

INSURANCE INDUSTRY IMPLICATIONS OF THE DODD-FRANK ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) has significant implications for the insurance industry. A newly established Federal Insurance Office within the U.S. Department of Treasury is authorized to collect data on the insurance industry, recommend changes to the state system of insurance regulation and preempt certain state insurance laws. A new Federal council of financial regulators led by the Treasury Secretary may determine that an insurance company or insurance broker is systemically significant and therefore subject to prudential supervision by the Board of Governors of the Federal Reserve System. In addition, the Dodd-Frank Act will specifically reform the state regulation of certain aspects of surplus lines insurance and reinsurance. Significant components of the Dodd-Frank Act related to insurance are described herein. The implications of the Dodd-Frank Act for the insurance industry will crystallize as the new Federal agencies develop prudential standards and recommendations for insurance regulation, and state regulators respond to the changes required by the new law.

Title I – Systemic Regulator

Financial Stability Regulation and Oversight

Composition of the Financial Stability Oversight Council

Title I of the Dodd-Frank Act establishes a Financial Stability Oversight Council (the “Council”) to identify risks to the financial stability of the United States, promote market discipline and respond to emerging threats to the stability of the United States financial markets. The Council is chaired by the Treasury Secretary. Voting members include the Chairman of the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the Chairperson of the Securities and Exchange Commission (the “SEC”), the Director of the newly established Bureau of Consumer Financial Protection (the “Bureau”) and other Federal agencies¹ and an independent member having insurance expertise appointed by the President. As a result of a compromise made during the conference committee stage, the Director of the Federal Insurance Office (the “FIO”), a new office within the Treasury Department described herein, and a state insurance commissioner will serve in an advisory capacity as nonvoting members of the Council.²

¹ The Council’s voting members also include the Comptroller of the Currency, the Chairperson of the Federal Deposit Insurance Corporation (the “FDIC”), the Chairperson of the Commodity Futures Trading Commission (“CFTC”), the Director of the Federal Housing Finance Agency and the Chairperson of the National Credit Union Administration Board.

² The process by which a state insurance commissioner will be chosen to serve on the Council is to be determined by state insurance commissioners. The other nonvoting members of the Council will be the Director of the Office of Financial Research, a state banking supervisor and a state securities commissioner (or an officer performing similar functions).

Implications for the Insurance Industry – One voting member of the Council is an independent member to be appointed by the President having insurance expertise. Two additional insurance regulatory experts - the Director of the FIO and a state insurance commissioner - are nonvoting members of the Council.

General Oversight and Monitoring Functions of the Council

To promote the stability of the United States financial markets, the Council is charged with monitoring financial services markets and domestic and international financial regulatory developments (including insurance issues), collecting information from various financial regulatory agencies and coordinating the exchange of information regarding financial services policy development, rulemaking and enforcement actions among agencies. To support the Council in fulfilling its duties, the Dodd-Frank Act creates an Office of Financial Research (the “Office”) within the Treasury Department, which will collect information on behalf of the Council and develop ways to measure and monitor risk. To mitigate the burden of reporting on financial companies, the Office must work with the relevant regulatory agencies to determine whether the requested data can be collected without directly requesting such information from a financial company. The Office will also assist agencies represented by a voting member of the Council in determining how best to collect data from the companies they regulate.

The Council is empowered to make recommendations to primary financial regulatory agencies regarding the application of new or heightened standards and safeguards for financial activities or practices, and certain participation in such activities, that threaten the stability of United States financial markets. A primary financial regulatory agency must impose standards recommended by the Council, or standards similar to those recommended, or must explain in writing to the Council why the agency has determined not to follow the recommendations.

Implications for the Insurance Industry – The Council may affect state regulation of the insurance industry by making recommendations to state insurance regulators to apply new or heightened financial standards.

The Council’s Authority to Require Federal Reserve Supervision of Certain Nonbank Financial Companies

The Dodd-Frank Act grants the Council the authority to determine, with a two-thirds vote, including an affirmative vote by the Treasury Secretary, that a “Nonbank Financial Company” whose material financial distress or failure would threaten the financial stability of the United States should be subject to supervision by the Federal Reserve.

Definition of a Nonbank Financial Company

A Nonbank Financial Company is a foreign or U.S. entity³ “predominantly engaged in financial activities.” A company is predominantly engaged in financial activities if either:

- (i) the company and all of its subsidiaries⁴ derive 85% or more of their consolidated annual gross revenues from activities that are “financial in nature”; *or*
- (ii) 85% of the company’s and all of its subsidiaries’ consolidated assets relate to activities that are “financial in nature.”⁵

The definition of “financial in nature” is found in the Bank Holding Company Act of 1956 (the “Bank Holding Company Act”). Section 4(k) of the Bank Holding Company Act identifies the following activities as being “financial in nature”:⁶

- Lending, exchanging, transferring, investing for others, or safeguarding money or securities;
- Insuring, guaranteeing or indemnifying against loss, harm, damage, illness, disability, or death or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any state;
- Providing financial, investment, or economic advisory services, including advising an investment company;
- Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
- Underwriting, dealing in, or making a market in securities; and
- Engaging in any activity that the Federal Reserve has determined . . . to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. . . .

