

Celebrating
125
YEARS
1888–2013

Recent Developments and Current Trends in
**Insurance Transactions
and Regulation**

YEAR IN REVIEW 2012

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I. Developments in Mergers and Acquisitions

I. Developments in Mergers and Acquisitions

A flurry of announced transactions in December 2012 ended what had otherwise been a subdued year for insurance M&A. The deals—Apollo Global Management's \$1.85 billion acquisition of Aviva's U.S. operations, Guggenheim Partners' \$1.35 billion acquisition of Sun Life Financial's U.S. annuity business and Markel's \$3.13 billion acquisition of Bermuda reinsurer Alterra Capital Holdings—illustrate many of the themes that defined insurance M&A activity in 2012, including: the role of private equity buyers in driving annuity M&A; the focus of strategic buyers on opportunities in emerging markets, and their limited appetite for consolidation transactions in the United States; and the retreat of European and Canadian insurers from U.S. markets. These themes and others are discussed in more detail below.

A. Overview

In 2012, life insurance M&A deal volume, measured by the total value of announced deals, exceeded 2011, while the number of announced deals remained constant. According to SNL, 15 transactions were announced, with \$4.5 billion of aggregate announced deal value. This compares with 16 transactions in 2011, with \$2.7 billion of announced deal value, and 12 transactions in 2010, with \$21.6 billion of announced deal value, according to SNL. Deals in 2012 were relatively small in size compared to prior years, with only two life transactions—the Apollo/Aviva and Guggenheim/Sun Life deals—exceeding \$1 billion of announced transaction value. The next largest transactions were Jackson National Life's \$621 million acquisition of Swiss Re's U.S. life insurance assets and Prudential Financial's \$615 million acquisition of Hartford's individual life insurance business. Another notable transaction involving a life insurer (but not a life insurance company target) was Principal Financial's announced acquisition of AFP Cuprum, a Chilean pension manager, for \$1.5 billion.

Property/casualty M&A deal volume measured by the number of announced transactions was off significantly in 2012. According to SNL, 77 transactions were announced in 2012,

with \$22.2 billion of aggregate announced deal value. These figures compare with 120 transactions in 2011, with \$20.2 billion of aggregate announced deal value, and 117 transactions in 2010, with \$10.6 billion of aggregate announced deal value, according to SNL. The largest deal, by far, was Markel's \$3.13 billion acquisition of Alterra. Other notable transactions included an affiliate of Goldman Sachs' acquisition of Ariel Re, ACE's \$865 million acquisition of Mexican auto insurer ABA Seguros and Validus Holdings' \$620 million acquisition of Flagstone Reinsurance Holdings. Also noteworthy was the continuing consolidation among London market companies, with CNA's acquisition of Hardy and Canopus' acquisition of Omega.

The most robust sector for insurance M&A in 2012 was insurance brokerage. According to SNL, more than 200 transactions were announced in 2012. Most of these transactions were small, private consolidations with no announced deal value. Two noteworthy transactions late in 2012 saw private equity firms Blackstone and GS Capital Partners sell large brokers that they had acquired only a few years before. In November 2012, Blackstone announced that it had agreed to sell Alliant Insurance Services to KKR for an undisclosed amount. Blackstone acquired the broker for \$1.1 billion in 2007. Only a few days later, GS Capital announced that it would sell USI Insurance Services to Onex Capital for \$2.3 billion. GS Capital acquired USI for \$1.4 billion in 2007.

B. Significant M&A Themes in 2012 (and 2013)

Several themes defined insurance M&A in 2012, and are likely to set the tone for 2013 as well.

Private Equity Firms Dominate Annuity M&A.

Private equity firms Apollo (through its affiliate Athene) and Guggenheim Partners have become the dominant players in the acquisition of annuity businesses in the United States. Guggenheim's string of closed and announced annuity acquisitions includes Security Benefit (2010), EquiTrust Life Insurance (2011), Industrial Alliance Insurance and Financial Services (U.S.) (2012) and Sun Life (U.S.) (2012). Apollo's list includes Liberty Life Insurance (2011), Investors Insurance (2011), Presidential Life (2012) and Aviva (U.S.) (2012). These businesses include fixed- and indexed-annuity writers and

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notably, in the case of Sun Life, a variable writer. In the current economic environment, the annuity business has come to be seen by strategic buyers as low return (in the case of fixed annuities) or volatile and difficult to hedge (in the case of indexed and variable annuities). Apollo, Guggenheim Partners and other private equity firms believe they can manage risk and allocate capital better than traditional life insurers. Their goal is to acquire annuity liabilities in order to gain assets to invest, typically with a heavier reliance on investments in high-yield and distressed debt than most traditional life insurers would find tolerable. Scale will be an important factor in generating “private equity” returns from these businesses going forward, and so we expect Apollo, Guggenheim Partners and other private equity firms to seek to add to their annuity portfolios with additional acquisitions in 2013. Variable businesses, which were seen as difficult to sell prior to the announcement of the Sun Life transaction, may provide particular opportunities for these buyers.

Strategic Buyers Focus on International Expansion.

In 2012, many large strategic buyers focused on building out their operations outside the United States, with a particular focus on the emerging markets. ING’s 2012 auction of its Asian operations was reported to have drawn significant interest from U.S. insurers, although none of them was able to announce a deal. Similarly, ING’s 2011 auction of its Latin American *afore* business attracted several U.S. companies, although the business was acquired by Colombian conglomerate, Grupo de Inversiones Suramericana. In 2012, however, Principal Financial succeeded in announcing its agreement to acquire AFP Cuprum, a Chilean pension fund manager. This transaction, the latest in a series of off-shore acquisitions by Principal, is meant to significantly increase the company’s exposure to a market that is growing much faster than the U.S. market and in a business—asset management—that promises higher returns than conventional life insurance. Other significant overseas acquisitions include ACE’s acquisition of Mexican auto insurer ABA Seguros and Markel’s announced acquisition of Alterra. Finally, Canada’s Sun Life is reported to be teaming up with a Malaysian sovereign-wealth fund to buy CIMB Aviva Malaysia, a Malaysian life insurer. Although these transactions were driven by different rationales, they illustrate the desire of certain strategic buyers to expand their global footprints in fast-growing markets and diversify their product offerings.

Many U.S. Strategic Buyers Have Limited Interest in Consolidation Transactions.

The year 2012 was notable for the shortage of transactions that have the primary goal of enhancing a strategic buyer’s scale in a market in which it is already a participant. In a year that was dominated by sales of annuity businesses, the strategic buyers were nearly invisible. Other than John Hancock’s ceding of a \$5.4 billion block of fixed annuities to Reinsurance Group of America (“RGA”), no strategic buyer announced the acquisition of an annuity business. The most significant “add-on” transaction of the year was Prudential Financial’s \$615 million acquisition of Hartford’s individual life operations. We expect that strategic buyers will continue to show limited interest in consolidation transactions in the coming year, given their focus on higher growth opportunities in the emerging markets, as noted above.

European and Canadian Life Insurers Rethink Their U.S. Strategies.

In recent years, several European and Canadian life insurers have taken steps to withdraw from, or reduce their exposure to, the U.S. life insurance market. The factors that have driven these companies to rethink their U.S. strategies vary, but include regulatory issues in their home countries, the expected impact of Solvency II, the eurozone crisis, the impact of low interest rates on profitability, lack of scale and highly competitive market conditions in the U.S. The initial manifestations of this theme were evident in 2010 and 2011, when U.K. financial services firm Old Mutual sold its U.S. life business to Harbinger Group, and Dutch insurer Aegon sold its Transamerica life reinsurance operation to SCOR. The year 2012 saw an accelerated retreat. In May, Swiss Re announced the sale of its U.S. life insurance assets to Jackson National Life. In July, Canadian life insurer Manulife’s John Hancock subsidiary announced that it was ceding a \$5.4 billion block of fixed annuities to RGA. In August, Industrial Alliance of Canada agreed to sell its U.S. fixed annuity business to Guggenheim Partners. In December, Sun Life agreed to sell its U.S. annuity operations to Guggenheim Partners and Aviva agreed to sell its U.S. operations to Apollo in the largest life insurance transaction of the year. ING has announced, and Generali is reported to be considering, the disposition of some or all of their U.S. businesses. We expect additional sellers will step forward in 2013.

I. Developments in Mergers and Acquisitions

Insurers That Struggled During the Financial Crisis Continue to Shed Non-Core Businesses.

Insurers that were hard hit by the 2008 financial crisis continued to divest non-essential businesses in order to focus on a more narrow core of operations. In 2012, ING announced the sale of its Malaysian life insurer to AIA Group for \$1.8 billion, and the sale of its Hong Kong and Thailand operations for \$2.1 billion to investor Richard Li (the son of Li Ka-shing). ING also disclosed that it would sell its U.S. life operations in 2012, but a transaction has not been announced. Also, in 2012 Hartford announced the sale of its individual life business to Prudential, its retirement plan business to MassMutual and its Woodbury Financial brokerage unit to AIG. With the exception of its variable annuity unit, Hartford will now be focused primarily on its property/casualty operations. Another deal that illustrates this theme is John Hancock's coinsurance transaction with RGA pursuant to which RGA agreed to reinsure a \$5.4 billion block of fixed deferred annuities from Hancock. Hancock had previously announced that the volatility of the equity markets and the low interest rate environment had caused it to restructure its annuity business and limit its writing. Finally, AIG announced two more large divestitures in 2012: the \$4.8 billion sale of its aircraft leasing business to a Chinese consortium and the sale of its remaining stake in Asian insurer AIA for \$6.5 billion. Having regained its financial footing and accomplished the sell-down of shares owned by the U.S. Treasury by the end of 2012, AIG is positioned to grow through M&A in 2013.

Publicly Traded Insurers Are Not Immune to Shareholder Activism.

Publicly traded insurers long have taken comfort from the protections against hostile shareholders afforded by the state insurance holding company acts. These acts, which exist in some form in all 50 states, generally require prior regulatory approval for the acquisition of control of an insurer. Many insurance company managements and boards have felt that this regulatory requirement would insulate them from the pressures of hostile takeover proposals and shareholder activism felt by their unregulated counterparts. In 2012, however, hedge fund Paulson & Company, which held an 8.5% stake in Hartford Financial, called for a breakup of the company. Hartford had come under significant pressure during the 2008 financial crisis, and its stock traded at a low valuation

compared to its peers. In February 2012, John Paulson used the company's earnings call to demand its breakup, challenging management to do something "drastic" to address the valuation of the company's stock. Paulson also sent a letter to Hartford's chairman and chief executive officer, which was filed with the Securities and Exchange Commission, outlining a spin-off of Hartford's property/casualty operations which, it was argued, would increase shareholder value by 60%. In the letter, Paulson threatened to initiate communications with other shareholders in an effort to force a split-up of the company. In March 2012, Hartford announced that it would stop selling variable annuities, and put its life insurance operations up for sale. In September 2012, the company announced the sale of its retirement plan business to MassMutual and its individual life insurance business to Prudential. We expect that publicly traded insurers with lagging share prices will attract the attention of activists in 2013. Companies that have non-core operations, or units that are perceived as millstones or unnecessary distractions to management or analysts, could face particular pressure. (See also "Developments in Corporate Governance, Public Company Regulation and Shareholder Activism," Section IV below.)

Runoff Transactions Remain a Viable Alternative in a Challenging M&A Environment.

Challenging conditions in insurance M&A have created opportunities for runoff specialists such as Enstar Group. Enstar announced two transactions in 2012: the \$250 million acquisition of workers' compensation writer SeaBright Insurance and the \$181 million acquisition of HSBC's U.S. and Canadian life insurance business. In addition, after a lengthy process in which it investigated several alternatives, including selling itself as an operating business, in 2012 Flagstone accepted Validus' \$620 million offer, and will be folded into the company and essentially run off. That being said, the environment for buyers pursuing a runoff strategy has become increasingly competitive as the playing field has become more crowded. A case in point was runoff specialist Tawa's announcement that it was putting itself up for sale and subsequent termination of the sale process based on its inability to obtain an offer satisfactory to the board.

II. Developments in Insurance-Linked Securities and Alternative Risk Transfer

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A. Insurance-Linked Securities

1. Overview

2012 was an active year for offerings of insurance-linked securities (“ILS”). According to industry sources, over \$6 billion in catastrophe bonds were issued in 30 transactions, the highest annual total since before the 2008 financial crisis. Dedicated ILS funds continued to attract significant amounts of new investor capital from traditional and non-traditional sources. Virtually all segments of the convergence market saw substantial increases from their 2011 totals, including catastrophe bonds, sidecars and collateralized reinsurance, among other structures. As additional capital was allocated to the ILS market, several traditional reinsurers sought to leverage their expertise in underwriting and managing insurance risk in order to create new opportunities through the creation of ILS fund vehicles and other investment partnerships.

Repeat catastrophe bond sponsors continued to dominate ILS issuances, with perennial participants Chubb, Hannover Re, Hartford, Liberty Mutual, Munich Re, SCOR, Swiss Re, Travelers, USAA and Zurich, among others, accessing the market. Of particular note in 2012 was first-time cedent Florida Citizens’ inaugural Everglades Re transaction, which at \$750 million was the largest single issuance since State Farm’s Merna Re transaction in 2007. Also noteworthy was SCOR’s Atlas VII issuance, which was the first Irish regulated reinsurance transaction in almost five years, a welcome accomplishment for French and other European sponsors with particular tax goals that may be met more efficiently in an EU jurisdiction than in either Bermuda or the Cayman Islands.

As a significant structural development, more than 50% by principal of total catastrophe bonds issued utilized an indemnity-based trigger, reflecting the favorable supply, demand and pricing dynamics of the market in 2012.

While beneficial to sponsors from a basis risk perspective, indemnity-based triggers historically have been used in the minority of transactions, as investors can be wary of the sometimes opaque risk exposure and loss development. The increase of indemnity triggers represents a milestone for ILS, as the types of coverage offered by insurance-linked products continue to converge with traditional reinsurance. On the collateral asset side, conservatism continued to trump yield, as U.S. Treasury money market funds and quasi-governmental assets, such as notes structured by the European Bank for Reconstruction and Development, continued to be the collateral arrangement of choice over more structured solutions, such as swaps and tri-party repurchase agreements.

2012 also saw the continuing resurgence of both market-facing and quota share sidecar equity transactions, which built upon modest growth in 2011 to reestablish the alternative structure as an important source of reinsurance and retrocessional capacity. Sponsors included Alterra, Argo, Everest Re, Lancashire, Montpelier, Renaissance Re and Validus. As a significant structural development, sidecar transactions increasingly utilized “just-in-time” funding commitments, whereby investor capital is only drawn upon when needed to underwrite particular reinsurance business. In addition, collateral release mechanisms continued to evolve, although a market standard approach that is favorable to both sponsors and investors still proves elusive. According to industry sources, in 2012 total sidecar commitments exceeded \$1.6 billion

Non-P&C catastrophe bonds also maintained their steady but modest presence, with Aetna bringing another morbidity bond to market in its Vitality Re franchise and Swiss Re bringing extreme mortality risk to market through repeat issuer Vita Capital and its novel Mythen Re structure, which for the first time combined U.S. hurricane and U.K. extreme mortality risk.

While the ILS market overall is increasing, uncertainty over the regulatory status of ILS under the final swap rules promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which are described in more detail in Section II.A.2.

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below, is affecting the structure of some transactions. In the several months since the enactment of the Dodd-Frank Act swap rules in October 2012, no transactions have been consummated utilizing a derivative contract. Instead, as discussed below, recent ILS risk transfer contracts have all been documented as reinsurance and structured to be accounted for as reinsurance under applicable GAAP or IFRS rules.

The low interest rate environment and the impact of Superstorm Sandy on the traditional reinsurance community have created significant opportunities throughout the ILS market, for both new and existing participants. Whether these positive trends will continue to develop in 2013 depends on numerous variables, including whether general financial conditions continue to make ILS an attractive asset class relative to more conventional asset classes, whether catastrophe losses remain relatively low, the impact of traditional reinsurance pricing and the absence of legal and regulatory impediments to growth.

2. Swaps Regulation under the Dodd-Frank Act

While the market dynamics of ILS supply and demand were especially positive in 2012, the rule-making required to implement the Dodd-Frank Act continues to create uncertainty as to whether ILS are trades captured by the rules further defining swaps and security-based swaps promulgated by the Commodity Futures Trading Commission (the “CFTC”) and the SEC (together with the CFTC, the “Commissions”), which became effective on October 12, 2012.

As discussed in Section V.D.3. below, the broad definition of “swap” set forth in Title VII of the Dodd-Frank Act includes any agreement, contract or transaction (the “subject agreement”) that provides for payment “dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic or commercial consequence.” Noting that the statutory definition of swap could be read to include certain types of agreements and transactions that have not previously been considered swaps, the Commissions clarified in the August 13th release adopting the final rules (the

“Adopting Release”) that: (a) nothing in Title VII suggests that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps; and (b) the Commissions do not interpret this clause to mean that traditional insurance products should be included within the swap or security-based swap definitions.

Implementing this position, the Commissions adopted a three-part non-exclusive safe harbor excluding certain insurance products from the definition of swap and security-based swap (the “insurance safe harbor”) and a grandfather provision. In addition, the Commodity Exchange Act as amended by the Dodd-Frank Act added “swaps” to the list of “commodity interests” in the definition of “commodity pool.”

As a result, securitization vehicles that enter into swaps will be holding “commodity interests,” and accordingly could be considered commodity pools under the Commodity Exchange Act. In such cases, transaction parties—including sponsors, administrators and trustees—could be required to register with the CFTC as commodity pool operators or commodity trading advisors in respect of such commodity pools unless an exemption from registration is available. In addition, absent future relief from the CFTC or other regulators, entities that are commodity pools would be “covered funds” under the Volcker Rule, and financial institutions would be subject to restrictions in respect of their sponsorship and ownership of such entities.

What this means for ILS transactions is difficult to say with certainty at this early stage. Transactions that do not meet the insurance safe harbor, for example where the cedent is not a U.S.-domiciled insurer or reinsurer, may have increased uncertainty as to whether the new swap rules and commodity pool requirements will be applicable. Consequently, in the several months since the enactment of the Dodd-Frank Act swap rules, no transactions have been consummated utilizing a derivative contract. Instead, recent ILS risk transfer contracts have all been documented as reinsurance and structured to be accounted for as reinsurance under applicable GAAP or IFRS rules, with an ultimate net loss limitation on the cedent’s recovery regardless of whether the underlying bond trigger is indexed-based or parametric. In addition, various industry groups, including the Securities Industry and Financial

II. Developments in Insurance-Linked Securities and Alternative Risk Transfer

Markets Association, Willkie Farr and other law firms have asked the CFTC to provide interpretative relief specifically for ILS products. We will continue to monitor and provide updates as these discussions with the CFTC progress. In short, although the uncertainty of the new swap rules has led to certain structural changes in the form and substance of the risk transfer contract, it has not materially slowed the size or pace of most transactions.

3. Elimination of Restrictions on Offers in Certain Private Placements and Rule 144A Offerings under the JOBS Act

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act"), which, among other things, will eliminate certain U.S. federal securities law restrictions on: (a) general solicitation and general advertising in connection with private placements of securities to "accredited investors"; and (b) offerings under Rule 144A under the Securities Act of 1993 (the "Securities Act"). The elimination of these restrictions could significantly affect how catastrophe bonds and other related securities are offered and sold by permitting expanded marketing efforts to non-core investors and by creating efficiencies between the underwriting and structuring processes.

Currently, catastrophe bonds and other ILS typically are offered and sold only to "qualified institutional buyers" ("QIBs") in reliance on the exemption from registration provided by Rule 144A under the Securities Act or, less frequently, under the safe harbor exemption for private placements under Rule 506 of Regulation D under the Securities Act or the statutory exemption under Section 4(a)(2) of the Securities Act. Securities to be issued in Rule 144A offerings currently may be offered solely to QIBs and persons the seller or person acting on its behalf reasonably believes to be QIBs. Private placements under Regulation D or Section 4(a)(2) currently must be structured to avoid any general solicitation or general advertising of securities made by or on behalf of the issuer.

As mandated by the JOBS Act, on August 29, 2012 the SEC proposed a rule: (a) to remove the prohibition on offers to non-QIBs under Rule 144A, provided that all sales in a Rule 144A

offering are made solely to QIBs or persons whom the seller or person acting on its behalf reasonably believe to be QIBs; and (b) to eliminate the prohibition against general solicitation and general advertising in connection with offerings of securities under Rule 506 of Regulation D under the Securities Act, provided that all sales are made to "accredited investors" as defined in Rule 501(a) and certain other conditions are met. The proposed rules are intended to make it easier for issuers to raise capital by facilitating their ability to communicate to potential investors during capital raises in certain unregistered offerings of securities. As of the date of publication of this Year in Review, the SEC has not yet approved final rules, missing the deadline set by Congress in the JOBS Act itself.

Under proposed Rule 506(c), a private placement could be made under conditions generally consistent with offerings under current Rule 506(b), with three notable exceptions: (a) general solicitation and general advertising would be permitted; (b) all purchasers would need to be accredited investors as defined in Rule 501(a) ("accredited investors") or persons the issuer reasonably believes to be accredited investors at the time of the sale of the securities; and (c) the issuer would be required to take reasonable steps to verify that purchasers of the securities are accredited investors. Under the JOBS Act and proposed Rule 506(c), securities could be offered to non-accredited investors, provided that they were sold only to accredited investors or persons the issuer reasonably believes to be accredited investors.

While the SEC provided some guidance as to what constitutes reasonable steps to verify accredited investor status, the proposed rules and the SEC's guidance do not set forth specific methodologies or processes. As a result, whether particular steps are sufficient remains a "facts and circumstances" analysis. Some of the factors to be taken into consideration are the following: (a) the nature of the purchaser and the type of accredited investor that the purchaser claims to be; (b) the amount and type of information that the issuer has about the purchaser; and (c) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as whether there was a minimum investment amount.

II. Developments in Insurance-Linked Securities and Alternative Risk Transfer

Following the review of comments by the SEC, final rules will be issued. Issuers are not able to avail themselves of the proposed rules until final rules are enacted and effective.

After the removal of the prohibition on general solicitation, participants in private placements of ILS will presumably be free to solicit investor interest publicly and across various forms of media, including newspaper advertisements, Internet web pages, e-mail and social media, subject to compliance with applicable state blue sky and foreign securities laws. The impact on ILS could be significant, particularly on the ability of underwriters and placement agents to expand their marketing efforts to non-core investors and their ability in certain circumstances to market a transaction contemporaneously with the structuring and drafting process, thereby streamlining the issuance timeline. Depending on how the changes are implemented by the SEC, we expect the ILS community to take full advantage of the increased flexibility permitted by the JOBS Act.

4. FINRA Rulemaking Developments Relevant to Private Placements of ILS

On June 7, 2012, the SEC approved new FINRA Rule 5123. Effective December 3, 2012, Rule 5123 requires FINRA member broker-dealer firms that sell an issuer's securities in a private placement to file with the FINRA Corporate Financing Department a copy of any private placement memorandum, term sheet or other offering document the member firm used or to indicate that they did not use any such offering documents. Member firms must make this "notice" type filing, which is accorded confidential treatment, within 15 calendar days of the date of the first sale and file materially amended versions of any documents previously filed. FINRA members need not wait for FINRA's approval before commencing the offering.

Rule 5123 exempts many types of private placement offerings from its requirements. In particular, FINRA members selling securities in private placements are exempt from Rule 5123 if the securities are sold only to any one or more of certain

types of investors, including institutional accounts, qualified purchasers, qualified institutional buyers, investment companies, banks and employees and affiliates of the issuer. In addition, Rule 144A offerings, Regulation S offerings and offerings of commodity pool interests operated by a commodity pool operator are likewise exempt from filing under Rule 5123.

Since many ILS offerings are made pursuant to Rule 144A, they would be exempt from filing under Rule 5123. However, ILS offerings made in private placements under Rule 506 of Regulation D or Section 4(a)(2) of the Securities Act would not be exempt from filing under Rule 5123, unless they were made solely to qualified purchasers or other types of institutional or sophisticated investors specified in the Rule.

