REGULATORY REFORM TASK FORCE
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The Dodd-Frank Act: A New Era of Financial Regulation and the Implications for the Insurance Industry

August 3, 2010

Background

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) into Law. The passage of the Act ends the first, lengthy chapter of financial services reform that in many ways began with the 2008 collapse of Bear Stearns and accelerated with the continued struggles of financial services firms throughout the next years. The next chapter, which will include hundreds of rulemakings and studies, along with the likelihood of "clean-up" legislation as early as the next session of Congress, will play a pivotal role in determining the detail brush-work on the new regulatory regime whose broad-brush strokes were set forth under the Act.

As we have done throughout the course of the regulatory reform debate, we focus on the Act's impact on the regulation and operation of our insurance company clients.[1] We have set forth below a summary of what we believe are the provisions of the Act having the most direct effect on insurers, and we highlight implications those provisions will or may have for the insurance industry.

The remainder of this Legal Alert focuses on:

(1) Systemic risk regulation and the roles of the Financial Stability Oversight Council and the Board of Governors of the Federal Reserve (Page 2);
(2) The creation and operation of the Federal Insurance Office (Page 14);
(3) Enhanced resolution authority (Page 17);
(4) Distribution issues resulting from changes to laws impacting broker-dealers and investment advisers (Page 21);
(5) Adviser registration issues (Page 25);
(6) Treatment of certain life insurance and annuity products as exempt securities (the so-called Harkin Amendment) (Page 28);
(7) The Seniors Investor Protections provisions providing for grants to states for enactment of certain model consumer protection regulations (Page 30);
(8) The establishment of the Bureau of Consumer Financial Protection (Page 30);
(9) Corporate governance issues (Page 33);
(10) Derivatives (Page 33);
(11) The Volcker Rule (Page 38) ; and
(12) Reinsurance and Surplus Lines (Page 43).

[1] See "The Dodd Bill Redux: The Senate Takes Aim at Financial Regulatory Reform" (Mar. 19, 2010); "Impact of Financial Regulatory Reform on the Insurance Industry: Proposed Legislation to Implement the Regulatory Reform White Paper" (Aug. 5, 2009); "Financial Regulatory Reform – A New Foundation: Building Financial Supervision and Regulation" (June 19, 2009). Click on the links for these relevant Legal Alerts on financial services regulatory reform.

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Systemic Risk Regulation and the Roles of the Financial Stability Oversight Council and the Board of Governors of the Federal Reserve System

Title I of the Act establishes a Financial Stability Oversight Council (Council) to oversee systemic risk. The Council will perform three key systemic risk functions: (1) identifying risks to the financial stability of the United States arising from the material financial distress or failure of large, interconnected bank holding companies *or* nonbank financial companies;[2] (2) promoting market discipline, by eliminating expectations that the U.S. government will protect shareholders, creditors, and counterparties from losses in the event of failure of a major institution; and (3) responding to emerging threats to the stability of U.S. financial markets. The Council will implement these functions through a variety of avenues, including but not limited to, making recommendations: to the member agencies[3] on general supervisory priorities and principles; to the Board of Governors of the Federal Reserve System (Board) on the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies that are supervised by the Board; and to primary financial regulatory agencies to apply new or heightened standards or safeguards on financial activities. The term "primary financial regulatory agency" is defined to include state insurance regulators for insurers domiciled in their states with respect to the insurance company's insurance activities.[4]

The Council is also charged with monitoring domestic and international financial regulatory proposals, and insurance regulatory proposals are expressly referenced. The Council also has an extremely broad information collection mandate and is charged with tapping member agencies, other Federal and State financial regulatory agencies, the Federal Insurance Office (FIO) (described in more detail below) for such information related to nonbank financial companies and bank holding companies. The Council is also authorized to direct the Office of Financial Research (OFR) (described in more detail below) to collect information from bank holding companies and nonbank financial companies.

Implications for the Insurance Industry
Nonbank financial companies would include insurance companies that meet the test of being "predominantly engaged" in activities that are financial in nature, which includes insurance and annuity issuance and brokerage.
The Council has the authority to collect information, through a variety of sources including the OFR and member agencies, on insurance companies that are nonbank financial companies.

[2] The definition of a "nonbank financial company" is broad and includes a U.S. or foreign company (other than a company treated as a bank holding company or a Farm Credit System institution and certain others) that is "predominantly engaged in financial activities" in the United States. An entity is deemed to be predominantly engaged in financial activities generally if 85% or more of its revenues or assets are derived from activities that are financial in nature (as defined in § 4(k) of the Bank Holding Company Act of 1956). Acting as a principal or agent with respect to insurance or annuities is deemed to be "financial in nature" under § 4(k) of the Bank Holding Company Act.

[3] Member agencies are the regulatory agencies represented by the voting members of the Council; Council membership is described below.

[4] Section 2(12)(D) of the Act. Section 2(12) also provides a detailed definition of the term "primary financial regulatory agency" that includes a variety of banking, securities, and commodities regulators for different types of entities.

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Composition of the Council

Under the Act, the Council will be composed of 10 voting members: the Secretary of the Treasury, who will also be the Chairman of the Council; the Chairman of the Board; the Comptroller of the Currency (OCC); the Director of the Bureau of Consumer Financial Protection (the head of the "to be formed" consumer protection agency described below); the Chairman of the Securities and Exchange Commission (SEC); the Chairperson of the Federal Deposit Insurance Corporation (FDIC); the Chairperson of the Commodity Futures Trading Commission (CFTC); the Director of the Federal Housing Finance Agency; the Chairman of the National Credit Union Administration; and an independent member appointed by the President, with the advice and consent of the Senate, who has insurance expertise. Importantly, there is a seat at the table for insurance expertise on the Council. The Council would also include five non-voting members who will serve in an advisory capacity: the Director of the OFR; the Director of the FIO; a state insurance commissioner; a state banking supervisor; and a state securities commissioner. The non-voting members will be permitted to participate in meetings and proceedings of the Council unless it is deemed necessary to exclude such non-voting members to safeguard and promote the free exchange of information.

Implications for the Insurance Industry
The Council will include one voting member who has insurance expertise. Rather than appoint the Director of the FIO, or a sitting state insurance regulator, the "insurance seat" will be filled through a Presidential appointment.
There are two non-voting members of the Council who will have an insurance background (the Director of the FIO and a designated state insurance commissioner).
It does not appear that the term "member agency" would cover any state insurance regulator since non-voting members are outside the scope of the definition. Therefore, any provision of the Act that delegates authority to, or a role for, a member agency could become difficult to interpret in the context of insurance companies.

Designation of Nonbank Financial Companies Subject to Board Supervision

Perhaps most importantly for insurance company complexes, the Council is also charged with requiring supervision by the Board of nonbank financial companies that "may pose a risk to the financial stability of the United States in the event of their material financial distress or failure." Section 113 of the Act sets forth the requirements and the process for designating a nonbank financial company that is subject to Board oversight. The Council, by at least a two-thirds majority vote, including an affirmative vote by the Chairman (i.e., the Treasury Secretary), may determine that a U.S. or foreign nonbank financial company *must* be supervised by the Board and be subject to prudential standards under Title I. To make the designation, the Council must determine that:

> material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness or mix of [business] could pose a threat to the financial stability of the United States.[5]

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[5] Section 113(a)(1) of the Act.

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Section 113 of the Act outlines 11 considerations for the Council to consider in conducting its analysis of a nonbank financial company, including but not limited, to the following:

- The leverage of the nonbank financial company;
- The extent and nature of the off-balance sheet exposure;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of activities;
- The degree to which the company is regulated by one or more primary financial regulatory authorities (which includes consideration of state insurance regulation);
- The amount and nature of assets and liabilities; and
- Any other risk-related factors that the Council deems appropriate.[6]

In addition to the considerations identified above, the Council is required under Section 113(g) to consult with the primary financial regulatory agency (if any) for any nonbank financial company (or subsidiary) that is being considered for supervision by the Board.

Designation Process. The Act includes a relatively robust process for designation of a nonbank financial company for supervision by the Board that includes hearings and review of that designation and re-evaluations of such a designation. A nonbank financial company is provided notice of the determination and such company can request a hearing to review the determination within 30 days. A hearing before the Council will then be scheduled within 30 days of such request, and a final hearing determination is due within 60 days after the hearing.[7] If no hearing is requested by the designated nonbank financial holding company, the Council will notify such company of the final determination within 10 days after the deadline for requesting a hearing. A nonbank financial company can bring an action in the applicable U.S. District Court or the U.S. District Court for the District of Columbia to appeal the determination; however, the standard of review is whether the final determination of the Council was arbitrary and capricious. For the remainder of this Legal Alert, we refer to nonbank financial companies that have been designated to be supervised by the Board as "Board Supervised NFCs."

Annual Reevaluation of Designation. The Council is required to reevaluate the designation of all Board Supervised NFCs at least annually. Upon a two-thirds vote, including an affirmative vote of the Treasury Secretary, the Council can find that the Board Supervised NFC may no longer be subject to Board supervision. The Board Supervised NFC's can rely only on judicial review as described above to contest any annual reevaluation of the Board Supervised NFC's status.

Implications for the Insurance Industry
Insurance companies with no banking or depository institution affiliate can still become subject to regulation by the Board upon the Council's determination.
In making the designation, the Council must consider the role of the state insurance regulator, which meets the definition of a "primary financial regulatory agency." It will be interesting to see whether the recent modifications of the National Association of Insurance Commissioners (NAIC) to the Model Holding Company Law and Regulation will impact the determination in any meaningful way. For more on those Model NAIC

[6] The Act includes similar, but not identical, criteria to evaluate foreign nonbank financial companies doing business in the U.S.

[7] Section 113(f) of the Act also provides for certain "emergency" procedures that provide for an accelerated process under certain circumstances.

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laws and rules, please click here for a recent Sutherland Legal Alert.
Given the arbitrary and capricious standard imposed on judicial review of a designation as a Board Supervised NFC, it appears that overturning such a designation will be difficult.
Once a company has been designated as a Board Supervised NFC, there is no hearing provided for during the annual review process; the only venue for challenging the annual review is a U.S. District Court.

Nonbank Banks and Savings and Loan Holding Company Treatment Under the Act

Under the Act, the Federal Reserve becomes the regulator of savings and loan holding companies, taking on the role previously played by the Office of Thrift Supervision. Federal thrifts will be supervised by the OCC, and state-chartered thrifts will be supervised federally by the FDIC. Unitary thrift holding companies may continue to engage in non-financial activities (e.g., general commercial activities), but the Board may require the formation of an intermediate level holding company to segregate the financial activities. These changes will be implemented on July 21, 2011.

In addition, Title VI of the Act calls for a moratorium on providing deposit insurance to nonbank banks, and calls for the Comptroller General to conduct a study of the oversight of thrifts, credit unions, and nonbank banks and their holding companies to determine whether the Bank Holding Company Act should apply to their holding companies. The study is due to Congress on January 21, 2012.

Implications for the Insurance Industry
Insurance company complexes that own a thrift will be subject to regulation by the Board as the successor agency to the Office of Thrift Supervision. However, unlike in previous versions of proposed regulatory reform provisions, savings and loan holding companies will not be subject to the Bank Holding Company Act regulatory regime.
Insurance company complexes that own nonbank banks such as trust companies will not be subject to regulation by the Board as a bank holding company.
The proposed Comptroller General study could lead to enhanced holding company regulation for savings and loan holding companies or owners of nonbank banks.

Registration of Board Supervised NFCs

Within 180 days of a final determination by the Council under Section 113 that a nonbank financial company shall be a Board Supervised NFC, the Board Supervised NFC must register with the Board on forms prescribed by the Board. The Board shall request information on such forms that it deems necessary or appropriate, and must consult with the Council on such information.

Prudential Standards for Board Supervised NFCs and Certain Bank Holding Companies

While regulation of Board Supervised NFCs and large, interconnected bank holding companies is generally carried out through the Board, the Council is granted the authority under Section 115 of the Act

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to recommend prudential standards and reporting and disclosure requirements applicable to Board Supervised NFCs and certain bank holding companies (BHCs). The recommendations of the Council may include more stringent standards related to the following: risk-based capital; leverage limits; liquidity requirements; resolution plan[8] and credit exposure requirements; concentration limits; contingent capital requirements;[9] enhanced public disclosures; short-term debt limits; and other risk management requirements. When applying such recommendations to foreign NFCs and foreign-based BHCs, the Council is required to also consider foreign-based regulation.

Implications for the Insurance Industry
The proposed prudential standards are the backbone of the new "tool chest" that is provided to the Board to oversee systemically important institutions. If an insurance company is designated as a Board Supervised NFC, then a new and comprehensive set of financial, operational, reporting and risk management requirements could be imposed on its operations.

Council Recommendations for More Stringent Regulation of Any Financial Activity

In addition to making recommendations of stricter rules for NFCs and certain BHCs, the Council is also granted the authority to provide recommendations to any primary financial regulatory agency to apply new or heightened standards (such as those described above under Section 115 of the Act) on the financial activities of its respective regulated institutions. As described above, a state insurance regulator is considered to be a primary financial regulatory agency for the insurance activities of an insurance company.