³ In addition to U.S. and non-U.S. “companies” “predominantly engaged in financial activities,” other entities such as national securities exchanges, clearing agencies, boards of trade and swap execution facilities are included within the definition of a Nonbank Financial Company.

⁴ For foreign Nonbank Financial Companies, references to companies and subsidiaries include only the U.S. activities and subsidiaries of such foreign companies except as otherwise provided. *See* Dodd-Frank Act, § 102C.

⁵ In determining whether the threshold amount has been met under either test, one must also consider, if applicable, the percentage amount derived from the ownership or control of one or more insured depository institutions.

⁶ *See* Section 4(k)(4) of the Bank Holding Company Act for the complete list of financial activities.

The Federal Reserve will establish additional requirements for determining if a company is predominantly engaged in financial activities.

Implications for Insurance Industry – Because the businesses of insurance companies and insurance brokers are “financial in nature,” a U.S. or non-U.S. insurance company or insurance broker that satisfies the 85% of gross revenues or consolidated assets test would be included in the definition of a Nonbank Financial Company.

Determination by the Council that a Nonbank Financial Company Should Be Supervised by the Federal Reserve

In making a determination that a Nonbank Financial Company should be subject to supervision by the Federal Reserve, the Council will consider the Company’s degree of leverage, the amount and nature of the company’s assets and liabilities, and the relationships the company has with other significant Nonbank Financial Companies and significant bank holding companies. Additionally, prior to recommending that the Federal Reserve supervise a company, the Council should consider the degree to which the company is already regulated by one or more primary financial regulatory agencies.⁷

Implications for the Insurance Industry – The Council must consult with the domestic state insurance regulator prior to making any final determination as to whether an insurance company that qualifies as a Nonbank Financial Company should be subject to supervision by the Federal Reserve. Whether the Council will give deference to the state insurance authorities remains to be seen.

Prior to making a final determination regarding supervision of a company by the Federal Reserve, the Council must provide written notice of the proposed determination, and the company may request a hearing before the Council within thirty (30) days from receipt of the notice.⁸ After the hearing, the Council must notify the company of its final determination, which is subject to judicial review if still disputed by the company. This review is deferential to the Council, however, since the Council’s decision will be overturned only if it is found to be “arbitrary and capricious.” The Council must reevaluate its determination that a company should be subject to supervision by the Federal Reserve no less than annually.

The Council may also make recommendations to the Federal Reserve regarding, among other things, the establishment of more stringent prudential standards for risk-based capital, resolution plans, increased reporting and disclosure requirements and general risk management for

⁷ The Federal Reserve in consultation with the Council may create safe harbors, exempting certain types of U.S. Nonbank Financial Companies from supervision by the Federal Reserve. Dodd-Frank Act, § 170.

⁸ The Dodd-Frank Act allows the Council to waive or modify these procedural requirements if the Council determines, upon a two-thirds vote, that such a waiver or modification is necessary to protect the financial stability of the United States.

Nonbank Financial Companies that are supervised by the Federal Reserve (“Supervised Nonbank Financial Companies”).⁹

Supervision of a Nonbank Financial Company by the Federal Reserve

A Supervised Nonbank Financial Company will be subject to specific prudential standards and reporting requirements regarding its activities and stability. In addition, the Federal Reserve may require enforcement by the functional regulator if the actions of a subsidiary of a Supervised Nonbank Financial Company subject to such regulator’s supervision do not comply with the regulations or orders of the Federal Reserve. Although rules and regulations regarding the Federal Reserve’s supervision of Supervised Nonbank Financial Companies are forthcoming, Title I indicates that among other requirements, Supervised Nonbank Financial Companies will be subject to prudential standards developed by the Federal Reserve, including:

- Risk-based capital requirements and leverage limits;
- Liquidity requirements;
- Overall risk management requirements;
- Submitting a resolution plan for the rapid and orderly resolution in the event of material financial distress or failure;
- Limitations on credit exposure - supervised companies may not have credit exposure that exceeds 25% of their capital stock and surplus;
- Concentration limits;
- Contingent capital requirements;
- Enhanced public disclosures;
- Limits on short-term debt, including off-balance sheet exposures; and
- Stress tests - evaluating the company based on whether it has the capital necessary to absorb losses as a result of adverse economic conditions.

These standards may be stricter than standards applicable to Nonbank Financial Companies that are not subject to supervision by the Federal Reserve. Before imposing prudential standards on supervised Nonbank Financial Companies, the Federal Reserve will consult with Council members that primarily supervise any subsidiary of the Nonbank Financial Company.