B. Excess Reserve Financings

Despite some caution from regulators and insurance companies in the life insurance reserve financing market as a result of the National Association of Insurance Commissioners' ("NAIC") Captive and Special Purpose Vehicle Use (E) Subgroup activities, 2012 continued the trend of recent years with a flurry of activity in the private market. Although not widely reported publicly, at least a dozen transactions of varying sizes closed in 2012. Several other existing transactions were restructured to take advantage of lower lending rates and the emergence of reinsurance companies as credit providers.

1. Summary of Deal Activity

a) AXXX Market Opens Up

Many of the transactions for which we acted as deal counsel were designed to provide reserve financing for universal life insurance policies subject to Regulation AXXX. The previously tight market for lenders willing to provide financing to fund AXXX reserves expanded significantly in 2012. The size of the transactions ranged from \$100 million to several billion dollars, as life insurance companies took advantage of increased lender interest in financing redundant reserves.

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In most transactions in both the XXX and AXXX markets, lender commitments were for 10-20 years, although several transactions involved shorter terms intended to act as a financing bridge until other expected sources of funding become available.

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

Although we saw several XXX transactions utilizing traditional letters of credit, in 2012, transactions secured by non-recourse letters of credit and contingent notes became increasingly acceptable to lenders and reinsurance companies active in the AXXX market. In the past, the obligation to reimburse the bank for any draw on the letter of credit was guaranteed by a parent holding company, thus being known as a “recourse” transaction. In a non-recourse transaction, no such guaranty is required. Rather, the ability to draw on the letter of credit or contingent note is subject to certain conditions precedent. These conditions usually include the reduction of the funds backing economic reserves to zero and a reduction in a prescribed amount of the captive’s capital, and a draw limited to an amount necessary for the captive to pay claims then due. Because of these conditions, lenders and other funding sources have become more comfortable assuming the risk of relying for repayment on the long-term cash flows from a block of universal life insurance policies.

c) Choice of Domicile for Captive Insurers and Limited Purpose Subsidiaries

Vermont remained the preferred domiciliary jurisdiction for captive life insurers in 2012. With several states adopting new captive insurer laws or amending existing captive insurer laws to facilitate reserve funding transactions, 2012 saw several other states—including Arizona, Delaware, Nebraska and Iowa—being utilized as captive insurer domiciliary jurisdictions. 2012 also saw the first use of the recently enacted “Limited Purpose Subsidiary” statutes in several states. The Limited Purpose Subsidiary statutes permit a ceding company to form a captive insurer, or “LPS”, in the same domiciliary state as the ceding insurer, which may provide for a more streamlined regulatory approval process for a transaction.

2. New Structures

a) Limited Purpose Subsidiaries

2012 saw the first use of the LPS laws in an AXXX transaction. Over the past few years, several states have enacted Limited Purpose Subsidiary statutes, which are meant to encourage their respective domiciliary life insurance companies to organize their captive insurers in the domiciliary state. Georgia, Indiana, Iowa and Texas have each enacted 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. This is a major development in the ability to finance Regulation XXX/AXXX reserves.

b) Credit-Linked Notes vs. Letters of Credit

2012 saw an expansion of the use of contingent credit-linked notes in a role that is analogous to a “synthetic letter of credit.” In these non-recourse transactions, a special purpose 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 available only to banks.

c) Expansion of Funding Sources Beyond Banks

With the emergence of the contingent credit-linked note transactions, the market for funding sources in AXXX transactions has expanded beyond banks. Large reinsurance companies have shown a keen interest in participating in

II. Developments in Insurance-Linked Securities and Alternative Risk Transfer

these transactions through support of the SPVs that issue the contingent notes. With the expansion of the group of potential funding sources for these transactions, life insurance companies can seek more competitive pricing and terms. We expect to see more transactions of this type in 2013.

3. Regulatory Environment

As discussed in Section V.D.1. below, the Captive and SPV Use Subgroup of the Financial Condition (E) Committee of the NAIC has been studying insurers' use of captive insurers and SPVs to transfer insurance risk in relation to existing state laws and regulations. The formation of this subgroup was prompted in part by growing concerns among some regulators about a perceived lack of consistent requirements for the use of captive insurers and SPVs. Insurance companies, and in particular life insurance companies that use affiliated captive insurers or SPVs as a means of funding XXX and AXXX reserve redundancies, should carefully follow these developments at the NAIC. As further discussed in Section V.D.1. below, in July the New York State Department of Financial Services issued its own request for information relating to the use of captive insurers.

C. Pension Risk Transfer Solutions

2012 witnessed several significant developments with respect to pension risk transfer transactions. Previously valued at about \$2 billion a year, the market for "buyout" annuities in the United States was fundamentally changed with the announcement of a \$26 billion transaction between Prudential and General Motors, which closed in May. This was followed by a \$7.5 billion buy-out transaction in December under which Prudential agreed to issue a group annuity contract covering Verizon's pension liabilities to some 41,000 of its management pension plan participants. Finally, in 2012 Ford Motor Company announced a pension de-risking plan under which it offered a voluntary lump-sum option to approximately 90,000 salaried retirees and former employees in an attempt to reduce its pension liabilities by as much as \$18 billion.

The significantly increased focus of sponsors of U.S. defined benefit plans on pension de-risking transactions is not surprising. It results from several factors, including the change in lump-sum calculations that took effect under the Pension Protection Act of 2006. In calculating lump-sum payments, companies previously were required to use 30-year Treasury rates as the discount rate. Following the changes, they may now use a combination of higher corporate bond rates, which results in smaller lump-sum payments. In addition, the IRS issued certain private letter rulings that provided much-needed guidance with respect to lump sums and annuities as a method of settling obligations of pension plans. In the absence of those letter rulings, it was widely believed that a lump-sum offer to current retirees of a pension plan would be extremely difficult, if possible at all.

In the United Kingdom, the value of pension risk transfer transactions declined compared to 2011. According to Towers Watson, in 2012 U.K. pension plans entered into approximately £4 billion of buy-out annuities under which both longevity and investment risks are passed on to insurance companies. In addition, pension plans entered into £2.2 billion worth of longevity-only swap agreements. In 2011, by comparison, U.K. pension plans entered into buy-out transactions worth in the aggregate approximately £5.6 billion and £7 billion worth of longevity swap transactions. In fact, the 2012 total is the lowest on record since 2007 when U.K. pension plans executed £3.6 billion worth of pension risk transfer agreements.

Notable U.K. buy-out transactions included a £230 million bulk annuity issued by Goldman Sachs' pension plan insurer Rothesay Life, covering pension obligations of General Motors U.K. Retirees Pension Plan to all 11,000 members of the Plan. In December, Rothesay also entered into a £680 million buyout transaction with the Merchant Navy Officers Insurance Fund, under which Rothesay agreed to cover benefits to approximately 40,000 members of the Fund. The MNO Fund previously transferred about half of its pension liabilities through insurance policies purchased from Lucida, a U.K. insurance company set up by Jonathan Bloomer, former chief executive of Prudential U.K.

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However, in November, Lucida announced that it was closed to new business and issued a warning about “unattractive economics in the current market environment.” In addition, several banks withdrew from the longevity swap market in 2012. According to *The Financial Times*, sources close to the banks cited regulatory pressures as the principal cause for withdrawal.

In 2013, we expect to see an expansion of the pension risk transfer market as more companies seek to reduce the financial risks associated with their pension liabilities in order to be able to focus on their core operating competencies. A recent report published by Moody's included Boeing, Lockheed Martin and Northrop Grumman Corporation as companies most likely to follow the buy-out pension risk transfer strategy utilized by GM and Verizon.

Pension risk transfer transactions can be complex. They involve insurance regulatory, ERISA fiduciary, tax, Dodd-Frank Act and accounting issues. Not surprisingly, structuring these transactions can be expensive and time-consuming. However, the benefit of eliminating the long-term uncertainties associated with their pension liabilities has prompted an increasing number of companies to seek pension risk transfer solutions.

D. Offshore Reinsurance Companies

A handful of hedge funds sponsored the formation of offshore reinsurance companies in Bermuda in 2012 with the formation and capitalization of Third Point Re by Third Point, S.A.C. Re by SAC Capital and PaC Re by Paulson, and many other hedge funds have expressed an interest in forming new reinsurers. The formation of these new companies in tax advantaged jurisdictions such as Bermuda has enhanced expected returns, which we believe will lead to further investment by hedge funds and other non-strategic investors in the reinsurance space. These new companies also increase the assets under management for hedge funds, which leverage their existing capabilities.

We also note that as non-traditional participants such as those referred to above become more active in the reinsurance markets, an increasing number of professional reinsurers are sponsoring the formation of ILS Funds to leverage their knowledge of the reinsurance and retrocessional marketplace. We believe these trends are indicative of the convergence that commentators have noted, which is beginning to have an increasing impact in terms of underwriting capacity, particularly in the catastrophe segment of the property/casualty market.

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A. General Overview and Update on Hybrid Capital Developments

The most significant insurance industry equity offerings in 2012 involved the sales by the U.S. government of its remaining equity interest in AIG. Following large secondary offerings in March, May and August, in September the U.S. Treasury sold \$20.7 billion worth of AIG's shares in the largest common stock offering in U.S. history (secondary or IPO). This was followed in December by the sale of the government's remaining stake in AIG for \$7.6 billion. At one time, the Federal Reserve Bank of New York and the U.S. Treasury pledged as much as \$182.3 billion to support AIG during the financial crisis. However, since May 2011, the U.S. Treasury sold approximately 1.65 billion shares (which originally represented 92% of AIG's outstanding common stock) in six public offerings at an average price of \$31.18 per share. As a result, the overall positive return from the common stock sales in excess of the government's commitment amounted to \$22.7 billion. In March, September and December 2012, AIG also sold approximately \$6.0 billion, \$2.0 billion and \$6.4 billion, respectively, worth of ordinary shares of AIA Group, completely divesting itself of its ownership interest in the Hong Kong-listed insurer.

Insurance debt capital markets were stronger in 2012 compared to 2011, as many companies continued to take the opportunity to refinance in the historically low interest rate environment. A number of both registered issuances and private placements of senior notes were completed over the course of the year, including benchmark transactions by AIG (\$3.5 billion), Allstate (\$500 million), Hartford (\$1.5 billion) and MetLife (\$750 million).

Regulatory reform continued to shape hybrid capital trends in 2012, in particular in international markets. See "Regulatory Developments Affecting Insurance Companies—

International Insurance Issues: Solvency II," Section V.G.4. below. If structured properly, hybrid capital securities can obtain favorable equity treatment from rating agencies and qualify as tier 2 regulatory capital for insurers. Since the financial crisis, regulators have increasingly focused on enhancing regulatory capital requirements applicable to insurers and ensuring greater transparency regarding capital instruments. Issuers confronted concerns in 2012 that future regulatory directives would reduce or eliminate the favorable capital treatment currently received for subordinated debt and preferred securities. In 2012, a new class of hybrids developed incorporating variation and exchange provisions that allow the issuing insurer unilaterally to vary the terms of the securities or to exchange them for qualifying securities in order to comply with still-evolving regulatory changes.

In January 2012, Aegon N.V. issued \$500 million of subordinated notes intended to qualify as tier 2 capital, both under current capital adequacy regulations applicable to Aegon and under Solvency II, with a redemption or variation or exchange provision exercisable if the subordinated notes no longer qualify as tier 2 capital upon implementation of Solvency II.

In the first quarter of 2012, Axis Capital, Arch Capital and Aspen Insurance issued \$400 million, \$325 million and \$150 million, respectively, of preference shares. Each issue was intended to constitute tier 2 capital, both under then-applicable Bermuda capital adequacy regulations and under anticipated regulatory changes. Each included a variation or exchange provision exercisable if the preference shares do not qualify as tier 2 capital when the BMA Group Solvency Rules are fully implemented.

In the United States, Prudential completed a series of junior subordinated notes offerings (totaling \$3 billion), each with a redemption provision in the event Prudential were designated a non-bank "systemically important financial institution" ("SIFI") and the junior subordinated notes did not qualify as tier 2 capital under the capital adequacy guidelines applicable to non-bank SIFIs. By comparison, previous transactions by Montpelier, Endurance and PartnerRe in 2011

III. Developments in Insurance Capital Markets

only included a straight five-year call and an early redemption upon the occurrence of a tax event, and did not include a variation or exchange provision or a redemption provision for a capital disqualification event. Hartford also accessed the hybrid market and issued \$600 million in aggregate principal amount of 30-year junior subordinated debentures, with an optional redemption right for tax or rating agency events.

In April, Prudential successfully completed a solicitation of termination consents from holders of the “covered debt” securities under its replacement capital covenants (“RCCs”). Following this termination, Prudential put in place a new RCC having more flexible and issuer-friendly terms in line with current S&P requirements. AIG also amended some of its existing RCCs for the same purpose by issuing a series of mezzanine subordinated debt that was redesignated as the covered debt under those RCCs and simultaneously obtaining consent to the amendment of the related RCCs from the purchasers of the mezzanine securities. Allstate took a similar approach in January 2013 with the issuance of high-equity content NYSE-listed subordinated debentures coupled with an entry consent for the termination of its existing RCCs. Allstate then entered into new RCCs consistent with current S&P standards replacing those that it terminated. As 2013 progresses, we anticipate that other issuers will continue to implement the latest generation of RCCs in respect of their outstanding hybrid securities in order to gain additional flexibility.

Moody's issued a release in March 2012 confirming that it may rate securities with variation provisions, but only if it is clear that the rated promise cannot be changed in a way that is materially adverse to the investor. Moody's and other rating agencies will continue to monitor the evolution of regulatory reforms and the willingness of authorities to accept loss-absorbing capital instruments and may refine its rating approach in the future to the extent that greater regulatory clarity increases its ability to predict the practical application of variation and exchange provisions. Notably, Moody's no longer takes RCCs into account in evaluating equity credit for hybrid securities.

According to a Moody's announcement in January 2012, one key feature of the new generation of hybrids that will cause Moody's to adjust its financial ratios to allocate additional equity credit is a requirement to skip coupons if the insurer is in breach of the capital requirements. In the eyes of the rating agencies, a hybrid security with a meaningful deferral of interest or distributions increases loss-absorption and affords enhanced protection to senior creditors.

The expectation is that rating agencies' capital models will follow the next generation of insurance regulation, and in particular Solvency II's group supervision and prudential capital approach. An S&P release from the fourth quarter of 2012 confirmed the equity content of a hybrid security must qualify as regulatory capital to be eligible for intermediate or high equity credit.

B. Insurance Capital Market Instruments

1. 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, such as a Delaware statutory trust, and transfer credit quality of a policyholder claim at the insurance company to the notes of that vehicle.

In 2012, issuances remained below pre-financial crisis levels, but the funding agreement-backed notes market continued to recover following the significant decrease in activity observed in 2009. According to a press release, S&P rated \$7.95 billion of funding agreement-backed notes over the first six months of 2012. Although this amount is significantly less than the record of nearly \$23.0 billion in the first half of 2008, it represented an increase of \$1.8 billion, or 30%, compared to the first six months of 2011.

The second half of 2012 continued strongly in the funding agreement-backed medium-term note space. In particular, MetLife accessed the market on a number of occasions with a mix of fixed-rate and floating-rate instruments in a mix of currencies, including U.S. Dollars, Canadian Dollars, Australian Dollars, U.K. Sterling, Euros and Japanese Yen.

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Approximately \$63.8 billion of funding agreement-backed notes were outstanding as of June 30, 2012, with \$22.1 billion scheduled to mature in 2013.

Although some insurance companies have not yet re-entered the marketplace, a number of issuers continue to maintain their programs in order to have the option to access the market opportunistically. The dominant market players continue to be MetLife, New York Life and MassMutual.

2. Surplus Notes

After a busy 2009-2010, when eight insurance companies came to the surplus notes market, 2011 saw no new issuances of surplus notes. However, 2012 witnessed renewed activity. In January, MassMutual issued \$400 million of 30-year fixed-rate surplus notes, the proceeds of which were used to strengthen its statutory capital position and for general corporate purposes. In June, Ohio National issued \$250 million in aggregate principal amount of 6.875% surplus notes due 2042. Ohio National used the proceeds from the offering principally to retire an intercompany surplus note and to fund its triple-X reserves through its captive reinsurer Montgomery Re.

C. SEC Comment Letter Developments

1. Investments and Financial Instruments

Given the continued economic downturn and the importance of investment portfolios to most insurance companies, SEC staff has continued to focus on disclosures relating to a company's investments and financial instruments. SEC staff frequently questioned conclusions reached by management about the credit quality of investments and, where necessary, asked for more information regarding the procedures used in making such determinations. In situations where a company did not obtain a credit rating for certain of its investments or a credit rating used in an SEC filing was different from the rating assigned by a third-party credit rating agency, the SEC focused on whether management's conclusions were appropriate.

2. Reinsurance Receivables

SEC staff has also questioned disclosures related to the credit quality of financing receivables and allowances for credit losses for insurance-specific balances, such as reinsurance recoverables.

ASU 2010-20, which amended ASC 310, requires registrants to enhance their disclosures related to the credit quality of financing receivables and the related allowance for credit losses. After the issuance of ASU 2010-20, FASB concluded that the reinsurance recoverable on paid claims is within the scope of ASU 2010-20 because it does not result from the sale of a good or service and the due date for the amount due from a reinsurer for claims paid is generally fixed. Although credit quality information about reinsurance recoverable on unpaid claims is not within the scope of ASC 310, certain disclosures may nevertheless be required under ASC 450. As a consequence, insurance companies should consider whether to enhance their disclosure with respect to reinsurance recoverables.

3. Statutory Disclosures and Dividend Restrictions

Due to the existing disclosure requirements related to statutory capital and surplus under ASC 944-505-50, SEC staff has commented when companies use labels such as "unaudited," "approximate" or "preliminary" to describe their statutory capital and surplus in their annual financial statements. According to the SEC, such labels do not comply with the disclosure requirements required under U.S. GAAP.

In addition, where there are restrictions on the transfer of assets, including the payment of dividends, to the parent company from its subsidiary or subsidiaries, SEC staff has requested information regarding compliance with Regulation S-X, Rules 4-08(e) and 7-05(c). The SEC has asked companies to add information about their underlying considerations in determining why they did not disclose such information. In applying Rule 4-08(e), the SEC also noted that companies must include foreign insurance operations and non-regulated subsidiaries as well as U.S. domestic

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subsidiaries. The failure to provide appropriate disclosures may lead investors to assume that the company (at either the parent or subsidiary level) has more discretion to transfer funds or pay dividends than is actually the case.

4. Interest-Sensitive Contracts

Given the persistent low interest rate environment, SEC staff has asked insurance companies to provide enhanced disclosures related to guaranteed crediting rates for interest-sensitive contracts. For example, SEC staff has asked companies that disclose ranges of guaranteed interest rates for interest-sensitive contracts to include in their MD&A disclosure information that quantifies the distribution of each of the interest-sensitive account values within each range. In addition, SEC staff has clarified that disclosure should state the minimum guaranteed crediting rate and account value by each major class of interest-sensitive product.

5. Reserves and Loss Adjustment Expenses (“LAE”)

SEC staff continues to ask registrants to provide more information on the process they use to develop their LAE and related reserves. SEC staff has requested that registrants disclose any changes in the process for determining such reserves and, if applicable, why a reserve change was recognized as appropriate within a given period. In addition, SEC staff comments often request that companies include more information about the key assumptions used by management in obtaining such estimates, whether the assumptions are likely to change and any sensitivity analyses.

6. Deferred Acquisition Costs

ASC 944-30, as amended by ASU 2010-26, requires insurance companies to defer and subsequently amortize certain costs incurred related to the acquisition of new or renewal insurance contracts. Although it could be adopted retrospectively or prospectively, ASU 2010-26 became effective for fiscal years beginning after December 15, 2011. SEC staff has asked insurance companies to describe their adoption of ASU 2010-26 and to include the required disclosures in their filings. In October 12, 2012, the American Institute of Certified Public Accountants issued two technical practice aids, TIS Sections 6300.39 and 6300.40, on selected practice issues related to ASU 2010-26.

Following the new guidance regarding accounting for deferred acquisition costs, certain insurance and reinsurance companies furnished to the SEC on Form 8-Ks revised historical financial results, which revised the information contained in quarterly financial supplements for the 2011 fiscal year. Although not required, the revised historical financial results were made available to aid investors in understanding the impact of the adoption and retrospective application of the new guidance.

7. Targeted Disclosure of Risk Factors

Throughout the year, SEC comment letters have continued to identify boilerplate risk disclosure and asked companies to provide more targeted discussions of the principal risk factors they face. As contemplated by Item 503(c) of Regulation S-K, companies should confine disclosure of risk factors to company-specific risk factors. In addition, SEC staff frequently asked companies about the completeness of their risk factors and whether they provided sufficient MD&A discussion when a risk constitutes a material trend or uncertainty. SEC staff has also reminded companies that the title of each risk factor should adequately describe the related risk.

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Companies should consider whether their risk factor disclosure should address the potential effect of the following current developments:¹

a) Hurricane Sandy

Hurricane Sandy, a category 1 hurricane that swept through the Caribbean and the east coast of the United States in late October 2012, is estimated to have inflicted more than \$50 billion of losses in the United States alone due to damage and business interruption. Although the final cost estimate will not be ascertained for some time, Hurricane Sandy is expected to be the second costliest Atlantic hurricane after Hurricane Katrina in 2005. SEC-registered companies, and in particular insurance companies exposed to the risks of such natural disasters, should consider whether to add a risk factor to their upcoming annual report relating to the potential impact of Hurricane Sandy on their results of operations and financial position.

b) European Sovereign Debt Exposure

Due to the continued European sovereign debt crisis and companies' inconsistent disclosure about the nature and extent of their direct and indirect exposures to European sovereign debt holdings, the Division of Corporation Finance of the SEC issued CF Disclosure Guidance: Topic No. 4 "European Sovereign Debt Exposures" on January 6, 2012. The guidance aims to assist companies in their assessment of what information about exposures to European countries they should disclose and how such information should be presented.

In particular, the guidance notes that such disclosure should be: (i) provided on a country-by-country basis; (ii) segregated by sovereign and non-sovereign exposures; and (iii) segregated by financial statement category to arrive at gross funded exposure. The guidance also notes that companies should consider disclosing gross unfunded commitments and providing information regarding hedges

in order to present an amount of net funded exposure. Companies should also disclose their risk management strategies, including how they are monitoring or mitigating direct exposure to the selected countries and/or the effects of indirect exposure.

In determining which countries are covered by the guidance, companies should focus on countries experiencing significant economic, fiscal or political strain that the company believes increases the risk of default. Companies should disclose the rationale for why they selected specific countries.

Not surprisingly, this enhanced disclosure guidance has resulted in additional disclosures by many SEC registrants throughout 2012. SEC staff has continued to comment on disclosures of insurance companies relating to European sovereign debt exposure throughout the year.

c) Cybersecurity Risks

Given the increasing dependence on digital technologies and recent data breaches in publicly traded companies, the Division of Corporation Finance of the SEC issued CF Disclosure Guidance: Topic No. 2 "Cybersecurity" on October 13, 2011. The guidance aims to clarify existing disclosure obligations by discussing the circumstances under which registrants should disclose cybersecurity risks in their filings. Appropriate disclosure may include any of the following: (i) discussion of the registrant's business or operations that give rise to material cybersecurity risks and the potential costs and consequences; (ii) description of cyber incidents experienced that are individually, or in the aggregate, material, including a description of the costs and other consequences; (iii) to the extent that the registrant outsources functions that have material cybersecurity risks, a description of those functions and how the registrant addresses those risks; (iv) risks related to cyber incidents that may remain undetected for an extended period; and (v) a description of relevant insurance coverage. As with other

¹ For a copy of our most recent review of public insurance company risk factor disclosure, please see http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/4285/2012_Insurance_Industry_Risk_Factor_Review.pdf.

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risk factors, registrants should avoid “boilerplate” disclosure and instead provide disclosures that are tailored to their particular facts and circumstances.

