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The Long and Winding Road to Financial Services Regulatory Reform: The U.S. Senate Moves a Step Closer to Passing a Comprehensive Reform Bill

by Satish M. Kini and Christopher J. Ray

On March 22, 2010, by a strict party-line vote, the U.S. Senate Committee on Banking, Housing and Urban Affairs (the "Committee") approved comprehensive financial services reform legislation, entitled the Restoring American Financial Stability Act of 2010 ("RAFSA"). RAFSA, the latest iteration of legislation that would bring sweeping reforms to virtually every aspect of the U.S. financial services industry, will now be taken up by the full Senate.

The bill that now goes to the floor of the Senate was introduced on March 15, 2010 by Senator Chris Dodd (D-CT), chairman of the Committee. RAFSA bears similarities to a draft bill released last fall by Senator Dodd but also incorporates a number of substantive changes, some of them drawn from the reform bill passed by the House of Representatives on December 11, 2009, entitled the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill"). In addition, RAFSA includes a version of the so-called Volcker Rule, which was originally proposed by President Obama on January 21, 2010, and discussed in the February 2010 issue of the *Debevoise & Plimpton Financial Institutions Report* available at www.debevoise.com.

RAFSA spreads out over 1300 pages, supplemented by a more than 100-page Manager's Amendment, and, as noted, deals with a broad swath of regulatory topics. At its core, however, RAFSA wrestles with three key topics: (1) how to supervise, regulate, and limit risk-taking by large and systemically significant financial institutions and other banking firms; (2) how to ensure an orderly resolution process for failing financial firms; and (3) how to revise and streamline the structure of depository institution regulation. This article covers these three topics, to the exclusion of many others that are addressed in the bill. A final section of this article notes some of the implications of RAFSA for the many firms that would be affected by these provisions.

Regulation of Systemically Important Financial Institutions

Not surprisingly, the first title of RAFSA is devoted to establishing a framework for identifying, applying heightened supervision to, and in certain respects limiting the activities of, various financial firms. For this purpose, RAFSA relies chiefly on an interagency council, the Financial Stability Oversight Council (the "FSOC"), to identify systemic risks, and on the Board of Governors of the Federal Reserve System (the "Federal Reserve"), to regulate and supervise identified firms. In this manner, RAFSA largely follows the approach taken by the House Bill. RAFSA differs from the House Bill by including a version of the Volcker Rule, which the Obama Administration first proposed after the House Bill had been already passed by the U.S. House of Representatives.

Determination of Systemic Importance

RAFSA would charge the FSOC, headed by the Treasury Secretary, to determine which nonbank financial institutions, financial activities (including payment, clearing, and settlement activities), and financial practices are likely to pose risks to the financial stability of the United States and its financial markets. In this function, the FSOC would be supported by a newly created Office of Financial Research (the "OFR"), established within the Treasury Department, to serve as the FSOC's data collection and analysis arm.

Under RAFSA, the FSOC would have authority, on a two-thirds vote, to designate nonbank financial companies as systemically

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What's Inside

Letter from the Editor

As this issue of the *Debevoise & Plimpton Financial Institutions Report* goes to press we are looking forward to our Global Financial Services M&A Conference that will take place at our New York office on April 21, 2010. We hope that many of you will be able to join us as we provide an in-depth overview of relevant international regulatory and industry developments, as well as targeted sessions designed to assist M&A participants in the U.S. and abroad in the failed bank, investment advisory and insurance arenas. Edward M. Liddy, a partner at Clayton, Dubilier & Rice and the former Interim Chairman and Chief Executive Officer of American International Group, Inc., will be the keynote speaker. The Conference will feature a dozen senior Debevoise lawyers who focus on transactions with financial institutions. Also participating will be Titus W. Leung, Partner, Perella Weinberg Partners LP; Barbara G. Novick, Vice Chairman, BlackRock, Inc.; and Joe Stangl, Principal, Sandler O'Neill + Partners, L.P. Details of the program and how to register appear in the invitation, available at www.debevoise.com.

Our Global Financial Services M&A Conference comes as Debevoise's financial institutions group continues its growth. As many of you know, last year, two leading lawyers, Gregory J. Lyons and Satish M. Kini, joined our team as partners, focusing on serving the needs of financial institutions, with a particular emphasis on domestic and cross-border bank regulatory, transactional and examination matters.

In addition to the Global Financial Services M&A Conference this month, we will continue to host events focusing on important issues to the financial services industry, including what will be our Ninth Annual Insurance M&A Seminar, which is scheduled to take place in September.

Last month saw the signing of the largest insurance M&A transaction in history, American International Group's agreement to sell American International Assurance, one of the world's largest pan-Asian life insurance companies, to Prudential plc for approximately $35.5 billion, including approximately $25 billion in cash and approximately $10.5 billion in face value in equity securities of Prudential. Debevoise is advising AIG on this transaction. And other insurance M&A activity continues for AIG and other companies. Meanwhile, Capitol Hill will be busy in April as Congress continues to work toward regulatory reform legislation.

As always, we will monitor issues facing financial institutions and other developments and will continue to report on them in the *Debevoise & Plimpton Financial Institutions Report* and in Client Updates.