⁹ Title II of the Dodd-Frank Act addresses the orderly liquidation of Nonbank Financial Companies supervised by the Federal Reserve. The implication of Title II for regulated financial companies, including insurance groups, is the subject of a forthcoming WFG Client Memorandum.

If the Federal Reserve determines that the company poses a grave threat to the financial stability of the United States, it may also impose leverage limitations, requiring the company to maintain a debt to equity ratio of no more than fifteen (15) to one (1). If the company is experiencing increasing financial distress, it may also be subject to “early remediation” to minimize the probability that the company will become insolvent and harm the financial stability of the United States.

Implications for the Insurance Industry – If an insurance company is subject to supervision by the Federal Reserve, that company may be subject to standards potentially more stringent than those already imposed on it by its state regulator.

Title V – Insurance

Title V of the Dodd-Frank Act addresses insurance industry matters in two subtitles: Subtitle A, entitled the “Federal Insurance Office Act of 2010” and Subtitle B, regarding state-based insurance reform, entitled the “Nonadmitted and Reinsurance Reform Act.”

The Federal Insurance Office Act of 2010 (the “FIO Act”)

The FIO Act establishes the FIO, a new office within the Treasury Department. The FIO is not granted general supervisory or regulatory authority over the insurance industry;¹⁰ however, it may have a significant effect on insurance regulation in general and certain insurers in particular. Specifically, the FIO (i) will affect those insurers it recommends for Federal Reserve supervision as Nonbank Financial Companies; (ii) may preempt state insurance measures that conflict with certain international agreements (“Covered Agreements”)¹¹ and disfavor non-U.S. insurers; and (iii) may make recommendations to Congress that will affect the current insurance regulatory framework.

The FIO Act also authorizes the Treasury Secretary and the United States Trade Representative to negotiate international agreements regarding prudential measures concerning insurance or reinsurance, subject to consultation with Congress.

¹⁰ Title V provides that it does not preempt state insurance measures governing rates, premiums, underwriting or sales practices, state coverage requirements for insurance or the application of state antitrust laws. Dodd-Frank Act, Title V, Subtitle A, § 313(j). Nothing in the FIO Act shall be considered to provide the FIO or the Treasury Department with general supervisory authority over the business of insurance. *Id.* at § 313(k).

¹¹ A “covered agreement” is a written international agreement (bilateral or multilateral) between the U.S. and one or more foreign governments, authorities or regulatory entities concerning the business of insurance or reinsurance that relates to the “recognition of prudential measures” and achieves protections for insurance and reinsurance consumers “substantially equivalent to the protection afforded under state insurance or reinsurance regulation.” *Id.* at § 313(r)(2).

FIO Functions

The FIO Director will be appointed by the Treasury Secretary and will serve in an advisory capacity on the Council. The Treasury Department may issue orders, regulations, policies and procedures to implement the FIO Act.

The FIO's authority to report on and monitor the insurance industry extends to all lines of insurance, with the exception of health insurance, certain long-term care insurance and crop insurance. The FIO's specific functions fall into the following categories:

1. monitoring the insurance industry;
2. coordinating Federal policy on international insurance matters, including representing the U.S. in the International Association of Insurance Supervisors and assisting the Treasury Secretary in negotiating Covered Agreements;
3. consulting with states regarding national and international insurance matters;
4. identifying gaps in insurance regulation that could contribute to a systemic crisis;
5. recommending to the Council that an insurer be supervised as a Nonbank Financial Company by the Federal Reserve; and
6. determining whether state measures are preempted by certain Covered Agreements.

Implications for the Insurance Industry – Although, in the short term, the FIO has limited direct regulatory insurance authority, its authority to assess the effectiveness of state insurance regulation and recommend a Federal insurance regulatory framework may have a significant impact on the insurance business in the future.

Data Collection Authority

The FIO is authorized to gather information, enter into information-sharing agreements with state insurance regulators, analyze and disseminate data and issue reports on the insurance industry.

The FIO may collect data and information reasonably required to carry out its functions from an insurer¹² or any affiliate of an insurer. In order to limit the burden of the data collection on insurers¹³ and their affiliates, prior to requiring an insurer's submission of such information, the

¹² For the purposes of this provision regarding data collection, an insurer is defined as "any person that is authorized to write insurance or reinsure risks and issue contracts or policies in one or more states." *Id.* at § 313(e)(2)(B).

¹³ Additionally, certain sufficiently small insurers (as may be established by the FIO) and their affiliates will be exempt from this requirement.

FIO must coordinate with relevant Federal agencies, state insurance regulators and public sources to determine if it can obtain the information from such sources. The FIO will have the power to subpoena information from insurers (and their affiliates) upon a written finding that such information is required to effectuate the FIO's functions and that such information is not available from other regulators or public sources. The submission of nonpublic information will not waive any privilege attaching to the information and will be subject to existing confidentiality agreements.