In addition, the guidance notes that registrants should address cybersecurity risks and cyber incidents in their MD&A if the costs or other consequences associated with a known incident or the risk of potential incidents represents a material event, trend, or uncertainty that is reasonably likely to have a material effect on the registrant’s results of operations, liquidity or financial condition.

d) Inability of the Public Company Accounting Oversight Board (the “PCAOB”) to Inspect Certain Foreign Auditors

Under the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”), public company auditors must be registered with the PCAOB. The PCAOB conducts inspections to assess the degree of compliance of each registered public accounting firm with the Sarbanes-Oxley Act, SEC rules and PCAOB rules. PCAOB inspections may result in the identification of deficiencies in an audit firm’s audit or in its quality control procedures. As a result of the inspection process, the audit firm may carry out additional procedures and/or revise its financial statements. In practice, PCAOB inspections should be conducted annually for firms that audit more than 100 issuers and at least once every three years for all other audit firms.

While the PCAOB has been able to conduct some foreign audit firm inspections, the PCAOB has been unable to conduct inspections in several jurisdictions, including certain members of the European Union, Switzerland and, most notably, China, primarily as a result of asserted restrictions under local law or objections based on national sovereignty.

The SEC has noted that as a result of the PCAOB’s inability to conduct certain foreign audit firm inspections in the regular course of business, U.S. investors that rely on the auditor’s reports are deprived of the benefits of such PCAOB inspection. As a consequence, affected issuers may wish to consider including a separate risk factor explaining the potential consequences of the PCAOB’s inability to inspect the non-U.S. audit firm.

In addition, the SEC’s inability to obtain access to the audit work papers of non-U.S. audit firms as a result of local law restrictions may have other consequences. For example, on December 3, 2012, the SEC began administrative proceedings against the China affiliates of each of the Big Four accounting firms for violating provisions of the Securities Exchange Act and the Sarbanes-Oxley Act that require foreign public accounting firms to provide the SEC upon request with audit work papers involving any company trading on U.S. markets. The audit materials are being sought as part of SEC investigations into potential wrongdoing by nine China-based companies whose securities are publicly traded in the U.S. However, this case, and the underlying unresolved issue as to production of non-U.S. audit work papers, may have ramifications beyond the enforcement context. It potentially could adversely affect not just the China-based issuers that rely on these audit firms to audit the financial statements included in their SEC filings, but also multi-national companies, including insurers, with significant operations in China, to the extent that their auditors may not be able to provide the SEC with the work papers of their China affiliates to demonstrate the adequacy of their work. While the outcome of this issue is unclear, it is to be hoped that the SEC will work with its Chinese counterparts toward a resolution.

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

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

The 2012 proxy season witnessed the continuation of some old trends and the uncertain evolution of some new themes. In addition, 2012 included several noteworthy examples of shareholder activism outside the shareholder voting process.

A. Proxy Access

As most readers will recall, in September 2011 the SEC adopted amendments to Rule 14a-8 under the Securities Exchange Act that in essence permit shareholders to propose that companies adopt their own individual versions of “proxy access.” Proxy access refers to the ability of shareholders, under defined circumstances, to require issuers to include one or more candidates for election to the issuer’s board of directors nominated by shareholders in the issuer’s own proxy statement. Having such a right would promote shareholder democracy and good corporate governance, the theory goes, by enabling shareholders to avoid the expense and trouble of preparing and distributing their own competing proxy materials. The Rule 14a-8 changes were proposed at the same time as the SEC’s own proxy access rule, Rule 14a-11, which was vacated by the D.C. Circuit Court of Appeals in mid-2011 and not repropoed by the SEC.

Taking advantage of the new rule, by most counts nearly 30 stockholder proposals were submitted to issuers for a vote on some form of proxy access at the 2012 annual meeting. Some of these proposals took the form of proposed by-law amendments that would have been binding on the issuers if adopted (based on the power of shareholders in most states to directly amend the by-laws), although slightly more were traditional precatory resolutions. These proposals included minimum ownership levels for persons seeking access to the issuer’s proxy statement ranging from \$200,000 worth of stock up to 3% of the issuer’s outstanding shares, and required holding periods prior to the proposal ranging from one year up to three years.

Of the proposals made, we are aware of 11 that actually came to a vote at a stockholders’ meeting; a number were excluded through the SEC no-action letter process, while others were withdrawn following engagement by the issuer with the proponent. Of the proposals that came to a vote, only two received more than a majority of the votes cast. It is noteworthy that these two precatory proposals were made at Chesapeake Energy and Nabors Industries, both companies under fire in the last 18 months for their executive compensation practices and other matters. It is equally noteworthy that both of the proposals that passed were on the most restrictive end of the spectrum, requiring the stockholder seeking proxy access to have held 3% or more of the issuer’s stock for at least three years. Both proposals also received a “for” recommendation from ISS. The other nine proposals all had lower ownership thresholds and shorter holding periods, and a mix of “for” and “against” recommendations from ISS. On average, the proposals at these other nine companies received 24% of the votes cast.

The 2012 results seem too small a sample size to draw any clear conclusions, and as a result proxy access, for now, goes into our “uncertain evolution” category. If we had to guess, however, we would predict that proxy access will not quickly catch on as a measure that (like board declassification or majority voting for directors) routinely garners greater than 50% of the votes cast. Proxy access has a fairly limited benefit (a committed insurgent can always run a proxy fight—there were at least 35 proxy fights over directors at U.S. public companies last year) and, at that, may be seen as only benefitting certain large, long-term holders. Our best guess is that in 2013, proxy access proposals will continue to pass predominantly at companies with visible governance issues and where structured as requiring 3% ownership for at least three years.

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

B. Say-on-Pay

As in 2011, voting results at U.S. public companies in 2012 were once again overwhelmingly in favor of approval of companies' executive compensation and related proxy statement disclosures. In fact, say-on-pay failed to receive a majority of the votes cast at only 11 of approximately 400 member companies of the Fortune 500 tracked by Georgeson, or less than 3% of companies. This percentage mirrored the rate of majority "no" votes in the larger Russell 3000 index as well. Across the board, support for say-on-pay averaged approximately 90%. ISS again issued many more negative recommendations than there were companies that received a majority vote against a say-on-pay proposal; and less than 20% of companies receiving a negative ISS recommendation failed the vote. However, a negative ISS recommendation did clearly correlate to a lower vote percentage in favor of say-on-pay. On average, "for" votes at such companies were 30% lower than votes at companies with a favorable ISS recommendation. As in 2011, an unfavorable ISS recommendation, coupled with poor linkage between pay and performance, is a reasonable predictor of a "no" vote.

The consequences of a failed vote can be significant. A "no" say-on-pay vote will result in an "against" (or "withhold") recommendation by ISS with respect to compensation committee members (at least where the issuer does not make significant changes in response to the vote), while a "yes" vote at a level of less than 70% in favor will result in enhanced scrutiny by ISS and potentially a negative recommendation with respect to such committee members. A "no" vote can also lead to litigation; although many such cases have been dismissed before the discovery phase, litigation is a costly distraction even if dismissed early. Corporate executives should continue to have a healthy regard for the benefits of passing the say-on-pay vote, lest a "no" vote be interpreted by the board as indicating a loss of confidence in the CEO's leadership on the part of stockholders. Examples of CEOs at financial services companies who left their posts in 2012 following a no vote on pay included Andrew Moss at Aviva plc and Vikram Pandit at Citibank.

C. Other Shareholder Proposal Trends

Outside the area of proxy access, other shareholder proposals continued to follow some familiar trends in 2012. According to Georgeson, which tracks those companies in the S&P 500 that hold annual stockholder meetings in the first six months of the year, the number of shareholder proposals voted on increased slightly to 269 in 2012 from 240 in 2011, both of which numbers are substantially lower than 342 in 2010. Votes to repeal classified boards and end pure plurality voting for directors continued to get majority support on average. Majority vote proposals at companies with "majority vote-lite" provisions (i.e., plurality voting coupled with a resignation policy) and other governance measures generally did not pass. Two other provisions that have been the focus of activists in recent years, enhancing the right of stockholders to call special meetings and enabling stockholders to act by written consent, continued to receive favorable votes that averaged in the 40-45% range, significant but still not enough to make them a sure thing, although some companies, seeing limited harm in such measures, agreed to present their own measures to implement the change rather than running the shareholder proposal.

Another popular shareholder proposal item in 2012 was resolutions seeking disclosure (or in a few cases, a prohibition on) political contributions by issuers. These proposals have become common in the wake of the Supreme Court's *Citizens United* decision, and ISS's announced policy in 2012 was to vote in favor of them. The pending presidential election was another contributing factor. Georgeson tracked a total of 70 such proposals (or closely related matters) in 2012. Somewhat surprisingly, none received a majority of the votes cast, and many were soundly defeated, receiving less than 10% of the vote. This type of proposal will be far less likely to be presented in 2013.

Finally, we cannot leave the topic of shareholder vote developments in 2012 without looking at developments in the U.K., which have influenced U.S. governance trends in the past (for example, U.K. listing rules required a non-binding

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

vote on executive compensation long before the Dodd-Frank Act became law). In mid-year, the U.K. government proposed rules under which shareholders would be given a binding vote on a company's pay policy, including its approach to exit payments. Companies would be only allowed to make remuneration payments and exit payments within the limits approved by shareholders. This vote will be required to be held annually, unless companies choose to leave their pay policy unchanged, in which case it must be held not less frequently than every three years. Companies would also be required to maintain the current annual advisory vote on pay. In addition, the government announced support for measures that would require that where the annual advisory vote results in a substantial minority of shareholders voting "no," the company would have to respond and say what it would do to address shareholder concerns. The U.K. government is drafting final regulations on these matters for presentation to Parliament in early 2013.

Although it is not clear that similar regulation would work under U.S. federal law (a binding shareholder vote may conflict with the primacy of state law on the internal affairs of a corporation), a federal rule could in other ways accomplish much the same effect (e.g., by creating limits on continued stock exchange listing). We will continue to watch this development with interest. We find the provision about responding to a substantial minority of no votes particularly interesting; this could be the next frontier in shareholder activism, given the failure of so many different types of shareholder causes to earn an outright majority of votes cast. Moving the goalposts could make a range of proposals even more relevant than they are today.

D. Proxy Fights and Other Stockholder Activism

Unlike in 2011, in 2012 there were no public proxy fights affecting a significant insurance holding company. These proxy fights are unique in their complexity because of the interplay of insurance regulation (with its strict limits on obtaining "control" of an insurer, as defined for insurance law purposes), and the federal securities and state corporate laws that govern proxy fights.

Outside the pure proxy fight context, one of the most-watched shareholder activism situations at this time last year was Paulson & Co.'s very public push for structural changes at Hartford Financial. Paulson's proposal was for Hartford to spin off its life business to stockholders, thereby "unlocking" the value of its property/casualty franchise. But Hartford had already been considering its options, and in the first part of 2012 announced a plan to sell its life insurance and retirement services businesses, which resulted in signed contracts in reasonably short order (given the complexities involved). Although some viewed Hartford's decision as driven by pressure from Paulson, industry insiders know that is not an accurate depiction; in fact, while Paulson generally hailed the move, his firm continued to complain that the sale alone did not do enough to promote the property/casualty business. However, in May 2012 Paulson & Co. amended its Schedule 13D filing in respect of Hartford to a Schedule 13G (passive investor) filing, which seems more appropriate given the firm's lack of an approved Form A insurance holding company filing permitting it to exercise control over Hartford.

Finally, although not in the financial services context, the battle between Third Point and Yahoo was noteworthy. Third Point, a well-known hedge fund, sought changes at Yahoo that would increase the latter company's value. The fund proposed a slate of directors. When Yahoo refused to go along, Third Point upped the ante by revealing its discovery that the then-CEO of Yahoo had not earned an undergraduate degree in computer science as he had claimed, but only an accounting degree. Third Point also disclosed that the Yahoo board member who headed the CEO search committee also had disclosure issues surrounding her educational qualifications. These tactics led to the prompt resignation of Thompson and the appointment of three Third Point designees to the Yahoo board.

V. Regulatory Developments Affecting Insurance Companies

V. Regulatory Developments Affecting Insurance Companies

A. Overview

In 2012, regulatory developments affecting insurance companies were not isolated to developments at the National Association of Insurance Commissioners (“NAIC”). With the increasing globalization of the insurance industry and the expanded role of the Federal government in insurance matters, insurance companies have had to monitor a myriad of regulatory developments at the state, federal and international levels.

The increasing complexity of insurance regulation is exemplified by the work of state, federal and international regulators regarding the supervision and regulation of insurance groups. In response to international standards applicable to insurance regulation, U.S. regulators pursued a number of initiatives. For example, a major initiative completed by the NAIC in 2012 was the adoption of the Risk Management and Own Risk and Solvency Assessment Model Act (the “ORSA Model Act”), which, if adopted by the states, would require U.S. insurers with premiums in excess of certain thresholds to maintain a risk management framework and to conduct an own risk and solvency assessment in accordance with guidelines established by the NAIC. In 2010, the NAIC adopted amendments to the NAIC Model Insurance Holding Company Systems Regulatory Act, requiring an ultimate controlling person of a U.S. insurer to file an enterprise risk report identifying risks posed to the insurer by its insurance and non-insurance affiliates. In 2012, eight additional states adopted the amendments to the Insurance Holding Company Act, and insurers may find that their first enterprise risk reports are due in 2013. At the Federal level, the Federal Insurance Office (the “FIO”) has also increased its visibility in 2012, including by becoming a member of the executive committee of the International Association of Insurance

Supervisors (“IAIS”) and participating in the IAIS’ project of building a framework for the supervision of internationally active insurance companies, known as ComFrame. FIO has also initiated a dialogue project with the European Union regulators to achieve a greater understanding of the key aspects of characteristics of each regime.

There were also significant developments in the life insurance industry regarding the requirements for establishing reserves. After almost a decade of work, the NAIC narrowly adopted the Valuation Manual at the end of 2012 to implement a principles-based approach to the establishment of life insurance reserves. Although this was a major accomplishment for the NAIC, in order for principles-based reserving to be implemented in the states, it will need to be adopted by a large majority of the state legislatures representing states with significant premium. The achievement of this level of state adoption may prove challenging given the narrow passage of the Valuation Manual at the NAIC. The NAIC also adopted in 2012 revisions to Actuarial Guideline 38 to clarify reserve requirements for universal life products with secondary guarantees.

Another major topic at the NAIC in 2012 was the use of insurer-owned captive insurers and special purpose vehicles. The NAIC exposed a draft white paper with suggestions on the regulatory framework for insurer-owned captive insurers, which generated much debate among industry representatives and regulators. A revised draft of the white paper is expected to be released by the NAIC in early 2013 and the debate is likely to continue.

On the property and casualty side, the end of 2012 was dominated by regulatory responses to the devastation that occurred from Superstorm Sandy, with New York insurance regulators at the forefront of these developments. For the surplus and excess lines market, the lack of state uniformity regarding the allocation of surplus lines taxes continued to be a major area of concern.

V. Regulatory Developments Affecting Insurance Companies

With respect to reinsurance regulation, 2012 marked the one-year anniversary of adoption of amendments to the NAIC's credit for reinsurance model law and regulation. At the Fall National Meeting, the NAIC reported that eleven states have adopted revisions to their credit for reinsurance statutes and regulations. The NAIC also reported that only Florida and New York have approved any reinsurers for collateral reduction.

B. Life Insurance Topics

1. Principles-Based Reserving for Life Insurers

In 2005, the NAIC started working on developing a "principles-based reserving" approach ("PBR") to life insurance reserving methods, in which actuarial judgment and the risks faced by each insurer would have greater weight on an insurer's reserves than the current formula-based reserving methodology. There are three key elements to implement PBR: (a) NAIC's amending the standard valuation law in order to provide authority for insurers to use PBR; (b) NAIC's adopting a Valuation Manual; and (c) the states' adopting the amendments to the standard valuation law and related items.

a) NAIC Amends Relevant Laws

The NAIC's amendment of the model standard valuation law was completed in 2009. However, since then, the introduction of the amendments to the model standard valuation law, and a related model non-forfeiture law, by state legislatures has been on hold until completion of the Valuation Manual by the NAIC.

b) NAIC Adopts Valuation Manual

The Valuation Manual provides detailed guidance from insurance regulators regarding insurers' implementation of PBR. However, in order for the Valuation Manual to become effective, a supermajority of the NAIC (i.e., at least 42 members) or three-fourths of the members voting, whichever is greater, must have voted for adoption. At the joint meeting of the Executive (EX) Committee and Plenary

at the 2012 Fall National Meeting, the NAIC members narrowly approved passage of the Valuation Manual by 43 members (one more than the required supermajority). The jurisdictions that voted against passage were California, Guam, Maryland, New Mexico, New York, North Carolina, Oregon, and Wyoming; Minnesota and Oklahoma abstained. After years of work, adoption of the Valuation Manual is a major accomplishment for the NAIC, although issues raised by several states that voted against adoption reflect open questions requiring additional NAIC focus on PBR.

Specifically, shortly prior to the 2012 Fall National Meeting, Superintendent Lawsky of the New York State Department of Financial Services ("NYSDFS") sent a letter to his fellow state insurance commissioners expressing reservations about adoption of the Valuation Manual. In his letter, Superintendent Lawsky expressed a number of concerns, including that PBR was "disastrous" in the banking sector and that "regulators are ill-equipped at present to implement and oversee [PBR]." Commissioner Jones of the California Insurance Department expressed similar concerns.

At the Principles-Based Reserving (E) Working Group ("PBR Working Group") meeting, which met before the vote by the Executive (EX) Committee and Plenary on adoption of the Valuation Manual, the PBR Working Group exposed a PBR implementation plan and timeline for comment ("Implementation Plan"). The Implementation Plan sets forth certain proposals designed to assist in implementing PBR, including training and additional resources for regulators. The Implementation Plan was clearly developed to address the concerns of regulators regarding the Valuation Manual.

The NAIC members also voted to elevate the PBR Working Group to an executive level joint working group of the Life Insurance and Annuities (A) Committee and the Financial Condition (E) Committee. As an executive level group, the PBR Working Group will have increased participation at the commissioner level. The PBR Working Group will focus on the implementation of PBR, including ensuring that regulators have adequate resources.

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c) Adoption by a Supermajority of States Is Necessary Next Step for PBR Implementation

With the Valuation Manual adopted by the NAIC, the third element, i.e., adoption by the state legislatures, is poised to be a major initiative in 2013. However, in order for the standard valuation law and the Valuation Manual to become effective, the amended standard valuation law has to be adopted by a supermajority of jurisdictions representing at least 75% of the applicable premium. Although certain key states voted against the Valuation Manual, the Implementation Plan and the elevation of the PBR Working Group to an executive level committee may help the NAIC address the large states' concerns, which is critical in order for PBR to become effective.

2. Unclaimed Life Insurance

a) Settlements and Investigations

States have recently increased their focus on life insurance company compliance with unclaimed property laws. State statutes generally address when life insurance proceeds are payable to the state under unclaimed property laws. In an effort to collect additional revenues, certain states have conducted investigations into life insurers' claims settlement practices, i.e., the process by which insurers determine when a death occurred requiring payment to a beneficiary or, if unclaimed, escheatment to a state. Certain states took the position that life insurers should affirmatively identify and confirm an insured's death by cross-checking against the Social Security Administration's Death Master File ("DMF"), although such practices were not required under policy forms or relevant insurance laws. In May 2011, the NAIC formed the Investigations of Life and Annuity Claims Settlement Practices Task Force ("Settlement Task Force") to coordinate regulatory investigations of life insurance companies' practices regarding the payment of death benefits and the use of the DMF.

In 2011 and 2012, a number of life insurance companies entered into settlement agreements with state officials, some of which agreements were brokered by the Settlement Task Force. Pursuant to those settlement agreements, life insurance companies generally agreed to reform their claims settlement practices to include use of the DMF to identify insureds, annuity owners and retained asset account holders who have died. In certain instances, settling insurers have agreed to pay fines with respect to past practices.

b) Legislative Action

In November 2011, the National Conference of Insurance Legislators ("NCOIL") approved its Model Unclaimed Life Insurance Benefits Act, which was amended and adopted by NCOIL in July 2012 ("Model Unclaimed Benefits Act"). The Model Unclaimed Benefits Act requires insurers to cross-reference on at least a semi-annual basis the DMF regarding in-force life insurance policies and retained asset accounts. Based on publicly available information, legislation to enact the Model Unclaimed Benefits Act (or similar requirements) was introduced in 2012 in the legislatures of six states, and was enacted by Alabama (effective January 1, 2014), Kentucky (effective January 1, 2013), Maryland (effective October 1, 2013) and New York (effective June 17, 2013). Proposed legislation was introduced in Tennessee but was not enacted; proposed legislation was introduced in November 2012 in Montana and is still pending.

c) New York

On July 5, 2011, the New York Insurance Department (now part of the NYSDFS) issued a letter pursuant to Section 308 of the New York Insurance Law, which initiated an investigation into how life insurers tracked policyholders, annuitants and retained asset account holders. Ultimately, the Section 308 letter required life insurers to conduct DMF cross-checks for all life insurance policies, annuities and retained asset accounts in effect as of January 1, 1986.

V. Regulatory Developments Affecting Insurance Companies

On May 14, 2012, the NYSDFS announced that it had promulgated Emergency Insurance Regulation 200 (11 NYCRR 226) (“Regulation 200”), which required life insurers and fraternal benefit societies to “implement reasonable procedures to identify unclaimed death benefits, locate beneficiaries, and make prompt payments.” It went on to require that life insurers and fraternal benefit societies conduct cross-checks with the DMF on at least a quarterly basis using the insured’s or account holder’s social security number or, if the social security number is not known, the name and date of birth of the insured or account holder. Regulation 200 also required that life insurers and fraternal benefit societies establish procedures to electronically receive electronic lost policy finder application requests. Upon receipt of such a request, Regulation 200 required life insurers and fraternal benefit societies to conduct a crosscheck for any policy matches. Regulation 200 became effective on June 14, 2012. Its effectiveness has been extended until February 6, 2013.

In addition, on December 17, 2012, legislation regarding unclaimed life insurance benefits was enacted in New York; it will become effective on June 17, 2013. In Governor Cuomo’s approval memorandum for this act, he indicated that the New York legislature had agreed to make certain technical amendments, including: (i) requiring that DMF cross-checks be performed based on social security numbers, with name and date of birth used when a social security number is unavailable; (ii) requiring insurers to accept alternate proof of loss in instances where a death certificate is unavailable; and (iii) clarifying the scope of any exemption in the law for group insurance policies. It is also expected that the NYSDFS will revise Regulation 200 to conform to the recently enacted New York legislation relating to unclaimed life insurance benefits.

3. Actuarial Guideline XXXVIII (AG 38)

Actuarial Guideline XXXVIII (“AG 38”) was enacted by the NAIC in 2003 to clarify reserve requirements for universal life products with secondary guarantees (“ULSGs”). Despite the enactment of AG 38 and subsequent revisions in 2005, debate persisted among insurance regulators and industry representatives regarding the lack of uniformity in implementation of these reserve requirements by insurers. Accordingly, in late 2011, the NAIC formed a Joint Working Group of the Life Insurance and Annuities (A) Committee and Financial Condition (E) Committee (“Joint Working Group”), chaired by the Texas Insurance Commissioner, to assess whether the NAIC should develop interim guidelines or other tools to evaluate the reserve requirements for these products.

On August 28, 2012, following months of work to address the consistency of AG 38 implementation, the Joint Working Group unanimously approved revisions to AG 38, which were thereafter, on September 6, 2012, adopted by the Life Insurance and Annuities (A) Committee and Financial Condition (E) Committee. The NAIC Executive Committee and Plenary also voted unanimously to adopt the revisions to AG 38 on September 12, 2012.

In particular, the revisions to AG 38, which are effective for statutory filings due in 2013, address reserve adequacy for ULSGs separately for in-force business and prospective business.

■ ***In-Force Business***

With respect to ULSG policies and certificates (a) issued on and after July 1, 2005, (b) issued prior to January 1, 2013 and (c) in-force on December 31, 2012, AG 38 provides primarily for a principles-based reserving gross premium approach.

