THE CHANGING LANDSCAPE OF INSURANCE REGULATION: A BRIEF LOOK AT THE NEW FEDERAL PARADIGM

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The regulation of the insurance industry has traditionally been entrusted to the states. But, in the last few years, the federal government has enacted a series of new federal statutes and regulations, and pursued enforcement initiatives, that impose new requirements on insurance companies and their officers and directors. Insurance company officers and directors need to be aware of these new laws, especially since some of them carry significant criminal penalties — even imprisonment. This article provides a brief overview of this new federal regulatory paradigm, including the Dodd-Frank Act, the Sarbanes-Oxley Act, the Foreign Corrupt Practices Act and requirements for insurance companies dealing with sanctioned nations and entities with terrorist connections. Future editions of the Insurance and Reinsurance Law Report will address elements of this new paradigm in greater detail.

I. THE DODD-FRANK ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act¹ is a wide-ranging financial regulatory reform act enacted on July 21, 2010 in response to the recent financial crisis. Dodd-Frank changes the existing financial regulatory structure, creating a host of new agencies while merging and removing others, to streamline the regulatory process and increase oversight of certain financial institutions.

A. FEDERAL RESERVE SUPERVISION OF INSURANCE COMPANIES

Title I of Dodd-Frank establishes the Financial Stability Oversight Council (“FSOC”) to identify risks to the financial stability of the United States, promote market discipline and respond to emerging threats to the stability of the United States financial markets. The FSOC will be monitoring domestic and international financial regulatory developments, including insurance issues. The FSOC may make recommendations to state insurance regulators to apply new or heightened financial standards.

The FSOC may subject a “nonbank financial company” to supervision by the Federal Reserve if it determines that the company’s material financial distress or failure would threaten the financial stability of the United States. The definition of a “nonbank financial company” would include most U.S. and foreign insurance companies and insurance brokers. The FSOC must consult with an insurance company’s state insurance regulator before deciding whether to subject the company to Federal Reserve supervision. A supervised nonbank financial company will be subject to specific prudential standards and reporting requirements, including risk-based capital requirements and leverage limits, liquidity requirements, risk management requirements and limitations on credit exposure. These requirements may be stricter than the standards imposed by state insurance regulators.

In January 2011, the FSOC published a notice of proposed rulemaking setting forth the specific criteria and analytical framework it will use for designating

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The proposed framework considers the following six categories:

1. Size;
2. Lack of substitutes for the financial services and products the company provides;
3. Interconnectedness with other financial firms;
4. Leverage;
5. Liquidity risk and maturity mismatch; and
6. Existing regulatory scrutiny.

The first three categories relate to the potential for a firm’s distress to “spill over” and affect the broader financial system. The remaining three categories relate to how vulnerable a company is to financial distress.

In October 2011, the FSOC issued a “proposed interpretive guidance” which describes the process for designating nonbank companies as a threat to the U.S. economy. The proposal involves a three-stage review process. In Stage 1, the FSOC will apply a uniform quantitative threshold to identify nonbank financial companies that warrant further review. Companies that have assets greater than $50 billion and that meet or exceed one of the following financial tests will be flagged for further review:

- $30 billion in gross notational credit default swaps outstanding.
- $3.5 billion in derivative liabilities.
- $20 billion of outstanding loans and bonds issued (debt).
- 15 to 1 leverage as measured by assets to equity.
- 10% ratio of short-term debt to total assets.

Stage 2 involves an analysis by FSOC of the nonbank companies using available public and regulatory information. If the FSOC deems that a nonbank company is sufficiently risky, the FSOC will label the company a “systemically important financial institution” (“SiFi”). In Stage 3, a company labeled a SiFi will then engage in discussions including exchange of written material with FSOC. One significant consequence for an insurance company labeled a SiFi is that insolvency proceedings will be handled by the Federal Deposit Insurance Corporation (“FDIC”), rather than under state insurance insolvency laws.

B. THE FEDERAL INSURANCE OFFICE

Title V, Subtitle A of Dodd-Frank establishes the Federal Insurance Office (“FIO”), a new office within the Treasury Department. While the Federal Insurance Office will not have general regulatory authority over the insurance industry, it will have a significant effect on insurance regulation in the following ways: (1) by recommending supervision by the Federal Reserve for insurance companies it determines to be at risk;
(2) by preempting state regulations that conflict with certain international agreements regarding insurance and disfavor foreign insurers; and (3) by making recommendations to Congress that may affect the current insurance regulatory framework.

The FIO’s primary function is to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system. The FIO will report on and monitor all lines of insurance, except for health insurance, long-term care insurance and crop insurance. To fulfill this function, the FIO will gather information, including information from state insurance regulators, and use that data to issue reports on the insurance industry. The FIO will have the power to subpoena information from insurance companies and their affiliates, but the submission of such information with not waive any privilege attaching to such information.

