WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

NAIC HIGHLIGHTS — WINTER 2009 NATIONAL MEETING

The NAIC

The National Association of Insurance Commissioners (the "NAIC") works to coordinate the efforts of the insurance commissioners of the U.S. states and territories and the District of Columbia (including by promulgating model laws and regulations and encouraging adoption thereof by legislators and regulators). The NAIC held its Winter 2009 National Meeting from December 3 through December 8, 2009 in San Francisco, California. At this meeting, many important issues were discussed by the various NAIC committees, task forces and working groups. Set forth below are certain highlights of the meeting.

Solvency Modernization Initiative

Group Solvency Issues

The Group Solvency Issues (EX) Working Group of the SMI (EX) Task Force met on December 4, 2009 and received preliminary comments on several exposure drafts including: Insurance Holding Company System Model Act (#440) ("IHCA"),[1] Insurance Holding Company System Model Regulation (#450) ("IHCR"),[2] Holding Company Best Practices,[3] Draft Memorandum on Group-wide Supervision,[4] and IAIS Draft Guidance Paper on Treatment of Non-Regulated Entities in Group-wide Supervision.[5] Comments are due by January 29, 2010 with the exception of the IAIS Draft Guidance Paper, for which comments are due on January 15, 2010. The Working Group also received reports from representatives of the Australian Prudential Regulation Authority and the Financial Services Authority regarding their respective jurisdiction's perspectives on group-wide supervision.

Proposed revisions to the IHCA and IHCR focus on transactions within insurance holding company systems, expanded regulatory authority to assess the financial and reputational impact of holding company affiliates on U.S. insurers (including the introduction of supervisory colleges) and consolidated filings and hearings in connection with the acquisition of control of affiliated insurers.

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1 The draft IHCA is *available at* http://naic.org/documents/committees_ex_isftf_group_solvency_exposure_100129_440.doc.

2 The draft IHCR is *available at* http://naic.org/documents/committees_ex_isftf_group_solvency_exposure_100129_450.doc.

3 The draft Holding Company Best Practices is *available at* http://naic.org/documents/committees_ex_isftf_group_solvency_exposure_100129_HC_best.doc.

4 The Draft Memorandum on Group-wide Supervision is *available at* http://naic.org/documents/committees_ex_isftf_group_solvency_exposure_100129_draft_memo.doc.

5 The IAIS Draft Guidance Paper on Treatment of Non-Regulated Entities in Group-wide Supervision is *available at* http://naic.org/documents/committees_ex_isftf_group_solvency_exposure_100115_iais_GP.pdf.

The IHCA currently provides for the application of certain general standards to agreements between a U.S. insurer and any member of its holding company system, including requirements related to reasonable contract terms and fees and proper allocation of expenses. Proposed amendments to the IHCA would incorporate very specific standards for cost sharing and management agreements affecting, *inter alia*, the maintenance of books and records, monthly reporting, indemnification, receivership of the insurer, and termination rights. During the December 4 meeting, regulators discussed the proposed revisions noting that the level of specificity suggested in the changes may be more appropriate for the IHCR than the IHCA, and also considered whether such standards should apply to all transactions between an insurer and its affiliates rather than being limited to cost sharing and management agreements. In addition, questions were raised regarding whether proposed contract terms related to an insurer's receivership were already incorporated in existing receivership statutes, and further study will be conducted in this regard. A proposed requirement that an insurer's board oversee compliance with cost sharing agreement standards drew significant discussion but was ultimately tabled.

Other proposals discussed by the Working Group included a new requirement that insurers notify regulators of amendments to approved agreements. In particular, the Group discussed appropriate thresholds for such notice and whether the filing standard should be notice, approval or non-disapproval. A proposal to remove the threshold for filing affiliate reinsurance agreements (5% or surplus) was also debated.

The Working Group has also been charged with studying the current state of U.S. group supervision and recommending enhancements to the oversight of U.S. insurers operating within corporate groups. A Draft Memorandum on Group-wide Supervision, which was exposed for comment, notes that the U.S. insurance regulatory system is generally characterized as a "solo entity" or "legal entity" approach to regulation, with attention focused on the U.S. regulated insurer. This contrasts with other jurisdictions that apply a consolidated or hybrid approach to insurance regulation by focusing on the entire holding company system. The draft memorandum suggests that, in fact, the U.S. system is a "solo plus" system in light of U.S. regulators' authority to monitor groups by virtue of licensing, holding company regulation and financial analysis. Nevertheless, the draft memorandum recommends the enhancement of U.S. group supervision in certain areas, suggesting a "windows and walls" approach to regulation which would "provid[e] a window into group operations, while building upon, rather than rejecting, the existing walls which provide solvency protection" to U.S. insurers. Specifically, the memorandum suggests the addition of the following general "regulatory windows": communication between regulators (the coordination of state participation on a national level for sharing information with international regulators); supervisory colleges for internationally active groups; access to information about unregulated entities within the holding company system; and group capital requirements to avoid potential financial and reputational contagion to other group entities.

