

INSURANCE HOLDING COMPANY REGULATION IN NEW YORK IN LIGHT OF THE 2010 Amendments to the NAIC Model ACT

Committee on Insurance Law

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<u>REPORT OF THE COMMITTEE ON INSURANCE LAW</u> <u>OF THE NEW YORK CITY BAR ASSOCIATION</u>

Background

Like other states, New York regulates the acquisition and maintenance of control of insurance companies and transactions between insurance companies and affiliated entities. In most other states, such oversight falls under a statutory "insurance holding company act" and regulations promulgated thereunder by the state's insurance department, in each case based on a model text¹ (collectively, the "<u>Model Act</u>") published by the National Association of Insurance Commissioners (the "<u>NAIC</u>").² New York is not a Model Act state; however, Article 15 of the New York Insurance Law ("<u>NYIL</u>") and Regulation 52 of the New York State Insurance Department (the "<u>Department</u>")³ (collectively, the "<u>NY Holding Company Provisions</u>") are similar in substance to the Model Act. The predecessor statute to Article 15 was enacted by the New York legislature in 1969, the same year that the Model Act was adopted by the NAIC.

The Model Act is one of the NAIC model laws that a state must adopt in substantially similar form in order to be an "accredited" state under NAIC standards.⁴ The concept of accreditation (which requires that a state meet a baseline threshold of laws and insurance department practices specified by the NAIC) enhances uniformity in insurance regulation across state borders, which benefits consumers and industry alike, while perpetuating the state-based insurance regulatory system. The NY Holding Company Provisions are generally considered similar to the Model Act as currently in effect in other states, and, like most other states, New York, is an NAIC-accredited state. However, in December 2010, the NAIC amended the Model Act in significant ways, a number of which are discussed herein. The amendments are primarily in response to the 2008 financial crisis and, in general, enhance the authority of the insurance

¹ Insurance Holding Company System Regulatory Act (NAIC Model Laws, Regulations and Guidelines ("<u>MLRG</u>") 440-1); Insurance Holding Company System Model Regulation With Reporting Forms and Instructions (NAIC MLRG 450-1).

² The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. The NAIC, which is not a governmental entity, provides a forum for the development of uniform state laws and other policies when uniformity is deemed appropriate and provides technical guidance to the insurance regulatory community.

³ 11 NYCRR §§80 - 1.1 et seq.

⁴ See "Financial Regulation Standards and Accreditation Program" p.8, Natl. Assoc. of Insurance Commissioners, March 2011, available at <u>http://www.naic.org/documents/committees f FRSA</u> - <u>pamphlet.pdf</u>.

commissioner in the adopting state to regulate insurers as well as their affiliated entities. The NAIC has indicated that the purpose of these amendments is to "address issues that exist within insurer groups, particularly issues identified during this most recent economic downturn"⁵ and to provide state regulators with "important new tools for evaluating risks within insurance groups."⁶

Separately from the NAIC's recent efforts on the Model Act, in March 2010 the Department organized the Insurance Filing Modernization Initiative ("IFMI") to study reforms in the area of New York insurance regulatory filing requirements, not merely related to holding company regulation but across the board. In connection with this initiative, the Department established a set of working groups comprising industry and Department representatives and asked these groups to suggest reforms to filing requirements in several distinct areas. One of IFMI's constituent working groups, the Transactional Committee, was asked to focus on filings in connections with corporate transactions including, *inter alia*, possible reforms to the NY Holding Company Provisions. Because IFMI was not primarily motivated by holding company act concerns generally, and because IFMI preceded the NAIC's final adoption of Model Act changes, the Transactional Committee did not specifically consider the objective of aligning New York law on insurance holding companies to NAIC reforms. IFMI's conclusions, including those of the Transactional Committee, are memorialized in its Report to the Superintendent of Insurance, dated December 2, 2010.⁷

Since the issuance of the Report, the Department has introduced a number of reforms designed to implement IFMI suggestions, including guidance on the Department's website concerning certain Article 15 filings. We understand that the process of implementing the IFMI suggestions is still ongoing. For purposes of this Report, we have assumed that all of the reforms suggested by IFMI that relate to the NY Holding Company Provisions have been adopted.

We note parenthetically that New York's recently adopted legislation merging the Department with the New York State Banking Department⁸ does not make any substantive changes to Article 15.

