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Developments and Trends in

Insurance Transactions and Regulation

2017 YEAR IN REVIEW

January 31, 2018

To Our Clients and Friends:

We are pleased to present our 2017 Year in Review. In it we review the year's most important developments in insurance transactions and regulation, including developments relating to mergers and acquisitions, corporate governance and shareholder activism, insurance-linked securities, alternative capital, traditional capital markets transactions and the regulation and taxation of insurance companies, both in the U.S. and internationally.

We hope that you find this 2017 Year in Review informative. Please contact us if you would like further information about any of the topics covered in this report.

Sincerely,

Insurance Transactional and Regulatory Practice
Willkie Farr & Gallagher LLP

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

SNL Financial
2014-2017, based on the aggregate number of deals in the U.S./Canada/Bermuda

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

Thomson Reuters
2017, 2016, 2015 and 2014, based on market share

Band 1 for Insurance – Transactional and Regulatory

Chambers USA
Nationwide and New York | 2017, 2016, 2015 and 2014

Insurance (Insurer) Firm Award

Chambers USA Awards for Excellence 2017

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I. REVIEW OF M&A ACTIVITY IN 2017

A. Market Trends – North America

1. By the Numbers

More M&A transactions were announced in the life and health and P&C insurance industry in North America in 2017 compared to 2016, but the aggregate size of the announced transactions dropped for the second year in a row. A total of 110 transactions were announced in 2017, representing approximately $15.1 billion in aggregate transaction value. These figures compare to a total of 83 transactions representing approximately $25.3 billion in aggregate transaction value in 2016.[1]

Nine separate transactions in the industry in 2015 and 2016 had aggregate transaction values near or in excess of $5 billion. By contrast, the transaction with the largest transaction value in the industry in 2017 (Assurant's acquisition of The Warranty Group) had an aggregate value of approximately $1.91 billion.

Transaction values, however, are not perfect indicators of size or significance. The aggregate values of a number of transactions announced in 2017 were relatively modest in comparison with the sizes of the businesses sold. For example, Voya's sale of its closed block variable annuity and certain of its fixed annuity businesses to an investor group involved the transfer of businesses with approximately $54 billion of reserves, Hartford's sale of Talcott Resolution to an investor group involved the transfer of businesses with more than $47 billion in reserves, and Transamerica's sale of its payout annuity and BOLI/COLI businesses to Wilton Re involved the transfer of businesses with approximately $14 billion in reserves. All three had equity values of less than $2 billion.

We discuss each of these transactions in greater detail below, and also provide our perspective on factors that drove M&A activity in 2017, and might drive it in the future.

2. The Life and Health Insurance Sector

a) Life Insurance, Annuities and Long-Term Care

Thirty-six transactions were announced in the life and health insurance sector in 2017, with an aggregate transaction value of $7.64 billion. By that measure, the largest transaction in the sector was the sale of Fidelity & Guaranty Life to an investor group for $1.835 billion. The sale followed an unsuccessful attempt by a Chinese firm, Anbang Insurance Group Co., Ltd., to acquire Fidelity & Guaranty Life. The deal with Anbang was terminated after Anbang was unable to obtain regulatory approvals to complete the acquisition.

Anbang is not the only Chinese buyer that has had difficulties trying to buy U.S. insurance companies in recent years. As detailed in our 2016 Year in Review, Fosun International Limited sold Ironshore Inc. to Liberty Mutual Holding Company, Inc. only about a year after acquiring control of the insurer. The sale followed concerns raised with respect to Fosun's ownership of Ironshore by representatives of the Committee on Foreign Investment in the United States ("CFIUS"), an inter-agency U.S. government entity that reviews foreign acquisitions to determine whether they may threaten U.S. national security, and negative ratings actions by A.M. Best Company, Inc. The most significant transaction in the life and health insurance sector in 2016, the $2.7 billion acquisition of Genworth Financial, Inc. by a subsidiary of China Oceanwide Holdings Group Co., Ltd., continues to face similar challenges and uncertainties. As of the date of this writing, the Genworth transaction has not yet closed, and the parties have extended the period for obtaining regulatory approvals under their merger agreement several times in order to address concerns raised by CFIUS. We anticipate that CFIUS will continue to be aggressive in seeking to examine financial services acquisitions, particularly those involving Chinese buyers, if they involve sensitive relationships (including with policyholders who are government employees) or large databases.

1 Deal volume and transaction values in this report are from the S&P Global Market Intelligence database.

I. Review of M&A Activity in 2017

In our 2016 Year in Review, we noted a number of reasons for the generally low level of life insurance M&A activity over the prior several years. We outlined, in particular, that a mature market, weak growth in the general economy, the persistent low interest rate environment, demographic trends and other factors had combined to create a situation in which fewer domestic strategic participants had been seeking growth through acquisitions in North America, and instead had looked to markets and industry sectors with greater potential for growth. Notwithstanding those factors, we believed that several countervailing factors might result in an increase in M&A activity in the life and health insurance sector, including: market fragmentation with room for consolidation among life insurers; a strong appetite for life insurance and annuities assets by run-off consolidators, financial buyers such as hedge funds and private equity firms, and Asian buyers, particularly "second round" Japanese buyers; technology and new business models; opportunities stemming from shifting demographics and historically low penetration rates in the U.S.; and regulatory changes. We continue to interpret these factors as indicative of increased M&A activity in the life and health insurance sector. In addition to these factors, rising interest rates, growth in the general economy and a different tax regime in the U.S. could contribute to increased M&A activity in the sector in 2018 and future periods. Indeed, we believe a trend toward increased activity levels may have begun in earnest in 2017.

Three significant transactions in the life and health insurance sector in 2017 involved divestitures of large blocks of annuity businesses that had previously been placed into run-off. In December, Voya announced that it was selling its closed block variable annuity business and its individual fixed and fixed indexed annuity business to a consortium of investors including affiliates of Apollo Global Management, Crestview Partners, Reverence Capital Partners and Athene Holding, Ltd. The transaction involved the transfer of approximately $54 billion of reserves. Similarly, The Hartford entered into an agreement to sell Talcott Resolution, its run-off life and annuity businesses with over $47 billion in reserves (over $40 billion of which related to a run-off block of variable annuities), to a group of investors led by Cornell Capital LLC, Atlas Merchant Capital LLC, TRB Advisors LP, Global Atlantic Financial Group, Pine Brook and J. Safra Group. In each of these two transactions, a publicly-traded insurance group divested itself of a large run-off block of variable annuities to a newly formed entity backed by private investors, while retaining other businesses that it viewed as being more profitable, less volatile and less capital-intensive. These transactions appear to have been viewed favorably by investors, since each of the sellers enjoyed an increase in its public share price in the aftermath of the announcement of its divestiture plans. For their part, the newly formed buyers can administer the run-off of the acquired businesses as private companies unburdened by the need to manage their operations and hedging strategies to minimize GAAP earnings volatility.

We expect that the buyers of the Voya and Hartford businesses, and perhaps other entrants to the market, will look to acquire other run-off blocks of variable annuities in future periods, and that buyers will find a general willingness by insurers to sell similar blocks for the right price. Having private companies backed by financial firms acquire variable annuities businesses could be a boon to M&A activity in the immediate future for two reasons. First, executing the acquisitions will, in itself, necessitate M&A activity. Second, sales of such businesses may remove some barriers to consolidation among market participants with freed-up capital who will be vying for new business in a fragmented market.

These newly formed buyers were not the only run-off buyers active in the life and health insurance sector in 2017. In May, Aegon's Transamerica life subsidiaries agreed to sell their two largest run-off businesses in the U.S., their payout annuity business and their Bank-Owned/Corporate-Owned Life Insurance business (BOLI/COLI), to Wilton Re, a private company backed by the Canadian Pension Plan Investment Board. The two businesses had aggregate reserves of approximately $14 billion.

The sale to Wilton Re was not the only significant transaction announced by Aegon's Transamerica life

subsidiaries in 2018. In late December, Aegon announced that it had agreed to sell to SCOR about half (approximately $750 million of reserves) of the life reinsurance business that Transamerica retained after it sold most of its U.S. life reinsurance business to SCOR in 2011.

Another significant transaction in the life and health insurance sector in 2017 was Aetna's sale of its U.S. group life and disability business to The Hartford for $1.45 billion. Soon after the sale to The Hartford, Aetna entered into a merger agreement to sell itself to CVS Health for $69 billion in a transaction that has the potential to change the managed care insurance sector dramatically.

3. The Non-Life/P&C Sector

Seventy-four transactions were announced in the P&C insurance sector in 2017, with an aggregate transaction value of $7.42 billion. No transaction announced in 2017 had a value of $2 billion or more, and only two had transaction values that exceeded $1 billion. By contrast, four separate transactions announced in 2016 had transaction values of $3 billion or more.

The largest transaction was the announced combination of Assurant, Inc. with The Warranty Group, which has an equity value of $1.91 billion. The transaction was first announced in October and contemplated a structure in which Assurant stockholders would own 77% of the holding company of the combined businesses, which was contemplated to be organized offshore. After the passage of tax reform in the U.S., the parties agreed in January 2018 to amend their transaction structure such that, among other things, Assurant Inc., a U.S. company, would acquire The Warranty Group and its subsidiaries and remain the top holding company in the group.

Two significant transactions in 2017 involved specialty insurance providers. In Bermuda, White Mountains Insurance Group sold specialty insurer OneBeacon Insurance Group to Intact Bermuda Holdings, Ltd., a Canadian firm, for $1.7 billion. In the U.S., Markel Corporation acquired State National Companies, Inc. for $922 million.

Finally, AmTrust Financial Services announced a pair of sales in 2017. In November 2017, it announced the sale of a majority stake in certain of its U.S.-based fee business to Madison Dearborn Partners for aggregate cash proceeds of approximately $950 million. Earlier in 2017, in June, AmTrust announced the sale of shares in National General Holdings Corp. to unaffiliated third parties for approximately $212 million.

Factors affecting M&A activity in the P&C sector in 2017 appear to have remained relatively unchanged from last year, despite the industry having experienced the worst hurricane season in modern U.S. history. For years, pricing pressure resulting from increased competition and excess capital throughout the industry squeezed underwriting margins, but many years of benign loss experience and, with a few exceptions, solid financial performance, allowed insurers to accumulate capital such that the industry entered the 2017 hurricane season with a record amount of surplus. This surplus appears to have allowed the industry to absorb the losses associated with the catastrophic events in 2017 without fundamentally changing the dynamics of the market. As a result, many commentators are predicting only a slight hardening of the market without a major shift in competition for business or in available reinsurance capacity. We will have to watch to see how the market actually develops in 2018, and how those developments could affect M&A activity in the sector.

We noted in our 2016 Year in Review that we expected continued M&A activity involving Bermuda reinsurers in the near term, although perhaps at a slower pace than in prior years. Since 2014, six takeovers have occurred involving Bermuda reinsurers listed in the U.S. and several more who were listed in the U.K., resulting in about a half-dozen public Bermuda reinsurers at present. It will be interesting to see what, if any, effects U.S. tax reform will have on their businesses, and on potential M&A activity. AIG's agreement to acquire Validus in January 2018 has spurred renewed speculation regarding the remaining stand-alone public Bermuda reinsurers. Whether that speculation ultimately leads to additional M&A activity

involving Bermuda reinsurers, as sellers or buyers, remains to be seen.

B. Market Trends – Europe

Following a relatively quiet 2016 for European M&A, a recent study[2] shows that, while fewer in number, the value of the deals concluded in 2017 exceeded the value of deals concluded in 2016. Research suggests that there has been a trend toward larger-value acquisitions.

The following key factors affected deal volume in Europe:

- *Political and economic factors* – Brexit continues to be a strategic consideration for European (re)insurers and intermediaries in the sector, mainly because they continue to be uncertain as to how the departure of the U.K. from the E.U. will affect the operation of the financial services sector, in particular in relation to passporting. As a result, corporate resources may have been redirected into making arrangements for Brexit, and away from growth and other strategic opportunities. The persisting political and economic uncertainty due to Brexit influenced some investors, although the fall in the value of the pound sterling is a positive investment theme.

- *Greater competition* – Although several relatively significant catastrophe events occurred in 2017, the (re)insurance market continues to experience soft pricing conditions. As a result, competition among market participants has increased, and has been further augmented by increased capacity provided by alternative capital. Firms are therefore focusing on internal capital optimization, and on sponsoring their own ILS offering utilizing such lower cost capital, rather than looking outwards for growth.

2 Conducted by Willis Towers Watson in conjunction with Mergermarket.

Notwithstanding these factors, a number of important deals have been completed in 2017, and in respect of these we note the following trends: the desire to increase firms' global footprint; the rise of InsurTech; expansion into asset management; and the increasing importance of run-off.

1. Increasing Global Footprint

The biggest deals conducted in 2017 have been large cross-border transactions aimed at increasing the global footprint of the firms involved. In part, these transactions reflect the goal of the firms involved to diversify across countries to ensure future durability in the changing global market. Nevertheless, synergies and capital optimization remain key concerns underlying this activity.

In March 2017, Sompo Holdings Inc. completed its purchase of Endurance Specialty Holdings Ltd. for a total consideration cost of $6.3 billion. The intention is for Endurance to be integrated into Sompo Holdings by creating a new arm "Sompo International," which will be based in Bermuda. The President and CEO of Sompo Holdings, Kengo Sakurada, said that this acquisition would "significantly enhance Sompo's presence in international markets and provides the group with greater opportunities to deepen and expand its geographic footprint by offering global diversification."

Endurance's Lloyd's operations, however, were not subsequently integrated with Sompo's existing Canopius Lloyd's business since the "culture and business mix of the two companies were very distinct." The acquisition of Endurance was, therefore, quickly followed by Sompo's agreed sale of Canopius in a management buyout backed by private equity firms, as in the absence of synergies it was not seen as advantageous to keep both businesses.

Another example of this trend can be seen in AXIS Capital Holdings Ltd's purchase of Novae Group plc via a scheme of arrangement that was completed in October 2017. This purchase was made for $611.5 million cash and created a $2 billion insurer in London and a top ten (re)insurer at Lloyd's, with gross written premiums of $6 billion globally for 2016. Again, the stated reasoning behind the

acquisition was to "greatly add to the scale and breadth of [AXIS's] international business" and do more for the clients and partners of AXIS globally.

2. InsurTech

InsurTech remains poised to "disrupt the market" in coming years and cause incumbent market participants to consider the ways in which technology can improve and enhance their business models.

Key market players such as Allianz, Swiss Re and XL Catlin have sought to get ahead of the curve by partnering with organizations such as Startupbootcamp InsurTech, which supports creators of new technology companies to "rapidly scale their companies by providing direct access to an international network of the most relevant mentors, partners, and investors in their industry." We will therefore need to watch this space for possible tie-ups that result from InsurTech initiatives.

The largest InsurTech deal of 2017 did not occur in Europe, but is worth noting as it can be seen as a forerunner for deals in this market. In the world's first InsurTech public offering, in September 2017, Chinese Internet-only insurance group Zhong An raised $1.5 billion in an initial public offering in Hong Kong. Zhong An is backed by Alibaba, Ping An and SoftBank Group, among others. Some forecast that this offering will pave the way for other companies in the space to consider listing or other capital-raising initiatives.

In the U.K. in 2017, the market saw more transactions involving InsurTech companies than in previous years. While the size of these deals remains more modest when compared to the largest deals of 2017, InsurTech is beginning to make its mark on the sector.

In March 2017, Travelers announced its intention to purchase U.K.–based insurance broker Simply Business from Aquiline Capital Partners LLC for approximately $490 million. Simply Business is a leading small business insurance intermediary and is renowned for its "strategic digital capabilities" and "digital commerce talent." Travelers's CEO Alan Schnitzer said that the acquisition would support its strategic priority of "advancing [its] digital agenda" since technology is increasingly "driving customer preferences and expectations." The transaction was completed in August 2017.

Further, Aviva has acquired a majority stake in robo-adviser Wealthify, which offers ISAs and general investment accounts that invest in five model portfolios that it manages. There is no public information regarding the size of the investment, though it is said to be significant. Along the same lines as Travelers, Blair Turnbull, the Aviva U.K. digital managing director, said that the investment was "another important step in Aviva's digital strategy. It underlines our commitment to invest in and partner with leading digital businesses, allowing our customers to benefit from new technology and making insurance and investments simpler, easier and more convenient."

3. Asset Management

Instead of looking for more traditional targets for growth within the insurance sector, a number of insurers have looked to see where combinations with asset managers might provide synergies with their insurance businesses, or present avenues for fee-based income and diversification. Two large U.K. transactions in 2017 evidence this, although other themes we have discussed above have played a role in these deals as well.

In August 2017, Prudential Plc announced its intention to combine Prudential UK & Europe with its asset manager M&G to form M&G Prudential. The combined business will manage £332 billion of assets for over six million customers. Among the reasons given for combining the businesses, Prudential suggested that M&G Prudential would be able to "leverage its scale, financial strength and complementary product and distribution capabilities to enhance the development of capital-light, customer-focused products," showing the continued focus of the industry on capital optimization. Prudential also said that M&G Prudential would be able to "develop and fund joint product propositions and to build new digital service and distribution to meet fast-changing customer needs," also

showing the growing importance of digital services and InsurTech across the industry.

Another large merger in August 2017 was that between Standard Life and Aberdeen Asset Management. This £11 billion merger created Europe's second-largest fund manager. Aberdeen CEO Martin Gilbert said that the tie-up "deepens and broadens [the firm's] investment capabilities and gives us a stronger and more diverse range of investment management skills as well as significant scale across asset classes and geographies." The increase in Standard Aberdeen's global footprint can therefore also be seen as a key driver for this deal.

4. Run-off

As Brexit looms, it is expected that the sales and purchases in the run-off market will accelerate in the coming months, as (re)insurers decide whether they will continue to write new business in the U.K. and Europe post-Brexit, and how to deal with their back-books of business in the U.K. and Europe.

This trend began in 2017 with Enstar's agreement to reinsure QBE's legacy business. The portfolio that was reinsured is made up of discontinued lines, including workers' compensation, construction defect and general liability. Collateral for the deal is being provided by Enstar to a QBE subsidiary, as well as a limited parent guarantee. An Enstar subsidiary will also provide administrative services for the reinsured portfolio; so, in effect, Enstar is taking on all of the economic and administrative burden of the discontinued lines.

Additionally, in December 2017, Generali confirmed the sale of approximately $353 million of non-life legacy liabilities from its U.K. branch to Compre. It is understood that the sale is to be structured as an initial reinsurance contract followed by a Part VII transfer of the portfolio.

We anticipate that in the coming months a number of similar run-off deals, as well as Part VII transfers of (re)insurance business will be reached, as U.K. and European insurers restructure their portfolios in line with their Brexit planning strategies. We understand that a number of Part VII deals driven by Brexit in particular are already in the pipeline for 2018.

II. DEVELOPMENTS IN CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM

Unlike in 2016, when three proxy contests were brought by activists seeking to elect directors at insurance holding companies, none were brought in 2017. The small number of proxy contests may have resulted purely by chance, or it may have been caused by the traditional factors that hold down the number of proxy contests in the insurance industry, including the specialized nature of the industry, which may attract less interest from activists (though there have been some notable exceptions in recent years, including at AIG), and the potential availability of the "insurance regulatory" defense to such approaches. Whatever the reason, we will leave proxy contests aside this year and review the latest trends in corporate governance and shareholder proposals generally.

A. Board of Directors Compensation

The final month of the year brought a significant decision on governance from the Delaware Supreme Court. On December 13, 2017, the court issued an opinion, *In re Investors Bancorp, Inc. Stockholder Litigation*, No. 169 (Del. Sup. Ct. Dec. 13, 2017), holding that stockholder challenges to certain types of director compensation awards will be governed by the fact-intensive "entire fairness" standard, rather than the more deferential "business judgment" rule. Specifically, *Investors Bancorp* holds that even where stockholders have ratified director compensation awards, boards of directors will not be able to get the benefit of business judgment rule protection when faced with a subsequent stockholder challenge unless (1) the stockholders approve the specific director awards or (2) the plan is self-executing (meaning the directors had no discretion in making the awards such as when the award is set pursuant to a predetermined formula). Under *Investors Bancorp*, where directors exercise any discretion in granting themselves compensation, they must demonstrate that the compensation award was entirely fair to the company. The "entire fairness" standard applies even if the stockholders approved the compensation plan in advance. The Delaware Supreme Court expressly rejected the prior Delaware cases holding that directorial compensation plans that impose meaningful, director-specific limits on compensation should nevertheless be subject to business judgment review as long as informed stockholders had approved the plan. After *Investors Bancorp*, for business judgment review to attach, the board must be divested of all discretion in awarding itself compensation.