Covered Agreements and Preemption

The FIO Act (i) defines an international agreement between the United States and foreign governments related to the recognition of prudential measures regarding the business of insurance or reinsurance as a "Covered Agreement"; (ii) authorizes the Treasury Secretary and the U.S. Trade Representative to jointly negotiate and enter into Covered Agreements with foreign governments, authorities or regulatory bodies in consultation with Congress; and (iii) authorizes the FIO to preempt a state insurance measure that conflicts with a Covered Agreement.¹⁴

The FIO is granted preemption authority over state measures in the limited circumstance where the state measure is (i) inconsistent with a Covered Agreement and (ii) results in less favorable treatment of a non-U.S. insurer, provided that such insurer's domiciliary jurisdiction is a party to such Covered Agreement. As part of the preemption process, the FIO must notify and consult with the appropriate regulators and interested parties, publish notice of its intent and allow interested parties the opportunity to comment.

More specifically, upon making a determination of inconsistency, the FIO must notify the appropriate state, establish a reasonable time period (not less than 30 days) before the determination becomes effective, and notify the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services of the inconsistency. Determinations of an inconsistency will be subject to *de novo* judicial review, a provision favored by such groups as the National Association of Insurance Commissioners (the "NAIC") and the Property Casualty Insurers Association of America and initially rejected by Senate conferees. No state may enforce an insurance measure to the extent that such measure has been preempted by the FIO.

Reports to Congress

The FIO is required to issue three sets of reports to Congress beginning in September 2011. The reports fall into the following categories:

- Annual Report to Congress. Beginning September 30, 2011, and annually thereafter, the FIO must report to the President and Congress on (i) any preemption actions taken by the FIO and (ii) the insurance industry in general.

¹⁴ A "state insurance measure" is broadly defined to include "any State law, regulation, administrative ruling, bulletin, guideline or practice relating to or affecting prudential measures applicable to insurance or reinsurance." *Id.* at § 313 (r)(7).

- Reports on U.S. and Global Reinsurance Market. The FIO must submit two kinds of reports to Congress regarding reinsurance: (i) no later than September 30, 2012, the FIO must submit a report to Congress on the global reinsurance market and “the critical role it plays in supporting insurance in the United States” and (ii) no later than January 1, 2013 (followed by an update by January 1, 2015), the FIO must report to Congress on the impact of the reinsurance reforms included in the Nonadmitted and Reinsurance Reform Act of 2010, discussed below, “on the ability of state regulators to access reinsurance information for companies regulated in their jurisdictions.”
- Study and Report on the Regulation of Insurance. By January 2012, the FIO is required to conduct a study and submit a report to Congress on how to modernize and improve insurance regulation in the United States. The FIO is authorized to consult with state insurance regulators, consumer and trade associations in connection with the report.
 - Title V sets forth several considerations for the FIO in developing the report, including: systemic risk regulation for insurance; capital standards; consumer protection; existing national uniformity of state regulation; regulation of insurers and affiliates on a consolidated basis; international coordination of insurance regulation; costs and benefits of Federal regulation of insurance (except health insurance); feasibility of regulating only certain lines of insurance at the Federal level; and the potential consequences of subjecting insurance companies to a Federal resolution authority, including the effect such authority would have on the operation of the state insurance guaranty fund systems.

The Nonadmitted and Reinsurance Reform Act of 2010 (the “NRRA”)

The NRRA was a standalone bill passed by the House of Representatives several times, including in 2009, but never passed by the Senate. The NRRA contains two primary subsections, Part I, regarding surplus lines insurance, and Part II, regarding reinsurance. Except as otherwise specifically provided, the NRRA will take effect on July 21, 2011.

NRRA – Surplus Lines Insurance

Surplus Lines Insurance Background

Under current state insurance laws, policyholders may obtain coverage from nonadmitted insurers, *i.e.*, U.S. or foreign insurers not licensed in the state, either directly, through a process known as a direct procurement, or with the assistance of a specially licensed insurance broker - the surplus lines broker. Access to the nonadmitted market is generally necessary when consumers are unable to purchase the insurance due to unavailability or lack of capacity in the admitted market.

Prior to placing the risk with a nonadmitted insurer, the surplus lines broker must demonstrate that it has searched the admitted market and must place coverage only with “eligible” surplus lines insurers. Generally, surplus lines brokers have been responsible for maintaining licenses in each jurisdiction where any portion of insured risk is resident or located, filing affidavits that

admitted insurers have declined the risk, paying the appropriate surplus lines taxes to the various jurisdictions at issue, and maintaining files that may be audited by regulators.

The placement of multi-state risks triggers confusing, and often conflicting, state surplus lines rules. States in which a portion of an insured risk is located apply their own regulatory schemes to a multi-state risk, including licensing requirements, surplus lines taxes, filing requirements, deadlines and compliance procedures. As a result, the surplus lines compliance requirements for a multi-state risk may be duplicative or mutually exclusive. The burden of compliance with conflicting regulatory requirements has fallen on surplus lines brokers. For years, the surplus lines industry and others have been working to streamline these regulatory issues. The NRRA's objective is to create order by imposing a single "home state" focus in connection with licensing, surplus lines tax payments and compliance filings. When the NRRA becomes effective in July 2011, it will preempt certain state surplus lines laws but also maintain state insurance regulation of surplus lines transactions.