The Need to Amend the New York Provisions and the Opportunity to Improve on the NAIC's Efforts

⁵ NAIC memorandum dated Sept. 1, 2010 from Noreen Vergara, Staff Attorney, to Commissioners and Interested Parties.

 ⁶ News release, Dec. 17, 2010, "NAIC Adopts Key Health Care Provisions, Budget, Other Regulatory Issues
— Special Session Finalizes Many Pending 2010 Regulatory Issues".

⁷ See <u>http://www.ins.state.ny.us/press/2010/Modernization2010.pdf</u>.

⁸ NYS Assembly Bill No. A04012, Senate Bill No. 2812, February 1, 2011.

The changes to holding company oversight represented by the Model Act amendments are so consequential that New York will have to amend the NY Holding Company Provisions in order to maintain accredited status, and the NAIC has begun to prepare guidance on exactly which provisions of the Model Act amendments will be required to be adopted by a state in order to remain accredited (the "<u>Substantially-Similar Guidance</u>").⁹ Even though such guidance is pending, some states have already taken steps to amend their holding company acts to conform to the NAIC revisions. At least three such states, Texas, Rhode Island and West Virginia, adopted legislation this past spring adopting the principal aspects of the NAIC changes,¹⁰ while in other states, including Florida¹¹ and Pennsylvania¹², bills were introduced in the most recent legislative session incorporating the NAIC amendments but were subsequently withdrawn or otherwise not brought to a final vote.

The instant Report is subject to the Substantially-Similar Guidance as ultimately issued. We believe that the suggestions made herein should be considered consistent with the Model Act amendments for purposes of NAIC objectives of harmonization of state laws. However, should the Substantially-Similar Guidance as ultimately issued make any of our suggested changes impracticable, we express no view as to whether our suggested changes are worth the loss of accredited status.

In addition to the need to retain accredited status, we believe that as other states enact the NAIC amendments (see above), New York will face pressure to adopt at least some of the critical components of the NAIC amendments (such as enterprise risk and supervisory colleges) in order not to be perceived as falling behind other states in terms of level of oversight of holding companies.

Moreover, amending the NY Holding Company Provisions will be an opportunity not only to ensure that New York is keeping up with the other states in terms of regulatory oversight but also to refine some of the concepts addressed by the NAIC that warrant reconsideration. To this end, any amendments to the NY Holding Company Provisions should be consistent with the following principles:

• Although "group supervision" (*i.e.*, the oversight of a group of affiliated companies as a whole) is a laudable goal, traditional notions of (i) territorial limits

⁹ See "Group Solvency Issues (EX) Working Group Draft Proposal for Substantially Similar Provisions of Revised Insurance Holding Company System Model Act (#440) and Regulation (#450)", NAIC email to interested parties, Feb. 16, 2011.

¹⁰ See 2011 Texas S.B. 1431; 2011 WV S.B. 253; 2011 RI H.B. 5730.

¹¹ 2011 Fl H.B. 1167.

¹² 2011 Pa. H.B. 644.

of a regulator's power and (ii) respect for a corporation's distinct identity (in the absence of fraud) must be observed.

- New York's reforms should be consistent with the goal of the U.S.'s achieving "equivalency" status for purposes of Solvency II.¹³ The main tests for equivalency have been defined under Solvency II, group supervision being one of them, but it is not yet known what specific features of the regulatory regime European regulators will require in their equivalency analysis of non-European jurisdictions. Therefore, some delay may be necessary in implementing reforms in New York until the Solvency II landscape becomes clearer.
- Obligations imposed on insurers and affiliates to report information to a regulator should be concomitant with the regulator's ability to act in response. In other words, if an annual form requests information concerning an agreement between two affiliates of an insurer, neither of which is an insurer itself, and it is not clear that the regulator has any authority over the content of the agreement; the information itself may be of little value relative to the burden associated with producing the information.

Basic Architecture of the NY Holding Company Provisions and the Model Act and Related Enforcement Mechanisms

Both the NY Holding Company Provisions and the Model Act regulate insurance company affiliations in essentially three ways:

- requiring pre-approval to be obtained from the insurance commissioner of an insurer's state of legal domicile before a person can acquire "control" over the insurer;
- requiring an insurer controlled by another entity to register with the insurance department as a "holding company system" and provide specified information to the regulator on a periodic basis; and
- imposing standards of fairness on transactions between insurers and their affiliate entities, including, in some cases, a requirement to pre-clear such transactions with the domiciliary regulator.