Although the facts of *Investors Bancorp* were egregious, the decision is important because it increases the risks of derivative litigation challenging director compensation. Although the precise ramifications of the Delaware Supreme Court's decision remain to be seen, *Investors Bancorp* will likely require Delaware corporations to conduct prompt, wholesale reviews of their director compensation plans to guard against stockholder litigation challenging directorial compensation as unfair and excessive. The Delaware courts clearly believe that boards of directors are self-interested when setting their own compensation as a group. If a board does not obtain stockholder approval of specific awards or adopt a self-executing plan, it needs to be ready to prove that its compensation plans were entirely fair to the corporation. As a result, it will be risky for boards to make judgments about what they are entitled to. Although exactly what evidence will suffice to enable a court to make a finding of fairness is unknown as of yet, at a minimum public companies should work with their compensation consultants to perform an objective peer review of their director compensation programs in order to judge whether their director compensation is reasonable. Such a review should include an honest assessment of peer companies' compensation programs, which can be hard to judge. This process should be thoroughly recorded in compensation committee and board minutes. It may also be useful to describe the process in the annual proxy statement to persuade plaintiffs' counsel that the program presents nothing worthwhile to pursue.

B. Proxy Access

As our readers know, proxy access refers to the ability of shareholders to include their candidates for election to the board in the issuer's own proxy statement. Proxy access does not mean that insurgent candidates will necessarily be elected; rather, it is intended to reduce the costs of running a proxy fight by allowing proponents of board candidates to avoid the costs of printing and distributing their own proxy statements. In 2011, the SEC's proposed proxy access regulations were vacated by the federal courts. The SEC's proposed rule would have permitted holders of more than 3% of the company's stock, who had held such stock for at least three years, to elect up to 25% of the company's board (a "3/3%/25%" formula). However, in the wake of that proposal, shareholder activists began to seek so-called "private ordering" solutions to proxy access, in which issuers would adopt their own rules allowing access to the issuer's proxy statement, generally through a bylaw amendment. Although activist interest in this topic was initially limited, in 2015 proxy access proposals boomed. Led by the NYC Comptroller's Office, activists submitted a total of 110 proxy access proposals to the S&P 1500 in 2015, of which 88 came to a vote.

In 2016, the pace of proxy access proposals accelerated. According to Georgeson Inc., there were approximately 200 such proposals presented to S&P 1500 companies that year, although a much smaller number actually came to a vote. In 2015, the SEC first suspended the use of, and then announced guidance on, Rule 14a-8(i)(9) of the proxy rules under the Exchange Act, which made it essentially impossible to avoid including a proxy access proposal on the basis that it was in conflict with a competing management proposal. In the proxy access context, the staff of the SEC had previously permitted companies to exclude, for example, a 3/3%/25% proposal if the company itself was proposing proxy access requiring 5% ownership for at least five years, with a right of such holders to elect up to 10% of the board. Issuers regrouped in 2016; a popular strategy emerged of adopting the company's own proxy access bylaw ahead of the annual meeting, and excluding the shareholder proposal under Rule 14a-8(i)(10), which permits exclusion on the basis that the proposal has already been "substantially implemented" by the issuer. Although this strategy requires companies to adopt a market standard proxy access formulation (generally 3/3%/20%), it permits them to include ancillary provisions that are different from or in addition to those proposed by activists. Further, even where the shareholder proposal was not excluded from the proxy statement, issuers that adopted their own form of proxy access prior to the meeting saw much lower rates of votes in favor of the shareholder's proposal at the meeting than those that did not have a version in place. In this regard, the results mirrored those in connection with shareholder proposals that directors be elected by a majority vote of all shareholders, rather than by a plurality. For many years now, companies that have adopted their own majority vote provisions (often so-called "majority vote-lite" provisions) have been able to defeat more robust majority vote proposals.

In 2017, the number of proxy access proposals declined, with many large companies having already adopted a form of proxy access and the NYC Comptroller's Office in particular slowing the pace of its proposals. According to Georgeson, only 26 companies in the S&P 1500 presented shareholder proposals to enact proxy access, compared to 61 in the prior year. However, 23 companies presented proposals from shareholders seeking changes to a previously-adopted proxy access measure in 2017, compared to only two in 2016. These so-called "fix-it" proposals generally seek changes in some of the core features of proxy access, such as the percentage of the board that can be elected through proxy access (with proponents often seeking 25% rather than 20%) and the number of holders whose shares can be aggregated to reach the 3% ownership threshold included in many companies' bylaws. (On the latter point, most bylaws limit the number of holders that can be aggregated to 20, while activist shareholders generally ask that this number be increased to 40 or 50, or that there be no such limit at all.) The good news, from the standpoint of issuers, is that fix-it proposals do not seem to attract much support. None of

the 23 proposals voted on in 2017 received a majority of the shares voted. Further, companies with proxy access bylaws were able, in certain circumstances, to exclude proposals to increase the shareholder aggregation limit to 40 or 50 shareholders as "substantially implemented," as described above.

For insurance holding companies, proxy access raises additional issues not present for many other types of issuers. Insurance holding company laws require persons who are presumed to have "control" of an insurer to file change of control approval filings or to effectively "disclaim" control before acquiring the rights that create a presumption of control. Although whether control actually exists is a question of facts and circumstances, having a representative on the board of directors of an insurance holding company is a significant fact for many insurance regulators. (And, as mentioned above, in some states merely holding proxies covering more than 10% of the outstanding shares of an insurance holding company creates a presumption of control.) Insurers implementing proxy access would be well-advised to require that any nominee have obtained all necessary regulatory approvals for board service, and to build such a requirement into their relevant bylaw. Of course, issuers should also require that to be eligible to use proxy access, the shareholder has acquired its shares without the intent to change or influence control of the company, and that it not presently have such intent. This requirement is common in company-adopted proxy access provisions, and is based on a provision included in the SEC's abandoned proxy access rule.

In fact, a "lack of control intent" provision came into play in what appears to be the only instance to date of a shareholder actually proposing a candidate using proxy access provisions. (Although almost 200 companies in the Fortune 500 have adopted them, none had ever received an actual candidate.) In late 2016, GAMCO Asset Management, an entity affiliated with activist investor Mario Gabelli, proposed a candidate for election at the annual meeting of National Fuel Gas Company, an NYSE-listed diversified natural gas company. NFG quickly rejected the bid to include the candidate in its proxy statement, on the basis that GAMCO had been pushing for the breakup of the company, a move consistent with a control intent as defined under the Exchange Act. GAMCO then withdrew its proposal.

C. Say on Pay

As in the four prior years, in 2017 shareholders once again overwhelmingly voted in favor of executive compensation in U.S. companies' annual "say-on-pay" votes. According to Georgeson, only four companies in the S&P 500 received less than majority support for their executive compensation. Adverse recommendations by Institutional Shareholder Services and Glass, Lewis & Co., the two biggest proxy advisory firms, once again greatly outnumbered failed votes.

Since 2014, companies incorporated in the U.K. and with a London Stock Exchange listing have been required to produce a directors' remuneration report, which must contain a directors' remuneration policy, which is subject to a binding vote at least every three years and an annual report on remuneration in the financial year being reported on, which is subject to an annual advisory vote. We reported in our 2016 Year in Review that FTSE 100 companies had had a bruising 2016, with 15% of companies that submitted directors' remuneration policies to shareholders failing to receive approval. In 2017, around two–thirds of FTSE 100 companies sought shareholder approval for their remuneration policies (the largest since the creation of this requirement in 2014). In 2017, all FTSE 100 remuneration policies were approved by shareholders, with only two companies receiving less than 80% support. While 2017 led to fewer defeats when it came to directors' remuneration, this appears to be a result of increasing engagement by FTSE 100 companies with their shareholders and institutional shareholder groups rather than shareholders disengaging from the remuneration of directors. Additionally we note that following shareholder discussions, there were certain FTSE 100 companies that modified their policy proposals illustrating the renewed importance of shareholder dialogue in getting remuneration policies approved at annual general meetings.

In the U.S., pay ratio disclosure will be required to be disclosed in the 2018 proxy statement. This disclosure will compare the total annual compensation of the company's CEO to that of the "median company employee," as determined under SEC guidance. This disclosure may engender additional votes against the pay of executives at U.S. companies next year. Not to be outdone, in August 2017, the U.K. government announced proposals to require similar pay ratio disclosure, as well as to create a register of companies that faced opposition to their pay policies from more than 20% of their shareholders. This government-led effort to "name and shame" corporate executives is unprecedented. In addition, the U.K.'s Financial Reporting Council published its proposals for a revised Corporate Governance Code ("CGC") to apply to listed issuers in December 2017. These proposals, among other things, would set out a reporting requirement in relation to workplace engagement on the alignment of executive remuneration with wider company pay policy and acknowledge that further changes to the CGC may be required in light of the proposed legislation on pay ratios.

D. Other Shareholder Proposals in 2017

The number of shareholder proposals in the 2017 proxy season was lower than in 2016, consistent with a multiyear trend that was interrupted in 2015. According to information compiled by Georgeson, the number of shareholder proposals received by companies in the S&P 1500 decreased from 418 in 2016 to 354 in 2017. The number of proposals actually voted on decreased dramatically as well, from 266 proposals in 2016 to only 221 proposals in 2017.

As in the past, shareholder proposals fall into two broad categories: those relating to corporate governance, and those relating to social or political goals. The former category includes proposals to require companies to have a board chairman independent from the chief executive officer, the most common governance proposal after proxy access. In 2017, 39 such proposals came to a vote, compared to 43 such proposals that were voted on in 2016. Average support for these proposals was approximately 30%, not enough to bring about change but enough to continue to show the importance of this issue to a range of institutional investors. As in prior years, shareholder proposals to eliminate classified boards, adopt majority voting for directors and eliminate supermajority voting provisions were more successful. These are the only types of proposals that routinely receive a majority of votes cast. However, the number of such proposals remained low, likely reflecting the extent to which these governance changes have already been adopted by the S&P 1500.

Environmental and social proposals were also active in 2017. There were approximately 45 proposals submitted on issues related to climate change, including many that asked companies to report on how increases in global temperatures would impact their operations, to prepare a sustainability report, to give more information about climate change policies or to adopt company-wide greenhouse gas goals. Nearly all of these resolutions failed to get majority support, although there were a few notable exceptions. These included ExxonMobil, where a solid majority of voting shareholders endorsed the NYC Comptroller's proposal that the issuer should, beginning in 2018, publish an annual assessment of the long-term portfolio impacts of technological advances and global climate change policies, and should analyze the impacts on ExxonMobil's oil and gas reserves and resources under a scenario in which reduction in demand results from carbon restrictions and related rules or commitments adopted by governments consistent with the globally agreed-upon two degree target. The passage of this resolution was widely reported in the business press. As in 2016, political contributions and lobbying continued to be the leading social issues presented to shareholders. In 2017, 65 such proposals were voted on, compared to 69 in 2016. None of these proposals passed.

Finally, there were ten proposals that went to a vote in 2017 addressing the topic of board diversity. Many more such proposals were presented to companies and withdrawn after the companies agreed to engage privately with their proposer. Of these, two passed, one at Hudson Pacific, which promptly added a female director, and one at Cognex Corp., which nevertheless still had not appointed any new directors as of the start of 2018.

Several large institutional investors have announced their support for board diversity, including BlackRock, State Street and Vanguard. The NYC Comptroller also made board diversity a focus in 2017, sending letters to over 100 companies requesting engagement on the topic and that those companies publish information about the diversity (or lack thereof) of their boards in a prescribed matrix form. Although no shareholder proposals accompanied these letters, it is possible that the NYC Comptroller will offer some in the 2019 proxy season. According to executive recruiters Spencer Stuart, on average female directors constitute 22% of the board of public companies. Those companies (and there are still some) with no female directors can expect stockholders to ask questions about this topic with frequency in the future.

III. INSURANCE-LINKED SECURITIES

A. Overview

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

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

Once a niche alternative to traditional reinsurance, ILS has developed into a mainstream component of insurance risk-taking capacity, often competing directly in or alongside traditional reinsurance catastrophe programs, in addition to more liquid securities products, such as cat bonds. This overarching trend of capital convergence deepened in 2017, as the distinction between ILS and traditional reinsurance capacity has grown increasingly less cognizable. The influx of efficient ILS capital is having a profound impact on the overall capital structure of the insurance and reinsurance industries, as Ricardo's theory of comparative advantage plays out in real time.

After more than a decade without a major hurricane (Category 3 or higher) impacting the U.S., 2017 was the costliest year on record for U.S. natural catastrophes. According to some industry estimates, the 2017 hurricane season cost insurers over $100 billion, with three large hurricanes making landfall in the U.S. (Harvey, Irma and Maria, or "HIM" for short), as well as costly wildfires in California.

In many respects, 2017 was the first significant test for alternative reinsurance capital since Hurricane Katrina and the global financial crisis. How well this alternative capital performs in response to the multiple events of 2017 is crucial to its perception and future as a true alternative market to traditional reinsurance going forward. While a final grade is still pending, the authors of this Section would like to highlight several important dynamics that began in 2017 following HIM and that will continue in 2018:

- *Overview*. Like all markets, reinsurance is subject to hard and soft market cycles depending on the availability of capital, particularly following large catastrophe events. This was especially true in the wake of Hurricane Katrina in 2005—the last major U.S. hurricane before 2017. One important thesis for ILS has been that access to the broader capital markets could help smooth out the volatility of the hard/soft reinsurance market cycle—in part because the underlying capital providers (i.e., the pension funds, endowments and others) have different portfolio needs and capital costs than traditional reinsurers. In addition, large ILS fund managers have been communicating to the market for several years that they had investors waiting on the sidelines for such catastrophe events to occur, and such investors would enter the market or increase their allocations following a bad catastrophe year. Early indications at January 1 reinsurance renewals, which saw a slight increase in overall reinsurance premium rates according to industry reports, foreshadow that the availability of capital may have dampened a larger potential increase in rates. We will need to wait for Q1 and Q2 catastrophe bond issuances and June 1 renewals to get a more definitive picture about the impact of ILS on the hard/soft market cycle, but the overall response could be more muted than it would otherwise have been. If this is indeed the case, the 2017 catastrophe events may end up having little lasting impact on the reinsurance pricing dynamic, which could spur further M&A activity in the reinsurance industry—either in terms of further consolidation or vertical integration. In other words, how long can certain participants in the reinsurance market continue to tolerate the current pricing dynamic without

real and meaningful strategic changes? To paraphrase TS Eliot (with some dramatic license), the world could end with a whimper and not with a bang.

- *Reactions of ILS Investors.* Prior to 2017, the cat bond market faced limited historical losses and was relatively untested compared with traditional reinsurance. Although the cat bond market will likely suffer fewer losses in 2017 than other forms of ILS or reinsurance, cat bond investors will still suffer significant losses for the first time in over a decade. One common criticism of ILS goes something like this: if you have a dispute in traditional reinsurance, the business parties can meet in a room to work out their differences in the context of a long-term relationship; whereas the anonymity and tradability of capital markets products (and the perceived litigiousness of investors, whether true or not) makes a reasonable resolution less likely in the securities context. While the authors of this Section do not subscribe to that criticism—mainly because of the robust documentation and structural standards in ILS—we note that ILS investors can answer their critics by paying claims in an orderly manner. If, however, ILS structures do not fare well relative to traditional reinsurance in paying 2017 claims, risk managers may reconsider the value of alternative capital and consequently the supply of insurance risk for the market to purchase.

- *Impact on Rates*. Has alternative capital created a self-defeating prophecy for premium rate increases? Namely, have investors entering the market post-HIM in search of opportunities created a dynamic where such increases are less likely to occur? And what will be the investor and reinsurer dynamic if similar cat bond losses occur in 2018? These are all questions that will play out in the next 12 months.

- *Trapped Capital.* An important footnote to the 2017 events is the issue of "trapped" capital in collateralized reinsurance, sidecars and cat bonds. In many of these collateral structures, the reinsurer is required to maintain capital at a multiple that decreases over time pursuant to a "buffer loss factor table." These buffers could result in investor capital being tied up in a reinsurance trust for a considerable period of time, even though no actual losses are expected. This trapped capital has the potential to impact the overall capital in the overall market, lower ILS fund returns, and cause the market to "rethink" certain loss development structures. We will see in 2018 whether trapped capital is a real and meaningful issue or solely a marginal and theoretical issue.

- *ILS Transactions.* 2017 was a historic year in terms of primary cat bond issuance volume, with approximately $12.6 billion in new issuances and total outstanding volume reaching approximately $31.1 billion at year-end, representing significant increases on last year ($7.1 billion and $26.8 billion, respectively). The fastest pace of transactions occurred in the first half of 2017, with what seemed like a new deal each week. In addition, sidecars remained a popular investment choice in 2017, with many established sidecar vehicles either maintaining their size or growing. Sidecar transactions included Turing Re (Hamilton), Fibonacci (RenaissanceRe), NCM Re (Neon), Viribus (MS Amlin), Harambee (Argo) and Eden Re (Munich Re), among others. Other ILS transactions in 2017 involved market-facing vehicles Kinesis (Lancashire) and ClaRe (Barbican). Whether the pace of transactions can be replicated in 2018, particularly in the wake of HIM, is an important question to be answered over the next few months.

B. U.K. ILS Regulations

In December 2017, the London Market Group's plans for creating the framework for an attractive onshore ILS jurisdiction in the U.K. came to fruition in the Risk Transformation Regulations 2017 and the Risk Transformation (Tax) Regulations 2017 (the "ILS Regulations"). The objective is that the ILS Regulations will permit the U.K. to compete with established centers for ILS transactions in coming underwriting cycles. The ILS Regulations therefore employ structural, regulatory, legal and tax features found in other jurisdictions, while adding some U.K.-specific elements.

The ILS Regulations amend U.K. company and insolvency law to allow for protected cell companies ("PCCs"), which had not previously existed under U.K. law, for the purpose

of "insurance risk transformation." Each PCC will have a "core" that administers the PCC, manages each cell and enters into reinsurance transactions on behalf of the cells in the PCC. Although the cells will not have a separate legal personality, the statutory segregation and ring-fencing of assets and liabilities in a cell mean that the assets of one cell cannot be used to discharge the liabilities of another.

The ILS Regulations also exempt PCCs from corporation tax for the insurance risk transformation profits and provide a complete withholding tax exemption for non-U.K. investors.

In preparation for the commencement of the ILS regime in the U.K., both the PRA and the FCA issued in December their supervisory statements and amendments to the PRA Rulebook and FCA Handbook, respectively.

Although the initial authorization for a PCC could take up to six months (although likely shorter, as discussed below), PCCs will be able to make a post-transaction notification to the PRA, provided the new risk assumed falls within the "scope of permission" of the PCC. This post-transaction notification should permit the U.K. to be on a more competitive footing with other, more established, ILS jurisdictions for repeat transactions. The "scope of permission" must form part of the PCC's initial application and will outline the arrangements, structures and mechanisms that the PCC will be permitted to use in order to conduct risk transformation business.

PCCs in the U.K. must be fully funded and the PRA has noted that it does not expect contingent assets to be included when calculating the PCC's fully funded requirement, though it expects PCCs to be able to recognize payments expected to be received from the cedant, provided that the PCC shall be able to pay amounts for which it is liable as they fall due.

The PRA has confirmed that the Senior Insurance Management Function roles under the Senior Insurance Managers Regime will apply to PCCs, which is a distinction from other ILS jurisdictions which tend to rely on the insurance manager being separately supervised. The PRA believes that the three roles of Chief Executive, Chief of Finance and Chair of the Board are appropriate and proportionate for PCCs, although it has clarified that it expects that a person may be able to fulfill more than one of these roles and there is no prohibition on outsourcing provided that such outsourcing is properly managed, maintained and documented.

The PRA encourages prospective PCC applicants to discuss their proposals prior to application and notes that, where effective pre-application engagement has taken place, a six–to–eight-week timeline to authorization may be feasible, notwithstanding the outside application time of six months.

The ILS Regulations entered into force late in 2017, which was too late for most participants who considered using a U.K. structure for the January 1, 2018 renewal season. Nonetheless, the Neon Group, the specialist Lloyd's and Bermuda (re)insurance company, managed to take advantage of the new regime, targeting a capital raise of approximately $72 million in January 2018 business through a new U.K. ILS vehicle, NCM Re. NCM Re is the first U.K. entity established under the new U.K. ILS regime, but we anticipate that more vehicles will be set up in the U.K. in 2018 to take advantage of new onshore U.K. ILS opportunities.

IV. EXCESS RESERVE FINANCINGS

The optimistic trend started in 2016 continued in 2017 as the number of new excess reserve financing transactions again increased significantly over the previous years' numbers, highlighted by the Brighthouse Financial and MetLife excess reserve financing by Brighthouse Financial's newly formed affiliate captive reinsurer, Brighthouse Reinsurance Company of Delaware, which is by far the largest deal of its type ever.* The transaction involved three separate financing partners, each taking a share of the risk exposure, and included the formation of several new insurance companies, four mergers, the complex termination of several existing financings and legislative amendments to existing captive insurance laws.