Wolcott B. Dunham, Jr.
Editor-in-Chief

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Corporate Governance of Insurers: Recent NAIC Developments

by Elizabeth K. Brill and Michael K. McDonnell

In light of the financial crisis and in connection with ongoing efforts to reform the regulation of financial institutions in general, and insurance companies in particular, regulators have been increasingly focusing on corporate governance practices of regulated entities. In this article, we briefly summarize the general corporate governance framework under state law and then discuss certain recent and ongoing initiatives at the National Association of Insurance Commissioners (the "NAIC") relating to corporate governance of insurers.

Corporate Governance Framework Under State Law

The basic prescriptions of corporate governance jurisprudence for directors of any major corporation are not new. Although the applicable statutory and case law varies from state to state, directors owe two primary fiduciary duties to the corporation: the duty of loyalty and the duty of care. The duty of loyalty includes an affirmative duty to protect the interests of the corporation, and an obligation to refrain from conduct that would injure the corporation and its stockholders or deprive them of profit or advantage. The duty of care requires directors to act using that degree of care that ordinarily prudent persons would use in similar circumstances, and consider all material information reasonably available in making business decisions.

Courts have developed the business judgment rule, which serves as a defense if disinterested directors' actions are later challenged. The rule acts as a presumption that, in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation and its shareholders. To satisfy the basic requirements of the business judgment rule, directors must act:

- in good faith;
- without a personal interest in the matter before them that conflicts with the interests of the company; and
- on a basis of being adequately informed, including consideration of information and advice from officers and professionals they consider worthy of reliance.

The business judgment rule creates a presumption in favor of the board, freeing its members from possible liability for decisions that result in harm to the corporation. This presumption may be rebutted by a plaintiff with evidence showing: (1) the board decision was uninformed or (2) the defendants violated either the duty of care or loyalty.

In addition, developments of the past several years indicate an emerging duty of oversight, heightening the importance of having a sound process for informed, disinterested decision-making by directors. Some courts (e.g., *In re The Walt Disney Co.*, 906 A.2d 27 (Del. 2006)) have also discussed a duty of good faith as a duty that is separate from, though related to, the duty of loyalty.

Recent and Ongoing NAIC Developments

Although corporate governance requirements have historically been the province of state corporate law, legislators and regulators at the state and federal level have been increasingly focusing on corporate governance. For example, the Sarbanes-Oxley Act of 2002 ("SOX") and related rules promulgated by the U.S. Securities and Exchange Commission (the "SEC") apply certain internal control and governance standards to SEC registrants. Similarly, the New York Stock Exchange applies certain director independence and other requirements to listed companies.

Recently, the NAIC has shown increased interest in corporate governance matters, in the context of various different projects. The following discusses NAIC developments and guidance related to corporate governance in the context of: (1) the NAIC's solvency modernization initiative; (2) proposed revisions to the NAIC Insurance Holding Company System Regulatory Act (Model 440) (the "Model Holding Company Act") and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (Model 450) (the "Model Holding Company Regulation"); (3) revisions to the Annual Financial Reporting Model Regulation (the "Model Audit Regulation"); (4) proposed requirements for additional disclosure of corporate governance and compensation information; (5) the NAIC Financial Condition Examiners Handbook (the "Examiners Handbook"); and (6) principles-based reserving for life insurers.

Solvency Modernization Initiative

As part of its ongoing solvency modernization initiative, the NAIC is considering various aspects of the corporate governance of insurers. Although the solvency modernization initiative, and the related corporate governance review, is still in the beginning stages, the NAIC has

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recognized the importance of approaching corporate governance issues from a global perspective.

On March 11-12, 2010, the Solvency Modernization Initiative (EX) Task Force (the "SMI Task Force") of the NAIC met in Phoenix, Arizona to, among other things, discuss corporate governance and risk management and receive comments on its *Consultation Paper on Corporate Governance and Risk Management*, which was exposed for comment on September 29, 2009. As noted at the interim meeting by Director Urias of Arizona, chair of the SMI Task Force, the financial crisis has highlighted certain unsafe business practices and regulators are increasingly becoming aware of the roles of corporate governance and risk management in maintaining the financial solvency of regulated companies. Director Urias also suggested that state insurance regulators should have the explicit authority to enforce corporate governance requirements and to take action when they believe such requirements have not been met. Depending on the scope of any such enforcement rights, this could represent a fundamental shift in the corporate governance framework and could impose significant new potential liabilities on directors and executive officers. The corporate governance working group of the SMI Task Force has, however, recognized the importance of avoiding conflicts with existing corporate governance requirements under state law. To this end, the working group plans to review the existing legal framework in at least several states at the outset of its review.

For additional discussion of the SMI Task Force and its *Consultation Paper on Corporate Governance and Risk Management*, see the article on the NAIC's solvency modernization initiative in the March 2010 issue of the *Debevoise & Plimpton Financial Institutions Report*, available at www.debevoise.com.

The NAIC recently adopted revisions to the Model Audit Regulation relating to auditor independence, corporate governance, and internal control over financial reporting, which are effective in 2010, and are intended to incorporate SOX best practices.