Enforcement mechanisms in the NY Holding Company Provisions differ somewhat from those in the Model Act. The Model Act authorizes the courts of the adopting state and the state insurance commissioner to exercise jurisdiction over persons resident in another state who file any "statement" with that regulator under the acquisition requirements of Model Act and "overall

¹³ EC Directive 2009/138.

[*sic*] actions involving such person arising out of violations of such provisions".¹⁴ More generally, the regulator may compel any insurer registered with it as a controlled insurer to produce books and records reasonably necessary to determine compliance with *any* provision of the state's insurance code. In the event the insurer fails to comply with such an order, the commissioner is given the power to examine the affiliates to obtain the information.¹⁵

The amended Model Act makes it easier for the regulator to obtain affiliate information. Specifically, under the amended Model Act, the commissioner may order any insurer registered as a controlled insurer to produce information not in the possession of the insurer if the insurer can obtain access to such. In the event the insurer cannot obtain the information requested by the commissioner, the insurer must provide the commissioner a detailed explanation of the reason therefor. If the commissioner determines that such explanation is "without merit", the commissioner may require the insurer, after notice and hearing, to pay a penalty for each day's delay, or may suspend or revoke the insurer's license. In addition, in the event the insurer fails to comply with such an order, the commissioner has the power to examine the affiliates to obtain the information. The commissioner also has the power to issue subpoenas, administer oaths and examine witnesses under oath for purposes of determining compliance with such provision. Upon the failure or refusal of any person to obey a subpoena under such circumstances, the commissioner may petition a court for an order compelling the witness to appear or to produce documentary evidence.¹⁶

The NY Holding Company Provisions already contain some of these features. Every holding company and its affiliates are subject to examination by order of the superintendent if he has cause to believe that the operations of such persons may materially affect the operations, management or financial condition of any controlled insurer within the system and that he is unable to obtain relevant information from such controlled insurer.¹⁷

Specific Items in the NAIC Amendments Warranting Revision When Applied to New York

Enterprise Risk Reporting Requirement. The Model Act amendments add the concept of "enterprise risk" and require controlled insurers to file a new annual form, called a "Form F",

¹⁴ Model Act §2F.

¹⁵ Model Act §6A.

¹⁶ Model Act §6E.

¹⁷ NYIL §1504(b).

detailing specified matters relating to the holding company group.¹⁸ The term "enterprise risk" is defined as

any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole, including, but not limited to, anything that would cause the insurer's Risk-Based Capital to fall into company action level . . . or would cause the insurer to be in hazardous financial condition. . ¹⁹

States will be required to have such a definition of "enterprise risk" under the draft Substantially-Similar Guidelines, and it can be assumed that this requirement will also be in such guidelines as ultimately issued. However, the definition is excessively vague, and several items required on Form F are broadly worded or otherwise vague or unclear.²⁰ It would behoove New York, if it must incorporate this defined term, to do so in a flexible way²¹ that acknowledges the inherent unforeseeability of risks affecting a group of companies and the sensitivity involved in disclosing such risks. Possible ideas to accomplish this would be one or more of the following:

• The amended NAIC regulations permit submission of SEC filings in response to the required "enterprise risk" factors in Form F.²² We express no view as to whether SEC filings are an adequate proxy for a statement of "enterprise risk". (We do note, however,

¹⁸ See Model Act §§1F, 3B(12)-(14), 4L; Form F.

¹⁹ Model Act §1F.

Among the items required to be listed in Form F are such open-ended matters as "any material developments regarding strategy, internal audit findings, compliance or risk management affecting the [group]"; "[any] reallocating of existing financial or insurance entities within the [group]; "any material activity or development of the [group] that, in the opinion of senior management, could adversely affect the [group]".

²¹ We note that in Texas's recently adopted legislation incorporating parts of the NAIC Model Act (signed by the Texas governor on June 17, 2011), enterprise risk reporting requirements are phased in over time based on insurer size. Specifically, holding companies need not file an enterprise risk before July 1, 2013 if the total direct or assumed annual premiums of the subsidiary insurer were \$5 billion or more during the preceding 12-month period; January 1, 2014 if premiums were more than \$1 billion but less than \$5 billion; January 1, 2015 if premiums were more than \$500 million but less than \$1 billion; or January 1, 2016 if premiums were \$300 million or more but less than \$500 million. For insurers with annual premiums of less than \$300 million, the parent company need not file an enterprise risk report at all, except that the Texas insurance commissioner may compel such a holding company to do so if the insurer is in hazardous financial condition. *See* 2011 Texas S.B. 1431 §6.