Over the past few years, the number of excess reserve financing transactions has slowed down, caused by an abundance of caution from both regulators and insurance companies in the life insurance reserve financing market as a result of the NAIC's Captives and Special Purpose Vehicle Use (E) Subgroup activities, and in particular the adoption by the NAIC of Actuarial Guideline 48 in late 2014 (as further described in Section IV.A.3 below), which applies to all policies issued after December 31, 2014 which fall under regulation XXX or AXXX. In 2017 new excess reserve financing transactions picked up, due to an increased level of certainty as to what will be permitted by regulators in present and future financings. In addition to an increase in new transactions, companies continued the trend of restructuring existing transactions to take advantage of lower lending rates and the continued interest by reinsurance companies in acting as financing providers. In addition, some companies were interested in financing XXX and AXXX without the use of a captive by adding admitted assets to the balance sheet of the insurer. Most insurers that have a history of excess reserve financing transactions completed the process of addressing the complexities of Actuarial Guideline 48 ("AG 48") issues in late 2016 or early 2017, with many closing new transactions involving AG 48 covered policies, or adding a block of AG 48 policies to an existing transaction, in 2017.

*Willkie advised on this transaction.

A. Summary of Deal Activity

1. AXXX Market Remains Open

As was the case in 2016, several transactions were designed to provide reserve financing for universal life policies subject to Regulation AXXX. In 2017, the expansion of lenders willing to provide financing to fund AXXX reserves continued the trend that started in 2012. In most transactions in both the XXX and AXXX markets, commitments were for 10-25 years, although it is still common to see shorter terms intended to act as a financing bridge until other expected sources of funding become available.

2. Non-Recourse Transactions Remain the Structure of Choice

In 2014, prior to the effective date of AG 48, the vast majority of deals were secured by non-recourse letters of credit, contingent notes or collateral notes, as those transactions had essentially replaced traditional letters of credit among lenders and reinsurance companies active in the AXXX/XXX market. In 2015 we saw a return, or at least a heightened interest, in traditional letters of credit. In 2016 we saw a return to the non-recourse contingent note structure, which remained by far the structure of choice in 2017. In the past, the obligation to reimburse the bank for any draw on the letter of credit was guaranteed by a parent holding company, thus being known as a "recourse" transaction. In a non-recourse transaction, no such guaranty is required. Rather, the ability to draw on the letter of credit or contingent note is subject to certain conditions precedent. These conditions typically include, among others, the reduction of the funds backing economic reserves to zero and a reduction in a prescribed amount of the captive's capital, and a draw limited to an amount necessary for the captive to pay claims then due. Because of these conditions, lenders and other funding sources became more comfortable assuming the risk of relying for repayment on the long-term cash flows from a block of universal life policies. With the advent of AG 48, some regulators initially had approached a non-recourse

transaction with added caution, where the proposed "Other Security" is a conditional draw letter of credit or a contingent draw note. Many regulators recognized in 2017 that this approach is not expressly forbidden by the new rules, and that these bespoke sources of contingent funding are acceptable in the age of AG 48. Collateral notes (demand notes backed by pools of assets) may, but typically do not, contain these contingent features and therefore should remain acceptable for financing under AG 48, at least as "Other Security."

3. Choice of Domicile for Captives and Limited Purpose Subsidiaries

Vermont and Delaware remained the preferred domiciliary jurisdictions for captive life insurers in 2017. Several states have adopted captive insurer laws or have amended and expanded existing captive insurer laws over the past few years to facilitate reserve funding transactions. Unlike 2016, 2017 saw a buck in the trend of fewer jurisdictions being utilized as captive insurer domiciliary jurisdictions, as the market appeared to adapt to AG 48 and the related Model Law and Model Regulation (as further described in Section IV.C below). Additional states, including Arizona, Nebraska and Iowa, were being utilized as captive insurer domiciliary jurisdictions. As was the case in 2016, the use of "Limited Purpose Subsidiary" statutes in several states has cooled off and may not currently be the captive of choice, at least for new AG 48 transactions. The exception would appear to be Iowa, where we have seen Iowa-domiciled insurers continuing to utilize the Limited Purpose Subsidiary law. The Limited Purpose Subsidiary statutes permit a ceding company to form a captive insurer, or "LPS," in the same domiciliary state as the ceding insurer, which has proven to provide for a more streamlined regulatory approval process for a transaction.

B. Utilized Structures

1. Limited Purpose Subsidiaries

We are aware of at least one new transaction that closed in 2017 that employed the use of an LPS law in a reserve financing transaction. Georgia, Indiana, Iowa and Texas have each promulgated an LPS statute. The advantage of an LPS over a captive insurer is that an LPS, once licensed, may provide its ceding company parent with full credit for reinsurance without posting any security in the form of a letter of credit or a credit for reinsurance trust. Under the LPS statutes, an LPS is permitted to take statutory financial statement credit for the face amount of letters of credit as well as parental guaranties by statutory authority; the LPS need not seek regulatory approval for a permitted practice or other dispensation to use this accounting treatment. Although this was a major development in the ability to finance Regulation XXX/AXXX reserves, we have not seen the use of the LPS statutes take off as expected, likely as a result of the generally lackluster market activity in the past few years brought on by general caution on the part of insurers and regulators alike.

2. Credit-Linked Notes and Collateral Notes vs. Letters of Credit

As mentioned above, recent activity in the marketplace implies that the use of contingent credit-linked notes in a role that may be analogous to a "synthetic letter of credit" will continue, along with collateral notes, to be the structure of choice for excess reserve financing transactions. In credit-linked note transactions, a special purpose securitization vehicle ("SPV") issues a puttable note to a captive insurer. The captive insurer's right to "put" a portion of the note back to the SPV in exchange for cash is contingent on the same types of conditions that would otherwise apply in a non-recourse contingent letter of credit transaction. The use of these notes, rather than letters of credit, has provided a means for reinsurance companies, which contractually agree to provide the funds to the SPV to satisfy the put, to enter a market that was once only available to banks. In collateral note transactions, demand notes backed by pools of assets are issued by an SPV to a credit for reinsurance trust on

behalf of the captive. Collateral notes are typically rated and qualify as admitted assets. The assets that back the collateral notes can be provided by banks, reinsurance companies or other providers of collateral.

3. Use of Excess of Loss Reinsurance as a Financing Source

The use of excess of loss reinsurance agreements as a reserve financing source, although utilized in the market for several years now, saw a resurgence in 2017, with several financing transactions choosing an XOL policy over a credit-linked note format. In an XOL transaction, the captive reinsurer and the XOL provider, usually a professional reinsurer or reinsurance affiliate of a financial guaranty insurance company familiar with credit-linked note transactions and reserve financings generally, enter into an XOL agreement whereby the captive reinsures mortality risk and the XOL provider assumes the captive's collection risk. The XOL provider pays claims in excess of the economic reserve, or for a financing of policies under AG 48, the amount of "Other Security." The advantages to an XOL transaction over a credit-linked note transaction are the relative simplicity of the transaction structure and corresponding agreements, as well as a more familiar format to present to regulators. Because many of the same financing providers that participate in the credit-linked note market also offer XOL agreements as an alternative structure, we would not be surprised to see more XOL transactions in the future.

4. Funding Sources Beyond Banks

As outlined above, the market for funding sources in AXXX transactions has expanded beyond banks in recent years through the use of contingent credit-linked notes and collateral notes. Large reinsurance companies have shown a keen interest in participating in these transactions through support of the SPVs that issue the contingent notes and collateral notes and through the use of XOL agreements. With the expansion of the group of potential funding sources for these transactions, life insurance companies can seek more competitive pricing and terms. With the increased activity in the market in 2017, it appears that the market will see a continuation of the trend started in 2012 of reinsurance companies surpassing banks as the primary "risk taker" in these transactions.

C. Regulatory Environment

As discussed in our previous reports, a very important development in the world of reserve financing transactions was the NAIC's adoption in 2014 of AG 48, which was part of the NAIC action plan to develop further regulatory requirements with respect to XXX and AXXX transactions. The adoption of AG 48 in 2014 was followed by the NAIC adopting the Term and Universal Life Insurance Reserve Financing Model Regulation and an amended version of AG 48 in December 2016. Importantly, the Model Regulation and AG 48 aim to set standards applicable to XXX and AXXX transactions, instead of restricting them outright.

For most states, the adoption of the Model Regulation will replace AG 48. Since the NAIC Fall National Meeting in December 2017, at least two states have adopted the Model Regulation.

During 2017, the NAIC engaged in discussions to determine whether the Model Regulation should be adopted as a Part A Accreditation Standard (which would have the substantive effect of requiring all U.S. states to adopt the Model Regulation within the next few years). For now, this accreditation decision has been deferred until more clarity emerges concerning the changes, if any, that will need to be made to the Credit for Reinsurance Model Law (which authorizes state insurance departments to promulgate the Model Regulation) as part of the NAIC's response to the Covered Agreement between the U.S. and the European Union.

V. DEVELOPMENTS AND TRENDS IN LONGEVITY, PENSION CLOSE-OUTS AND DE-RISKING TRANSACTIONS

Despite the continued strong desire for further geographical market expansion and diversification outside of the U.K. longevity and pension risk transfer market, 2017 was a relatively quiet year for European transactions. This follows a similarly quiet 2016, a year overshadowed by regulatory scrutiny with respect to certain Dutch index-linked transactions that dominated deal activity during 2015. The market witnessed the re-emergence of index-linked transactions in December 2017 with the announcement that NN Life (part of the Nationale-Nederlanden Group) entered into an index-based longevity derivative with reinsurer Hannover Re that protects NN Life against the longevity risk associated with approximately €3 billion of its liabilities. In order for the transaction to provide the desired reduction to NN Life's risk margin, the transaction must effectively transfer the longevity risk to Hannover Re. Typically index-linked derivatives are shorter in duration than indemnity transactions (a feature that is not easily reconcilable with effective risk transfer). However, the term of the derivative is 20 years and, according to the announcement of the transaction, protection can continue using a commutation factor mechanism where longevity improvements are significantly stronger than expected at maturity. We believe that such structural features, which further enhance the effectiveness of risk transfer and mitigate basis risk, will contribute towards a resurgence of index-linked transactions during 2018.

The U.K. bulk annuities market demonstrated a robust performance during 2017, with buy-in and buy-out transactions in the first half of the year coming in at close to £5 billion (compared with £2.7 billion during the first half of 2016). Current expectations are that the year achieved in excess of £10 billion from buy-in and buy-out transactions.

Our 2016 Year in Review announced that the number of active insurers in the U.K. bulk annuities market decreased from nine to seven during 2016. Following confirmation from Phoenix Life that they view the bulk annuities market as being aligned with their strategy of buying closed book insurer business and, consequently, that they would be actively entering the market, there are now eight active insurers. Market commentators suggest that at least two other insurers are investigating and pursuing an entry into the market. There is still widespread speculation that both Prudential Plc and Standard Life are looking to dispose of significant individual and bulk annuity portfolios in the U.K. Given the size of these books of business, they will likely need to be split among a number of insurers, consistent with the division of the Aegon portfolios between Rothesay Life and Legal & General ("L&G") in 2016. If these significant back-book transactions come to market during 2018, they potentially may reduce the insurer capacity and resources available to pension schemes that are also looking to transact business.

The debate that commenced in 2016 regarding the slowdown in longevity improvement rates in the U.K. continued into 2017. In summary, one consultant explains that life expectancies are not falling; people are still living longer but the rate at which life expectancies are improving is not as high as it has been over the past few decades. The debate has centered around whether or not the improvements are part of a genuine trend or a series of "blips" (for example, caused by one-off events, such as the failure of the winter flu vaccine). Pension schemes in the U.K. typically rely on the Continuous Mortality Investigation ("CMI") model to project their future longevity rates (which, in turn, are used to determine the future liabilities of the pension scheme). Pension schemes that rely upon the CMI model, updated to include the slowing in the rate of life expectancy improvements, have experienced a reduction of liabilities by around 3%. As a result, during the last half of 2016 and the first half of 2017 the U.K. market experienced dislocation of pricing while the (re)insurance market caught up with the pension schemes' view of the liabilities. A number of pension consultants advised trustees of pension schemes to seek

lower prices from incumbent (re)insurers or to delay transacting until reinsurer pricing adjusted downwards. As the (re)insurance market has started to include the effect of the slowdown in the models they use to project future longevity rates, pricing for (re)insurance cover has lowered and, according to one reinsurer, the cost of entering into a longevity risk transfer and reinsurance arrangement is at a historical low.

Driven by Solvency II's risk margin relief available to insurers that transfer longevity risks to the reinsurance market as well as competitive reinsurance pricing, demand for longevity reinsurance capacity continues to be strong and nearly all of the active insurers expect to reinsure a material proportion of the longevity risks associated with bulk annuity transactions. Our 2016 Year in Review reported that we have witnessed a number of repeat reinsurance transactions between a small number of counterparties. This trend continued and became further established during 2017. We are finding that insurers and reinsurers are developing close relationships and agreeing on preferred terms and/or base documentation (in the form of master terms or facility arrangements) to ease the transition from pricing to execution as efficiently as possible. During 2017, Rothesay Life and U.S. life insurer Prudential Financial ("Prudential") announced their sixth major longevity reinsurance transaction since 2011, with a $1.2 billion deal covering liabilities associated with approximately 22,500 pensioners across eight pension schemes. Pension Insurance Corporation ("PIC") announced a £1 billion transaction with SCOR in July 2017 covering approximately 7,000 pensioners across six pension schemes and, later in the year, PIC announced a further $1.2 billion reinsurance transaction with Prudential covering approximately 4,000 pensioners across four pension schemes. PIC and Prudential have closed five transactions since 2015 worth nearly $5 billion. The year ended with the announcement that L&G and Prudential had entered into their sixth major longevity reinsurance transaction since 2014, with an $800 million deal covering more than 2,000 pensioners.

The larger side of the longevity risk transfer market was dominated by pension schemes using offshore captive insurance companies to intermediate the transfer of risk from pension schemes to the reinsurance market. The British Airways Pension Scheme entered into a £1.6 billion transaction, using a captive insurance cell in Guernsey, which passed the longevity risk to reinsurers Partner Re and Canada Life Re. The largest single transaction in 2017 featured a £3.4 billion transfer from MMC UK Pension Fund (the U.K. pension scheme of Marsh & McLennan Companies), which also used a Guernsey–based incorporated cell company established by the trustees of the pension scheme to facilitate the transfer of longevity risk to reinsurers Prudential and Canada Life Re. These two captive transactions follow the 2014 transaction whereby the BT Pension Scheme transferred £16 billion in pension liabilities to Prudential and the 2015 transaction whereby the Merchant Navy Officers Pension Fund transferred £1.5 billion in pension liabilities to Pacific Life Re—in both instances, also utilizing a Guernsey–based cell company. Given the success and replication of the structure, we expect other large and sophisticated pension schemes to enter into transactions using offshore cell companies. We anticipate that 2018 will be a momentous year for "jumbo" captive transactions.

Other notable transactions from 2017 include the conversion by Phoenix Life of the longevity swap it wrote in 2014 in favor of the Phoenix Group's own pension scheme, the PGL Pension Scheme, into a £1.2 billion buy-in transaction. To reflect the ultimate de-risking aspirations of pension scheme trustees, it is not uncommon for parties to longevity-only transactions to spend considerable time negotiating the contractual flexibility and parameters whereby the pension scheme trustees may request a conversion of the transaction to a buy-in transaction or buy-out transaction at some point following execution. This marks the first conversion of a longevity swap into a buy-in transaction (which we understand took the form of an amendment to the longevity-only insurance agreement).

On the asset side, the year ended with an announcement that Reinsurance Group of America ("RGA") had completed a $900 million reinsurance transaction covering a portfolio of annuity business from U.K. insurer

Liverpool Victoria in a deal that transferred both asset and longevity risks to RGA.

Following on from 2016, during which Zurich Insurance Group ("Zurich") entered into a number of small transactions with a combined value of £740 million using its "streamlined structure" that was designed to provide small schemes with access to the reinsurance market, in 2017 Zurich entered into two more longevity swap transactions covering a combined value of £600 million of pension longevity liabilities during 2017. While the 2016 transactions were reinsured to Pacific Life Re, the two 2017 transactions disclosed in the public domain were reinsured to SCOR.

We have not witnessed any dramatic change to deal volume during 2017 as a result of the uncertainty surrounding Brexit. One aspect to note is that following a consultation period launched in September 2016 the House of Commons Treasury Committee (the "Committee") published a report on the Solvency II Directive and its impact on the U.K. insurance industry with a focus on competitiveness and the options available to the industry following the decision of the U.K. to leave the European Union. The report highlights the dissatisfaction of both the U.K. insurance industry and the PRA with the risk margin calculation under Solvency II. The Committee has called for the PRA to provide a report by March 31, 2018 detailing, among other things, a solution to the risk margin to improve calibration (although it should be noted that EIOPA has, in a recent report, not recommended any changes to the risk margin at the European level, despite suggestions from a number of European regulators, including the PRA, that changes to the risk margin are needed). We currently have no reason to believe that the PRA's report will, in and of itself, bring about any changes to the Solvency II rules. Moreover, given the uncertainty surrounding Brexit, it is not yet clear whether the U.K. will have an opportunity to lobby for changes to existing insurance regulation. However, given that the risk margin is a key driving force behind the strategy of U.K. and European insurers to reinsure longevity risk, this area will certainly be one to watch during 2018.

Our 2016 Year in Review explored possible future innovation in the longevity risk transfer market through the use of capital markets solutions that would allow investors to participate in longevity risk transfer transactions. Although no notable transactions in the life space utilizing capital markets technology were reported during 2017, the market remained focused on exploring and structuring such alternative solutions. The U.K. market took a large stride during 2017 toward establishing itself as a leading center for alternative risk transfer instruments when the ILS Regulations came into force. The Regulations amend U.K. company and insolvency law to allow for PCCs, which had not previously existed under U.K. law, for the purpose of "insurance risk transformation." It is hoped that such technology can eventually be employed and/or adapted to provide further risk transfer solutions and introduce an alternative source of capital into the pension risk transfer market in the future. For more information on the U.K. ILS Regulations, please see Section III.B.: Insurance Linked-Securities: U.K. ILS Regulations, above.

The U.S. market saw accelerated growth in 2017. Single premium buyout sales in the third quarter of 2017 reached $6.38 billion, the highest third quarter sales total on record since the late 1980s, and followed record second quarter buyout sales of $4.1 billion, nearly triple the 2016 second quarter total. Total buyout sales for the first three quarters of 2017 totaled $11.89 billion, compared to $8.06 billion for the same period in 2016. Overall, although the aggregate amount of 2017's final buyout sales in the U.S. is not yet available, current publicly available information indicates that the total is roughly equal to 2016's total of $14 billion, with some commentators expecting it to be as much as between $18 billion and $20 billion. In addition, the number of insurance companies offering pension risk transfer services in 2017 had grown to 15, nearly doubling the number of market participants in the space of just a few years.

Commentators have noted that 2017's market growth was driven in particular by the impact of significantly increasing premiums payable to the Pension Benefit Guaranty Corp. ("PBGC"), which were imposed by 2012's Moving Ahead for Progress in the 21st Century Act ("MAP-21"). The

fixed premium rate in 2017 was $69 per plan participant, almost 100% more than the $35 payable per participant in 2012. As industry professionals pointed out, this increase has created a strategic need for plans to reduce the number of participants with lower monthly benefits, since the premium for those participants, assessed per head, is disproportionately expensive. The year 2017 saw a number of noteworthy group annuity purchases designed to transfer the liabilities of retirees with small monthly benefits, a trend that kicked off in late 2016 with United Technologies Corp.'s transfer of approximately $775 million of plan liabilities through a group annuity contract with Prudential related to about 36,000 retirees who receive a monthly benefit of $300 or less. Following this trend, 2017 transactions included Sears Holding Corp.'s purchase of two group annuity contracts from MetLife. The first, in May, related to around $515 million of liabilities for 51,000 retirees, each of whom has a monthly gross benefit of less than $150. The second, in August, transferred a further $512 million of liabilities and reduced Sears' plan by approximately 20,000 participants. Also in August, Ball Corp. purchased a group annuity contract from Prudential in respect of approximately $220 million of liabilities representing around 11,000 retirees whose monthly benefit was reported to be below a certain monthly threshold. In November, NCR Corp. purchased a group annuity contract from Principal Life Insurance Co. to transfer around $190 million of pension liabilities, related to 6,000 retirees whose monthly benefit was less than $500 as of January 1, 2017.

MAP-21 has also increased variable PBGC premiums, which are based on the level of a plan's underfunding. In 2013, the variable rate was $9 per $1,000 of underfunding; by 2017, this had shot up to $34 per $1,000 of underfunding. This increase has incentivized plan sponsors to decrease the level of underfunding, which has had the knock-on effect of facilitating further risk transfer transactions in 2017, including a mix of large and moderate–size deals that added more diversity to the year's total. At the end of the second quarter, The Hartford Financial Services Group, Inc. transferred $1.6 billion of plan liabilities via a group annuity contract with Prudential, in combination with a $300 million contribution to the plan. Three months later, International Paper Co.'s purchase of a group annuity contract from Prudential, announced on October 2, transferred approximately $1.3 billion of liabilities representing benefits for about 45,000 beneficiaries whose monthly benefit is less than $450. Shortly before the buyout, International Paper made a $1.25 billion contribution to the pension plan, which was funded in part by a $1 billion debt offering.