The Council is required to consult with the primary financial regulatory agency, and must provide public notice and an opportunity for comment on any recommended heightened standards. The primary financial regulatory agency must either apply the recommended rule, or explain in writing to the Council its determination not to follow the recommended rule within 90 days of the Council issuing the recommendation. The Council is required to report on its recommendations to Congress, and identify whether the primary financial regulatory agency implemented the regulation, thus possibly creating additional incentive to such agency to impose the new standard.

Implications for the Insurance Industry
An insurance company could become subject to new standards imposed and enforced by a state insurance regulator after a recommendation from the Council.

Board Authority to Mitigate Risks to Financial Stability

Section 121 of the Act provides the Board with some significant tools to mitigate the risks where a BHC with greater than $50 billion in consolidated assets or a Board Supervised NFC poses a "grave threat to

[8] This is the so-called "living will" proposal that requires a Board Supervised NFC (and certain BHCs) to prepare a plan to provide for rapid resolution in the event of material financial distress.

[9] The Council is required to conduct a study on the use of contingent capital requirements for Board Supervised NFCs and submit a report to Congress no later than July 21, 2013.

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the financial stability of the United States." If the Board determines that such a "grave threat" exists, and if the Council approves upon a two-thirds vote, the Board can require the company to:

- Limit the company's merger, acquisition or consolidation activity;
- Restrict the ability of the company to offer financial products;
- Terminate or impose conditions on designated activities; and
- Compel the sale or transfer of assets or off-balance sheet items.

Section 121 provides for a notice and hearing opportunity for the applicable BHC or Board Supervised NFC.

Implications for the Insurance Industry
While this authority appears to be designed to address only the most grave of financial situations, an insurance company that is a Board Supervised NFC could effectively be subject to "management" of its business by the Board as directed by the Council.
As drafted, it appears that the potential Board actions in response to a "grave threat" would be permitted only with respect to the Board Supervised NFC, and not to its subsidiaries. However, the Council has the flexibility to determine which entity or entities it might designate as a Board Supervised NFC.

Office of Financial Research

The Act provides for the OFR to be established within Treasury. The director of the OFR who serves for a six-year term will be appointed by the President with the advice and consent of the Senate. The OFR will support the Council in fulfilling its duties and will essentially be the information-gathering arm of the Council through a data center and a research and analysis center. The director of the OFR, on the Council's mandate or in consultation with the Council, may require any financial company, which includes any insurance company,[10] to submit periodic and other reports for the purpose of assessing the extent to which the financial company or a financial activity or financial market in which the financial company participates poses a threat to the financial stability of the U.S. To decrease the potential burden on such financial companies, the OFR must coordinate with any member agency that regulates the financial company, primary financial regulatory agency[11] or foreign supervisory authority and rely on information already provided by the financial company to such agency or authority to the extent possible.

[10] Section 151(2) of the Act.

[11] In the case of an insurance company, the primary financial regulatory agency is such company's insurance regulator in its domiciliary state.

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Implications for the Insurance Industry
An insurance company may have to comply with additional reporting requirements that may not be in the same format or include the same information provided to its primary regulator.
Information that an insurance company provides to its primary regulator and is then provided to the OFR may become available to the public.
An insurance company will need to consider whether to mark as confidential any proprietary or business sensitive information that it provides to a regulator if it wants to protect such information.

Increased Authority for the Board

The goal of Title I of the Act, and the regulations and studies to be conducted thereunder, is to mitigate and prevent risk and set up an early-warning system that would allow the Board, in conjunction with the Council and the FDIC as appropriate, to require companies to take action immediately, if needed, in reaction to any early signs of a threat to financial stability. The Act has significantly expanded the Board's authority and subjects new institutions that did not previously fall within the purview of Board oversight to reporting, supervision, examination and enforcement by the Board. In addition, the Board has been given new tools in its arsenal through the ability to impose a range of prudential standards. However, the Board on behalf of, and in consultation with, the Council is also required to issue regulations establishing criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by the Board.

Once a company is designated as a Board Supervised NFC, it must:

- Register with the Board (as described above);
- Submit reports to the Board and disclose certain information to the public;
- Be subject to examinations and enforcement by the Board;
- Comply with all prudential standards (e.g., risk-based capital) set by the Board;
- Subject its functionally regulated subsidiaries to certain types of exceptional prudential regulation;
- Be subject to limits on its acquisition activity; and
- Develop a "living will" to provide for "early remediation" in the event of the company's financial distress.

Implications for the Insurance Industry
Any insurer or insurance company complex designated as a Board Supervised NFC will be subject to a material increase in oversight, reporting and examination requirements.

Reporting; Examination. Pursuant to Section 161 of the Act, the Board now has authority to require a Board Supervised NFC and any of its subsidiaries to submit reports to, and submit to examination by, the Board. A Board Supervised NFC will be required to report to the Board with respect to such Board Supervised NFC and/or any of its subsidiaries on: (1) its financial condition; (2) systems for monitoring and controlling financial, operating, and other risks of the Board Supervised NFC or the applicable subsidiary; (3) the extent to which activities and operations of the Board Supervised NFC and/or any subsidiary pose a threat to the financial stability of the U.S., and (4) compliance with the requirements of Title I of the Act. The Board is encouraged to rely on, and a Board Supervised NFC and/or any of its subsidiaries must provide copies to the Board, upon request, of: (1) any reports and supervisory

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information that a Board Supervised NFC or its subsidiary has been required to provide to other Federal or State regulatory agencies; (2) information otherwise obtainable from Federal or State regulatory agencies; (3) information that is otherwise required to be reported publicly; and (4) externally audited financial statements of such Board Supervised NFC or subsidiary. The Board must coordinate, in part to avoid duplication, with the primary financial regulatory agency for any subsidiary before imposing a reporting requirement or examination on such subsidiary.

Enforcement. A Board Supervised NFC and any of its subsidiaries (other than any depository institution subsidiary) shall be subject to the provisions of subsections (b) through (n) of Section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), in the same manner and to the same extent as if the Board Supervised NFC were a bank holding company, as provided in Section 8(b)(3) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)(3)). However, if the Board determines that a condition, practice, or activity of a depository institution subsidiary or functionally regulated subsidiary of a Board Supervised NFC does not comply with the regulations or orders prescribed by the Board under this Act, or otherwise poses a threat to the financial stability of the U.S., the Board may issue a written recommendation, which describes its concerns, to the primary financial regulatory agency for the subsidiary that such agency initiate a supervisory action or enforcement proceeding. If the primary financial regulatory agency fails to take supervisory or enforcement action against a subsidiary that is acceptable to the Board within 60 days of receiving the Board's recommendation, then the Board has the option (upon a vote of its members) to take the recommended supervisory or enforcement action as if the subsidiary were a bank holding company subject to Board supervision.

Implications for the Insurance Industry
The Board can compel any Board Supervised NFC, or any subsidiary of a Board Supervised NFC, including any insurance company, to submit reports, although the Board is required to use reports provided to other agencies, including State regulatory agencies, to satisfy the requirements.
Insurance companies that are Board Supervised NFCs, or are subsidiaries of Board Supervised NFCs, would be subject to examinations by the Board, and by the FDIC under its potential "back-up" examination authority.
If the Board instructs an insurance regulator to take supervisory or enforcement action, and the insurance regulator fails to do so, then the Board can step in and take the action itself.
Insurance companies that are Board Supervised NFCs, or are subsidiaries of Board Supervised NFCs, would be subject to the enforcement tools available under the Federal Deposit Insurance Act.

Acquisitions. With respect to acquisitions by a Board Supervised NFC, the Board Supervised NFC will be deemed to be, and treated as if it were, a BHC under the BHC Act and subjected to the same approval process. Subject to certain exemptions, both BHCs with total consolidated assets equal to or greater than $50 billion and Board Supervised NFCs must notify the Board in advance of any acquisition of a company, excluding an insured depository institution, that is engaged in the activities described in Section 4(k) of the Bank Holding Company Act and has total consolidated assets of $10 billion or greater. In general, the standard procedures for review of a BHC acquisition would apply, although the Board must consider the extent to which the proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy.

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Implications for the Insurance Industry
If an insurance company or insurance holding company is a Board Supervised NFC, any covered acquisition (i.e., an acquired company engaged in financial activities with more than $10 billion in assets) it makes will be subject to advance notice to the Board.

Enhanced Supervision and Prudential Standards

Under Section 165 of the Act, the Board must, on its own or pursuant to recommendations by the Council under Section 115 (as described above), establish prudential standards for Board Supervised NFCs and BHCs with total consolidated assets equal to or greater than $50 billion with the goals of preventing and mitigating risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions. While the approach for adopting the new standards is intended to take into account practical considerations, the challenge will be to develop and adopt such standards in a manner that allows for transparent and even administration of such standards.

These new prudential standards must: (1) be more stringent than the standards and requirements applicable to nonbank financial companies and BHCs that do not present similar risks to the financial stability of the United States; and (2) increase in stringency based on the following considerations:

- (i) the factors described in Section 113 (described above), (ii) whether such company owns an insured depository institution, (iii) non-financial activities and affiliations of such company, and (iv) any other risk-related factors that the Board determines appropriate;
- to the extent possible, ensure that small changes in the factors listed in Section 113 (described above) would not result in "sharp, discontinuous changes" in the newly established prudential standards;
- take into account the Council's recommendations; and
- adapt the required standards as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate.

In developing the prudential standards, the Board has the authority, either on its own or pursuant to a recommendation by the Council, to: (1) differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board deems appropriate; and (2) establish an asset threshold above $50 billion for the application of any standard established under subsections (c) through (g) of Section 165 of the Act.[12]

Required and Permitted Standards. Section 165 of the Act sets forth specific guidance as to the prudential standards that are either required or permitted for Board Supervised NFCs and BHCs with total consolidated assets equal to or greater than $50 billion.

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[12] Essentially, this would include standards imposed with respect to contingent capital, resolution plan and credit exposure reports, concentration limits, enhanced public disclosures and short-term debt limits.

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The Board is ***required*** to impose standards on Board Supervised NFCs and BHCs with total consolidated assets equal to or greater than $50 billion to address the following:

- risk-based capital requirements and leverage limits,[13] unless the Board, in consultation with the Council, determines that such requirements are inappropriate for a company subject to more stringent prudential standards because of such company's activities (i.e., investment company activities or assets under management) or structure, in which case, alternative standards that result in similarly stringent risk controls will be applied by the Board;
- liquidity requirements;
- overall risk management requirements;
- periodic reports to the Board, the Council and the FDIC by such Board Supervised NFC or BHC on its resolution plans for rapid and orderly resolution in the event of its material financial distress or failure;[14]
- requirements to provide credit exposure reports on a periodic basis to the Board, the Council and the FDIC as to the nature and extent to which such Board Supervised NFC or BHC has credit exposure to other such companies and vice versa; [15] and
- concentration limits to prohibit each such Board Supervised NFC and BHC from having credit exposure to any unaffiliated company that exceeds 25% (or such lower amount as determined by regulation) of the capital stock and surplus of the company.[16]

As a result of these new standards, Board Supervised NFCs and BHCs with total consolidated assets equal to or greater than $50 billion generally will need to take into account "off-balance-sheet activities" in calculating capital for purposes of satisfying any capital requirements imposed by the Act or implementing rules or regulations.

The Board ***may*** (is ***permitted*** but not required to) impose standards on Board Supervised NFCs and BHCs with total consolidated assets equal to or greater than $50 billion that address the following:

- a contingent capital requirement;
- enhanced public disclosures;
- short-term debt limits; and
- such other prudential standards as the Board, on its own or pursuant to a recommendation made by the Council, determines are appropriate.

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[13] Generally, such Board Supervised NFCs and BHCs will be limited to a debt-to-equity ratio of no more than 15 to 1, upon a determination by the Council that such company "poses a grave threat" to the financial stability of the U.S. and that the requirement is necessary to mitigate such risk.

[14] The Board and the FDIC will review any resolution plan submitted by a Board Supervised NFC or BHC and jointly determine if it's a "credible plan" and notify the Board Supervised NFC or BHC of any deficiencies in the plan, in which case a revised plan must be submitted.

[15] Within 18 months of July 21, 2010, the Board and the FDIC must jointly issue rules implementing the resolution plan and credit exposure requirements.

[16] These requirements and related regulations issued by the Board will be effective three years after July 21, 2010, although the Board may extend the period by an additional two years.

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Functionally Regulated Subsidiaries. Before the Board imposes prudential standards or any other similar requirements[17] that would be expected to have a significant impact on a functionally regulated subsidiary or depository institution subsidiary of a Board Supervised NFC or BHC with total consolidated assets equal to or greater than $50 billion, the Board must consult with each Council member primarily supervises any such subsidiary with respect to any such standard or requirement. With respect to an insurance company that is designated as a Board Supervised NFC, this reference could mean either the FIO or the state insurance regulator who is a member of the Council even though neither may otherwise have any direct regulatory authority over such company.

Foreign Companies and International Coordination. The Act seeks to strike a balance between providing for oversight of non-U.S. companies that are interconnected with the U.S. economy and have systemic importance for U.S. financial stability while recognizing that the non-U.S. entities are regulated in their country of domicile and may be subject to equally rigorous and/or conflicting regulation in such country. Since many foreign multi-national financial institutions with significant U.S. operations are already subject to some level of U.S. regulation and oversight, it is unclear the extent to which the Act will have an impact, if any, on the operations of such institutions and their ability to conduct business in the U.S. Pursuant to the Act, the Board must give due regard to the principle of national treatment and equality of competitive opportunity and take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States when applying prudential standards to any foreign nonbank financial company supervised by the Board or foreign-based bank holding company.
The Act requires coordination on international policy by the Council, the Board and the Treasury Secretary, and permits coordination by the President or a designee, with foreign governments and multilateral organizations, among others. The goal is to encourage coordination and consultation on policy matters to address financial stability and systemic risk on a global scale and "to encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies".