Proposed changes to the IHCA would provide certain "regulatory windows" into the insurance holding company system. For example, in connection with obtaining approval to acquire control of a U.S. insurer, an applicant would be required to (i) agree to provide annual reports to the regulator identifying all material risks within the holding company system that could pose a financial or reputational contagion to the insurer and (ii) agree that it, and all subsidiaries within its control, would provide information to the regulator upon request as necessary to evaluate the risk of

financial and reputational contagion to the insurer. Failure to comply with such agreements may serve as an independent basis for disapproving dividends from the insurer. The draft IHCA would also increase the regulators' authority to examine the insurer and its affiliates and impose harsh penalties on the insurer for failure to produce such information.

Lastly, the revised IHCA would provide for the regulators' participation in supervisory colleges. As background, a report to the Working Group's Subgroup on Supervisory Colleges and Methods of Cross Border Communications notes that the use of supervisory colleges has been increasing in recent years, especially with respect to the regulation of global financial institutions.[6] The Obama Administration has recommended that U.S. authorities enhance the supervision of significant global financial institutions through the establishment and continued development of supervisory colleges consisting of the regulators of such institutions in various countries.[7] A "supervisory college" does not currently have a universal definition but is "essentially a meeting of all the regulators of entities that are part of a financial group, including regulators from outside the group's domiciliary jurisdiction."[8] The revised draft IHCA authorizes U.S. insurance commissioners to participate in supervisory colleges in order to determine the regulated insurer's compliance with the IHCA. A new Section 7(C) provides:

> In order to assess the business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance processes, and as part of the examination of individual insurers . . . the commissioner may participate in a supervisory college with other regulators charged with supervision of the insurer or its affiliates, including other state, federal and international regulatory agencies.

U.S. insurance commissioners would be authorized to initiate the establishment of supervisory colleges (which may be temporary or permanent forums) and coordinate their ongoing activities. The commissioner's expenses would be payable by the regulated insurer. The commissioner's authority to share confidential information would be expanded to include members of supervisory colleges. In this respect, the Subgroup is conducting a survey of state regulators regarding whether, pursuant to their confidentiality laws, the states are authorized to sign the IAIS Multilateral Memorandum of Understanding on Cooperation and Information Exchange rather than signing separate memoranda of understanding with each nation. The regulators' review of supervisory college participation is ongoing, including discussions of the role of the NAIC, lead state appointment and the possibility of a white paper on supervisory colleges.

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6 Memorandum from Daniel Schelp, Managing Attorney, NAIC Legal Division to Subgroup on Supervisory Colleges and Methods of Cross Border Communications, dated October 5, 2009.

7 Minutes of Group Solvency Issues (EX) Working Group Conference Call, November 12, 2009.

8 *See* Schelp Memorandum, *supra* n. 6.

Regulatory Modernization

On December 5, the NAIC held a Regulatory Modernization Public Forum in order to describe and receive comments on the proposed National Insurance Supervisory Commission (the "NISC").[9] The NISC proposal was developed by the Regulatory Modernization (EX) Subgroup in support of the NAIC's goals of enhanced regulatory uniformity and to respond to national and international challenges to a state-based system of regulation. Recent federal proposals to establish a national insurance office within the Treasury Department and federal bills attempting to address issues of insurance uniformity were cited as external pressures for regulatory reform.

The central element of the NISC proposal is a "Commission," authorized by an act of Congress and comprised of states, which would establish, adopt and implement standards for uniform national regulatory treatment of certain identified areas of insurance. Once legislative action is taken by a state to join the Commission, the Commission's uniform standards would apply to the state; no affirmative action would be required by the state legislature or regulator to adopt Commission standards. The NISC proposal envisions the formation of a federal Office of National Insurance ("ONI") or Federal Insurance Office ("FIO") as proposed in certain currently pending federal bills. If a state fails to adopt legislation to join the Commission the ONI/FIO rulemaking would preempt conflicting state law.

A legislative committee comprised of state legislators would monitor the operations of, and make recommendations to, the Commission. The Commission would report to the ONI/FIO to share information and report on the development and implementation of national uniformity.