The second half of 2017 saw a number of buyouts, some of which were funded by recent contributions. In October, the New York Times Co. transferred roughly $225 million of liabilities from two plans with a purchase of group annuity contracts from Massachusetts Mutual Life Insurance Co., affecting around 3,800 beneficiaries and funded by pension plan assets, including proceeds from a $100 million contribution to the plans on October 20. Also in October, A.H. Belo Corp. purchased a group annuity contract with an undisclosed insurer to transfer $43.5 million of plan liabilities, using about $23.5 million of existing assets and a $20 million voluntary contribution to fund the transaction. The buyout reduced the number of its plan participants by 36%, and its PBGC annual fees by $500,000, or 38%. Overall, by comparison with 2016, publicly available information indicates that 2017 saw a proliferating variety of small to medium–size deals, mixed with a trend away from "jumbo" transactions but including, nonetheless, very large buyouts shifting more than $1.0 billion of liabilities.

According to commentators, the prospects of increased growth in the Canadian market in 2018 are bullish. This market has seen an increase of more than 250% in buy-in and buy-out annuities over the last eight years, and commentators estimate that between $8 billion to $10 billion in risk could be transferred over the next three years. The year 2017 saw about $1.8 billion of defined benefit pension risk transferred to insurers over the first two quarters, approximately triple the amount for the first two quarters of 2016. The average deal size during the first two quarters of 2017 was close to $100 million, compared with $30 million for the same period in 2016.

Industry professionals believe that a mix of factors has contributed to the growth of the market in 2017 in Canada. Part of the success has been attributed to the willingness and ability of plan sponsors and insurers to develop innovative, customized solutions to plan needs, including longevity risk transfer. While Canada has rarely seen billion-dollar "jumbo" deals such as are relatively common in the U.K. and the U.S., three insurers (Sun Life, Canada Life and RBC Insurance) completed the largest single Canadian annuity transaction to date in the second quarter of 2017, transferring $900 million of pension risk from an undisclosed company. The transaction was innovative, not just because of its size, but because the annuity purchase was part of a larger strategy that further reduced the plan's liabilities, and included an in-kind transfer of securities from the pension fund to the insurer. In the second quarter of 2017, Sun Life also completed an innovative $45 million buy-in annuity transaction with an undisclosed plan sponsor, covering both past and future benefits for active members.

Other factors cited by commentators and market participants in support of 2017's market growth in Canada are the increase in inflation-linked annuity transactions, an improvement in solvency–funded ratios, which were at a ten-year high in 2017, a stabilized pool of insurers, and a legislative trend towards the elimination of "boomerang" risk, which is the risk that some obligations transferred to an insurer in a risk transfer may revert to the plan sponsor if the insurer becomes insolvent. A maturing market and steadily increasing participation in buy-in annuities is also seen as evidence that plan sponsors are less concerned about insurer insolvency and boomerang risk.

At the end of 2017, indications point to continued robust markets in 2018 in the U.K. and North America. In the U.K., generally low costs for longevity risk transfers with reinsurance should assist market activity, while there is also expected to be regrowth in index-linked transactions, and captive-structured "jumbo" transactions. De-risking in the U.S. is expected to continue in 2018 in response to continually rising PBGC premiums and increased interest rates. In addition, the Tax Cut and Jobs Act, signed into law in December 2017, has introduced several changes to the U.S. tax code that could significantly affect the pension and longevity risk transfer markets, including a reduction of the U.S. corporate income tax rate and additional changes that impact affiliate reinsurance and the computation of taxable income. See Section VIII: Tax, below. In Canada, the generally high solvency of plans at the end of 2017 should encourage sustained market development. Indeed, market watchers are excited by the prospect that global pension risk and longevity risk transfer could also expand to Australia in 2018 in response to improved regulatory and market conditions.

VI. CAPITAL MARKETS

A. U.S. Capital Market Activity

1. Equity Offerings

Equity markets as a whole had a very strong year with the S&P 500 meeting its average annualized total return before the end of the first half of 2017. Insurance companies generally experienced stock price gains as well, with the implementation of tax reform, despite a number of catastrophe events that affected the property and casualty sector. Several landmark equity transactions occurred in 2017, with the completion of the spin-off of Brighthouse Financial, Inc. from MetLife, Inc. and the announcement of the IPO of AXA Equitable Holdings, Inc. by AXA, S.A.

In August 2017, MetLife completed the distribution to its shareholders of approximately 80.8% of the common stock of Brighthouse Financial, MetLife's U.S. retail life insurance and annuity business. At the time of the spin-off, Brighthouse Financial became one of the largest retail-focused U.S. life insurance and annuity companies with more than $220 billion of total assets, total shareholder's net investment of more than $16 billion, including accumulated other comprehensive income, and more than $653 billion of life insurance face amount in-force. Brighthouse Financial implemented a hedging program, which seeks to mitigate the potential adverse effects of changes in equity markets and interest rates on its statutory capitalization and statutory distributable cash flows. The company intends to support its variable annuity business with assets which are $2.0 billion to $3.0 billion in excess of the average amount of assets required under a CTE95 standard, which it defines as the amount of assets required to satisfy contract–holder obligations across market environments in the average of the worst 5% of 1,000 capital markets scenarios over the life of the contracts. As of September 30, 2017, assets above CTE95 were $2.3 billion, unchanged from the second quarter of 2017, which would be equivalent to holding assets at approximately a CTE98 standard as of such date. The excess assets are intended to absorb modest losses, which may be temporary, from changes in equity markets and interest rates without adversely affecting the company's financial strength ratings. Prior to the spin-off in 2016, MetLife had sold its former retail business's proprietary distribution channel to Massachusetts Mutual Life Insurance Company, and Brighthouse Financial intends to distribute its products through independent, third-party distribution channel partners. Following the spin-off, MetLife retained approximately 19.2% of Brighthouse Financial's common stock, and in November 2017, MetLife indicated its intent to dispose of its remaining Brighthouse Financial stock through an exchange offer for MetLife common stock during 2018, subject to market conditions and regulatory constraints.

In June 2017, Brighthouse Holdings, LLC, Brighthouse Financial's wholly owned subsidiary, issued $50 million aggregate liquidation preference of Series A Preferred Units to MetLife, which subsequently resold the Series A Preferred Units to third parties in exchange for cash. The issuance of the preferred interests facilitated gain/loss recognition by MetLife on the disposition of the shares of Brighthouse and certain related restructuring transactions.

Following on from AXA, S.A.'s May 2017 announcement of its intention to IPO its U.S. operations, in November 2017, AXA Equitable Holdings, Inc. filed a Form S-1 registration statement pursuant to which AXA plans to sell a minority stake in the company's stock. AXA Equitable Holdings is one of the U.S.'s leading financial services companies with more than $225 billion in total assets and $600 billion of assets under management through its two principal franchises, AXA Equitable Life and AllianceBernstein. AXA currently holds approximately 63% of AllianceBernstein across three entities and has said that it will transfer this ownership to AXA Equitable Holdings prior to the IPO. In addition, AXA's U.S. property and casualty business would remain with the parent company. In a similar vein to Brighthouse Financial, AXA Equitable Holdings has targeted an asset level for all its variable annuity contracts at or above CTE98. The IPO is expected to be completed in the second quarter of 2018, subject to market conditions.

We expect that additional insurance companies may be considering a spin-off of some or all of their U.S. life insurance and annuity businesses in 2018 as they seek additional financial flexibility and the low interest rate environment continues to hinder growth in the U.S. life insurance sector.

In 2017, Apollo Global Management continued to sell down its position in Athene Holdings Ltd. with offerings of common stock in April and June, which together raised proceeds of more than $2.1 billion for the selling stockholders.

In June 2017, AmTrust Financial Services Inc. sold shares of common stock in National General Holdings Corp. through separate, privately negotiated purchase agreements with unaffiliated third parties. AmTrust had held an ownership interest in National General since 2010. The selling stockholders resold those shares in registered transactions during the remainder of 2017.

In the same month, American International Group, Inc. sold $590 million of common stock of Arch Capital Group Ltd., which were issued upon conversion of certain convertible preferred shares held by AIG following the same of United Guaranty Corporation to Arch Capital in 2016.

Arch Capital, Maiden Holdings, Ltd. and Validus Holdings, Ltd. also conducted offerings of preferred stock, some in the form of depositary shares, raising proceeds of approximately $300 million, $150 million and $250 million, respectively.

2. Surplus Notes

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

Following a quiet 2016, several of the large mutual insurance companies returned to the surplus note market in 2017, combining new longer maturity issuances with liability management transactions. Guardian kicked off the year with a new issuance of $350 million surplus notes with a 60-year maturity in January and closed the year with a $200 million exchange offer in December for an existing series of its surplus notes for new 60-year surplus notes of the same series issued in January. Massachusetts Mutual Life Insurance Company issued $475 million of 60-year surplus notes in March and used the proceeds to repurchase an aggregate of $350 million of three series of its existing surplus notes later that month. In April, Teachers Insurance and Annuity Association of America conducted a cash tender offer for up to $750 million of an existing series of its surplus notes, which it increased to $950 million as a result of investor demand. The tender offer was funded in part by a new $2.0 billion issuance of 30-year surplus notes in May 2017. In September, Northwestern Mutual Life Insurance Company issued $1.0 billion in 30-year surplus notes and, in October, Farmers Insurance Exchange issued $400 million of 40-year surplus notes, the proceeds of which it used, together with cash on hand, to repay its certificate of contribution issued to Zurich American Insurance Company. Also, in October, Pacific Life Insurance Company issued $750 million of 50-year surplus notes and followed that with a cash tender offer by PacLife and Pacific LifeCorp for up to $500 million of five series of a mix of surplus notes and senior notes.

3. Debt

With interest rates continuing to rise gradually in 2017, companies in the insurance industry regularly came to the market in advance of anticipated interest rate increases in 2018. In particular, companies took the opportunity

presented by low spreads and investor interest to repurchase or redeem outstanding debt with high coupons and replace it with debt with lower coupons.

In June 2017, in advance of its spin-off, Brighthouse Financial issued $1.5 billion of five-year and $1.5 billion of ten-year senior notes in a Rule 144A and Regulation S offering. MetLife initially guaranteed the senior notes on a senior unsecured basis, but the guarantee was automatically and unconditionally released upon the completion of the spin-off in accordance with its terms. Brighthouse Financial used the proceeds to pay down $2.5 billion of its commitments under a $3.0 billion term loan, and the offering allowed the company to achieve its goals at the time of its separation from MetLife of having: (i) adequate liquidity at the Brighthouse holding company level; (ii) a debt-to-capital ratio of approximately 25%; and (iii) $2.0 billion to $3.0 billion of assets in excess of CTE95 to support its variable annuity contracts.

In June and September, XLIT Ltd. and Prudential Financial, Inc., respectively, continued with their issuances of hybrid securities with a €500 million and $750 million issuance of 30-year subordinated debentures containing tax, rating and regulatory capital triggers for redemption.

Other notable debt issuances during the year included issuances by Aflac (¥120 billion), AIG (€1.0 billion), American Financial Group ($715 million), AXIS Capital Holdings Limited ($350 million), CNA Financial ($500 million), Markel ($600 million), Marsh & McLennan ($1.0 billion), Progressive ($850 million), Radian ($450 million), RenaissanceRe Holdings Ltd. ($300 million), Travelers ($700 million) and Voya ($400 million).

4. Funding Agreement-Backed Notes

Funding agreement-backed notes are designed to generate regular cash flows to service the debt on short- or medium-term notes issued through an SPV, and transfer credit quality of a policyholder claim at the insurance company to the notes of the SPV. In order to eliminate a mismatch, the terms of the funding agreements match the terms of notes to be issued by the SPV. The insurance company establishes the maximum aggregate principal amount for its funding agreement-backed notes program, but the notes can be issued in unlimited series or tranches. Funding agreement-backed notes programs have been an attractive alternative for insurance companies that have participated in institutional investment markets to non-tradable guaranteed investment contracts ("GICs") and standalone funding agreements. The notes attract a wider base of investors compared to illiquid GICs or funding agreements, which allows insurance companies to diversify their funding sources and reduce their overall cost of funds. From the investor's perspective, the notes are tradeable securities, which offer access to highly-rated insurance company issuers at a level higher up in the capital structure than senior noteholders, with attractive relative spreads.

In 2017, the market for funding agreement-backed notes continued to be strong and continued its gradual move to larger, more liquid transactions. The majority of transactions continues to be in U.S. dollars, but there has been a consistently significant proportion of trades in other currencies. These currency transactions are typically converted back to U.S. dollars to shield issuers from foreign exchange risks.

The market continues to be led by MetLife and New York Life but witnessed increased issuances from Principal Financial, Protective Life, Jackson National, Mass Mutual, AIG, Guardian, Prudential and Reliance Standard. MetLife has been the leading issuer of funding agreements in each of the last nine years, with New York Life the next largest. The year 2018 opened with more than three new issuances in the first week, and we expect 2018 to be a busy year as capacity continues to exist for additional issuances by industry participants based on stronger balance sheet positions, a reduction in operating leverage and a strengthening of statutory capital.

B. SEC Disclosures

In 2017, the staff of the SEC (the "SEC Staff") continued to concentrate its comments on insurance company disclosure on some of the topics we discussed in the

2016 Year in Review. These include disclosures regarding investments, compliance and regulatory matters, reserves and short-duration insurance contracts. The SEC Staff also adopted modifications to Regulation S-K, and instituted new rules regarding exhibit hyperlinking and shortened settlement cycles. A number of developments in 2017 may also require publicly listed insurance groups to evaluate the current risk factors they include in disclosure documents. We discuss each of these in more detail below.

1. Investments

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

2. Compliance and Regulatory Matters

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

Additionally, the SEC Staff has continued to crack down on the misuse of non-GAAP financial measures. Many comment letters focus on the requirement that companies using non-GAAP measures present the most directly comparable GAAP measure with equal or greater prominence. Additionally, although Regulation S-K provides limited relief for the use of non-GAAP measures in pay-related proxy statement discussions with respect to target levels for performance, the SEC Staff has been asking companies to justify using non-GAAP measures in their proxy statements for non-compensation–related matters. As in 2017, misleading financing measures, per share non-GAAP liquidity measures, and inappropriate adjustments for tax expenses also continue to be potential bases for enforcement action.

3. Reserves

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

4. Short-Duration Insurance Contracts

A major area of focus for the SEC in 2017 has been the short-duration contracts disclosure requirements of ASC 944. In particular, the SEC Staff has issued comment letters with respect to the claims development tables, including management's judgments regarding the aggregation of different products or lines of business, disclosures related to the basis for reporting commutations and the presentation of items such as international operations and reinsurance. Other areas of focus included enhanced disclosure regarding the determination of the amounts presented in liabilities incurred but not reported and expected development on reported claims.

5. Regulation S-K

In October, the SEC proposed amendments to Regulation S-K with the intent to modernize and simplify certain disclosure requirements, as well as improve the readability

and navigability of disclosure documents. The proposed amendments include changes to Item 303(a), such that when financial statements in a filing cover three years, a discussion of the earliest year will not be required if (i) the omitted discussion is not material to an understanding of the company's financial condition, changes in financial condition and results of operations, and (ii) the company has filed its prior year Form 10-K containing a Management's Discussion and Analysis of the omitted year. Other proposed changes to Item 303(a) include simplifying Instruction 1 to eliminate references to five-year selected financial data for trend information and to emphasize that a company may use any presentation that, in its judgment, would enhance a reader's understanding, such as narrative discussion for certain years instead of a year-to-year comparison.

The SEC also proposed amendments to the exhibit requirements of Item 601. The proposed changes would allow companies to omit entire schedules and similar exhibits unless they contain material information that is not otherwise disclosed in the exhibit or disclosure document. Companies would be required to provide the SEC Staff, on a supplemental basis, a copy of any omitted schedules or attachments upon request. Additionally, the amendments would allow companies to omit personally identifiable information from exhibits without seeking a confidential treatment request or providing an analysis to redact such information and to omit confidential information from material contracts filed as exhibits without seeking a confidential treatment request where such information is not material and would be competitively harmful if publicly disclosed. Where confidential information is omitted, the company would instead be required to mark the exhibit index to indicate that portions of the exhibit have been omitted and to include a prominent statement on the first page of the redacted exhibit that certain information has been excluded because it is both (i) not material and (ii) competitively harmful to the company if publicly disclosed. The company must also use brackets to indicate where information is omitted from the filed version of the exhibit.

6. Hyperlinking

In September, the SEC began requiring companies to include active hyperlinks for documents in the exhibit index for most registration statements and reports. However, non-accelerated filers and smaller reporting companies are subject to a phase-in period and do not become subject to the new rules until September 2018. The new requirements apply to filings subject to the requirements of Item 601 of Regulation S-K, including registration statements under the Securities Act and Forms 10, 10-K, 10-Q and 8-K but not filings with exhibit requirements under other rules such as Schedule 13D or 13G, insider ownership reports under Section 16 or Form 144. For exhibits incorporated by reference, the company must include a hyperlink to the exhibit separately filed on EDGAR. For exhibits attached to registration statements, the company must include a hyperlink in the initial registration statement, each subsequent pre-effective amendment and the registration statement that becomes effective. The SEC also added an instruction to Rule 105 of Regulation S-T to require companies to correct non-functioning or inaccurate hyperlinks, although the SEC expressly noted in the adopting release that an inaccurate hyperlink alone would not render a filing materially deficient or affect a company's eligibility to use short-form registration statements.

7. T+2 Settlement Cycles

In September, amendments to Rule 15c6-1 of the Exchange Act went into effect to shorten the standard settlement cycle for most securities transactions effected by a broker-dealer from T+3 to T+2. The change is intended to reduce a number of risks for participants in the securities markets, including reducing the number of unsettled trades, the time period of exposure to unsettled trades and potential price movements in the securities underlying unsettled trades, as well as lowering transactional costs and aligning U.S. markets with many non-U.S. markets which already use a T+2 settlement cycle. Parties may still affirmatively contract for longer settlement periods, however, and the

shorter settlement cycle does not apply to securities sold in cash–only firm commitment underwritings.

8. Risk Factors

In 2018, companies should consider a number of key risk factors that may be relevant in their disclosure documents. Cybersecurity continues to be a concern for many companies, and companies should consider whether their existing disclosures need to be updated. Political changes resulting from the Trump presidency and Republican-controlled Congress likely will also affect the risk evaluations across multiple risk factors. Companies may consider including Brexit-related risk factors to address the resulting political, social and economic uncertainty, stock market volatility and current exchange rate fluctuations, and these risk factors should continue to be evaluated as the Brexit process progresses. Other potential risk factors that companies should consider include climate change, terrorism and armed conflict, and shareholder activism.

C. European Capital Market Activity

1. Prospectus Regulation

As we noted in our 2016 Year In Review, the European Commission has continued to pursue its goal of creating a capital markets union within the E.U., in order to strengthen E.U. capital markets and address concerns that capital markets-based financing in the E.U. is relatively underdeveloped. As part of this initiative, the new Prospectus Regulation entered into force on July 20, 2017 (the "Prospectus Regulation"). We have set out below the main changes to the European prospectus regime contained in the Prospectus Regulation, together with their dates of implementation.

With effect from July 20, 2017, issuers with existing securities admitted to trading on a regulated market in the E.U. may issue additional securities without the need to publish an approved prospectus, provided that the newly issued securities are fungible with those already listed and represent less than 20% of the existing listed securities calculated over a 12-month period. Previously, this exemption was capped at 10% of the existing listed securities. This change will be welcome for listed issuers, who will now be able to access the capital markets without undergoing the costly and time-consuming process of publishing an approved prospectus.

From July 21, 2018, issuers will not be required to publish an approved prospectus in relation to offers of securities to the public with a total consideration in the E.U. of less than €1 million over a 12-month period. Although the Prospectus Regulation decreases this limit from €5 million under current regulation, individual E.U. states will be permitted to raise the cap up to €8 million (although any such offers will not be able to be made in other E.U. states under the passporting regime). It is unclear which E.U. states will increase the threshold to €8 million. However, we expect further details over the course of 2018.

Commencing on July 21, 2019, a new universal registration document regime (similar to the U.S. shelf registration scheme) goes into effect. The new regime should benefit frequent issuers, who will be able to gain faster access to the capital markets. Where a competent authority has approved an issuer's universal registration document for two consecutive years, future universal registration documents may be filed or amended without prior approval. Any prospectus published using a universal registration document will also benefit from a five working-day approval process (which is currently ten working days for other prospectuses). Additionally, issuers may use their universal registration document to satisfy their obligation to publish annual financial reports and half-yearly reports. Frequent issuers will appreciate the ability to consolidate their public filings, saving the time and expense currently required to duplicate such information.

Also from July 21, 2019, a new "prospectus-lite" regime will be available for follow-on issuances by issuers with their existing securities admitted to trading on a regulated market continuously for the previous 18-month period.

2. Tier 2 Capital Issuances

The issuance of subordinated notes that qualify as Tier 2 capital under Solvency II continued in 2017. As we noted in the 2016 Year in Review, several insurers issued subordinated notes or preference shares intended to qualify as Tier 2 capital under the Bermuda regulatory regime (which, with effect from January 1, 2016, was granted full equivalence to Solvency II in respect of group solvency calculations), as administered by the BMA. This trend has continued in 2017: for example, XLIT Ltd., a subsidiary of the XL Catlin group, issued €500,000,000 Fixed to Floating Rate Subordinated Notes due 2047, to qualify as Tier 2 ancillary capital under the BMA's Group Supervision Rules.