Risk Committee. Section 165 of the Act requires public Board Supervised NFCs and BHCs with assets of $10 billion or more to establish a risk committee, with the possibility that the Board may extend these requirements to BHCs with assets of less than $10 billion. The Act specifies that risk committees must be responsible for the oversight of the enterprise-wide risk management practices of the company and must include: (1) such number of independent directors as the Board determines appropriate;[18] and (2) at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

Risk management is a familiar topic for governance professionals. Corporate governance best practices emphasize treating risk assessment and risk management as topics that the whole board should consider in fulfilling its fiduciary duty to oversee the company. Whereas the Act contemplates risk assessment at the committee level, governance professionals, such as the National Association of Corporate Directors, believe that the full board should have primary responsibility for risk oversight, with the board's standing

[17] The obligation to consult would also apply to requirements imposed by the Board with respect to notices of deficiencies in resolution plans and more stringent requirements or divestiture orders resulting from such notices.

[18] This number is to be based on the nature of operations, size of assets and other appropriate criteria related to the company.

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committees supporting the board by addressing the risks inherent in their respective areas of oversight.[19] It is important to note that the use of a risk committee should not replace the entire board's active engagement in risk oversight, something the Act does not contemplate but may yet follow in its implementation.

Implications for the Insurance Industry
If an insurance company or insurance holding company is a public Board Supervised NFC, its board of directors could be subject overlapping and possibly conflicting mandates from Section 165 of the Act, general corporate law duties, and possibly even direction under the NAIC's updated Model Holding Company Law and Regulation.[20]

Stress Test. The Board, in coordination with the appropriate primary financial regulatory agencies and the Federal Insurance Office, will conduct annual stress tests for Board Supervised NFCs and BHCs with total consolidated assets equal to or greater than $50 billion to evaluate whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. The Board may also require these tests for bank holding companies and nonbank financial companies. Stress tests should be conducted based on baseline, adverse, and severely adverse scenarios at a minimum, and the Board will publish the results of the stress tests. The implications of these stress tests must be incorporated into a company's resolution plans.

In addition to the stress tests conducted by the Board, stress tests must be conducted by the company itself for (1) each Board Supervised NFC and BHC with total consolidated assets equal to or greater than $50 billion on a semiannual basis; and (2) any other financial company that has total consolidated assets of more than $10 billion that is regulated by a "primary Federal financial regulatory agency" on an annual basis. Any such stress test must be reported by such company to the Board and the company's primary financial regulatory agency at such time, in such form, and containing such information as the primary financial regulatory agency requires by regulation.

It is unclear how the requirements, imposed on any other financial company that has assets at least equal to $10 billion that is regulated by a "primary Federal financial regulatory agency," will apply to an insurance company. While the term "financial company" clearly covers an insurance company, the term "primary Federal financial regulatory agency" is not defined under the Act. An insurance company's "primary financial regulatory agency" means the state insurance regulator in such company's home state. It is unclear whether the FIO might be deemed to be the "primary *Federal* financial regulatory agency." In the alternative, the language related to company-initiated stress tests could be read to mean that, since there is no agency that clearly qualifies as an insurance company's primary Federal financial regulatory agency, then company-initiated stress tests of insurance companies are not required. Since these requirements will be implemented through regulation issued by the primary financial regulatory agency, presumably, if these requirements are intended to apply then state insurance departments will issue any applicable regulations.

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[19] *See* Blue Ribbon Commission of the NACD, *Risk Governance: Balancing Risk and Reward*, National Association of Corporate Directors (October 2009).

[20] *See Sutherland Legal Alert,* "NAIC Proposes Expansive New Governance, Risk Management and Reporting Duties on Insurance Holding Company Systems; A New Liability Profile Emerges for Directors and Senior Management" (July 9, 2010).

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Implications for the Insurance Industry
The Board will conduct stress tests on any Board Supervised NFC, and the Board is permitted to conduct stress tests on any nonbank financial company. Therefore, the Board could conduct a stress test on any insurance company.
It remains to be seen how the requirement for companies to conduct their own stress tests will play out for insurance companies.

Intermediate Holding Company. Pursuant to Section 167 of the Act, a Board Supervised NFC will be required to establish an intermediate holding company if the Board makes a determination that doing so is necessary to (1) "appropriately supervise activities that are determined to be financial in nature or incidental thereto;" or (2) to ensure that Board supervision does not extend to the Board Supervised NFC's commercial activities. In addition, the Board may require a Board Supervised NFC, which conducts activities other than those that are **determined** to be financial in nature or incidental thereto under Section 4(k) of the Bank Holding Company Act, to establish and conduct all or a portion of such activities in or through an intermediate holding company within 90 days (or longer at the Board's discretion) of a request from the Board.[21] Any company that directly or indirectly controls an intermediate holding company must be "a source of strength" to its subsidiary intermediate holding company (e.g., through capital infusions) and may have to submit reports to the Board on its ability to support such intermediate holding company.

Leverage and Risk-Based Capital Requirements. The appropriate Federal banking agencies shall establish minimum leverage capital requirements and risk-based capital requirements, in each case on a consolidated basis for insured depository institutions, depository institution holding companies, and Board Supervised NFCs. These requirements may not be less than any generally applicable leverage capital requirements or risk-based capital requirements, which shall serve as a floor for any capital requirements that the agency may require, nor quantitatively lower than the generally applicable leverage capital requirements or risk-based capital requirements that were in effect for insured depository institutions as of July 21, 2010.

The Creation and Operation of the Federal Insurance Office (FIO)

Title V of the Act establishes the FIO in the U.S. Department of the Treasury (Treasury). The FIO will advise the Secretary of the Treasury (Secretary) on major domestic and international prudential insurance policy issues, providing national policymakers with access to key information and expertise on the insurance sector. Title V also amends the Secretary's duties to include advising the President on insurance policy issues.

The FIO will be headed by a Director, who is appointed by the Secretary to a career-reserved position that does not require Senate approval. The Director of the FIO is authorized to serve in a non-voting capacity on the Council, the systemic risk regulator. In carrying out the functions of the FIO, the Director is required to consult with State insurance regulators, individually or collectively, to the extent the Director determines appropriate.

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[21] Generally, internal financial activities, including internal treasury, investment, and employee benefit functions, will not be considered "financial in nature or incidental thereto under section 4(k) of the Bank Holding Company Act" for this purpose.

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The Act gives the FIO the authority 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;
- **Recommend** to the Council any insurer, including its affiliates (defined as any person who controls, is controlled by, or is under common control with the insurer), as an entity that should be subject to regulation as a Board Supervised NFC;
- **Represent** the U.S. in the International Association of Insurance Supervisors (IAIS);
- **Coordinate** Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including assisting the Secretary in negotiating written international agreements on prudential matters with respect to the business of insurance or reinsurance in consultation with the U.S. Trade Representative (covered agreements);
- **Determine**, in connection with the Administrative Procedures Act, whether State insurance measures are preempted by international insurance agreements;
- **Consult** with the States, including State insurance regulators, on insurance matters of national importance and prudential insurance matters of international importance; and
- **Perform** such other duties and authorities as may be assigned to it by the Secretary.

The Act gives the FIO broad authority to gather information from insurers and any affiliates as it may reasonably require in carrying out its functions, and grants the Director of the FIO subpoena power to require production of the data, enforceable in any U.S. District Court. Before collecting any data, the FIO must coordinate in advance with each relevant Federal agency and State insurance regulator (or other relevant Federal or State regulator in the case of any affiliate of an insurer) and any publicly available sources to determine if the information is available from, and may be obtained in a timely manner by, such agency or public source.

The Act pays considerable attention to keeping information privileged and confidential and to enabling information-sharing agreements between the FIO and State insurance regulators, individually or collectively.

The Director must submit an annual report on the insurance industry to the President and to Congress and any information deemed relevant by the Director or by Congress.

Implications for the Insurance Industry
The sweeping powers of the FIO to collect and analyze data on insurers and their affiliates would, for the first time, give the Federal government the analytic tools it needs to critically assess the adequacy and effectiveness of State insurance prudential measures.
The information-gathering and analysis potential of the FIO will require insurers and their affiliates to consider how information currently provided to the States on capital, surplus, reserves, liquidity and risk management might be interpreted by the FIO, and eventually by the Council. Recent proposals at the NAIC to require the controlling person in an insurance holding company system to provide the NAIC with an annual report on the risks of financial and reputational contagion heighten such concerns. (Sutherland Legal Alert July 9, 2010)

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> The information-gathering and analysis potential of the FIO could have a major impact on the potential for Federal regulation of the insurance industry, as the FIO gains expertise in insurance and develops the basis for recommending the designation of an insurer as a Board Supervised NFC.

Power to Negotiate International Insurance Agreements and State Law Preemption

The FIO is granted substantial authority in the area of international insurance regulatory agreements. Under Title V, the Secretary and the U.S. Trade Representative are jointly authorized to enter into agreements with foreign governments relating to the recognition of prudential measures with respect to the business of insurance or reinsurance.

In implementing such international agreements, the FIO has specific, but limited, authority to preempt State insurance measures inconsistent with international agreements. The FIO must determine that the State law is inconsistent with the international agreement and that a particular State insurance measure treats a non-U.S. insurer less favorably than a U.S. insurer. The Director of the FIO is required to submit an annual report to the President and to Congress on or before September 30th each year regarding any preemptive actions taken by the FIO.

Implications for the Insurance Industry
By granting the Secretary of the Treasury the power, in coordination with the U.S. Trade Representative, to negotiate and enter into international insurance agreements, while granting the FIO the power to represent the U.S. at the IAIS and to preempt inconsistent State measures, the Act will accelerate the global supervision of insurance enterprises, provide a unified voice on insurance matters for the United States in global deliberations, and cause insurers to pay closer attention to the ways in which international agreements could impact their solvency and risk management measures.

Report on Improving the Insurance Industry

The Director of the FIO must submit to Congress a report within 18 months on how to modernize and improve the system of insurance regulation in the U.S. The study and report would be based on and be guided by considerations such as:

- Systemic risk regulation of insurance;
- Capital standards, including standards relating to liquidity and duration risk;
- Consumer protection, including gaps in state regulation;
- The degree of national uniformity of state insurance regulation;
- The regulation of insurance companies and affiliates on a consolidated basis; and
- International coordination of insurance regulation.

The report and study must also consider:

- The costs and benefits of potential Federal regulation of insurance across various lines of insurance (except health insurance);
- The feasibility of regulating only certain lines of insurance at the Federal level, while leaving other lines of insurance to be regulated at the State level;

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- The ability of any potential Federal regulator(s) to eliminate or minimize regulatory arbitrage;
- The impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential Federal regulation of insurance;
- The ability of any potential Federal regulation or Federal regulators to provide robust consumer protection for policyholders; and
- The potential consequences of subjecting insurance companies to Federal resolution authority, including the effects of any Federal resolution authority on: (1) the operation of State insurance guaranty fund systems, including the loss of guaranty fund coverage if the insurance company is subject to a Federal resolution authority; (2) policyholder protection, including the loss of priority status of policyholder claims over other unsecured general creditor claims; (3) the loss of the special status of life insurance separate account assets and separate account liabilities; and (4) the international competitiveness of insurance companies.

The study and report must contain legislative, administrative and regulatory recommendations, as the Director deems appropriate, to carry out and effectuate the report's findings. In conducting the study, FIO's Director must consult with the NAIC, consumer organizations, representatives of the insurance industry and policyholders, and other organizations and experts, as appropriate.

Implications for the Insurance Industry
Assuming that the FIO report calls for increased Federal involvement in insurance regulation, it remains to be seen whether Congress will respond positively to the report and impose greater Federal authority over insurance matters.

Enhanced Resolution Authority

Sections 202 and 203 of the Act set forth a three-part procedure for an "Orderly Liquidation" of certain "covered" financial companies.

Orderly Liquidation Procedure

First, the Board or the FDIC alone, or at the request of the Treasury Secretary, must determine that the financial company (defined below) is in default or in danger of default such that the Secretary should appoint the FDIC as receiver. The recommendation must be made with not less than a two-thirds majority vote of each of the Board and the board of directors of the FDIC. If the financial company is an insurance company – or if an insurance company is the largest United States subsidiary of a financial company - the determination of default or in danger of default must be made by the Director of the FIO and the Board, alone or at the request of the Treasury Secretary, and in consultation with the FDIC. If the financial company is a broker-dealer – or if the largest United States subsidiary of the financial company is a broker-dealer - the determination of default or danger of default must be made by the Board and the SEC, alone or at the request of the Treasury Secretary, and in consultation with the FDIC. In any case, the recommendation must contain, among other findings: (1) an evaluation of whether the financial company is in default or in danger of default; (2) a description of the effect of a default on financial stability in the United States; (3) a description of the effect that the default would have on economic conditions or financial stability for low income, minority, or underserved communities; (4) a recommendation of actions to be taken; and (5) an evaluation of why a case under the Bankruptcy Code is not appropriate.