State legislators represented by the National Conference of Insurance Legislators and National Conference of State Legislators strongly opposed the NISC proposal. The state legislators objected to the substance of the NISC which they claim ignores the separation of powers between the legislative and executive functions by substituting insurance regulators for legislators as the rule makers on insurance issues and promotes the preemption of state law by the federal government rather than presenting a unified state posture in opposition to federal initiatives. State legislators also objected to the development of the NISC proposal, which they said was done without consultation.

Valuation of Securities

Residential Mortgage Backed Securities Proposal

In recent months a significant segment of AAA rated residential mortgage backed securities ("RMBS") have been downgraded by one or more Nationally Recognized Statistical Rating Organizations (collectively, "NRSROs") to below investment grade, resulting in a significant

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[9] The National Insurance Supervisory Commission Discussion Draft can be found at http://www.naic.org/documents/committees_ex_rmsg_nisc_discussion_draft.pdf.

increase of RBC required for the life and health insurers that hold RMBS.[10] In a proposal made earlier this year, the American Council of Life Insurers (the "ACLI") brought to the regulators' attention that NRSROs' ratings do not discern securities that, in the event of default, are projected to experience a near total loss, such as a typical corporate bond, from securities projected to continue paying out remaining principal and interest subject to minor losses, such as RMBS.[11]

In November 2009, the NAIC adopted a proposal that for year-end 2009 reporting purposes, RBC for non-agency RMBS would be determined using a financial model instead of the NAIC ARO credit ratings (the "Short Term Proposal").[12] The NAIC determined that the flaw in relying on rating agency default rating methodologies for RBC is that default ratings predict the likelihood of default but not the impact an actual default would have on the tranches of insurance company-owned structured securities. The modeling proposal would look at RMBS on a CUSIP-by-CUSIP basis to determine the actual projected loss, thereby taking into account both probability of default and severity of loss.[13] During its interim meeting via telephone conference on November 17, 2009, the Executive (EX) Committee passed a motion to award the RMBS modeling contract to Pacific Investment Management Company ("PIMCO") Advisory, an independent analytical services firm, to assist the NAIC with calculating expected carrying value for each RMBS and estimating losses in RMBS held by U.S. insurers for their year-end 2009 reporting.[14]

During its December 6, 2009 meeting, the Valuation of Securities (E) Task Force formally placed non-agency RMBS under regulatory review.[15] To provide guidance for accounting for RMBS under regulatory review, the Task Force adopted revisions to (i) the Statement of Statutory Accounting Principle ("SSAP") No. 43 - Loan-backed and Structured Securities - Revised (SSAP 43R) and (ii) the Interim Reporting Instructions for the Year Ending December 31, 2009 For Use in

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[10] The NAIC has historically utilized credit quality ratings issued by NRSROs to set RBC by assigning an NAIC Designation to any NRSRO-rated securities based on a prescribed formula, and RBC charges are determined by reference to the NAIC Designation. The Purposes and Procedures Manual (the "Purposes and Procedures Manual") of the NAIC Securities Valuation Office (the "SVO"), which sets forth the NAIC's procedure for placing a security or asset class under regulatory review, identifies the criteria that make an NRSRO eligible to be an NAIC vendor of rating services, and an NRSRO that meets such criteria may be added to the NAIC Acceptable Rating Organization (each, an "ARO") List by the SVO if directed by the Capital Adequacy (E) Task Force.

[11] It is estimated that with almost half a trillion dollars in RMBS, downgrades are driving increases in RBC to an additional $9 billion for year-end 2009. *See* Valuation of Securities Task Force Minutes, September 22, 2009.

[12] The Short Term Proposal affects non-agency RMBS, which are securities created by private, not government-sponsored, entities. As used herein, the term RMBS refers only to non-agency RMBS, unless otherwise specified. The NAIC intends that the Short Term Proposal would be in effect until the long term solution is in place to determine the appropriate NAIC Designation for RMBS.

[13] *See* Valuation of Securities Task Force Minutes, September 22, 2009, *supra* n. 11.

[14] In selecting PIMCO, the NAIC considered factors such as modeling technique, assumptions and conflicts of interest, and PIMCO was considered to have met or exceeded all foregoing criteria.

[15] The regulatory review process was undertaken in accordance with the procedure specified in Part Two, Section 3(e) of the Purposes and Procedures Manual.

