for (i) the two insurance companies currently designated as SIFIs by FSOC, and (ii) the 12 insurance depository institution holding companies supervised by the Federal Reserve Board ("Depository Groups")).

The ANPR proposes two distinct frameworks to calculate group capital: the Building Block Approach ("BBA") and the Consolidated Approach ("CA"). The BBA would apply to Depository Groups and CA would apply to insurance SIFIs. For insurer members of Depository Groups the BBA would build on state-based capital standards. In contrast, CA would be a consolidated approach based on risk categories applied to assets and liabilities across the holding company system. The Federal Reserve Board proposed two frameworks because it believes that Depository Groups and SIFIs present different risks to the financial system.

The Federal Reserve Board has received comments from interested parties on the ANPR. Notably, the NAIC submitted a comment letter in September 2016 expressing the view that any capital requirements put into place by the Federal Reserve Board should not contradict state-based capital regimes and regulations. The NAIC further encouraged the Federal Reserve Board to focus on the BBA first "to determine if it can be utilized to adequately address the material risks for all supervised insurers including SIFIs", as the NAIC is concerned with the complexity and potential for unintended consequences of the novel CA. The NAIC argued that the BBA directly supports financial stability goals by incorporating the specific regulatory capital expectations for each legal entity in the group, prevents any capital deficiencies of legal entities without individual

capital requirements from being masked in a consolidated financial statement, and would retain statutory accounting provisions that are designed to serve the regulatory needs of insurers.

Should the BBA approach prove unworkable, the NAIC suggested a hybrid BBA/CA as a solution. Under a hybrid approach, in addition to the capital requirement under the BBA, additional risks that have been deemed most associated with financial stability and systemic risk could be consolidated on an enterprise-wide basis.

Other interested parties have expressed concerns about possible spillover effects, *i.e.* the possibility that any standard imposed by Federal Reserve Board could become considered industry best practice over time, even for non-SIFIs, and influence state regulators and insurance rating agencies.

The Federal Reserve Board has not yet responded to comments on the ANPR and there is no set limit on the amount of time the agency can take to review public comments.

ii. IAIS and ComFrame

The IAIS's Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame") is intended to provide basic standards for internationally active insurance groups ("IAIGs") and a means through which supervisors of IAIGs around the world may cooperate in the process of group supervision.

(1) Insurance Capital Standard Update

A key area of the IAIS's work with respect to ComFrame is the development of a risk-based global insurance capital standard ("ICS") for IAIGs. The IAIS expects to deliver "Version 1.0" of ICS in June 2017, following a series of public consultation documents and field-testing with IAIG volunteers that has been underway since 2014. Per the latest IAIS consultation document, the ICS is intended to be a consolidated, group-wide standard with a globally comparable risk-based measure of capital adequacy for IAIGs. The amount and type of capital required to be held will be based on the characteristics of the risks held by the IAIG, irrespective of the location of its headquarters.

ICS Version 1.0 will allow for confidential reporting by IAIGs and enable further refinements leading up to ICS Version 2.0. In his annual testimony before Congress in September 2016, FIO Director Michael McRaith stated that many questions regarding the ICS remain open, but noted that the U.S. participants at IAIS (including FIO, the NAIC and the Federal Reserve Board) have worked together in support of an approach that recognizes U.S. statutory accounting practices. At the 2016 NAIC Fall National Meeting, IAIS representatives indicated that there is still much work to be done on Version 1.0 between now and June 2017, and that ICS Version 1.0 will be "rough" but will be improved with ICS Version 2.0, targeted to be completed by December 31, 2019. The goal for ICS Version 2.0 is a version that is fit for implementation by supervisors. After ICS Version 2.0 is adopted there will be an implementation period while jurisdictions embed the ICS into regulatory requirements and the IAIS anticipates further refinements to the ICS during this period.

iii. NAIC Group Capital Tool

(1) Background

In 2015, the NAIC's ComFrame Development and Analysis (G) Working Group ("CDAWG") began to explore the possibility of developing a U.S. insurance group capital calculation that could be compatible with the IAIS's global insurance capital standard ("ICS") applicable to Internationally Active Insurance Groups (IAIGs), including Globally Systemically Important Insurers ("G-SII"). CDAWG considered several approaches and ultimately opted to pursue a calculation based on a risk-based capital ("RBC") aggregation approach. From the outset, interested parties queried whether the intent was to produce a U.S. calculation that would satisfy international standards and be compatible with or equivalent to the ICS. Interested parties have also questioned the extent to which the methodology would overlap with the calculation being developed by the Federal Reserve Board for SIFIs and other non-bank groups.

(2) 2016 Developments

In February 2016, the Group Capital Calculation (E) Working Group of the NAIC ("Group Capital WG") was created and charged with constructing a U.S. group capital calculation using an RBC aggregation approach. In the spring, the Group Capital WG noted that its charge contemplates coordination with the Federal Reserve Board and CDAWG with respect to ongoing developments, but stopped short of any commitment that its U.S. group capital calculation would be equivalent to the ICS. CDAWG and the Group Capital WG have consistently maintained that this calculation will be a regulatory "tool" and not form the basis of a regulatory requirement.

Some of the issues facing the Group Capital WG have been how capital of non-insurance entities should be measured, how capital of non-U.S. insurers should be measured, the scope of a holding company group for this analysis, the appropriateness of a small group exemption, and how the calculation itself would be implemented and used.

The Group Capital WG has been working with NAIC staff to develop a group capital aggregation and calibration tool using an inventory methodology and "scalars" to quantify and adjust group capital. Under the proposal, all insurance and non-insurance legal entities would be identified and an inventory would be made of the entities' applicable regimes, intragroup transactions, affiliated reinsurance and permitted and prescribed practices accounting practices. The available and required capital of each entity under its regulatory regime would be quantified and adjusted for intragroup transactions, reinsurance and permitted accounting practices and cross-regime scalars would be applied to achieve comparability with U.S. RBC.

Following the Summer National Meeting, the Group Capital WG released a questionnaire to interested parties to gather input regarding the application of the calculation tool. At the Fall National Meeting, the Group Capital WG focused on two alternative proposed approaches for calculating a "scalar" to analyze the capital of non-U.S. entities in a group. The staff memorandum presented to the Group Capital WG states that a scalar should be included at least in part to "remove the differences that exist between countries because of the different level of conservatism built into the accounting and capital requirements." The memorandum describing "scalar" options has been exposed for comment through January 24, 2017.

Although significant aspects of the methodology remain under discussion, in December the Group Capital WG shared a loose timeline for development of the group capital calculation methodology, which includes field testing beginning in the summer of 2017 and continuing into 2018.

iv. A Place at the Table

(1) NAIC Response to Federal and International Initiatives

Despite the so-called "Team USA" approach, where the NAIC coordinates with the Federal Reserve Board and FIO with respect to international insurance regulatory developments, the NAIC continues to be concerned that federal and international objectives are not aligned with the state-based regulatory system. For example, the NAIC has criticized the fact that, for example, the NAIC is excluded from discussions at the FSB that influence the IAIS's Workstreams.

The NAIC supported the "U.S. Insurance Regulation Works Act of 2016," and the "Transparent Insurance Standards Act of 2016," both of which were introduced in the House of Representatives during the 114th Congress. The bills would have required parties representing the federal government on international insurance regulatory proposals to ensure that any proposals are consistent with existing state insurance laws, and to consult with state insurance commissioners in meetings and negotiations concerning international insurance issues. The NAIC has pointed out that although international standards developed by the IAIS are not binding on U.S. insurers, such standards form the basis of the IMF's Financial Sector Assessment Program, which assesses a jurisdiction's regulatory regime.

With respect to federal developments, in addition to its comments on the Federal Reserve Board's ANPR, as summarized above, the NAIC has criticized FSOC's

designation process for non-bank SIFIs as being opaque and failing to provide state insurance regulators and companies with sufficient information as to the risks that FSOC considers leading to a SIFI designation. The NAIC has also pressed for FSOC to set forth an explicit process for non-bank SIFIs to be "de-designated," and to consider the views of non-bank companies' primary regulatory agency in connection with the designation process.

(2) IAIS Stakeholder Engagement

In response to criticisms about a lack of transparency since the IAIS eliminated its "Observer" status in favor of closed meetings in late 2014, the IAIS created a Stakeholder Engagement Task Force in January 2016 to address engagement with the insurance industry, professional groups, consumers and academic communities. At the Task Force's recommendation, the IAIS opened certain portions of its 2016 Annual Conference and Global Seminar to stakeholder participation. The Task Force has also released for consultation a Draft Stakeholder Engagement Plan that sets out other commitments and policies to strengthen stakeholder participation. In his Congressional testimony, FIO Director McRaith praised the new procedures as having significantly increased transparency. Director McRaith also noted that U.S. stakeholders have opportunities to meet and work with the U.S. participants at IAIS (*i.e.*, the NAIC, FIO and the Federal Reserve Board). However, it was reported at the 2016 NAIC Fall National Meeting that no consideration is being given to reopening IAIS meetings to stakeholders.

b) Group Supervision Matters

i. Federal Reserve Board Prudential Rulemaking

In June, the Federal Reserve Board also invited public comment on a Notice of Proposed Rulemaking ("NPR") to apply enhanced prudential standards to systemically important insurance companies. The NPR proposes standards aimed at bolstering enterprise risk management ("ERM"), corporate governance and liquidity risk management measures. Such standards would be applicable to "systemically important insurance companies," defined as enterprises that (i) have been designated by the FSOC as nonbank SIFIs; and (ii) have 40% or more of their total consolidated assets related to insurance activities.

With respect to the NPR, the NAIC expressed general support for the Federal Reserve Board's proposed use of ERM and corporate governance frameworks to assist in supervision of SIFIs, but cautioned against rigid application of such frameworks not tailored to insurance companies. Other interested parties have agreed that the NPR standards require additional tailoring to reflect that insurance companies have different risk profiles than banks.

ii. Enterprise Risk Report

The NAIC's Group Solvency Issues (E) Working Group ("GSIWG") revisited the Enterprise Risk Report (Form F) filing requirements in 2016, after a mid-year survey of regulators showed that the majority of respondents viewed the Form F filing process as only "somewhat effective" or even "ineffective." The reasons for such limited effectiveness included that many filers simply answer "no changes" or "none" in response to the topics listed in the Form F and indicate that no enterprise risks have been identified; filings are often presented at the insurer level as opposed to addressing all enterprise risks at the ultimate controlling person level; many filers appear to treat the Form F as merely a compliance requirement rather than a tool to communicate important information on risk exposure; many filers limit their filing to referencing publicly available information (e.g., SEC filings); and some filers provide only a list of generic risks without detail regarding their specific exposures.

GSIWG members were in agreement that the Insurance Holding Company System Model Act and Model Regulation should not be reopened at this time. Instead, per the request of survey respondents, GSIWG drafted a Guidance Manual intended to improve effectiveness by communicating the intent of the filing and related regulator expectations. The

draft Guidance Manual released prior to the 2016 NAIC Fall National meeting provides instructions on the scope of the universe of risks that should be disclosed in a Form F, and guidance on what information should be included for each enumerated request.

Comments were provided by insurance regulators in California and New York, as well as by interested parties. These comments were discussed and largely accepted at the NAIC's Fall National Meeting. Among other points, interested parties contended that naming the document a "Guidance Manual" is not appropriate, as it would not be referenced by or adopted explicitly in the governing Credit for Reinsurance Model Law. Comments expected to be incorporated in the Guidance Manual include that the Guidance should emphasize that there should be one Form F covering an entire system, and affirmatively state that there is no premium threshold exception for Form F filings.

NAIC staff is working to revise the Guidance Manual based on comments. A revised Guidance Manual will likely be exposed in February so that any further comments may be discussed at the NAIC 2017 National Meeting.

c) 2017 and Beyond

It is not certain how the new presidential administration and Congress will affect the insurance group capital and group supervision workstreams described above. However, the Financial CHOICE Act, which was introduced by Rep. Jeb Hensarling of Texas in September 2016 before the expiration of the 114th Congress, points to a potential rollback of the Dodd-Frank Act that would curtail the authority of, or dismantle, FSOC and FIO. Changes to Dodd-Frank could affect both FSOC's ability to designate non-bank SIFIs and the Federal Reserve Board's authority to supervise SIFIs and impose capital and prudential standards. As FIO is tasked with representing the U.S. at IAIS, changes to Dodd-Frank or executive actions that affect FIO or federal regulators could affect U.S. participation and negotiations on a global scale.

3. Mutual Recognition, Equivalence and Cooperation in 2016

a) U.S. and E.U. Covered Agreement

On January 13, 2017, following a full year of meetings and negotiations, the Treasury Department/FIO and the USTR announced the conclusion of their successful negotiation of a "covered agreement" between the United States and the E.U. Simultaneously with this announcement, the Treasury Department and the USTR presented the final legal text of the covered agreement to U.S. Congress, as required under the Dodd-Frank Act. The covered agreement addresses three areas of prudential regulatory supervision: (i) reinsurance; (ii) group supervision; and (iii) exchange of information between supervisory authorities. We are currently preparing a separate client alert, which will discuss the covered agreement in more detail.

b) Potential Removal of Qualified Jurisdictions by NAIC as Retaliation for E.U. Nations' Non-Recognition of U.S. Companies

The NAIC's Reinsurance (E) Task Force ("Reinsurance Task Force") and its subcommittees have devoted a significant amount of time this year to analyzing the potential need for an NAIC response to actions recently taken by certain E.U. member-states to restrict market access to U.S. reinsurers as a result of their interpretation of Solvency II. (See Section VII.B below for a discussion of Solvency II). One retaliatory measure that could be considered by the NAIC is action against four E.U. member-states that have been recognized by the NAIC as "qualified jurisdictions" for the purpose of making insurers domiciled in those countries eligible to apply for certified reinsurer status in the U.S.—*i.e.*, Germany, France, Ireland, and the United Kingdom. In December 2016, the Reinsurance Task Force received a report from the Qualified Jurisdiction (E) Working Group describing the actions taken in these countries to date to restrict market access for U.S. reinsurers. The Reinsurance Task Force exposed this report for a 30-day comment period, and directed the Qualified Jurisdiction (E) Working Group to prepare a report recommending what action, if

any, should be taken as regards the qualified jurisdiction status of these four countries. Such report will evaluate the economic impact on cedents and reinsurers of any revocation of such status.

c) Reinsurance

i. XXX/AXXX Regulation and AG 48 Memo Adopted by NAIC

Over the last several years, state insurance regulators and the NAIC have devoted significant energy to reassessing their regulation of captive XXX and AXXX transactions, leading to the adoption of: (a) a new regulatory framework for such transactions, the XXX/AXXX Reinsurance Framework (the "Framework"), and (b) AG 48, an important component of the Framework. The purpose of AG 48 was to implement the substantive requirements of the Framework effective as of January 1, 2015, pending the development and adoption by the states of the new Term and Universal Life Insurance Reserve Financing Model Regulation, commonly referred to as the "XXX/AXXX Regulation."