Home State Regulation of Nonadmitted Insurance

The NRRA requires single-state regulation of surplus lines insurance placements and requires the application by all states of uniform eligibility criteria for U.S. and foreign surplus lines insurers. Specifically, the NRRA:

- streamlines and simplifies the reporting, payment and allocation of premium taxes¹⁵ by providing that only the insured's home state¹⁶ may require payment of premium taxes for surplus lines insurance, and encourages the states to develop an interstate compact to provide for allocation and remittance procedures for these taxes;¹⁷

¹⁵ "Premium tax means, with respect to surplus lines or independently procured insurance coverage, any tax, fee, assessment, or other charge imposed by a government entity directly or indirectly based on any payment made as consideration for an insurance contract for such insurance, including premium deposits, assessments, registration fees, and any other compensation given in consideration of insurance." Dodd-Frank Act, Title V, Subtitle B, § 527(12).

¹⁶ "Home state" is defined as the principal place of business of the insured (or an individual's principal residence) unless 100% of the insured risk is located outside of that state, in which case it is the state with the greatest percentage of taxable premium for the insured risk. If the insured is an affiliated group, the "home state" is the principal place of business of the group member with the greatest percentage of taxable premium for the insured risk. *Id.* at § 527(6).

¹⁷ The impact of this provision is unclear. Congress does not mandate that states develop such a compact. If states fail to develop an interstate compact, the home state of the insured may opt to keep 100% of the premium tax. Conversely, since other states' measures to regulate the placement are preempted, in the absence of an interstate compact or similar measure, states other than the home state may collect no premium tax. If a compact is reached within 330 days of enactment, the NRRA provides that the premium taxes collected will be shared retroactively according to the compact. If the compact is reached after the expiration of 330 days, premium taxes will be shared on an ongoing basis beginning on January 1 of the first year after adoption of the compact.

- provides that surplus lines insurance will be subject solely to the requirements of the insured's home state (except for workers' compensation coverages), and prohibits states other than the insured's home state from requiring a surplus lines broker to be licensed there in order to procure surplus lines insurance;
- prohibits a state from collecting fees relating to licensing surplus lines brokers unless it has a mechanism in effect to participate in the NAIC's national insurance producer database or its equivalent;
- prohibits states from establishing eligibility criteria for U.S. surplus lines insurers except in conformance with the NAIC Nonadmitted Insurance Model Act or its equivalent;
- eliminates state prohibitions on placing insurance with a non-U.S. surplus lines insurer listed on the NAIC's Quarterly Listing of Alien Insurers;
- eliminates state requirements for a due diligence search with respect to coverage sought by an "exempt commercial purchaser"¹⁸ provided that (i) the surplus lines broker discloses that the coverage may or may not be available in the admitted market and (ii) the commercial purchaser has subsequently requested such nonadmitted coverage in writing;¹⁹ and
- requires the Comptroller General of the United States to study the impact of the enactment of these surplus lines reforms on the surplus lines market, studying, among other things, the consequences on the size and market shares of admitted and nonadmitted insurers.

State insurance regulators are working to develop interstate agreements, universal premium tax reporting forms and appropriate changes to applicable model laws prior to the effective date of the NIRA. The most recent compact solution considered by the NAIC was the Surplus Lines Insurance Multi-state Compliance Compact (the "SLIMPACT"). The SLIMPACT is a draft interstate compact that would allow surplus lines brokers to comply with the laws of, and be licensed in, only the home state of the insured when placing a multi-state risk, as well as permit

¹⁸ An "exempt commercial purchaser" is any person that (1) employs or retains a qualified risk manager; (2) has paid aggregate nationwide commercial property and casualty premiums in excess of \$100,000 in the past twelve (12) months; or (3) has

- (a) a net worth in excess of \$20,000,000, or
- (b) generates annual revenue in excess of \$50,000,000, or
- (c) employs more than 500 full-time employees per individual insured or as a member of an affiliated group employs more than 1,000 employees in the aggregate, or
- (d) is a not-for-profit or public entity that has annual budgeted expenditures of at least \$30,000,000, or
- (e) is a municipality with a population in excess of 50,000.

Id. at § 527(5).

¹⁹ The Comptroller is supposed to study the change in size and market share within the eighteen-month period after July 21, 2010. The report itself is due not later than January 2013.

compacting states to adopt uniform tax allocation formulae and establish an information clearinghouse for purposes of calculating the taxes owed to member states. Compacts, like the SLIMPACT, have failed to garner majority support from the states in the past; however, the anticipated implementation of the NRRA has spurred renewed interest in the compact approach. The NAIC also continues to work on the development of a universal tax allocation reporting form acceptable to all states.