Reporting Residential Mortgage Backed Securities.[16] Placing RMBS under regulatory review permits regulators to determine the appropriate NAIC Designation for RMBS, used to calculate the RBC charge for the RMBS held by U.S. insurers at year-end 2009. As a result, RMBS are no longer eligible for the filing exempt rule and ARO rating cannot be used to derive RBC for RMBS.[17]

Agency RMBS would not be subject to regulatory review by the SVO and resulting financial modeling. Instead, insurers would continue to utilize the ARO ratings along with the carrying value to determine the appropriate NAIC Designation for such RMBS. RMBS with no ARO ratings would follow the existing "Not Rated" or "NR" process and be filed with the SVO or be subject to the certification process set forth in the Purposes and Procedures Manual.

Depending on the outcome of the financial modeling of the non-agency RMBS, NAIC may apply the similar RBC methodology to other structured securities, such as commercial mortgage backed securities.

Reduction of Regulatory Reliance on Rating Agencies

During the Fall 2009 National Meeting, the Rating Agency (E) Working Group held a public hearing to discuss the role of rating agencies in state insurance regulation. During the hearing, a panel of insurance and ratings experts informed state insurance regulators of the flaws in the current use of ratings in insurance regulation (such as treating partial loss on RMBS similar to near total losses on typical corporate bonds) and urged regulators to reduce their reliance on rating agencies, particularly with respect to certain types of structured securities, such as RMBS.

The Rating Agency (E) Working Group prepared a draft report to the Financial Condition (E) Committee, which was discussed during the Working Group's December 6, 2009 meeting, and in which the Working Group recommended that the NAIC: (i) ascertain ways for the NAIC and regulators to reduce their reliance on ARO ratings for structured securities or alternative asset classes, particularly by introducing additional or alternative risk measurement benchmarks; (ii) explore alternative investment risk assessment measures by regulators, including expansion of the SVO's scope of assessment; and (iii) require major reforms of rating agencies to obtain or maintain the ARO status.

Specifically, in its draft report, the Working Group noted the difficulty with assuming that the ARO ratings and the resulting NAIC Designation, which is the basis for determining the RBC, are comparable. The Working Group further noted that despite efforts by certain AROs, rating agencies in general have not yet established a consolidated or uniform rating scale, and that ARO

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16 The Interim Reporting Instructions are *available at* http://www.naic.org/documents/committees_e_vos_rmbsinteriminstrux_091217.pdf.

17 While certain securities that are rated by an ARO are assigned an equivalent NAIC Designation (subject to certain limitations) and are exempt from the filing requirements with the SVO, non-agency RMBS are no longer exempt. Instead, non-agency RMBS are required to be reviewed by the SVO in a process that replaces ARO ratings with a financial model to establish price ranges for each non-agency RMBS to be translated to appropriate NAIC Designation and accompanying RBC charges.

ratings should not be used to set RBC for structured securities because the probability of default methodology for structured securities does not reflect the loss severity characteristics of different senior tranches in different securitizations. The Working Group recommended in its draft report that the SVO evaluate the materiality of the difference between the rating for municipal and other securities to warrant changing how ARO ratings are converted into the NAIC Designations. The Working Group also noted in the draft report that many insured municipal bonds' ratings only assess the risk of the financial guaranty insurer insuring the bonds and its corporate rating, but not the risk of the municipality. The Working Group reported that to assign appropriate NAIC Designations, the SVO has been temporarily authorized by the regulators to evaluate the credit worthiness of the municipalities.

The Working Group recommended in its draft report that the NAIC continuously monitor and evaluate AROs' activities by promoting transparency of the rating determination process, compensation, and the like. The Working Group also recommended that the regulators, industry and consumers rely on federal legislation to develop a regulatory framework for the rating agency industry. The Working Group noted that the SVO, as a not-for-profit agency, was free from competitive pressures that could lead to the conflicts of interest faced by AROs and recommended that regulators evaluate whether to expand the role of the SVO to increase regulator reliance on the SVO for evaluating credit and other risks of securities. The Working Group also recommended in its draft report recalibration of RBC formulas to require different levels of capital for municipal, corporate and structured securities.

The draft report was released for exposure with comments due January 6, 2010, with the objective of presenting a final report to the Financial Condition (E) Committee before the March 2010 National Meeting.