The FIO will be responsible for coordinating federal policy on insurance matters, including assisting the Treasury Secretary in negotiating agreements with foreign governments, authorities or regulatory bodies. If a state regulation is inconsistent with one of these agreements and disfavors a foreign insurer, the FIO has the authority to preempt the state regulation.

The FIO is required to issue three sets of reports to Congress. Beginning September 30, 2011, the FIO must annually report to Congress on any preemption actions and the insurance industry in general.3 The FIO must submit reports on the global and U.S. reinsurance markets by September 2012 and January 2013.

Finally, the FIO is required to submit a report to Congress by January 21, 2012 on how to modernize and improve insurance regulation in the United States. This report should consider systemic risk regulation for insurance, capital standards, consumer protection, existing national uniformity of state regulation, regulation of insurers and affiliates on a consolidated basis, international coordination of insurance regulation, costs and benefits of federal regulation of insurance, the feasibility of regulating only certain lines of insurance at the federal level, and the potential consequences of regulating insurance companies on a federal level, including the effect on the operation of the state insurance guaranty fund systems.

Other key functions of the FIO include: (1) monitoring whether traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products, and (2) assisting the Treasury Secretary in administering the Terrorism Risk Insurance Program.

C. SURPLUS LINES INSURANCE REGULATION

Title V, Subtitle B of Dodd-Frank is entitled the Nonadmitted and Reinsurance Reform Act (the “NRRA”). Part I of the NRRA addresses surplus lines insurance, while Part II concerns reinsurance.

Under current state insurance laws, policyholders may obtain coverage from insurers that are not licensed in the state (whether U.S. or foreign) when they are unable to purchase the required coverage from licensed insurers. Before placing a risk with a nonadmitted insurer, a surplus lines broker must demonstrate that it has searched the licensed market, and must place coverage only with “eligible” surplus lines insurers. These brokers are responsible for maintaining licenses in each state where any portion of the risk is located, filing affidavits that licensed insurers have

3 The FIO did not issue a report in September 2011, apparently because it has negotiated no international agreements to date.
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Where a risk is located in more than one state, this triggers confusing and sometimes conflicting state requirements for surplus lines placement, including allocation of taxes. The NRRA, which became effective on July 21, 2011 (one year later than the rest of Dodd-Frank), simplifies surplus lines compliance by imposing a “home state” for licensing, surplus lines tax payments and compliance filings.

The NRRA streamlines surplus lines tax payments by providing that only the insured’s home state may require surplus lines premium taxes. Under the act, “home state” is generally defined as the insured’s principal place of business or an individual’s principal residence. If the entire risk is located outside that state, however, the home state is the state with the greatest percentage of the taxable premium for the insured risk. The NRRA encourages (but does not require) the states to develop an interstate compact to allocate and remit these taxes to the appropriate state.

The NRRA also simplifies compliance by providing that surplus lines insurance is subject only to the requirements of the insured’s home state (except for workers’ compensation coverage). For U.S. surplus lines insurers, states’ eligibility criteria must conform to the NAIC Nonadmitted Insurance Model Act or its equivalent. States may not prohibit brokers from placing insurance with a foreign surplus lines insurer listed on the NAIC Quarterly Listing of Alien Insurers.

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Under state insurance laws, a U.S. cedent is authorized to take financial statement credit for ceded reinsurance, so long as the assuming reinsurer satisfies the state’s “credit for reinsurance” requirements. Some states impose these requirements on all insurers licensed (not just admitted) in the state. The NRRA prohibits a state from denying credit for reinsurance if the insurer’s domiciliary state (1) recognizes credit for reinsurance for the ceded risk, and (2) is a NAIC-accredited state or has substantially similar solvency requirements.

The NRRA also preempts the application of the non-domiciliary state’s laws if those laws:

- Restrict or eliminate the cedent’s right to arbitrate disputes;
- Require a certain state’s law to govern the terms of a reinsurance contract; or
- Attempt to enforce a reinsurance contract on terms different than those set forth in the contract.

Finally, the NRRA makes the U.S. reinsurer’s state of domicile the sole regulator of the reinsurer’s financial solvency if the state of domicile is a NAIC-accredited
state or has substantially similar solvency requirements. No other state may require the reinsurer to provide additional financial information.