In December 2016, after over a year of substantive work at the NAIC on the XXX/AXXX Regulation, the NAIC's Executive (EX) Committee and Plenary ("Executive and Plenary") adopted the XXX/AXXX Regulation. The adopted XXX/AXXX Regulation contains a number of provisions that are different from the corresponding provisions in AG 48. As a result, Executive and Plenary has also adopted amendments to AG 48 intended to align AG 48 with the adopted XXX/AXXX Regulation.

It is currently expected that the NAIC's Accreditation Committee will shortly commence the process of adopting as accreditation standards both the XXX/AXXX Regulation and the Credit for Reinsurance Model Law revisions adopted in January 2016 that provide authority, among others, to promulgate the XXX/AXXX Regulation. In the meantime, states have slowly begun to consider these revisions to the Credit for Reinsurance Model Law. According to the NAIC, as of early December 2016, only two states had adopted these revisions.

ii. Amended Credit for Reinsurance Models Made an Accreditation Standard

An amended Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation (the "Amended Credit for Reinsurance Models"), which were adopted by the NAIC several years ago, and which generally permit a non-U.S. reinsurer that is domiciled in a "qualified jurisdiction" and that has qualified as a "certified reinsurer" to post such reduced collateral for reinsurance assumed from a U.S. cedent. The reduced collateral requirements in the Amended Credit for Reinsurance Models are currently merely an "optional" accreditation standard—meaning that a state is not required to adopt the Amended Credit for Reinsurance Models, but that any state adoption of reduced collateral requirements for non-U.S. reinsurers must conform with the requirements of the Amended Credit for Reinsurance Models. As a result, according to the NAIC, only a total of 35 U.S. jurisdictions had adopted the reduced collateral provisions in the Amended Credit for Reinsurance Models as of December 1, 2016. In order to ensure that the NAIC's reduced collateral initiative is adopted on a nationwide basis, the NAIC voted in 2016 to make the Amended Credit for Reinsurance Models an accreditation standard, to become effective January 1, 2019. This effectively requires all U.S. jurisdictions to adopt the Amended Credit for Reinsurance Models in 2017 or in 2018.

4. Technology, Innovation and Cybersecurity

a) Cybersecurity

i. NAIC

(1) NAIC's Cybersecurity Model Law Development Pushed into 2017 Amid Concerns from Interested Parties

Since the establishment of the Cybersecurity (EX) Task Force (the "Cyber Task Force") in late 2014, the NAIC has focused on cybersecurity standards for the industry and guidance for consumers. In 2015, the NAIC adopted the Roadmap for Cybersecurity Consumer Protections (the "Roadmap") to outline standards and protocols for consumers if their personal information is compromised, along with Principles for Effective Cybersecurity: Insurance Regulatory Guidance (the "Principles"), which set forth 12 guiding principles for the protection of insurance customers.

The Roadmap and Principles were a precursor to the NAIC's efforts to draft a new Insurance Data Security Model Law (the "Cyber Model Law"), which was the main focus of the Cyber Task Force in 2016. The current draft of the Cyber Model Law would require insurers, insurance producers and other licensed entities to develop and maintain a written information security program and conduct risk assessments; oversee the data security practices of third-party vendors; investigate and notify consumers and regulators of data security breaches; and implement remedial measures following breaches as prescribed by the applicable state insurance commissioner.

Interested parties and regulators are focused on whether the Cyber Model Law should be a "floor" (a minimum requirement subject to additional state standards) or a "ceiling" (which would provide a safe harbor for companies that are compliant with the Cyber Model Law). Industry representatives, including ACLI, AHIP and AIA, support the uniformity and exclusivity of a regulatory "ceiling". The "minimum" regulatory standard is supported by certain consumer representatives and state regulators. Other issues being addressed by the Cyber Task Force include: (i) whether and how to include an exemption for licensees subject to the Health Insurance Portability and Accountability Act of 1996 (HIPAA) or the Gramm–Leach–Bliley Act, (ii) whether to include a harm trigger in the definition of "data breach," (iii) how to define personal information, (iv) how to address the effect of the Cyber Model Law on smaller companies, and (v) how to address licensee oversight of third-party service providers.

(2) Other NAIC Cyber Activities

(a) Examination Procedures

The NAIC's 2016 Financial Condition Examination Handbook was amended to enhance guidance for examiners assessing insurers' cyber risks. The NAIC's goal for the Handbook revisions was to modernize IT examination procedures and incorporate standards set forth in the National Institute of Standards and Technology's (NIST) "Framework for Improving Critical Infrastructure Cybersecurity."

Based on examiners' feedback, further revisions to the Handbook have been adopted, including additional cyber-related information requests and enhanced discussion of cybersecurity findings called for in examiners' reports. Regulators have also observed through recent examinations that insurers have made progress with respect to the identification of and protection against cyber risks, but have had more difficulty detecting specific threats and responding to and recovering from breaches. Looking forward, regulators have recommended that the NAIC consider devoting additional resources to assist state examiners by consulting on technical cybersecurity issues and supporting ongoing training to improve the abilities of regulatory staff in addressing cybersecurity issues.

(b) Coordination with Other Bodies

The NAIC continues to serve on the Treasury Department's Financial Banking and Information Infrastructure Committee and on Cybersecurity Form for Independent and Executive Branch Regulators, where state insurance regulators work with federal regulators to address cybersecurity threats in the U.S.

In addition, the NAIC continues to recommend that insurers share information on cyber activity through the Financial Services Information Sharing and Analysis Center (FS-ISAC). The FS-ISAC is a resource for the financial sector on cyber and physical threat intelligence analysis and information-sharing. The FS-ISAC is a member-owned non-profit entity providing an anonymous information-sharing capability across the entire financial services industry.

On February 9, 2016, President Obama directed his Administration to implement a Cybersecurity National Action Plan ("CNAP"), and in connection therewith, signed an executive order establishing the Commission on Enhancing National Cybersecurity within the Department of Commerce. CNAP also includes an allocation of $3.1 billion in the President's 2017 proposed budget to a technology modernization fund for federal information technology and the creation of a brand-new position in the federal government, namely a federal chief information security officer. This person will report to the White House.

On December 1, the Commission on Enhancing National Cybersecurity released its report on "Securing and Growing the Digital Economy." The report provides detailed short- and long-term recommendations for the current and next presidential administrations to strengthen cybersecurity in the public and private sectors, including emphasizing the need for broad public-private cooperation. The report includes 16 recommendations and more than 50 action items. The NAIC submitted a comment letter to the commission regarding the work done by the Task Force, as well as results collected from the NAIC P&C annual statement supplement, discussed below. President Obama indicated that he had asked the commission to brief the president-elect's transition team at the earliest opportunity.

ii. Federal Agency Cyber ANPR

On October 19, 2016, the Federal Reserve Board, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency (the "Agencies") invited comment on an advance notice of proposed rulemaking (the "Cyber ANPR") regarding enhanced cyber risk management standards for certain large entities under the Agencies' supervision, including non-bank SIFIs. The ANPR contemplates the establishment of standards to enhance the cybersecurity of these entities and reduce the potential impact on the financial system in the event of a cyber-related event. The ANPR notes that nonbank SIFIs "perform critical functions for the U.S. financial system" and accordingly, the Agencies are concerned that a cyber event at a SIFI could have systemic consequences.

The Cyber ANPR addresses five categories of potential standards: cyber risk governance; cyber risk management; internal dependency management; external dependency management; and incident response, cyber resilience, and situational awareness. Notably, the standards would also apply to services provided by third parties to the supervised entity. The Agencies are considering implementing standards in a tiered manner, with higher standards imposed on systems of entities that "provide key functionality to the financial sector." Such "sector-critical systems" could be identified based on factors such as substitutability and interconnectedness. Comments on the Cyber ANPR are due on January 17, 2017.

iii. New York Proposed Regulation

The NYDFS issued a proposed cybersecurity regulation in September 2016 that was revised and reissued on December 28. The regulation will be promulgated under the New York Financial Services Law and applies to all entities licensed, registered, authorized or accredited by the NYDFS including banking, insurance and other regulated financial services entities ("Covered Entities"). For the insurance industry, the entities covered by the regulation include insurance companies, agents, brokers and other licensees. And consistent with the extraterritorial application of New York law, the regulation will apply to foreign insurers licensed or otherwise authorized in the state.

In support of the regulation, the NYDFS identified the growing threat posed to information systems and financial systems of a cyber breach executed by nations, terrorist organizations or criminal actors and noted that financial services firms are a significant target of cybersecurity threats. Accordingly, adoption of the regulation is deemed a priority for the state.

The cybersecurity program outlined in the regulation focuses on building information technology-related protections against financial losses for Covered Entities and protections for New York consumers whose private information may be revealed or stolen for illicit purposes. The proposed regulation is described as a regulatory minimum standard for the protection of a Covered Entities information systems and the electronic, non-public information stored on those information systems. Non-public information includes both the licensee's business-related information and consumer information that is not otherwise publicly available. Significant aspects of the proposed regulation include:

- **Cybersecurity Program and Policy:** Requirements that Covered Entities maintain a cybersecurity program designed to protect the confidentiality, integrity and availability of its information systems and a written cybersecurity policy. The cybersecurity policy must be approved by a senior officer or the licensee's board of directors (or committee thereof.)

- **CISO:** Appointment of a Chief Information Security Officer ("CISO") who may be employed by the licensee or an affiliate or a Third Party Service Provider as defined in the regulation. The CISO must deliver a written report to the board annually.

- **Risk Assessment:** A Covered Entity must conduct documented periodic risk assessments of its information systems in order to execute its cybersecurity program. Such risk assessments must be updated to address changes in its information systems, nonpublic information and business operations.

- **Testing and Monitoring:** In accordance with its Risk Assessment, each Covered Entity must monitor and test its cybersecurity program either through continuous monitoring or periodic penetration testing and vulnerability assessments.

- **Breach Reporting to DFS:** Upon the Covered Entity's determination that a Cybersecurity Event has occurred and such Cybersecurity Event either (a) must be disclosed to any government body, self-regulatory agency, or other supervisory body, or (b) has "a reasonable likelihood of materially harming any material part of the normal operation(s) of the Covered Entity" the event must be reported to the NYDFS.
  - "Cybersecurity Event" means any act or attempt, successful or unsuccessful, to gain unauthorized access to, disrupt or misuse an Information System or information stored on such Information System.

- **Small Business Exemption:** Covered Entities with fewer than 10 employees, less than $5 million in gross annual revenue for the last three years or less than $10 million in total assets, including assets of affiliates, shall be exempt from some aspects of the regulation including the appointment of a CISO, testing and vulnerability assessments, training, incident response plans and other technical requirements of the regulation.

- **Audit Trail:** To the extent applicable, and based on its risk assessment, a Covered Entity must have systems designed to (i) reconstruct material financial transactions sufficient to support normal operations and (ii) include an audit trail designed to detect and respond to Cybersecurity Events that are reasonably likely to materially harm any material part of its operations.

- **Effective Date and Certification:** The regulation will be finalized in January 2017 following a 30-day notice and public comment period and will become effective on March 1, 2017. Covered Entities will be required to submit annual certificates of compliance to the DFS beginning February 15, 2018.

- **Transitional Periods**: While Covered Entities generally must be in compliance with the regulation 180 days after the March 1, 2017 effective date, they have additional time to comply with many important provisions, such as those pertaining to risk assessments, penetration testing and vulnerability assessments, encryption and third-party service provider security policy requirements.

iv. Cyber Insurance Coverage

The Data Breach Insurance Act (HR 6032) that was introduced in the U.S. House of Representatives in September 2016 is expected to be reintroduced in January 2017. If passed, the Act would incentivize businesses to purchase cybersecurity insurance policies by providing a tax credit upon the purchase of such a policy if the coverage meets certain standards.

Additionally, at the NAIC 2016 Summer National Meeting, the Cyber Task Force heard a report on the Cybersecurity Insurance and Identity Theft Coverage Supplement (the "Supplement"), which was added to the Property and Casualty Annual Statement for 2015 to allow regulators to gather information to better understand the cybersecurity insurance markets. Based on information reported in the Supplement, insurers writing standalone cybersecurity insurance products reported approximately $500 million

in direct written premium, and those writing cybersecurity insurance as part of a package policy reported roughly $1.0 billion in premium writings (out of a total $522.4 billion in net written premium reported by property and casualty insurers for 2015). The most common form of cybersecurity insurance is in the form of identity theft coverage. The reported $1.5 billion does not include alien surplus lines insurers. NAIC staff noted that estimates about the growth of the cybersecurity insurance market vary widely, with industry sources predicting the market to reach anywhere from $7.5 billion to $1 trillion over the next 5-10 years.

b) InsurTech and the Challenges of Innovation

InsurTech Companies – technology-based insurance startups – were a source of much regulatory discussion in 2016, and will continue to be a focal point for regulators in 2017. In October 2016, the first InsurTech Connect Conference was held in Las Vegas and attracted around 1,500 individuals, including representatives from major insurance companies. InsurTech companies aim to "disrupt" the insurance industry by using technology to improve data analysis, and using artificial intelligence as a brokering method to increase the accuracy and personalization of insurance coverage.