Model Holding Company Act and Regulation

Through its group solvency issues working group, the SMI Task Force also has been considering revisions to the Model Holding Company Act and the Model Holding Company Regulation. At the NAIC's December 2009 national meeting, the working group debated a proposal by the Connecticut Insurance Department (the "Connecticut Proposal") to include language in the Model Holding Company Act requiring that certain agreements between an insurer and its affiliate contain provisions stating that the insurer's board and management—rather than just the entity—will maintain oversight and responsibility for maintenance of internal controls and oversight of the affiliate's performance. Several members of the working group spoke out against this proposal, arguing that it would unnecessarily alter the standard of care traditionally applied to directors and that it would be inappropriate to require board involvement in such a quintessentially managerial function, particularly since neither the draft nor the Connecticut Proposal contained a materiality qualifier for agreements covered. One working group member compared the Connecticut Proposal to a proposal that was considered and ultimately rejected in the course of the NAIC's development of corporate governance standards relating to principles-based reserving for life insurers. That proposal would have made board members directly responsible for oversight of policies related to the adequacy of an insurer's principles-based reserves, but was clarified (due in part to concerns that directors' responsibilities would be too uncertain) to state that a board's oversight would be general in character and to delineate the scope of a board's responsibilities regarding processes, infrastructure and documentation. At the March 2010 national meeting, the group solvency issues working group referred these questions regarding board oversight and responsibility to the SMI Task Force's corporate governance working group.

Model Audit Regulation

The NAIC recently adopted revisions to the Model Audit Regulation relating to auditor independence, corporate governance, and internal controls over financial reporting, which are effective in 2010, and are intended to incorporate SOX best practices. Among other things, these revisions include audit committee requirements, similar to those set forth in SOX and related rules promulgated by the SEC, that apply to insurers. The Model Audit Regulation recognizes that publicly-traded companies are subject to their own governance requirements including a requirement under SOX that they have an audit committee composed of independent directors. To avoid multiple layers of governance requirements, although the Model Audit Regulation is applicable to

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insurers generally, if a parent holding company has an audit committee composed of independent directors, then the parent's audit committee can act as the audit committee of a subsidiary insurer for purposes of the Model Audit Regulation, and the subsidiary is not required to reconstitute its board in order to establish a subsidiary audit committee composed of independent directors.

Under the Model Audit Regulation, an insurance company must have an audit committee established by the board of directors for the purpose of overseeing the financial and reporting processes of the insurer or group of insurers. The audit committee is solely responsible for the appointment, compensation and oversight of the company's auditor for the purpose of preparing or issuing the company's audited financial reports. Insurers with direct written and assumed premiums between $300 million and $500 million during the prior calendar year must have a majority (50% or more) of independent audit committee members and insurers with premiums over $500 million must have a supermajority (75% or more) of independent audit committee members.

In addition, the revisions to the Model Audit Regulation include standards for the conduct of directors and officers. Directors and officers may not make materially false or misleading statements, or omit to state any material fact necessary to make statements made not misleading, to an accountant in connection with an audit. Insurers required to file an audited annual report and that have annual direct written and assumed premiums of at least $500 million must annually report on their internal control over financial reporting. This report must be signed by the chief executive and chief financial officers and must include a statement by management as to whether its internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of the statutory financial statements and disclosure of any unremediated material weaknesses in internal control over financial reporting. The revisions to the Model Audit Regulation also specify requirements for qualified independent certified public accountants and enumerate prohibited non-audit services that may not be provided to an insurer contemporaneously with an audit (including bookkeeping, financial information systems design and implementation, appraisal or valuation services, certain actuarial services, internal audit outsourcing, management functions or human resources, broker-dealer or investment advisory services and legal services).

Disclosure of Additional Corporate Governance and Compensation Information

At the NAIC's March 2010 national meeting, the NAIC/AICPA working group announced its intention to consider adopting new insurance regulations based on recent amendments by the SEC to the proxy disclosure rules applicable to public companies. The SEC's recent amendments are contained in SEC Release No. 33-9089[1] and would, among other things, require disclosure in a company proxy statement of:

- the effect on risk management and risk-taking incentives of compensation policies and practices that are "reasonably likely to have a material adverse effect" on the company;
- the "specific experience, qualifications, attributes or skills" that led to the conclusion that all continuing directors and director nominees should serve on the company's board of directors;
- the "leadership structure" of the board of directors, including a discussion of whether and why the company has chosen to combine or separate the positions of chairman of the board and chief executive officer;
- the role of the board of directors in the oversight of risk; and
- the role of diversity in evaluating director candidates.

In connection with its ongoing work on a system of principles-based reserving for life insurers, the NAIC has developed guidance regarding corporate governance of life insurers holding principles-based reserves.

The foregoing list is not exhaustive. Because the NAIC/AICPA working group's review of this matter is at a preliminary stage, it is unclear what elements of the recent SEC amendments might be incorporated into any proposed new insurance regulations, or if the working group might consider adopting other elements of the proxy disclosure rules that predate the recent SEC amendments. If the working group moves forward with this proposal, it will represent a significant new burden for some insurers. For example, if adopted, new regulations based on the new proxy disclosure rules presumably would, like the Model Audit Regulation, apply to insurers

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that would not otherwise be subject to federal securities laws and regulations affecting public companies, including, for example, mutual insurers that do not issue stock.

As a next step, the working group has asked NAIC staff to create a discussion draft setting forth an approach to the implementation of new insurance regulatory disclosure rules, and plans to schedule a conference call to solicit feedback on the discussion draft from the insurance industry and other interested parties.