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Second, the Treasury Secretary, after consultation with the President, must reach a number of conclusions, including that: (1) the financial company is in default or in danger of default; (2) the financial company's failure and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States; (3) no viable private sector alternative is available to prevent default; and (4) any action taken under the resolution authority would avoid or mitigate those adverse effects.

Third, upon such determinations by the Treasury Secretary, the Treasury Secretary is required to notify the FDIC and the financial company. If the financial company acquiesces or consents to the appointment of the FDIC as receiver, the Treasury Secretary is authorized by Section 202 to so appoint the FDIC.[22] If the financial company does not acquiesce or consent to the appointment of the FDIC as receiver, the Treasury Secretary is required to file a petition under seal to the United States District Court for the District of Columbia for an order authorizing the Treasury Secretary to appoint the FDIC as receiver. After notice to the financial company and a hearing at which the financial company may oppose the petition, and a determination by the Court that the determination of the Treasury Secretary is not arbitrary and capricious, the Court will issue an order authorizing the Treasury Secretary to appoint the FDIC as receiver. If the Court finds that the Treasury Secretary's determination is arbitrary and capricious, it is required to inform the Treasury Secretary in writing of each reason supporting its decision and permit the Treasury Secretary to refile the petition. If the Court does not make a determination within 24 hours of receipt of the original filing then the petition is deemed granted by operation of law, the FDIC will be appointed as receiver, and the liquidation procedures will automatically begin without further notice or action. The Act provides for a limited right of appeal as to the arbitrariness and capriciousness of the decision of the Treasury Secretary to the United States Court of Appeals for the District of Columbia and ultimately to the United States Supreme Court on an expedited basis. The District Court is required to establish rules no later than six months from the enactment date to ensure the orderly conduct of proceedings, including rules to ensure that the 24-hour decision deadline is met.

If the covered financial company is a broker-dealer, the FDIC pursuant to Section 205 of the Act must appoint the Securities Investor Protection Corporation (SIPC) to act as trustee for liquidation under the Securities Investor Protection Act of 1970; however, SIPC will not have powers or duties with respect to assets and liabilities transferred by the FDIC to a bridge financial company or with respect to certain other enumerated actions that may be taken by the FDIC as receiver.

Definition of Financial Company

Section 201(11) of the Act defines a financial company as a company that is incorporated or organized under any provision of State or Federal law and is (i) a bank holding company as defined under the Bank Holding Company Act, (ii) a Board Supervised NFC, (iii) any company that is predominantly engaged in activities that the Board has determined are financial in nature or incidental thereto for purposes of Section 4(k) of the Bank Holding Company Act, which would include among other companies, insurance companies, broker-dealers, and investment advisers, and (iv) any subsidiary of such named companies that is predominantly engaged in activities that the Board has determined are financial in nature or incidental thereto for purposes of Section 4(k) of the Bank Holding Company Act (other than a subsidiary

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[22] Section 207 of the Act provides that members of the board of directors of a financial company will not be liable to shareholders or creditors of the financial company if they acquiesce or consent in good faith to the appointment of the FDIC as receiver.

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that is an insurance company or an insured depository institution). An insured depository institution, a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971, as amended, and a governmental or a regulated entity as defined under Section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 are deemed either not to be financial companies or not subject to the orderly liquidation provisions of the Act.

An insurance company is defined as an entity that is (i) engaged in the business of insurance, (ii) subject to regulation by a State insurance regulator, and (iii) covered by a state law designed specifically to address liquidation, insolvency or rehabilitation of an insurance company. Under the Act, insurance companies, but not their non-insurance company affiliates or subsidiaries, are exempted from the Act's resolution provisions and instead, rehabilitation or liquidation of an insurance company will be conducted under applicable State law.

Definition of Predominantly Engaged

For purposes of determining whether a company is predominantly engaged in financial activities, Section 201(b) of the Act establishes an 85% test such that no company will be deemed to be engaged in activities that the Board has determined to be financial in nature or incidental thereto unless the consolidated revenues of the company from such activities constitute 85% of the total consolidated revenues of the company, including consolidated revenues derived from the ownership or control of a depository institution. The FDIC, in consultation with the Treasury Secretary, is required to promulgate regulations to effect the calculation of consolidated revenues.

Other Insolvency Laws

Section 208 of the Act provides that once the FDIC is appointed receiver (or SIPC as trustee for a broker or dealer), several mandated actions take place, including dismissal of pending Bankruptcy Code (or Securities Investor Protection Act) cases or proceedings with respect to the covered financial company, and revesting of assets in the covered financial company as a result of a proceeding commenced under the Bankruptcy Code, the Securities Investor Protection Act or any similar state liquidation statute, provided that any court order or other relief granted by a bankruptcy court prior to the appointment of the FDIC as receiver will remain valid.[23]

FDIC's Broad Resolution Authority

The stated purpose of the Act, as set forth in Section 204, is to provide "necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." To that end, the Act contains three additional requirements for the liquidation: first, creditors and shareholders will bear the losses; second, management responsible for the financial company's condition will not be retained; and third, the FDIC and other appropriate agencies will take steps to recoup losses from parties, including management, who have responsibility for the condition of the financial company. Therefore, Section 206 requires that (1) the FDIC determine that action taken under its authority is taken for purposes of the financial stability of the

[23] Section 202(c) of the Act provides that the provisions of the Bankruptcy Code do not apply to covered financial companies for which the FDIC is appointed receiver and that the Act's provisions are exclusive.

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United States and not for the purpose of preserving the financial company, (2) shareholders will not be paid until after all other claims and the Orderly Liquidation Fund (discussed below) have been repaid in full, and that unsecured creditors will bear losses in accordance with the claim priorities contained in the Act, (3) directors and management responsible for the failed condition are removed, and (4) the FDIC not take an equity interest or become a shareholder of any covered financial company or covered subsidiary. Section 210 of the Act gives the FDIC as receiver broad resolution authority, and notably includes:

- removal of management responsible for the company's condition;
- pursuit of actions against directors and officers; and
- recoupment of compensation from senior executive officers and directors, in which compensation will be defined to include, without limitation, salary bonuses, benefits, severance, deferred compensation, and profits from the sale of securities of the covered financial company.

Additionally, under Section 213, the FDIC or the Board, as applicable, has the authority to issue orders of prohibition to ban certain culpable senior executive officers and directors from participating in the affairs of any financial company.

Orderly Liquidation Fund

Section 210(n) provides that funding for the FDIC to carry out its receivership functions will be made through the "Orderly Liquidation Fund." The fund is not required to be pre-funded, but when the FDIC needs funds to cover the costs of resolving any particular covered financial company, the FDIC upon appointment as receiver is permitted to issue obligations to the Treasury Secretary. The purchase of the obligations by the Treasury Secretary is subject to the approval of a repayment plan that demonstrates the ability to retire the obligations from the liquidated assets of the covered financial entity and assessments[24] - first on "claimants" of the covered financial company who may have received additional payments on their claims as permitted by the Act, and second, on "eligible financial companies"[25] and financial companies with total consolidated assets equal to or greater than $50 billion that are not eligible financial companies. The FDIC, in consultation with the Treasury Secretary and with recommendations from the Council, is charged with establishing regulations to determine how the assessments will be applied to eligible financial companies.

Impact on Complex Insurance Entities

The Act allocates resolution authority along financial and non-financial business lines. That is, in a complex entity that includes broker-dealers, State licensed insurance companies, and banking institutions, three separate agencies in four different roles may be involved:

> ***Example One:*** The FDIC as receiver for the "financial company"; a holding company that is not also an insurance company, and its failing non-regulated subsidiaries; SIPC for a failing broker-dealer subsidiary; the FDIC as receiver of a failing insured depository institution subsidiary; and a State insurance regulator for a failing insurance company subsidiary.

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[24] Section 210(o) of the Act.

[25] Section 210(o)(1)(A) of the Act defines eligible financial companies as bank holding companies with total consolidated assets equal to or greater than $50 billion and any Board Supervised NFC.

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Example Two: The State insurance regulator for a failing financial company that is an insurance company; SIPC for its failing broker-dealer subsidiary; the FDIC as receiver for its failing depository institution subsidiary, and the FDIC as receiver for its failing non-regulated subsidiaries. Complicating matters further, Section 203(e) provides that if the applicable Federal authority does not file the appropriate judicial action in a State court to place an insurance company into an orderly liquidation under the laws of the State, then the FDIC has back-up authority to file the action.

Effective Time. Although there are several rulemakings and studies required in Title II of the Act, the orderly liquidation authority provisions of Title II became effective on July 21, 2010.

Implications for the Insurance Industry
Title II does not change the way insurance companies are resolved under state law (as long as the company meets the definition of insurance company) except that (1) an insurance company may be deemed (through the complex process described above) to be a covered financial company and be required to be resolved, and (2) the FDIC has back-up authority to resolve an insurance company under state law if the state regulator does not take action.

Distribution Issues Resulting from Changes to Broker-Dealer and Investment Adviser Regulation

Title IX of the Act is called "Investor Protections And Improvements To The Regulation Of Securities" (Title IX). Title IX focuses on a number of areas including broker-dealer and investment adviser standards of conduct, pre-dispute customer arbitration and certain disclosure issues.[26] Like other titles of the Act, the impact of Title IX will be shaped significantly by studies and rulemakings conducted by the SEC and others. Title IX has the potential to significantly impact the way insurance company products are distributed, and the business activities of an insurance company's affiliated broker-dealers and investment advisers.

Broker-Dealer and Investment Adviser Standards of Conduct – A Study and Freestanding Rulemaking Authority

The Act provides two different avenues for the SEC to regulate broker-dealers' standard of care: (1) a rulemaking resulting from an SEC study required by January 21, 2011; and (2) rulemaking authority under Section 913(g) of the Act that provides for regulations addressing standard of conduct and other disclosure issues. Importantly, the trigger for nearly all proposed sales practice regulation is the provision of personalized investment advice about securities to retail customers.

The Study. Much of the fanfare related to financial services regulatory reform has focused on the proposal to impose equal standards of care on broker-dealers and investment advisers serving retail investors. Section 913 of the Act requires the SEC to conduct a very detailed study of the broker-dealer

[26] In addition to the topics discussed in this Legal Alert, Title IX also includes significant provisions related to, among other things, SEC enforcement powers, credit rating agencies, and the oversight of asset-backed securities.

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and investment adviser regulatory framework and submit the report to the House Committee on Financial Services and the Senate Banking Committee by January 21, 2011. The SEC is required to seek and consider public comments in order to create the report.[27] The study must evaluate:

- The effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers; and
- Whether there are legal or regulatory gaps, or overlap, in the protection of retail investors related to the standards of care for broker-dealers and investment advisers.

In addition, the Act sets forth 14 “considerations” related to the regulation of broker-dealers and investment advisers that must be reviewed including, but not limited to, the following:

- The regulatory, examination and enforcement resources devoted by the SEC and the Financial Industry Regulatory Authority, Inc. to broker-dealer and investment adviser standards of care;
- The substantive differences in the regulation of broker-dealers and investment advisers providing personalized investment advice to retail customers;
- Specific instances in which retail customers of a broker-dealer receive greater protections than an investment adviser, and vice versa;
- The potential impact on retail customers of the range of products and services offered by broker-dealers if the fiduciary duty standard of care is applied to broker-dealers;
- The ability of investors to understand the differences in standard of care provided by broker-dealers and investment advisers; and
- The varying level of services provided by broker-dealers and investment advisers and the varying terms of retail customer relationships.

The SEC is granted rulemaking authority “to address the legal or regulatory standards of care” for broker-dealers and investment advisers providing personalized investment advice about securities. In any such rulemaking, the SEC is required to take into consideration the findings of the study.

Freestanding Rulemaking Authority on the Standard of Conduct. The Act amends Section 15(g) of the Securities Exchange Act of 1934, as amended (1934 Act), to provide authority to the SEC to promulgate rules that would make the standard of conduct for broker-dealers providing personalized investment advice to retail customers the same as provided for under Section 211 of the Investment Advisers Act of 1940, as amended (Advisers Act). As amended under the Act, Section 211 of the Advisers Act provides the SEC with rulemaking authority to impose the following standard of conduct:

> To act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice.

Section 913 of the Act also addresses certain issues that arise in raising the standard of care owed by broker-dealers as follows:

- ***Commissions.*** The receipt of commissions or other traditional transaction-based compensation by broker-dealers is not, in and of itself, a violation of the “best interest” standard.

[27] The SEC has already published the request for comments.

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- ***Ongoing Duty.*** Broker-dealers and registered representatives do not owe a continuing duty of care or loyalty after providing personalized investment advice.
- ***Proprietary or Limited Range of Products.*** Where broker-dealers sell "only proprietary or other limited range of products" as determined by the SEC, the SEC has rulemaking authority to compel such broker-dealer to provide notice and receive consent of the customer. The sale of such proprietary or limited range of products is not deemed to be a per se violation of the broker-dealer's standard of conduct.

There is no explanation of the interplay between the rulemaking to be conducted under the study, and the independent rulemaking authority granted under the new Section 15(g) of the 1934 Act. We are not aware of any legislative history that explains the interplay of the two sections. It seems unlikely that the SEC would rely on the Section 15(g) rulemaking authority in advance of, or without reference and deference to, the study.