One of the major areas of innovation and disruption has been peer-to-peer insurance, in which InsurTech companies provide an online platform that members of the policyholder community use to "insure" each other. In this peer-to-peer insurance system, if the community's premiums paid exceed losses, the excess premiums are returned to the policyholder or contributed to a charity; if losses exceed premiums, additional losses are paid from the platform's retained funds, then by reinsurers.

Tensions have emerged between InsurTech Companies and insurance regulators trying to fit new technologies and ideas into insurance regulatory codes written over 100 years ago. In response to the tension between InsurTech companies and insurance regulators, a "regulatory sandbox" process has been proposed by one insurer, and presented at the NAIC 2016 Fall National Meeting, to lower the barriers for testing new ideas in InsurTech. The proposal is a "FITLab" that would be conducted three times a year at NAIC meetings. At these FITLabs, InsurTech companies would discuss new ideas and concepts, and regulators would offer regulatory advice and establish parameters. This process would be confidential and would involve no solid commitments, but would enable more open communication and more workable ideas in the growing area of InsurTech. Some regulators appeared generally receptive to the idea of sandboxing, although it remains to be seen whether the NAIC would incorporate this approach.

c) Big Data

In 2016 the NAIC Market Regulation and Consumer Affairs committee appointed the Big Data (D) Task Force, whose mission is "to gather information to assist state insurance regulators in obtaining a clear understanding of what data is collected, how it is collected and how it is used by insurers and third parties in the context of marketing, rating, underwriting and claims." This includes evaluating both the potential concerns and benefits for consumers and the ability to ensure data is being used in a manner that is compliant with state insurance laws. The Big Data Task Force will also explore opportunities for regulatory use of data to improve the efficiency and effectiveness of state-based insurance regulation.

5. Life Insurance Developments

a) PBR Update

During 2016, a milestone was reached in the NAIC's project to implement, on a nationwide basis, a principle-based approach to life insurers' reserving methods, when the amendments to the NAIC Model Standard Valuation Law (the "SVL") providing for the principle-based reserving ("PBR") approach were adopted by 42 states representing over 75% of total U.S. life insurance industry premium. As a result, the Valuation Manual, which sets forth the PBR-based reserve calculation requirements, has become operative as of January 1, 2017.

Following the Valuation Manual operative date, a three-year transition period commenced, during which life insurance companies domiciled in states that have adopted the SVL will be able to implement PBR, but will not be required to do so. Following this transition period, on January 1, 2020, PBR will become a mandatory reserve valuation standard. The NAIC is currently developing a proposal to make certain elements of the amended SVL an accreditation standard, with an effective date that is likewise expected to occur on January 1, 2020. As a result, all U.S. states would be required to adopt PBR, and all U.S. life insurers would be required to utilize PBR in calculating their reserves, starting in 2020. In the meantime, based on the results of an NAIC survey conducted during 2016, it is expected that approximately 20 insurers will adopt PBR in 2017, with others adopting PBR during the remainder of the three-year phase-in period.

b) Variable Annuities Update

During 2016, the Variable Annuities Issues (E) Working Group ("VAIWG") continued work related to its charge to study, and provide a recommendation for addressing, variable annuities captives. This work began in 2015, with the VAIWG drafting a preliminary framework (the "VA Framework") based on a report by a consultant, which proposed revisions to Actuarial Guideline 43, the C3 Phase II component of the life RBC formula, and state laws as well as statutory accounting rules pertaining to hedging activities. During the first half of 2016, the consultant conducted a quantitative impact study with selected variable annuities writers in order to assess the efficacy of the proposed VA Framework, culminating with a report to the VAIWG during the summer of 2016 with the consultant's findings. The VAIWG is currently fine-tuning a proposal to be presented to Executive and Plenary for the consultant to engage in a second quantitative impact study ("QIS 2") during 2017 to test the recommendations previously proposed by the consultant. If approval to conduct QIS 2 is obtained, it is currently expected that the VAIWG will develop a proposal for addressing its charges following the completion of QIS 2 and the report by the consultant to the VAIWG on the results thereof.

6. Other NAIC Developments

a) Valuation of Securities

The Reporting Exceptions Analysis (E) Working Group ("REAWG") has worked during 2016 on developing a process to reconcile differences in ratings utilized by insurers for reporting filing-exempt securities with ratings reported to the NAIC Securities Valuation Office ("SVO") through the ratings reporting services to which the NAIC subscribes (referred to as "data feeds"). Ratings agencies providing data feeds to the SVO and insurers update rating changes with varying frequencies. These differences, among others, lead to discrepancies in NAIC designations. In order to implement the recommendations of the REAWG, the SVO had, at the direction of the REAWG, prepared a presentation to the NAIC Valuation of Securities (E) Task Force ("VOSTF") proposing amendments to the NAIC SVO Purposes and Procedures Manual. Certain interested parties have objected to the approach of these proposed amendments.

In particular, during the VOSTF's session at the NAIC Fall National Meeting in December, interested parties argued that the REAWG had agreed that insurers should be able to use ratings from whatever data feeds they determine are most accurate. If those ratings differ from ratings reported to the SVO from data feeds utilized by the SVO, the differences would need to be reconciled. The proposed amendments take a different approach, namely that the SVO would be the only source of ratings designations and would be the final arbiter of such designations.

Kevin Fry of the Illinois Department of Insurance, who chaired the VOSTF's meeting, rejected the SVO's approach. He stated that the SVO would not be the sole rating source and that there would be an appeals process. He directed the SVO to revise the proposed NAIC SVO Purposes and Procedures Manual amendments and recirculate them to the VOSTF. In addition, he accepted on behalf of the VOSTF an offer by an interested party to provide the NAIC with access to the interested party's product that contains the applicable ratings agency data provided by such interested party free of charge for 12 months.

7. New York Developments

a) The NYDFS Agrees to Implement PBR

The NYDFS—which has for years been the most vocal critic of PBR at the NAIC and elsewhere—issued a press release in July 2016 announcing that New York will adopt PBR for its regulated life insurers, beginning in January 2018. At the same time, the NYDFS has established a working group comprising industry and consumer representatives that will provide input to the NYDFS on the "appropriate reserving safeguards," including a "minimum reserve floor for all products sold to consumers, regardless of company experience." At the same time, the NYDFS has also promised to engage with the NAIC in order to "properly calibrate [PBR] components to safeguard industry solvency" and ensure regulatory uniformity with respect to PBR across the United States.

b) Personnel Changes

On June 15, 2016, the New York State Senate confirmed Maria T. Vullo as the new Superintendent of Financial Services. Ms. Vullo had served as Acting Superintendent since February 2016. Prior to joining the NYDFS, Ms. Vullo was a litigation partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP and also previously served in the New York State Attorney General's Office focusing on investor and consumer protection matters. In addition, in April 2015 Celeste Koeleveld, previously with the New York City Law Department, was appointed General Counsel of the NYDFS; Scott Fisher, formerly Special Deputy Superintendent of the New York Liquidation Bureau, was appointed Executive Deputy Superintendent of Insurance; and Laura Evangelista, previously employed in the insurance industry, was appointed Deputy Superintendent for Insurance.

8. Federal Laws Affecting Insurance

a) DOL Fiduciary Rule

As reported in our client memorandum dated May 6, 2016, on April 8, 2016, the Department of Labor (the "DOL") published the final regulation to the definition of investment advice fiduciary for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") and the prohibited transaction rules under the Internal Revenue Code of 1986 (the "Code"). The final rule amends the definition of investment advice fiduciary and broadens the categories of service providers who will become fiduciaries with respect to retirement plans and individual retirement accounts ("IRAs"). On the same day, the DOL also issued two new prohibited transaction exemptions, the Best Interest Contract Exemption (the "BIC Exemption") and the Principal Transaction Exemption, and amended several existing prohibited transaction class exemptions, including PTE 84-24, which is the class exemption frequently used by insurance agents and brokers, pension consultants and insurance companies to, among other things, exempt the receipt of insurance commissions in connection with the sale of certain insurance products to plans and IRAs. Amended PTE 84-24 removes variable and fixed indexed annuities (but not fixed rate annuities) from the exemption. The receipt of compensation and commissions for the sale of those products will now be covered under the BIC Exemption. In addition, amended PTE 84-24 requires fiduciaries that rely on the exemption to adhere to "Impartial Conduct Standards," including acting in the best interest of the plans and IRAs when providing advice.

While there has been some public speculation that the incoming presidential administration may take action to postpone the application of the final rules or otherwise modify the impact of the rules, they are currently slated to become applicable on April 10, 2017. The DOL provided a transition period until January 1, 2018, during which time financial advisers and financial institutions relying on the BIC Exemption or the Principal Transaction Exemption will have to comply with some, but not all, conditions of those exemptions.

Two recent developments in connection with the DOL fiduciary rule and exemptions include court challenges by various industry groups opposed to the implementation of the rules, and the publication of additional guidance by the DOL in the form of Frequently Asked Questions ("FAQs").

On November 4, 2016, the United States District Court for the District of Columbia ruled in a case brought by the National Association for Fixed Annuities ("NAFA")

that the DOL did not exceed its rulemaking authority, and it further found that the new definition of "fiduciary" was promulgated after an adequate regulatory analysis. The DOL also prevailed in a similar challenge to the rule by a Kansas-based insurance agency that develops fixed indexed annuities and other proprietary insurance products in a November 28, 2016, ruling in the United States District Court for the District of Kansas. The DOL is also facing a consolidated action challenging the rule by other industry groups, including the Securities Industry and Financial Markets Association, which is proceeding in the United States District Court for the Northern District of Texas.

On October 27, 2016, the DOL issued FAQs on the final fiduciary rules, with an emphasis on questions and issues raised under the BIC Exemption. The FAQs generally restate much of what is already set out in the text of the fiduciary rule and BIC Exemption, although it did provide guidance on topics that were not previously fully explained, including how financial advisors may be paid in accordance with revenue-based payout grids, whether financial advisors may be paid certain recruitment bonuses, and whether fees may be discounted.

Finally, in anticipation of the application date for the final rules, several insurers filed with the SEC during the summer of 2016, new variable annuity products that appear to be responsive to the DOL fiduciary rule and the BIC Exemption. Most of the products appear to be fee-based, and designed to be offered by advisors who charge an advisory fee based on assets under management. While trends concerning pricing and fee structures will likely continue to develop over time, particularly given the uncertainty about whether and how the final DOL rule and exemptions may be impacted by the Trump Administration, there were some trends to note with the annuity products that were recently filed with the SEC. For example, several of the new products have no surrender charges, and a few have relatively low surrender charges with short surrender periods. None of the newly filed products charge a front-end sales load. As such, the products include features that could be appropriate for insurance companies and their distribution partners that intend to rely on the BIC Exemption.

b) NARAB II

In early 2015, the National Association of Registered Agents and Brokers Reform Act of 2015 ("NARAB II") was enacted and signed into law. NARAB II is intended to aid the implementation of streamlined producer licensing requirements on a nationwide basis and requires the President to nominate, and the U.S. Senate to confirm, 13 individuals who will serve as the board of directors of the National Association of Registered Agents and Brokers ("NARAB"). Although President Obama nominated ten individuals to serve on the board, the U.S. Senate did not confirm any of the nominated individuals. As a new presidential administration will take office in January 2017, the nomination process will restart. Until such time as all 13 members of the NARAB board have been nominated and confirmed, progress in the establishment of NARAB and implementation of true insurance producer reciprocity will remain on hold.

c) National Flood Insurance Program

The National Flood Act and National Flood Insurance Program are scheduled to expire in September 2017. As the program is $24 billion in debt, a bipartisan consensus seems to be emerging in Congress to alleviate the tax-payer burden by moving the risk of flood events to the private market and away from the federal government. The Federal Emergency Management Agency recently announced that it has secured over $1 billion in private reinsurance effective January 1, 2017 through January 1, 2018 from a group of 25 reinsurers. The NAIC supports the growth of a state-regulated private flood insurance market, reporting that surplus lines carriers and (on a very limited basis) licensed insurers have begun selling flood insurance, and has charged certain of its subgroups with working to facilitate the private market writing flood insurance in 2017 and to develop guidance for consumers shopping for flood insurance.

9. 2017 Forecasting

Looking to 2017, we note that there is substantial uncertainty with respect to how current supervisory initiatives will be impacted by the priorities of the new administration and Congress. We expect that group capital will continue to be a focus of the IAIS and NAIC, while it remains to be seen how the Federal Reserve Board's proposed rulemakings for non-bank SIFIs will develop. Similarly, the execution of the covered agreement with the E.U. (and the potential for multinational group supervision in the future) as well as the final DOL fiduciary rule, may be impacted by legislative or executive action. Meanwhile, cybersecurity risk management, prioritization and reporting are expected to be a top priority in 2017. In addition, technology-related developments will continue to be a focus of development, with regulatory attention paid to the risks and benefits presented by InsurTech and Big Data.

10. Trade and Economic Sanctions

U.S. trade and economic sanctions continue to evolve and provide a "moving target" for both U.S. and non-U.S. insurance companies. The most significant change for 2016 was the easing of sanctions on Iran in January under the terms of the multilateral nuclear agreement. The E.U. lifted most prohibitions, and the United States lifted most "secondary sanctions," which were aimed at non-U.S. entities providing or brokering insurance for Iran or Iranian individuals and entities. The United States also broadly authorized the foreign subsidiaries of U.S. companies to conduct business involving Iran, subject to certain specified conditions. However, SEC reporting requirements remain in place, and listed companies must continue to report on transactions with the Government of Iran or the provision of insurance, reinsurance, or brokering services to certain parts of Iran's energy sectors. In addition, U.S. persons remain generally prohibited from engaging in or facilitating business with Iran. As a result, companies that have permitted their overseas subsidiaries to engage with Iran have had to screen U.S. employees, managers, and directors from any involvement in providing coverage for Iran-related risks.