E. REGULATION OF CREDIT DEFAULT SWAPS

Given the intense public scrutiny of credit derivatives, some states have sought to regulate certain types of credit default swaps as insurance. Title VII of Dodd-Frank mandates federal regulation of the derivatives markets, including credit derivatives. Dodd-Frank amends the Commodity Exchange Act and the Securities Exchange Act of 1934 to state that a swap and a security-based swap shall not be considered insurance and thus may not be regulated as insurance under state insurance laws. Any state regulation of credit default swaps would be preempted.

F. STATE REGULATION OF Indexed Annuities

Indexed annuities guarantee the purchaser’s principal and a certain rate of return and offer a chance for additional returns linked to a securities index. Indexed annuities are currently regulated as insurance by the states. While the SEC adopted Rule 151A in December 2008 to regulate indexed annuities as securities under the SEC’s jurisdiction, a lawsuit filed by a group of insurance companies has blocked implementation of the rule.

The Dodd-Frank Act preempts the SEC’s regulation of indexed annuities and maintains state regulation as insurance as long as these products satisfy applicable standard nonforfeiture laws and applicable suitability requirements.4

II. THE SARBANES-OXLEY ACT

In the wake of the collapse of Enron, Worldcom and other corporations, Congress in 2002 enacted the Sarbanes-Oxley Act.5 Sarbanes-Oxley set new or enhanced accounting standards for all U.S. public company boards, management and public accounting firms. Sarbanes-Oxley thus applies to any publicly-held insurance company, notwithstanding the primacy of state regulation of the insurance industry. It is therefore useful to restate its principal features here, even though they have become well known since 2002.

Among other requirements, Sarbanes-Oxley:

• Establishes standards for external auditor independence to limit conflicts of interest;

• Mandates that senior executives take individual responsibility for the accuracy and completeness of corporate financial reports;

• Enhances reporting requirements for financial transactions, including off-balance-sheet transactions, pro forma figures and stock transactions for corporate officers;

• Requires companies to develop internal controls for assuring the accuracy of financial reports and disclosures and mandates both audits and reports on those internal controls;

• Requires timely reporting of material changes in financial condition;

4 See Dodd-Frank Act, Title IX, Subtitle I, §989J.
5 Pub. L. 107-204.
• Provides criminal penalties for manipulating, destroying or altering financial records or interfering with investigations;

• Provides criminal penalties for retaliating against whistleblowers; and

• Increases the criminal penalties associated with white-collar crimes and conspiracies.

A. REPORTING REQUIREMENTS FOR COMPANY OFFICERS

Section 302 of Sarbanes-Oxley mandates a set of internal procedures designed to ensure accurate financial disclosure. The CEO and CFO of the company must certify that the financial statements and other information included in each annual or quarterly company report fairly present the financial condition, results of operations and cash flows of the company. They must also certify that they have designed internal controls to ensure that the information presented is accurate. The officers must have evaluated the effectiveness of the company’s internal controls within 90 days of the report. External auditors must issue an opinion on whether management has maintained effective internal control over its financial reporting. The Act also provides that if a company restates its financials, the company’s CEO and CFO “shall reimburse” the company for any bonuses received during the twelve months following the restated period, as well as any stock sale profits earned during those twelve months. There is no requirement of wrongdoing or fault of the officer in the statute.

B. DEVELOPING AND MAINTAINING INTERNAL FINANCIAL CONTROLS

A controversial aspect of Sarbanes-Oxley is Section 404, which requires management and the external auditor to provide an annual report on the adequacy of the company’s internal control over its financial reporting. The documentation and testing of these financial controls requires enormous effort and cost.

To help alleviate the costs of compliance, the Public Company Accounting Oversight Board and the SEC released interpretive guidelines in 2007. The two standards require management to base the scope of its assessment and the evidence gathered on risk, thus giving management wider discretion in its assessment approach. Together, the two standards require management to:

• Assess both the design and operating effectiveness of selected internal controls, related to significant accounts and relevant assertions, in the context of material misstatement risks;

• Understand the flow of transactions, including IT aspects, in sufficient detail to identify points at which a misstatement could arise;

• Evaluate company-level (entity-level) controls, which correspond to the components of the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) framework;

• Perform a fraud-risk assessment;

• Evaluate controls designed to prevent or detect fraud, including management override of controls;

• Evaluate controls over the period-end financial reporting process;

• Scale the assessment based on the size and complexity of the company;

• Rely on management’s work based on factors such as competency, objectivity and risk; and

• Conclude on the adequacy of internal control over financial reporting.

The costs of complying with Sarbanes-Oxley affects smaller companies disproportionately since there are significant fixed costs involved in completing the assessments. In September 2010, the SEC issued final rule 33-9142, which permanently exempts registrants that are not accelerated filers or large accelerated filers under Rule 12b-2 from complying with Section 404’s requirements.