■ ***Prospective Business***

With respect to ULSG policies and certificates issued on or after January 1, 2013, the newly revised AG 38 provides for a blended approach to reserving, with three proposed “safe harbors” and, for products that do not meet one of the safe harbors, a “greatest deficiency reserve” methodology.

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To address inevitable interpretive questions and to promote uniformity and ensure that there is not substantial deviation among insurers, on October 29, 2012 the NAIC's Financial Condition (E) Committee established the Emerging Actuarial Issues (E) Working Group. This working group will adopt formal interpretations of questions that are presented to it regarding AG 38, which interpretations will then be reported to the Financial Condition (E) Committee. In turn, upon adoption by the Financial Condition (E) Committee, the Financial Analysis (E) Working Group will be directed to follow such interpretations in performing its review of reserving methodologies under AG 38.

In New York, draft amendments to Regulation 147 (Valuation of Life Insurance Reserves) were proposed by the NYSDFS to implement the revised AG 38. Although the draft amendments do not simply incorporate AG 38 in its entirety by reference to the NAIC's Accounting Practices and Procedures Manual, the NYSDFS reportedly does not view the proposed amendments to Regulation 147 as containing any substantive differences. The draft amendments to Regulation 147 are under review by the NYSDFS's Office of General Counsel, and are expected to be adopted in short order.

C. Property/Casualty Insurance Topics

1. Surplus and Excess Lines

The Nonadmitted and Reinsurance Reform Act ("NRRA"),² which became effective on July 21, 2011, addresses certain inefficiencies in the regulation of surplus line insurance and reinsurance. Specifically, the NRRA provides for the regulation of the surplus line placement by the policyholder's "home state," including with respect to broker licensing, and surplus line tax payments. The NRRA also establishes uniform standards for surplus line insurer eligibility. With respect to U.S.-domiciled surplus and excess lines insurers, the NRRA prohibits states from imposing eligibility requirements, or otherwise establishing eligibility criteria, except in conformance with the NRRA, which incorporates specific

elements of the NAIC's Nonadmitted Insurance Model Act. With respect to non-U.S. surplus and excess lines insurers, the NRRA provides that a state may not prohibit a surplus line broker from placing non-admitted insurance with an insurer that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.

a) Surplus Line Tax

The NRRA grants the home state exclusive authority to require surplus line tax payments for non-admitted insurance, but also permits states to enter into a compact or otherwise establish procedures to allocate surplus line taxes among the states based on the premium paid to an insured's "home state."

Two separate approaches to state surplus line tax allocation have been adopted by certain states: (i) the Nonadmitted Insurance Multi-State Agreement ("NIMA"), backed by the NAIC, which is limited to surplus line tax collection and allocation for multi-state surplus line coverage; and (ii) the Surplus Lines Insurance Multi-State Compliance Compact ("SLIMPACT"), endorsed by NCOIL, which is a more comprehensive approach that addresses, in addition to surplus line tax collection and allocation, such issues as uniform insurer eligibility and broker regulatory requirements. Neither approach, however, gained broad support and, in fact, several states have dropped out of NIMA. Although NIMA went into effect in the summer of 2012, it did so with only six of its original 12 member jurisdictions. NIMA members currently include Florida, Louisiana, Puerto Rico, South Dakota, Utah and Wyoming. With nine members, SLIMPACT has more members than NIMA, but has not yet gone into effect since it requires, by its own terms, 10 states to sign on before the tax-sharing operation becomes effective. SLIMPACT members currently include Alabama, Indiana, Kansas, Kentucky, New Mexico, North Dakota, Rhode Island, Tennessee and Vermont. As other states continue to consider SLIMPACT, including Ohio, which has passed legislation that

² Title V, Subsection B of the Dodd-Frank Act.

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permits the Ohio Superintendent to enter into SLIMPACT, it is possible that SLIMPACT will go into effect in 2013 among its member states. Other states, including New York and California, have amended their laws to provide for home state collection of surplus line tax and have not entered into either compact. Should SLIMPACT become operational, the presence of two competing approaches, coupled with states that have opted to forego both approaches and instead keep 100% of surplus line premium tax for coverage provided to their home state insureds, is likely to present challenges to excess line brokers as they would need to continue to navigate excess line tax issues on a state-by-state basis in a non-uniform manner. For example, the determination of the “home state” of the insured could require brokers to review the applicable definitions under state law, as well as those under SLIMPACT and NIMA, as applicable.

b) NRRRA Interpretation/Implementation Issues

In 2012, following reports of differences in how states are interpreting the NRRRA surplus line insurer eligibility standards that have resulted in inconsistencies and a lack of true uniformity, the NAIC has undertaken a survey of states to determine, among other things: (i) whether a state’s current statutes and regulations related to nonadmitted insurer eligibility requirements conform to the mandates listed in the NRRRA; (ii) whether a state currently maintains a “white list” for nonadmitted insurers deemed eligible to transact business in such state; and (iii) which eligibility requirements a state considers essential for the oversight of nonadmitted insurers.

Following completion of the survey, it is expected that in 2013 the NAIC will issue interpretive guidance for NAIC member states to assist with the uniform implementation of the NRRRA insurer eligibility standards across all states.

2. Lender-Placed Insurance

Creditor/lender-placed insurance (“LP Insurance”) came under increased scrutiny in 2012. The reasons for this increased attention, both from federal and state regulatory authorities and private litigants, are multifaceted, although the increase in home foreclosures brought about by the financial and home loan crisis, which coincided with a concomitant increase in the volume of LP Insurance, has served to bring the issues surrounding LP Insurance to the forefront.

LP Insurance is insurance procured by a lender when its customer fails to carry or renew property hazard insurance on an asset in which the lender has a security interest. Coverage obtained by the lender under these circumstances is known as lender-placed (or force-placed) insurance.

At the state level, insurance regulators in California, Florida, New York and Texas have all held public hearings on LP Insurance. In addition, public hearings were held during the NAIC’s 2012 Summer National Meeting. Throughout these hearings, consumer advocates challenged the LP Insurance system and alleged it contained impermissible kickbacks and inflated prices for policies, while the financial industry defended the LP Insurance system and emphasized the necessity of LP Insurance and the large risks taken on by LP Insurance providers. It is expected, for example, that in 2013 the NAIC will explore whether its Creditor-Placed Model Act, which was promulgated by the NAIC 16 years ago but has been adopted by only four states, currently contains sufficient consumer safeguards, or should be amended or replaced.

At the federal level, the Dodd-Frank Act amended the Real Estate Settlement Procedures Act of 1974 (“RESPA”) to impose requirements on banks specifically with respect to LP Insurance. Those amendments impact the notification required to be provided to borrowers regarding the possibility of incurring LP Insurance coverage, and require that “[a]ll charges . . . related to force-placed insurance imposed on the

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borrower by or through the services shall be bona fide and reasonable.” The Dodd-Frank Act’s amendments to RESPA do not become effective until after the Consumer Financial Protection Bureau, the federal agency that holds primary responsibility for regulating consumer protection in the United States, finalizes its implementing regulations, which are expected in January 2013.

3. Biggert-Waters Flood Insurance Reform Act

On July 6, 2012, President Obama signed the Biggert-Waters Flood Insurance Reform Act of 2012 (the “Flood Act”), which extended the National Flood Insurance Program (“Program”) for five years. This development was substantial, as the Program had previously been extended for several sequential one-year periods. The Flood Act requires the phasing out of various subsidies of premium rates, the establishment of a program to update zone maps, a report to Congress from the Federal Emergency Management Agency and the Government Accountability Office on the private reinsurance market’s capacity to assume some of the Program’s insurance risk, and various other changes that may reduce the debt of the Program.

Following Superstorm Sandy, the Program has received additional attention. While Superstorm Sandy is currently expected to generate \$12-15 billion in flood claims alone to be paid by the government, the Program had only \$4 billion in borrowing authority remaining as of December. President Obama promised to take action to increase that borrowing authority, and in early January 2013 Congress passed, and President Obama signed, legislation increasing the Program’s borrowing authority by \$9.7 billion. It remains to be seen whether there will be any further changes legislated as a result of the impact of Sandy.

4. Disaster Recovery

In the aftermath of Superstorm Sandy, we considered how insurance companies prepare for the risks presented to their own business operations by natural disasters.³ Insurers’ disaster response to policyholders and regulators after Superstorm Sandy was an urgent priority. Also important, however, is an assessment by insurers of the risks presented to their own business operations by such natural disasters. The key aspects of an insurer’s disaster risk assessment and recovery efforts should include the protection of data, information technology, business records and private medical and financial information. The contours and legal necessity of such aspects of disaster recovery are discussed in certain statutory and regulatory frameworks that relate directly or indirectly to insurance company disaster recovery planning, including: (a) authorities issued by State Insurance Departments (e.g., circular letters issued by the NYSDFS and guidance issued by the Florida Office of Insurance Regulation); (b) the Sarbanes-Oxley Act; (c) the Health Information Technology for Economic and Clinical Health Act of 2009; and (d) Title V of the Gramm-Leach-Bliley Act.

The complex priorities of assessing, monitoring and planning for risks in order to maintain business operations while also protecting confidential policyholder information present unique challenges to the insurance industry. Based upon the previously mentioned statutory and regulatory frameworks, set forth in the following list is a brief overview of data protection and recovery best practices that insurance companies should consider implementing to minimize risk and maximize compliance: (a) analyzing vulnerabilities by conducting a business impact analysis and a risk analysis; (b) ensuring that the appropriate data and systems security protocols are followed leading up to, and maintained during, a disaster to avoid exposure to legal liability; (c) ensuring that proper backup, emergency access and restoration

³ For an in-depth discussion, please refer to our Client Memorandum dated December 11, 2012, on this topic entitled “In the Wake of Storm Sandy, Insurance Companies Should Ensure That Their Business Continuity and Disaster Recovery Plans Comply with Legal Requirements and Best Practices.” at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/4273/In_The_Wake_of_Storm_Sandy_Recovery_Plans.pdf.

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procedures are in place; (d) training employees in respect of, and ensuring that employees have ready access to, the disaster recovery plan; and (e) testing, reviewing and redrafting, where necessary, the procedures contained in the disaster recovery plan. It should be noted that a given insurer may be subject to one or more of the laws discussed above, and thus some of these best practices may also be legal requirements; this is particularly true for HIPAA-covered insurers.

D. Insurance Topics of General Interest

1. Special Purpose Vehicles/Captives

In late 2011, the NAIC formed a subgroup (the "Captive/SPV Subgroup") of its Financial Condition (E) Committee to study insurer-owned captive insurers and special purpose vehicles ("SPVs"). The formation of the Captive/SPV Subgroup was prompted, in part, by perceived inconsistencies in state regulatory requirements for insurers' use of captive insurers and SPVs. The Captive/SPV Subgroup has emphasized that the traditional policyholder-owned self-insurance captive structure is not a focus of this review. Rather, the Captive/SPV Subgroup's focus is on certain insurers' use of captive insurers and SPVs to transfer certain insurance risks to the capital markets or affiliated entities in different jurisdictions in order to overcome conservative reserve requirements, as in the case of XXX or AXXX reserves, or for other purposes. Accordingly, the Captive/SPV Subgroup has studied whether the existing regulatory framework as it relates to traditional policyholder-owned captives and in other respects is appropriate for regulating an insurance company-owned captive insurer or SPV.

Draft Captive White Paper.

The Captive/SPV Subgroup activity in 2012 culminated in the release of a draft white paper (the "Draft Captive White Paper"), which currently addresses: (a) accounting considerations regarding the treatment of XXX and AXXX reserve redundancies; (b) possible enhancements to the

NAIC's Special Purpose Reinsurance Vehicles Model Act; (c) adherence to the standards of the IAIS requiring that insurer- or reinsurer-owned or commonly controlled captives/SPVs, which are not otherwise self-insurance, are subject to the same regulatory framework as commercial insurers; (d) enhanced financial statement disclosures; (e) enhanced transparency to other functional regulators; (f) enhanced analysis guidance, including holding company analysis; (g) development of accreditation guidelines to ensure consistency and uniformity among states reviewing these transactions; and (h) a recommendation to study further the developments regarding letters of credit issued on a qualified basis.

International Standards.

Members of the Captive/SPV Subgroup have acknowledged the necessity and value of mechanisms designed to shift insurance risk to the capital markets or other forms of financing. At the same time, the Captive/SPV Subgroup expressed support for the IAIS's guidance that captive insurers and SPVs affiliated with insurers should be subject to a similar regulatory framework as commercial insurers.

Accounting Issues/Credit for Reinsurance.

During meetings and conference calls held throughout 2012, certain members of the Captive/SPV Subgroup discussed their view that, notwithstanding the need to address accounting issues relating to the perceived redundancies of XXX and AXXX reserves, the use of captives/SPVs to address statutory accounting reserving requirements should be discouraged. In addition, the Captive/SPV Subgroup received comments regarding credit for reinsurance standards applied to insurance industry captive/SPV transactions. Specifically, the Draft Captive White Paper highlights captive/SPV use of conditional letters of credit that differ from standard letter of credit requirements as set forth in the NAIC's Model Credit for Reinsurance Act. The Draft Captive White Paper currently recommends that the effects of conditional letters of credit or other forms of reinsurance security be studied in 2013.

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Holding Company Analysis.

The Draft Captive White Paper suggests that the most effective method to monitor risk-transfer transactions involving insurance industry captives/SPVs is through insurance holding company system analysis. Accordingly, the Captive/SPV Subgroup is likely to recommend that the holding company analysis procedures of the NAIC's Financial Analysis Handbook be amended to include a section on alternative risk-transfer arrangements, and that ceding company procedures be developed for alternative risk-transfer arrangements in order to assist regulators in documenting their review and approval of these transactions. Furthermore, with the stated goal of achieving a more uniform and consistent review of these transactions, as well as the ongoing monitoring of the ceding insurer, the captive and the holding company system, the Captive/SPV Subgroup may propose that the NAIC develop guidance for the states. Once the guidance is developed, the Captive/SPV Subgroup may propose that such guidance be considered to be added to the accreditation standards.

Ongoing Work of the Subgroup.

The Captive/SPV Subgroup continues to revise the Draft Captive White Paper, and it is expected that it will be exposing the revised draft in January 2013 for further comments.

New York Section 308 Requests.

In July 2012, the NYSDFS issued Section 308 requests for special report letters to certain New York-authorized insurers seeking broad information on their use and the use by other companies within their holding company systems of captive insurers or off-shore entities for reinsurance of insurance risk. The request covered all companies within the authorized insurers' holding company systems, and was not limited to New York-authorized insurers. Although the NYSDFS has not publicly stated its purpose or intended use of this information, the breadth of the request suggests that the NYSDFS is conducting its own review of the use of captive insurers and SPVs similar to the NAIC Captive/SPV Subgroup's review.

2. Reinsurance: Reduced Collateral Requirements/ Credit for Reinsurance: NAIC's Amended Credit for Reinsurance Model Act

The end of 2012 marked the one-year anniversary of the NAIC's adoption of amendments to its Credit for Reinsurance Model Law and Regulations ("Amended Credit for Reinsurance Model Act") that allow reduced reinsurance collateral requirements for unauthorized reinsurers. Under the Amended Credit for Reinsurance Model Act, reinsurers domiciled in countries found to have strong systems of domestic insurance regulation (i.e., "qualified jurisdictions") are eligible to apply for "certified reinsurer" status in states that have adopted the amendments. In addition, in order to qualify as a "certified reinsurer," an applicant must also meet certain criteria as to financial strength and reliability as provided in the Amended Credit for Reinsurance Model Act. Certified reinsurers would be permitted to post collateral at reduced levels, and U.S. ceding insurers would be permitted to take full financial statement credit for the reinsurance obligations of such certified reinsurers.

a) Revisions to Accreditation Standards

The NAIC accreditation standards required that the states have in place the Credit for Reinsurance Model Act or a substantially similar law. Since the Amended Credit for Reinsurance Model Act reduces collateral requirements, the NAIC needed to amend the accreditation standards in order to allow states to adopt the Amended Credit for Reinsurance Model Act while still remaining accredited. On November 29, 2012, the NAIC's Financial Regulation Standards and Accreditation (F) Committee adopted a revised accreditation standard on an expedited basis, i.e., it was effective upon adoption, rather than after the typical two-year phasing-in period. The revised accreditation standard imposes an optional standard, rather than requiring adoption of the Amended Credit for Reinsurance Model Act. Specifically, if a state decides to reduce the collateral requirements, it needs to enact a law substantially similar to the Amended Credit for Reinsurance Model Act; but maintenance of the Credit for Reinsurance Model Act without changes for reduced collateral incorporated in the amended act would continue to qualify for accreditation.

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b) Implementation

It was reported by the NAIC during its 2012 Fall National Meeting that 11 states have adopted revisions to their credit for reinsurance statutes and/or regulations to implement reduced collateral requirements. These states are: California, Connecticut, Delaware, Florida, Georgia, Indiana, Louisiana, New Jersey, New York, Pennsylvania and Virginia. A further 11 states have reportedly indicated that they intend to adopt the revisions, while 26 states have reported being undecided at year-end. Thus far, only Florida and New York have approved any reinsurers for collateral reduction, with reduced collateral requirements reportedly ranging from 10% to 60% of the certified reinsurer's reinsurance obligations.

c) "Qualified Jurisdictions"

Under the Amended Credit for Reinsurance Model Act, in order to be eligible for certification, an assuming insurer must be domiciled and licensed to transact insurance or reinsurance in a "qualified jurisdiction." Each state has the authority to evaluate a non-U.S. jurisdiction's reinsurance regulatory system to determine whether such jurisdiction is qualified. In order to assist states in this respect, the NAIC is working to develop and maintain a list of jurisdictions that the NAIC recommends for recognition by the states as "qualified jurisdictions" in accordance with the Amended Credit for Reinsurance Model Act. An initial draft was made available in 2012 of the "NAIC Process for Developing and Maintaining a List of Qualified Jurisdictions" ("Draft NAIC Process"), which sets forth an evaluation process to be used by the NAIC for creating and maintaining this list of qualified jurisdictions. The Draft NAIC Process provides that the process for evaluating the reinsurance supervisory systems of non-U.S. jurisdictions is intended as an "outcomes-based comparison to financial solvency regulation under the NAIC Accreditation Program, [with] adherence to international supervisory standards, and relevant international guidance for recognition of reinsurance supervision." The Draft NAIC Process further provides that "[a]lthough the methodology includes a description of the jurisdiction's supervisory system in comparison to a number of key elements from the NAIC

Accreditation Program, it is not intended as a prescriptive assessment under the NAIC Accreditation Standards."

The Draft NAIC Process specifies that the "standard for qualification of a jurisdiction is that the NAIC must reasonably conclude that the jurisdiction's reinsurance supervisory system achieves a level of effectiveness in financial solvency regulation that is deemed acceptable for purposes of reinsurance collateral reduction." The Draft NAIC Process proposes that the NAIC initially evaluate and expedite the review of those jurisdictions that were approved by the States of Florida and New York (i.e., Bermuda, Germany, Switzerland and the United Kingdom), and that subsequent priority be on the basis of objective factors, including ceded premium volume and reinsurance capacity issues raised by the states. Priority will also be given to requests from states and from those jurisdictions specifically requesting an evaluation by the NAIC. Following the receipt of any comments to the Draft NAIC Process during the exposure period, it may be revised and thereafter prepared for consideration by the NAIC in early 2013.

d) Increased Use of Multi-Beneficiary Reinsurance Trusts and Reduction of Collateral

In 2012, there was a continued trend by offshore reinsurers to establish multi-beneficiary reinsurance trusts ("MBRTs") as a means of securing their reinsurance obligations with U.S. cedents. The advantage of a MBRT is that it allows the reinsurers to establish one trust with multiple beneficiaries instead of having to negotiate separate trusts with each cedent or post letters of credit, which can be expensive for the reinsurers. In 2013, we expect to see more offshore reinsurers considering the MBRT option.

MBRTs may be used by certified reinsurers to hold reduced collateral amounts as provided in the Amended Credit for Reinsurance Model Act. In addition, the Amended Credit for Reinsurance Model Act permits a reduction in the amount of trusteed surplus required to be maintained by certified reinsurers maintaining MBRTs. Prior to the recent amendments, the Credit for Reinsurance Model Law required all single assuming reinsurers using MBRTs to secure all their

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reinsurance obligations to U.S. cedents and maintain trustee surplus of not less than \$20,000,000. Under the Amended Credit for Reinsurance Model Act, a certified reinsurer may fund a MBRT in an amount corresponding with its certified reinsurer rating plus a required minimum trustee surplus amount of \$10,000,000. However, the reduced collateral rules apply only to reinsurance contracts entered into or renewed on or after the effective date of the reinsurer's certification. Therefore, if a reinsurer already maintains a MBRT to fully secure its obligations, the Amended Credit for Reinsurance Model Act would require that upon certification the reinsurer establish and maintain a separate trust account for its obligations under reinsurance contracts eligible for reduced collateral treatment.

3. CFTC and SEC Exclude Certain Insurance Products from Swaps Regulation under the Dodd-Frank Act

Title VII of the Dodd-Frank Act defines a swap to include any agreement, contract or transaction ("subject agreement") that provides for payment "dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic or commercial consequence." Read literally, almost all insurance products could be swaps subject to the requirements of the Dodd-Frank Act. Nevertheless, in August of 2012 the CFTC and the SEC (jointly, the "Commissions") issued joint final rules and interpretations⁴ that, among other things, remove most traditional insurance products from the definition of "swap" under the Commodity Exchange Act and of "security-based swap" under the Securities Exchange Act of 1934.

a) The Insurance Safe Harbor

The Commissions stated in the Adopting Release that (i) nothing in Title VII suggests that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps and (ii) the Commissions themselves do not interpret this clause to mean that traditional insurance products should be included within the swap or security-based swap definitions.⁵

Accordingly, in the final rules adopted by the Commissions as part of the Adopting Release, the Commissions clarified the status of certain insurance products as being outside the definition of swap and security-based swap by establishing a three-part safe harbor (the "insurance safe harbor") and a grandfather provision. The insurance safe harbor requires that the subject agreement either: (i) be one of the insurance products enumerated in the final rules⁶ ("enumerated products"); or (ii) meet certain conditions, including a requirement that the beneficiary of the insurance contract have a continuing insurable interest that is the subject of the transaction and that payments be limited to actual loss (the "product test"). In addition, the subject agreement must be provided by a person that is subject to the supervision of the insurance commissioner of any state or by the U.S. (the "provider test").⁷ Significantly, the provider test incorporates a requirement that the subject agreement be regulated as insurance under applicable state or federal law, thus incorporating a regulated insurance product requirement into the provider test. The final rules also include a grandfather provision that excludes from the swap and security-based swap definitions a subject agreement entered

⁴ Further Definition of "Swap," "Security-Based Swap" and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48207 (August 13, 2012) (codified at 17 C.F.R. pt. 1, 230, 240 and 241) (the "Adopting Release"). Title VII of the Dodd-Frank Act ("Title VII") directs the Commissions to define these terms. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁵ The Commissions noted other sections of the Dodd-Frank Act that address the status of insurance more extensively than Title VII and note that swaps and insurance are subject to different regulatory regimes as reflected in Section 722(b) of the Dodd-Frank Act and the new Section 12(h) of the CEA, which provides that a swap "shall not be considered to be insurance" and "may not be regulated as an insurance contract under the law of any State."

⁶ The enumerated products include the following types of products: (i) surety bond; (ii) fidelity bond; (iii) life insurance; (iv) health insurance; (v) long-term care insurance; (vi) title insurance; (vii) property and casualty insurance; (viii) annuity; (ix) disability insurance; (x) insurance against default on individual residential mortgages; and (xi) reinsurance of any of the foregoing products.

⁷ In addition, the United States or any state or any of their respective agencies that issues a contract meeting the product test pursuant to a statutorily authorized program would satisfy the provider test, and in the case of non-admitted insurance, a person that is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the NAIC, or meets the eligibility criteria for non-admitted insurers applicable under state law and issues a contract that meets the product test, would also meet the provider test.