The United States also continued to ease sanctions on Cuba, allowing insurance providers to cover risks for authorized travel to Cuba and authorized business by U.S. persons and companies owned or controlled by U.S. persons. Insurers and brokers also may cover risks for third-party nationals traveling to Cuba as part of a global health, life, or travel insurance policy. U.S. persons, and any foreign entity owned or controlled by a U.S. person, remain generally prohibited from engaging in business in Cuba and covering risk related to Cuba, unless authorized by the U.S. government under the increasingly-broad general licenses or a specific license.

Companies have continued to implement sanctions programs for Cuba, Syria, Sudan, and Crimea, as well as targeted sanctions programs against designated individuals and entities. U.S. companies must continue to avoid covering or placing coverage for risks in any of those countries or for any of the designated persons. In August 2016, the Treasury Department's Office of Foreign Assets Control ("OFAC") issued a public finding of violation of sanctions to Humana Inc. for the failure of its subsidiary, a third party administrator, to screen policyholders and for continuing to administer health insurance policies for three individuals who had been designated by OFAC. To the extent that non-U.S. companies engage with sanctioned countries, they must ensure that no U.S. individuals or entities are involved in any coverage of risk in sanctioned countries or for their governments or individuals or entities resident in those sanctioned countries. Non-U.S. companies should also ensure they are compliant with local sanctions regimes, such as E.U., U.K., and Canadian sanctions.

11. CFIUS

In Section I.A.2 above, we discuss the continuing participation in the North American and European insurance M&A markets by insurance and investment companies based in the Asia-Pacific region. The volume and value of acquisitions by such entities in recent years have resulted in an added and at least initially unexpected regulatory "wrinkle"—the need to notify CFIUS of transactions involving such buyers. CFIUS obtains its authority from the "Exon-Florio" law, a provision in the U.S. Defense Production Act that grants the President the authority to review, approve, seek modification of, or reject a transaction in which a foreign person obtains "control" of a U.S. business. The link between insurance companies and national security may not seem obvious, and was not a matter of concern when the primary foreign acquirers were from countries that were close strategic allies of the United States. The surge in Chinese acquirers has raised concerns focused on the fact that the companies being acquired have very large databases, containing vital personal information on millions of individuals, or on the fact that they may in particular sell insurance products to U.S. government employees. In a climate of deep concern about cybersecurity, CFIUS review has quickly become a standard issue in U.S. insurance M&A transactions.

Notice to CFIUS is voluntary, but receiving a "no action" notification from CFIUS indicating that there are no national concerns or that they have been fully addressed represents a "safe harbor" for the parties. A decision not to file a CFIUS notice carries with it the risk that CFIUS will reach out to the parties, before or after closing, to request extensive information on the transaction and on the purchaser and the seller and that, in an extreme circumstance, could order the buyer to unwind that portion of the transaction involving U.S. operations. In November 2015, Fosun acquired the 80% of Ironshore that it did not already own. This transaction was not notified to CFIUS. In December 2015, CFIUS contacted Fosun seeking information. It was reported that the focus of CFIUS concerns was Ironshore's Wright USA business, which provides professional liability insurance to U.S. law enforcement and intelligence (CIA and others) personnel. Fosun was forced to delay its planned IPO of Ironshore, subsequently resolved the Wright issue with CFIUS by selling Wright to Starr Companies, and in December 2016 announced that Liberty Mutual would acquire 100% of Ironshore. We anticipate that, in 2017, CFIUS will continue to be aggressive in seeking to examine financial services acquisitions, particularly those involving Chinese buyers, if they involve sensitive relationships or large databases.

B. Regulatory Developments in Europe

1. The Regulatory Impact of Brexit

The referendum on the U.K.'s membership in the E.U. was held on June 23, 2016 and resulted in a majority of 52% in favor of Brexit. The vote to leave means that insurance and reinsurance carriers and insurance intermediaries operating in the U.K. now face a period of regulatory uncertainty as the U.K. and the E.U. enter into a complex and potentially protracted process to redefine the U.K.'s economic and political relationships with its closest neighbors.

Brexit can only be formally implemented after a notification from the U.K. government is made to the E.U. under Article 50 of the Treaty on European Union ("Article 50"). The U.K. will remain a member state of the E.U. until it negotiates and reaches an agreement in relation to the withdrawal from the E.U. or, if earlier, upon the expiration of a two year period following the Article 50 notification. This two-year period can be extended only by the agreement of all E.U. member states.

On October 2, 2016, the U.K. government announced that it intended to invoke Article 50 by the end of March 2017. However, in a case concerning the constitutional process required for invoking Article 50, the U.K. High Court ruled that an act of Parliament must be passed in order for the U.K. to give an Article 50 notice and that such notice could not be given by the U.K. government using prerogative

powers. The High Court's decision is currently under review by the U.K. Supreme Court and its judgment is expected in January 2017. This could have an impact on the process that is required to be observed before Article 50 can be triggered. Given the uncertainty regarding the process for triggering Article 50, it is possible that the timetable for departure could extend beyond 2019. Furthermore, there are increasing calls for a transitional period of up to five years for the U.K.'s withdrawal in order to provide for an orderly transition to the new post-Brexit world.

For the time being, the legal and regulatory framework remains exactly as it was prior to the Brexit referendum. The U.K. continues to be a full member of the E.U., subject to existing E.U. law, and will be subject to all future E.U. law that comes into force prior to the effective date of the Brexit. For now, it is "business as usual" for U.K. insurance businesses and E.U. insurance businesses operating in the U.K., but it is nevertheless very important for such firms to engage in contingency planning for the various potential outcomes of the Brexit negotiations.

a) The Impact of Brexit on the Insurance Industry

According to the Association of British Insurers, the U.K. insurance industry manages £1.8 trillion worth of investments, making it the largest in Europe and the third largest in the world. The industry contributes £18 billion worth of taxes to the exchequer and to the employment of over 300,000 people. As such, the outcome of the Brexit process on the industry will be watched keenly, although the specific effects will depend on the precise exit terms that are negotiated with the E.U.

Brexit could well lead to divergences between U.K. and E.U. law as the U.K. becomes excluded from certain aspects of E.U. membership and the U.K. government moves to repeal, replace or replicate E.U. laws. We consider below two particular areas of potential regulatory change that could have significant impact on insurance businesses in the context of Brexit: the E.U. passporting regime and Solvency II.

i. Passporting

Perhaps the most important area of potential change in regulation for insurers and insurance intermediaries as a result of Brexit relates to the E.U. system of financial services "passporting." Passporting is a system that enables regulated financial firms in one EEA[6] member state to provide financial services (including insurance and insurance mediation) into other EEA member states without the need to obtain additional regulatory authorization in those other EEA member states.

Depending on the outcome of the Article 50 negotiations, it is possible that passporting rights could be lost for U.K. firms wishing to conduct business in other EEA member states and for firms from other EEA member states to conduct business in the U.K. If passporting rights are lost, U.K. firms that write risks in EEA countries from the U.K. will need to establish an authorized branch or subsidiary in the country where the risk is situated or in another EEA country so the risks can be written on a passporting basis in the remaining EEA states. For U.K. firms with branches in other EEA countries, they will need to either apply for local authorization of those local branches or set up a local subsidiary in the EEA so the subsidiary can write business on a domestic or passporting basis. Firms authorized in other EEA countries that have branches in the U.K. will need either to apply for authorization of those branches in the U.K. or set up a U.K. authorized subsidiary.

ii. Solvency II

Depending on the outcome of the Article 50 negotiations, the U.K.'s Solvency II-based insurance regulatory regime could be amended following Brexit. This could have an extremely important influence on how insurers operate, in relation to prudential regulation (including capital requirements) and conduct of business regulation.

[6] The EEA comprises the 28 member states of the E.U. plus Norway, Iceland and Liechtenstein. Passporting rights apply to the whole of the EEA.

Furthermore, if the post-Brexit U.K. regulatory regime diverges from Solvency II, it may not be deemed "equivalent" by the European Commission. The equivalency mechanism affords insurers within the EEA with certain benefits with respect to Solvency II compliance in relation to reinsurance, group supervision and group solvency calculations when dealing with insurers and reinsurers outside of the EEA. For example, an EEA insurer can treat reinsurance from a reinsurer located in an equivalent jurisdiction in the same way as reinsurance from a reinsurer located in the EEA. This, in turn, means that reinsurers in an equivalent jurisdiction are competing on equal terms with reinsurers from within the EEA from a regulatory perspective. We expect, therefore, that equivalence for reinsurance will be high on the wish list of the London market post-Brexit. While equivalence is beneficial to reinsurers in equivalent jurisdictions (such as Bermuda) who wish to access the E.U. market, it is in no way commensurate with passporting rights.

Some argue that repeal or amendment of Solvency II would be a boon to the U.K. insurance sector and could result in streamlined regulation and reduced costs for insurers without harming the credibility of the U.K. insurance market. However, it is not yet clear if there will be a reduced regulatory burden for insurers post-Brexit and the U.K. government may want to ensure regulatory equivalence with the E.U. Furthermore, dismantling this regulation so soon after its effective date would mean that the considerable time and money spent preparing for implementation may be wasted. A streamlined regime would also require U.K. regulators to develop rulebooks that are considered to be favorable to the industry. If past practice is to be considered a guide, there is a likelihood that the U.K.'s freedom to set its own regulation will lead to more, rather than fewer, obligations. In the past the U.K. has been fairly accused of "gold-plating" many E.U. requirements when transposing them into domestic law.

b) Possible Brexit Models

The nature of the impact of Brexit on insurers and insurance intermediaries will depend on the type of Brexit model that is ultimately adopted. Because of the uncertainty of the situation and the complexity of the process, at this stage there is no single model of Brexit that is considered to be most likely to define the future relationship between the U.K. and E.U. However, commonly cited models on which Brexit might be based are described below.

We note above the current consideration by the U.K. Supreme Court of a legal challenge in relation to the constitutional process for the triggering of Article 50. There is also a possibility that similar legal proceedings may be commenced in relation to the triggering of the departure mechanism from the EEA, which some argue exists separately to the U.K.'s membership in the E.U. The relevant provision, Article 127 of the EEA Treaty, provides for a one-year notice period to be given and therefore suggests that the debate and possible challenges to Brexit may continue for the foreseeable future.

i. EEA Membership – The Norway Model

The Norway model (representing a "soft Brexit") affords qualifying non-E.U. members with full access to the European single market (including free movement of people and services) by way of membership in the EEA and the European Free Trade Association ("EFTA"). Such countries are required to contribute towards the E.U. budget and are subject to a significant range of E.U. laws and regulation but have negligible rights to influence them. While this option would provide insurance firms with access to the single market and the passporting regime, this soft Brexit option has been subject to negative media and political coverage as it is believed that it offers few advantages over full E.U. membership and does not deal with what is considered to be one of the key political drivers behind Brexit—the free movement of people.

ii. EFTA Membership and Bilateral Agreements – The Swiss Model

The Swiss model represents membership in the EFTA together with bi-lateral agreements that govern access to the single market on a sector-by-sector basis. Switzerland is not subject to E.U. law but, in areas covered by bilateral agreements, Swiss law must be equivalent to E.U. law. Switzerland must also contribute to the E.U. budget. The

functioning of the bilateral agreements is complex and it is not thought likely that the E.U. would be willing to put this model in place with any other country. Furthermore, Swiss financial institutions are not afforded passporting rights.

iii. Free Trade Agreement

Under this model, the U.K.'s trading relationship with the E.U. would be governed by a bilateral free trade agreement. Regulatory systems would constrain trade in financial services so this model would not give financial firms the benefit of E.U. passporting. The negotiation process for countries seeking a free trade agreement with the E.U. has historically been lengthy and complex, and the U.K. would not benefit from free trade agreements between the E.U. and other non-E.U. countries.

c) What Should Insurance Businesses Do Now?

Given the uncertainties surrounding the possible outcomes of the U.K. and E.U. Brexit negotiations, U.K. insurers and insurance intermediaries as well as international insurance groups with U.K. operations should monitor closely the negotiations between the U.K. and the E.U. on an on-going basis and engage in contingency planning to deal with potential outcomes of the Brexit negotiations.

Policymakers in European countries, including France, Germany and Ireland, have been open about their interest in luring London-based insurers and other financial firms to their jurisdictions in the context of Brexit. For example, on September 28, 2016, the AMF and the ACPR published a joint statement[7] on shared procedures to help U.K.-authorized institutions set up more easily and quickly in France. The publication contains a commitment to welcome U.K.-based institutions that wish to locate their business in France. In order to ensure that applications for authorization are processed smoothly, an English-speaking contact point will be appointed to guide applicant firms through the procedure starting with the pre-authorization period, and will provide all necessary information to ensure the smooth processing of the application.

Insurers should consider their current and future U.K. and European group structure and operations and consider whether the possible loss of passporting rights justifies changes to group structure or cross-border strategy. In addition, insurance firms and groups should:

- consider whether existing key commercial contracts will be affected and develop plans to address any potential issues;
- consider opportunities to grow certain classes of insurance business that may see an increase in demand as a result of pre-Brexit volatility or the new post-Brexit political and economic landscape (e.g. insurance against rejection of applications of E.U. nationals wanting to become permanent residents in the U.K. or insurance covering the costs associated with repatriation orders).
- consider how cross-border data movements might change and if and how data protection laws will be implicated;
- in the context of the current and forecasted uncertainty, finance departments should maintain agile planning systems that are able to quickly re-model forecasts and plans, and allow for many new potential scenarios to be run;
- maintain an up-to-date and accurate risk assessment of the potential impacts of Brexit throughout the negotiation process; and
- consider lobbying and contributing to an industry dialogue with policymakers throughout the formal negotiation process.