Reinsurance Issues

Reinsurance Regulatory Modernization Framework Proposal

As discussed in previous NAIC Highlights, the NAIC adopted the Reinsurance Regulatory Modernization Framework Proposal (the "Framework") during its Winter 2008 National Meeting to reform state reinsurance regulation for both domestic and foreign reinsurers electing to participate.[18]

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[18] NAIC Highlights - Fall 2009 National Meeting (October 9, 2009) 1-4, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3129/NAIC%20Highlights%20Fall%202009%20Meeting.pdf; NAIC Highlights - Summer 2009 National Meeting (June 25, 2009) 1-3, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3015/NAIC_Highlights_Summer_2009_Meeting.pdf; *see also* NAIC Highlights - Spring 2009 National Meeting (March 15, 2009) 1-3 (describing the Framework in further detail), *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2932/NAIC_Highlights_Spring_2009_Meeting.pdf; *see also* NAIC Highlights - Winter 2008 National Meeting (Dec. 19, 2008) 1-2, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2826/NAIC_Highlights_Winter_2008_National_Meeting.pdf; NAIC Highlights - Fall 2008 National Meeting (Oct. 3, 2008) 3-7, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2718/NAIC_Highlights_Fall_2008_National_Meeting.pdf; NAIC Highlights - Summer 2008 National Meeting (June 12, 2008) 1-3, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2616/NAIC_Summer_2008.pdf; NAIC Highlights - Spring 2008 National Meeting (April 8, 2008) 1-2, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2582/NAIC_Spring_2008.pdf.

The Framework is part of the larger NAIC Solvency Modernization Initiative.[19] As a first step toward implementation of the Framework, on March 24, 2009 the Reinsurance Task Force exposed a draft federal bill entitled the "Reinsurance Regulatory Modernization Act of 2009" (the "RRMA") for comments through April 23, 2009.[20]

During the NAIC Fall 2009 National Meeting, the Government Relations Leadership Council approved the submission of the RRMA to Congress. However, as reported to the Government Relations Leadership Council, the NAIC-endorsed RRMA has failed to gain traction on Capitol Hill this fall, largely due to the lack of appetite for this proposal among domestic reinsurers. In addition, the section of the bill regarding points of entry has been unpopular with the U.S. Department of the Treasury. Therefore, the Reinsurance (E) Task Force is focusing its attention on the credit for reinsurance section of S. 1363, the Senate counterpart to the Nonadmitted and Reinsurance Reform Act of 2009 (H.R. 2571), which passed the House of Representatives unanimously on September 9, 2009 (the "NRRA"), a proposal on which the Task Force circulated to the Leadership Council for a regulator-to-regulator only discussion on December 14.

Congressional Initiatives Affecting Insurance

At its meeting on December 7, 2009, the Government Relations (EX) Leadership Council discussed recent federal initiatives regarding financial regulatory reform and the efforts made by NAIC members and staff to protect state-based regulation of the insurance industry from encroachment from various pieces of federal legislation. Four days later, on December 11, the House of Representatives approved H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill"), introduced by Financial Services Committee Chairman Barney Frank (D-MA) and intended to provide for financial regulatory reform, protect consumers and investors, and enhance the federal government's understanding of insurance issues, among other things.

At its meeting, the Government Relations (EX) Leadership Council addressed three important pieces of legislation that could affect state-based insurance regulation: the Consumer Financial Protection Agency Act of 2009, the Financial Services Improvement Act of 2009, and the Federal Insurance Office Act of 2009. These specific acts, or at least key concepts within each piece of legislation, were incorporated into the omnibus House Bill. The Consumer Financial Protection Agency (the "CFPA") is tasked with regulating the provision of consumer financial products and services and otherwise providing consumer protection. The Financial Services Committee legislation regarding the CFPA initially sought to bring consumer protection elements of credit, mortgage, and title insurance under the jurisdiction of the CFPA, but the NAIC and members of the insurance industry were successful in their efforts to amend the House Bill to remove the entire "business of insurance" from the CFPA's regulation.

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[19] The Solvency Modernization Initiative is coordinated by the Solvency Modernization Initiative (EX) Task Force, which oversees the work of five NAIC groups focusing on capital requirements, international accounting, group supervision, valuation issues in insurance, and reinsurance. A summary of SMI activities can be found at http://www.naic.org/committees_ex_isftf.htm.

[20] The draft RRMA is *available at* http://www.naic.org/documents/committees_e_reinsurance_090915_reins_ref_modernization_act.pdf.