NRRA – Reinsurance

Part II of the NRRA addresses states' extraterritorial regulation of credit for reinsurance and the solvency regulation of U.S. reinsurers.

Elimination of Extraterritorial Application of Credit for Reinsurance Standards

Under state insurance laws, a U.S. insurer, as ceding insurer, is authorized to take financial statement credit (as a deduction from liabilities or an addition to assets) for ceded reinsurance, provided that the assuming reinsurer satisfies specified "credit for reinsurance" requirements such as maintaining a state license or approval designation or establishing, in the United States, collateral in support of its reinsurance obligations. Many states apply such credit for reinsurance requirements only to their domestic insurers. However, some states impose their credit for reinsurance standards to all insurers licensed in the state, including insurers domiciled in another state. The application of credit for reinsurance standards to ceding insurers that are licensed, but not domiciled, in the state is deemed the "extraterritorial application" of the state's credit for reinsurance standards.

The NRRA prohibits a state in which a U.S. ceding insurer is licensed, but not domiciled, from denying credit for reinsurance if the ceding insurer's domestic state recognizes credit for reinsurance for the insurer's ceded risk and is an NAIC-accredited state (or has substantially similar financial solvency requirements). In addition, the NRRA generally preempts the application of a non-domiciliary state's laws to the extent such laws (i) restrict or eliminate an insurer's right to resolve disputes pursuant to contractual arbitration, (ii) require a certain state's law to govern the terms of a reinsurance contract, or (iii) attempt to enforce a reinsurance contract on terms different from those set forth in the actual contract.

Solvency Regulation of U.S. Reinsurers

The NRRA makes the U.S. reinsurer's state of domicile the sole regulator of the reinsurer's financial solvency if the state of domicile is an NAIC-accredited state (or has substantially similar financial solvency requirements), and no other state may require the reinsurer to provide financial information other than that required by its state of domicile.

The NAIC has been less supportive of the reinsurance portion of the NRRA, taking the position that it is insufficient to address the scope of issues facing state insurance regulators.²⁰

²⁰ Instead, the NAIC has supported its own proposed bill, the Reinsurance Regulatory Modernization Act of 2009 (the "RRMA"), as a more comprehensive measure. However, the RRMA has not yet been able to obtain congressional sponsorship.

Timing and Regulatory Actions

With limited exceptions, the NRRA becomes effective July 21, 2011. In connection with surplus lines insurance, the NAIC intends to work with surplus lines premium tax allocation forms currently in development as well as consider means, including an interstate compact such as SLIMPACT, to effectuate the home state regulation of surplus lines placements and surplus lines premium tax payments. The NAIC will also coordinate with the states to make necessary changes in their laws to conform to the NRRA's requirements. In connection with reinsurance, the NAIC intends to address the NRRA requirements by developing uniform standards for reinsurance credit consistent with the Reinsurance Regulatory Modernization Act, including amending and reducing reinsurance collateral requirements applicable to nonadmitted U.S. and non-U.S. reinsurers.

Also Noted

Title IX - Credit Rating Agency Reform

The recent financial crisis brought to light flaws in the reliance on credit rating agencies in regulation of financial services, including insurance. The Dodd-Frank Act provides for enhancement of the regulation of credit rating agencies through increased governmental oversight and greater transparency in rating agency procedures. Title IX, Subtitle C of the Dodd-Frank Act presents initial findings that the activities of rating agencies, including Nationally Recognized Statistical Rating Organizations (“NRSROs”), have a significant impact on capital formation, investor confidence and efficient performance of the U.S. economy and as such, should be held to higher standards of accountability and oversight than are currently in place.²¹

The Dodd-Frank Act gives the SEC rulemaking authority over credit rating agencies with respect to methodologies for determining ratings, protecting users of credit ratings, promoting accuracy of ratings and protecting against undue influence from conflicts of interest in the ratings industry.²² The SEC must issue final regulations to implement the applicable provisions of the Dodd-Frank Act by July 21, 2011. A new oversight office, the Office of Credit Ratings, will be established within the SEC to administer these rules as well as conduct annual examinations of each NRSRO and levy fines and other penalties for rule violations.²³ In addition to the greater oversight by the SEC, the bill gives investors a private right of action against credit rating agencies in certain circumstances.²⁴

In recent years, the NAIC has also held hearings and expressed concern regarding the use of credit rating agencies. The Rating Agency (E) Working Group (the “Working Group”) was formed to consider the role of rating agencies in state insurance regulation. As part of this

²¹ See Dodd-Frank Act, Title IX, Subtitle C, § 931.

²² See Dodd-Frank Act, Title IX, Subtitle C, § 932.

²³ See *id.*

²⁴ See Dodd-Frank Act, Title IX, Subtitle C, § 933.

charge, in the fall of 2009, the Working Group held a public hearing, during which a panel of insurance and ratings experts informed state insurance regulators of the flaws in the current use of ratings in insurance regulation and urged regulators to reduce their reliance on rating agencies, particularly with respect to certain types of structured securities.