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into on or prior to October 12, 2012 (i.e., the effective date of the final rules), provided that at the time it was entered into, the subject agreement was issued by a person meeting the provider test.

The final rules also address the status of reinsurance. In order for a reinsurance contract to come within the insurance safe harbor, the *reinsured* must satisfy the provider test; i.e., the reinsured must be a U.S. regulated insurance company. In addition, the underlying risk must either satisfy the product test or be an enumerated product. Finally, payments under the reinsurance agreement cannot exceed actual loss.

The Commissions further confirmed that the insurance safe harbor is non-exclusive and that transactions falling outside the insurance safe harbor are not presumed to constitute a swap or security-based swap. Subject agreements that do not satisfy the insurance safe harbor will require further analysis of the applicable facts and circumstances to determine whether they are insurance and thus not swaps or security-based swaps. The Adopting Release establishes a process for submission of a request to the Commissions to provide a joint interpretation of whether a particular agreement, contract or transaction (or class thereof) is a swap or security-based swap.

b) Application of Insurance Safe Harbor

Under the Final Rules, most traditional insurance products issued by U.S. regulated insurance companies, and reinsurance purchased by such insurers that reinsure such products, will fall under the insurance safe harbor and not be regulated as swaps under the Dodd-Frank Act. Nevertheless, there are certain products and types of reinsurance that will need to be analyzed on a case-by-case basis under the facts and circumstances test.

First, certain direct products may not meet the requirements of either the enumerated products test or the product test. These might include guaranteed investment contracts, synthetic GICs, funding agreements and certain financial guaranty policies.

Second, reinsurance assumed by U.S. reinsurers from non-U.S. cedents appears to not come within the insurance safe harbor. While the Commissions have not issued any guidance on how the facts and circumstances test will be applied, one useful approach may be to determine whether the underlying risk is one that the U.S. reinsurer could have written on a direct basis in its state of domicile. If so, there should be a good argument that the underlying risk is traditional insurance and that the reinsurance of such risk therefore would not constitute a swap under the Dodd-Frank Act. If not, further analysis would be required to determine whether the underlying risk is the type of risk that Congress intended to be regulated as a swap, regardless of whether the transaction is documented as a swap or as a reinsurance agreement.

4. NAIC Solvency Modernization Initiative

In 2012, the NAIC continued its Solvency Modernization Initiative (“SMI”) by addressing capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. Key completed activities include adoption of revisions to the NAIC Model Holding Company Act and Regulation, and adoption of the ORSA Model Act (both discussed below).

a) Own Risk and Solvency Assessment / Enterprise Risk Management

Adoption of the Risk Management and Own Risk and Solvency Assessment Model Act.

In 2012, U.S. insurance regulators continued to implement requirements designed to ensure that insurers effectively monitor their solvency position and maintain adequate risk management functions. Most notably, 2012 saw the NAIC adopt the ORSA Model Act. The drive to adopt the ORSA Model Act was, in part, a response to the desire to strengthen the quality of domestic insurance supervision in advance of the upcoming assessment of U.S. financial regulation by the International Monetary Fund’s Financial Sector Assessment Program (“FSAP”) in 2014. The upcoming FSAP review will assess the quality of U.S. insurance supervision

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against an international framework that already contains a requirement that insurers conduct an own risk and solvency assessment (“ORSA”).⁸ Although regulators aimed to have the ORSA requirement fully enacted in advance of the 2014 FSAP review, practical considerations caused the proposed effective date of the ORSA Model Act to be delayed until January 1, 2015.

If adopted by the states, the ORSA Model Act will require each U.S. insurer (or insurance group on behalf of its subsidiary insurers) with premiums in excess of certain thresholds to maintain a risk management framework and to regularly conduct an ORSA in accordance with the Own Risk and Solvency Assessment Guidance Manual (“OGM”).

At the NAIC’s 2012 Fall National Meeting, it was noted that implementation of the ORSA Model Act and adoption of the Model HCA Amendments (as defined below) should be considered together by the states because they contain complementary, although not identical, information. As noted by the Group Solvency Issues Working Group on a December 15, 2011 conference call, “. . . Form F and the ORSA [do have some differences]. The Form F targets non-regulated entity risk. The ORSA is an assessment and description of internal risk-management process, stress testing and group capital [for an insurer or an insurance group]. The ORSA might not include a discussion on non-regulated entities that are not involved in the activities of the [insurance group], whereas the Form F does.”

When conducting an ORSA, an insurer will assess the adequacy of its risk management and current (and likely future) solvency position in accordance with the OGM. The results of an insurer’s ORSA will be documented through the ORSA Summary Report, a confidential, high-level summary that will be provided to an insurer’s domiciliary regulator (or, if the ORSA Summary Report is being submitted on behalf of an insurance group, to the applicable lead state regulator). An

ORSA Summary Report should assess material risk categories, including credit, market, liquidity, underwriting, and operational risks. Regulators will receive ORSA Summary Reports annually, upon request.

As mentioned above, the ORSA Model Act contains a proposed effective date of January 1, 2015; inaugural ORSA Summary Reports may be requested by regulators in 2015. Practically speaking, this will require insurers to begin to implement the ORSA Model Act’s requirements before the ORSA Model Act is effective. Further, the ORSA Model Act will need to be enacted by the various states in advance of that date. While some states are reportedly considering legislative initiatives relating to the ORSA Model Act, it has not been adopted in any state to date.

The NAIC is considering inclusion of the ORSA Model Act among its Part A accreditation standards. The desire to make the ORSA Model Act an accreditation standard results, in part, from the need for uniformity in the enactment of the ORSA Model Act. Because the NAIC believes that the majority of insurance groups will file ORSA Summary Reports on a group basis with the group’s “lead state,” a uniform legal framework must exist in all states so that coordinated regulatory effort can be effected.

Results of the 2012 ORSA Feedback Pilot Projects.

The NAIC conducted a 2012 ORSA Feedback Pilot Project, pursuant to which it received 14 ORSA Summary Reports from confidential volunteers.

The 2012 ORSA Feedback Pilot Project also resulted in a number of proposed revisions to the OGM. In addition to certain updates to align the OGM with the ORSA Model Act, suggested revisions resulting from the 2012 ORSA Feedback Pilot Project include: (i) identifying the basis for accounting used for the ORSA Summary Report (i.e., GAAP, SAP or IFRS); (ii) explaining which entities in an insurer’s group are included

⁸ An FSAP review assesses the quality of insurance supervision against the Insurance Core Principles (“ICPs”) adopted by the IAIS. Although the IAIS had not yet adopted an ORSA requirement at the time of the last FSAP review, the FSAP noted that the U.S. insurance regulatory system did not require an insurer to have “comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling [an insurer’s] risks.” The FSAP review went on to recommend that laws, regulations and standards should be revised to require such risk management policies and systems.

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in the ORSA, possibly through the inclusion of an organizational chart; (iii) including a summary of material changes to the ORSA from the prior year; and (iv) providing group risk capital in a comparative format. The proposed revisions to the OGM were recently released for comment and have not yet been adopted by the NAIC.

The 2012 ORSA Feedback Pilot Project also resulted in referrals to the drafters of the Financial Analysis Handbook and Financial Condition Examiners Handbook. Pursuant to these referrals, guidance will be drafted for the review of ORSA.

The NAIC intends to conduct a 2013 ORSA Pilot Project, which will include a number of key changes from the 2012 ORSA Pilot Project. Significantly, there will be additional time for insurers to prepare an ORSA Summary Report and additional time for review. The results of the 2013 ORSA Pilot Project may result in additional revisions to the OGM and will be used to guide the drafting of inclusion of the ORSA requirement into financial condition examinations and financial analysis.

b) Update Regarding State Adoption of Amendments to the Model Insurance Holding Company System Regulatory Act and Regulation

In late 2010, the NAIC adopted amendments to the Model Insurance Holding Company System Regulatory Act and Regulation (“Model HCA Amendments” and “Model HCA Regulation Amendments,” respectively) to respond to perceived gaps in the regulation of insurance holding company systems. These changes increase the group-level reporting requirements of such systems, including the annual filing of an “enterprise risk report” by the ultimate controlling person of regulated insurance companies, and also increase regulators’ access to information about non-insurer affiliates.

While Rhode Island, Texas and West Virginia were the first states to enact changes substantially similar to the Model HCA Amendments in 2011, other states and jurisdictions followed in 2012, namely: California, Connecticut, Indiana, Kentucky, Louisiana, Nebraska, Pennsylvania and Puerto Rico. Rhode

Island and West Virginia have also promulgated regulations that are substantially similar to the Model HCA Regulation Amendments, while several states, including New York, have proposed some amendments to their holding company regulations. The NYSDFS published its proposed amendments to the holding company act regulation in the New York State Register on December 26, 2012 and will be accepting public comments for 60 days. However, the NYSDFS has indicated in commentary regarding its proposed amendments that its adoption of the enterprise risk report requirement will be accomplished through the adoption of a separate regulation that will apply not only to Article 15 insurers that are members of an insurance holding company system, but also to Articles 16 and 17 domestic insurers that own or invest in subsidiaries.

The NAIC’s Financial Regulation Standards and Accreditation (F) Committee has moved the effective date for holding company analysis accreditation standards and guidelines to January 1, 2014. Nonetheless, we anticipate that quite a few states will introduce legislation in their 2013 sessions that incorporates the Model HCA Amendments, as well as seeking to promulgate the Model HCA Regulation Amendments. Further, under the state laws already adopted to date, many companies may find that their first enterprise risk reports are due in 2013.

c) Corporate Governance

In December 2011, as part of its charge to assess U.S. corporate governance principles for use in U.S. insurance regulation and to develop regulatory guidance for the corporate governance of U.S. insurers, the Corporate Governance (E) Working Group (the “Working Group”) finalized a summary of existing corporate governance requirements affecting U.S. insurers. The summary was organized based on the seven core principles developed by the NAIC in 2010 to illustrate financial solvency insurance regulation in the U.S., as set forth in the United States Insurance Financial Solvency Framework.

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In 2012, the Working Group also conducted a comparative analysis of existing U.S. and international corporate governance requirements and standards, including the IAIS ICPs, in order to identify areas where U.S. requirements would satisfy international requirements or areas where enhancements to the U.S. system would be beneficial. The Working Group prepared a draft document summarizing the results of this analysis and comparison, the "Proposed Response to a Comparative Analysis of Existing U.S. Corporate Governance Requirements" ("Draft Proposal"), which was developed with the assistance of the industry and proposes 16 enhancements to the existing U.S. system. The proposed enhancements include proposals to: (i) require more regular and timely information on corporate governance practices in a confidential supplement to a domestic insurer's annual financial statement regarding insurer governance practices; (ii) develop a common methodology for assessing corporate governance that is flexible enough to distinguish between governance expectations for large and small insurers; (iii) consider insurers' corporate governance best practices in developing and approving resolution/contingency plans; (iv) add a section to the Model Audit Rule requiring insurers exceeding a certain size to maintain an internal audit function; and (v) request the addition of any necessary procedures and guidance to incorporate elements of the IAIS ICP 5 (suitability of directors, officers and management), IAIS ICP 7 (corporate governance) and IAIS ICP 8 (risk management and internal controls) into the financial examination process. In addition, the Working Group suggested in the Draft Proposal that a confidential, standardized assessment template be created to assist regulators in assessing the corporate governance practices of insurers in specific areas.

The Draft Proposal was exposed for comment at the NAIC's 2012 Summer National Meeting, and received a number of detailed comments. At the 2012 Fall National Meeting, the Working Group announced that it would seek additional time to reach resolution on certain corporate governance

subjects because certain issues, most notably confidentiality of disclosed information, had not been sufficiently resolved. Therefore, it re-exposed certain exhibits of the Draft Proposal, and the deadline for finalization of the Draft Proposal was extended to the 2013 Spring National Meeting.

d) Group Supervision and Issues Relating to the Identification of the Lead State

Among the SMI activities related to group supervision are efforts by the NAIC to: (i) increase U.S. insurance regulators' participation in, and the efficacy of, international supervisory colleges; and (ii) enhance communication between regulators and clarify the role of the U.S. lead state regulator both with respect to U.S. holding company system analysis and participation in supervisory colleges for international insurance groups.

In 2012, U.S. and international regulators continued to address issues arising out of the U.S. insurance regulatory system's reliance on a "lead state" regulator, which is typically the domiciliary state insurance regulator of the insurance company parent (or the largest insurer in the group by premium written). The NAIC's Financial Analysis Handbook currently includes a number of factors for determining an insurance group's lead state insurance regulator. Ultimately, the determination of the lead state is up to the domestic state insurance regulators of the group and certain insurance groups are assigned multiple lead state regulators depending on the groups' businesses and legal entities.

NAIC staff was recently charged with working to establish one single lead state for the U.S. insurance company groups that have multiple lead states. The NAIC's goal is to identify a single lead state regulator for each insurance group to serve as the single point of contact and coordination for various examinations; the lead state regulator could also be used as the point of contact with international regulators.⁹

⁹ We note that the lead state with respect to the filing of the Form F Enterprise Risk Reports is determined in accordance with the Financial Analysis Handbook except in instances where the lead state regulator has not yet adopted the amendments to the NAIC Model Holding Company Act. The lead state for Form F filings must have enacted the applicable Form F and related confidentiality provisions.

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The identified lead state will then serve as the single point of contact and coordination for various examinations, including the completion of holding company analyses, as discussed below. The NAIC will likely retain the concept of a “sub” lead state for certain circumstances, such as those instances where two separate states examine a life insurance unit and a property/casualty insurance unit within the same insurance group.

e) International Issues Relating to the Identification of the Lead State

In the course of the EU/U.S. Dialogue Project (discussed in more detail in Section V.G.3. below), questions raised as to the U.S. approach to group supervision led the NAIC to charge its staff at the 2012 Fall National Meeting with developing a section within the Financial Analysis Handbook that clearly discusses the roles and responsibilities of the lead state/group-wide supervisor. This section is intended to help international regulators to understand the U.S. approach to group supervision. The timing of production of this document is unclear, but a draft will likely be released for public discussion in 2013.

The Financial Analysis Handbook currently contains an appendix entitled “Holding Company and Supervisory College Best Practices.” This appendix suggests that, where the lead U.S. state is supervising an insurance company with a parent holding company domiciled in another country, the lead state should be available to attend supervisory colleges, gather material from non-lead state U.S. regulators in advance of supervisory college meetings or calls, and communicate the results of supervisory meetings to such non-lead state U.S. regulators. The appendix envisions that the lead state regulator will serve as a coordinator of communications among international companies and the non-lead state regulators. The NAIC has started drafting a supplementary best practices document that will provide more detailed and granular guidance to lead state regulators. The NAIC expects to continue drafting this forthcoming best practices document during 2013.

E. New York Corner

1. Superstorm Sandy

Superstorm Sandy tore through the northeastern United States in October of 2012. In its aftermath, insurers and state insurance regulators alike were inundated with claims from those devastated by the storm. In New York, the NYSDFS and the Governor’s Office took a variety of steps in response to this natural disaster. Within days of the storm, Governor Cuomo announced that New York homeowners would not have to pay potentially large hurricane deductibles on Superstorm Sandy-related insurance claims. Although some industry representatives expressed concern over this action, others commended it for the certainty it established with respect to a storm that otherwise would have given rise to much controversy given the storm’s unique, hybrid nature as it made landfall on the eastern U.S. coastline. The Governor also quickly directed insurers to accept homeowners’ documentation, including photos and video, of losses, and to process claims without conducting the usual on-site inspection, in order to expedite the removal of dangerous debris and the payment of claims. In this spirit of expediting claims processing, the Governor also issued an executive order that allowed for temporary licenses to be issued on an expedited basis to qualified out-of-state public insurance adjusters, thereby increasing the number of adjusters available to New York policyholders.

Relief was also given by the Governor’s Office to the NYSDFS itself, the offices of which were severely damaged by Superstorm Sandy. On November 20, 2012, Governor Cuomo issued Executive Order No. 77, which, among other things, temporarily suspended the “deemer” feature of certain provisions of the New York Insurance Law that require the approval of the Superintendent of the NYSDFS within a set period of time, after which such approval is deemed to have been given. Executive Order No. 77 expired on November 25, 2012, but was extended through December 25, 2012 by Executive Order No. 81.

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For its part, the NYSDFS imposed additional reporting obligations on insurers, requiring that claims data information (e.g., number of claims, dollar value of claims and type of claims) be submitted on a periodic, ongoing basis through the first quarter of 2013.

2. Domestic Surplus Line Insurance Legislation

On June 12, 2012, the New York Senate approved legislation (A.9783/S.6808) ("NY Domestic Excess Line Bill") that would amend the New York Insurance Law to authorize "domestic excess line insurance companies." The NY State Assembly did not act on the proposed legislation during its 2012 session, but it is likely the bill will be reintroduced in 2013.

If ultimately adopted in substantially the same form as proposed in 2012, an eligible "domestic excess line insurance company" would be permitted to write insurance in New York in the same manner as an unlicensed excess line insurer, notwithstanding that it is organized and incorporated in New York. As a result, it has been noted that this legislation could have the effect of spurring economic development in New York. Part of the motivation for introducing the NY Domestic Excess Line Bill would be to eliminate certain regulatory inefficiencies encountered by U.S.-domiciled excess line insurers under the current framework, whereby an insurance group seeking to operate in multiple jurisdictions is required to establish: (a) an excess line insurance company to underwrite excess line insurance in all jurisdictions other than the state of domicile of such excess line insurance company; and (b) a separate excess line insurance company domiciled in another state solely to underwrite excess line insurance in the market of its originally domiciled excess line insurance company. Other states, such as Arkansas, Delaware, Illinois, New Hampshire, New Jersey and Oklahoma, have already enacted laws authorizing domestic excess line insurance companies.

In the 2012 version of this legislation as proposed, eligibility requirements included that the domestic excess line insurance company have and maintain a minimum capital and paid-in surplus of equal to or exceeding the greater of: (a) \$45 million; or (b) the minimum amount required by New York for foreign insurer excess line eligibility (which is currently \$35 million, but will increase to \$45 million on January 1, 2013, and thereafter by \$1 million each year commencing January 1, 2016). In its current form, the proposed legislation exempts domestic excess line insurance companies from the requirements to file or seek approval for their policies or rates, although such companies would still be subject to other provisions of the New York Insurance Law, including: (a) admitted assets and deposits (Article 13); (b) permitted investments (Article 14); (c) holding companies (Article 15); (d) subsidiaries (Article 16); (e) merger, consolidation and redomestication (Article 71); and (f) rehabilitation, liquidation, conservation and dissolution (Article 74). Among the revisions expected to this legislation in 2013 is a clearer statement regarding the extent to which these domestic excess line companies would be subject to regulation under the New York Insurance Law (subject to targeted exceptions).

F. Federal Insurance Office Update

The Dodd-Frank Act authorized the establishment of the FIO as an office within the U.S. Treasury Department to monitor all aspects of the insurance industry, develop and coordinate federal policy on international insurance regulatory matters and advise the Secretary of the Treasury on insurance issues of major national or international importance. In June 2011, Michael McRaith, former Director of the Illinois Department of Insurance, was appointed the Director of FIO. In 2012, Director McRaith stated that although FIO has a myriad of responsibilities, its immediate, predominant focus is on international issues involving key bilateral relationships and international initiatives. During the past year, FIO increased its involvement in international insurance matters, serving as a federal point of contact for the international insurance sector and insurance supervisors around the world.

V. Regulatory Developments Affecting Insurance Companies

In October 2011, FIO became a full member of the IAIS. In 2012, FIO participated in the IAIS's Financial Stability Committee, which was charged with developing consultation papers regarding the designation of Global Systemically Important Insurers ("G-SIIs") discussed in Section V.G.2. below. In this respect, FIO has focused on ensuring that the IAIS G-SII process aligns with the process of the U.S. Financial Stability Oversight Council ("FSOC") for designating systemically important non-bank financial institutions. As of February 2012, FIO joined the IAIS's Executive Committee, and as of October 2012, FIO Director McRaith became the Chair of the IAIS's Technical Committee, succeeding Monica Mächler, Vice Chair of the Board of Directors of FINMA, Switzerland's financial regulatory authority. This Committee is centrally involved in developing ComFrame as described in Section V.G.1. below. FIO has endorsed the objectives of the ComFrame initiative as critical to the increasingly global nature of insurance markets.

FIO has also played a role in the EU/U.S. Dialogue Project discussed in Section V.G.3 below, with Director McRaith serving as a member of its Steering Committee. In comments regarding the EU/U.S. Dialogue Project, Director McRaith noted the elements of Solvency II that require the European Commission to determine whether non-EU jurisdictions provide a level of solvency protection to policyholders similar to that of Solvency II, and therefore whether such other jurisdictions are "equivalent" to the EU. Noting that interaction between insurance regulators in the United States and the EU has not been constructive, Director McRaith identified the EU/U.S. Dialogue Project, which evaluates similarities and differences between the United States and the EU and identifies areas for regulatory convergence or, at a minimum, better understanding between regulators, as an alternative to either or both jurisdictions entering into unilateral equivalence exercises.

FIO convened several meetings of its advisory committee, the Federal Advisory Committee on Insurance ("FACI"), whose members include regulators, industry representatives and experts/consumer advocates. FACI is chaired by Brian

Duperreault, former CEO and President of Marsh & McLennan Companies Inc., with strong participation by Director McRaith. FACI held its inaugural meeting in March 2012 and met three times that year. FACI focused on internationalization in August, and spotlighted flood insurance and the IAIS in November. FACI has formed three subcommittees to address, respectively: (i) affordability and accessibility of insurance; (ii) international regulatory balance; and (iii) the development of international standards. The general consensus of the subcommittees on various issues was reported as follows: (i) personal lines will be the market sector most affected by the aging world population; (ii) effective group supervision of financial services groups requires collaboration among insurance and other financial services regulators; (iii) U.S. group supervisory principles should be more strongly considered in developing international regulatory systems; (iv) a prescriptive approach to, or any mandate regarding, group capital is not favored; (v) identification of the lead group supervisor who, as a "first among equals," coordinates, collaborates, communicates and cooperates with relevant regulators should be made by consensus among relevant regulators; and (vi) although ComFrame proposes useful regulatory tools, it also presents unfavorable aspects for companies operating in the U.S. market. Director McRaith will participate in the upcoming discussion of each of the subcommittees, which have been asked to provide recommendations for the next FACI meeting in March 2013.

FIO also continues to interact with the NAIC on a variety of topics, including the development of the Superstorm Sandy data call form and the Reinsurance (E) Task Force's work on evaluating qualified international jurisdictions with respect to credit for reinsurance collateral reform.

Although FIO had a busy year in 2012, it did not release either of the two reports it was authorized to issue under the Dodd-Frank Act: (i) a report on the improvement of insurance regulation in the U.S. due in January 2013; and (ii) a report on the global reinsurance market due in September 2012. Despite rumors regarding their imminent release, as of the date of this advisory neither report has been submitted to Congress.

V. Regulatory Developments Affecting Insurance Companies

G. International Insurance Issues

1. ComFrame

In July 2010, the IAIS (supported by the G20 and the Financial Stability Board) initiated a three-year process to build the Common Framework for the Supervision of Internationally Active Insurance Groups (“IAIGs”), known as ComFrame.

ComFrame is intended to provide a framework of basic standards for IAIGs and a process for supervisors around the world to cooperate in the supervision of IAIGs. The main goals of ComFrame are to develop methods of operating group-wide supervision of IAIGs, establish a comprehensive framework for international regulators, address group-wide activities and risks, and foster a global convergence. Both the requirements and the process of ComFrame touch upon risk management, governance, structure, strategy and financial conditions. The ComFrame architecture would regulate anywhere from 50 to 100 IAIGs.