III. THE FOREIGN CORRUPT PRACTICES ACT

While the Foreign Corrupt Practices Act8 ("FCPA") has been around since 1977, enforcement has increased in the last few years. From 2009 to 2010, the number of investigations brought by U.S. regulators nearly doubled. The U.S. Department of Justice and the U.S. Securities and Exchange Commission are currently pursuing more than 250 investigations. In 2010, eight companies reached settlements, in separate cases, together totaling $1.6 billion. Those numbers are likely to rise as a result of Dodd-Frank, which provides that whistleblowers can receive bounties of up to thirty percent of monetary sanctions greater than $1 million.9

The Foreign Corrupt Practices Act, prohibits U.S. citizens from offering or promising bribes to foreign government officials, politicians, political parties or state-run businesses in order to keep or obtain business. Offenses carry steep criminal fines of up to $2 million per violation for corporations. Officers, directors and employees may be given a criminal fine of up to $250,000 per violation and up to five years in prison. Moreover, an employer cannot pay a fine levied on an individual. The Attorney General or the SEC can also bring a civil action against a company or an officer, director or employee.

It may not always be apparent what constitutes a bribe or “corrupt payment” under the FCPA. For example, a company may engage in promotional activities, such as paying for customers to travel to company facilities for product demonstrations, training programs and conferences. However, if that customer is a state-owned or state-controlled business (which may not be readily apparent), these payments may be construed as bribes in violation of the FCPA.

Because many insurance companies today have operations in foreign nations, including but not limited to overseas sales operations, broker relationships and reinsurance placements, it is important for them to be aware of potential FCPA liabilities. To avoid problems under the FCPA, a well-designed compliance program is essential.

This should include

• A clearly stated ethics policy specifically prohibiting actions that violate the FCPA and other anti-corruption laws, with appropriate consequences for violations;

• Senior-level oversight of the compliance program;

• Accounting measures to comply with internal controls requirements;

• Extensive vetting and memorializing of foreign agent relationships to avoid improper behavior by business partners;

• Senior management review of agent relationships;

• Frequent training of employees, officers and agents on the obligations and prohibitions of the FCPA and other applicable anti-corruption laws;

• Internal reporting mechanisms permitting secure referral of corruption issues;

• More frequent audits of operations in problematic jurisdictions or sectors of a business; and

• Frequent review and revamping of all FCPA-related policies and procedures.

IV. TRADE SANCTIONS AND ANTI-TERRORISM MEASURES

The federal government maintains a number of sanctions programs against certain nations, including Iran, Cuba, Burma, and Sudan, as well as individuals and organizations that support terrorism. The Office of Foreign Assets Control (“OFAC”) in the U.S. Department of the Treasury controls these programs. Insurance companies must be aware of these programs and develop programs to ensure full compliance. Depending upon the program, violations can carry criminal fines of $50,000 to $10,000,000 and imprisonment for 10 to 30 years for willful violations.

A. GENERAL SANCTIONS AGAINST DEALINGS WITH TERRORISTS

The federal government maintains a list of known terrorists and narcotics traffickers and individuals, companies and organizations with ties to terrorist nations or organizations. The Specially Designated Nationals (“SDN”) List, available at http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx, is over 500 pages long. In general, all United States citizens and businesses are prohibited from any dealings with these individuals and organizations. This includes the following requirements for insurance companies:

• An insurance company that receives an application from an SDN must not issue a policy. If the applicant sends in a deposit, the company must block the payment.
• If the insurance company discovers that a policyholder is or has become an SDN, the company must contact OFAC Compliance immediately. Insurance companies may want to consider screening software to ensure that no business is done with any SDN.

B. IRAN SANCTIONS

The federal government has maintained a sanctions program against Iran for the last fifteen years. In 2010, Congress enacted the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 ("CISADA"), H.R. 2194, which amended the Iran Sanctions Act of 1996. CISADA prohibits individuals or companies from assisting Iran with importing refined petroleum products into Iran.

CISADA specifically prohibits individuals or entities from “underwriting or entering into a contract to provide insurance or reinsurance for the sale, lease, or provision” of “goods, services, technology, information, or support that could directly and significantly contribute to the enhancement of Iran’s ability to import refined petroleum products.” Sec. 102(a)(3).

The act also includes an exception for insurers who exercise “due diligence in establishing and enforcing official policies, procedures, and controls” to ensure compliance with CISADA. Insurance company officers should ensure that their companies develop and follow such due diligence procedures to avoid liability and sanctions.

V. CONCLUSION

Federal oversight of the insurance industry has increased dramatically in the last few years, creating a new paradigm of regulation for the insurance industry. As a result, insurance company officers and directors must be aware of these new laws and regulations and implement policies and procedures to ensure compliance.
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