Examiners Handbook

The Examiners Handbook, which serves as a guide for financial examinations by state insurance regulators, includes guidance and recommendations concerning monitoring of insurers' corporate governance frameworks. Although the Examiners Handbook does not include specific corporate governance requirements, it instructs the examiner to understand and assess an insurer's board of directors and management. For example, the Examiners Handbook suggests that, among other things, the following be considered in connection with the examiner's assessment of the insurer's board of directors:

- whether the membership criteria and terms for the board of directors are sufficient to enable the effective monitoring and oversight of management;
- whether the board of directors effectively monitors and oversees management activities;
- whether the board of directors is sufficiently independent from management;
- the frequency and timeliness with which meetings are held with the chief financial and/or accounting officers, internal auditors and external auditors;
- whether the information provided to directors is sufficient and timely enough to allow monitoring of management's objectives and strategies, the entity's financial position and operating results, and terms of significant agreements;
- whether there is a formal process through which the board or audit committee is apprised of sensitive information, investigations and improper acts sufficiently and in a timely manner;
- the board's role in establishing the appropriate "tone at the top"; and
- the actions the board takes as a result of its findings, including special investigations as needed.

Examiners also are instructed to assess risk management activities as well as the audit function, including the audit committee and the company's internal and external audit functions.

Principles-Based Reserving

In connection with its ongoing work on a system of principles-based reserving for life insurers, the NAIC has developed guidance regarding corporate governance of life insurers holding principles-based reserves. The system of principles-based reserves that is being developed by the NAIC confers significant discretion on company actuaries, giving additional flexibility in the establishment of the assumptions and methodologies used to calculate reserve liabilities. As a result, the principles-based reserving reform includes new, detailed governance procedures that will be required to ensure thorough oversight and controls in connection with the establishment of life insurer reserves.

While the NAIC has provided detailed guidance regarding corporate governance in the context of principles-based reserving, this guidance is not intended to alter basic duties under applicable corporate law. In fact, the September 2009 draft of VM-G, the section of the NAIC's proposed reserving valuation manual that would set forth corporate governance requirements, specifically notes that it does not expand "the existing legal duties of a company's board of directors, senior management and appointed actuary and/or other qualified actuaries." Instead, the valuation manual indicates that it is intended "to emphasize and clarify how their duties apply to the principle-based reserves actuarial valuation function of an insurance company or group of insurance companies." The valuation manual implies, for example, that directors may continue to rely on experts as appropriate in the oversight of principles-based reserving. Nonetheless, the adoption of principles-based reserves will require that directors and management devote significant attention to the establishment of procedures for compliance with the governance guidelines set forth in the new Model Standard Valuation Law and the valuation manual.

For additional discussion, see the article on principles-based reserves in the October 2009 issue of the *Debevoise & Plimpton Financial Institutions Report*, available at www.debevoise.com. ■

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1 *See www.sec.gov/rules/final/2009/33-9089.pdf*

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important. Firms would be entitled to notice and an opportunity for comment before a final FSOC determination. Once designated, firms would be subject to heightened regulation and supervision by the Federal Reserve and would be treated as bank holding companies for certain purposes (for example, by being subject to the management interlocks limits currently applicable to bank holding companies). As a general matter, systemically important firms would not need to conform their activities to the limits of the Bank Holding Company Act (the "BHCA"), although the Federal Reserve could require such firms to establish intermediate holding companies for their financial activities.

The FSOC also would have the authority to issue recommendations to primary financial regulatory agencies that they apply heightened standards to an activity or practice conducted by companies under their respective jurisdictions, if the FSOC determines that such activity or practice could pose significant liquidity, credit, or other risks to bank holding companies, nonbank financial firms, or U.S. financial markets. The FSOC would be required to consult with primary financial regulatory agencies and provide public notice and opportunity for comment for any proposed recommendation.

In cases of "grave threats" to the financial system, the FSOC would have additional powers. In any case in which a bank holding company with $50 billion or more of total consolidated assets or a systemically significant nonbank holding company poses a "grave threat" to the financial system, the FSOC would call on the Federal Reserve to impose conditions on, or demand the cessation of, the firm's activities.

Enhanced Supervision and Regulation of Systemically Important Financial Firms

RAFSA would entrust the Federal Reserve to apply heightened supervisory standards to (1) the nonbank financial companies found to be systemically important by the FSOC, and (2) "large, interconnected" bank holding companies. (This article will refer to such companies collectively as "Systemically Important Financial Firms"). Bank holding companies would need to have at least $50 billion in total consolidated assets to be designated "large and interconnected"; the Federal Reserve would have discretion to increase the $50 billion threshold, but not to lower it.

If enacted, RAFSA would dramatically alter the U.S. financial regulatory landscape. ... RAFSA would create a significantly more restrictive regulatory environment for many large U.S. financial institutions and international financial institutions with significant U.S. operations.