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There have been a number of significant events relating to ComFrame’s development over the past six months. On July 2, 2012, the IAIS released for comment a second working draft of ComFrame. Comments on the second ComFrame draft were published on September 4, 2012, with key respondents including NAIC, Lloyd’s, the FSA, the European Insurance and Occupational Pensions Authority (“EIOPA”) and a number of insurance groups. These comments, along with other general commentary on the ComFrame proposals from supervisors and insurers, including at the IAIS’s annual conference in October and at the NAIC’s 2012 Fall National Meeting, have shown the lack of consensus on what ComFrame should look like, who should supervise it, and the timetable for implementation.

Of particular note, views diverge on the extent of quantitative regulation that ComFrame should impose. While some regulators see a clear role for a group supervisor and

quantitative and qualitative requirements, other regulators and most insurers want to focus on cooperation and coordination but do not want specific metrics to measure them. However, most parties commenting on the second ComFrame draft fall between these two positions. The argument for the group in favor of a less prescriptive form of group supervision is that capital and some other quantitative standards should not be imposed globally and supersede local regulation, since this could create an unlevel playing field where major companies conducting international business would compete with companies subject to a more lenient set of rules. For example, in the United States, the NAIC and state regulators generally support a group supervisory framework that complements current legal entity supervision and adds regulatory steps only to the extent required to gain information from the group that may affect insurers. In addition, U.S. regulators emphasize maintaining authority over insurance supervision at the legal entity level using the lead group supervisor to aid communication and coordination rather than ceding authority to a lead group supervisor.

A third working draft of ComFrame will be published in 2013 after which a final consultation will take place. The development phase of ComFrame will be completed by the end of 2013 and this will be followed by one or more impact assessments.

2. U.S. and International Developments on Systemically Important Financial Institutions

In 2012, the IAIS released proposed measures regarding the assessment and supervision of G-SIFIs as part of a global initiative overseen by the Financial Stability Board (“FSB”)¹⁰ to identify global systemically important financial institutions (“G-SIFIs”). Background regarding the FSB’s global initiative regarding G-SIFIs as well as a summary of the proposed measures issued by the IAIS with respect to G-SIFIs are set forth below.

¹⁰ The Financial Stability Board emerged from the Financial Stability Forum, a group of finance ministries, central bankers and international financial bodies founded in 1999 to promote international financial stability. The FSB is made up of national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors and committees of central bank experts. It is based in Basel, Switzerland, and hosted by the Bank for International Settlements.

V. Regulatory Developments Affecting Insurance Companies

a) Financial Stability Board

In 2010, the G20¹¹ reestablished the FSB to promote stability in the international financial system by: assessing vulnerabilities in the system; advising on and monitoring best practices in meeting financial regulatory standards; promoting coordination and information exchanges among financial authorities; and managing contingency planning for the management of cross-border crises, particularly with respect to systemically important financial institutions. Members of the FSB have agreed to pursue the maintenance of financial stability, implement international financial standards (including the key standards for sound financial systems)¹² and submit to periodic peer reviews using, *inter alia*, the IMF/World Bank public FSAP reports.¹³

Global Systemically Important Financial Institutions (G-SIFIs).

In response to the recent economic crisis, the G20 and the FSB identified the need for more effective supervision of Systemically Important Financial Institutions (“SIFIs”). The FSB is coordinating an initiative to reduce the moral hazard posed by G-SIFIs and in 2010 developed a general framework, recommendation and timeline for identifying G-SIFIs and determining added loss absorbency measures necessary for risk reduction (“FSB Framework”).¹⁴ Initially G-SIFI-related work focused on the banking sector. In November 2011 the

Basel Committee on Banking Supervision finalized a framework for identifying global systemically important banks, and at that time the FSB announced its first list of globally systemically important banks, which was thereafter revised in November 2012. The FSB Framework also reflected an intent to extend the G-SIFI framework to cover a wider group of SIFIs, including insurance companies. Therefore, in November 2011 the G20 leaders reiterated their expectation that the IAIS complete its assessment methodology for G-SIFIs in time for the June 2012 G20 Summit.

b) IAIS Proposal for Global Systemically Important Insurers (“G-SII”): IAIS G-SII Assessment Methodology and G-SII Policy Measures

Accordingly, in 2012 the IAIS issued two public consultation documents: (i) Global Systemically Important Financial Insurers: Proposed Assessment Methodology, dated May 31, 2012 (“G-SII Assessment Methodology”);¹⁵ and (ii) Global Systemically Important Financial Insurers: Proposed Policy Measures, dated October 17, 2012 (“G-SII Policy Measures”).¹⁶ The G-SII Assessment Methodology was developed to identify any insurer whose distress or disorderly failure would cause significant disruption to the global financial system, and the G-SII Policy Measures sets forth a proposed framework of policy measures that should be applied to insurers determined to be G-SIIs.

¹¹ The G20 brings together finance ministers and central bank governors from 20 major economies: 19 countries plus the EU. It was formed as a forum for cooperation and consultation on matters pertaining to the international financial system. The heads of the G20 nations met biannually at G20 summits between 2008 and 2011. Since the November 2011 Cannes summit, all G20 summits have been held annually.

¹² The FSB has highlighted standards under 12 policy areas as key for sound financial systems and deserving of priority implementation depending on country circumstances. The key standards are broadly accepted as the minimum requirements for good practice that countries are encouraged to meet or exceed. Details as to the key standards are available at http://www.financialstabilityboard.org/cos/key_standards.htm.

¹³ The Financial Sector Assessment Program (FSAP) is a joint program of the IMF and the World Bank launched in 1999 for the purpose of creating comprehensive and in-depth analyses of a country's financial sectors. It is a key instrument of the IMF's and World Bank's economic surveillance. Further information, including country reports, is available on the IMF's website at <http://www.imf.org/external/NP/fsap/fsap.aspx>.

¹⁴ “Reducing the moral hazard posed by systemically important financial institutions – FSB Recommendations and Time Lines,” Oct. 20, 2010, available at http://www.financialstabilityboard.org/publications/r_101111a.pdf.

¹⁵ The G-SII Assessment Methodology document is available on the IAIS's website at http://www.iaisweb.org/view/element_href.cfm?src=1/15384.pdf.

¹⁶ The G-SII Policy Measures document is available on the IAIS's website at http://www.iaisweb.org/view/element_href.cfm?src=1/16647.pdf.

V. Regulatory Developments Affecting Insurance Companies

Findings Regarding Insurance and Financial Stability.

The IAIS G-SII Assessment Methodology incorporates and reiterates the IAIS's position on insurance and financial stability¹⁷ and includes the following findings:

- Insurance is founded on the law of larger numbers. Because the insurance business model is to assume a large number of ideally uncorrelated risks, large, diversified insurers should present a lower systemic risk profile.
- In general, insurance underwriting risks are not correlated with economic, business cycle and financial market risks; however, insurers are exposed to risks faced by other financial institutions, including credit risk, operational risk and market risk, as well as interest rate and exchanges risk.
- In contrast, insurance groups that engage in non-traditional or non-insurance ("NTNI") activities can be more vulnerable to financial market developments and therefore may be more likely to contribute to system risk. Examples of NTNI activities include financial guaranty insurance, capital markets activities such as credit default swaps, transactions for non-hedging purposes, derivatives trading or leveraging assets.
- Reinsurance is considered to be a traditional insurance activity and can be a source of stabilization. Reinsurance is unlike the inter-bank market, and the degree of interconnectedness in the reinsurance sector is relatively small.

In summary, the IAIS noted that neither past insurance market experience nor the recent financial crisis provides any evidence of traditional insurance either generating or amplifying systemic risk. The potential for systemic importance is considered to arise only in NTNI activities undertaken by a small number of insurers.

Highlights of Assessment Methodology.

The IAIS's proposed assessment methodology involves the following three steps:

Data Collection.

The IAIS noted that, unlike the banking sector where Bank for International Settlements statistics cover various areas of banking activities on a global basis, the IAIS has few precedents for collecting data on a global basis for the insurance sector. Nevertheless, in producing the G-SII Assessment Methodology, the IAIS looked at data collected from national supervisors and 48 insurers in 13 jurisdictions, selected on the basis of size and global reach (determined by reference to year-end 2010 data).

The IAIS intends to further improve data quality and consistency and is planning to collect year-end 2011 data based on revised instructions and definitions, taking into account the experiences of the year-end 2010 data collection exercise and recent developments.

Methodical Assessment.

The data collected by the IAIS was used in the development of a set of "indicators" that are intended to identify G-SIIs by evaluating an individual insurer's actual systemic importance to the global financial system by assessing the impact of a failure of that insurer on the global financial system and the wider economy. The process has 18 indicators, which are divided into the following five categories: (i) size; (ii) global activity; (iii) interconnectedness; (iv) NTNI activities as described above; and (v) substitutability.

The overall score for a particular insurer is calculated as the sum of all of the category scores, which are assessed by reference to a weighting for each indicator. As noted above, the IAIS does not believe that insurers engaged in traditional insurance activities in general are likely to pose systemic risk.

¹⁷ The IAIS November 2011 report entitled "Insurance and Financial Stability" presents a supervisory perspective on the insurance and reinsurance sector and on financial stability issues. It is available at the IAIS's website at http://www.iaisweb.org/__temp/Insurance_and_financial_stability.pdf.

V. Regulatory Developments Affecting Insurance Companies

The IAIS's focus is instead on NTNI activities of insurers as well as interconnectedness with other financial institutions and interconnectedness through exposure to other group companies carrying on non-insurance activities. Therefore, categories (iii) and (iv) above are the two most heavily weighted categories for assessing the systemic importance of insurers.

Incorporating Supervisory Judgment and Validation.

The supervisory judgment and validation stage introduces a quantitative as well as a qualitative assessment. It involves applying an additional business segment specific risk-weight assessment approach that centers around segmenting the business portfolio of insurance companies and insurance-dominated groups and conglomerates into the following categories: (i) traditional insurance; (ii) semi-traditional insurance; (iii) non-traditional insurance; (iv) non-insurance financial; and (v) industrial activities.

Again, risk weightings are then applied to calculate the systemic importance of the aforementioned business activities, which range from marginal (in traditional insurance) to potentially significant (in non-insurance financial activities, such as banking).

The results are then compared to the results derived from the indicator-based approach. Effectively, this comparison adds an additional layer to the analysis of an insurer as a G-SII beyond that of the indicator-based approach, as it allows for the filtering out of insurers that are large but engaged significantly in traditional insurance or non-insurance industrial activities.

Once this process is completed, the IAIS will discuss the results with the relevant group-wide supervisors of each G-SII candidate to obtain their views on the results of the calculations.

Highlights of Proposed Policy Measures

The G-SII Policy Measures are broken down into three main categories:

Enhanced Supervision.

These measures build upon the IAIS ICPs, the FSB's key standards for sound financial systems and ComFrame.

NTNI activities of G-SIIs are regarded as particular sources of systemic risk and, within most G-SIIs, NTNI activities are carried out in separate group entities. As such, the IAIS believes it is necessary for supervisors to have enhanced group-wide supervision powers comprising a number of elements, including:

- ***Systemic Risk Reduction Plan ("SRRP")***

All G-SIIs will be expected to develop SRRPs, the main purposes of which are to reduce the systemic importance of the G-SII and shield traditional insurance business from NTNI business. Where feasible and appropriate, the SRRP may include measures to separate traditional from NTNI activities or measures that restrict or ban the G-SII from carrying out certain NTNI activities.

- ***Enhanced Liquidity and Management***

Management of G-SIIs will be required to have adequate processes and controls, including written strategies and policies, to manage group liquidity risk, particularly in relation to NTNI activities and interconnectedness.

- ***Restrictions and Prohibitions***

Group supervisors could choose to apply restrictions or prohibitions on G-SIIs' activities in order to decrease G-SIIs' probability of failure or limit their systemic importance. Restrictions and prohibitions are expected to be targeted particularly in relation to NTNI activities and activities that support interconnectedness.

V. Regulatory Developments Affecting Insurance Companies

Effective Resolution

The FSB's October 2011 "Key Attributes of Effective Resolution Regimes for Financial Institutions" sets out the basis for these measures. These requirements could include establishing Crisis Management Groups, preparing Recovery and Resolution Plans, conducting resolvability assessments, and adopting cross-border agreements between group entities.

Effective resolution should involve consideration of: the plans and steps needed to separate traditional insurance activities from NTNI activities; the possible use of portfolio transfers and run off arrangements in the resolution of entities conducting traditional insurance activities; and the existence of policyholder protection and guarantee schemes (or similar arrangements).

Higher Loss Absorption ("HLA") capacity

The G-SII Policy Measures document proposes that G-SIIs should face a higher loss absorption capacity so as to reflect the greater risks that the failure of G-SIIs poses to the global financial system. The IAIS proposes that a cascading approach to achieve HLA capacity should apply, taking into account the extent to which the G-SII has demonstrated effective separation between traditional insurance and NTNI activities.

Timing

It is planned that the first group of G-SIIs will be designated and subsequently published in April 2013, with annual designations thereafter expected each November. Once an insurer is designated as a G-SII, measures on enhanced supervision and effective resolution will then begin to be implemented immediately thereafter. The G-SII Policy Measures document contains a further detail as to the implementation timetable for the period from 2013 to 2019.

c) Financial Stability Oversight Council (U.S.)

Section 113 of the Dodd-Frank Act grants FSOC the authority to identify and designate the non-bank companies that pose the greatest threat to U.S. financial stability. Non-bank companies so designated by FSOC are required to comply with several regulatory requirements, including enhanced Federal Reserve supervision and prudential regulation, and submission of a "living will" addressing its orderly resolution by U.S. regulators if systemic risk results from the company's material financial distress. In April 2012, FSOC adopted final rules formalizing a three-stage designation process for non-bank companies. All non-bank companies start in Stage 1, but only those deemed to warrant further scrutiny move on to the next stage in the process. Companies that meet the criteria in all three stages will be formally designated if two-thirds of FSOC members vote in favor of such determination.

The FSOC process adopts specific criteria to assess companies within each stage. In Stage 1, every non-bank company with \$50 billion or more in total consolidated assets will be screened using predetermined quantitative metrics, including swaps, derivative liabilities, total debts outstanding, leverage ratio and short-term debt ratio. In Stage 2, FSOC will apply a six-category framework, focused on interconnectedness, substitutability, size, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny, using a combination of quantitative and qualitative assessments to evaluate each company and make a subjective determination. In Stage 3, FSOC will closely review each company that reaches this stage, using several more qualitative factors to assess the company's resolvability, the opacity of its operations, its complexity, and the extent and nature of its existing regulatory scrutiny.

V. Regulatory Developments Affecting Insurance Companies

Although FSOC's final rules for the designation process have been in place for many months, there are several related rules that have not yet been finalized. These include final rules establishing which activities are "financial in nature." Only companies "predominantly engaged in financial activities" are eligible for FSOC designation, which generally requires that 85% of the company's assets or revenues be derived from activities "financial in nature." This is a potentially critical threshold and one for which several proposed rules have been released to no effect. Generally, however, regulatory agencies have adopted final rules relating to the Dodd-Frank Act at a much slower pace than many anticipated in 2012, likely contributing to FSOC's slow start to the designation process. Further, FSOC has not made any official public announcements regarding the status or progress of the designation process or when the process is expected to be completed. The most recent development occurred in October 2012, when certain non-bank companies, including at least one insurance company, voluntarily announced they had received notice that they will be reviewed by FSOC in Stage 3, suggesting that final FSOC designations may be imminent. Until then, many observers appear to agree that FSOC will almost certainly designate at least one (but likely more than one) company from each of the following market segments: insurance companies, asset managers, investment advisers, private equity funds, hedge funds, non-bank lenders and other financial services companies.

3. EU/U.S. Dialogue Project

In January 2012, U.S. and EU insurance regulators began the EU/U.S. Dialogue Project (the "Project"), a cross-border effort designed to achieve a greater understanding of "the overall design, function and objectives of the key aspects of the two regimes, and to identify important characteristics of both regimes." The Project has been guided by a Steering Committee of three U.S. and three European officials, including FIO's Director and the NAIC CEO as well as the Chairman of EIOPA and the Head of the Insurance and Pensions Unit of the European Commission.

Building on 10 years of communication between U.S. and EU regulators, FIO initiated the Project in an attempt to increase bilateral clarity on regulatory and capital expectations and requirements and to provide an alternative to either side performing unilateral adequacy assessments of the other's regulatory system. It comes at a time when the implementation of Solvency II and its regulatory equivalency requirements now look to be delayed further, possibly to 2016 or 2017.

In December 2012, the Project Steering Committee issued a joint report that describes the commonalities and differences between the U.S. (state-based) and the EU (Solvency II) insurance regulatory frameworks with respect to: (a) professional secrecy and confidentiality; (b) group supervision; (c) solvency and capital requirements; (d) reinsurance and collateral requirements; (e) supervisory reporting, data collection and analysis and disclosure; (f) supervisory peer reviews; and (g) independent third-party review and supervisory on-site inspections.

In December, the Project also released formal objectives for the next five years, in the form of its "Way Forward" plan. These objectives include: (i) promoting the free flow of information between regulators; (ii) establishing a robust regime for group supervision that incorporates a holistic approach to determining a group's solvency and financial condition and is complementary to solo/legal entity supervision; (iii) improving approaches to valuation; (iv) achieving a consistent approach to reinsurance collateral requirements, including the examination of the possibility of reducing or removing collateral requirements in both jurisdictions; and (v) increasing the consistent application of requirements such as peer reviews. In early 2013 the Steering Committee expects to formulate detailed plans to take action on these objectives. The NAIC International Insurance Relations Leadership Group has recommended that the NAIC engage appropriate committees as necessary to evaluate and carry out the work contemplated by these objectives.

V. Regulatory Developments Affecting Insurance Companies

4. Solvency II

The major European regulatory issue in 2012 was Solvency II and the question of when it is going to be implemented. This issue has significance beyond Europe for a number of reasons. First of all, Solvency II affects international groups and how their group solvency is calculated and therefore affects the assessment of groups that have insurance companies in Europe and outside of the European Union; second, it affects reinsurers outside of the European Union who wish to reinsure European insurance companies; and third, Solvency II has been held up as a new gold standard to which international insurance regulation should aspire. That latter point has undoubtedly taken a hit to its credibility, given the continued delay over the implementation of Solvency II.

Why is Solvency II being delayed? The answer to this has two aspects: the first has to do with the legislative timetable for implementation and the continual postponement of the steps that should have been taken under the original legislative timetable; and the second has to do with deeper anxieties about what Solvency II will mean in practice and is the real cause of the delay.

Slippage in the Legislative Timetable

The original Solvency II directive was made in 2009. However, the full implementation of Solvency II depends on the drafting and adoption of a series of subordinate rules that flesh out the higher principles set out in the Solvency II directive. These in turn will need to be translated into the domestic legislation and rule making of each Member State of the European Union. One of the regulatory responses to the financial crisis was the creation of new Europe-wide regulatory authorities that would have the power to make binding rules and coordinate a greater degree of regulatory cooperation among the individual European regulators. In the case of the insurance industry, EIOPA was created pursuant to European Regulation 1094/2010. However, before it could take up its powers to propose rules and issue binding guidance under the Solvency II regime, the Solvency II directive had to be amended; it also had to be amended to provide for transitional arrangements to the introduction of the new regime, which had not been adequately dealt with under the original directive. The so called Omnibus II

directive is the legislative means to amend the Solvency II directive. The legislative process involves the European Parliament, the European Commission and the European Council agreeing on the revised Omnibus II directive. Once the Omnibus II directive is adopted, the legislative framework will be complete and the subordinate rules and guidance can then officially be made.

In this process, participants have taken the opportunity to revisit some of the issues that had been debated in the run-up to the adoption of Solvency II and were causing concern. Of particular concern were two issues: one had to do with the valuation of so-called long-term guarantee products, i.e., life insurance products that are long-term, such as annuities, where the insurer has made promises to make certain payments in the future; and the second had to do with assessment of “equivalency” to Solvency II of regulatory regimes outside the European Union and what transitional arrangement may be made for countries that are not deemed equivalent.

In the course of negotiations between the European Parliament and the European Commission, considerable amendments to the drafting of the Omnibus II directive were made. But at each deadline set in the calendar where the European Commission and the European Parliamentary representatives were meant to agree to a finalized text, the decision has been postponed. This takes us to the deeper reason for the delay, which primarily is anxiety about the potential overall effect, not only on the insurance industry, but on the real economy, of the measures that have been proposed to deal with long-term guarantee (“LTG”) products.

The LTG Issue

The worry is that Solvency II could cause long-term products to be priced out of the market; it also could discourage insurers from investing long-term. At the end of 2010, the European insurance industry managed assets worth €7.4 trillion, which is about 50% of European GDP. It is a major investor in long-term projects and is important not only for the provision of its protection to policyholders but also as an investor and promoter of economic activity in the real economy. Accordingly, a reduction in long-term investment by insurers could significantly affect the real economy.

V. Regulatory Developments Affecting Insurance Companies

One of the key principles of Solvency II is that assets and liabilities should be valued on a market consistent basis and that solvency capital will be calculated by reference to such valuations. Market valuations can cause an increase in volatility and in extreme cases might not reflect economic reality. If the present value of future liabilities is out of step with economic reality, then insurers may end up having to hold too much capital (or, conversely, not enough capital). This particularly concerns life insurers, whose business is to provide protection for many years in the future.

Following the last of the quantitative impact studies in 2010 (QIS5) in which draft Solvency II rules were road-tested, changes to the detailed Solvency II rules were proposed in 2011 in response to concerns that the draft rules would result in long-term insurers having to hold overly prudent amounts of capital. First, a “matching adjustment” was introduced. This provides for life insurers to increase the discount value over the standard “risk free” value when calculating the present value of future liabilities (and hence reduce solvency capital) in certain cases where they have illiquid liabilities (such as annuities) that they can match with long-term assets that they would typically hold to maturity (and so mitigate any short-term pricing volatility). Second, a mechanism was introduced to adjust the standard “risk free” discount rates for calculating the present value of future liabilities in certain extreme economic scenarios—the so called Counter Cyclical Premium—which again is intended to dampen artificially high increases in liabilities, in times of economic stress, which are caused by the risk-free rates being lower than is economically justified. And third, a methodology was introduced for calculating long-term risk-free discount rates beyond periods for which reliable market data exist. These three elements form the “LTG Package” and the European Parliament and the European Commission have been debating the final scope of these rules and where the rules should appear—should they be hard-wired into the amended Solvency II directive, or should they form part of the subordinate rules, with respect to which there would be more flexibility to propose amendments in the future?

One result of the debate about these changes has been the commissioning of EIOPA to produce a technical assessment of the LTG Package. EIOPA expects to complete its work in June 2013. After that report has been prepared and digested, it is expected that the Omnibus II directive and any amendments to Solvency II will be finalized and passed into European law. Given this timetable, it is impossible for Solvency II to be implemented by the current proposed target date of January 1, 2014. While the target date has not been officially postponed, some further delay in Solvency II clearly will occur. But the question is, for how long? Comments from officials at EIOPA indicate a postponement to at least 2016 and possibly 2017.

Effects of Solvency II on Investment Decisions.

In a separate development in September 2012, the European Commission asked EIOPA to examine whether the calibration and design of capital requirements for investments in certain assets under Solvency II needed any adjustment under current economic conditions. At a time when policymakers are endeavoring to generate economic growth and banks are still not lending enough, the insurance industry is perceived to be a source of capital that can be tapped to stimulate growth in the real economy. The European Commission noted that regulatory capital requirements are one of the determinants of investment decisions. The analysis is to be based on the most recent draft of the Solvency II rules that was prepared in November 2011 and has not been publicly released for consultation. But we know that those rules reflect the measures making up the LTG Package referred to above. EIOPA was asked to focus particularly on long-term financing, i.e., financing over an extended economic business cycle, such as 10 years.

These two separate but linked issues reveal concerns that the design of Solvency II may have unintended consequences. It was originally conceived under very different economic conditions. With the European economies at best stagnant and at worst in recession and no prospect of significant growth for some time, policymakers want to make sure that the final rules are suitable to current conditions. They have to balance the needs of policyholders and the wider economy and, given how complex Solvency II has become, it is important that the effects of the new rules are examined in some depth.

V. Regulatory Developments Affecting Insurance Companies

Solvency 1.5?