In the spring of this year, the Working Group released a report making broad recommendations, reiterating, among other things, that state insurance regulators ascertain ways to reduce their reliance on NRSROs and explore alternative investment risk assessment measures. The final report also detailed specific recommendations for future undertakings of the Working Group (such as evaluation of whether public entities' creditworthiness should reflect burdens faced by such entities due to aging populations, public pension liabilities, infrastructure needs, and revenue instability, and examination of the extent of insurers' reliance on ratings) and other NAIC committee task forces and working groups (such as conducting a comprehensive review of Risk Based Capital formulae).

During a recent meeting of the NAIC, the Working Group noted that the NAIC Securities Valuation Office (the "SVO"), as a not-for-profit agency, was free from competitive pressures that could lead to the conflicts of interest faced by NRSROs and recommended that regulators evaluate whether to expand the role of the SVO to increase regulator reliance on the SVO for evaluating credit and other risks of securities.

Thus, in addition to the Federal efforts, state insurance regulators are focused on rating agencies in connection with insurance regulatory requirements. With the enactment of the Dodd-Frank Act, the NAIC will be faced with the consideration of whether the applicable provisions of the Dodd-Frank Act are sufficient to regulate rating agencies or additional regulatory measures will be necessary for insurance companies.

Title VII – Regulation of Credit Default Swaps

In light of intense public scrutiny of the utilization of credit derivatives, some states have recently sought to regulate certain types of credit default swaps (each, a "CDS," and collectively, "CDSs") as insurance.²⁵ CDSs deemed insurance by some states are those wherein the purchaser has an interest in the referenced asset and enters into CDSs to hedge against the risk of loss on such asset (each, a "Covered Swap," and collectively, "Covered Swaps"). In contrast, CDSs purchased by a buyer with no interest in the underlying asset have been referred to as a "Naked Swap."

²⁵ See N.Y. Assem. A10783, 233rd Sess. (N.Y. 2010) (proposing to regulate and classify a CDS as credit default insurance, a species of insurance to be regulated by the state) (the "NY Credit Default Insurance Legislation"); see also Mo. Bulletin 08-12 (dated November 19, 2008) (while deeming issuance of a covered CDS as conducting insurance business requiring a certificate of authority, regulatory enforcement is being deferred pending enactment of comprehensive Federal regulation of CDSs); see also 2009 Va. Acts H.B. 2320 (proposing to create a mechanism to regulate financial guaranty insurance and attempting to define when a CDS is insurance in the context of financial guaranty insurance); see also NCOIL Credit Default Insurance Model Legislation.

In 2009, the National Conference of Insurance Legislators (“NCOIL”)²⁶ adopted the “Credit Default Insurance Model Legislation” (the “NCOIL Model Legislation”), which bans Naked Swaps and regulates Covered Swaps as “credit default insurance,” which may be issued only by a “credit default insurance corporation” licensed and regulated by the applicable state departments of insurance.²⁷ In April of this year, New York introduced a bill based on the NCOIL Model Legislation, which classifies CDSs as a “species of insurance” regulated by the state, and bans Naked Swaps.²⁸ New York, through another pending bill, has also proposed to expressly grant authority to the Insurance Superintendent of New York to assess the efficacy and sufficiency of Federal regulation of CDSs and determine whether Covered Swaps should be regulated as insurance and whether sellers of Covered Swaps should be subject to insurance company licensing requirements.²⁹

Despite the introduction of state-level efforts to regulate CDSs as insurance, their enforcement has been deferred pending enactment of comprehensive regulation of over-the-counter derivatives, including CDSs, by the Federal government. The Dodd-Frank Act mandates Federal regulation of the derivative markets, including credit derivatives.³⁰ The Dodd-Frank Act amends the Commodity Exchange Act and the Securities Exchange Act of 1934 to state that a swap and a security-based swap, respectively, shall not be considered insurance and thus may not be

²⁶ NCOIL is an organization of state legislators whose main area of public policy interest is insurance legislation and regulation. Most legislators active in NCOIL either chair or are members of the committees responsible for insurance legislation in their respective state houses across the country. See NCOIL’s website at <http://ncoil.org/>.

²⁷ In a letter dated June 15, 2010, NCOIL emphasized to Representative Barney Frank and the U.S. House-Senate Financial Reform Conference Committee that the approach taken in H.R. 4173 in regulating credit derivatives, including CDSs, neglects a major problem of permitting trading of Naked Swaps. NCOIL urged that Representative Frank reconsider whether Covered Swaps should be regulated as insurance and the banning of Naked Swaps. We will continue to follow NCOIL’s position on this issue.

²⁸ N.Y. Assem. A10783, *supra* at 22.

²⁹ Program Bill #50, Assem. 8855, 232nd Sess. (N.Y. 2009); S.B. 6001, 232nd Sess. (N.Y. 2009); A.B. 8855, 232nd Sess. (N.Y. 2009) (“Program Bill #50”).