With input from the FSOC, the Federal Reserve would be required to establish a wide array of prudential standards and reporting and disclosure requirements for Systemically Important Financial Firms. As a rule, those standards would need to be "more stringent" than comparable standards applicable to non-Systemically Important Financial Firms. For example, the required prudential standards would include:

- *Risk-based capital requirements, leverage limits, and liquidity requirements.* RAFSA does not, however, mandate any specific leverage, capital, or other similar levels.
- *Resolution plan or "Living Will" requirements.* Systemically Important Financial Firms would need to develop plans for rapid and orderly resolution in the event of material financial distress or failure. Various regulatory penalties could be applied by the Federal Reserve and Federal Deposit Insurance Corporation ("FDIC") if they deemed a submitted plan inadequate.
- *Credit exposure requirements.* Systemically Important Financial Firms would need to report periodically to the Federal Reserve, FSOC, and FDIC on their credit exposures to other Systemically Important Financial Firms.
- *Concentration limits.* Systemically Important Financial Firms would not be permitted to have credit exposure to any unaffiliated company that exceeds 25 percent (or a lesser percentage if deemed appropriate by the Federal Reserve) of capital and surplus.
- *Risk Committees.* Each publicly traded bank holding company with $10 billion or more in total consolidated assets, and each nonbank Systemically Important Financial Firm that the Federal Reserve supervises, would need to establish a risk committee (presumably a committee of the board of directors), including independent directors and at least one risk expert. (The Federal Reserve would also have the discretion to require a risk committee at smaller publicly traded bank holding companies as well.)

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The Federal Reserve also would have broad discretion to impose various other standards, including contingent capital (i.e., debt that would convert to equity under certain conditions of financial stress), enhanced public disclosure and overall risk management requirements. The Federal Reserve would need to consider various factors in determining the stringency and application of the required and discretionary standards.

RAFSA would flatly prohibit any "covered transactions" (such as extensions of credit) under Section 23A of the Federal Reserve Act between an insured depository institution, a company that controls such an institution or is treated as a bank holding company, or any subsidiary thereof and a hedge fund or private equity fund that is managed by such company.

The Federal Reserve would be granted enhanced supervisory and examination powers as well. To give an example, the agency may examine any firm (including its subsidiaries) that the FSOC determines is a Systemically Important Financial Firm. RAFSA also would require the Federal Reserve to conduct stress tests of Systemically Important Financial Firms. RAFSA does not specify the frequency of such tests.

Finally, Title I of RAFSA contains what some have dubbed a "Hotel California" provision. Under this provision, a bank holding company that had total consolidated assets of $50 billion or more as of January 1, 2010, and that received financial assistance under the Troubled Asset Relief Program, may not escape Federal Reserve supervision as a Systemically Important Financial Firm merely by ceasing to be a bank holding company. Essentially, this limit would prohibit institutions from "de-banking" to escape heightened regulatory standards, unless they are allowed to do so by the FSOC.

Volcker Rule and Related Concentration Limits

As originally proposed by the Obama Administration, the Volcker Rule would have prohibited any financial institution that includes a bank to own, invest in, or sponsor a hedge fund or private equity fund or to engage in proprietary trading. Draft legislative language released by the Treasury Department on March 4, 2010 expanded the scope of this prohibition to apply to any insured depository institution or any company that controls an insured depository institution. For nonbank Systemically Important Financial Firms, the draft legislative language would not have imposed a ban on these activities, but instead would have required regulations imposing additional capital requirements and quantitative limits if these companies choose to engage in them. The March 4 draft legislation also would have imposed a concentration limit prohibiting an acquisition by a financial institution that would result in its control of more than ten percent of total aggregated consolidated liabilities of all financial companies.

RAFSA would impose similar requirements, but with the potential for certain alterations based on the results of studies to be conducted by the FSOC. One significant deviation from the Treasury proposal is that, subject to alterations based on the studies described below, all subsidiaries either of an insured depository institution or of any company that controls it directly or indirectly would be subject to the Volcker Rule, in addition to the insured depository institution and the company that controls it. In general, with regard to the Volcker Rule, RAFSA would require the federal banking agencies to issue rules to prohibit an insured depository institution and its affiliates from engaging in proprietary trading or from sponsoring or investing in a hedge fund or private equity fund. "Proprietary trading" would not include transactions on behalf of a customer, market-making activities, or transactions undertaken in connection with or in facilitation of customer relationships. In addition, trading in U.S. government and agency obligations, certain government-sponsored entity obligations, and obligations of states and municipalities would be exempted.

RAFSA also could potentially lead to the imposition of Volcker Rule limits to nonbank Systemically Important Financial Firms. Specifically, like the Treasury proposal, RAFSA would require the Federal Reserve, again subject to the FSOC's study process, to impose additional capital requirements and quantitative limits on nonbank Systemically Important Financial Firms that engage in proprietary trading or sponsoring or investing in hedge and private equity funds, with similar exceptions to those described above.

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With regard to concentration limits, RAFSA essentially follows the Treasury Department's March 4 draft legislation by requiring the Federal Reserve to issue rules, subject to an FSOC study, prohibiting a financial company from merging, consolidating with, acquiring all or substantially all of the assets of or otherwise acquiring control of, another company, if the resulting total consolidated liabilities would exceed 10 percent of aggregate consolidated liabilities of all financial companies as of the end of the prior calendar year. RAFSA contains exceptions for *de minimis* acquisitions and acquisitions of banks in default or danger of default or involving FDIC assistance.

RAFSA's study element is new and potentially important. Under RAFSA, each of the above requirements would be subject to the recommendations of the FSOC. The required rulemaking would follow the FSOC study process; the FSOC would have six months after the enactment of RAFSA to complete its work, after which the federal banking agencies named above would have nine months to issue regulations reflecting the FSOC's recommendations. This process seems to allow for the possibility that the statutory requirements could be heightened, softened, or otherwise varied by regulators, but it is not clear the extent to which the study process could significantly alter the prohibitions or exempt transactions and entities from the statutory limits.