Nonetheless, regulators and industry practitioners are frustrated at the continued delay in Solvency II and some worry that the overall credibility of the project is being undermined. In what can be seen as an attempt to deal with that issue, certain parties have been advocating what has been termed “Solvency 1.5.” The idea is to introduce certain Solvency II measures earlier than the formal implementation of the entire Solvency II regime; e.g., measures dealing with an insurer’s system of governance, including risk management and the forward-looking assessment of its own risks, pre-application of internal models and reporting to supervisors. EIOPA has been charged with contributing to this process and in December 2012 announced that it will produce guidance for insurance regulators on how to proceed in the interim phase leading to Solvency II. The purpose will be to maintain some momentum for Solvency II against a background of a probable delay of a further two years and to ensure that the efforts and money that have been spent to date by the insurance industry in preparing for Solvency II are not seen to be wasted or to be creating distortions to competition in the European market.

Equivalence.

Where does this all leave the vexed question of “equivalence”? Equivalence refers to the concept whereby the European Commission under Solvency II assesses whether the insurance regulatory regime of a non-EU country is equivalent to Solvency II for three purposes: (a) reinsurance; (b) group solvency; and (c) group supervision. The equivalence assessments will affect reinsurance collateral requirements for non-EU reinsurers that reinsure EU cedents, as well as group capital requirements and other compliance requirements generally for non-EU groups with EU subsidiaries and for non-EU subsidiaries of EU groups. As we reported last year, a finding of non-equivalence could affect the way international groups choose to organize themselves as well as affect the way international reinsurers consider and how they provide security to their EU cedents. A number of countries are in the first wave of assessment for equivalence but a number of others—most notably the United States—were not candidates for equivalence consideration.

A related issue is whether there will be transitional provisions for Solvency II that would allow a further period of time for equivalence assessments, such as an assessment of the U.S. insurance regulatory regime. The issue of transitional provisions has been caught up in the work on the Omnibus II directive and, therefore, the further delay referred to above also will affect the issue of equivalence. In effect, whether or not formal transitional periods are granted, an additional transitional period of most likely at least another two years will pass before Solvency II becomes effective.

Another relevant development in 2012 is the establishment of the EU-U.S. Dialogue Project (which we discuss in Section V.G.3. above).

It is interesting to note that in the initial report drawn up by the EU-U.S. Dialogue Project on the similarities and differences between the EU and U.S. insurance regulatory regimes, there was a palpable breaking down of barriers to understanding between the two regimes. One of the perceived barriers to the finding of equivalence of the regimes in the United States, for example, was the issue of professional secrecy and confidentiality. Under the European regime the default position is that all information supplied to regulators is confidential and may not be disclosed, although there are then exceptions to that rule, notably in the freedom of regulators within the EU to share information because they are all subject to the same obligation of confidentiality. In the United States, the provisions on professional secrecy vary from state to state and there is a clearer emphasis on access to public records. The presumption in most cases is that information is publicly available unless it is designated confidential through state laws or statutes. However, when one reads the report there are various signs that it would be possible for regulators on both sides of the Atlantic to get comfortable with the treatment of information supplied to regulators and their ability to share it with their fellow supervisors. The report noted that both regimes tend to the same outcomes in terms of protecting information identified as confidential while facilitating information exchange among supervisory authorities across jurisdictions. This may be the start of a better informed process to mutual recognition of the regulatory regimes, which one can only hope would benefit the industry as a whole.

V. Regulatory Developments Affecting Insurance Companies

5. The New U.K. Financial Regulatory Structure

On December 19, 2012, the Financial Services Act 2012 ("FS Act") received royal assent. The FS Act provides the statutory framework for a radical overhaul of the U.K.'s financial regulatory structure. It implements the current U.K. Government's policy response to the regulatory weaknesses exposed by the financial crisis. The U.K. Government intends to bring forward secondary legislation that will, among other things, make the administration of the setting of LIBOR and the provision of information relating to the setting of LIBOR subject to regulation, so that the FS Act will come into force as of April 1, 2013.

a) New Regulatory Architecture

The FS Act will abolish the Financial Services Authority ("FSA") and launch a new regulatory architecture consisting of the following three new bodies:

- **Prudential Regulation Authority ("PRA")**

The PRA will be responsible for micro-prudential regulation. It will be established as a subsidiary of the Bank of England (BOE). The PRA will be responsible for the authorization, regulation and day-to-day supervision of all firms that are subject to significant prudential regulation, including banks, investment banks, building societies and insurance companies. It will be accountable to the BOE, HM Treasury, Parliament and the National Audit Office.

- **Financial Conduct Authority ("FCA")**

The FCA will regulate the conduct of all firms, including firms authorised and subject to prudential supervision by the PRA, in their dealings with retail consumers and the wholesale financial markets. It will also be the prudential regulator for firms that are not regulated by the PRA. Responsibility for the regulation of consumer credit is also due to be transferred from the U.K. Office of Fair Trading to the FCA on April 1, 2014. The U.K. Government also intends to bring forward secondary legislation that will bring setting of LIBOR into regulation by the FCA.

- **Financial Policy Committee ("FPC")**

The FPC will be a committee of the Court of Directors of the BOE, responsible for considering macro issues affecting economic and financial stability and for responding to any threats which it identifies. The aim of the body is to address the criticisms of the current system by assuming responsibility for maintaining financial stability. It will be accountable to the BOE Court of Directors, Parliament and HM Treasury. It will have powers to direct the PRA and FCA to take certain courses of action to respond to systemic threats to the financial system.

The majority of the FSA's existing functions will transfer to the PRA and the FCA, although its responsibilities for systemically important infrastructure (i.e., settlement systems and recognised clearing houses) will transfer to the BOE.

Consultations to define more clearly the scope of the new powers are currently underway. The FSA has published two consultation papers setting out how it is proposed that each of the FCA and PRA will exercise their new powers of direction. Responses to these consultations are currently being accepted and it is intended that the PRA and FCA will review and approve final versions of their statements of policy on or before the April 1, 2013 effective date for the new regulatory structure.

b) FCA and PRA Powers over Unregulated Holding Companies

An important new element of the FS Act that will be of interest to insurance groups is that it creates new powers for the FCA and PRA to impose requirements on U.K. "parent undertakings" of certain regulated firms. The purpose of these powers is to ensure that the regulatory bodies are not prevented from taking appropriate actions with respect to a regulated firm due to the legal structure of the regulated firm's corporate group. For example, if an authorised firm is in crisis, the new powers may allow a regulator to direct a parent company to provide that firm with capital or liquidity necessary to improve the position of the firm.

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How the FCA and PRA will exercise these powers over unregulated holding companies is currently uncertain. The key definition of what is a “qualified parent undertaking,” which will determine which entities will be subject to these powers, could be altered by subordinate legislation. Under the FS Act, a qualified parent undertaking is an entity that satisfies the following conditions:

- The parent undertaking must be a parent of a qualifying “authorised person” (i.e., an entity regulated by the FCA and/or the PRA), or of a U.K. “recognised investment exchange” or of a U.K. “recognised clearing house.”
- Any direct or indirect parent of a regulated firm, not just the immediate parent undertaking, could be a qualified parent undertaking. Therefore, an intermediate parent undertaking that is not at the head of the ownership chain could be a qualified parent undertaking.
- The parent company must be a body corporate, it must be incorporated in any part of the U.K. or have a place of business in the U.K. (which means it could be a company incorporated anywhere in the world), and it must not itself be an authorised person, a recognised investment exchange or recognised clearing house.
- A qualified parent undertaking must be a financial institution of a type prescribed in subordinate legislation. The relevant subordinate legislation has not yet been made, so at this time we cannot be sure what is within or without the scope of these new provisions. The current indications are that an insurance holding company likely would fall within the definition of qualified parent undertaking.

This new feature of the U.K. regulatory system will be one to watch in 2013. Undoubtedly, insurance groups will want to take the scope of these new rules into account when considering where to locate their parent companies.

VI. Developments at Lloyd's of London

VI. Developments at Lloyd's of London

A. Market Overview

From the perspective of Lloyd's, 2012 will inevitably be viewed as two very distinct halves: while the first half was characterized by relatively few natural catastrophes, resulting in a half-year pre-tax profit of £1.53 billion (compared to a loss of £697 million for the corresponding period in 2011), the second half will be dominated by the impact of Superstorm Sandy.

The strong figures for the first half of 2012 included a combined ratio of 88.7% (113.3% in 2011), the result of a steady claims climate and a lack of significant events (with the notable exception of the capsizing of the *Costa Concordia*). In contrast, it is too early to be able to definitively gauge the impact of Superstorm Sandy on the Lloyd's market and its participants. At the beginning of November, Lloyd's formally requested details of estimated gross and net loss exposures to Superstorm Sandy from the Lloyd's (re)insurers with a view to issuing a major claims return. The current net claims estimate is between \$2-2.5 billion for the Lloyd's syndicates, based on the industry-wide predicted loss of between \$20-25 billion. This would mean that Superstorm Sandy would represent Lloyd's third-worst loss ever, after Hurricane Katrina and the 9/11 attacks. However, Lloyd's has said that it expects minimal impact on Lloyd's member capital and no impact on the Central Fund.

The Beazley Group was the first Lloyd's (re)insurer to estimate its likely loss from Superstorm Sandy, predicting a \$90 million loss, on the basis of a \$20 billion market-wide loss. This was larger than its loss estimate for both the Japanese and New Zealand earthquakes in 2011. Caitlin has estimated a net, pre-tax loss of \$200 million, while Hiscox has published a forecast of \$145 million. Amlin has predicted \$236 million, net of reinsurance recoveries and inwards reinstatement premiums.

The stamp capacity for 2013, i.e., the volume of premium that a syndicate has been authorised to underwrite in a year of account by the Lloyd's Performance Management Directorate and the clearest single indicator of a syndicate's intentions for the upcoming year, is estimated to be £24.9 billion (\$40.5 billion), which would be a record figure (against £23.8 billion for the 2012 year of account). A significant proportion of the new capacity is from insurers who are looking to expand their Lloyd's platforms, such as Scor and WR Berkley. Market talk regarding opportunities would appear to be focused on U.S. property, where the effects of Superstorm Sandy are likely to result in upward pricing pressure on property cat rates, and marine, where pricing has been impacted by both Superstorm Sandy and *Costa Concordia*.

B. Changes at Lloyd's

In May, Lloyd's announced Vision 2025, its new long-term strategic growth plan, which was launched by the British Prime Minister, David Cameron. With Vision 2025, Lloyd's intends to focus on growth opportunities in the emerging economies in Asia, Latin America and certain other high-growth territories in order to ensure that it becomes the major global hub for specialist insurance and reinsurance. A further aim is to ensure that the growth of Lloyd's premium from its established markets is at least in line with the GDP growth for those markets, with greater growth from faster growing emerging markets. At present, developing countries account for just 12% of the Lloyd's premium base. Lloyd's aim is to raise this to over 25% by 2025. In addition, the capital base of the Lloyd's market will be diversified, with increased participation by entities from emerging economies.

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The latest Lloyd's three-year plan, which forms the first phase of Vision 2025, places emphasis on encouraging the participation of private capital and states that the fact that a new entrant proposal is supported by private capital will be seen as a positive. We note that in the recent past starting a new business at Lloyd's has been notoriously difficult, as Lloyd's has jealously guarded the entrance gates to the market. New entrants have typically been aligned corporate capital. The new plan is an interesting indicator of Lloyd's thinking: it wishes to foster a diversified capital base and evidently reverse the previous trend to increasingly aligned businesses at Lloyd's. In this vein, a new syndicate start-up, Syndicate 1991, started writing from January 1, 2013, with a mixed capital base via Lloyd's names and trade backers in the form of Scor and XL Capital. Syndicate 1991 will be managed by Randall & Quilter.

Lloyd's saw further change with the appointment of John Nelson as its new Chairman, effective as of October 2011. Prior to taking up his new role, Mr. Nelson had a long career in banking with, among others, Kleinwort Benson, Lazard and Credit Suisse First Boston Europe. He was deputy chairman of Kingfisher plc and a non-executive director of BT, Woolwich plc, JP Morgan Cazenove and Cazenove Group.

Finally, Lloyd's has also initiated a consultation process on whether it should continue to maintain its three U.S. admitted lines licenses in Illinois, Kentucky and the U.S. Virgin Islands, partly due to the cost of maintaining such licenses and also due to the stagnant admitted lines market. An alternative would be to migrate the business from the two states and the territory into the excess and surplus lines distribution channel. Lloyd's already has excess and surplus lines authorization in Illinois and the U.S. Virgin Islands. The consultation process will involve managing agents and brokers with a final decision to be taken by mid-2013.

C. M&A Activity in the Lloyd's Market

The steady flow of M&A activity in the Lloyd's market continued in 2012, which is an indication of the ongoing interest in entrance into the Lloyd's market, particularly by private equity funds. An example is the Paraline Group, which is a member of the Asta consortium (with Tawa and Skuld) that purchased the Whittington managing agency in January. Another example is Aquiline, which agreed with IAG in December to purchase the latter's troubled Lloyd's motor business, Equity Redstar, for £87 million. This represented a significant discount to stated book value, which is understood to be in the region of £130 million. The sale will therefore represent a multiple of 67% to book. We are also aware of a number of other private equity funds that are attempting or have attempted to engage in transactions within the Lloyd's market in the past year.

Also noteworthy was the continuing consolidation among listed London Market companies with Lloyd's operations. In the spring, following a public takeover, CNA acquired Hardy Underwriters in a £143 million cash transaction. Hardy had previously been the target of two unsolicited proposals by Beazley, the first of which was increased twice to a final offer of £180 million and the latter of which valued the equity of Hardy at £99 million. The first Beazley proposal was made prior to a series of catastrophe losses that significantly affected Hardy's share price and that according to some market observers, made it more amenable to a sale process. In addition, the long saga of Omega's M&A travails ended with its acceptance of Canopus' (£164 million) cash offer over the summer. This takeover was effected via an amalgamation under Bermuda law as the target was incorporated in Bermuda. Following the acquisitions of Hardy and Omega and the deals in 2011 involving Brit and Chaucer, there are now only five independent publicly traded Lloyd's market insurers.

Lastly, in December, Markel Corporation announced it had entered into a merger agreement with Alterra Capital Holdings Limited, which will include the latter's Lloyd's operations, via its subsidiary Alterra at Lloyd's.

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A. FATCA: Challenges for the Insurance Industry

The Foreign Account Tax Compliance Act (“FATCA”) provisions of the Hiring Incentives to Restore Employment Act of 2010 introduced a complex reporting and withholding regime applicable to foreign financial institutions (“FFIs”) and certain other foreign corporations (non-financial foreign entities or “NFFEs”) that could have significant and wide-ranging implications for both U.S. and non-U.S. insurers. The FATCA provisions were designed to discourage U.S. persons attempting to avoid U.S. tax by opening accounts with foreign institutions or investing through foreign entities. The FATCA withholding regime could result in a 30% withholding tax on payments of dividends, interest and certain other types of income, including insurance premiums, from sources within the United States (which are defined under FATCA as “withholdable payments”) and the proceeds from the sale of property producing withholdable payments starting January 1, 2014 and January 1, 2017, respectively. On February 8, 2012, the U.S. Department of the Treasury (“Treasury”) and the U.S. Internal Revenue Service (“IRS”) issued long-awaited proposed regulations related to the implementation and administration of FATCA and provided specific guidance on a number of implementation issues relevant to the insurance industry (the “2012 Proposed Regulations”).

An FFI is a non-U.S. entity that is a “financial institution” as defined under FATCA. Under the FATCA legislation, the definition of a “financial institution” includes an entity that as a “substantial portion” of its business holds financial assets for the account of others or is engaged primarily in the business of investing, reinvesting or trading securities, partnership interests, commodities or any interest in such securities, partnership interests or commodities. An entity will be considered to hold financial assets for the account of others as a “substantial portion” of its business if the entity’s gross income attributable to the holding of financial assets and related financial services equals or exceeds 20% of the entity’s gross income during the three-year period ending

December 31 of the year in which the determination is made or, if shorter, during the entire period for which the entity has existed. An entity will be considered “engaged primarily” in an investment business if the entity’s gross income attributable to investing, reinvesting or trading equals or exceeds 50% of the entity’s gross income during the three-year period ending December 31 of the year in which the determination is made or, if shorter, during the entire period for which the entity has existed.

The 2012 Proposed Regulations include an additional category of “financial institution”: an “insurance company” (or a holding company of an “insurance company”) that issues or is obligated to make payments with respect to a “financial account,” as defined below. An “insurance company” is defined for this purpose as a company more than half the business of which during the calendar year is issuing (or being obligated to make payments with respect to) insurance or annuity contracts or the reinsuring of such contracts. A “financial account” includes, among other things, insurance contracts with cash value, annuity contracts, investments in investment funds and derivatives and other instruments whose value is driven by investment-like returns.

The Preamble to the 2012 Proposed Regulations explains that the proposed “insurance company” category in the definition of “financial institutions” would include only insurance companies that issue (or are obligated to make payments with respect to) cash value insurance policies or annuity contracts. The Preamble further indicates that contracts that provide “pure insurance protection (such as term life, disability, health, and property and casualty insurance contracts and indemnity reinsurance)” are not “financial accounts” for FATCA purposes. As a result, an entity that issues or is obligated to make payments only with respect to types of insurance that are not financial accounts for FATCA purposes, such as property and casualty insurance contracts, would not be deemed an “insurance company” under the 2012 Proposed Regulations and therefore would not be a “financial institution” under FATCA, unless it were to meet one of the other definitions of a financial institution.

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It is unclear, however, whether Treasury and the IRS intended that a non-U.S. entity that does not satisfy the definition of “insurance company” under the 2012 Proposed Regulations could nevertheless be deemed a “financial institution” under the statutory definition described above based on its other financial or investment activities. The American Bar Association has recommended that the final FATCA regulations make clear that an insurance company that does not issue cash value insurance contracts or annuities, or make payments on such contracts, is not a “financial institution,” regardless of whether its activities would otherwise cause it to be treated as an entity engaged in an investment business or holding financial assets for the account of others. Nonetheless, unless this is clarified in the final regulations, a non-U.S. insurance company that does not qualify as a financial institution based on the insurance contracts it issues may nevertheless qualify as a “financial institution” and, by extension, an FFI, because it holds financial assets for the account of others as a substantial portion of its business or is engaged primarily in the investment business.

Assuming a non-U.S. insurance company is not an FFI under any of the definitions described above, it will be an NFFE and would be subject to FATCA withholding on withholdable payments if it does not provide the withholding agent with certain information (as described below). FATCA defines an NFFE as any foreign entity that is not a financial institution. FATCA distinguishes between NFFEs and “excepted NFFEs.” “Excepted NFFEs” are not subject to withholding on “withholdable payments” (as defined above).

The 2012 Proposed Regulations provide several categories of excepted NFFEs, including publicly traded corporations and affiliates and “active NFFEs.” An active NFFE is defined, according to the Preamble to the 2012 Proposed Regulations and statements by the IRS, as a foreign entity if less than 50% of the entity’s gross income for the preceding calendar year is passive income (“income test”) and less than 50% of the assets held by the NFFE at any time during the preceding calendar year are assets that produce or are held for the production of passive income (“asset test”). As used in the 2012 Proposed Regulations, passive income includes gross income from dividends, interest, annuities, death benefits

from life insurance contracts, amounts received from or with respect to a pool of insurance contracts if the amounts received depend upon the performance of the pool and net income from notional principal contracts, among other types of income. We note that it seems highly unlikely that an insurance company would have less than 50% passive assets. While the wording of the proposed regulation itself states that an NFFE can be an active NFFE if it has less than 50% passive income or holds less than 50% passive assets, the Preamble to the 2012 Proposed Regulations, as well as the model Intergovernmental Agreement released in late July 2012 (discussed below), describes an active NFFE as an NFFE that satisfies *both* the income test and the asset test. Based on statements of IRS staff and other steps being taken by the IRS to implement FATCA, in the final FATCA regulations this discrepancy will almost certainly be resolved in favor of a requirement that both the asset test and the income test to be met by an entity in order for the entity to be treated as an active NFFE.

The 2012 Proposed Regulations exclude “nonfinancial holding companies” from the definition of “financial institution” and classify such entities as excepted NFFEs; therefore, non-financial holding companies are exempt from withholding without having to make any certifications as to their U.S. owners. A “nonfinancial holding company” is a foreign entity “substantially all” the activities of which is to own (in whole or in part) the stock of one or more subsidiaries that engage in trades or businesses, provided that no subsidiary is a “financial institution.” “Substantially all” has not been defined. An entity will not be a non-financial holding company “if the entity functions (or holds itself out) as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund or any investment vehicle whose purpose is to acquire or fund companies and then hold interests in those companies as capital assets for investment purposes.”

When an NFFE that is not an excepted NFFE receives a withholdable payment of which it or another NFFE is the beneficial owner, the NFFE must provide the withholding agent with either a certification that the beneficial owner has no “substantial United States owners” or it must provide the name, address and TIN of each substantial United

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States owner, and the withholding agent must provide such information to the IRS to avoid FATCA withholding. The name, address and TIN of each substantial United States owner is provided by the NFFE to the withholding agent on the draft Form W-8BEN-E. For these purposes, a substantial United States owner of a corporation is a “specified United States person” as defined in FATCA, including a U.S. individual that owns more than 10% of the stock of the corporation by vote or value. The 2012 Proposed Regulations provide that a substantial United States owner of a corporation is one that holds such an ownership interest in the entity directly or indirectly. An individual (or entity) will be treated as owning the stock of a NFFE indirectly if such person owns stock in a corporation that owns stock in the NFFE, unless the intermediate corporation is a participating FFI, a deemed-compliant FFI, a U.S. financial institution, an exempt entity (such as a foreign government or international organization) or an excepted NFFE.

An FFI will be required to enter into an agreement (“FFI Agreement”) with Treasury in order to avoid being subject to withholding when it receives a withholdable payment. Pursuant to an FFI Agreement, an FFI will be required to obtain certain information about its account holders to determine whether they are U.S. accounts, to comply with verification and due diligence procedures as may be required, to report certain information with respect to U.S. accounts on an annual basis, to deduct and withhold from payments to recalcitrant account holders, to comply with requests made by the IRS for additional information and to attempt to obtain a waiver from any foreign law that would prevent such reporting or close the account if the waiver were not obtained within a reasonable period of time.

As privacy rules in the European Union and elsewhere prohibit many foreign entities from providing to the IRS the data required by FATCA, Treasury has been negotiating Intergovernmental Agreements to provide alternatives consistent with local laws. Under certain such agreements, the government of the foreign country would collect the FATCA-specific U.S. account information from its domestic financial institutions, for eventual tax information exchange with the U.S. Government; in certain of these agreements,

this obligation would be reciprocal and the U.S. Government would share similar information regarding taxpayers of the foreign country with accounts at U.S. financial institutions. Compliance with these obligations would eliminate the requirement to withhold on payments to an FFI in a country with an Intergovernmental Agreement in effect. Under such agreements, local country FFIs will generally be classified as “deemed compliant FFIs” and would not need to enter separately into FFI Agreements with Treasury.

U.S. insurers also need to consider the impact of FATCA, as such insurers may make withholdable payments to non-U.S. companies and may be treated as withholding agents for FATCA purposes with respect to such payments. As a result, U.S. insurers will need to identify their withholdable payments, confirm the FATCA status of their payees and collect appropriate documentation from payees prior to payment (or confirm that such documentation was obtained by an agent or broker and, if necessary, withhold payment). Consequently, such insurers must have established systems and procedures for compliance with their obligations as withholding agents, as reporting obligations take effect on January 1, 2013 and withholding obligations take effect on withholdable payments on January 1, 2014. These withholdable payments can include, for example, certain life insurance and annuity payments to non-U.S. entities, reinsurance premiums paid to non-U.S. insurers and interest payments to non-U.S. lenders.