The establishment of the Financial Services Oversight Council, under the Financial Services Improvement Act of 2009 incorporated into the House Bill, also has the potential to affect the insurance industry. The Council's duties include monitoring the financial services markets to identify potential threats to the stability of the American financial system. The legislation provides the Financial Services Oversight Council with the authority to wind down large, failing financial companies in an orderly manner. However, it was reported that the NAIC successfully worked with Financial Services Committee members on an amendment that maintains state insurance regulators' receivership authority over insurance companies. A manager's amendment, which would require the Financial Services Oversight Council to resolve failing insurers in accordance with state law, was introduced by Congressman Frank and also passed on December 11.[21]

Lastly, the Government Relations (EX) Leadership Council discussed legislation creating an FIO within the Treasury Department. The Federal Insurance Office Act initially was voted out of Committee on December 3 and was then incorporated into the House Bill. The FIO's duties include monitoring the insurance industry, identifying gaps in the regulation of insurers that could contribute to systemic crisis in the industry and financial system, and determining whether state insurance measures are preempted by certain international agreements. The NAIC believes the current FIO legislation is narrower than the initial draft. The current legislation contains provisions that explicitly state that the creation of the FIO does not establish general supervisory or regulatory authority of the Treasury Department over the insurance industry and that nothing in the House Bill preempts state measures governing rates, premiums, underwriting or sales practices, and capital or solvency requirements (unless disparate treatment of foreign entities would result).

A discussion draft of a parallel bill, the Restoring American Financial Stability Act, was introduced in the Senate on November 10, 2009 by Banking Committee Chairman Christopher Dodd (D-CT) (the "Senate Bill"). The NAIC is currently working with Banking Committee members to have the provisions of the Senate Bill mirror the House Bill.

Statistical Agent for Principles-Based Reserving Needs

At a joint meeting of the Executive (EX) Committee and Plenary during the NAIC Fall 2009 National Meeting, the NAIC adopted amendments to the Standard Valuation Model Law (#820) to implement the principles-based reserving methodology. The amended model law requires a life insurance company to submit its experience data to applicable state insurance regulators through a statistical agent, the NAIC or directly as prescribed in the Valuation Manual. During the Fall Meeting, the Principles-Based Reserving (EX) Working Group exposed for comments until November 9, 2009 a draft memorandum to the Executive (EX) Committee, which requests the membership's input on whether the NAIC should serve as a statistical agent (or some other centralized agent) for the collection and submission of insurers' experience data to state insurance regulators (the "Draft Letter").

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[21] That same manager's amendment would also require states to adopt annuity suitability standards at least as strict as the standards adopted by the NAIC.

During its meeting on December 5, 2009, the Principles-Based Reserving (EX) Working Group discussed the comments on the Draft Letter submitted by three parties. While the comment letters from a state insurance regulator and an insurance industry member supported the NAIC's involvement in the data collection process, a life insurance trade group's comment letter opposed such involvement noting the NAIC's lack of expertise on the collection and/or processing of large volumes of data and the abundant availability of private entities with such expertise.

Update on the Revised Model Audit Rule

In 1980, the NAIC adopted the Model Regulation Requiring Annual Audited Financial Reports. The most recent amendments to the Model Regulation were adopted by the NAIC on June 11, 2006, which changed the Model Regulation's name to the Annual Financial Reporting Model Regulation (#205) (as amended, the "Model Audit Rule"). Based in large part on the Sarbanes-Oxley Act of 2002, the goal of the Model Audit Rule is to improve financial oversight of insurers. At its meeting on June 13, 2009, the Financial Regulation Standards and Accreditation (F) Committee voted to adopt the Model Audit Rule as an accreditation standard, effective as of January 1, 2010. To help companies comply with the new requirements, the NAIC has published an Implementation Guide which explains how terms are defined in the Model Audit Rule and provides interpretative guidance (the "Implementation Guide").

The new requirements of the Model Audit Rule, which become effective on January 1, 2010, address auditor independence, corporate governance, and internal control over financial reporting. The revisions reduce the number of consecutive years an audit partner may participate as the lead auditor (that person who is primarily responsible for the company's audit) for an insurance company from seven years to five. Additionally, the Model Audit Rule sets forth various activities an auditor must refrain from doing to maintain its independence. The revisions also require insurance companies to have an audit committee, charged with the appointment, compensation, and supervision of the company's auditor. The audit committee must have a certain percentage of independent members, determined by the preceding year's revenue premiums. Lastly, the revisions require the management of any insurer with $500 million or more in direct written and assumed premium to file a statement with the state insurance department evaluating the company's internal control over financial reporting.

During its December 6, 2009 meeting, the NAIC/AICPA (E) Working Group of the Financial Condition (E) Committee discussed, among other things, various issues regarding the Model Audit Rule and considered the adoption of proposed revisions to the Implementation Guide. The Working Group first discussed the effect the Statement of Standards in Attestation Engagements ("SSAE") No. 15, which aids auditors tasked with evaluating the effectiveness of a non-public company's internal controls, could have on compliance with the Model Audit Rule. The NAIC's legal department ultimately determined that as long as the SSAE No. 15 opinion complies with and includes the information required by the Model Audit Rule, such opinion could be filed with an addendum without having to amend the language of the Model Audit Rule.