[7] http://www.amf-france.org/en_US/Actualites/Communiques-de-presse/AMF/annee-2016.html?docId=workspace%3A%2F%2FSpacesStore%2F8fae240f-bc82-4b44-91ac-49ee1390a223

d) Lloyd's and Brexit

Lloyd's estimates that it would lose about £800 million of premiums if it lost passporting rights, which would represent 4% of its total global gross written premium ("GWP"). More could be at risk as a result of the Brexit vote as nearly £3 billion, or 11% of GWP originates in EEA.[8] However, it should be noted that almost half of the 11% GWP figure derives from reinsurance, and the loss of passporting rights will not significantly affect pure reinsurance business that can, to a large extent, be written across borders without local regulatory authorization.

Lloyd's has confirmed its commitment to plan for Brexit and on December 15, 2016 publically stated that it is planning to establish a new separately capitalized subsidiary in Europe should U.K. passporting rights not be secured for the post-Brexit regulatory environment. The confirmation came following a report in the Financial Times, which said that Lloyd's is deciding from a shortlist of five jurisdictions where to locate such a subsidiary. Regulatory authorization of the new subsidiary in the relevant jurisdiction would first be required, following which the entity could write business throughout the EEA using passporting rights.

Lloyd's has announced that it will put a proposal before members of the Lloyd's market in February, in advance of the U.K. government invoking Article 50 of the Treaty on the European Union.

2. The Introduction of Solvency II

After a 10 year gestation period, and investment of over £3 billion by U.K. insurers alone, the regulatory marathon that is known as Solvency II came into effect on January 1, 2016. Solvency II 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 both within and outside of the E.U. Second, part of the structure is a requirement for a form of group supervision. While group supervision is a concept that is common in many insurance regulatory regimes, it is not universal—the U.S. is a notable exception. Again, international insurance groups with an insurer located in the E.U. are affected. Third, it affects reinsurers outside of the E.U. that wish to reinsure European insurance companies.

The Solvency II regime and changes in the political and regulatory landscape since its introduction have given rise to issues that are of particular interest to international groups, including in relation to equivalence, group supervision and Brexit.

a) Equivalence

Equivalence refers to the concept whereby the European Commission determines whether the insurance regulatory regime of a non-E.U. country ("third country") is equivalent to Solvency II for three purposes, which are described below.

- **Group Solvency Calculation:** This applies to any insurance group that operates in a third country but the ultimate holding company of which is headquartered in the EEA. If an EEA group has an insurance subsidiary in a third country that is deemed equivalent, the EEA group can use the "alternative method" to calculate group solvency. This means that the local capital requirement rules of the third country—rather than Solvency II capital rules—can be applied in respect of insurance subsidiaries operating in that third country.
- **Group Supervision:** This is relevant where the ultimate holding company of an insurer with EEA activities is headquartered in a third country. If the third country's rules are deemed equivalent in this area, EEA supervisors can rely on the group supervision by the regulator in that third country rather than apply Solvency II group supervision rules.
- **Reinsurance:** This applies to third country reinsurers where the solvency regime of a third country is deemed equivalent to the E.U. In these circumstances, the E.U. regulators must treat reinsurance contracts between EEA insurers and reinsurers in the third country in the same way as reinsurance contracts concluded between EEA firms.

[8] Statistics were noted by chief executive Inga Beale or global markets director Vincent Vandendael during a briefing to the Lloyd's market on June 30, 2016.

Switzerland, Bermuda and Japan were in the first "wave" of assessment for equivalence, but some others, including the U.S. and Canada, chose not to engage in the formal equivalence assessment process. E.U. institutions have made a number of important decisions regarding the equivalence of the regulatory regimes of eight countries.

b) Countries Granted Full Equivalence under Solvency II

- **Switzerland:** The European Commission granted Switzerland full equivalence in all three areas of Solvency II for an indefinite period. Switzerland was the first country to be granted full equivalence. The decision to grant Switzerland full equivalence was not surprising given the country's close relationship with the E.U., its prominent insurance and reinsurance market and the steps taken by Swiss authorities in recent years to align the Swiss regulatory regime with Solvency II.

- **Bermuda:** With effect from January 1, 2016, Bermuda was granted full equivalence in all three areas of Solvency II. However, the Bermudian systems for regulating captive insurers and special purpose insurers were not found to be equivalent. The decision enables Bermuda's commercial reinsurers, which cover a significant portion of European reinsurance and catastrophe risks, to compete on an equal footing in Europe with EEA companies. However, the exclusion of special purpose insurers from the equivalence assessment means that European cedents have to insist that the arrangements comply with Solvency II rules in order for them to count reinsurance with such vehicles for solvency purposes. Most notably, compliance with rules on collateral are likely to be key.

c) Japan, the U.S. and Other Countries Granted Provisional Equivalence under Solvency II

- **Japan:** The European Commission also granted third country equivalence in respect of Japan with effect from January 1, 2016. The Japanese Financial Services Agency sought to achieve equivalence only in respect of reinsurance so as to allow Japanese reinsurers to assume business in Europe without collateral requirements for unearned premium or reinsurance recoverables. Japan has been granted (i) temporary equivalence in respect of reinsurance and (ii) provisional equivalence for group solvency purposes. Temporary equivalence is granted for five years and this may be extended for an additional year. Provisional equivalence is granted for third countries that may not meet all the criteria for full equivalence but where an equivalent solvency regime is expected to be adopted and applied by the third country in the foreseeable future. Provisional equivalence is granted for a period of 10 years and may be renewed for an additional 10-year period.

- **The U.S. and other countries:** The U.S., along with Australia, Brazil, Canada and Mexico, have been granted provisional equivalence for group solvency purposes only. As such, these jurisdictions will be treated as equivalent for purposes of group solvency for a period of 10 years from January 1, 2016. At the end of this period, the European Commission will need to reassess each country's regime to decide whether to grant full equivalence or grant an additional period of temporary equivalence.

In practice, provisional equivalence means that EEA headquartered insurance groups that are active in one of these countries can either (i) use the default capital requirement calculation method by assessing group solvency using Solvency II rules on an accounting consolidation basis or (ii) use the alternative method by disaggregating group operations and applying local capital requirement rules of equivalent jurisdictions to operations in such equivalent jurisdictions while applying Solvency II rules to other operations of the group. In order to apply the alternative method, the group must first demonstrate to its group supervisor that the exclusive application of the default method is inappropriate.

As noted and discussed in Section VII.A.3 above, the Treasury Department and the USTR have completed negotiations with the E.U. to enter into a covered agreement. The covered agreement will address reinsurance collateral, cross-border regulatory information exchange issues and group supervision issues between the E.U. and the U.S.

The covered agreement is of particular interest to U.S. and E.U. reinsurers. E.U. reinsurers have long been subjected

to U.S. reinsurance collateral requirements, which result in them having not only to satisfy E.U. solvency rules, but also local requirements as well when underwriting business in the U.S. Likewise, U.S. reinsurers operating in the E.U. will face similar duplication of capital requirements between U.S. requirements and Solvency II requirements. The covered agreement may be a tool for achieving a set of measures for ensuring that U.S. and E.U. reinsurers are not subject to multiple sets of capital requirement rules.

However, there is concern that U.S. state insurance regulators may consider a covered agreement to be an undesirable step because it could potentially preempt state law and reduce their scope of activity.

d) Group Supervision

When an insurance group headquartered in a non-EEA jurisdiction has operations in the EEA, the question arises as to whether EEA insurance supervisors can rely on the group supervision exercised in the third country jurisdiction or whether group supervision has to be conducted by a group supervisor in Europe.

Guidance from the European Insurance and Occupational Pensions Authority ("EIOPA") notes that where the ultimate parent company of a group is headquartered outside the EEA and is subject to "equivalent" third country supervision (for example, in Switzerland or Bermuda), the EEA group supervisor should rely on the group supervision exercised by the equivalent third country supervisory authorities and exempt the third country group from group supervision by an EEA regulator on a case-by-case basis, where this would result in a more efficient supervision of the group and would not impair the supervisory activities of the EEA supervisory authorities concerned in respect of their individual responsibilities.

However, EIOPA's guidance notes that where the ultimate parent company is headquartered outside the EEA and is not subject to equivalent third country supervision (for example, in most states of the United States), group supervision should be applied at the level of the ultimate parent undertaking in the E.U.

If there is no E.U. holding company, then the issue for international groups is whether they should consider a group reorganization in order to create an E.U. sub-group that will be supervised by the relevant E.U. regulator, or whether they should negotiate with the relevant E.U. regulator on appropriate "other methods" for exercising group supervision. The latter is an option where there is no equivalent group supervision. In the lead-up to Solvency II's introduction, we saw clients adopt both approaches as it suited their particular facts and circumstances. Thus, some international insurance groups underwent a reorganization to create an E.U. sub-group headed by an E.U. holding company within which the E.U. insurers were placed while the non-E.U. insurers were moved outside of the sub-group. This meant that the Solvency II group supervision and solvency capital rules would largely be limited to the E.U. sub-group. In other cases, we have seen international groups seek and obtain regulatory consent to a set of measures that will take the place of formal group supervision. Such measures vary from group to group but typically include additional reporting requirements and regulatory pre-notification of proposed dividend payments, capital extraction or intra-group transactions involving E.U. insurers in the group.

e) Brexit

The potential impact of Brexit on the Solvency II regime is further analyzed from a regulatory perspective in Section VII.B.1.a.ii above. Depending on the outcome of the Brexit negotiations, the U.K.'s Solvency II based insurance regulatory regime could be amended following the U.K.'s exit from the E.U. Clearly this is an area to be monitored by international insurance groups on an ongoing basis.

3. Solvency II Public Disclosure Requirements - The Solvency and Financial Condition Report

One of the objectives of the Solvency II regime is to deliver more transparency to stakeholders about the solvency position of insurers. This is often referred to as the "Third Pillar" of the Solvency II regime. One means by which this has been addressed is through the new requirement for regulated insurers to prepare a Solvency and Financial

Condition Report ("SFCR"). The SFCR will be an annually published narrative and financial report that is publically available. U.K. insurers will be required to submit and make public their first SFCR in May 2017 alongside their first Regulatory Supervisory Report (a private report to the regulator), each based on the 2016 year-end.

The SFCR will contain qualitative and quantitative information on the following categories of an insurers' operations:

- Business and Performance;
- Systems and Governance;
- Risk Profile;
- Capital Management; and
- Valuation for Current and Future Solvency Position.

Each of the above categories of information contains significant related sub-topics that will require input from various professionals within the organization. By way of example, the Systems and Governance category requires a summary of roles and responsibilities of boards and committees, remuneration policies, fit and proper guidelines, risk management, internal controls and the ORSA process. Based on our experience, the functional areas for which input from professionals is likely, include almost every part of an insurer's organization, including risk, regulatory, secretarial, compliance, legal, finance, actuarial and internal audit. Like any report that is submitted to a regulator and made public, it will be important to co-ordinate and agree sections where there is functional overlap.

As the SFCR is a new requirement, most insurers are still feeling their way in relation to how to approach it, particularly in relation to its formatting and level of detail that the reports will contain. We expect that, over time, a consensus will emerge in relation to these aspects. We also note that waivers are available for insurers that wish to avoid releasing particular information that may be deemed commercially sensitive. Nevertheless, insurers preparing their first SFCR will need to ensure that the key areas noted in the Solvency II Directive[9] are addressed and that the content is comprehensible for the intended readers. The PRA have noted in a supervisory statement[10] that an insurer's governing body (e.g., the board of directors) has responsibilities in respect of the ongoing appropriateness of the information disclosed in the SFCR and, upon finalization, the governing body must approve and sign an acknowledgement of responsibility in the SFCR.

a) Consistency of SFCR with Other Reports

Given the public nature of the SFCR, it will be important that the content of the SFCR is consistent with other disclosures that the insurer or the group has made or will be making. Many insurance groups will have to prepare and publicly release several forms of SFCR for insurers within the organization. For example, insurance groups with a BMA regulated insurance company will have to prepare and release a Financial Condition Report ("FCR"), which is the Bermuda equivalent to the SFCR. To the extent that the group has implemented consistent governance, risk and capital management structures and practices, it will wish the U.K. SFCR and the Bermuda Financial Condition Report to be consistent. In our experience, the guidance for the SFCR is currently more detailed than that available for the Bermuda Financial Condition Report.

For insurers that are part of a U.K.-listed or U.S. public company group, it will also be critical for the content of the SFCR to be consistent with related disclosures that the parent of the group has made or will be making in connection with such listing or SEC registration. A determination also may have to be made by the disclosure committee of the group as to whether or not information being publicly released via the SFCR or FCR may be material to security-holders.

[9] See Articles 51, 53, 54 and 55 of Directive 2009/138/EC
[10] http://www.bankofengland.co.uk/pra/Documents/publications/ss/2016/ss1116.pdf

b) SFCR Audit Requirements

Solvency II does not contain a requirement for internal audit of the calculations or reporting contained in the SFCR. EIOPA has come out in favor of external audit, particularly in respect of the main disclosures contained in the SFCR. EIOPA does not have authority to impose such requirements directly upon insurers, however, so specific regulations would have to be determined at the E.U. member state level if this requirement is to be applied.

In implementing rules around the SFCR, the PRA requires external audit of the information contained in the "Valuation for solvency purposes" and "Capital management" sections of the SFCR. We believe this will become best practice, particularly for U.K. insurers that are part of a listed or public company group. However, insurers whose solvency capital requirement ("SCR") are calculated using an approved internal model will not need to have the SCR calculations audited.

c) What Insurers Should Do Now Regarding the SFCR

As 2017 will be the first year in which SFCRs will appear, there will be significant advantages to preparing for the submission as early as possible. Indeed the workload associated with preparing the SFCR reports for the first time should not be underestimated. We have been advising our clients on the SFCR requirements generally and in particular in relation to the appropriate level of detail to facilitate an informed overview of the five main areas of the reports, while acknowledging the concepts of proportionality and materiality. We recommend that firms obtain regulatory input on draft SFCR reports prior to finalization so as to ensure they contain the appropriate level of disclosure.