In 2017, issuances by insurance groups tended to be structured in such a way as to qualify as Tier 2 capital under Solvency II or under other applicable supervisory regulations (notably the BMA rules) in the event that the group becomes regulated in another regulatory jurisdiction. We set forth below a selection of these transactions:

- Validus Holdings, Ltd. issued 10,000,000 Depositary Shares, each representing a 1/1,000th interest in a Share of 5.800% Non-Cumulative Preference Shares, Series B, intended to qualify as Tier 2 capital under then-applicable capital adequacy regulations imposed by the BMA or the then-applicable regulatory authority.

- Allianz SE issued €1,000,000,000 Subordinated Fixed to Floating Rate Notes with scheduled maturity in 2047, intended to qualify as Tier 2 capital under Solvency II or then applicable supervisory regulations.

- Arch Capital Group Ltd. issued 4,000,000 Depositary Shares, each representing a 1/1,000th interest in a share of 5.45% Non-Cumulative Preferred Shares, Series F, intended to qualify as Tier 2 capital under then-applicable capital adequacy regulations imposed by the BMA or the then-applicable regulatory authority.

- Sirius International Group, Ltd. issued SEK 2,750,000,000 Floating Rate Callable Subordinated Notes due 2047, intended to qualify as Tier 2 capital under the Bermuda Group Rules or under Solvency II or the nearest corresponding concept by the then-applicable supervisory regulations.

VII. PRINCIPAL REGULATORY DEVELOPMENTS AFFECTING INSURANCE COMPANIES

A. U.S. Insurance Regulatory Developments

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

a) First Steps Taken to Convergence of Group Capital Standards

i. NAIC Group Capital Tool. Both the NAIC and the Federal Reserve Board, each of which is working toward completion of an aggregation method for measuring group capital, will work together to develop aligned standards in order to achieve greater marketplace efficiency, according to NAIC CEO Michael Consedine.

In order to better capture contagion risk in a group structure, the NAIC's Group Capital Calculation (E) Working Group is developing a risk-based capital aggregation methodology that includes (i) an inventory of the group's insurance and non-insurance members, (ii) individually identifying insurers, banks, asset managers and registered investment advisors and grouping together other entities for the purpose of calculation, and (iii) determining the appropriate method for calculating the entity's capital.

With respect to non-U.S. insurers, the Working Group has reached a tentative consensus that "scalars" should be developed for purposes of the group capital calculation tool. A scalar refers to the multiplication of the non-U.S. insurer's local capital requirement by a certain factor, intended to result in an adjusted required capital level that is comparable to U.S. requirements.

In 2018, the NAIC will continue to work on the treatment of XXX/AXXX captives and certain non-financially regulated entities.

ii. Team USA Records a Win in Malaysia. At its meeting in Kuala Lumpur in November 2017, the IAIS agreed to use the U.S. Group Capital aggregation method in addition to the market-adjusted valuation approach currently being tested by the IAIS for use in developing an Insurance Capital Standard ("ICS"), which would apply to Internationally Active Insurance Groups, including G-SIIs (as defined below), under ComFrame.[3] U.S. insurance regulators and interested parties view the incorporation of two methods for assessing group capital as extremely positive. If the data supports comparability between the approaches, U.S. regulators hope that the U.S. capital aggregation method will be incorporated into the ICS.

b) Global Systemically Important Insurers ("G-SIIs")

In November 2017, the FSB (which is responsible for designating G-SIIs) announced its decision to not publish a new list of G-SIIs (maintaining, however, the nine G-SIIs identified in 2016). The FSB also encouraged the IAIS to continue work on an activities-based approach to systemic risk assessment for G-SIIs—which may ultimately affect the global insurance groups identified as G-SIIs.

2. Mutual Recognition, Equivalence and Cooperation in 2017

a) U.S. and European Union Sign the Covered Agreement

On January 13, 2017, as authorized under the Dodd-Frank Act, Treasury and the Office of the U.S. Trade Representative notified Congress that they had negotiated a bilateral trade agreement with the E.U., known as a "covered agreement." The Covered Agreement was signed on September 22, 2017, and certain aspects will be "provisionally applied" until the date of entry into force, which will occur upon written notification between the parties certifying that they have completed their respective internal requirements.

The Covered Agreement addresses three areas of insurance regulation: group supervision, reinsurance and the exchange of information between insurance supervisors. When fully implemented, the Covered Agreement will eliminate reinsurance collateral and local

3 ComFrame is the Common Framework for the Supervision of Internationally Active Insurance Groups being developed by the IAIS.

presence requirements in the U.S. for an E.U.-domiciled reinsurer that satisfies certain criteria unrelated to collateral. The Covered Agreement also addresses the group solvency, capital and financial reporting of U.S. or E.U. insurance or reinsurance groups.

b) NAIC Reaction

At the NAIC 2017 Fall National Meeting, the NAIC Reinsurance (E) Task Force Chair NYDFS Superintendent Maria Vullo spoke about beginning the process of implementing the Covered Agreement at the state level and noted that, under the Dodd-Frank Act, FIO has the authority to take action where it finds that E.U.–domiciled (re)insurers are treated less favorably than U.S. (re)insurers. The NAIC is scheduled to hold a public hearing on the Covered Agreement on February 20, 2018, in New York City. The following proposed NAIC responses to the Covered Agreement will be considered during this meeting:

- Amending the Credit for Reinsurance Model Law and Model Regulation to eliminate reinsurance collateral requirements for E.U.-based reinsurers meeting the conditions of the Covered Agreement.
- Extending similar treatment to reinsurers from other jurisdictions covered by potential future covered agreement(s) that might be negotiated pursuant to Dodd-Frank.
- Providing reinsurers domiciled in NAIC Qualified Jurisdictions with similar reinsurance collateral requirements.
- Considering changes to the criteria for evaluating whether a jurisdiction should be a Qualified Jurisdiction.
- Considering additional "guardrails" relative to U.S. ceding companies, such as changes to the risk-based capital formula or new regulatory approaches to help address the increased financial solvency risks caused by the elimination of reinsurance collateral.

3. Technology, Innovation and Cybersecurity

a) NAIC Adopts the Cybersecurity Model Law

On October 24, 2017, the NAIC Executive and Plenary adopted the Insurance Data Security Model Law, commonly referred to as the NAIC Cybersecurity Model Law. The adopted Model Law now goes on to the states for adoption into state law, and the NAIC will presumably begin the process of considering the Model Law as a part of the NAIC Part A Accreditation Standards at the appropriate time.

The Model Law applies to all "licensees" including insurance companies, insurance producers, adjusters and others required to be licensed, authorized or registered by the state insurance department. However, risk retention groups chartered in another state, assuming insurers domiciled in another state, and risk purchasing groups are exempt from the Model Law. Substantively, the Model Law provides, among other things, for each licensee to comply with requirements including maintenance of plans and protocols around cyber risk, and annual reporting and certifications regarding compliance on cyber measures.

Adoption of the Model Law followed promulgation by the NYDFS of a cybersecurity regulation in early 2017 (the "NY Cyber Regulation"), and the Model Law significantly overlaps with—without completely tracking—the NY Cyber Regulation. The Model Law also shares certain aspects of the NY Cyber Regulation, such as the 72-hour time frame to report qualifying cyber incidents to the NYDFS and the requirement of an annual report to the board of directors on relevant compliance. However, there are some differences. The NY Cyber Regulation defines a "cybersecurity event" as a successful or unsuccessful attempt to gain unauthorized access to information systems, while the Model Law defines a "cybersecurity event" as an event "resulting in unauthorized access"—i.e., not merely an attempt. The NY Cyber Regulation requires that all entities regulated by the NYDFS, not just New York resident entities, comply therewith. Importantly, a drafting note in the Model Law advises that compliance with the NY Cyber Regulation should be deemed to be compliance with the Model Law.

b) InsurTech

The NAIC Innovation and Technology (EX) Task Force was formed in 2017 amid the rapid development of insurance technology. Throughout the year, the Task Force heard proposals to implement a "sandbox" approach, in which innovators would be permitted to test pilot insurance programs without being required to comply with full regulatory oversight. Balancing the interest of creating space for getting innovative products and services to market and enforcing existing laws and regulation, the American Insurance Association proposed draft legislation related to giving insurance commissioners more flexibility in working with start-ups and existing insurers to promote insurance innovation. We will be keenly monitoring the development of these proposals during 2018.

c) Big Data

In 2017, the NAIC Big Data (EX) Working Group focused on (i) identifying conflicts and gaps under the current regulatory frameworks regarding insurers' use of consumer and non-insurance data to create a proposal that will balance consumer protection with industry innovation; (ii) surveying state regulators on whether the laws of their states include specific prohibitions on the use of consumer data in underwriting and rating, starting from personal lines auto and homeowners' insurance lines of business and moving to other lines of business later; (iii) assessing data needs and required tools for regulators to appropriately monitor the marketplace and evaluate underwriting, rating, claims, and marketing practices; and (iv) proposing a mechanism to provide resources and allow states to share resources related to their review of complex models. In particular, the Working Group has discussed the current regulatory framework for oversight of insurers' use of consumer data, noting that the Working Group would like to understand the gaps and conflicts inherent in this framework, and that the Working Group's effort will attempt to balance consumer protection with industry innovation. As an initial step, the Working Group is surveying state regulators on whether the laws of their states include specific prohibitions on the use of consumer data in underwriting and rating. Initially, the Working Group will focus its analysis on personal lines auto and homeowners' insurance lines of business—although the Working Group has reaffirmed its interest in also subsequently analyzing other lines of business. Separately, the Working Group has also been discussing data needs and tools for state insurance regulators to monitor the marketplace and a proposal for the NAIC to assist state insurance regulators with the analysis of complex models.

d) Federal Initiatives

Large-scale data breaches, such as at Equifax, have reportedly renewed Congress's interest in significant federal legislation addressing data breaches. There have been numerous hearings in both houses over the past year, and several bills have been introduced in Congress addressing cyber issues. The report that Treasury released in October on asset management and insurance reported favorably on the adoption of the NAIC Cybersecurity Model Law, recommended that all states adopt it promptly and recommended that if there has not been uniform adoption within five years the federal government should enact federal legislation setting standards for insurer data security. The NAIC is a member of Treasury's Financial and Banking Information Infrastructure Committee ("FBIIC"), and Director Raymond Farmer of the South Carolina Department of Insurance (who is also the NAIC's FBIIC representative) recently participated in cyber tabletop exercises at Treasury in order to discuss strategies for how to respond following cyber incidents. Cyber resiliency is a top priority for Treasury Secretary Steven Mnuchin. Treasury has emphasized the importance of cyber security to the country's overall financial stability and may review data standards applicable to financial institutions at the federal and state levels. Such review would be undertaken with the goal of strengthening regulatory collaboration and communication and leveraging the Cybersecurity Framework of the National Institute of Standards and Technology.

4. Life Insurance Developments

a) Principle-Based Reserving

The Principle-Based Reserving Implementation (EX) Task Force was disbanded in 2017, since principle-based reserving ("PBR") went into effect in most states effective as of January 1, 2017. In addition, the revisions to the Standard Valuation Law were adopted as an accreditation standard by the NAIC during 2017, to be effective as of January 1, 2020 (which matches the date on which PBR will become broadly applicable following a three-year transition period).

b) Variable Annuities

At the NAIC 2017 Fall National Meeting, the Variable Annuities Issues (E) Working Group exposed for comment until March 2, 2018 the recommendations of the Working Group's outside consultant with respect to potential modifications to the regulatory framework governing variable annuity products. This first exposure follows the completion of two quantitative impact studies by the outside consultant, which were conducted over a two-year period. The Working Group noted that the outside consultant's recommendations reflect extensive input from the industry but only limited input from regulators—and that the regulators would be reviewing and potentially modifying the recommendations following the end of the comment period.

As expected, the outside consultant's recommendations are mainly focused on revisions to Actuarial Guideline 43 (including in particular revisions to the calculation of the Conditional Tail Expectation amount and the Standard Scenario amount) and revisions to the calculation of the C3 charge in the risk-based capital framework. In addition, the proposed recommendations include increased disclosure requirements, increasing admissibility limits for variable annuity hedges and variable annuity-related deferred tax assets, changes to statutory accounting rules applicable to interest rate derivatives that are part of variable annuity hedge programs, and certain revisions to the reserve allocation methodology. These changes are designed to: (i) decrease balance sheet volatility for companies with economically-focused hedges, which is expected to reduce disincentives for companies to hedge their variable annuity exposures; (ii) result in greater comparability across companies writing variable annuity business and the variable annuity products they offer; (iii) provide for enhanced oversight of company assumptions via the revised Standard Scenario; and (iv) simplify the interpretation and calculation of variable annuity reserves and risk-based capital. The outside consultant has suggested that a three-year phase-in period be implemented with respect to the adopted recommendations, with additional extensions permitted for qualifying companies, so as to enable companies to better comply with the proposed changes.

Along with the outside consultant's initial recommendations, the Working Group also exposed proposed revisions to Actuarial Guideline 43 and the "Interest Rate Risk and Market Risk" sub-part of the risk-based capital calculation. Following the end of the comment period on March 2, 2018, the Working Group will schedule calls to discuss the various subcomponents of the outside consultant's recommendations. In addition, the Working Group will meet for a full day before or at the NAIC 2018 Spring National Meeting to further discuss these recommendations.

c) Suitability

The NAIC Annuity Suitability (A) Working Group is continuing discussions on revisions to the NAIC's Suitability in Annuity Transactions Model Regulation (the "Annuity Model Regulation"), which are intended to result in the adoption of a "best interest" standard on a nationwide basis in order to create uniformity between state insurance law requirements and requirements imposed by the Financial Institution Regulatory Authority, the U.S. Department of Labor and the SEC. The Working Group has exposed an initial draft of the revised Annuity Model Regulation for comment, and intends to present a draft of the proposed revisions to the Life Insurance and Annuities (A) Committee at the NAIC 2018 Spring National Meeting.

In December 2017, the NYDFS exposed for comment until February 26, 2018 revisions to New York Insurance Regulation 187 ("Suitability in Annuity Transactions"), which not only incorporate the "best interest" standard but also expand the scope of the regulations to apply to the sale of life insurance policies. The regulation explains that a licensee acts in the "best interest" of the consumer when the recommendation is based on the consumer's suitability information and reflects the care that a prudent person would exercise in a similar situation without regard to the financial interests of any other party, when the transaction is suitable and when the consumer has been reasonably informed of the consequences of the transaction. Among other requirements, the regulation also requires licensees to make certain additional disclosures to the consumer; prohibits a licensee from making a recommendation unless the licensee has a reasonable basis to believe that the consumer can meet the financial obligations under the policy; and requires insurers to establish and maintain procedures to prevent financial exploitation and abuse.

d) Life and Health Guaranty Association Coverage

During 2017, the NAIC adopted changes to the Life and Health Insurance Guaranty Association Model Act, which: (i) add health maintenance organizations as members of the guaranty fund; (ii) split guaranty fund assessments between health insurers and life insurers; and (iii) allow guaranty associations to request rate increases if they are actuarially justified. These changes were adopted as a preventative measure in connection with any potential future insolvencies of carriers writing long-term care insurance. The revised model law now goes on to the states for adoption into state law.

5. Other NAIC and Federal Developments

a) Macro-Prudential Initiative/Liquidity

The Financial Stability (EX) Task Force was created to consider issues concerning domestic or global financial stability as it pertains to the role of state insurance regulators and make recommendations for improvements. During the NAIC 2017 Summer National Meeting, the Task Force unveiled a proposed work plan for a new Macro-Prudential Initiative or "MPI." The MPI will take post-crisis efforts a step further in recognition of the continued scrutiny on the insurance sector in terms of "understanding how insurers react to financial stress, and how that reaction can impact, via various risk transmission channels, policyholders, other insurers and financial market participants, and the broader public."

One area of focus is improving insurance regulators' ability to assess liquidity risk. The Liquidity Assessment (EX) Subgroup, has introduced a proposal to identify insurance product categories with greater particularity in the statutory statement blanks. After a lengthy discussion at the NAIC 2017 Fall National Meeting, the Task Force decided it would expose the proposal for 45 days, but noted that this should still provide enough time for the initiative to be approved by the Blanks (E) Working Group for year-end implementation.

b) Overlap in the Regulatory Roles of Own Risk Solvency Assessment ("ORSA") and Form F

The NAIC Group Solvency Issues (E) Working Group has spent much of the year working on a project designed to better delineate the function and role of the Form F as compared to the ORSA and to identify the uniquely useful characteristics of these respective reporting processes. As part of this project, the Working Group has developed a draft NAIC Enterprise Risk Report (Form F) Implementation Guide and a Comparison of Form F and ORSA Reporting Requirements. The former document is intended to create more certainty on regulators' expectations by helping companies understand the intent of the Form F; recommend good or best practices while not overreaching its statutory scope; and help companies to avoid repetitive filing of the same information.

c) Federal Developments

i. FSOC. The most significant development with respect to FSOC's activities during the year occurred on September 29, 2017, when FSOC voted to rescind

the designation of AIG as a non-bank systemically important financial institution ("SIFI").

In addition, in November 2017, in response to President Trump's memorandum ordering the Secretary of the Treasury to conduct a "thorough review" of the FSOC process, the Treasury issued a report recommending that FSOC focus on an activities-based approach to designating SIFIs and work with regulators to address systemic concerns. The Treasury report also made several recommendations, including increasing "analytical rigor," improving the engagement between the FSOC and primary regulators, increasing the public transparency of FSOC's basis for SIFI designations and providing a clear "off-ramp" for designated non-bank financial companies.

Finally, the Trump administration has nominated Thomas Workman, former longtime President and Chief Executive Officer of the Life Insurance Council of New York, to replace S. Roy Woodall, Jr. as the independent insurance industry's voting member of FSOC for a term of six years. As of early February 2018, Mr. Workman's nomination was subject to Senate confirmation.

ii. FIO. In January 2017, the former Director of FIO Michael McRaith stepped down from this role. A permanent replacement has not yet been named, but Steven Seitz, Deputy Director of FIO, is performing the role of Director.

A Treasury report released in October on the insurance and asset management industries contained several suggested reforms of the FIO. The report noted that the Treasury is "committed to realigning FIO's operations through five pillars of focus" to "help promote the state-based insurance regulatory system in the United States and make FIO's work more effective."

To effectuate these pillars of focus, the Treasury made several recommendations to the FIO, including increased transparency and stakeholder engagement. Treasury and the FIO plan to achieve these objectives by committing to more regular and consistent engagement between state insurance regulators and stakeholders with regard to important issues in the insurance industry.

iii. National Flood Insurance Program ("NFIP"). The NFIP was set to expire on September 30, 2017, but was extended through January 19, 2018 as part of the stopgap funding for the U.S. government. The NFIP's authorization lapsed between January 20, 2018 and January 22, 2018. On January 22, 2018, the President signed legislation passed by both houses of Congress that extended the NFIP's authorization through February 8, 2018 as a part of a resolution to reopen the federal government. This authorization enabled FEMA to honor all policy-related transactions inadvertently accepted during the NFIP authorization's lapse period between January 20, 2018 and January 22, 2018. The NFIP is now set to expire at 11:59 pm on February 8, 2018, unless the Congress reauthorizes it prior to that time.

According to a statement from FEMA on January 23, 2018, following the extension of NFIP to February 8, 2018, "FEMA and Congress have never failed to honor the flood insurance contracts in place with NFIP policyholders. In the unlikely event the NFIP's authorization lapses, FEMA would still have authority to ensure the payment of valid claims with available funds. However, FEMA would stop selling and renewing policies for millions of properties in communities across the nation. Nationwide, the National Association of Realtors estimates that a lapse might impact approximately 40,000 home sale closings per month."

B. Insurance Regulatory Developments in Europe

1. Brexit

The consequences of Brexit on the insurance industry continue to dominate the insurance regulatory scene in Europe. Despite a period of 18 months having elapsed since the British electorate voted to leave the E.U. on June 23, 2016 by a majority of nearly 52%, the longer-term implications for insurers of this decision are still not clear.

a) Transitional Arrangements

The formal process of the U.K. leaving the E.U. ("Brexit") commenced on March 29, 2017, when British Prime Minister Theresa May notified the European Council under Article 50 of the Treaty on the European Union ("Article 50") of the U.K.'s intention to leave. The U.K. will remain a member state of the E.U. until it negotiates and reaches an agreement in relation to the withdrawal from the E.U. or, if earlier, upon the expiration of a two-year period following the Article 50 notification, which expires on March 28, 2019 (the "Leaving Date").