The Working Group also discussed the interpretation of "bookkeeping services," which is one of the activities an external auditor must refrain from doing to maintain his independence under the new rules. The Working Group adopted changes to the Implementation Guide that interpret "bookkeeping services" to include tasks related to the preparation of the annual report while excluding the drafting of the audited financial report, so long as the accountant does not assume any decision-making authority in making the report.

The Working Group next discussed proposed revisions to the definition of "Group of insurers" in the Model Audit Rule and the Implementation Guide. The Implementation Guide explains that the concept was intended to provide flexibility for insurers by recognizing that a variety of corporate structures may exist and therefore allowing insurers to identify a "Group of insurers" for purposes of evaluating the effectiveness of their internal control over financial reporting. A proposed change, previously exposed for comment, had included language in the definition, which would require management, when determining the scope of controls subject to review for a "Group of insurers," to include all controls significant at each individual entity within the group. This proposal was criticized by many insurers, who argued that focusing on the legal entity level unnecessarily increased administrative costs and decreased the flexibility the initial definition was designed to provide. Many insurers are permitted to file audited statutory financial statements on a pooled basis, whereby certain legal entities cede and pool risk to higher organizational levels, and the comments submitted to the NAIC suggested that such an approach should be used when evaluating a company's control program. As a result of the comments received, the Working Group voted to adopt alternate language that allows management to avoid testing of internal controls that would be redundant for each legal entity included within a group of insurers when preparing their report on internal controls. Additionally, a "Group of insurers" that is approved to file audited statutory consolidated financial statements need only comply with a level of testing that is consistent with that used in the preparation of such statements.

Antifraud Issues

The Antifraud (D) Task Force met on December 6, 2009, and discussed, *inter alia*¸ efforts to monitor and recommend appropriate guidance on state issues arising from the application of the Violent Crime Control and Law Enforcement Act of 1994, 18 U.S.C. §§ 1033 and 1034 (the "Act"). Under the Act, an individual who has been convicted of any criminal felony involving dishonesty or a breach of trust and who willfully engages or participates in the business of insurance is subject to fine or imprisonment.[22] In addition, any individual engaged in the business of insurance who willfully permits a convicted person to participate in the business of insurance is subject to fine and imprisonment under the Act.[23] However, a convicted person "may engage in the business of insurance or participate in such business if such person has the written consent of any insurance regulatory official authorized to regulate the insurer."[24]

22 *See* 18 U.S.C. § 1033(e)(1)(A).

23 *See* 18 U.S.C. § 1033(e)(1)(B).

24 *See* 18 U.S.C. § 1033(e)(2).

In 1998, the Task Force established guidelines for the states in connection with issues arising under the Act. The Task Force is currently considering possible revisions to the guidelines to address questions such as the appropriate insurance regulator to provide written consent to a convicted person and provide guidance regarding the types of crimes considered felonies or breach of trust and therefore subject to the Act.[25] A conference call will be held on January 20 to discuss the draft.

Surplus Lines Matters

The Task Force received a report on the status of the NRRA, which, as stated above, passed the House of Representatives unanimously on September 9, 2009. Since then, much of the language of the NRRA was added to Title V of the Senate Bill. Title I of the NRRA would give an insurer's home state the exclusive right to require premium tax payment for nonadmitted insurance and allow the states to establish uniform nationwide requirements and procedures for the allocation of premium taxes (the "NRRA-Title I"). At the Summer 2009 National Meeting, interested parties had requested that the Surplus Lines (C) Task Force survey its members on methods for implementing the requirements under the NRRA-Title I. The survey addressed four main areas of concern: alternative methods, compact considerations, incidental exposures and uniformity.