²² Form F, item 1.

that SEC filings are intended to be used chiefly by common stock investors in the public company, usually not itself an insurer, while insurance law filings are a regulatory tool to be used in the oversight of a downstream subsidiary.) However, in amending the Model Act the NAIC has made a policy judgment that SEC filings can be indicative of such risks. Accordingly, insurers whose affiliates have an SEC-compliant reporting function should not be required to speculate about which "enterprise risk" factors are not captured by the SEC filings, or, conversely, which SEC-reported items are not indicative of enterprise risk. New York should go beyond the NAIC's permissive use of SEC filings and create a safe harbor for such reporting. Specifically, the New York provision should specify that where a holding company is an SEC-reporting company, the use of SEC reports in detailing enterprise risks would be deemed presumptively sufficient for Form F purposes.

• The safe harbor could also include any existing "group-wide" reporting, whether or not SEC-mandated. "Group-wide" reporting could be defined to include any periodic report or filing required by law to be provided to regulators, securities exchanges, public investors, policyholders, depositors or other constituencies that contain disclosures on a consolidated group of companies or companies representing 90% or more of the revenues or assets of the group.

We note that the IFMI report recommends harmonizing the annual reporting requirements of controlled insurers, which are currently located in two distinct provisions, one regarding "registration" and one regarding "reporting".²³ Assuming these provisions are streamlined in accordance with the IFMI recommendation, there would be substantial similarity between New York's annual reporting requirements for controlled insurers and the NAIC's Form B and Form C, both pre- and post-amendment. However, the streamlined New York reporting provisions would not contain any requirements similar to those contemplated by the NAIC's Form F, which encompasses enterprise risk reporting.

Confidentiality of Enterprise Risk Disclosure. Expressions of matters that could cause enterprise risk are a fundamentally different kind of disclosure from ordinary factual matters both because they are subject to much judgment and because they could cause unwarranted adverse market reactions if publicly known. As a result, to encourage insurers to be as candid as possible without concern for undue negative publicity, we would also propose the strongest possible confidentiality protections for information disclosed on Form F or any equivalent form.

Under the Model Act amendments, Form F is entitled to confidential treatment.²⁴ New York's existing confidentiality statute, NYIL Section 1504(c), prescribes confidential treatment for any information filed under Article 15. At a minimum, any New York equivalent to Form F

²³ 11 NYCRR §80-1.2, §80-1.4.

²⁴ Model Act §8A.

should fall within the scope of Section 1504(c); this should not require any particular change because of the broad scope of existing Section 1504(c).²⁵ In the event that the Department then receives a request from a third party for a copy of an insurer's Form F (or equivalent New York filing) under the Freedom of Information Law ("FOIL"),²⁶ the fact that the Form F is entitled to confidential treatment under Section 1504(c) should be a sufficient basis for the Department to resist such request by invoking the exception to FOIL for materials "specifically exempted from disclosure by state or federal statute."²⁷

Morever, in crafting amendments to the NY Holding Company Provisions to conform to the Model Act amendments, the Department should consider strengthening confidentiality protection for any enterprise risks filings even *beyond* what is required under Section 1504. Under the Model Act amendments, for instance, Form F disclosures are covered by a pre-existing Model Act provision that specifically prohibits holding company filings from being discovered or admitted as evidence in any civil action.²⁸ It may be desirable for the NY Holding Company Provisions to incorporate such a requirement to the extent New York adopts a version of Form F or, at minimum, a provision permitting the Department or the insurer to seek a protective order shielding such information²⁹ if discovery thereof is sought in litigation and requiring that the presiding court may not deny such a request without conducting an *in camera* review of the filings.

Non-control determinations. The Model Act amendments alter the method by which a person can "disclaim" control over an insurer where a presumption of control exists. Such a filing is now to be deemed approved 30 days after filing if not objected by the regulator.³⁰ Existing NYIL Section 1501(c), which governs similar "determinations of non-control", is somewhat unclear on timing because it requires the Superintendent to rule within 30 days, or such longer period as he may permit, on a request for a determination of non-control but also states that the application is considered effective on filing, other than for purposes of Section

²⁵ "The superintendent shall keep the contents of each report made pursuant to [Article 15] . . . confidential and shall not make the same public without the prior written consent of the controlled insurer . . . unless the superintendent after notice and an opportunity to be hear shall determine that the interests of policyholders, shareholders or the public will be served by the publication thereof."