In 2018, firms must be prepared for significant regulatory changes during a period of continued uncertainty, although the extent to which such changes will occur in practice remains unclear. The prospect of the insurance industries—in both the U.K. and the E.U.—facing a cliff edge on the Leaving Date appears to have abated, following the Prime Minister's proposal in September 2017 for a transitional period of up to two years in which all current arrangements between the U.K. and the E.U. would remain unchanged. While the parties have not formally indicated that such a transitional period will be agreed, both sides acknowledge that it would be beneficial (not least because the U.K. would continue to contribute to the E.U.'s finances in this period). Until formal agreement is reached on any transitional arrangement, it will not be clear to what extent contingency plans will need to be in place prior to, and implemented after, the Leaving Date.

Since Article 50 was triggered, the basis for the longer-term relationship between the U.K. and the E.U.—the so-called "trade deal"—has been the subject of ongoing discussions. While the U.K. has been keen to focus on a comprehensive, and in its view, mutually beneficial arrangement to allow the continued free movement of goods and services following Brexit, the E.U. had insisted that such discussions could not begin until sufficient progress had been made in three key areas: the rights of E.U. citizens currently residing in the U.K.; arrangements relating to the border between Northern Ireland and the Republic of Ireland; and the amount that the U.K. will need to contribute for liabilities of the E.U. that were incurred when it was a member. While the ultimate position is far from clear on any of these matters, in December 2017 it was deemed that sufficient progress had been made to begin discussions on the trade deal. The U.K.'s stated aim is that any arrangement should extend to both goods and services, implying that the trade deal should include some form of mutual recognition for regulation in the area of financial services. However, no detail has been provided as yet about how this might work in practice.

If the U.K. and the E.U. fail to reach an agreement, whether in relation to transitional arrangements or a longer-term trade deal, the U.K. may generally need to trade with the E.U. on the basis of World Trade Organization ("WTO") rules from the relevant date that the U.K. formally leaves the E.U. These rules do not extend to recognition of financial services regulation. As a result, if WTO rules were to apply, insurers could potentially be very significantly affected, whether WTO rules begin to apply on the Leaving Date or at the end of an agreed transitional period. Insurers' contingency plans will need to consider not just how to write new business on a cross-border basis between the U.K. and the E.U., but also how to run off existing business in the absence of any understanding or agreement as part of a trade deal. For example, the act of paying a claim from the U.K. to an E.U. insured may not be possible, if the U.K. insurer no longer has permission to conduct business in the E.U. Although most insurers agree that this outcome would be perverse and unwelcome, in the absence of any signs that the politicians will be able to reach an agreement it currently remains a legal possibility.

We set out below some of the options that firms wishing to plan ahead for the post-Brexit environment have been considering. We note, however, the inherent uncertainties regarding every aspect of Brexit and its implications on the insurance sector, including the absence of a hard timescale for firms to work toward in order to ensure that their plans for the post-Brexit world are in place. A number of firms may already have activated their contingency plans on the assumption of a hard Brexit, whereas others are waiting for more information about the expected post-Brexit environment before doing so.

b) Options for U.K. Insurance Firms Writing Both U.K. and European Business Following Brexit

U.K. firms may consider setting up a subsidiary within the European Economic Area ("E.E.A.") in order to access the rest of the European single market using the passporting regime for their direct insurance and reinsurance. The most important question for firms planning to set up an E.E.A. subsidiary is in which member state to set it up. While in theory all E.E.A. regulators are implementing the same rules following the implementation of Solvency II (which is intended to be a directive to create "maximum harmonization"), in practice insurers identify some jurisdictions as being more attractive than others, based on differences in the approach of the relevant regulatory authorities as well as other factors. As a result, certain jurisdictions have emerged as preferred choices. Common jurisdictions under consideration include Belgium, France, Germany, Ireland, Malta, Luxembourg, Liechtenstein and the Netherlands. In considering the most attractive jurisdiction for its business, a firm should consider a number of factors, including:

- Regulatory environment;
- Authorization process;
- Substance requirements and the ability to outsource (i.e., what activities actually need to be "onshore" in the relevant jurisdiction);
- Local expertise in the (re)insurance industry for those activities that cannot be outsourced;
- Any limits on the amount of business that can be reinsured outside of the jurisdiction;
- The availability of cell company structures (particularly in the context of ILS transactions);
- The language of the jurisdiction;
- The speed, certainty and repute of the legal system;
- Size of the existing insurance market;
- Ease of access from London and other relevant E.E.A. states; and
- Tax matters.

Another option for U.K. (re)insurers might be to set up a Third Country Branch, which is a locally authorized branch of the U.K. (re)insurer in the relevant E.E.A. jurisdiction where business will be written. Solvency II permits the establishment and regulation of Third Country Branches, but this can technically only occur once the U.K. has actually left the E.E.A. Where a firm establishes Third Country Branches across multiple E.E.A. member states, third country insurers are able to satisfy certain requirements relating to the lodging of assets and the holding of capital by complying with the requirements in any one member state, provided that the other relevant supervisory authorities in the E.E.A. agree. However, the establishment of a branch in one E.E.A. state does not create a right to conduct business in other states through passporting rights (as would be the case where an E.E.A. subsidiary has been created), and we note that certain regulators (including the U.K.'s PRA) have generally discouraged the establishment of Third Country Branches. This has particularly been the case since the implementation of Solvency II. Should a firm need to set up Third Country Branches in multiple member states,

it would require multiple authorization applications and increased ongoing compliance requirements.

If the U.K. is granted Solvency II equivalence following Brexit, a third option for firms would be to write reinsurance (but not direct insurance) into the European single market from the U.K. Although it has not been confirmed, there are reasons to believe that the U.K. might well be granted equivalence under Solvency II following Brexit. One of the main arguments to support this would be that immediately following Brexit, the U.K. will have exactly the same rules as the remaining E.E.A. member states. However, were equivalence initially granted, over time regulatory divergence may cause the U.K.'s equivalence status to be revoked. Under equivalence to Solvency II, U.K. reinsurers would be treated in the same way as E.E.A. reinsurers. This option is the way in which pure reinsurers currently operate in the E.E.A. from equivalent jurisdictions such as Bermuda and Switzerland. Irrespective of an equivalence ruling, most E.E.A. member states currently have no restrictions on non-E.U. reinsurance, but the placement and marketing of such will need to be considered carefully by firms in order not to bring the reinsurer onshore for both regulatory and tax purposes.

A final option for firms is to write European business through a Lloyd's syndicate. We discuss Lloyd's plans for Brexit in the next section.

For firms that choose not to continue to write European business post-Brexit, under current rules their run-off business may require separate authorization in the relevant E.E.A. member state. However, we contend that it would be an unexpected outcome if the E.E.A. prevented claims being paid post-Brexit and so some transitional measures, or at least clarifications of current law, will be required.

c) Lloyd's and Brexit

For context, approximately £3 billion ($4 billion) or 11% of Lloyd's premiums comes from continental Europe and Lloyd's indicated that it could lose around £800 million ($1.1 billion), or around 4% of its premiums, if it lost its passporting rights without a solution. To manage the effect of these potential pitfalls, Lloyd's announced in March 2017 that it would be opening a subsidiary in Brussels to allow Lloyd's business to write insurance from the E.U.

Therefore, following the establishment of a subsidiary in an E.E.A. member state, Lloyd's could be an option for insurers and capital providers that wish to access both the U.K. market and the European single market following Brexit (in addition to the other jurisdictions in which Lloyd's operates) without having to undergo the separate regulatory authorization process in multiple jurisdictions. This option is likely to be attractive to both E.E.A. firms wanting to write business in the U.K. and U.K. firms wanting to write business in the remaining member states of the E.E.A.

The proposal for the Lloyd's post-Brexit operation is that the Brussels-regulated entity would front European risks and reinsure 100% of the business back to the relevant Lloyd's syndicate(s). It is anticipated that the Brussels entity would have a branch in London, so that all underwriting would take place in London with dual stamps (for the syndicate(s) and the London branch of Lloyd's Brussels subsidiary). Lloyd's would also outsource its claims and administrative functions back to London. As such, Lloyd's operations in Brussels would be limited to a relatively small number of its own staff that are required to administer the Brussels subsidiary. It is not expected that the staff of managing agents necessarily would be on the ground in Brussels. We understand that the capital requirements required to write business would be met by a combination of the Central Fund and a capital charge for syndicates that write European risk, although the details of how this would operate in practice are still under development.

d) Options for U.K. Firms Writing Predominantly E.E.A. Business Post-Brexit

For U.K. insurers that predominantly write non-U.K. E.E.A. business, a number of other options exist to continue to write business in the E.E.A.

Such firms may wish to undertake a cross-border merger between a U.K.- and an E.E.A.-based insurer and domicile the surviving entity in the E.E.A. Alternatively, the firm could acquire an existing E.E.A. insurer rather than establish and authorize a new E.E.A insurer and go through the, generally, less arduous process for obtaining change in control approval. Finally, if the amount of business written in a member state is small, the U.K. insurer may be able to partner with a local insurer to provide an alliance or fronting arrangement.

e) Options for E.E.A. Insurers to Access the U.K. Market Post-Brexit

A large number of E.E.A.–based insurers currently use passporting rights to access the U.K. insurance market. Such insurers incorporated and authorized in E.E.A. member states that maintain branches in the U.K. will need to either obtain U.K. authorization for the branches or establish a U.K. subsidiary with its own regulatory capital or acquire a U.K. insurer. As we note above, the PRA generally discourages the establishment of Third Country Branches; however, there have been some recent signs that the PRA is changing its stance to accommodate post-Brexit possibilities. Please refer to the discussion on "Brexit and E.E.A. Insurers Operating in the U.K.: the PRA's Approach to Authorization" in Section VII.B.9. below.

As we note above in our discussion of European M&A, depending on the terms of any Brexit deal, we expect some European insurers to leave the U.K. market, which will likely see an uptick in the number of portfolio transfers in the coming years.

For European insurers that stop writing business in the U.K. following its withdrawal from the European Union, it would be an unexpected outcome if they were prevented from paying claims to U.K. insureds post-Brexit, and so we expect that this will be the subject of some transitional arrangements.

2. Solvency II Directive: Developments

The European Solvency II Directive ("Solvency II") and its implementing rules have been in effect for two years. With the benefit of practical experience of Solvency II's application, regulators in the U.K. and at the European level are considering what, if anything, should be changed.

In the U.K., the PRA has published three consultation papers which propose a number of changes relating to the U.K.'s implementation of Solvency II.

The first consultation paper concerns the matching adjustment ("MA"). The MA is a means of effectively increasing the discount rate that is applied to determine a life insurer's best estimate of its liabilities. Indirectly, the use of the MA will reduce a life insurer's capital requirements and it can have a very significant effect on a life insurer's overall capital needs. If a life insurer wishes to use the MA it must obtain approval from the PRA and demonstrate that it complies with the conditions required for approval. The PRA has proposed a new supervisory statement which will: (i) consolidate and update the material previously set out in executive directors' letters and feedback statements; and (ii) introduce updated guidance in relation to various aspects of the MA, including how to demonstrate final cash flows, criteria for assessing sufficient compensation on a change of assets, asset restructuring, trading in the MA portfolio and changes to the portfolio approval. It is to be hoped that the changes proposed will clarify areas of uncertainty for the market and streamline the process for obtaining MA approval.

In December 2017, the PRA published its second consultation paper on Solvency II changes. This related to the process for obtaining approval for minor internal model changes with the aim of reducing the burden on firms. This consultation also proposes a process for quarterly model change reporting.

Further in January 2018, the PRA published a third consultation paper on Solvency II rule changes aimed at reducing the reporting burden on firms. The proposals

include reducing the content required in the PRA's National Specific Templates and a revised approach on how the PRA grants quarterly reporting waivers. The sheer volume of reporting obligations and the associated costs have been a common source of complaint by the insurance industry. It is to be expected that any proposals to reduce this burden will be welcomed by the industry.

In parallel, the PRA is continuing to work on a number of areas for potential improvements, which include:

- *Recalculation of the Transitional Measure on Technical Provisions:* the PRA is continuing to assess the feasibility of further simplification to the recalculation process; and
- *External audit of Solvency and Financial Condition Report:* the PRA is obtaining evidence from firms to support its review of whether the policy remains proportionate, particularly for smaller firms.

At the European level, EIOPA's first set of advice to the European Commission on specific items in the Solvency II Delegated Regulation was published in October 2017. The European Commission asked EIOPA to provide technical advice as part of its review of the methods, assumptions and standard parameters used in calculating the solvency capital requirement (the "SCR") with the standard formula. EIOPA's first set of advice covers the following areas:

- simplified calculations of capital requirements in the SCR standard formula;
- reducing reliance on external credit ratings in the calculation of the SCR;
- exposures to and guarantees by regional governments and local authorities;
- risk-mitigation techniques;
- undertaking specific parameters;
- look-through for investment-related undertakings; and
- loss-absorbing capacity of deferred taxes ("LAC DT").

It is interesting to note, as regards risk mitigation techniques (which include reinsurance), EIOPA was asked for advice on market developments in longevity reinsurance and whether the Solvency II framework appropriately covers these developments or should be updated. The advice delivered by EIOPA did not cover this topic. Indeed, it stated that there was lack of definition of risk mitigation technique and it would include further clarification in its second set of advice. EIOPA expects to publish its second set of advice to the European Commission by the end of February 2018. This will address issues such as policy proposals on LAC DT to increase supervisory convergence, risk margin, catastrophe risks, non-life and life underwriting risks, non-proportional reinsurance covers, unrated debt and unlisted equity and own funds.

3. Extension of the Senior Managers and Certification Regime to Insurers

On July 26, 2017, the FCA announced that it is seeking to align its existing Senior Insurance Managers Regime with the wider Senior Managers and Certification Regime ("SM&CR"). Consequently, the SM&CR will be extended to insurers to strengthen accountability (the "Extended SM&CR"). The SM&CR is an enhanced individual accountability framework which currently applies to directors and senior managers of banks, building societies, credit unions and dual-regulated investment firms. Different rules will apply to "Core SMCR Firms," "Enhanced SMCR Firms" and "Limited Scope Firms." However, the new self-certification regime and conduct rules will be extended to apply to all firms offering financial services in the U.K., including firms authorized in the U.K. and incoming branches of non-U.K. authorized financial services.

The Extended SM&CR will have a particular significance to the senior managers of firms whose responsibilities fall within the SM&CR ("Senior Managers"). Senior Managers will be expected to take personal responsibility for their actions.

a) Scope of the SM&CR

There are three parts to the SM&CR:

1. *Five conduct rules.* These rules require individuals to: act with integrity; act with due care, skill and diligence; be open and cooperative with the regulator; pay due regard to customer interests and treat customers fairly; and observe proper standards of market conduct. The rules will apply to all persons carrying out senior management functions ("SMFs") or certification functions from the commencement of the Extended SM&CR. Other persons within the scope of the conduct rules, such as employees who are not ancillary staff, will be subject to these rules 12 months after the Extended SM&CR comes into force.

2. *Responsibility of Senior Managers.* The responsibilities of the Senior Managers will be clearly set out and, in the event that something goes wrong that is within a certain Senior Manager's purview, that individual will be held personally to account. As with the current APR, all Senior Managers will be approved by the FCA and appear on the Financial Services Register.

3. *Certification regime.* Once a year, firms will need to carry out the first certification of persons falling into the certification regime as "fit and proper" for their roles 12 months after the Extended SM&CR comes into force. Firms are not required to obtain regulatory approval for existing employees who will be performing the same role at the start of the new regime.

b) Particular Requirements for Lloyd's and ISPVs

In the FCA's consultation paper published in July 2017 concerning the Extended SM&CR, the FCA stated that it intends to create a specific "Lloyd's FCA Conduct Risk Oversight" function for those entities operating at Lloyd's only. This function will be in addition to the other functions required under the "core" and "enhanced" versions of the regime.

Further, the FCA is proposing that the Extended SM&CR will also apply to Insurance Special Purpose Vehicles ("ISPVs") and small run-off companies, but on a more limited basis. For ISPVs there will be only three mandatory roles, although even at this level the regime could be more intrusive than equivalent requirements which apply to similar entities in other jurisdictions.

c) Timing

In December 2017, the PRA and FCA indicated that they will publish their final policy and rules on the Extended SM&CR in summer 2018. It is expected that the Extended SM&CR will apply to insurers from late 2018.

U.K. insurers are planning for implementation of the Extended SM&CR. Among other things, such plans would identify individuals who will perform SMFs; identify certification staff; draft statements of responsibilities for Senior Managers and establish systems and processes to ensure that: (i) an annual fit and proper assessment is carried out for Senior Managers and staff performing certification functions; (ii) all staff are trained on the relevant conduct rules; (iii) relevant background checks are made for new staff, including obtaining regulatory approvals; and (iv) disciplinary action for breaches of conduct rules are recorded and reported to the FCA as required.

4. E.U./U.S. Covered Agreement on Insurance and Reinsurance Regulation

In September 2017, the E.U. and the U.S. signed a covered agreement on Prudential Measures Regarding Insurance and Reinsurance (the "Covered Agreement"). The Covered Agreement covers three areas of prudential insurance supervision: reinsurance, group supervision, and the exchange of insurance information.

With regard to reinsurance, the Covered Agreement will eliminate collateral and local presence requirements for E.U. and U.S. reinsurers operating in each other's markets. For group supervision, E.U. and U.S. insurers operating in one another's markets will only be subject to worldwide prudential insurance group oversight by supervisors in their home jurisdictions. Finally, the Covered Agreement's information exchange provisions encourage E.U. and U.S.

insurance supervisory authorities to exchange information on insurers and reinsurers that operate in the two markets.

a) Implementation

The E.U. and the U.S. have agreed to meet within a Joint Committee to discuss the implementation of the Covered Agreement, particularly where there are differences between E.U. and U.S. approaches. It will be fully applicable to both sides 60 months after signature.

Some parts of the Covered Agreement, such as those concerning group supervision and the establishment of a Joint Committee, will be "provisionally applied" now that the Covered Agreement has been signed. Once notified that the U.S. internal requirements and procedures for provisional application have been completed, the E.U. must ensure that E.U. supervisory authorities apply the group supervision provisions. Furthermore, upon receipt of this notification, or within 24 months of the Covered Agreement taking effect (whichever is sooner), the E.U. must begin applying the elimination of local presence requirements. The U.S., once notified that the E.U.'s internal requirements and procedures for provisional application have been completed, must "encourage" U.S. state supervisory authorities to apply the group supervision provisions. Additionally, the U.S. must encourage individual states to phase out their collateral requirements, some of which are already being reduced.

b) Benefits

The Covered Agreement is expected to provide a major benefit to reinsurers operating cross-border between the U.S. and the E.U. that are currently required to post full or partial collateral or establish a physical presence in both jurisdictions. Under the Covered Agreement, all collateral requirements for U.S.-E.U. cross-border reinsurance would be eliminated. E.U. reinsurers that currently benefit from the reduced collateral regime available for U.S. "certified reinsurers" will no longer have to be from a "qualified jurisdiction" and will no longer be subject to the ratings-linked tiering percentages of the revised Credit for Reinsurance Model Law and Regulation (the "Reinsurance Models") adopted by the National Association of Insurance Commissioners in 2011.

However, significant conditions and capital requirements must be satisfied before reinsurers and cedants are eligible for equal treatment under the Covered Agreement. Many are the same conditions for "certified reinsurers" under the Reinsurance Models. Conditions for reinsurers that can automatically confer credit for reinsurance include a $250 million minimum capital and surplus requirement, periodic financial reporting, maintaining a practice of prompt payment of reinsurance claims, agreeing to notify the host jurisdiction of regulatory actions, agreeing not to participate in any solvent schemes of arrangement involving the host jurisdiction's ceding insurers without posting full collateral, and agreeing to fully collateralize all reinsurance for cedants in receivership upon request. Importantly, the Covered Agreement, like the Reinsurance Models, is available only for new and renewal business or newly amended contracts involving only prospective, not retroactive, reinsurance.

c) Implications of Brexit

Following Brexit, the U.K. will not have the benefit of the Covered Agreement because it will have ceased to be a member of the E.U. It is currently unknown whether and how the contents of the Covered Agreement would be incorporated into the withdrawal agreement between the U.K. and the E.U.

5. Insurance Distribution Directive: FCA Policy Statement and Application Date Postponement

The European Commission announced a proposal in December 2017 to delay the application date of the Insurance Distribution Directive ("IDD") by seven months to October 1, 2018, following requests from the European Parliament and Member States for a postponement. Member States (including the U.K.) will still be required to transpose the IDD into national law by February 23, 2018. However, under the current proposals, firms will not be required to comply with the IDD until October 1, 2018. The European Parliament and the Council will need to agree

and confirm the new application date in an accelerated legislative procedure.

In terms of the U.K.'s implementation of the IDD, the FCA published a policy statement in December 2017 which set out its response to the feedback received following its second consultation paper on the implementation of the IDD. The policy statement summarized the FCA's approach to the following matters:

- changes to its rules to implement the IDD requirements for life insurance business generally, including additional requirements related to the distribution of insurance-based investment products;
- changes to its rules to implement requirements in the IDD that apply to life and non-investment insurance business;
- additional changes to the FCA Handbook relating only to non-investment insurance business, including information disclosure requirements and the insurance product information document; and
- consequential amendments to other parts of the FCA Handbook.

The minor changes reflect amendments that have been made to implement the Markets in Financial Instruments Directive II and the Financial Advice Market Review.