Implications for the Insurance Industry
If a heightened standard of care is adopted, as appears likely, variable insurance products and other securities recommendations will be subject to stricter scrutiny by both regulators and customers.
Specific analysis of proprietary distribution channels may be necessary to determine that the operation of such a channel does not violate the "best interest of the customer" standard.
Additional disclosure obligations (and sometimes client consent) may be required to address the issues described above concerning the receipt of commissions and the sale of proprietary (or other limited range of) products.
Will the heightened standard of conduct for broker-dealers impact the requirements for the sale of fixed life insurance and annuities under state insurance laws? Will state insurance regulators, and/or the NAIC, attempt to legislate or regulate a fiduciary duty for insurance agents selling fixed products?

Enhanced Disclosures and Sales Practice Rulemaking

Section 913(g) of the Act also adds Section 15(l) to the 1934 Act, which provides additional authority to the SEC to regulate and prescribe disclosure and sales practice requirements. The SEC is required to facilitate the provision of disclosure to investors describing the terms of their relationships with their broker-dealers or investment advisers, including conflicts of interest. This provision appears to be designed to address the perceived lack of understanding by customers about their relationships with their investment professionals.
The SEC is also required to examine, and where necessary, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes that adversely impact investor protection.

Implications for the Insurance Industry
Additional disclosure requirements on the sale of insurance products that are securities appear very likely.
The SEC's "blank check" authority on sales practice regulation could be used to eliminate certain securities sales practices.

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Disclosure Requirements Before Purchase

Section 919 of the Act adds a new Section 15(n) to the 1934 Act, which grants authority to the SEC to issue rules that designate documents or information that must be provided by a broker-dealer to a retail investor *before* the purchase of an investment product or service. Any such rule must provide for documentation that is in a summary format, and must contain clear and concise information about investment objectives, strategies, costs, risks and compensation received by a broker-dealer or any other intermediary in connection with the purchase.

Implications for the Insurance Industry
Section 919 of the Act could provide a clear avenue to prescribe a "point of sale" disclosure document that is required to be delivered by the broker-dealer prior to sale.
The possible required disclosures in such a point of sale document will need to be carefully drafted and reviewed to ensure consistency with current disclosure documents as well as any other new disclosure requirements emanating from other provisions of the Act.

Mandatory Pre-Dispute Arbitration Clauses

The Act expressly addresses mandatory pre-dispute arbitration clauses. Section 921 of the Act indicates that the SEC may conduct a rulemaking to prohibit, or impose conditions or limitations on, the use of mandatory arbitration provisions for broker-dealer or investment adviser customers or clients upon a finding that such rulemaking is in the public interest and for the protection of investors.

Mutual Fund Advertising Study

Section 918 of the Act provides that the Comptroller General shall conduct a study on mutual fund advertising. Within 18 months of the date of enactment of the Act, the study must be submitted to the House Financial Services Committee and the Senate Banking Committee. The study focuses on existing practices, particularly with respect to performance, and requires the Comptroller General to provide recommendations for improving the current requirements in a way that allows for investors to make better informed decisions.

Changes to the Accredited Investor Standards

Section 413 of the Act effectively amends the "accredited investor" definition in Rule 501(a)(5) of Regulation D under the Securities Act of 1933 (1933 Act) (as well as Rule 215(e) under the 1933 Act) by specifying that the value of a natural person's primary residence must be *excluded* in determining whether such person meets the $1 million net worth threshold set forth therein. This change to the definition went into effect on July 21, 2010. Since there is no grandfathering provision accompanying the change, issuers and broker-dealers in private placements must ensure that natural persons relying on their net worth to qualify as accredited investors satisfy the new standard prior to participating in a private placement.

Section 413 of the Act also effectively instructs the SEC to adjust the net worth standard for the "accredited investor" definition set forth in Rule 501(a)(5) of Regulation D (and Rule 215(e) under the 1933 Act) after four years so that the net worth of any natural person (or joint net worth with a spouse) at

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the time of purchase is *more than* $1 million excluding the value of the primary residence of the natural person.

The exclusion of a prospective investor's primary residence in evaluating whether he/she meets the net worth threshold in Regulation D, and the SEC's future adjustments of the dollar threshold for the net worth standard, will shrink the pool of natural persons who will be able to purchase private placement variable products.

Implications for the Insurance Industry
The new accredited investor standards for high net worth investors raise difficult issues for private placement variable insurance product issuers and distributors whose purchasers make continuing payments. Consideration will need to be given to what requirements, if any, must be met to accept additional payments.
Issuers and broker-dealers should implement policies and procedures to ensure that investors relying on their net worth to qualify as accredited investors satisfy the new standard, and should review and update all documentation to reflect the new standards.

Optional SEC Review of Accredited Investor Standard*.* In addition to the change to the net worth standard discussed above, Section 413 of the Act provides that the SEC *may* review the definition of the term "accredited investor," as such term applies to natural persons, to determine whether the requirements of the definition, apart from the net worth standard, should be adjusted for the protection of investors. Upon completion of this optional review, the SEC can, via rulemaking, adjust the definition of "accredited investor" as the term applies to natural persons. This would enable the SEC, for instance, to adjust for inflation the so-called "income test" in Rule 501(a)(6) of Regulation D (under which a natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year is an accredited investor).

Mandatory Ongoing SEC Review of Accredited Investor Standard*.* Starting four years after passage of the Act, the SEC is required to review the definition of "accredited investor" in its entirety as it applies to natural persons not less frequently than once every four years to determine if the requirements of the definition should be adjusted for the protection of investors. Upon completion of such review, the SEC may, via rulemaking, adjust the definition of "accredited investor" as such term applies to natural persons.

Government Accountability Office (GAO) to Study and Report on Accredited Investor Standard*.* Section 415 of the Act instructs the Comptroller General to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds. By July 21, 2013, the Comptroller General must submit a report to Congress on the results of the study.

Changes to Investment Adviser Act Registration and Other Requirements

Title IV of the Act makes a number of changes to the Advisers Act, including changes that will require most investment advisers to hedge funds and other similar privately offered investment vehicles (private funds) to register under the Advisers Act, and also makes changes in the regulation of investment advisers that are related to these registration changes. More specifically, the Act eliminates the existing exemption from registration for advisers with fewer than 15 clients that hedge fund advisers have

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historically relied on to avoid Advisers Act registration. However, the Act provides (or directs the SEC to adopt rules to provide) certain new exemptions from Advisers Act registration, some of which would have the effect of reducing the impact of the repeal of the 15-client exemption. In addition, Title IV gives the SEC rulemaking authority to specify recordkeeping and reporting requirements for private fund advisers. Finally, Title IV includes a few provisions not directly related to private fund advisers or registration requirements.

Repeal of the 15-Client Exemption

Section 203(b)(3) of the Advisers Act has provided that an investment adviser that has had fewer than 15 clients during the preceding 12 months and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to a registered investment company or a business development company is exempt from registration under the Advisers Act. The Act repeals this provision, which will force private fund advisers to register unless eligible for one of the exemptions discussed below.

The New Exemptions

Foreign Private Advisers. A new registration exemption has been added for "foreign private advisers," which are defined as investment advisers: (1) having no place of business in the U.S.; (2) having fewer than 15 U.S. clients or private fund investors; (3) having less than $25 million in assets under management (or such higher amount specified by the SEC) attributable to U.S. clients or private funds investors; and (4) that neither hold themselves out to the public in the United States as investment advisers nor advise registered investment companies or business development companies. The provision will exempt foreign advisers (including foreign private fund advisers) that have only an incidental presence in the United States. However, in light of the narrow definition of foreign private adviser and particularly the limits on U.S. clients and assets, foreign advisers with any significant U.S. business will not be able to rely on this exemption.

Advisers to Smaller Private Funds. The Act directs the SEC to provide a registration exemption for advisers that provide advice solely to private funds and that have assets under management of less than $150 million. "Private fund" is defined as an issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. The Act directs the SEC to adopt recordkeeping and reporting rules for these advisers, and the anti-fraud provisions of the Advisers Act will apply to these advisers (as with any advisers exempt from registration), so this exemption provides only limited relief. Furthermore, it is possible that states may regulate these advisers, although a state may not, under Section 222(d) of the Advisers Act, require the registration of an adviser with fewer than six clients in the state, and state adviser laws typically focus currently on advisers to retail clients.

Advisers to Venture Capital Funds. The Act directs the SEC to provide a registration exception by rule for advisers that provide advice solely to one or more venture capital funds, but, as with advisers to smaller private funds, directs the SEC to adopt recordkeeping and reporting rules for venture capital fund advisers. The SEC rule will need to define the term "venture capital fund," so the precise scope of the exemption is unclear at this time.

Mid-sized Advisers. An investment adviser that: (1) is required to be registered with and that, if registered, would be subject to examination by the securities commission of

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the state in which it maintains its principal office; and (2) has assets under management between $25 million and $100 million (or as each such amount may be adjusted by the SEC in the future) would be required to register with the states instead of with the SEC, unless the adviser would be required to register with 15 or more states. This provision expands the existing prohibition on Advisers Act registration for investment advisers with less than $25 million in assets under management. The primary difference between advisers with assets under management of less than $25 million and those with assets under management of between $25 million and $100 million would be that the former must be required to register in 25 states (rather than 15) before they may register with the SEC.

Family Offices. The Act adds an exception to the Advisers Act definition of investment adviser (rather than merely a registration exemption) for a "family office." The SEC is directed to adopt a definition of family office that is consistent with the exemptive orders it has previously granted with respect to family offices. Such exemptive orders generally exempt advisers organized to furnish investment advice to trusts created by and for the benefit of the members of one family and to charitable entities created by a member of such a family.

Other Exemptions. Title IV also adds a new registration exemption for advisers to small business investment companies. In addition, it adds an exemption for private fund advisers registered with the Commodity Futures Trading Commission as commodity trading advisers that appears to be slightly broader than the current Advisers Act exemption for CFTC-regulated investment advisers generally. On the other hand, the Advisers Act specifically preserves the right of the CFTC to regulate registered investment advisers that may also be required to register as commodity trading advisers.

Regulation of Private Fund Advisers

The Act grants the SEC authority to require any registered investment adviser to maintain records of and file with the SEC reports regarding their private fund clients. These records and reports must include, for each private fund client, a description of: (1) the amount of assets under management and use of leverage; (2) counterparty credit risk exposure; (3) trading and investment positions; (4) valuation policies and practices of the fund; (5) types of assets held; (6) side-letter arrangements whereby certain investors obtain special rights; (7) trading practices; and (8) such other information as the SEC, in consultation with the Council, determines is necessary or appropriate (including necessary or appropriate for the assessment of systemic risk). The records required to be maintained will be subject to periodic inspection by the SEC, and the SEC will also have authority to conduct inspections of private fund advisers as it deems necessary or appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. The Act provides for limited confidentiality of reports by private fund advisers.

In addition, existing Advisers Act requirements, including disclosure requirements, will presumably be applied to private fund advisers. Finally, the Act directs the Comptroller General of the United States to conduct a study on the feasibility of forming a self-regulatory organization to oversee private funds.

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Other Provisions

Custody. The Act adds new Section 223 to the Advisers Act, which provides that a registered adviser shall take such steps specified by SEC rule, including verification by an independent public accountant, to safeguard client assets over which the adviser has custody. The Act also directs the Comptroller General to conduct a study of the compliance costs associated with the current Advisers Act custody rule (Rule 206(4)-2), including the costs of subsection (b)(6) of the current rule "relating to operational independence." These provisions appear to signal a partial endorsement of the recently amended custody rule -- supporting its provisions for independent verification of assets that a registered investment adviser has access to, but questioning the need for the internal control reports required by subsection (b)(6), at least where client assets are actually held by an operationally independent affiliate of the adviser.

Qualified Clients/Accredited Investors. The Act directs the SEC to periodically adjust for inflation any dollar amount tests used in its rules permitting advisers to charge certain clients (qualified clients) performance-based advisory fees. Currently, Rule 205-3 under the Advisers Act defines qualified client in part as a natural person who has at least $750,000 under the management of the investment adviser or that the adviser reasonably believes has a net worth (including assets held jointly with a spouse) of more than $1.5 million. In addition, the Act directs the Comptroller General to conduct a study on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for "accredited investor" status and eligibility to invest in private funds.

Implications for the Insurance Industry
In light of the elimination of the 15-client exemption, existing Advisers Act Section 203(b)(2), which provides a registration exemption for any adviser whose only clients are insurance companies, becomes more relevant. There currently is little guidance on the scope of Section 203(b)(2), presumably because Section 203(b)(3) has been relied upon by insurance-affiliated advisers providing advice to their affiliated insurance companies, the unregistered separate accounts of such insurance companies, and/or other affiliated entities.
Any eventual SEC rule changes resulting from the custody provisions of Title IV may make it less burdensome for insurance-affiliated advisers to act as such in connection with asset allocation programs offered to owners of variable insurance contracts/policies. In light of the recently-adopted amendments to the Advisers Act custody rule, some insurance companies are currently discontinuing offering such programs or limiting them so that no investment advisory relationship with the contract owner need exist.
Insurance Companies that have invested in private funds or have retained unaffiliated unregistered advisers should consider making inquiries regarding their advisers' compliance with the Act.