The detailed nature of the SFCR means that insurers will be required to disclose certain potentially sensitive company information to the public, and therefore also to their competitors. Given the nature of such information, we have found that insurance groups are treating the reporting requirements as more than a mere compliance exercise with need for input from disclosure and compliance committees. Weak reporting could potentially convey a misleading message to stakeholders including shareholders, regulators and the general public. On the other hand, insurers may not wish to over-include details in areas that would be more commercially sensitive. It will be important to get the balance right, particularly for the first reports due in 2017.

4. The Senior Insurance Managers Regime

On March 7, 2016, U.K. insurers became subject to the new Senior Insurance Managers Regime ("SIMR"), a regime that increases accountability and responsibilities of senior managers and directors of insurance companies. SIMR has replaced the PRA's Approved Persons' Regime ("APER") in respect of senior insurance staff. The purpose of the SIMR is to (i) ensure that insurance entities have clear and effective governance structures and (ii) clarify and enhance accountability of senior insurance managers. The new regime serves to implement requirements under Solvency II relating to governance and fitness and propriety.

A key feature of the SIMR is the requirement on firms to identify key functions in the business and the individuals who are in charge of these key functions. Such individuals should be fit and proper for their roles and will have to be pre-approved by the PRA; the FCA must also give its consent. Chief executive officers, chief financial officers, chief risk officers, heads of internal audit, chief underwriting officers and chief actuaries must be included. Furthermore, in relation to international insurance groups, the PRA also has to pre-approve individuals employed by a parent or group entity where those individuals are involved in decisions affecting the firm's U.K. business. This applies where the individual exercises direct influence over the U.K. regulated entity and not merely a strategic influence. The existing FCA APER regime continues to apply in respect of less senior insurance staff.

In connection with the implementation of the Solvency II requirement that there be appropriate and transparent allocation of oversight and management responsibilities within each firm, firms are required to draw up and

maintain a "Governance Map" that sets out the names and roles of the individuals who effectively run the firm as well as individuals with key functions within the firm. Firms are obliged to update the Governance Map at least quarterly and also when there is a significant change to the firm's governance structure or to the responsibilities of a key function holder.

Senior managers within the scope of the SIMR and employees within the scope of the FCA's regime for approved persons are subject to a new set of conduct rules in place of the pre-existing Statements of Principle and Code of Practice for approved persons under the APER. These rules take the form of short statements of high-level principles and standards of behavior. Most employees of insurers who are based in the U.K. or who deal with customers in the U.K. are also subject to application of these rules by the FCA. Three generic standards 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.

Some of our clients have reorganized their governance structures as a result of the introduction of the SIMR and have sought our help with identifying key function holders, allocating responsibilities among senior managers and preparing Governance Maps.

5. The Insurance Distribution Directive

The Insurance Distribution Directive ("IDD") was adopted on February 22, 2016. The IDD will replace the Insurance Mediation Directive ("IMD"), which sets out the current framework for regulating E.U. insurance brokers, agents and other intermediaries. It is intended that the IDD will address the inconsistent implementation of the IMD across E.U. member states and enhance and modernize regulation in this area to account for increased complexity of the market. The U.K., along with other E.U. Member States, are required to transpose the IDD into national law by February 23, 2018, although the U.K.'s ultimate position on this is likely to be interlinked with the Brexit discussions.

The IDD widens the scope of the IMD so that it covers all sellers of insurance products, including insurers and reinsurers that sell their products directly to customers and any person who assists in the administration or performance of insurance contracts and persons who distribute insurance products on an ancillary basis (such as travel agents and car rental companies). Certain exemptions exist for entities such as claims managers, loss adjusters and consumer association websites that provide insurance product comparisons but do not seek to sell specific contracts.

The IDD is a "minimum harmonizing directive," meaning that individual E.U. member states can "gold-plate" the directive by adding additional requirements when transposing the directive into national law. Given the flexibility for member states to augment IDD's provisions and the potentially large number of new firms that will be brought within the scope of regulatory requirements (including reporting, compliance and disclosure requirements), it will be important for firms to keep track of the development of the IDD at a national level during 2017.

6. Germany: Rules for Reinsurers From Third Countries

On August 30, 2016, BaFin issued an interpretative decision[11] on certain aspects of conducting reinsurance business in Germany by undertakings situated in a third country.

As a general rule, insurers and reinsurers from third countries (*i.e.*, countries that are not members of the E.U. or EEA) must establish a branch in Germany that is authorized by BaFin if they wish to carry on insurance or

[11] https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/VA/ae_160901_rueckversicherung_drittstaaten_va.html

reinsurance business. However, the new German Insurance Supervision Act (Versicherungsaufsichtsgesetz ("VAG")), which came into force on January 1, 2016, provides an exemption that applies if an insurance or reinsurance entity from a third country solely carries out reinsurance business in Germany. This exemption only applies where the reinsurance business is carried on by provision of cross-border services and where the European Commission has deemed the solvency regime in the relevant country to be equivalent for reinsurance activities in accordance with Articles 172 (2) or (4) of the Solvency II directive.[12]

The European Commission has until now decided that only the solvency regimes for reinsurance activities in Switzerland, Bermuda and Japan are to be regarded as equivalent. In its August 30, 2016 interpretative decision, BaFin clarified that the equivalence decisions pursuant to Articles 172 (2) and (4) are decisive and that, where such equivalence decisions exist, third country insurance or reinsurance undertakings may conduct reinsurance business in Germany without authorization. Therefore, with regard to third countries, only insurers or reinsurers with head offices in Switzerland, Bermuda and Japan may conduct reinsurance business in Germany on a cross-border basis without needing to establish a locally authorized branch office.

In the interpretative decision, BaFin also clarified the circumstances whereby a third country undertaking would be deemed to be carrying on reinsurance business in Germany and concludes that the decisive element is whether the undertaking deliberately targeted the German market in order to offer reinsurance to German insurers or to initiate such business. This would also be the case if the third country undertaking uses brokers or other intermediaries in Germany or abroad to contact German insurers.

The carrying-on of reinsurance business by entities in violation of these rules is a criminal offense regardless of whether it was conducted with intent or negligence. The regulatory requirements commented on above apply to reinsurance contracts concluded on or after January 1, 2016, including renewals that require agreement among the parties. This interpretative decision has caused considerable anxiety in the international reinsurance community located in non-equivalent third countries. Extreme care will be required to ensure that any reinsurance placement does not contravene the interpretative decision and thereby result in a criminal offense being committed.

7. The Insurance Act 2015

The Insurance Act 2015 (the "IA") came into force in the U.K. on August 12, 2016. The IA is considered to be the most significant reform of U.K. insurance contract law since the Marine Insurance Act 1906. It modernizes and clarifies the legal framework for certain aspects of commercial insurance in the U.K. The IA has made significant changes to the policyholder's duty of pre-contractual disclosure and includes a duty to provide a fair presentation of risks. Other changes soften what can amount to a harsh outcome for policyholders under existing insurance law and so has the potential to make it more difficult for insurers to decline claims.

All contracts of insurance entered into on or after August 12, 2016 are subject to the new regime. Insurers and policyholders must be careful to consider the potential implications of the IA on all contracts and variations entered into after that date.

We consider below key changes brought about by the act as they relate to the following five areas of reform:

- The duty of fair presentation;
- Insurance warranties;
- Remedies for fraudulent claim;
- Good faith; and
- Contracting out.

[12] Directive 2009/138/EC

a) The Duty of Fair Presentation

The general rule that insurance contracts are based upon utmost good faith remains in place. However, the IA has modified the law of pre-contractual disclosure by non-consumer policyholders (*i.e.*, businesses) by introducing a new duty to provide a fair presentation of the risks.

i. The Meaning of Fair Presentation of Risk

Essentially, the new duty requires that business policyholders either:

- disclose every material circumstance that the policyholder knows about or ought to know about; or
- provide sufficient information to put a prudent insurer on notice that further enquiries are needed to reveal material circumstances.

"Material circumstance" means a circumstance or representation that would influence the judgment of a prudent insurer in determining whether to write the policy and if so, on what terms.

The duty of fair presentation requires that business policyholders present information in a manner that would be reasonably clear and accessible to a prudent insurer. The IA seeks to discourage data dumping and the explanatory notes to the IA make it clear that overly brief or cryptic presentation would not be considered fair presentation.

The policyholder must also ensure that material representations on matters the policyholder knows (or ought to know) are substantially correct. Material representations on matters of expectation or belief must be made in good faith.

ii. Knowledge

The IA sets out fairly detailed provisions determining whose knowledge is relevant when determining what material circumstances a policyholder knows about or ought to know about. Under the IA, the knowledge of the policyholder extends to the knowledge of anyone within senior management or to individuals responsible for the policyholder's insurance (e.g., risk managers, employees who negotiate insurance or the policyholder's insurance broker). The IA defines senior management as anyone who plays a significant role in the making of decisions about how business activities are to be managed or organized, so senior management will include the board but may extend to other senior management. As there is some ambiguity as to whom within a business will count, organizations should consider putting in place a clear list of positions that fall within the senior management category and should seek agreement from their insurers that such a list is appropriate and exhaustive.

As noted above, a policyholder must disclose information that it "ought to know," meaning information that should reasonably be revealed by a reasonable search of information available to the policyholder. What amounts to a "reasonable search" is not expounded on in the IA, thereby creating an area of uncertainty and potential contention. Policyholders should consider engaging with insurers to specify the steps that should be taken so that the insurers can consider if those steps are appropriate and then sign-off on the approach. Policyholders should also consider putting in place an audit trail detailing all searches undertaken for the purposes of pre-placement disclosure, so it can: (i) disclose this information to insurers prior to entering into policies; and (ii) refer, if necessary, to the evidence documenting the reasonable searches conducted, should any future disputes arise.

b) Insurance Warranties

Prior to the IA, a breach of insurance warranty could permanently relieve the insurer of its obligations under the policy, even where the breach of warranty has been remedied or where the breach did not cause the loss in question. The IA has changed the law so that warranties are now construed as "suspensive conditions," meaning the insurer's liability under the policy is suspended until the breach is remedied. Therefore, an insurer will not be liable for loss that occurs during the suspension of liability and its liability will be restored once the breach is remedied.

Furthermore, the IA abolishes "basis of contract clauses," which seek to convert all representations by policyholders, including responses to questions on proposal forms, into warranties. In practice, these clauses meant that where a policyholder answers a question on a proposal form incorrectly, even if by mistake, the policy would never come into effect and the policyholder would be left without cover. Basis of contract clauses are no longer permitted and the parties are not able to contract out of this.

c) Remedies for Fraudulent Claims

Under the IA, an insurer is not liable to pay out money for a fraudulent claim and can claw back any payments made under the policy in respect of such claim. Furthermore, the insurer can terminate the insurance contract from the time of the fraudulent act and keep any premium received up to that point. However, valid claims that arose prior to the fraud are unaffected.

The IA also details the remedies available to insurers where there are fraudulent claims in relation to group insurance policies. Where a member of a group makes a fraudulent claim, the insurer only has a remedy against the fraudulent member and all other policyholders remain unaffected. What exactly constitutes "fraud," "fraudulent claim" or "fraudulent device" is not specifically defined in the IA, so these terms continue to be determined in accordance with existing common law precedent.

d) Good Faith

The IA abolishes the remedy of contractual avoidance where there has been a breach of the duty of good faith. This applies to both consumer and business insurance policies. For policy reasons, the remedy of avoidance was seen as inappropriate because, where the insurer breaches its duty of good faith, the policyholder would still wish its claims to be paid.

e) Contracting Out

It is possible to contract out of certain provisions in the IA (excluding those relating to the basis of contract clauses) provided that, in general, the policyholder is not placed in a worse position than he would be by virtue of the IA.

The IA's contracting-out rules differ depending on whether the policyholder is a consumer or a business. Where the policyholder is a business, the parties can contract out of certain provisions of the IA if the insurer draws such clauses to the insured's attention and such clauses are clear and unambiguous as to their effect. Where the policyholder is a consumer, contracting out provisions have no effect where they relate to warranties, fraudulent claims or late payment of claims and would put the policyholder in a worse position than it would have been under the rules in the IA.

f) The IA and Structured Reinsurance

Insurers and reinsurers should give due consideration to the effect of the IA when considering and negotiating structured reinsurance. Typically, the parties to such reinsurance contracts have excluded the remedies available under the common law and the Marine Insurance Act 1906 to avoid coverage for non-disclosure or misrepresentation. To achieve a similar result under the IA, it will be necessary to carefully draft carve-outs from the IA in a way that complies with the transparency requirements under the IA. Failure to do so would bring into play the rules on fair presentation including making enquiries of senior management as to their knowledge of material circumstances affecting the risk. Insurers would not want to inadvertently include the knowledge of somebody within their organization who they would otherwise not want to include when placing structured reinsurance.

g) The IA and Warranty and Indemnity Insurance

The IA will be relevant where a warranty and indemnity "W&I" policy is being purchased in the context of an M&A deal. This is likely to have different implications depending on whether the buyer or seller is looking to buy the W&I policy, but in both cases the concern will be whether the

insurer has a reason not to pay out on claims and how this is linked to the requirement for the risk to be fairly presented. For example, what would the position be if it were to emerge that the target or the seller was aware of an issue prior to entering a policy but the buyer is not? How does the disclosure process under the M&A transaction interact with the presentation of the risk under the W&I policy, and what are the implications for each if the two processes are to diverge? It has become common practice in the W&I sector for there to be detailed underwriting (including underwriting calls with members of the target's management) and it may be the case that this process is sufficient to meet the requirements under the IA.

h) Comment

As is the case for all new legislation, the impact of the IA will not be fully appreciated until its provisions have been interpreted by the courts. Indeed, uncertainty remains in relation to certain provisions of the IA, most notably in relation to the concept of identifying "knowledge" for business policyholders. The IA creates increased responsibility on such policyholders to investigate their risks internally and to present that information to insurers in a clear and accessible manner. Prudent policyholders will put systems in place to ensure that appropriate information is provided to insurers prior to entry into new policies or renewals. Insurers and businesses are advised to stay abreast of continuing developments relating to the IA in relation to fair presentations, but market practice is expected to evolve and settle over the coming months.