One aspect of RAFSA's limits is not contingent on studies and rulemaking. RAFSA would flatly prohibit any "covered transactions" (such as extensions of credit) under Section 23A of the Federal Reserve Act between an insured depository institution, a company that controls such an institution or is treated as a bank holding company, or any subsidiary thereof and a hedge fund or private equity fund that is managed by such a company. Other transactions between funds and such companies would be subject to the market terms requirements of Section 23B of the Federal Reserve Act.

To pay the costs of a resolution, RAFSA would establish an Orderly Liquidation Fund with a target size of $50 billion.

Resolution Authority

RAFSA's second title would establish a mechanism for the "orderly liquidation" of failing Systemically Important Financial Firms. In many ways, RAFSA's liquidation approach parallels the dissolution authority established by the House Bill. In both bills, the FDIC would act as receiver and possess broad powers analogous to its existing powers to resolve failed depository institutions under the Federal Deposit Insurance Act ("FDIA").

There are, however, some differences between RAFSA and the House Bill. One of these differences centers on process. Under RAFSA, a special panel of bankruptcy judges would review a determination to invoke the FDIC's powers; such a process was not built into the House Bill. In addition, the size of RAFSA's "Orderly Liquidation Fund" would be $50 billion as opposed to $150 billion as in the House Bill, and there would be certain differences in the companies that would be subject to assessment and in the manner of assessment. Also, RAFSA does not contain the mandatory "haircuts" to certain secured creditor claims that the House Bill would require.

Firms Subject to Liquidation Process

RAFSA's orderly liquidation process would apply to what it terms "covered financial companies," which would include not only Systemically Important Financial Firms but also any U.S. bank holding company and any U.S. company "predominately engaged in activities that are financial in nature or incidental thereto" under section 4(k) of the BHCA, as well as to the subsidiaries of such firms. Subsidiaries of covered financial companies that are insured depository institutions, broker-dealers that are members of the Securities Investor Protection Corporation ("SIPC") and insurance companies generally would not be subject to RAFSA's orderly liquidation process.

If an insurance company is a covered financial company or a subsidiary or affiliate of a covered financial company, its liquidation or rehabilitation generally would not be conducted under RAFSA's liquidation process but under state law, except in the case of a subsidiary or affiliate of an insurance company that is not itself an insurance company. If, however, the appropriate regulatory agency has not filed the appropriate judicial action in state court to place an insurance company into orderly liquidation under relevant state law within sixty days of a systemic risk determination (as described below), the FDIC would have the authority to stand in the place of the appropriate regulatory agency and file such an action in state court.

Appointment of FDIC as Receiver

In general, the initial stages of an orderly liquidation under RAFSA would involve a joint recommendation in favor of resolution to the Treasury Secretary from the Federal Reserve and the FDIC or, in the case of a broker-dealer, from the Securities and Exchange Commission ("SEC"). The Treasury Secretary could then, in consultation with the President,

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make a determination that the financial company is in "default or in danger of default" and that, among other things, the firm's failure would have serious adverse consequences to U.S. financial stability.

On making this determination, the Treasury Secretary would be required to petition a panel of three judges in the U.S. Bankruptcy Court for the District of Delaware for an order authorizing the appointment of the FDIC as receiver for the financial company. The Panel would be required to rule within twenty-four hours on whether the Treasury Secretary's determination that the covered financial company is in default or danger of default is supported by substantial evidence. This ruling would be final, but would be subject to appeal within thirty days to the U.S. Court of Appeals for the Third Circuit and ultimately to the U.S. Supreme Court.

General Powers of FDIC as Receiver

As noted, RAFSA would grant broad powers to the FDIC that generally parallel the agency's existing powers under the FDIA for dealing with the resolution of failed insured depository institutions. The FDIC's powers would generally include serving as successor to the covered financial company and operating it during the orderly liquidation; liquidating the company through asset sales or the transfer of assets to a bridge financial company; determining (subject to certain restrictions) the rights and claims of shareholders and creditors; and paying claims.

RAFSA would limit the FDIC's authority as receiver in one potentially important respect, by requiring the agency to determine that any action it takes in an orderly liquidation process is necessary for U.S. financial stability and not for the purpose of preserving the covered financial company. The FDIC also would be required to ensure that shareholders do not receive payment until all other claims and the Orderly Liquidation Fund (as described below) are fully paid, that unsecured creditors bear losses in accordance with RAFSA's priority of claim provisions and that management responsible for the failure of the covered financial company is removed.

Orderly Liquidation Fund and Assessments

To pay the costs of a resolution, RAFSA would establish an Orderly Liquidation Fund with a target size of $50 billion. This Fund would initially be funded for a period beginning one year after the enactment of RAFSA until five to ten years after enactment, subject to extension by the FDIC. RAFSA would require the FDIC and the Treasury Secretary, in consultation with the FSOC, to establish regulations governing a specific assessment mechanism. In general, all assessments would be required to be risk-based, on a graduated basis.

During the initial capitalization period, assessments would be imposed on all Systemically Important Financial Firms. If a company becomes a Systemically Important Financial Firm after the initial capitalization period, it would also be subject to an assessment.