New Exemption for Certain Insurance Products – The Harkin Amendment

Section 989J of the Act includes a provision that has been referred to as providing an exemption for indexed annuities from regulation as securities, as a preservation of state insurance treatment for indexed

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annuities, and as a nullification of the SEC's Rule 151A under the 1933 Act for indexed annuities. Before the Act was signed, the D.C. Circuit Court of Appeals (on July 12, 2010) vacated Rule 151A. In any event, Section 989J was enacted, and it is a new exemption that provides a "safe harbor" that is not limited to indexed annuities; rather, it applies to any fixed insurance product that meets its three conditions.

Implications for the Insurance Industry
The new exemption, by its terms, applies to life as well as annuity products, and to products with market value adjustments, universal life insurance, traditional excess interest annuities, etc. (but see below regarding life products).

Section 989J provides that the SEC "shall treat as exempt securities described under section 3(a)(8) of the Securities Act of 1933 … any insurance or endowment policy or annuity contract or optional annuity contract" (any "insurance product") that meets the following three requirements:

(1) Separate Account - The value of the insurance product does not vary with the performance of a separate account;

(2) Nonforfeiture - The insurance product either

(A) satisfies standard nonforfeiture laws or similar requirements at the time of issue; or

(B) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or the Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the NAIC; and

Implications for the Insurance Industry
This requirement to meet nonforfeiture standards is far different than the "investment risk" requirement of Rule 151, which requires a guarantee of principal, a minimum interest rate, and a one-year guarantee of excess interest. Since those requirements of Rule 151 do not apply, Section 989J allows substantially more flexibility in product design.
Similarly, the investment risk standard of Section 3(a)(8) jurisprudence should not apply to products that meet the nonforfeiture and other requirements of Section 989J.

(3) Suitability - The insurance product is issued either

(A) on and after June 16, 2013 in a state, or issued by an insurance company that is domiciled in a state, that adopts rules that govern suitability requirements in the sale of an insurance product which substantially meet or exceed the minimum requirements established by the NAIC's Suitability in Annuity Transactions Model Regulation (this can be referred to as the *mandatory* suitability prong); or

(B) by an insurance company that adopts and implements practices nationwide for the sale of any insurance product that meet or exceed the minimum requirements established by the NAIC Suitability in Annuity Transactions Model Regulation and any successor thereto, and is

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therefore subject to examination (by the state of domicile of the insurance company, or by another other state where the insurance company sells insurance products), for the purpose of monitoring compliance "under this section" (this can be referred to as the *voluntary* suitability prong).

Implications for the Insurance Industry
Section 989J, unlike the extant Section 3(a)(8) jurisprudence and Rule 151, does not include a marketing test.

The new "exemption" included in Section 989J is written as a direction to the SEC, and does not actually amend, and therefore will not be codified in, Section 3(a)(8) (or any other section) of the 1933 Act. In addition, Section 989J does not by its terms specifically refer to indexed annuities (or Rule 151A).

As noted above, Section 989J operates as a safe harbor (although that term is not used). Subsection (b) of 989J contains a rule of construction that provides that nothing in the new provision shall be construed to affect whether any insurance product that is not described in that section is or is not exempt under Section 3(a)(8). Accordingly, if an insurance product does not satisfy the Section 989J requirements, then the product still may come within the Section 3(a)(8) exemption based on (a) current judicial and the SEC's interpretations of the 1933 Act, or (b) the Rule 151 safe harbor for certain fixed annuity contracts.

Implications for the Insurance Industry
By its terms, Section 989J would apply to life insurance products that meet its three requirements. However, since it is aimed at indexed annuity products, and particularly since both suitability prongs specifically reference the NAIC Suitability In Annuity Transactions Model Regulation, the availability of Section 989J to life insurance products may be especially problematic.

Senior Investor Protections – Grants to States for Enactment of Certain Model Regulations

Section 989A of the Act provides for grants to states that have adopted certain model consumer protection laws and regulations. As an incentive to adopt such legislation, states (or state agencies) are eligible to apply for and receive up to $500,000 a year for up to three consecutive years if the state has adopted model NASAA and NAIC regulations addressing Senior Specific Designations, and suitability or fiduciary standards that meet or exceed the requirements in the NAIC's Suitability in Annuity Transactions Model Regulation. These grants could provide extra incentive to states to adopt these model acts and regulations.

The Bureau of Consumer Financial Protection

Title X of the Act creates a new executive agency, the "Bureau of Consumer Financial Protection" (Bureau) which "shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws".[28] The Bureau generally has jurisdiction over "consumer financial

[28] Section 1011(a).

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products and services" such as loans and other financial products from credit card companies, mortgage companies, brokers, banks and others. Covered persons subject to the Bureau's jurisdiction include any person that engages in offering or providing a consumer financial product or service and any affiliate of such person if that affiliate acts as a service provider to the covered person. As discussed below, there are important exclusions for (a) the business of insurance, (b) persons regulated by a state insurance regulator, and (c) persons regulated by the SEC. (There are numerous other exclusions for groups such as auto dealers, accountants, lawyers, retail merchants, real estate brokers, etc.).

Implications for the Insurance Industry
The Bureau generally should not have jurisdiction over the life insurance industry or life insurance and annuity products *per se.* However, it would seem prudent to carefully monitor the Bureau's rulemaking and other activities because of the possibility, however remote, that the Bureau could attempt to claim jurisdiction over areas of insurance that would seem to be covered by the exclusions summarized below but that are not specifically addressed in Title X, such as premium financing, life settlements, insurance-related financial planning, reverse mortgages, and possibly even policy loans.

Bureau Powers and Authority

Title X of the Act provides, in part, that it shall be unlawful for any covered person to engage in any "unfair, deceptive, or abusive act or practice" (UDAP), or to provide any financial product or service not in conformity with Federal consumer financial law or otherwise to commit any act or omission in violation of Federal consumer financial law. The Bureau, through rulemaking, can define UDAPs in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. "Federal consumer financial law" is a defined term. Importantly, the Bureau's primary functions include the supervision of covered persons for compliance with the Federal consumer financial laws, the taking of appropriate enforcement action to address violations of Federal consumer financial laws, the issuance of rules, orders, and guidance under the Federal consumer financial laws, and the prevention of evasions thereof. The Bureau can prescribe rules to ensure that the features of any consumer financial product or service are fully, accurately, and effectively disclosed to consumers, and can examine and compel information from covered persons.

Exclusions – Insurance Generally

Title X of the Act generally excludes life and annuity insurance products (both fixed and variable) from the Bureau's jurisdiction, but there are some uncertainties as to insurance-related activities (such as investment or financial planning). In addition, other more technical or nuanced areas, such as life settlements and premium financing, are also not directly addressed.

Exclusion for Business of Insurance. The Act defines "financial product or service" broadly to include many enumerated products or services, including such "other financial product[s] or service[s]" as the Bureau may define by regulation, but provides that the term "does not include the business of insurance." The Act also provides separately that "the Bureau may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance." The term "business of insurance" is defined broadly to mean "the writing of insurance" (or reinsuring of risks) "including all acts necessary to such writing" (or reinsuring), by persons who act as, or are, officers, agents, employees or other persons authorized to act on behalf of such persons.

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***Exclusion for Persons Regulated by a State Insurance Regulator**.* The Act states that Title X does not alter or amend any State insurance regulator's rulemaking, enforcement, or other authority over persons regulated by a State insurance regulator, and includes an exclusion for such persons. The exclusion is limited to activities subject to such regulation, and provides that the Bureau shall have no authority to enforce Title X of the Act with respect to persons regulated by a state insurance regulator, *except* to the extent that such persons are engaged in the offering of any consumer financial product or service (or is otherwise subject to a Federal consumer financial law).

Exclusion for Persons Regulated by the SEC. Title X of the Act also includes an exclusion for persons regulated by the SEC, including broker-dealers, investment advisers, and investment companies, and employees, agents, and contractors thereof (to the extent that such persons are acting in a regulated capacity). This exclusion provides that Title X does not alter or amend the SEC's rulemaking, enforcement, or other authority over such persons. The exclusion also provides that the Bureau shall have no authority to enforce Title X with respect to such persons (unlike the exclusion noted just above for persons subject to State insurance regulation, this provision does *not* contain an exception for offering consumer financial products or services). However, Title X of the Act does require the SEC to consult and coordinate with the Bureau, where feasible, on any rule (including advance notice of any rulemaking) regarding an investment product or service that is the same type of product as, or that competes directly with, a consumer financial product service that is subject to the jurisdiction of the Bureau.

Independence

The Bureau will be established within the Federal Reserve System but as an independent Executive agency. No rule or order of the Bureau shall be subject to review by the Board. The Bureau will have dedicated funding and will be autonomous from the Board with respect to any matter or proceeding before the Bureau's Director (including examination and enforcement actions), and will have the ability to appoint, direct, or remove any officer or employee of the Bureau. The Bureau will have an independent director who will be appointed by the President for a five-year term, who will be confirmed by the Senate, and who can only be removed by the President for cause.

"Start-up" Provision

The Bureau was legally established as of July 21, 2010, the enactment date of the Act, but only certain functions and authority of the Bureau went into effect on that date. Most functions and authority of the Bureau will go into effect on the "designated transfer date" (see below). Until the Director is confirmed, the Secretary of the Treasury is authorized to perform the functions of the Director.

Within 60 days of the enactment date, the Treasury Secretary must, in consultation with certain regulators, establish a single date for the transfer of functions to the Bureau (the "designated transfer date"). The designated transfer date shall not be earlier than 180 days nor later than 12 months after the enactment date. This date can be extended to 18 months after the enactment date if the Secretary transmits to Congress a written determination that an extension is necessary.

Numerous consumer financial protection responsibilities and functions, as well as staff employees, will be transferred to the Bureau from other agencies, offices and departments (including the Federal Reserve System, the Federal Trade Commission, the FDIC, HUD, the OCC, the Office of Thrift Supervision, and the National Credit Union Administration). The consumer financial protection function will be transferred as of the designated transfer date, and the staff employees must be transferred no later than 90 days

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after the designated transfer date. Further, on the designated transfer date, certain Bureau authorities will become effective, such as the ability to take any action to prevent a covered person from engaging in any UDAP, the ability to require that certain disclosures be made to consumers, the state preemption provisions, and the Bureau's enforcement powers.

Corporate Governance Issues

Title IX of the Act contains provisions addressing executive compensation and corporate governance issues that apply to *all companies*. Notably, the Act requires issuers of securities under the SEC's proxy solicitation rules to institute a non-binding up or down advisory vote on executive compensation (a "Say on Pay" vote) and, in the event of a business combination, a non-binding vote on "golden parachute" payments to named executive officers. Issuers of securities also will be required to provide a separate resolution for shareholders to vote on the frequency of such Say on Pay votes. Further, the Act allows, but does not mandate, the SEC to issue "Proxy Access" rules requiring the inclusion of shareholder nominees in an issuer's proxy solicitation materials. The Act also requires issuers to adopt "clawback" policies on excessive incentive-based compensation if the issuer is required to prepare an accounting restatement based on material noncompliance with financial reporting requirements under federal securities laws.

Other provisions in these titles address topics such as:

- Employee and director hedging activities;
- Discretionary broker voting;
- The separation of the chairman and CEO roles within a company;
- The independence of compensation committees and compensation consultants; and
- Enhanced executive compensation disclosures.

For more detailed information on the implications of corporate governance and executive compensation, please click here to see Sutherland's July 22, 2010, Legal Alert titled "*It's Signed, Now Comes the Hard Part*: What Your Board Needs to Know About Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act."

Derivatives

In general, Title VII , known as the "Wall Street Transparency and Accountability Act of 2010," would impose a completely new regulatory structure for the over-the-counter (OTC) derivatives market that will inevitably impact the way that insurance companies and their affiliates hedge their investments and other business risks.

Swaps available for trading on an exchange or otherwise designated by the CFTC and the SEC as subject to mandatory clearing requirements may no longer be traded in the OTC market (Cleared Swaps). Any OTC swaps that are not mandated for clearing will continue to be settled on a bilateral basis (Non-Cleared Swaps). Title VII of the Act also imposes broad new capital, margin, disclosure, reporting and recordkeeping requirements on certain participants in the swaps market, including swap dealers, major swap participants and major security-based swap participants, and gives new authority to the CFTC and the SEC to impose position limits on both exchange-traded contracts and swap contracts.

A chart summarizing key provisions of Title VII is attached here.

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While Title VII generally divides regulatory authority between the CFTC, which will regulate swaps,[29] and the SEC, which will regulate security-based swaps,[30] it also directs them to closely consult with each other and in some cases to jointly issue rules and regulations.

The effective date for most of the requirements of Title VII is July 21, 2011, one year after its enactment (the Effective Date). The CFTC and the SEC are also required to promulgate clarifying and enabling regulations and rules by the Effective Date.[31]

Nearly every key provision of this massive piece of legislation calls for some type of administrative rulemaking to be undertaken. Within these rules will lie the answers to most of the questions circulating throughout the derivatives market in response to this legislation. Myriad issues will be determined by the future rules, and an attached chart, available here, enumerates certain significant rulemakings related to the key issues under Title VII. The true impact of the legislative changes on insurance companies and their affiliates cannot be determined until these rules have been promulgated.

Trades Subject to Mandatory Clearing

At this point, it is impossible to assess with certainty which groups or classes of swaps will be designated for mandatory clearing requirements. However, it is highly likely that the CFTC and the SEC will impose mandatory clearing requirements on highly standardized interest rate and foreign currency swaps, credit default swaps, and certain equity swaps. (At present, roughly 80% of inter-dealer interest rate transactions are already cleared through LCH Clearing, a central clearing entity.)