B. The New Controlled Foreign Company Regime Makes the United Kingdom a More Attractive Holding Company Location for International Insurance Groups

1. Background

Changes in U.K. corporate tax have re-focused attention on the United Kingdom as a potentially attractive location for a holding company in a multinational insurance group. The U.K. Government’s ambition is to create the most competitive tax system in the G20 and make the United Kingdom the best location for corporate headquarters in Europe. A recasting of the U.K. controlled foreign company (“CFC”) tax regime is intended to complete a package of corporate tax reforms to this end.

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In many respects, the United Kingdom already scored highly as a suitable location, for both a top holding company and an intermediate holding company. However, a key remaining problem area has been the CFC regime.

Most foreign (as well as U.K.) source dividends can take the benefit of exemption from U.K. corporation tax. Combined with the absence of withholding tax on outbound dividends and the exemption for gains realized on disposals of trading subsidiaries, this means that the United Kingdom can offer tax neutrality for many international investments. In addition, a U.K. resident company benefits from the United Kingdom's large double tax treaty network.

Nevertheless, over a period of years, there has been a clear trend for U.K. headquartered groups to "redomicile" their parent company away from the United Kingdom, and for other groups to choose to establish themselves from the outset in more "tax friendly" jurisdictions. This has been evident in a range of industry sectors including, in particular, the insurance industry. The preferred locations have included Bermuda, Ireland, the Netherlands and Switzerland.

Meanwhile, a long-running consultation on a reform of the U.K. CFC regime has culminated in a completely new CFC regime being introduced in the Finance Act 2012. The new rules take effect as of January 1, 2013.

2. Tax-Efficient Dividend Flows

a) Exemption for Incoming Dividends

Most dividends received in the United Kingdom will be free of U.K. corporation tax, even dividends from low-tax/passive subsidiaries.

A number of "classes" of dividend payment are tax-exempt, provided the dividend payment is not tax deductible in the source jurisdiction (and certain specific anti-avoidance exclusions do not apply). The most relevant classes of exempt dividend, none of which have a minimum holding period, are:

- Dividends paid on shares of any kind where the U.K. recipient controls (or jointly controls) the payer, in terms of powers or economic rights;

- Dividends paid on non-redeemable ordinary shares—there is no minimum shareholding size;
- Dividends paid on shares of any kind where the recipient (together with connected persons) holds less than 10% of the issued share capital of the paying company (or less than 10% of the class of shares held, where there is more than one class in issue); and
- Dividends paid on shares of any kind, where the profits are not derived from transactions designed to achieve a reduction in United Kingdom tax.

The introduction of this dividend exemption in 2009 has been widely welcomed as a replacement for the foreign tax credit regime that was formerly in place. The credit rules have not been removed entirely, and remain as the default regime, which applies where dividends are not exempt. These credit rules render foreign dividends liable to U.K. corporation tax (currently levied at 24% and due to fall to 23% on April 1, 2013 and 21% on April 1, 2014), but with credit for foreign tax. Subject to conditions, both withholding tax and local tax on the profits out of which the dividend is paid are creditable. Given the rate of U.K. corporation tax compared with foreign tax rates, these credit rules will often give complete relief from U.K. tax on dividend receipts, but they are relatively complicated and administratively burdensome.

In addition to being the default regime, it is possible for a U.K. dividend recipient to elect out of exemption treatment so that the credit rules will apply—and there are circumstances where this may be beneficial. For instance, a number of the United Kingdom's tax treaties (including, for example, those with Germany, Israel and Russia) only reduce withholding tax on dividends paid from those jurisdictions, if the dividend is subject to tax in the United Kingdom. Where dividends are to be received from these treaty jurisdictions, and where it is necessary to rely on the treaty for withholding tax reduction (rather than, for instance, intra-EU exemption), the credit rules may give a better overall outcome than dividend exemption.

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b) Reduced Withholding Tax on Dividends from Foreign Jurisdictions

U.K. companies can receive dividends from foreign subsidiaries free of local withholding tax, in accordance with the EU Parent/Subsidiary Directive, if those subsidiaries are located within the European Union.

For subsidiaries outside the EU, withholding tax on dividends can be reduced, often to nil, by the United Kingdom's excellent tax treaty network. The relative advantages of different locations need to be assessed on a case-by-case basis, depending on the detailed provisions of the relevant treaties. But, in terms of the sheer size and range of its treaty network, with around 112 active tax treaties, the United Kingdom compares favorably with other well-known holding company jurisdictions, including (for instance) Ireland, Luxembourg, Malta, the Netherlands, Singapore and Switzerland.

c) No U.K. Withholding Tax on Outbound Dividends

The United Kingdom does not levy withholding tax on dividends, share buybacks or liquidation distributions, paid by U.K. companies.

This combination of extensive relief from foreign withholding tax, exemption from U.K. tax on dividend receipts and the absence of U.K. withholding tax on outbound dividends means that it is possible for distributions of profits from operating subsidiaries in many foreign jurisdictions to flow through the United Kingdom with no, or minimal, incremental tax cost.

3. Controlled Foreign Company Regime

Even if the incoming dividends are not taxable, one still needs to consider whether the undistributed profits of foreign subsidiaries could be taxed on the U.K. parent company under the CFC regime.

The U.K. Government's stated objective in reforming the CFC regime is to target more accurately profits that have been artificially diverted away from the United Kingdom.

This article does not seek to outline the whole of the new CFC regime. It concentrates instead on plotting a possible way through the legislation for members of a U.K. headed insurance group or sub-group, with operations in the general (non-life) insurance sector, particularly in relation to CFCs located in tax-efficient jurisdictions.

a) Summary

Essentially, profits of insurance group CFCs are potentially taxable if:

- key operational and management functions that relate to the foreign company's assumption and management of risks or assets are carried out in the United Kingdom by a member of the group (but with an allowance for any U.K. activities which one might reasonably suppose would otherwise have been outsourced to an unconnected company); or
- the foreign subsidiary has excessive capital or reserves.

If neither test is failed, then, generally, the insurance group does not have to consider the intricacies of the CFC regime further.

b) Framework

The starting point is that the new CFC regime applies to companies resident outside the United Kingdom that are controlled by U.K. residents. Similar rules will apply to exempt foreign branches of U.K. resident companies.

The approach of the legislation is now different. Instead of having to find an exemption from CFC taxation for foreign subsidiaries, only those profits of foreign subsidiaries that pass through a charge "gateway" are potentially taxable.

A CFC charge arises if:

- the CFC has "chargeable profits," meaning, essentially, profits that pass through the gateway;
- none of the entity-level exemptions apply; and

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- there is a U.K. person that holds an interest in the CFC, that is not exempt (e.g., certain offshore funds and share traders) and that, together with connected companies, holds an interest of at least 25%.

It is not necessary to work through the conditions in order. For example, if one of the entity-level exemptions applies, it is not necessary to consider whether or not the CFC has any chargeable profits. These entity-level exemptions relate to “exempt periods” (for foreign companies becoming CFCs for the first time, for example by reason of takeover or migration), “excluded territories” (for CFCs resident in certain territories, subject to conditions), “low profits” (for CFCs with low levels of profit), “low profit margin” (for CFCs whose profit is a small margin above certain defined expenditure) and “tax exemption” (for CFCs that pay at least 75% of the tax they would have paid if U.K. resident). These have many similarities with elements of the definition of a CFC and the various entity-level exemptions under the old CFC regime.

If a CFC charge arises, there is a U.K. corporation tax liability on each chargeable company holding a relevant interest in the CFC, on the relevant proportion of the CFC’s chargeable profits.

c) Initial and Main Gateways

A feature of the legislation is an initial filter (in Chapter 3 of Part 9A of the Taxation (International and Other Provisions) Act 2010 (“TIOPA”).

Chapter 3 covers several different categories of profit. If certain profits pass through the initial filter for the relevant category in Chapter 3, then the more detailed applicable “main gateway” rules for that category in Chapters 4 to 9 of Part 9A of TIOPA need to be examined. Only if they pass through the main gateway as well will they constitute “chargeable profits,” potentially triggering a CFC charge. If the initial filter in Chapter 3 for a particular category filters out the relevant profits of the CFC at that stage, then there is no need to look at the more detailed rules for that particular category in Chapters 4 to 9.

However, the various profit categories are not mutually exclusive. In other words, even if a particular item of profit does not pass through the initial (or main) gateway under one heading, it might pass through under another.

Her Majesty’s Revenue and Customs (“HMRC”) says in its draft guidance published during 2012 (“Draft Guidance”) that the tests in Chapter 3 are intended to provide a simple and accessible means for companies to identify CFCs for which there can be no CFC charge because there are no chargeable profits, and that for most CFCs there will be no need to consider the CFC legislation beyond Chapter 3. The U.K. company is entitled to self-assess the non-application of the CFC regime solely on the basis of the initial filter in Chapter 3, where appropriate. In addition, HMRC says that, where appropriate, it will give a CFC clearance by reference to Chapter 3, only considering the main gateway chapters where the Chapter 3 rules make it necessary to do so.

The documentation requirements, demonstrating a company’s consideration of whether any of the CFC’s profits pass through the CFC charge gateway, are intended to be similar to those applicable under the transfer pricing rules.

d) Gateway—Trading Profits—Underwriting Profit and Investment Return—U.K. Management

An insurance company’s trading profits, both the profits from its underwriting activities and also the income and gains arising from its investment portfolio, potentially fall within the first main category of profits (the initial gateway in Section 371CA in Chapter 3 and the main gateway in Chapter 4, of Part 9A of TIOPA).

The initial gateway in Chapter 3 does not let through trading profits if the CFC does not have any U.K. managed assets or bear any U.K. managed risks (alternative Conditions B and C). What this test is examining is whether the acquisition, creation, development or exploitation of the asset or the taking on, or bearing, of the risk, is managed or controlled to any significant extent by way of activities carried on in the United Kingdom, either by the CFC itself (otherwise than through a U.K. permanent establishment) or by companies

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connected with the CFC under arrangements that would not, it is reasonable to suppose, be entered into by companies not connected with each other.

The respective scope and interaction of the two alternative conditions (B and C) is somewhat confused (and the illustrations in the Draft Guidance do not clarify the point). However, what is clear is that the basic concern is that a CFC is being used to divert profits from the U.K. by separating the assets and risks from the associated group activity, and that the CFC would not be capable of managing the business on its own without loss of commercial effectiveness.

There is an allowance for any U.K. activities that one might reasonably suppose would otherwise have been outsourced to an unconnected company. HMRC says that this is aimed at the sort of situation where the nature of the services or the degree of control or access to information required is not such that it would be reasonable to assume that such support or services could have been provided by, or given to, an unconnected person.

HMRC goes out of its way to say in its Draft Guidance that this test is not synonymous with that of “key entrepreneurial risk-taking functions” (“KERTs”) in the OECD Report on the Attribution of Profits to Permanent Establishments dated July 22, 2010 (the “OECD Report”). This is no doubt intended to be helpful, in terms of simplifying the interpretation of the initial gateway, but in practice the essence of the test seems to be very similar to the approach in the OECD Report.

Helpfully, HMRC’s Draft Guidance indicates (consistent with the OECD Report) that the CFC’s assets or risks would not be regarded as “U.K. managed” simply because a U.K. parent company carries out oversight or group governance functions; for example, setting parameters according to which the business of overseas group companies must be conducted or adopting a strategy or business plan for the group. As long as “active, day to day decision-making” in respect of the assets and risks does not take place in the U.K., they would not be “U.K. managed.” If a group is relying on this distinction, care should be taken to make sure that the CFC is doing more than simply “rubber stamping” a decision that has really been taken in the United Kingdom. The concept

of “active” decision-making encompasses the informed and responsible assumption of underwriting risk.

In addition, the Draft Guidance says that guidance or advice on specific matters could be given to a CFC from the United Kingdom, provided that the CFC’s staff had the skills and capacity to understand and evaluate the guidance and make appropriate decisions that take account of it.

On the face of it, it does not seem that there should be many instances where an insurance CFC will fall afoul of the initial gateway, without having triggered another U.K. tax problem in any case. If, in fact, contrary to standard operating guidelines for a foreign subsidiary, the CFC’s assets and risks are being managed and controlled from the United Kingdom, then in most situations the profits will effectively fall within the scope of U.K. corporation tax anyway, without the need for HMRC to resort to the CFC regime:

- This could be because the CFC itself is chargeable to U.K. tax, on the basis that the CFC is trading in the United Kingdom through a permanent establishment, either through its own employees or through a dependent agent;
- Alternatively, where the support or services being provided from the United Kingdom are significant, the U.K. transfer pricing rules are likely to result in a significant proportion of the gross income arising from such activities being deemed to be payable to the U.K. affiliate as an arm’s-length fee, which fee would be taxable in the hands of the U.K. service provider.

During the early stages of the lengthy consultation period, there were many representations questioning the need for a CFC regime at all; for these reasons. HM Treasury rejected the idea that it could dispense with a CFC regime altogether but, as the Draft Guidance acknowledges, these other mechanisms for protecting the U.K. tax base take priority.

One situation where the CFC regime might pick up an artificial diversion of profits from the United Kingdom, which would otherwise not be caught by the permanent establishment or transfer pricing rules, could be a situation where the CFC relies on a combination of several different

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U.K.-connected companies to provide key services, which in aggregate amount to its assets and risks being managed and controlled from the United Kingdom.

Another might be where the kind of services provided to the CFC by U.K. affiliates are not, by their nature, suitable for third-party outsourcing. In that situation, it might be difficult to compute the correct transfer price on arm's-length principles.

Nevertheless, the new CFC regime is more commercial in approach. Unlike under the old CFC regime, it is not necessary for the CFC to manage and control its assets and risks from its home territory.

Of particular note for the London insurance market is that a significant level of reinsurance by the non-resident insurance company of a U.K. connected insurance company no longer automatically triggers a CFC tax charge, provided that the underlying risks originate outside the group. (However, once U.K. sourced business represents more than 20% of the foreign company's income, the Section 371DF of TIOPA "safe harbor" route for satisfying the main gateway test for this category of profits is not available.) U.K. transfer pricing rules will, of course, continue to apply the international arm's-length principle to the terms of any intra-group reinsurance.

e) Gateway—Trading Profits—Underwriting Profit and Investment Return—Motive Test

Alternatively, the initial gateway in Chapter 3 does not let through trading profits if a form of motive test is met (Condition A in Section 371CA of TIOPA). The question is whether the CFC holds assets or bears risk under an arrangement with all three of the following characteristics:

- The main purpose, or one of the main purposes, of the arrangement is to reduce or eliminate any liability of any person to U.K. tax or duty;
- The consequence of the arrangement is that at any time the CFC expects its business to be more profitable (other than negligibly) than it would otherwise be; and

- The arrangement gives rise to an expectation that one or more persons will have liabilities to tax or duty imposed under the law of any territory reduced or eliminated, and it is reasonable to suppose that the arrangements would not have been made if there were not that expectation.

In its Draft Guidance, HMRC makes the comment in relation to the third feature that it would be reasonable to suppose that an arrangement would have been made if there were a clear objective expectation of commercial non-tax benefits in the arrangement as compared with other options realistically available to the CFC, group and these benefits, on an objective calculation, are clearly sufficient on their own for the arrangements that have been adopted.

This approach marks a change in the evidential burden compared with the motive test under the old CFC regime. This was very narrowly drafted and interpreted—in particular, it was not enough under the previous rules that general commercial reasons might be more important than tax-related reasons. The motive test could be passed only if the achievement of a reduction in U.K. tax was not one of the main reasons for the existence of the company.

It remains to be seen whether, in practice, taxpayers will be able to become comfortable with relying on this initial gateway filter in relation to trading profits. In particular, it could become the simplest route for steering the trading profits of subsidiaries in full tax jurisdictions away from the gateway, rather than looking to the other initial/main gateway tests or one of the entity-level exemptions (such as the excluded territories exemption or the tax exemption).

f) Gateway—Trading Finance Profits—Investment Return

A CFC carrying on an insurance business will also need to consider the "trading finance profit" category of profits, insofar as the return on its investment portfolio (such as interest and dividends) is concerned (the initial gateway in Section 371CE in Chapter 3 and the main gateway in Chapter 6, of Part 9A of TIOPA).

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Profits in this category only pass through the initial gateway where the CFC has funds or other assets that derive (directly or indirectly) from any capital contribution to the CFC made (directly or indirectly) by a U.K. resident company that is connected with the CFC. It is not relevant whether that capital contribution is related to an issue of shares in the CFC.

However, there are obvious practical difficulties in tracing the source of funds of a CFC. This means that, even in a situation where the CFC has been in business for a while (and has realized profits and paid significant dividends to its U.K. parent), the fact that typically all or part of the CFC's initial finance was provided by the group is likely to mean that the prudent approach will be to proceed to the next step, and test whether the trading finance profits pass through the main gateway.

The main gateway test looks at the CFC's free capital and free assets and asks whether the CFC has "excess free capital" or "excess free assets." If it does, the attributable profits pass through the main gateway and are potentially taxable.

"Free capital" means the funding that the CFC has for its business and that does not have an associated cost in a form that would normally be tax-deductible, such as interest, discount or premium. In other words, "free capital" means amounts received by way of subscription for shares, free capital contributions, interest-free loans or similar instruments. The free capital is "excess" to the extent that it exceeds what it is reasonable to suppose its free capital would be were it a company that is not the 51% subsidiary of any other company.

"Free assets" means the amount by which the value of the CFC's assets exceeds its loan capital. The free assets are "excess" to the extent that they exceed what it is reasonable to suppose its free assets would be were it a company that is not the 51% subsidiary of any other company.

HMRC has the power to make regulations that will provide a "safe harbor." The regulations may make provision by reference to the territory in which a CFC is resident or in which its insurance business is regulated or carried on, or the insurance regulatory requirements imposed from time to time in any territory.

The safe harbor is capable of protecting CFC insurance business that consists of contracts of insurance entered into with a connected U.K. resident company or U.K. permanent establishment, provided that the insurance contract represents reinsurance, and the original contract of insurance is not with a connected U.K. resident company or U.K. permanent establishment.

For the purposes of this test, certain assets of an insurance CFC can be ignored in certain circumstances. Those circumstances are that the insurance CFC, for regulatory reasons, is required to hold more assets than it otherwise would because it has provided a guarantee to another insurance company that is connected with the CFC, and that guarantee is required for regulatory reasons in order for the connected company to carry on insurance business.

Conversely, for the purposes of both the excess free capital and excess free assets test, the free capital or free assets are increased by the amount of any borrowing by the CFC, where the lender is a connected CFC that is claiming the benefit of the group treasury company exemption (under Chapter 9 of Part 9A of TIOPA). Essentially, if E% of the profits arising from the loan are exempt for the lender, then E% of the borrowing is added to the borrower's amount of "free capital" or "free assets."

The draft regulations have not yet been formally published. In its update document issued in January 2012, HMRC mentioned that it was thinking in terms of the insurance safe harbor being set at between 200% and 250% of minimum regulatory capital. It remains to be seen whether the final version of the regulations adopts a measure and multiple which is flexible and generous enough to accommodate counterparty and rating agency expectations, as well as the evolving nature of regulatory requirements as a result of Solvency II. Attention will also focus on the frequency and method of valuing assets; the hope is for an approach that does not impose material extra compliance burdens.

Even if the safe harbor in the regulations does not apply, it is still open to the taxpayer to demonstrate that the CFC is not over-capitalized on fundamental commercial principles.

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g) Gateway—Captive Insurance Business

Another category of profit potentially relevant to an insurance CFC relates to captive insurance business (the initial gateway in Section 371CF in Chapter 3 and the main gateway in Chapter 7, of Part 9A of TIOPA).

However, this category is aimed at captive insurance CFCs owned by non-insurance groups, including in relation to extended warranty plans. There is a specific exclusion for contracts of reinsurance with a connected U.K. resident company or permanent establishment, where the original contract of insurance is not with a connected U.K. resident company or permanent establishment (Section 371GA(5) of TIOPA).

h) Entity-Level Exemptions

If profits pass through the gateway, one of the entity-level exemptions may still prevent a U.K. tax charge.

The main features of these exemptions will ring bells with those who are familiar with the prior CFC regime. In particular, there is a simplified version of the “excluded territories” exemption for subsidiaries resident in Australia, Canada, France, Germany, Japan or the United States.

i) Commencement

The new CFC regime takes effect in relation to accounting periods of CFCs beginning on or after January 1, 2013.

4. No U.K. Tax on the Sale of Operating Subsidiaries

The so-called “substantial shareholding exemption” provides a tax exemption corresponding to the capital gains tax component of the “participation exemption” in some other jurisdictions.

Where a U.K. company sells a trading subsidiary, it will not normally be subject to any U.K. corporation tax on the realized gain, provided the U.K. company has owned at least 10% of the ordinary shares of the trading subsidiary (and has been beneficially entitled to at least 10% of the distributions and

assets of the subsidiary) for at least 12 months and is itself either a trading company or a member of a trading group (and will remain so immediately following the disposal).

A key requirement is that the target is a “trading company” or a “holding company of a trading sub-group” and that the U.K. parent is a “member of a trading group.” This means that the activities of the company, group or sub-group as a whole do not comprise non-trading activities to a substantial extent (which HMRC interprets to mean more than 20%). “Trade” is distinguished from “investment” activities for this purpose. Intra-(sub)group transactions are ignored. HMRC usually looks at three measures—the assets, the income and the time spent/expenses incurred by employees.

The capital and reserves of an insurance company and the “investment income” earned thereon should count as trading assets and income for the purposes of the substantial shareholding exemption. Provided the insurance company does not have excess capital or funds (in other words, all surplus cash has been distributed to shareholders and all cash and investments are necessary to support the underlying insurance business), it is likely that the necessary “trading” status for the company’s activities can be established.

5. Deductible Interest Costs

Interest costs on borrowings incurred to purchase or fund subsidiaries (both U.K. and overseas) are, in principle, tax deductible (subject to certain anti-avoidance rules).

The level of debt taken on, and the interest rate payable, will need to meet arm’s-length standards.

In certain cases, the worldwide debt cap could impact upon the deduction of debt financing costs. Put simply, this rule can apply where a group puts a greater amount of debt into the U.K. sub-group than it has borrowed externally. Interest costs on the excess are not tax-deductible. However, the regime is subject to gateway and *de minimis* tests, and contains important exemptions—including, in particular, for certain groups in the financial services sector, including insurance groups.

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6. No U.K. Tax on the Sale of Shares in a U.K. Company by a Foreign Shareholder

The United Kingdom does not tax any capital gain realized by a non-resident shareholder on a sale of shares in a U.K. insurance group holding company (unless the shares are assets of the shareholder's U.K. permanent establishment).

7. Other Advantages

The United Kingdom is a leading international center for the insurance industry, with an excellent pool of experienced employees and a strong business infrastructure.

The tax treatment described in this note is based on the general U.K. corporation tax regime applicable to all companies, whatever their ownership or activities, and whether the subsidiaries are located in the United Kingdom or abroad, and hence may be less vulnerable to attack from anti-avoidance rules in other countries, compared with a special holding company regime.

English company law and contract law is robust and flexible, and company formation procedures in the United Kingdom are simple, fast and cheap.

There is no capital duty payable on share capital subscriptions and no minimum capital requirement as a matter of English company law; however, sales of shares in U.K. incorporated companies do incur stamp duty at 0.5 per cent of the sale price.

London provides excellent access to the international financial and capital markets.

The United Kingdom, especially London, remains an attractive work base for many executives, for reasons of language, lifestyle, transport links and the favorable tax treatment of resident but non-domiciled individuals.

8. Transfer Pricing

All that being said, the suitability of the United Kingdom needs to be assessed on a case-by-case basis.

The United Kingdom is a full-tax jurisdiction with a highly developed tax system.

In particular, under U.K. transfer pricing rules, a U.K. holding company will be required to adjust its taxable profits in line with the internationally accepted arm's-length principle.

This means that it will be required to recognize an arm's-length fee for the provision of any services to affiliates (such as management and administrative services, loans or guarantees, or licenses of intellectual property). Equally, expenses incurred by the U.K. company under arrangements with affiliates will be tax deductible only to the extent that they do not exceed an open market rate.

9. Conclusion

The United Kingdom deserves serious consideration, alongside other traditional holding company jurisdictions, for structuring international insurance groups.

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