The FCA aims to publish a third policy statement in January 2018, with a proposed implementation date of February 23, 2018. The policy statement will interest insurance and reinsurance companies, intermediaries, other firms and customers in the insurance market, and bodies representing these groups.

6. General Data Protection Regulation

a) Generally

On May 25, 2016, the European General Data Protection Regulation (the "GDPR") entered into force, which repeals the Data Protection Directive (95/46/EC) and will be directly applicable in all E.U. member states from May 25, 2018. The territorial scope of the GDPR is extensive and can apply to non-E.U. data controllers. First, the GDPR applies to the processing of personal data in the context of the activities of an establishment of a controller or processor in the E.U. regardless of whether the processing takes place in the E.U. Second, the GDPR applies to the processing of personal data of E.U.-based data subjects by a controller or processor not established in the E.U. where the activities relate to either: (i) the offering of goods or services to E.U.-based data subjects (regardless of whether a payment of the data subject is required); or (ii) the monitoring of the behavior of data subjects insofar as their behavior takes place in the E.U.

The GDPR sets out a number of requirements that must be complied with when handling the personal data of such E.U.-based data subjects, including the obligation to appoint data protection officers in certain circumstances, new rights for individuals to be "forgotten," rights to data portability, "privacy by design," the principle of accountability and the obligation to make public notification of significant data breaches. The GDPR also retains and adds to some existing requirements, including restrictions on transfers outside the E.E.A. and the requirement to include specific data protection provisions in agreements with data processors.

Businesses that breach the provisions of the GDPR may be subject to significant monetary damages, regulatory enforcement actions, fines and/or criminal prosecution in one or more jurisdictions. For example, the GDPR increases sanctions for non-compliance, which could result in a penalty of up to the higher of (a) €20 million; and (b) 4% of a firm's global annual revenue for the preceding financial year for certain infringements, such as unlawful data transfer outside of the E.E.A.

In October 2017, Insurance Europe, the European insurance and reinsurance federation, published a template for data breach notifications under the GDPR. On a new cyber insurance webpage, Insurance Europe indicates that the template is easy to use and allows the information to be compared across sectors. The data gathered would be anonymized, but would be sufficiently granular to be of use to insurers.

As the implementation date of the GDPR is fast approaching, insurers, like other businesses, have been considering the changes required to ensure compliance with the GDPR throughout the course of 2017. In particular, one area of concern for insurers is the scope of the consent they obtain from individual policyholders both in terms of the processing that the insurer may need to do, and whether they can pass on personal data to reinsurers who may not be located in the E.U.

b) Brexit and the GDPR

The GDPR will become directly applicable in all E.U. member states, including the U.K. on May 25, 2018. On September 13, 2017, the U.K.'s Data Protection Bill had its first reading in the U.K. House of Lords. This will replace the Data Protection Act 1998 and provide a comprehensive modern framework for data protection in the U.K. The Data Protection Bill aims to ensure that the U.K. and the E.U. data protection regimes are aligned post-Brexit and to address the derogations contained in the GDPR. Further, the Data Protection Bill will legislate beyond the GDPR as it will address data processing in law enforcement and the intelligence services.

7. FCA Study on Wholesale Brokers

In November 2017, the FCA published its terms of reference for its wholesale insurance broker market study. The FCA states that the purpose of this market study is to ensure that the sector fosters innovation and competition in the interest of its diverse range of clients. Effective competition between brokers should ensure that clients obtain appropriate coverage for their needs, not only in terms of price, but in respect of other factors including breadth of coverage, financial limits of policies, the insurer's claim handling and its financial strength and the insurer's risk management services.

The FCA plans to focus on three key issues examining the conditions on the wholesale insurance broker market:

- *Broker market power*: The FCA plans to explore whether brokers possess market power that they might be able to use to restrict competition. For example, market power could result in brokers receiving higher commissions than would exist in a more competitive market. The FCA will consider whether there is evidence of sub-segments in the wholesale insurance sector, according to, for example, client type, type of risk and client location, and, if so, whether the intensity of competition differs between them. Further, the FCA also plans to look at the barriers to entry and expansion, whether a broker's expertise and access to information gives a specific broker a competitive advantage and how brokerage firms can take advantage of economies of scale and scope.
- *Conflicts of interest*: Brokers are often relied upon to bridge information gaps between commercial clients and insurers, which may cause conflicts of interest. The FCA is concerned that brokers are incentivized to choose insurers for their clients which provide the broker with the highest remuneration, instead of the most appropriate insurer for the client in terms of service, quality of cover, and the premium charged. The FCA plans to assess the extent to which these potential conflicts of interest exist and the mechanisms in place to manage these conflicts and protect clients.
- *Broker conduct*: The FCA considers that there are certain broker practices that might exclude insurers from the market or dampen competition between brokers through tacit coordination.

The FCA intends to publish an interim report in autumn 2018, setting out its analysis and preliminary conclusions.

8. General Insurance Stress Test 2017: PRA Feedback

Following the PRA's General Insurance Stress Test in April 2017, Anna Sweeney, the PRA's Director of Insurance, sent a "Dear CEO Letter" to CEOs of participating firms. The main findings of the review related to:

(i) *resilience:* the U.K. general insurance sector in aggregate, and regulated firms at an individual level, are resilient to those scenarios within the regulatory ambit of Solvency II; and

(ii) *reinsurance interconnectedness:* there is no evidence that the level of interconnectedness reflected by the concentration to specific reinsurers has increased since the PRA's last exercise in 2015.

The results indicate that concentration to individual reinsurers has marginally fallen since 2015, with alternative capital remaining an important part of reinsurance panels. The letter also explains that the results suggest that exposure management, natural catastrophe modelling weaknesses, post-loss planning and accounting are all potential areas for improvement that impact underwriting, finance and risk functions. The PRA anticipates that the next stress test exercise will be in 2019.

9. Brexit and E.E.A. Insurers Operating in the U.K.: the PRA's Approach to Authorization

Under the E.U.'s financial services passporting regime, E.E.A. insurers can currently write insurance business in the U.K. on a services basis or through a branch by relying on the regulatory authorization they hold in their home E.E.A. state. When the U.K. leaves the E.U. on March 29, 2019, and absent any provisions which extend the application of the current passporting regime, E.E.A. insurers face the real possibility of being unable to carry on insurance business in the U.K. without obtaining PRA authorization. Without PRA authorization, it would be illegal for such insurers to carry on insurance business in the U.K., whether they are writing new business or simply paying claims and otherwise servicing existing insurance contracts. In this context, E.E.A. insurers have been actively implementing plans to establish subsidiaries or branches in the U.K. to enable them to continue to carry on insurance business in the U.K. after Brexit.

On December 20, 2017 HM Treasury and the PRA published separate important messages on the steps they are planning to take to alleviate some of the immediate issues concerning regulatory authorization which would be caused by a sudden departure of the U.K. from the E.U. in March 2019. HM Treasury released a statement announcing that it plans to provide the means by which the U.K. regulators could issue temporary permissions to firms. On that same date, Sam Woods, CEO of the PRA, published a letter welcoming HM Treasury's proposal but noted that the PRA would consider the use of a temporary permissions regime only as a fallback. Instead, the PRA is encouraging E.U. firms with businesses in the U.K. to apply for full authorization as the preferred means of ensuring they are able to continue insurance business in the U.K. post-Brexit.

Mr. Woods's letter states that firms may submit applications for post-Brexit authorization from January 2018 (a process which may take up to 12 months from the time of application), and the PRA will then review timelines and assumptions as the political process moves forward. Mr. Woods's letter acknowledges that the PRA will consider applications from E.E.A. insurers for authorization as either branches or subsidiaries. For existing E.E.A. insurers with existing branches in the U.K. operating under the passporting regime, the possibility of obtaining full authorization for their branch, rather than establishing a new subsidiary, may be an attractive and efficient option, providing the PRA's requirements can be met. On the same date as HM Treasury's and Mr. Woods's publications, the PRA also published a consultation paper (CP30/17) and accompanying draft Supervisory Statement, which set out proposals for a new approach to branch authorization and supervision of international insurers. In particular, for those E.E.A. firms that are currently branching into the U.K. under the passporting regime, and which are intending to apply for PRA authorization in order to continue operating in the U.K. after the U.K.'s withdrawal from the E.U., the PRA would apply the new approach set out in the final Supervisory Statement in assessing the firm's application.

As presented in CP30/17, the PRA expects those insurers that undertake, or plan to undertake, significant retail insurance activities in the U.K. to apply for authorization as a subsidiary rather than a branch. As a means of gauging the level of retail insurance activity, the PRA consultation paper refers to the level of policyholder liabilities covered by the U.K. Financial Services Compensation Scheme ("FSCS"). Although not a hard limit, the PRA is proposing

that firms which are likely to have more than £200 million of FSCS-protected liabilities should apply for authorization as a U.K. subsidiary rather than conduct business through an authorized branch. Furthermore, when considering whether it is appropriate to apply for authorization as a branch rather than a subsidiary, the PRA proposes to consider a range of factors including the quality and type of regulatory regime that the firm is subject to in its home state, the level of supervisory cooperation between the PRA and the home supervisor and the ability of the branch to meet PRA governance and operational rules. The PRA's consultation with respect to CP30/17 is ongoing and the deadline for comments is February 27, 2018.

The PRA's approach to authorizing E.E.A. firms operating in the U.K. in the run-up to Brexit will be influenced by the ongoing and heavily-politicized negotiations between the U.K. and E.U. Despite widespread support from U.K. regulators and insurance firms, it is currently uncertain whether financial services will form part of any post-Brexit final trade agreement or if the current passporting regime will be continued for a transitional period following Brexit. Despite this, the vital message being communicated by the PRA to E.E.A. firms operating in the U.K. is to engage with the PRA as early as possible. The PRA will entertain the possibility of existing E.E.A. branches applying for post-Brexit authorization straight away, but there are a number of factors to be considered in determining if this option will be available, not least in relation to business make-up, home state supervision and future branch governance. Given the significant time frame involved in making an application to the PRA to authorize either a subsidiary or a branch, E.E.A. firms with U.K. insurance operations need to be focused on implementing their post-Brexit strategies as early as possible.

10. FRC Thematic Reviews to Stimulate Improvement in Corporate Reporting and Auditing

The U.K.'s Financial Reporting Council ("FRC") announced in November 2017 that it would be undertaking a series of thematic reviews of certain aspects of corporate reports and audits where there is particular shareholder interest, and scope for improvement and learning from good practices. One of the FRC's priority areas for focus is insurance and the FRC intends to review the effect of new international financial reporting standards ("IFRS") on revenue and financial instruments on companies' 2018 interim financial statements; the expected effect of the new IFRS for lease accounting; and the effect of Brexit on companies' disclosure of principal risks and uncertainties. The FRC intends to undertake this work for the 2018/2019 year and expects to write to 40 small listed and AIM-quoted companies prior to their year-end to inform them that the FRC will review two specific aspects of their next published reports and accounts.

VIII. TAX

A. U.S. Income Tax Reform

On December 22, 2017, the Tax Cuts and Jobs Act (the "Act") was signed into law. The Act fundamentally overhauls the Internal Revenue Code of 1986, as amended (the "Code"), and the U.S. tax system by, among other things, lowering the U.S. corporate income tax rate to 21% (and repealing the corporate alternative minimum tax) and moving the U.S. closer to a territorial system of taxation (including through a 100% dividends received deduction for certain foreign source dividends received by a U.S. corporation from a 10% or greater owned foreign subsidiary that is not a passive foreign investment company or "PFIC").

The Act includes a number of provisions that significantly change the landscape for the insurance and reinsurance sectors, particularly in the context of outbound cross-border affiliate reinsurance. This summary briefly discusses some of the general corporate, business and international provisions and then focuses on the provisions of the Act that could have the most significant impact in the insurance and reinsurance space.

1. General Corporate and Business

a. *Rate change and alternative minimum tax* – The Act lowers the corporate income tax rate to 21% for taxable years beginning after December 31, 2017 and repeals the corporate alternative minimum tax.

b. *Dividend received deduction ("DRD")* – The 80% DRD for dividends paid from one eligible corporation to another is reduced to 65% (and the 70% DRD is reduced to 50%).

c. *Interest deductibility* – The Act generally provides that the net interest expense deduction (for interest paid to both related and unrelated parties) is limited to 30% of the taxpayer's "adjusted taxable income" for the taxable year. Under the Act, adjusted taxable income would be computed without regard to depreciation, amortization and depletion for taxable years beginning after December 2017 and before January 1, 2022. Thereafter, adjusted taxable income is computed taking into account these amounts, thereby lowering the threshold for disallowance to an amount closer to EBIT. Unused deductions are generally carried forward indefinitely. The new limitation does not apply to any electing real estate trade or business or to small-business taxpayers meeting a gross receipts test of less than $25 million. Although the new limitation is broader in certain respects than the existing earnings stripping rules that it replaces, it appears that a taxpayer exempt from the new rules may be able to deduct interest that would have been disallowed under the old Code § 163(j) rules—e.g., interest paid to a related foreign party even if the interest is not subject to U.S. tax. Note that unlike the House and Senate bills, the Act does not include the additional interest expense limitation that would have been imposed through a worldwide debt cap. This provision is expected to have a significant impact on leveraged buyouts and other debt-intensive deals (such as those in private equity).

d. *Net operating losses* – For taxable years beginning after December 31, 2017, the net operating loss ("NOL") deduction is limited to 80% of taxable income. In addition, the Act eliminates for most corporate taxpayers the ability to carryback NOLs and permits an indefinite carryforward. Notably, property and casualty ("P&C") insurance companies are not subject to the 80% limitation and are permitted to carryback NOLs for two years (and carryforward for 20 years, rather than indefinitely).

2. International

The Act provisions are generally designed to move towards a more "territorial" tax system, by creating a 100% DRD for foreign corporation dividends to a U.S. corporate shareholder holding at least 10% of its stock (by vote or value) ("10% U.S. Corporate Shareholder" or for both corporate and non-corporate shareholders "10% U.S. Shareholders") and applying a one-time "repatriation" tax

on 10% U.S. Shareholders in certain non-U.S. corporations based on such corporation's accumulated non-U.S. earnings. The Act also creates provisions designed to decrease "base erosion" transactions that reduce the U.S. tax base.

a. *100% DRD for foreign source dividends to 10% U.S. Corporate Shareholders* – Under new Code § 245A establishing a "participation exemption system," a 10% U.S. Corporate Shareholder (other than a RIC or REIT) may deduct 100% of the foreign-source portion of dividends received from such foreign corporation (other than a PFIC that is not a CFC), including its share of otherwise eligible dividends allocated to it by a partnership, as long as the 10% U.S. Corporate Shareholder meets a one-year holding period requirement. The Act provisions also contain the following:

i. *Deductible gains on stock sales.* Gains on the disposition of stock in a CFC with undistributed earnings, including lower-tier CFCs, are generally deemed to be a dividend that would qualify for the DRD.

ii. *Hybrid dividends.* No deduction is permitted for "hybrid dividends." A "hybrid dividend" is an amount otherwise eligible for the DRD for which the distributing CFC received a deduction (or other tax benefit) with respect to any income taxes imposed by any non-U.S. country or possession of the U.S. A hybrid dividend paid from one CFC to another may also result in subpart F income to a 10% U.S. Corporate Shareholder in such CFCs.

iii. *Adjustment to stock basis for loss.* Solely for determining a loss on the stock's disposition, the deduction reduces the stock basis.

iv. *No foreign tax credit.* No foreign tax credit or deduction is permitted for foreign taxes paid or accrued with respect to the dividend qualifying for the DRD.

v. *Income from transferred loss amounts.* A 10% U.S. Corporate Shareholder eligible for the above DRD on a non-U.S. corporation's dividends that transfers substantially all of a foreign branch's assets to the foreign corporation includes a "transferred loss amount" as U.S.-sourced income, subject to certain limitations.

vi. *Repeal of active trade or business exception for U.S. corporate Code § 367 transfers to non-U.S. corporations.* The Act also eliminates an exception under Code § 367(a)(5) to gain recognition by a U.S. person transferring property in an active conduct of a trade or business to a non-U.S. corporation in certain reorganizations or liquidations.

b. *One-time deemed repatriation tax* – The Act requires a one-time tax on a 10% U.S. Shareholder's share of post-1986 undistributed earnings (other than subpart F income or income effectively connected to a U.S. trade or business ("ECI")) of either a CFC or any non-U.S. corporation that has at least one 10% U.S. Corporate Shareholder. The rate of tax is 15.5% on accumulated foreign earnings held in cash or cash equivalents and 8% on the remaining amount (i.e., earnings invested in illiquid assets). A partial foreign tax credit is permitted generally in proportion to the taxable amount of income inclusion by the 10% U.S. Shareholder. Regulatory authority for appropriate basis adjustments relating to the inclusions is provided.

i. *Post-1986 undistributed earnings.* These earnings are determined as of November 9, 2017 or December 31, 2017, whichever results in a greater amount. Post-1986 undistributed earnings do not include previously included subpart F income, ECI, or earnings from periods prior to the existence of a 10% U.S. Shareholder. Deficits as of November 2, 2017 of other related specified non-U.S. corporations may reduce post-1986 undistributed earnings of a 10% U.S. Shareholder, including the pro rata share of deficits of another 10% U.S. Shareholder in the same affiliated group.

ii. *Installment payment of tax.* The 10% U.S. Shareholder may elect to pay the net tax liability over eight years.

iii. *Inverted foreign corporations.* If a foreign corporation engaged in a Code § 7874 inversion (an "expatriated

entity") not resulting in U.S. corporate status within 10 years of the bill's enactment, a full 35% deemed repatriation tax is instead applied without the benefit of a foreign tax credit offset.

iv. *Anti-abuse provisions.* The Act's language authorizes Treasury to provide regulations or other guidance to disregard transactions a principal purpose of which was to reduce the aggregate foreign cash position and to prevent the avoidance of the purposes of the deemed repatriation tax, including through a reduction in earnings and profits, changes in entity classification or accounting methods or otherwise.

c. *CFC status/subpart F income* – The Act contains the following provisions relating to CFCs and subpart F income:

i. *Attribution rules expanded.* Stock owned by a non-U.S. person is attributed downward to a U.S. person, effective for the last taxable year of a CFC beginning before January 1, 2018. For example, if a foreign (non-U.S.) parent corporation owns stock in a foreign corporation and a U.S. corporation, the U.S. corporation will be attributed the foreign parent's stock in the subsidiary foreign corporation.

ii. *U.S. Shareholder status.* The definition of a 10% U.S. Shareholder for purposes of the Code is changed to include any U.S. person who owns 10% of the value (as well as vote) of the stock of the non-U.S. corporation.

iii. *Elimination of 30-day rule.* CFC status is no longer dependent on the non-U.S. corporation being a CFC for 30 days of the tax year.

iv. *Code § 956 retained.* Subpart F income continues to include under Code § 956 a CFC's investment in U.S. property (including a loan to a U.S. subsidiary or certain credit support to such subsidiary), although originally eliminated in the House and Senate bill.

v. *Look-thru payment rule still sunsets.* A provision permitting a look-thru to income underlying related-party dividend, interest or royalty payment continues to expire after 2019.

d. *Foreign tax credits* – The Code § 902 deemed-paid foreign tax credit with respect to dividends received by a U.S. corporation that owns 10% or more of the voting stock of a foreign corporation is repealed. Foreign branch income is also required to be allocated to a specific foreign tax credit basket.

e. *Base erosion anti-abuse tax ("BEAT")* – An additional tax applies to certain corporate taxpayers (other than RICs, REITS, or S-corporations) with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least $500 million. The BEAT could have a significant impact on outbound cross-border affiliate reinsurance and is described in greater detail in Section VIII.A.4.a below. Taxpayers meeting that test that have a "base erosion percentage"—which generally is determined by the amount of deductions from base-eroding payments (defined below) to related parties—of 3% or higher for the tax year (2% in the case of banks and certain security dealers) must pay a tax equal to the excess of (a) 10% (or 5% for tax years beginning in 2018) of "modified taxable income" for the tax year, determined by adding back to taxable income "base erosion payments" and a portion of allowable NOLs, over (b) an amount equal to the taxpayer's "regular tax liability" for the tax year.

i. *Base erosion payment.* A "base erosion payment" generally includes a payment or accrual to a foreign-related party of a deductible amount, certain acquisitions of depreciable or amortizable property, and premium or other consideration for certain reinsurance payments. A base erosion payment does not include payments for certain services provided at cost, reductions in gross receipts, including payments for costs of goods sold, and certain qualified derivative payments.

ii. *Certain tax credits may increase BEAT.* The potential amount of BEAT may be increased by otherwise allowed credits, other than research credits and a portion of other Code § 38 business credits for low-income housing, renewable electricity production and certain investments allocable to energy, by reducing

"regular tax liability" by such credits when calculating the tax.

iii. *Post-2025 BEAT rate increase.* For tax years beginning after December 31, 2025 the 10% BEAT rate increases to 12.5% and the exception preventing research credits and a portion of other credits from increasing the BEAT is eliminated.

f. *Global and Foreign Derived Intangible Income – GILTI and FDII*. The Act provides for (i) the inclusion by 10% U.S. Shareholders of (and, thus, a tax on) "global intangible low-taxed income" or "GILTI" earned by CFCs, which is taxable at a lower rate and (ii) a deduction for certain "foreign-derived intangible income" or "FDII."

i. *GILTI inclusions from CFCs.* Under a new Code § 951A, 10% U.S. Shareholders in a CFC must include in income 50% of their share of "GILTI" (rising to 62.5% in 2026). GILTI is generally determined as the excess of aggregate net income (other than certain excluded income) over an assumed 10% rate of return on tangible business assets.