²⁶ New York Public Officers Law ("<u>POL</u>") §87 *et seq.*

²⁷ POL §87(2)(a).

²⁸ Model Act §8A. This provision as in effect in the Model Act states currently applies to Form B and Form C filings (annual registration statements).

²⁹ See New York Civil Practice Law and Rules §3103.

³⁰ Model Act §4K.

1506 (acquisition of control requirements). This makes the "deemer" provision uncertain, because even a good faith filing of an application can lead to a violation of Article 15 if the relevant shareholding is later determined to be a controlling one. New York could use the amendment process to conform its disclaimer to the more intuitive NAIC model. In this construct, a determination of non-control would have a 30-day deemed approval period; the regulator would not have the ability to disapprove a disclaimer following such approval or deemed approval.

Divestitures. In an episode that gained some notoriety, Kingsway Financial Services Inc., a Canadian firm, in 2009 donated shares of its wholly owned subsidiary, a Pennsylvaniadomiciled insurer, to 20 charities, with each charity receiving five percent of the total outstanding shares. Neither Kingsway nor any of the charities sought prior regulatory approval from the Pennsylvania insurance regulator for any of the transactions. The Pennsylvania regulator sued Kingsway and the charities alleging violations of Pennsylvania's version of the Model Act.³¹ Because no single charity acquired 10 percent or more of the outstanding shares (the presumptive threshold for "control" under the Model Act) and because Kingsway, as a divesting rather than acquiring party, was not under any obligation to make a filing anyway, Kingsway argued that no violation had, in the fact, occurred. (The trial-level court found for Kingsway, the Pennsylvania regulator appealed, and the parties are currently in settlement discussions.) Some observers, however, concluded that this incident underscored a gap in the Model Act insofar as a person can *divest* control of an insurer without prior regulatory review as long as no single acquirer obtains control. To address this, the NAIC included in the Model Act amendments a provision expressly dealing with divestitures. Specifically, a requirement is added to the effect that, any person divesting control over an insurer must provide 30 days' prior notice to the regulator and the insurer (with an exception for cases where a Form A is being filed).³² This requirement could prove impractical in capital markets settings (where there may be a heightened need for confidentiality prior to announcement of a transaction) or where a Form A is not being filed for valid reasons (e.g., an exemption has been obtained). If New York adds such a provision, appropriate exceptions should be added, including for cases where control is being divested by means of a registered share offering.

Multi-state hearings. The NAIC amendments provide for multi-state Form A hearings.³³ The existing NY Holding Company Provisions do not contemplate a hearing on an acquisition-of- control filing except in the event of a disapproval.³⁴ The failure to incorporate a multi-state

³¹ See Petition for Review in <u>Commonwealth of Pennsylvania Insurance Department</u> v. <u>Kingsway Financial</u> <u>Services, Inc., et al.</u>, Commonwealth Court of Pennsylvania, Docket No. 611 MD 2009, November 20, 2009, available at <u>www.portal.state.pa.us/portal/server.pt/document/878250/kingsway6_pdf</u>.

³² Model Act § 3A(2).

³³ Model Act \S 3A(2).

³⁴ NYIL §1506(b).

hearing concept in New York could lead to New York being frozen out of multi-state Form A applications. New York law should expressly authorize the Superintendent to participate in multi-state hearings. Care, however, should be taken to ensure that (i) no hearing is *required* in New York for approval under any circumstances and (ii) the confidentiality provisions of the existing NY Holding Company Provisions (which are more protective of Form A filings than the NAIC model) are preserved.

Financial projections. The NAIC amendments require that a Form A provide three-year financial projections for the target insurer.³⁵ This should not always be necessary, particularly where (as in many cases) a sale transaction does not involve any change to the insurer's operations or financial condition or where the transaction is capital-neutral to the insurer. New York's existing provision that a "detailed plan of operations" may be required by the Superintendent in a Section 1506 application³⁶ vests the Superintendent with appropriate discretion and should be retained without projections being required in all cases.

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³⁵ Form A, Item 12.

³⁶ 11 NYCRR §80-1.6, item 5

The Committee on Insurance Law is composed of members representing a diverse crosssection of the insurance community, including, among others, lawyers practicing in the areas of insurance company acquisitions, holding company regulation and related matters. This Report represents the views of the Committee as a whole and not necessarily those of any particular member thereof.

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