Additional assessments would be imposed in order to replenish the Orderly Liquidation Fund, recoup losses during the initial capitalization period or as otherwise necessary. These additional assessments would apply not only to Systemically Important Financial Firms, but also to any other financial companies with total consolidated assets of over $50 billion.

In addition, companies that have received payments on claims from a covered financial company under an orderly liquidation process would face additional assessments at a "substantially higher rate" than would otherwise be the case. This means that, while the resolution process could provide for payments to creditors and other parties that are financial companies, these payments could in part effectively be clawed back through a higher future assessment.

Finally, RAFSA would require the FDIC, in determining the amounts of assessments, to take into account any assessment imposed on a subsidiary of a financial company that is an insured depository institution, an SIPC broker-dealer or an insurance company pursuant to state law to cover costs of rehabilitation or liquidation. However, as is the case with the House Bill, RAFSA does not go into further detail on how such assessments are to be taken into account. It remains unclear, for example, whether the FDIC would provide any relief to an insurance company due to the potential for future assessments by state guaranty associations, if the insurance company has not already had to pay such assessments.

Depository Institution Regulatory Framework

RAFSA's third title reallocates regulatory powers among the Federal Reserve, FDIC, and the Office of the Comptroller of the Currency ("OCC"). Last fall, in his initial regulatory reform bill, Senator Dodd had proposed consolidating regulation of banks, thrifts, and their holding companies in one new regulatory agency. RAFSA abandons that approach, but it does alter the current regulatory structure in a number of ways.

As an initial matter, RAFSA, like the House Bill, would abolish the Office of Thrift Supervision ("OTS"). Under RAFSA, no additional thrifts could be chartered, but existing thrifts would continue to be subject to the Home Owners Loan Act, albeit with a different federal supervisor. RAFSA also would impose a three-year moratorium on approval of any application for depository insurance for an industrial bank, credit card bank, or trust bank owned or controlled by a commercial firm, subject to an exception in the case of a *bona fide* merger or whole acquisition of an insured depository

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institution's parent company. In addition, the Government Accountability Office ("GAO") would be required to conduct a study to determine whether it is necessary to eliminate exceptions under section 2 of the BHCA for industrial banks, credit card banks, trust companies and savings institutions.

As part of its regulatory reorganization, RAFSA would vest the Federal Reserve with vast new powers over Systemically Important Financial Firms, as discussed above. The Federal Reserve also would have rulemaking authority over all bank and thrift holding companies, supervisory authority over bank and thrift holding companies with assets of $50 billion or more, and rulemaking authority pertaining to specific matters, such as transactions with affiliates.

The Federal Reserve would, however, lose supervisory authority over smaller bank holding companies (an outcome that would have a significant impact on several of the regional Federal Reserve Banks, as they would no longer have any institutions to supervise). Specifically, bank holding companies and thrift holding companies with less than $50 billion in total consolidated assets would be supervised by the OCC or FDIC, depending on whether federal or state-chartered insured depository institutions predominate among the holding company's depository subsidiaries. Thus, the OCC and FDIC would, for the first time, become holding company regulators.

The Federal Reserve also would lose supervisory and regulatory authority over state banks, including state member banks. The FDIC generally would gain supervisory and regulatory authority over state-chartered banks and thrifts.

In addition, RAFSA would depart from the House Bill in establishing a consumer protection body, the Bureau of Consumer Financial Protection, as an arm of the Federal Reserve (albeit insulated from the direct authority of the Federal Reserve) rather than as an independent agency. The scope, organizational location and reporting relationships of this body remain a point of significant negotiation.

RAFSA would grant broad rulemaking powers and discretion to regulators, in part by design so as to enable regulators to be flexible over time as new financial products, practices, and risks develop and evolve, but the bill would demand prompt regulatory action on a broad range of issues.

Leaving aside specific jurisdictional shuffling, as a general matter, RAFSA would meaningfully expand the powers of the federal holding company regulators. For example, the relevant holding company regulator would have expanded authority to obtain reports from, examine, and regulate the subsidiaries of bank and thrift holding companies. The regulators' authority to impose capital requirements at the holding company level also would be clarified. In short, through various provisions, RAFSA seeks to tighten and close any holes in the regulatory framework applicable to banking and thrift organizations.

A Few Observations Regarding RAFSA's Implications

If enacted, RAFSA would dramatically alter the U.S. financial regulatory landscape. Some of the implications of this sea change are obvious; RAFSA would create a significantly more restrictive regulatory environment for many large U.S. financial institutions and international financial institutions with significant U.S. operations. In addition, many financial organizations – whether or not they are deemed Systemically Important Financial Firms – likely would face new regulatory requirements. The compliance burdens and expenses for financial firms would increase markedly. Other changes may be somewhat less obvious and are worth brief note:

- *New and added regulatory relationships create new challenges.* As described above, RAFSA would create new regulators such as the FSOC, and would also create relationships between financial institutions and existing regulators that are new to both sets of parties. Each of these new relationships would involve a "ramp up" period during which a regulator becomes familiar with a financial company and the company with the regulator, in terms of facts, processes, culture and politics. In addition, many firms may need to wrestle with multiple regulatory relationships (e.g., the FSOC and Federal Reserve, or the Federal Reserve as rulemaker and the OCC or FDIC as supervisor). The multiple regulatory points of contact would create opportunities for interagency conflict, notwithstanding the FSOC's role as a mediator of any interagency disputes.
- *For regulators: much to do, but little time.* RAFSA would grant broad rulemaking powers and discretion to regulators, in part by design so as to