During its December 7, 2009 meeting, the Surplus Lines (C) Task Force discussed the results of the surveys submitted by eight states. While all responding states agreed that some uniform method of tax allocation was necessary, there was little consensus on the method of implementation. Responses were evenly split on whether to use a compact to establish nationwide allocation procedures, though a majority of the states looked favorably on the provisions of the Surplus Lines Insurance Multistates Compliance Compact (the "SLIMPACT"). The SLIMPACT, as discussed in our NAIC Highlights - Summer 2008 National Meeting,[26] is a draft interstate compact which would allow for more uniform regulation of surplus lines insurance. Under the provisions of the SLIMPACT, surplus lines brokers would only be required to comply with the laws of, and be licensed in, the home state of the insured when placing a multi-state risk. In addition, compacting states would adopt uniform tax allocation formulae and a clearinghouse would be created to gather tax information to calculate taxes owed to each member state by surplus lines brokers. The SLIMPACT would be governed by a commission made up of representatives from each compacting state and would have the authority to adopt uniform standards for compliance with regulatory requirements when agreed upon by two-thirds of the member states. With regard to the allocation of incidental exposures, most respondents felt the term "incidental" was not clearly defined; however, most expected to receive an allocated share for such exposures. Finally, the majority of states indicated a willingness to change current procedures, such as tax collection due dates, in order to facilitate uniform reporting.

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[25] The draft revision is *available at* http://www.naic.org/documents/committees_d_antifraud_revision_us_code_1033_1034.doc.

[26] See NAIC Highlights - Summer 2008 National Meeting (June 12, 2008) 6-7, *available at* http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2616/NAIC_Summer_2008.pdf

Credit-Based Insurance Scores

At its meeting on December 8, 2009, the Property and Casualty Insurance (C) Committee discussed plans for addressing the use of credit-based insurance scores. While insurance companies use policyholders' credit scores in their risk calculus for determining premiums (believing there is a corollary between one's credit score and the risk of providing that individual with insurance), consumer advocates argue that the use of credit scoring can lead to unfair and harmful discrimination. Consumer advocates, including the Center for Economic Justice, which has been critical of the pace at which the NAIC has addressed this issue, argue that the need to protect consumers is even greater in light of current economic conditions, as failing credit markets could have a severe impact on policyholders' credit scores, thereby affecting insurance premiums. Currently, states deal with the issue of credit-based insurance scores in a variety of ways. While some states are concerned with the discriminatory effects of credit-based scoring and therefore prohibit insurers from using credit scores as the sole factor in determining risk, other states believe the majority of policyholders benefit from the use of credit-based scoring. During the meeting, the Committee proposed to address credit-based insurance scores by holding a data call to evaluate the range of premium differences stemming from the use of such scores. The Committee plans to hold an interim public conference call in January to discuss how regulators can gather information from insurers on their use of consumers' credit information. Additionally, the NAIC plans to consider the possibility of developing model law to enable states to supervise the companies that create the processes by which insurers determine policy rates. The Committee aims to have a report on the issue of credit-based insurance scores by the third quarter of 2010.

Also Noted

Several other developments during the NAIC's Winter 2009 National Meeting are noted below.

- Restructuring Mechanisms for Troubled Companies Subgroup of the Financial Condition (E) Committee. During the Fall 2009 National Meeting, the Subgroup exposed to interested parties until October 15, 2009 the "White Paper on Alternative Mechanisms for Troubled Companies" on schemes of arrangement and Part VII portfolio transfers (a transfer leaving no recourse to the original contractual obligor/insurer) and similar restructuring mechanisms that are employed internationally for financially troubled insurers.[27] At its meeting on December 4, 2009, the Subgroup adopted the White Paper for consideration by the Financial Condition (E) Committee and by the Financial Analysis (E) Working Group for incorporation of the White Paper in the Appendix of the NAIC's Trouble Insurance Company Handbook. After having completed its charges, it is anticipated that the Subgroup will not likely be reconstituted in the upcoming year.

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[27] The white paper will comprise a review of alternative mechanisms for troubled insurers within and outside the U.S., such as the run-off of existing blocks of business, New York Regulation 141 commutations and Rhode Island voluntary restructurings as well as U.K. Solvent Schemes of Arrangement and Part VII Portfolio Transfers. *See* NAIC Highlights - Spring 2009 National Meeting, *supra* at 10 (describing the white paper in further detail).

- RBC Health Accreditation Standard. At its meeting on December 6, 2009, the Capital Adequacy (E) Task Force scheduled an interim meeting in February via telephone conference to discuss whether to request having the Risk-Based Capital (RBC) for Health Organizations Model Act (#315) become an accreditation standard. The Task Force will prepare and distribute a proposal prior to the February call for a 45-day comment period.

Upcoming NAIC Activities

The NAIC's Spring 2010 National Meeting is scheduled to be held in Denver, Colorado from March 26 through March 29, 2010. In the meantime, the NAIC's committees, task forces, and working groups continue to work on the issues discussed above and other issues faced by state insurance commissioners, including through interim meetings and conference calls. The NAIC's calendar of upcoming meetings and events is available at http://www.naic.org/meetings_calendar.htm.

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

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