8. PRA Consultation on Matching Adjustment Portfolios Under Solvency II – Illiquid Unrelated Assets and Equity Release Mortgages

On December 15, 2016 the PRA published a consultation paper[13] proposing a PRA Supervisory Statement setting out its expectations in relation to insurance firms investing in illiquid, unrated assets (including equity release mortgages ("ERMs")) within their Solvency II matching adjustment ("MA") portfolios. The consultation is relevant to life insurance and reinsurance firms that hold or plan to hold these types of assets in a MA portfolio.

Following on from responses the PRA received on a discussion paper it published in March, 2016 on ERMs,[14] the PRA is cognizant that illiquid, unrated assets lack observable market prices and credit ratings, making it difficult to assess what the appropriate allowable amount of MA should be. The draft supervisory statement contained in the consultation paper contains the PRA's proposals regarding valuation of, and spread mapping to be used in relation to, restructured ERMs in order to determine their contribution to a firm's MA benefit.

This consultation closes on March 14, 2017 and the PRA welcomes feedback on the proposals set out in the consultation paper. The PRA intends to implement its proposals in the second half of 2017.

9. PRA Consultation on Cyber Insurance Underwriting Risk

One of the hottest areas for innovation and product development in most developed insurance markets over the past few years has been in relation to cyber risk. While much of the attention has been focused on the potential for insurance to be an efficient (and for insurers, potentially profitable) way of assisting in the management of such risk, it appears that regulators are now sounding a note of caution for underwriters seeking to expand their exposure to this type of product and questioning whether others are correctly assessing their current exposure to this growing area of risk. The PRA published a consultation paper[15] and an accompanying "Dear CEO" letter[16] on November 14, 2016 on cyber insurance underwriting risk. In the consultation paper, the PRA proposes a new supervisory statement setting out its expectations for the prudent management of cyber underwriting risk by insurers and reinsurers, including

[13] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp4816.pdf

[14] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/dp116.pdf

[15] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp3916.pdf

[16] http://www.bankofengland.co.uk/pra/Documents/about/letter141116.pdf

the Society of Lloyd's and Lloyd's managing agents. A draft of the proposed supervisory statement is included with the consultation paper.

For these purposes, the PRA defines cyber underwriting risk broadly as insurance contracts that are exposed to losses resulting from a cyber-attack. This will include both risks covered by policies that are deliberately aimed at providing insureds with protection against risks associated with information technology processes, such as a data breach product, and "silent" cyber risks, where the exposure may be less immediately apparent to underwriters. For example, an all-risk liability product that does not explicitly exclude cyber risk might also create exposure for insurers arising as a result of a cyber attack. In the consultation paper, the PRA said it has "significant concerns about the loss potential of 'silent' cyber risk and has identified material shortcomings in the management of this risk." It said insurers must "robustly assess and actively manage their insurance products with specific consideration to 'silent' cyber risk exposures."

This is an excellent example of the requirement for insurers continually to be innovating, not only in order to expand the scope of their business but also to defend themselves against external developments. The PRA believes that insurers should be responding to this challenge by introducing measures that reduce the unintended exposure to silent risk. These might include, for instance, adjusting the premium to reflect the additional risk or offering explicit cover, introducing robust wording exclusions, attaching specific limits of cover, or offering cyber cover at no extra premium only when the board has confirmed that a particular line of business does not carry material "silent" cyber risk and is in line with the stated risk appetite.

The PRA also noted that it considers insurers not yet to have invested sufficiently in developing internal knowledge and expertise on both the affirmative and "silent" elements of cyber risk underwriting, and proposes that they should focus on putting in place the necessary expertise specifically to monitor and manage those risks. The PRA also proposes that insurers should have clear strategies and articulated risk appetites on the management of the associated risks which are owned by the board, and which are reviewed on a regular basis.

The PRA's consultation highlights that insurance firms should be aware of the potential aggregations resulting from silent cyber risk and recommends that insurers look to address this in the future. Furthermore, it suggests that listed insurance groups should consider the implications of potential aggregations in the context of the risk factors they list in their regulatory filings and offering documents.

The PRA has invited responses to the consultation document by February 14, 2017. While cyber risk has been a topical issue in insurance markets for several years now, the outcome of this process means that it is likely to remain high on the agenda for U.K. insurers for many years to come. During 2017 insurers will need to assess whether they are part of the group of insurers that can properly assess and underwrite this risk in a way that gives them an edge over their competitors in terms of product offering or whether, on reflection, the PRA has provided a timely reminder that they may be behind the curve in their present position.

VIII. Tax

A. U.S. Developments

1. The United States Treasury Department and Internal Revenue Service Issue Earnings Stripping Regulations

On October 13, 2016, the Treasury Department and the Internal Revenue Service (the "IRS") released final and temporary regulations under section 385 of the Internal Revenue Code of 1986, as amended (the "Code"), relating to the classification of certain intercompany loans as equity for U.S. federal income tax purposes. The regulations adopt portions of regulations on the same topic that were proposed in April 2016, but they also significantly narrow the scope of the proposed regulations.

The regulations adopt the basic approach of the proposed regulations, which provided for new documentation requirements on intercompany debt and treated loans in certain intercompany transactions as "per-se stock." However, the final and temporary regulations made substantial changes to the proposed regulations, including: (i) limiting the application of the final and temporary regulations to debt issued by U.S. borrowers (reserving on the application of the rules to foreign issuers); (ii) eliminating the so-called "bifurcation rule" pursuant to which the IRS would be able to treat intercompany debt in part as debt and in part as equity; (iii) expanding the types of intercompany loans and identity of issuers that are exempt from the rules; and (iv) generally delaying the effective dates of the regulations to allow taxpayers time to comply with the regulations.

The Section 385 regulations require certain groups of foreign or domestic corporate or partnership affiliates (generally determined by reference to an 80% vote or value test) to maintain certain documentation to support debt treatment of intercompany debt issued by domestic corporations. The documentation requirements would apply to publicly traded groups with more than $100 million of assets or more than $50 million in revenue, and failure to meet the requirements could result in a rebuttable presumption that the intercompany debt is equity for U.S. tax purposes. The documentation is intended to establish that the debt instrument bears the hallmarks of debt for U.S. tax purposes. In response to concerns voiced by the insurance industry with respect to surplus notes, the final regulations provide that debt issued by a regulated insurance company is considered to meet the documentation requirements even if it requires the consent of a regulator to pay interest and principal, provided that at the time of the issuance it is expected to be repaid and documentation is maintained to reflect this expectation.

The final regulations generally retain the basic construct of the proposed regulations with respect to so-called "per-se stock" transactions. Specifically, an intercompany debt instrument issued in a distribution, in an acquisition of stock of an expanded group member or in exchange for property in an asset reorganization is treated, per se, as stock for tax purposes. As a backstop to this rule, the final regulations also retain the so called "funding rule" pursuant to which intercompany debt is treated as stock to the extent it funds a distribution or acquisition within the six-year period surrounding the issuance of the debt instrument. However, the final regulations provide a variety of new exceptions and relax certain provisions of the proposed regulations. Among the most significant exceptions that were added or expanded by final regulations are those described below.

- **Exclusion for Debt Issued by Regulated Entities:** Debt instruments issued by regulated financial entities and regulated insurance companies that are subject to a specified degree of regulation are exempt from the per-se stock rule, reflecting the view of the Treasury Department and the IRS that regulated financial companies that are subject to risk-based capital requirements and other regulations are less likely to engage in the types of transactions targeted by the Section 385 regulations. Specifically, with respect to insurance companies, the debt issued is not subject to the per-se stock rule if the insurance company is: (i) subject to tax under subchapter L of the Code; (ii) domiciled or organized under the laws of a state or the District of Columbia; (iii) licensed, authorized or regulated by one or more states or the District of Columbia to sell insurance, reinsurance or annuity contracts to

unrelated persons; and (iv) engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance or annuity contracts with unrelated persons. These requirements effectively carve out captive insurers and reinsurers from the exclusion, as such companies typically are not subjected to the degree of regulation applied to commercial insurance companies.

- **Exclusion for Short-Term Cash Management and Cash Pooling Arrangements:** The regulations generally exclude from the per-se stock rule deposits to cash management arrangements, as well as certain loans that finance short-term liquidity needs.

- **Exclusion for Ordinary Course Loans:** A debt instrument issued to acquire property, other than money, in the ordinary course of the issuer's trade or business that is reasonably expected to be repaid within 120 days is excluded from the rule.

- **$50 Million Exception:** Taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.

- **Earnings and Profits Exception:** The regulations include an earnings and profits exception, which offsets intragroup distributions and acquisitions that could otherwise cause a recharacterization of debt as equity, to include all earnings and profits of a corporation that are accumulated while the company is a member of the expanded group in taxable years ending after April 4, 2016.

- **Reinsurance Arrangements:** In response to concerns expressed by the insurance industry, the regulations clarify that insurance and reinsurance arrangements generally would not be subject to the recast rules as these rules only apply to interests that would otherwise be characterized as debt instruments, and such arrangements generally would not be considered debt instruments.

The per-se stock rule applies to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016. Thus, taxpayers were given a 90-day window to unwind instruments issued after April 4, 2016, which instruments might otherwise be caught by these rules, without adverse effect. Neither the documentation or per-se stock recast rules apply to debt instruments issued within a consolidated group, as all members of a consolidated group are treated as a single corporation for purposes of the section 385 regulations. However, the Treasury Department and the IRS denied the insurance industry's request to include life insurance companies in the consolidated group exception during the five-year waiting period to join a consolidated group for recently acquired life insurance companies.

2. Uncertain Application of Border Adjusted Tax Proposals to Offshore Insurance

With a Republican sweep of the executive and legislative branches of government in last November's elections, it is expected that Republicans in Congress will undertake substantive discussion of comprehensive tax reform during the early days of the new Congress that convened this January, and will be in a position to enact their approach to tax reform into law. These tax reform efforts are expected to build upon principles incorporated in the House Tax Reform Task Force "blueprint" for comprehensive tax reform released on June 24, 2016, (the "Blueprint") as well as tax proposals advanced by President–Elect Donald Trump during his campaign. In addition, the Republican leadership in the Senate has been working on a comprehensive corporate tax integration plan designed to eliminate the current system of double taxation of corporate earnings, and this plan could significantly differ from the House and Trump proposals. While President-elect Trump has promised individual and business tax reductions across the board, it is important to note that the congressional Republican leadership's approach to tax reform over the past few years has been to lower tax rates, but close loopholes to produce what amounts to a revenue-neutral package. Trump has indicated little concern about tax losses or deficits with regard to his tax proposals, so this could be the basis for some tension between the new administration and congressional Republican leadership. However, Trump seems willing to show a good deal of deference to congressional leadership on tax reform,

while reserving to presidential leadership such areas as immigration, trade and foreign relations. As a result, while there may be tension, the probability that Republicans will take advantage of this "once in a lifetime" chance for comprehensive tax reform and quickly resolve their differences is high.

Both the Blueprint and the Trump plan call for significant reductions in the corporate tax rates. The Blueprint, which is a far more developed plan, allows for full and immediate write-offs of investment in tangible and intangible assets, indefinite carryforward of net operating losses (although NOLs could not be carried back and the NOL carryforward to a particular taxable year could only be used to offset 90% of the taxable income in that taxable year) and a reduction in the tax imposed on individual shareholders with respect to dividends and capital gains from the disposition of shares to mitigate the effective double taxation of corporate earnings. The Blueprint also would eliminate the deductibility of interest expense in excess of interest income in a bid to equalize the tax treatment of different types of financing and eliminate tax-induced distortion in investment financing decisions. In a nod to the importance of interest expense and interest income to the business models of financial services companies, including insurance companies, the Blueprint would provide for an exception to the interest expense limitation for such companies.

In a dramatic shift in the corporate income tax system, the Blueprint moves towards a territorial system based on consumption, largely repealing the subpart F anti-deferral rules that required U.S. multinationals to include in their U.S. corporate income tax base certain types of income of foreign subsidiaries on a current basis and excluding from tax dividends received from foreign subsidiaries of U.S. multinationals. The shift to a consumption-, or destination-, based tax for taxing business income would assert tax jurisdiction on the basis of consumption rather than production through border adjustments exempting exports and taxing imports, rendering the jurisdiction of incorporation irrelevant. The idea would be to tax sales of products, services or intangibles to U.S. customers and exempt such sales to foreign customers, regardless of the location of the production activities or whether the taxpayer is foreign or domestic. The intent would be to eliminate the incentives under current law to move or locate operations outside the United States. The application of any such system to the insurance industry, if no exemption is provided, would be fraught with complexity, and the method through which any such tax would be collected is unclear. Insurance industry participants have been meeting with House Ways and Means Committee representatives to discuss the implementation of any such proposals. In addition to concerns of the insurance industry, there is growing resistance to this potential proposal from the manufacturing and retail sectors such that, despite the support the border adjustment proposal has from Republicans on the House Ways and Means Committee, the prospects for such a dramatic change are still unclear. We are likely to have a better feel for where comprehensive tax reform is heading by the spring of 2017.

B. U.K. Developments

1. Restrictions on Tax Deductibility of Interest Expense

New U.K. restrictions on the tax deductibility of net interest expense will apply, without modification for the insurance sector, from April 1, 2017. There is no grandfathering of existing debt. Accordingly, all groups containing U.K. corporation tax payers should review their existing debt financing arrangements.