Implications for the Insurance Industry
As a financial entity, insurance companies will not qualify for an exemption from the clearing requirements of Title VII and therefore, will have to submit all Cleared Swaps for clearing.

Title VII provides for an exemption from the clearing requirements otherwise applicable to Cleared Swaps. However, as a "financial entity," as defined under Title VII, an insurance company will not qualify for this exemption and will have to clear all Cleared Swaps. This new clearing requirement will impact insurance companies in various ways:

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[29] Swaps are defined broadly to include options, with certain exclusions; any agreement, contract, or transaction that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; and swaps; security-based swap agreements. The definition excludes: sales of a non-financial commodity, or a security, for deferred shipment or delivery, so long as the transaction is intended to be physically settled; any option on any security or group or broad-based index of securities that is subject to the 1933 Act and 1934 Act; any forward on one or more securities that is subject to the 1933 or 1934 Acts; any note, bond, or evidence of indebtedness that is a security; and "identified banking products," including loans and certificates of deposit.

[30] Security-based swaps, a subset of swaps, include any agreement, contract, or transaction that is a swap and is based on: narrow-based security index (generally, nine or fewer component securities), single security or loan, credit default swaps relating to a single issuer of a security, and issuers of securities in a narrow-based security index.

[31] Certain provisions have shorter timelines, including a six-month timeline for adopting position limits.

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- **Access to Central Clearing Entities**. It is unlikely that insurance companies will be members of Central Clearing Entities (CCE). As a result, they will continue to enter into trades with dealers that are CCE members and that will then submit the trades for clearing.
- **Mutualization of Counterparty Credit Risk.** For cleared trades, insurance companies will look to the creditworthiness of the CCE (rather than the dealer) which, in addition to its own resources, will have additional financial backing from all the members of the CCE.
- **New Margin Requirements**. Like futures transactions, all cleared trades will be subject to both initial and variation margin requirements imposed by the central clearing entity.
- **Effective Date**. Outstanding trades entered into before July 21, 2010, must be reported to a registered swap data repository or the CFTC or SEC, as applicable, by a date that is not later than 30 days after issuance of the interim final rule or such other period as the CFTC or SEC, as applicable, determines to be appropriate.

Trades Not Subject to Mandatory Clearing

More highly structured and customized trades entered into by insurance companies that are not subject to mandatory exchange execution or clearing requirements will continue to be entered in the bilateral OTC market. However, these trades will be subject to new requirements, including:

- ***New Margin Requirements****.* Unlike earlier drafts of the legislation, the final bill does not include an end-user exemption from margining and collateral requirements applicable to Non-Cleared Swaps. Transactions of insurance companies not subject to the execution and clearing requirements will nevertheless be subject to new minimum initial and variation margin requirements established by the regulators of the dealer counterparties.
- ***Segregation of Initial Margin****.* Upon request of insurance companies, dealer counterparties to non-cleared trades will be required to segregate funds or securities posted as initial margin with an independent custodian.
- ***Reporting Requirements****.* Both parties to non-cleared trades will be required to report their swaps to a registered swap repository.
- ***Disclosure Requirements****.* Dealer counterparties will be subject to various "business conduct" requirements including disclosure of material risks, source and amount of anticipated fees or other remuneration, and conflicts of interest.
- ***Effective Date.*** At this time, it is unclear whether outstanding swaps entered into prior to the Effective Date (180 days after the date of enactment) will be subject to the new initial and variation margin requirements. An amendment that would have expressly limited retroactive application of these requirements was suggested but never adopted, thus, creating this uncertainty.

Insurance Companies as "Swap Dealers" or "Major Swap Participants".

The legislation provides only limited guidance to the regulators, generally the CFTC and the SEC, which will be responsible for more precisely defining the scope of these key terms.

Swap Dealer. Under the new law, a "swap dealer" is any person, irrespective of the size of its OTC portfolio, that:

(i) holds itself out as a dealer in swaps;
(ii) makes a market in swaps;

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(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

While there are exemptions for those entities not conducting this activity as part of their regular business or on a *de minimis* basis with or on behalf of their customers, it is reasonably likely that a person that regularly assists (or holds itself as willing to assist) its customers or others in laying off risk through OTC transactions will be considered such a swaps dealer under one or more of the enumerated categories.

Major Swap Participant. Separately, the Act defines "major swap participant" as, among other things, any person that is not a swap dealer, and:

(i) maintains a substantial position in swaps for any of the major swap categories as determined by the [CFTC or SEC] …; or

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.

Swaps "held for hedging or mitigating commercial risk" are excluded. The CFTC and SEC will be required to determine what constitutes a "substantial position" and further define what is meant by "hedging or mitigating commercial risk."

Implications for the Insurance Industry
There is a possibility that certain insurance companies or their affiliates could be determined to be either swap dealers or major swap participants and if this were to occur, these companies or their affiliates would be subject to additional regulatory registration and operational requirements.

In the event that an insurance company or its affiliate were to be deemed a swap dealer or a major swap participant, it would become subject to radically more intrusive CFTC and/or SEC oversight (depending on whether the insurer is engaged in swaps and security-based swaps oversight, including the following):

(i) Capital requirements;
(ii) Regular examinations by the CFTC and/or SEC;
(iii) Extensive reporting requirements;
(iv) Direct CFTC trading oversight;
(v) Clearing requirements;
(vi) Margin requirements; and
(vii) Business conduct standards with respect to derivatives trading

It will be very important for insurance companies to closely monitor and participate in the regulatory process that will further define who is a swap dealer and a major swap participant.

Swaps or Insurance?

There has been considerable debate over whether certain derivative products are insurance and should be regulated as such under state insurance laws. Most notably, certain states, including New York, raised the prospect of regulating certain credit default swaps as insurance in the wake of the failure of

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AIG. Sutherland's Legal Alerts relating to various proposals regarding regulating credit defaults swaps as insurance can be found here and here. In order to establish greater certainty that derivatives do not become regulated as insurance, Section 722 of the Act specifically provides that a swap shall not be considered insurance and may not be regulated as insurance under state law.

During the legislative debate, concerns were expressed regarding the possibility that the broad definition of swaps in the proposed legislation could lead to insurance products being regulated as swaps. Such a characterization could lead to unanticipated and considerable regulatory requirements that could render the offering of these products uneconomic and could dramatically alter how insurers using these products conduct their business. The Act addresses this concern with respect to one insurance product, stable value contracts.[32] Section 719(d) of the Act mandates a study that addresses stable value contracts and whether these contracts should be included in the definition of swaps for purposes of the new legislation. The law provides that stable value contracts in effect before any regulations characterizing them as swaps are effective would not be considered swaps. The CFTC and SEC must conduct a study within 15 months of enactment of the Act (by October 21, 2011).

The status of other insurance products was not addressed in the Act. Given the specific exclusion regarding one type of insurance product from the definition of swap under one provision of the Act, and another provision that indicates that swaps are not insurance, it can be anticipated that insurers, State regulators, the CFTC and the SEC may be involved in debates over the proper characterization and regulation of certain products. These debates may entail consideration of the interplay between the Act and the McCarran Ferguson Act, which generally prevents Federal preemption of state laws regulating the business of insurance unless the Federal law specifically relates to insurance.[33]

Foreign Currency Transactions

The Act includes foreign currency swaps and foreign currency forwards within the definition of swaps subject to new regulation. The extension of swap regulation to cover foreign currency swaps appears to override the Treasury Amendment to the Commodity Exchange Act, which had exempted foreign currency transactions from CFTC oversight since 1974. This new regulation of foreign currency swaps and forwards, however, may be removed if the Treasury makes a determination that foreign currency

[32] For purposes of Act, the term "stable value contract" means any contract, agreement, or transaction that provides a interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity offered by a bank, insurance company, or other State or federally regulated financial institution for the benefit of any individual or commingled fund available as an investment in an employee benefit plan (as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, including plans described in Section 3(32) of such Act) subject to participant direction, an eligible deferred compensation plan (as defined in Section 457(b) of the Internal Revenue Code of 1986) that is maintained by an eligible employer described in Section 457(e)(1)(A) of such Code, an arrangement described in Section 403(b) of such Code, or a qualified tuition program (as defined in section 529 of such Code).

[33] The Gramm-Leach-Bliley Act may provide a useful guide as to the dividing line between insurance and swaps. Section 302(c) of the Gramm-Leach-Bliley Act defines "insurance" with respect to limiting banks insurance underwriting authority. That definition carves out from qualified financial contracts from the definition of insurance (which is essentially within the definition of a swap under the Act) offered after January 1, 1999 and further provides that products offered before that date and regulated as insurance are insurance. New products issued after that date can also be insurance, but there are bank products excepted from the definition, including the previously noted qualified financial contracts and financial guarantees (other than guarantees that qualify for life insurance, certain letter of credit, or annuity treatment under the Internal Revenue Code).

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swaps and forwards should not be regulated as swaps and/or that these transactions are not structured to evade the Act in violation of any rule. Even if the Treasury determines that foreign currency swaps and forwards should not be fully regulated, these transactions will still be subject to new reporting requirements, and any swap dealers or major swap participants engaging in them must conform to new business conduct standards.

Bank "Push Out" Provision

Similar to the Volcker Rule, banks and other insured depository institutions, BHCs and Board Supervised NFCs would lose federal deposit insurance, access to the Federal Reserve credit facility and other potential federal assistance if they are registered as swap dealers. Thus, each such entity would effectively be required to move all of its swap activities to an affiliated entity, e.g., a separately capitalized subsidiary of the holding company. There are certain activities, including most interest rate and foreign exchange transactions directly related to the mitigation of banking risks, and certain cleared credit default swaps, that may still be conducted directly, but these BHCs and Board Supervised NFCs still must comply with the proprietary trading ban under the Volcker Rule with respect to those activities.

Implications for the Insurance Industry
This "push out" will be very disruptive both for insurance companies that have depository institutions or other counterparties subject to the rule and also for insurance companies and their affiliates that have trades with entities subject to this requirement because there is no assurance that the new swap entities will have the same financial strength as the existing counterparties, and could have other significant ramifications, e.g., by limiting the right to set off against obligations to or from a bank affiliate of the new entity or the application of different insolvency regimes. Insurance companies may be faced with whether or not to terminate or continue their trades with new counterparties and must evaluate the liquidity, tax, and other consequences for any termination or transfer.

The Volcker Rule

The Volcker Rule, which is contained in Section 619 of the Act and which establishes a new Section 13 to the Bank Holding Company Act, prohibits all banking entities,[34] including certain insurance companies as discussed below, from: (a) engaging in proprietary trading or (b) acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or a private equity fund (hedge fund activities), unless otherwise allowed as permitted activities. In addition, insurance companies that are Board Supervised NFCs, even if they are not banking entities, will be subject to additional capital requirements and quantitative limits on their proprietary trading and hedge fund activities in accordance with rules that the Board is required to adopt.

[34] "Banking entities" are defined as (1) any insured depository institution as defined in Section 3 of the Federal Deposit Insurance Act (subject to a limited exception for certain trust institutions), (2) any company that controls an insured depository institution, (3) any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and (4) any affiliate or subsidiary of such companies. Certain trust companies are excluded from the definition of banking entity.

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Implications for the Insurance Industry
The Volcker Rule will primarily affect insurance holding company systems that include insured depository institutions. Each affiliate within such holding company, including insurance companies, falls within the definition of a banking entity, for purposes of the Volcker Rule, and will be subject to its limitations.
The Volcker Rule will also affect insurance complexes that are Board Supervised NFCs. The Board must, by rule coordinated through the Council, impose additional capital and quantitative limits on those proprietary trading and hedge fund activities of the Board Supervised NFC.
The Volcker Rule does not apply to insurance companies that are not Board Supervised NFCs or banking entities.
The Volcker Rule may also impact the structure (and possibly the permissibility) of certain private placement and bank-owned insurance products.

The Volcker Rule and the rules to be adopted thereunder will prohibit or limit proprietary trading and hedge fund activities by insurance companies that are banking entities or are Board Supervised NFCs. The following definitions are key to understanding any of these restrictions:

Proprietary Trading is defined as engaging as principal for the "trading account" of the banking entity or Board Supervised NFCs in any transaction to purchase or sell or otherwise acquire or dispose of any "(h)(4) instrument", defined below.

Trading Account is defined as any account used for acquiring or taking positions in securities and (h)(4) instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any other such accounts as may be determined by future rulemaking.

Subsection **(h)(4) instruments** are securities, derivatives, contracts of sale of a commodity for future delivery, options on any such securities, derivatives, contracts of sale, and any other security or financial instrument that may be determined by future rulemaking of the Federal banking agencies, the SEC and the CFTC. (subsection (h)(4))

Private Equity Fund and Hedge Fund. Private equity funds and hedge funds are generally defined as issuers that would be investment companies under the Investment Company Act of 1940, but for sections 3(c)(1) or 3(c)(7) of such Act and similar funds to be defined by future rulemaking.