³⁰ The Dodd-Frank Act authorizes the CFTC to regulate swaps, and the SEC to regulate security-based swaps. See Dodd-Frank Act, Title VII, Subtitle A, Part I, § 512. A “swap” is defined broadly by the Dodd-Frank Act and extends to any other transaction that in the future becomes commonly known as a swap. It generally covers trades in which there is an exchange of payments based on the value of interest rates, currencies, securities, indices and other financial or economic interests or property of any kind. It excludes certain types of trades such as physically settled commodity trades, foreign currency trades entered into on a national securities exchange and security-based swaps. See Dodd-Frank Act, Title VII, Subtitle A, Part II, § 721(a)(47). A “security-based swap” is narrowly defined by the Dodd-Frank Act and generally covers a swap based on a narrowly based security index, a single security or a loan or in which the occurrence or nonoccurrence of an event is tied to a single issuer of a security or issuers of securities in a narrowly based security index. See Dodd-Frank Act, Title VII, Subtitle A, Part II, § 721(a)(42). The CFTC and the SEC will have joint jurisdiction over mixed swaps. A “mixed swap” is generally a security-based swap that is also based on the value of interest rates, currencies, securities, indices and other financial or economic interests or property of any kind. See Dodd-Frank Act, Subtitle A, Part II, § 721(a)(47).

regulated as an insurance contract under the state insurance laws.³¹ As a CDS would be either a swap or a security-based swap, it would be subject to Federal regulation, and state regulation would be preempted.

States' decisions to delay regulating Covered Swaps pending Federal action appeared to be based on their recognition that it is not practical to ban Naked Swaps completely and that dividing the regulation of CDSs between state and Federal regulators is not the most desirable solution. The NAIC has taken an approach consistent with this view by supporting the steps taken by the industry, Federal agencies and Congress toward a holistic solution to achieve a transparent and regulated market.

The Dodd-Frank Act requires that most derivatives be traded on a registered exchange or a swap execution facility and cleared through regulated central clearing organizations, and that higher capital and margin be required for trading derivatives that are not cleared.³² The Dodd-Frank Act does not ban Naked Swaps.³³

With the enactment of the Dodd-Frank Act, states have the opportunity to closely review the adequacy and sufficiency of Federal regulation of CDSs and determine whether state laws should be amended to exclude Covered Swaps from insurance regulation or take other actions to protect and regulate the CDS market.

Title IX - State Regulation of Indexed Annuities

Indexed annuities are products that guarantee purchaser's principal and a certain rate of return, and offer a chance for additional returns linked to a securities index or indices. While indexed annuities are currently regulated as insurance, in December of 2008, the SEC adopted Rule 151A to regulate indexed annuities as securities under the SEC's jurisdiction. The rule has not become effective because of a lawsuit filed by a group of insurance companies against its implementation.³⁴ The Dodd-Frank Act preempts the SEC's regulation of indexed annuities and

³¹ See Dodd-Frank Act, Title VII, Subtitle A, Part II, § 722(b) & Subtitle B, § 767.

³² See Dodd-Frank Act, Title VII, Subtitle A, Part II, § 723 & Subtitle B, § 763.

³³ For a more detailed discussion of the regulation of over-the-counter derivatives, including CDSs, under Title VII of the Dodd-Frank Act, see *The Wall Street Transparency and Accountability Act: Implications for Derivatives Markets Participants* (July 23, 2010), available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3437/The-Wall-Street-Act.pdf.

³⁴ On July 12, 2010, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 151A. *American Equity Inv. Life Ins. Co., et al. v. Sec. and Exch. Comm'n*, SEC-74FR3138, No. 09-1021 (July 12, 2010).

maintains state regulation as insurance as long as such products satisfy applicable standard nonforfeiture laws and applicable suitability requirements, such as model acts and regulations promulgated by the NAIC.³⁵

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If you have any questions regarding this memorandum, please contact Leah Campbell (212-728-8217, lcampbell@willkie.com) or the Willkie attorney with whom you regularly work.

This memorandum was authored by Leah Campbell.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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³⁵ See Dodd-Frank Act, Title IX, Subtitle I, § 989J (providing for the treatment as exempt securities described under the Securities Act of 1933 of any insurance or endowment policy or annuity contract or optional annuity contract, the value of which does not vary according to the performance of a separate account, that satisfies applicable standard nonforfeiture laws (or in their absence, the NAIC Model Standard Nonforfeiture Law for Life Insurance or the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities), that is issued on and after June 16, 2013 and issued in a state, or issued by an insurance company that is domiciled in a state, that adopts suitability requirements that substantially meet or exceed the minimum requirements established by the NAIC Suitability in Annuity Transactions Model Regulation and any successor modifications thereto, or by an insurance company that adopts practices meeting or exceeding the minimum requirements established by the NAIC model regulation and subject to examination by the applicable state's insurance regulator).