The Organisation for Economic Cooperation and Development (the "OECD"), in its final reports on Base Erosion and Profit Shifting issued in October 2015 ("BEPS Reports"), made certain recommendations with respect to the tax deductibility of interest expense. Restrictions of a similar nature already exist in certain jurisdictions, such as Germany and Italy. Following a consultation on its proposals to implement the OECD recommendations, the U.K. Government published draft legislation in December 2016 for inclusion in the Finance Bill 2017.

a) Key Features of the New Regime

All groups will be able to deduct up to £2 million of net interest expense (being interest expense less interest income) each year in calculating profits subject to U.K. corporation tax. Net interest expense above this lower limit will be subject to a cap, which is either:

- 30% of the tax-adjusted EBITDA of the U.K. group (the fixed ratio method); or
- the ratio of the net interest expense of the worldwide group to its worldwide EBITDA, multiplied by the tax-adjusted EBITDA of the U.K. group (the group ratio method).

The group can elect which method to apply in a reporting period.

The purpose of the group ratio is to allow genuine third party interest costs to be deducted if a business has a higher level of gearing than 30%. However, reliance on the group ratio does introduce some volatility into the U.K. interest tax capacity because, if the non-U.K. operations outperform the U.K. operations, then the U.K. interest tax capacity under the group ratio goes down.

In neither case can the net interest deduction exceed the net interest expense of the worldwide group. This additional rule prevents groups from using intra-group debt to impose (tax-deductible) interest costs on the U.K. group, in a situation where the U.K. group can satisfy the 30% fixed ratio test but there is very little external debt in the worldwide group. This is effectively a surviving element of the U.K.'s existing worldwide debt cap ("WWDC") regime, which will itself be repealed as part of these new measures. Hence the label given to this element of the new rules: the "modified debt cap."

Interest expense includes all financing costs on loans, such as discounts, premia and facility fees. In calculating net interest expense, interest income is similarly broadly defined. Impairment losses in respect of financial assets are generally excluded from "interest expense" unless those losses arise from the use of fair value accounting. In other words, only impairment losses on capital assets are outside the new restrictions; impairment losses on an insurance company's investment portfolio holdings of bonds would be taken into account in calculating the net interest expense.

Importantly, tax deductions for interest on both external and intra-group debt are potentially restricted. Accordingly, the new measures have a wider reach than the familiar restrictions on related party debt, such as transfer pricing and thin capitalization.

If a U.K. group does not use up all of its interest capacity in a particular year, it can carry forward that excess capacity for up to five years. Furthermore, any disallowed net interest expense can be carried forward indefinitely.

b) No Exemption or Modification for the Insurance Industry

Insurance groups were exempted from the WWDC regime but will not be exempted from any of these new restrictions. In the BEPS Report, the OECD recognized that the proposed measures may not be appropriate in the context of banking and insurance groups, and a separate public discussion draft was released in July 2016 on approaches to applying restrictions on deductibility of interest in these sectors (the "BEPS Discussion Draft"). On December 22, 2016, an updated report was released with a new section on addressing base erosion, involving interest payments, in the banking and insurance sectors (the "Updated BEPS Report").

The OECD noted that banking and insurance businesses are unique in the sense that they are more likely to have net interest income than net interest expense and are already subject to regulatory capital rules and commercial constraints that require them to hold minimum amounts of equity and prevent them taking on excessive debt. Modified rules for the banking and insurance sectors were floated as a possible alternative approach in both the BEPS Discussion Draft and the U.K. consultation exercise. This idea was rejected by respondents as being too difficult to administer and likely to give rise to unintended consequences.

The Association of British Insurers (the "ABI"), in its response to the BEPS Discussion Draft, suggested that insurance groups be excluded altogether from the rules. Most respondents to the U.K. consultation also expressed this view. However, in its December 2016 response to the consultation exercise, a full exclusion from the restrictions was rejected by the U.K. Government as unjustified. While no reasons were given for this conclusion, the Updated BEPS Report and the BEPS Discussion Draft observe that, despite regulatory and commercial constraints, excessive debt and interest deductions can be used in the banking and insurance sectors to carry out base erosion and profit shifting. This could be because regulatory restrictions allow certain interest-bearing instruments to be treated as regulatory capital, meaning leverage for tax purposes is higher than leverage for regulatory purposes. The comment is also made that debt can be placed in non-regulated entities or branches that do not need to be separately capitalized for regulatory purposes, in which case the regulatory regime is not policing the level of debt independently of tax law.

In their response to the consultation exercise, the U.K. Government say that in calculating the worldwide group's net interest expense, interest on related party debt and interest that would not ordinarily qualify for tax relief in the U.K. because of its equity-like features is to be ignored. The relevant sections of the draft legislation have not yet been published. When they become available, it will be important to see whether interest paid on Solvency II compliant Tier 1 and Tier 2 securities (which, by virtue of specific U.K. tax regulations, is treated as (deductible) interest for U.K. tax purposes despite the permanency and subordination characteristics of the securities) will be taken into account in determining the worldwide group's net interest expense.

2. More Flexible, but Slower, Use of Tax Losses

Reforms to the U.K. corporation tax loss relief regime will apply from April 1, 2017. The aim is to increase flexibility for businesses while ensuring that large profitable businesses pay at least some corporate income tax each year. For accounting periods that straddle April 1, 2017, losses and profits will be split between pre- and post- commencement date tax periods on a time-apportionment basis.

a) Greater Flexibility in Use of Carried Forward Tax Losses

The U.K.'s existing loss relief rules contain a number of restrictions on the use of carried-forward losses. For example, trading losses can only be carried forward and set off against losses of the same trade in future periods. Non-trading losses can be carried forward but cannot be set off against future trading profits. Under the new rules, corporation tax losses incurred after April 1, 2017 will be able to be set off against total profits and not just against certain income streams.

Furthermore, the current rules only allow a member of a U.K. group to offset its current year losses against profits of other group members. Under the new rules, losses incurred after April 1, 2017 can be carried forward and set off against profits of other members of the group in subsequent years.

b) Restrictions on Deduction of Carried-Forward Losses

Counteracting the benefits of this increased flexibility, the new rules restrict the amount of trading profits that can be sheltered by carried-forward losses in any year. The restrictions will apply to all losses, including losses that arose before April 1, 2017.

A company will only be able to use carried-forward losses to shelter trading profits up to the sum of:

- its allocation out of the £5 million annual allowance for each U.K. group (or £5 million in the case of a standalone U.K. company that is not a member of a U.K. group); and
- 50% of the company's relevant profits above its allowance.

The £5 million allowance is available to each U.K. "group", with "group" broadly defined in the same way as for group relief purposes (that is, a company and its 75% subsidiaries). There are additional rules that look through trusts, unincorporated associations and other arrangements that could be designed to break the group relationship artificially so as to gain an additional £5 million allowance.

There are no changes to the utilization of a company's current year losses nor to in-year group relief. Losses will also continue to be capable of being carried forward indefinitely.

The insurance industry expressed concerns during the consultation process as to the impact of these restrictions. In particular, it noted that they could have a disproportionate effect on insurance companies due to volatility of profits in the sector. The U.K. Government rejected proposals to mitigate this effect, on the basis that the policy intention of the restrictions is to ensure businesses with substantial profits pay tax each year.

In addition, the insurance industry expressed concern that the restrictions would reduce the value of carried-forward losses recognized on the balance sheet as a deferred tax asset, thereby potentially reducing the insurer's loss absorbing capacity or increasing its solvency capital requirement and thus reducing its capital ratio for the purposes of the regulatory capital requirements of the Solvency II Directive 2009/138/EC. The U.K. Government consulted with the insurance industry, including the ABI and the PRA, but came to the conclusion that this adverse result was an acceptable consequence of the new rules.

3. More Generous Substantial Shareholding Exemption

The substantial shareholding exemption (the "SSE") exempts companies from corporation tax on gains made on a disposal of a "substantial shareholding" in another company, provided both the investing and investee companies meet certain trading conditions with regard to their activities. The U.K. Government has consulted on changes to the SSE to make it simpler to apply and increase the U.K.'s competitiveness internationally as a holding company jurisdiction.

Draft Finance Bill 2017 provisions, amending the SSE, have now been published. The following new rules will apply in respect of disposals on or after April 1, 2017:

(a) *The investing company (i.e., the company disposing of its substantial shareholding) no longer needs to be a trading company or a member of a trading group, before or after the disposal.*

This will be welcome news for large groups that have otherwise had the administrative burden of assessing whether the trading requirement is met in respect of the whole group or a sub-group. Investing companies that cease to satisfy the trading requirement as a result of the disposal will not be prevented from accessing the SSE.

(b) *The investing company must have held the substantial shareholding (i.e., a 10% shareholding) for a continuous period of 12 months at any time in the six years prior to the disposal (rather than the previous two years).* This amendment will address concerns about disposals of a shareholding in tranches that might otherwise have fallen foul of the holding period requirement.

(c) *While the investee company (i.e., the company whose shares are being disposed) will still need to be a trading company or a holding company of a trading group or sub-group prior to the disposal, this trading requirement no longer needs to be satisfied after the disposal where the disposal is to a person unconnected with the investing company.*

An investing company will no longer need to obtain assurances from a third party buyer, over which it has no control, that the investee company will continue to trade after the transaction.

(d) *The SSE will be available to investing companies that are owned by qualifying institutional investors.*

As highlighted in the consultation papers, certain institutional investors (such as pension funds, charities, etc.) could directly dispose of a 10% shareholding in a company for a gain that is exempt from U.K. corporation tax. However, if those same institutional investors had interests in an intermediate U.K. company that in turn sold that same 10% shareholding in another company, that intermediate U.K. company would not necessarily be entitled to the SSE. This has led to artificial distortions in the tax treatment of different holding structures.

The Finance Bill 2017 will extend the scope of the SSE for investing companies that are owned by qualifying institutional investors. If more than 80% of the investing company's ordinary share capital is directly or indirectly owned by qualifying institutional investors, there will be no taxable gain or loss on disposal of a "substantial shareholding" by the investing company, without regard to the trading status of the investing or investee companies. A pro-rata exemption will apply where the ownership percentage of qualifying institutional investors is between 25% and 80%. Qualifying institutional investors are pension schemes, life assurance businesses, sovereign wealth funds, charities, investment trusts and widely marketed U.K. investment schemes.

The new rules will also recognize that investing companies that are directly or indirectly owned by qualifying institutional investors may make a significant investment in another company without acquiring 10% of the ordinary share capital, that being the current minimum stake in order to constitute a "substantial shareholding." In the future, the "substantial shareholding" requirement will be met if the cost of acquiring shares in the investee company is at least £50 million (whether or not the investment is made in tranches), provided the investing company is beneficially entitled to a proportionate share of the profits available for distribution by the investee company and its assets on a winding-up.

By way of example, if a U.K. investing company that was wholly owned by a life assurance business acquired a 9% stake in a non-trading investee company for £50 million, then the investing company would qualify for the SSE if it were beneficially entitled to 9% of the dividends and 9% of the assets on a winding-up.

The U.K. Government rejected the proposal of some respondents that the SSE be replaced with an exemption that mirrored the generous scope of the U.K. corporate tax exemption for dividend income. The tax avoidance risks, such as enveloped assets being held through layers of U.K. companies, were thought to outweigh the benefits of a broader participation exemption. Nevertheless, these various relaxations in the SSE conditions will further enhance the U.K. as an attractive holding company jurisdiction, both for a parent of an insurance group and for an intermediate investment vehicle for certain institutional investors.

4. Onshore U.K. ILS Vehicles

The U.K. Government has published a further consultation document and draft legislation, with a view to introducing a new corporate, tax and regulatory framework during 2017, in order to facilitate the establishment of ILS vehicles onshore the U.K. These proposals are described in more detail in our Client Alert titled "Proposed ILS Regime for the U.K." dated December 1, 2016.

ACPR—the French Autorité de Contrôle Prudentiel et de Résolution, which oversees prudential regulation of insurers in France.

AMF—the French Autorité des Marché Financiers, which is France's listing authority.

BaFin—the German Federal Financial Supervisory Authority, which oversees the supervision of insurance companies in Germany and ensures the viability, integrity and stability of the German financial system.

BMA—the Bermuda Monetary Authority, which supervises and regulates financial institutions in Bermuda, including insurers.

EIOPA—the European Insurance and Occupational Pensions Authority, which is responsible for supporting the stability of the E.U.'s financial system, transparency of markets and financial products as well as the protection of insurance policyholders, pension scheme members and beneficiaries.

FCA—the U.K.'s Financial Conduct Authority, which oversees the conduct of the U.K's financial institutions as well as acting as the U.K.'s listing authority.

Federal Reserve Board—the Board of Governors of the Federal Reserve System of the United States, which oversees the central bank of the United States and helps to implement U.S. monetary policy.

FIO—the Federal Insurance Office. Established by the Dodd-Frank Act as an office within the Treasury Department to monitor the insurance industry in the United States and to represent the United States on international insurance matters.

FSB—the Financial Stability Board. An international body formed by the G-20 to promote reform of international financial regulation.

FSOC—the Financial Stability Oversight Council. Established under the Dodd-Frank Act to provide comprehensive monitoring of the financial system of the United States.

IAIS—the International Association of Insurance Supervisors. A member of the FSB, the IAIS is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions.

IMF—the International Monetary Fund. An organization of 188 countries established in 1944 to, among other things, work toward securing international financial stability.

Lloyd's—Lloyd's of London.

NAIC—the National Association of Insurance Commissioners. The U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories.

PRA—the U.K.'s Prudential Regulation Authority, which is responsible for the prudential regulation and supervision of insurers in the U.K.

USTR—the Office of the United States Trade Representative. Executive agency responsible for developing and recommending U.S. trade policy to the President.

Willkie's Insurance Transactional and Regulatory Practice

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