Implications for the Insurance Industry
Insurance company separate accounts that are offered as private placements fall within the definition of a private equity fund and hedge fund in subsection (h)(2).
Unregistered separate account products, including private placement variable life and bank-owned life insurance products, could be caught up in the

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prohibitions imposed by the Volcker Rule on sponsorship and ownership of interests in hedge funds and private equity funds. Among the questions that arise are: ▪ Will Federal regulators follow precedent in other legal areas and “look-through” to the underlying assets owned by the unregistered separate account in applying the Volcker Rule to banking entities? ▪ How will the availability of a stable value wrapper or general account guarantee affect the applicability of the Volcker Rule?
Insurers that are banking entities or will be required to analyze their investment activities and those of their affiliates to determine whether such activities qualify as “permitted activities” under the Volcker Rule.
In defining trading accounts, (h)(4) instruments, private equity and hedge funds, and the scope of various permitted activities, the Federal banking agencies, the CFTC and the SEC are not required to seek input from or consult with State insurance regulators. How the Federal agencies interpret these provisions will be critical to determining the scope of activities in which insurers, deemed banking entities, are permitted to engage.

Permitted Activities: General Account Transactions. Subsection (d)(1) sets forth a number of permitted activities for banking entities under the Volcker Rule, including a carve-out in (d)(1)(F) for qualified transactions for the general account of an insurance company. The general account provision permits purchases, sales, acquisitions, or dispositions of securities and (h)(4) instruments by a regulated insurance company directly engaged in the business of insurance for the general account of the company (and by any affiliate of the insurance company provided that such activities by any affiliate are solely for the general account of the insurance company), if each of the following two tests is met:

- The transaction is conducted in compliance with, and subject to, insurance company investment laws and regulations, and written guidance of the insurance company’s domicile State or jurisdiction.
- The appropriate Federal banking agencies, after consultation with the Council and the relevant insurance commissioners, have not jointly determined after notice and comment that a particular law, regulation, or written guidance described above is insufficient to protect the safety and soundness of the banking entity or of the financial stability of the U.S.

Implications for the Insurance Industry
At any time, a Federal banking agency, after consultation with the Council and the relevant State insurance commissioners, can determine, after notice and comment, that a particular state insurance investment law is insufficient to protect the safety and soundness of the banking entity (including the insurance company) or of the financial stability of the U. S.
In such cases, the Federal banking agencies may order, after due notice and opportunity for hearing, the insurance company to terminate the activity or dispose of the instrument. Moreover, the applicable Federal agencies can issue such termination orders with regard to any investment activity that functions as an evasion of the Volcker Rule or otherwise violates the restrictions under Section 619 of the Act.
Even if the general account activities of a regulated insurance company that is a banking entity or a Board Supervised NFC qualify as permitted activities, the Federal agencies (banking, CFTC and SEC), with no required input from or

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consultation with state insurance regulators, may determine that additional capital and quantitative limits on the permitted activities of the insurance company are appropriate in order to protect the safety and soundness of the insurance companies that are banking entities or Board Supervised NFCs engaged in such activities. In such case, the Federal agencies must adopt coordinated rules under (b)(2) imposing such additional capital requirements and quantitative limits.

Permitted Activities: Risk-Mitigating Hedging Activities. Subsection (d)(1)(E) permits banking entities to engage in "risk-mitigating hedging activities" in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce specific risks to the banking entity in connection with and related to such positions, contracts or other holdings.

Implications for the Insurance Industry
Purchases of (h)(4) instruments for and on behalf of a separate account would certainly seem to be a risk-mitigating hedging activity because the insurance company would owe policy benefits based on the value of the (h)(4) instrument, and therefore purchases of such instruments would match the asset (investment) with the liability (policy cash value) and thus hedge the liability.

Permitted Activities: "On Behalf of Customers". Banking entities may engage in the purchase, sale, acquisition or disposition of securities and (h)(4) instruments on behalf of customers.

Implications for the Insurance Industry
The permitted activity carve-out for transactions on behalf of customers would appear to capture most trading activities performed by insurers on behalf of their separate accounts, although the applicability and contours of this provision are subject to rulemaking. Will the scope of the carve-out ultimately depend on the amount of insurer investment in the separate account, the percentage of director or employee interest in the underlying fund, or the existence of any direct or indirect guarantees issued by the insurer?
Although Section 619 of the Act addresses permitted activities of the general account, the Volcker Rule does not specifically address separate account trading activities of insurers deemed to be "banking entities." This raises a number of issues involving various separate account practices, including: ▪ Are separate account trading accounts for purposes of the prohibition on proprietary trading? ▪ Is trading on behalf of a separate account equivalent to trading on behalf of customers? ▪ Is trading on behalf of a separate account a risk-mitigating hedging activity? Does the analysis vary depending on whether the separate account is insulated, registered or unregistered, and the nature of the separate account investments?

Permitted Activities: Sponsoring a Private Equity or Hedge Fund. Banking entities are also permitted to organize and offer a private equity fund or hedge fund, including serving as a general

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partner, managing member, or trustee of the fund and in any manner selecting or controlling[35] a majority of the directors, trustees or management of the fund – if several tests are met, among them:[36]

- The banking entity provides bona fide trust, fiduciary or investment advisory services to the fund
- The fund is offered only to the banking entity's customers and only in connection with providing bona fide trust, fiduciary, or investment advisory services;
- The banking entity does not maintain an ownership interest in the fund other than a *de minimis* interest as defined by the Act;
- The banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests;
- The banking entity does not share with the hedge fund or private equity fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name;
- No director or employee of the banking entity takes or retains an equity, partnership or ownership interest in the hedge or private equity fund; and
- The banking entity discloses to investors in the fund, in writing, that any losses in such hedge fund or private equity fund are borne solely by investors in the fund and not by the banking entity.

Implications for the Insurance Industry
The limitations on the offering of private equity and hedge funds by banking entities may restrict the ability of insurers to offer insurance products that invest in private equity and hedge funds sponsored by affiliates and/or that provide guarantees and stable value wrappers offered by the insurer or an affiliate.
Could such restrictions also apply to unregistered separate accounts that invest in registered underlying funds?

Other Permitted Activities. Banking entities may also engage in the following:

- Investments in small business investment companies as defined under the Small Business Investment Act and certain investments of the type permitted under 12 U.S.C. 24(11) or investments that are qualified, rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure as such terms are defined in Section 47 of the Internal Revenue Code or a similar State historic tax credit program.
- Proprietary trading conducted solely outside the U.S., provided the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the U.S.[37]
- Investment in or sponsorship of a hedge fund or private equity fund solely outside the U.S. provided that no ownership interest in such fund is offered for sale or sold to a resident of the

[35] Including having employees, officers, directors or agents constitute a majority of the directors, trustees, or management of the fund.

[36] The Act also applies the requirements of Sections 23A and 23B of the Federal Reserve Act (transactions with affiliates) to transactions with the hedge fund, provided that certain prime brokerage services are excepted from Section 23A.

[37] The proprietary trading must be conducted pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act. Section 4(c)(9) relates to investments in companies organized under the laws of a foreign country, the greater part of whose business is conducted outside the U.S., and Section 4(c)(13) relates to investments in companies that do no business in the U.S., except as an incident to the companies' international or foreign business.

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U.S. and the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the U.S.
- Other activities as may be provided by rule, subject to safety and soundness requirements.

Exceptions to Permitted Activities. A transaction will not be deemed a permitted transaction if it would (1) involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties; (2) result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (3) pose a threat to the safety and soundness of the entity; or (4) pose a threat to the financial stability of the U.S. The Federal banking agencies, the CFTC and the SEC must issue coordinated regulations to implement these provisions.

De Minimis Investments. Subsection (d)(4) sets forth an exception for *de minimis* investments in private equity and hedge funds organized and offered by the banking entity. While this exception contains a number of requirements, the investment limitation is 3% of the total ownership interests in the fund with the total interest in all such funds limited in the aggregate to less than 3% of the Tier 1 capital of the banking entity.

Effective Date. Section 619 will become effective upon the earlier to occur of 12 months after the promulgation of required rules under the section or two years from the date of enactment. An additional two-year divestiture period follows the effective date in order for a banking entity or an NFC supervised by the Board to bring the company into compliance. Additional limited extensions will also be available subject to the approval of the Board.

Studies and Rulemakings. The Act contains a number of studies and rulemakings (including rules relating to capital, internal control and recordkeeping requirements), which will make the ultimate impact of the Volcker Rule uncertain.

Implications for the Insurance Industry
The Federal agencies (banking, CFTC and SEC), with no required input from or consultation with the State insurance departments, must issue regulations regarding internal controls and recordkeeping, in order to ensure compliance with the Volcker Rule. Such rules would, it appears, extend to the general and separate account activities of regulated insurance companies that are deemed to be banking entities. (subsection (e)(1))

Reinsurance and Surplus Lines

Title V of the Act reforms surplus lines (referred to in the Act as non-admitted insurance) and credit for reinsurance aspects of state insurance law.

Non-admitted Insurance (Surplus Lines)

This portion of the Act applies to property and casualty insurance coverage that is issued by an insurer that is not admitted in a state, and the coverage is placed directly or placed through a surplus lines broker. For the sake of clarity, workers compensation coverage is expressly excluded from Title V of the Act.

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The Act provides:

- Only the “home state” of the insured may regulate the placement of non-admitted insurance, including the licensing of the surplus lines broker(s) involved in the issuance of the coverage;
- Only the “home state” of the insured may impose premium taxes for non-admitted insurance;
- Commercial purchasers of non-admitted insurance have the benefit of a streamlined application process in which the broker need not perform due diligence to determine whether the coverage is available from insurers admitted in the state;
- States are prohibited from collecting surplus lines licensing fees after two years following the enactment of the Act unless the state participates in the NAIC’s national insurance producer database for the licensing of surplus lines brokers, or an equivalent database; and
- The GAO must submit to Congress a study, within 30 months of the effective date of the Act, on the size and market share of the surplus lines market for providing coverage typically provided by the admitted insurance market.

Implications for the Insurance Industry
The determination of the home state may not always be a simple process. In many cases, the home state for an individual is simply the state of his/her principal residence. If, however, the insured risk is totally outside of such state, one must determine to which state is allocated the largest percentage of the taxable premium for the insurance contract.
For commercial insureds, the home state is the one in which the insured maintains its principal place of business. In the case of an affiliated group, where more than one affiliate is a named insured, one needs to identify the affiliate with the largest percentage of premium attributed to it, then identify its home state.

Study of Non-Admitted Insurance Market. The GAO must submit to Congress a study within 30 months of the effective date of the Act on the size and market share of the surplus lines market for providing coverage typically provided by the admitted insurance market. The study will need to determine and analyze:

- **Change in the size.** The change in the size and the market share of the non-admitted market;
- **Shifting.** The extent to which there has been a shift from the admitted market providing coverage to the non-admitted market providing it;
- **Consequences.** The consequences of the changes discussed above, including pricing and availability of coverage;
- **Shifts in volume.** The extent to which insurers and insurance holding companies that sell both admitted and non-admitted insurance have experienced shifts in the volume of business between admitted and non-admitted insurance; and
- **Change in number of policies**. The extent to which there has been a change in the number of individuals who have non-admitted policies, the coverage provided under those polices, the insurers and whether the coverage is available on an admitted basis.

Implications for the Insurance Industry
The implications for insurers will be largely addressed by the content of the GAO report. The non-admitted market may grow, as a result of a potential increase in property and casualty insurance coverage being purchased from non-admitted insurers.

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It remains unclear whether European insurers will be able to provide sufficiently competitive pricing once they become subject to Solvency II. A possible effect is that new direct writers may be established offshore (in jurisdictions largely catering to reinsurers and captives) to write this coverage directly into the U.S. on a non-admitted basis.

Credit for Reinsurance and Reinsurer Solvency

This portion of the Act applies to the credit that a ceding insurer may take on its statutory financial statements for risks that it ceded (i.e., passed) through reinsurance, and to the amount of financial information that a reinsurer may be required to file with state regulators.

The Act provides:

- That only the state of domicile of a ceding insurer may establish whether the insurer will receive credit for reinsurance;
- No other state may deny credit once the domiciliary state has granted it;
- For preemption of the application of the insurance law of a state (that is not the domiciliary state of the ceding insurer) to a reinsurance agreement, including any: restriction on arbitration that is consistent with Title 9 USC, choice of law requirements for the reinsurance agreement, and attempt to enforce the contract on terms different from those in the reinsurance agreement;
- That the domiciliary state of a reinsurer will be solely responsible for regulating its financial solvency; and
- That no state may require financial information to be filed in addition to the information required by the reinsurer's domiciliary state.

The Act requires the ceding insurer's domiciliary state to be accredited by the NAIC, or have financial solvency requirements substantially similar to the NAIC, for the first two bullet points (shown above) to apply; and for the reinsurer's domiciliary state to be accredited by the NAIC, or have financial solvency requirements substantially similar to the NAIC, for the last two bullet points to apply.

As defined, a "Reinsurer" (1) must be principally engaged in the business of reinsurance; (2) may not conduct significant amounts of direct insurance; and (3) may not be engaged in the business of soliciting direct insurance on an ongoing basis.

Implications for the Insurance Industry
Unlike the non-admitted insurance provisions of the Act, no report is mandated for reinsurance. Initiatives that sought to reduce the amount of collateral for non-U.S. reinsurers failed on a national basis. These initiatives may succeed in several states.
The effect on pricing and other key terms, as well as availability, of reinsurance for cedents in those states will be of interest to the industry, but there may be less publicly available information on this subject. Redomestications to such "reinsurance-friendly" states may also happen.

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We will continue to monitor developments related to the regulatory reform initiatives impacting our insurance company clients. If you have any questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorneys with whom you regularly work.

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