(1) *GILTI calculation.* GILTI is generally a CFC's modified gross income (excluding ECI, subpart F income, related-party dividends, certain high-tax income and certain other income) reduced by the excess of (a) 10% of the average of the aggregate of the CFC's adjusted basis in specified depreciable tangible property used in its trade or business over (b) certain allocated interest expenses.

(2) A deemed-paid foreign tax credit is permitted to be reduced generally by applying 80% of the corporation's GILTI inclusion percentage to the applicable foreign income taxes.

ii. *FDII deductions.* A U.S. corporation (other than a RIC or REIT) may deduct an amount equal to 37.5% of its FDII (decreasing to 21.875% after 2026).

iii. *FDII determination.* Similar to the GILTI formula, FDII is determined by assuming a rate of return on tangible business assets to determine foreign source deemed intangible income.

(1) *FDII calculation.* To calculate FDII, "deemed intangible income" is multiplied by a percentage determined by the amount of "deduction eligible income" considered foreign source.

(a) *"Deemed intangible income"* is "deductible eligible income" in excess of a deemed tangible income return. The deemed tangible income return is generally determined as 10% of the average aggregate adjusted tax basis in specified tangible depreciable property.

(b) *"Deduction eligible income"* is the corporation's gross income, excluding certain income including subpart F income, GILTI, certain financial services income and CFC dividend income to a 10% U.S. Shareholder, reduced by allocable deductions (including taxes).

(c) *"Foreign source deduction eligible income"* is generally deductible eligible income derived in connection with (i) the sale of property to a non-U.S. person that the taxpayer establishes is for foreign use or (ii) taxpayer-provided services established to be provided to any person, or with respect to property, located outside the U.S. Certain exceptions apply for transactions with related foreign parties or U.S. intermediaries.

g. *Other provisions aimed at base erosion* – The Act contains other provisions designed to address "base erosion" transactions that reduce the U.S. tax base.

i. *Denial of deduction for "hybrid" interest or royalty payments.* The Act denies a deduction for certain interest or royalty payments paid to a related party either (i) pursuant to a "hybrid transaction" involving inconsistent treatment under applicable foreign tax law or (ii) by or to a "hybrid entity" to the extent under applicable foreign tax law there is either no corresponding inclusion of income, or a deduction is permitted with respect to the amount. An entity that is fiscally transparent for U.S. federal income tax

purposes but not for foreign tax purposes, or vice versa, is a hybrid entity.

ii. *Definition of intangibles expanded.* The Act amends the definition of intangibles under Code § 936(h)(3)(B) to include any goodwill, going-concern value, or workforce in place or any other item the value or potential value of which is not attributable to tangible property or the services of any individual. Treasury is provided authority to require valuation on an aggregate basis or on the basis of realistic alternatives to the transfer. This change would have application to Code § 482 transfer pricing and certain Code § 367 transfers involving foreign corporations.

iii. *No reduced rate on dividends from inverted corporations.* Dividends received from surrogate foreign corporations defined in Code § 7874's provisions on inversion transactions that are not treated as U.S. corporations are not entitled to lower rates of tax for qualified dividends.

h. *PFIC changes affecting insurance companies* – The Act generally limits the application of the active insurance exception to the PFIC rules (the "Active Insurance Exception"), which is discussed in more detail under Section VIII.A.4.b below, to companies that would be treated as insurance companies for U.S. tax purposes with (i) losses and loss adjustment expenses, (ii) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and (iii) life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks equal to more than 25% of its total assets as reflected on the company's financial statement (with a lower 10% threshold applying in the case of certain run-off or rating-related circumstances, in which case a U.S. taxable investor may elect non-PFIC treatment) (the "Reserves Test"), provided certain other requirements are satisfied. Congress did not include unearned premium reserves in the Reserves Test calculation, despite intense industry lobbying efforts.

3. Select Insurance Company Tax Accounting Rules

The following subsections briefly summarize select insurance company tax accounting provisions in the Act that could impact the insurance and reinsurance sectors:

a. The tax rate applicable to life insurance companies would not include the 8% surcharge from the House bill.

b. NOL carryovers of life insurance companies would be conformed to the general rules, which would, as discussed above, be revised by the Act to eliminate the carryback period, provide for an indefinite carryforward and limit the offset for NOLs arising in taxable years beginning after December 31, 2017 to 80% of taxable income determined before the NOL carryover. Further, as noted above, the NOLs of property/casualty insurance companies would be carried back two years and carried forward 20 years and would not be subject to the 80% offset limitation.

c. The computation of life insurance reserves would be modified to limit the amount of the life insurance reserves for a contract (other than certain variable contracts) to the greater of the net surrender value of the contract or 92.81% of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined (the House version of the bill initially called for a 23.5% discount, which would have been catastrophic for some life insurance industry participants). The Act would allow for an eight-year spread of the difference in reserves as of December 31, 2017 resulting from the modification.

d. The loss reserve discounting rules applicable to property/casualty companies would be modified by changing the prescribed interest rate, extending the periods applicable under certain loss payment patterns and repealing the election to use a taxpayer's historical loss payment pattern rather than the aggregate industry-experienced-based pattern.

e. The amortization period for certain deferred acquisition costs ("DAC") would be extended from 10 years to 15 years (the original Senate plan called for a 50-year amortization), and the DAC rates would increase by roughly 19.5% (2.09% for annuity contracts, 2.45% for group life insurance contracts, and 9.2% for all other specified contracts subject to the DAC "tax").

f. The special 10-year rule for taking into account adjustments in computing life insurance reserves under Code § 807(f) would be replaced with the general rule for making tax accounting adjustments under Code § 481 (generally negative adjustments are deducted in the taxable year of the change and positive adjustments are required to be included ratably over four taxable years).

g. The proration rules for life and property/casualty insurance companies would be modified.

h. The Act generally would require an accrual-method taxpayer to recognize income that is subject to the all-events test no later than the taxable year in which the income is taken into account on the taxpayer's financial statements. The conference agreement providing an explanation of the Act states that the provision does not revise the rules associated with when an item is realized for federal income tax purposes and, accordingly, does not require the recognition of income in situations where the federal income tax realization event has not yet occurred. For example, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. Further, the provision's application to insurance companies subject to tax under Subchapter L of the Code is not clear, as the provision generally would not apply to any item of gross income for which a taxpayer uses a special method of accounting.

4. International Provisions with Significant Impact on the Insurance and Reinsurance Sectors

a) Prevention of Base Erosion

The Act generally adopted the Senate provision on base erosion, known as the BEAT, requiring an "applicable taxpayer" to pay the excess of 10% (5% for one taxable year beginning after December 31, 2017 and 12.5% for taxable years beginning after December 31, 2025) of "modified taxable income" for a taxable year over an amount equal to its regular corporate tax liability for that year reduced by certain credits (the "base erosion minimum tax amount"). Modified taxable income generally is computed by adding back the base erosion tax benefit derived from a base erosion payment, and a base erosion payment includes, among other items, any amount paid or accrued by an applicable taxpayer to a foreign related person that is deductible to the payor and any reinsurance premium paid to a foreign related person. An applicable taxpayer generally means a corporation with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least $500 million (subject to aggregation rules for certain groups) with a "base erosion percentage" (defined as the aggregate amount of base erosion tax benefits for the taxable year divided by the aggregate amount of deductions for such year) of at least 3%. A foreign person is related to the applicable taxpayer if either (i) it owns 25% or more of the taxpayer, (ii) it is related to the taxpayer or any 25% owner of the taxpayer under Code § 267 (related to loss disallowance rules applicable to transactions between related parties) or Code § 707 (related to transactions between partners and partnerships) or (iii) it is related to the taxpayer under the transfer pricing rules of Code § 482. The Act modified the Senate version to specify that reinsurance premiums generally would be treated as base erosion payments, likely in response to arguments that reinsurance premiums were not deductible payments otherwise subject to the base erosion minimum tax rules under the insurance accounting rules of Subchapter L of the Code. Such premiums appear to remain subject to the 1% federal excise tax on reinsurance premiums.

An offshore insurance and reinsurance group that engages in significant outbound cross-border affiliate reinsurance will need to assess its particular fact pattern to determine whether to continue such arrangements in their current form, including considering the possibility of establishing a Code § 953(d) reinsurer if the nontax benefits warrant the continuation of such arrangements.

b) Active Insurance Exception to the PFIC Rules

As noted above, the Act included a provision to tighten the Active Insurance Exception to the PFIC rules. A U.S. taxable investor in an offshore insurer or reinsurer is generally able to defer U.S. taxation until a sale of its shares in the offshore insurer or reinsurer and to pay tax on such sale at long-term capital gain rates, if, among other things, the offshore insurer or reinsurer qualifies for an exception to classification as a PFIC because it is treated as an insurance company for U.S. tax purposes that is predominantly engaged in the insurance business and is engaged in the active conduct of an insurance business (the "Active Insurance Exception"). The Act generally limits the application of the Active Insurance Exception to companies that would be treated as insurance companies for U.S. tax purposes with (1) losses and loss adjustment expenses, (2) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and (3) life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks equal to more than 25% of its total assets as reflected on the company's financial statements (with a lower 10% threshold applying in the case of certain run-off or rating-related circumstances, in which case a U.S. taxable investor may elect non-PFIC treatment) (the "Reserves Test"), provided certain other requirements are satisfied. Among other things, the Act could result in PFIC treatment for offshore insurers or reinsurers that write business on a low frequency/high severity basis, such as property catastrophe companies and financial guaranty companies, since significant reserves for losses are not recorded until a catastrophic or guaranty loss event actually occurs. Congress did not include unearned premium reserves in the Reserves Test calculation, despite intense industry lobbying efforts. It also is not clear how offshore life reinsurers that provide coverage on a modified coinsurance basis would avoid PFIC status.

c) Controlled Foreign Corporation ("CFC") Rules

A 10% U.S. Shareholder of a CFC would be required to include in income for a taxable year its pro rata share of subpart F income of the CFC, including certain insurance and related investment income, even if such income is not distributed. A non-U.S. insurer or reinsurer would be considered a CFC if 10% U.S. Shareholders own more than 25% of the vote or value of its shares. As noted above, the Act expanded the definition of 10% U.S. Shareholder to include U.S. persons owning 10% or more of the **value** of the CFC's shares (whereas current law only looks to voting power). In addition, the Act expanded certain attribution rules for stock ownership in a way that would cause foreign subsidiaries in a foreign-parented group that includes a U.S. subsidiary to be treated as CFCs. Although the conference agreement providing an explanation of the Act clarifies that the provision is intended to target transactions that avoid subpart F by "de-controlling" a foreign subsidiary so that it is no longer a CFC and indicates that the proposed rule is not intended to impact other 10% U.S. Shareholders that are not related to the U.S. subsidiary if the foreign subsidiaries are not otherwise treated as CFCs, the legislative language does not appear to comport with this intent.

As a result of the modifications to the CFC rules, voting cutback and push-up provisions in the organizational documents of many non-U.S.-parented insurance and reinsurance groups will be ineffective in avoiding 10% U.S. Shareholder status of 10% or greater U.S. economic owners in the CFC analysis. U.S. tax exempt entities subject to the unrelated business taxable income ("UBTI") rules that own 10% or more of the value of a non-U.S. insurer or reinsurer that is characterized as a CFC should consider the implications of Code § 512(b)(17), which could result in UBTI for such investors. In this regard, it should be noted that the Act rejected a House provision

that would have subjected state and local pension plans to the UBTI rules.

B. U.K. Corporate Tax Residence: Recent Reported Case

Considering U.K. tax developments, 2017 saw a further addition to the line of cases on the subject of U.K. corporate tax residence, namely the U.K. First Tier Tribunal ("FTT") decision in Development Securities [2017] UKFTT 565 (TC), which was published on July 14, 2017.

The residency of a company for U.K. tax purposes turns on the detailed facts. Under U.K. tax law, a company will be resident in the U.K. if it is either incorporated there, or has its "central management and control" there. This means that it is possible for non-U.K. incorporated companies to be U.K. tax resident by virtue of being centrally managed and controlled in the U.K. Consequently, it is also possible for such companies to be dual resident, which means that, absent any U.K. tax treaty "tie breaker," such companies will face certain U.K. tax restrictions. (Such tie-breaker may determine a company's sole residency jurisdiction according to where its place of effective management is situated. This will often in practice be the same location as that of the company's central management and control, although the two tests are not the same. However, the "place of effective management" tie-breaker that exists under many U.K. treaties will in due course be replaced with a competent authority agreement tie-breaker clause once the U.K. gives effect to the Multilateral Instrument, discussed in the next section below.)

The "central management and control" concept originates from the leading case of De Beers Consolidated Mines Ltd v. Howe (Surveyor of Taxes) [1906] AC 455, 5 TC 198. It means the place where the "real business" is carried on. Subsequent case law and guidance by HM Revenue and Customs ("HMRC") has since refined the circumstances in which a company will, and will not, be considered to be centrally managed and controlled in the U.K. for U.K. tax purposes, although it is by no means a "bright line" test. Normally, the place of central management and control will be the place where the board of directors meets to exercise its powers in accordance with the company's constitutional documents. However, this will not necessarily be so, in more unusual circumstances. The case law prior to Development Securities indicates that an English court will consider a non-U.K. incorporated company to be centrally managed and controlled in the U.K. for U.K. tax purposes if (for example):

- The fact pattern indicates that "high level" policy, management or strategic decisions on behalf of a non-U.K. company are actually taken (by the directors) in the U.K., regardless of what the company's constitution says; and/or

- The powers of the local board of a non-U.K. company have effectively been usurped by a U.K. resident person (typically a U.K. resident parent or other dominant shareholder) and not merely influenced by that person's advice or recommendations—with the result that the board ends up effectively "rubber stamping" the decisions of that U.K. person. In order to prevent the board's powers from being usurped in this manner, some level of engagement by the board in the decision-making process is required, even if that decision is ill-informed or ill-advised.

HMRC guidance (Statement of Practice 1/90) broadly reflects the approach of the English courts. In HMRC's view, central management and control is the place where "the real heart of the company is" and one needs to look to the "command structure" of the company to determine where central management and control is in fact exercised. HMRC emphasize that the place where the board meets is significant only to the extent that these meetings are the medium through which central management and control is exercised, and that if, for example, the directors are actively engaged in running the business from the U.K., the company will not be regarded as resident in, say, Bermuda merely because its formal board meetings are held there. The HMRC guidance specifically addresses the situation of a non-U.K. subsidiary of a U.K. parent. It acknowledges that the parent will normally influence, to a greater or lesser extent, the actions of the subsidiary and the question is the degree of autonomy which the directors have in conducting the subsidiary's business.

The Development Securities case concerned a highly unusual set of circumstances in which DS plc, the U.K. parent company, wished to implement a tax planning scheme devised by a Big 4 accounting firm that was designed to create capital losses for the benefit of the group as a whole. In broad outline, the scheme involved a newly incorporated Jersey company purchasing from a fellow group company some capital assets at a price significantly above their market value, and then becoming U.K. tax resident before disposing of the assets to a third party at a sizable loss, all within the space of a few weeks. It was essential to this U.K. tax planning that the Jersey company was non-U.K. resident at the time it acquired the assets. The FTT held that the Jersey company was in fact centrally managed and controlled in the U.K. from the outset, and hence U.K. resident at the time it acquired the assets, on the grounds that the transaction was inherently uncommercial and the Jersey board was convened merely to confirm the legality of the transaction.

The FTT noted that it does not necessarily follow that central management and control of an overseas group company, which has been formed for a specific purpose (whether as part of a tax plan or otherwise), is in the U.K., if it falls in with the plan of the U.K. group parent and does what is expected, provided that proper consideration is given to the proposal and the directors are in fact exercising their discretion to exercise central management and control of the company. The directors must attempt to understand the consequences of what they were signing or agreeing to. As a matter of Jersey company law, because the acquisition of the assets was clearly not in the commercial interests of the Jersey company, it could only lawfully take place with approval from the shareholder. There was no evidence in the board minutes or any other written records, nor in the directors' testimony, that the board considered for itself whether the transactions were for the company's or the parent's benefit; any discussion was confined to the position as to the legality of the proposed acquisition under company law, based on the approval by the parent. Accordingly, the FTT came to the "inescapable conclusion" that the Jersey board was simply acting on the instructions of its U.K. parent, DS plc.

Some important practical considerations emerge from the FTT's decision.

First, the FTT reviewed in considerable detail not only the minutes of the key board meetings but also the nature and sequencing of the prior preparations (including the incorporation of the company, the appointment of the directors and the circulation of board packs), all the associated emails and other communications with group executives, advisors and service providers, and also the contemporaneous notes taken during the board meetings. This illustrates that careful implementation is crucial in the context of the highly factual test for determining U.K. tax residency status.

Secondly, the fact that the only director on the Jersey board, who was not a "professional" director supplied by a local service provider, was a U.K. resident officer and the company secretary of DS plc was not necessarily damning; indeed, the FTT specifically concluded that he did not exercise any particular dominant or influential role as regards the Jersey board.

Thirdly, the FTT focused on the key decisions of a strategic or management nature (in this case, to acquire the assets and then to migrate the tax residency to the U.K.), paying little attention to the various administrative and mechanical steps which were undoubtedly taken by the local directors.

Fourth, the FTT took the view that substantive decision-making involves looking at the merits of the proposed transaction, not merely compliance with applicable company law requirements. The prefacing, in the board minutes, of the record of the board resolution with the formulaic wording "after consideration" was not sufficient evidence of any independent thought on the part of the directors.

Finally, the decision suggests that the FTT would have accepted that the Jersey board had engaged in genuine local decision-making if the FTT had been presented with evidence of a discussion by the directors as to a reason for the board to go through with the transaction other than because a (U.K. resident) third party wanted

them to do so, even if the intended benefit had been to the parent or the wider group rather than the company itself. However, it is clear that if a transaction is inherently uncommercial from the company's solo perspective, in similar circumstances, absent any evidence of the exercise of independent discretion by the directors to agree to a course of action proposed by the U.K. parent, the inevitable conclusion is that the company is acting on the instructions of the parent, with the result that the company's central management and control will be in the U.K.

C. OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument")

The U.K. signed up to the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (also known as the "Multilateral Instrument" or "MLI") on June 7, 2017, along with 66 other countries. The text of the MLI was published by the OECD on November 24, 2016 with a view to being transposed into more than 2,000 tax treaties worldwide and sets out some minimum standards to address certain concerns identified in the OECD's work on base erosion and profit-shifting ("BEPS"): Action 2 (Hybrid Mismatches), Action 6 (Treaty Abuse), Action 7 (artificial avoidance of permanent establishments) and Action 14 (improving dispute resolution).

In addition to the competent authority agreement tie-breaker test for determining company residence discussed briefly in the preceding section, the U.K. will be implementing a "principal purpose test" ("PPT") in its tax treaties, which denies treaty benefits to persons for whom obtaining treaty benefits is one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in those benefits. The U.K. will not be implementing a supplementary "limitation of benefits" clause in its treaties (although, exceptionally, the U.K.-U.S. treaty already has such a clause) notwithstanding the fact that the OECD has given member countries the option to do so. The U.K. will also opt to implement a binding arbitration procedure (in addition to the required dispute resolution mechanism) for situations where a taxpayer considers that it is being unfairly denied treaty benefits. Perhaps unsurprisingly, the U.K. will not be implementing the recommended changes to the definition of a "permanent establishment" in its treaties, given that the U.K. diverted profits tax regime already substantively addresses the relevant issues highlighted by the OECD in Action 7.

Annex A-Glossary of Certain Regulatory Bodies

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

AMF—the French Autorité des Marché Financiers, which is France's listing authority for securities on its exchanges.

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

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

CFIUS—the Committee on Foreign Investment in the United States, an inter-agency U.S. government entity that reviews foreign acquisitions to determine whether they may threaten U.S. national security.

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

FCA—the U.K.'s Financial Conduct Authority, which oversees the conduct of the U.K.'s financial institutions, including insurers, as well as acting as the U.K.'s listing authority for securities on its exchanges.

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

FEMA—the U.S. Federal Emergency Management Agency, which, among other things, administers the NFIP.

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

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

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

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

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

Lloyd's—Lloyd's of London, the specialist insurance and reinsurance market comprised of numerous managing agencies, underwriting syndicates and capital providers.

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

NYDFS—the New York Division of Financial Supervision, whose Insurance Division is responsible for insurance regulation in New York.

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

SEC—the U.S. Securities and Exchange Commission.

Treasury—the U.S. Department of the Treasury.

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

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