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enable regulators to be flexible over time as new financial products, practices, and risks develop and evolve, but the bill would demand prompt regulatory action on a broad range of issues. This rulemaking and discretion would allow for a significant amount of input from companies but, particularly in the short term, likely would severely tax the capacities of federal regulators. To the frustration of regulated institutions, regulators would be likely to face significant time constraints and limits on their ability to deal with heretofore routine matters, such as requests for guidance and no-action type relief. Working with regulators likely would be highly difficult for the first few years after RAFSA is enacted.

- *Many studies to further distract regulators.* In addition to the sheer volume of required rulemaking, RAFSA would require a large number of studies by various bodies such as the FSOC and the GAO, some to be completed in a matter of months. These studies would be likely to create additional regulatory issues and uncertainty during the period of initial implementation of RAFSA and may pose a further strain on the capacity of regulators to deal with the institutions they regulate. At the same time, however, such studies could present opportunities for financial institutions to weigh in on policy options.
- *Regulators will face stricter oversight.* RAFSA, in various ways, envisions stricter oversight of regulators and regulatory actions by Congress and the GAO. RAFSA's heightened oversight of federal regulators could encourage regulators to be less flexible in the application of statutory provisions, rules, and regulations. If RAFSA is enacted, financial institutions will need to be prepared for regulators to take a more black-and-white approach and to be less accommodating in the future.

* * *

It remains to be seen whether financial regulatory reform will be enacted into law, and what final form it might take. Even if RAFSA passes the Senate, which is by no means certain, the legislation will still need to be reconciled with the House Bill, with which RAFSA shares much in common but from which it also differs in many ways. Given the potential stakes, financial institutions operating in the United States need to keep following and engaging in the debate as the legislative process continues to move forward. ■

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Reinsurance Reform:
U.S. Federal Financial Regulatory Reform Bills

by John Dembeck

Enactment of federal financial regulatory reform legislation still remains possible in 2010. As discussed in this issue of the *Debevoise & Plimpton Financial Institutions Report*, the U.S. Senate Committee on Banking, Housing and Urban Affairs approved the Restoring American Financial Stability Act of 2010 on March 22, 2010 ("RAFSA"). The House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173) on December 11, 2009. While much attention has been paid by financial firms, including insurance groups, to the potential burdens that they will bear if this legislation is enacted, one clear benefit to the insurance industry contained in each of these bills is reinsurance reform – contained in Title IX, Subtitle B of H.R. 4173 and Title V, Subtitle B, Part II of RAFSA (the "Reinsurance Reform Provision"). The Reinsurance Reform Provision (1) will make it easier for U.S. ceding insurers (and their reinsurers) to comply with state laws regulating reinsurance credit and certain other laws and regulations regulating reinsurance, (2) will streamline solvency regulation of certain U.S. reinsurers and (3) would become effective 12 months after enactment of the legislation (the "Effective Date").

Federal Preemption of State Insurance Law

Under current U.S. federal law, the business of insurance is subject to state laws which relate to the regulation or taxation of the business of insurance and no act of Congress is to be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance unless such act specifically relates to the business of insurance. In other words, while state insurance regulation generally controls the regulation of the business of insurance in the U.S., an act of Congress can always supersede or preempt state law. That is what the Reinsurance Reform Provision does – it preempts certain state laws and regulations relating to reinsurance as they may apply to non-domestic insurers and leaves in place only state laws and regulations that apply to domestic insurers.

Regulation of Credit for Reinsurance

Current Law. Many states model their reinsurance credit laws and regulations after the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation adopted by the National Association of Insurance Commissioners (the "NAIC"). Under these models, a state only regulates credit for reinsurance ceded by a ceding insurer that is domiciled in the state, but not all states take this approach. By our count, there are fifteen states whose reinsurance credit laws apply not just to domestic ceding insurers but also to foreign ceding insurers licensed in the state. Among these is New York which takes its regulation of credit for reinsurance of non-domestic ceding insurers quite seriously.

Preemption. Under the Reinsurance Reform Provision, if a ceding insurer's domestic state is NAIC-accredited and the state recognizes credit for reinsurance for the ceding insurer's ceded risk, then no other state may deny such credit for reinsurance. Since all states are now NAIC-accredited, with these few words the Reinsurance Reform Provision removes all state laws and regulations imposing requirements on non-domestic ceding insurers as a condition of obtaining reinsurance credit in their state – so long as reinsurance credit is allowed in the ceding insurer's domestic state.

Benefits for Ceding Insurers. Following the Effective Date, a ceding insurer need only comply with its domestic state reinsurance credit laws and regulations. A New York domestic ceding insurer will only have to comply with New York's reinsurance credit laws and regulations but not those of California or any other state. A New Jersey domestic ceding insurer licensed in New York will only have to comply with New Jersey's reinsurance credit laws and regulations but not those of New York or any other state. Among the benefits for ceding insurers that are licensed but not domiciled in New York will be the following: (1) cessions to unauthorized reinsurers that post collateral in the form of a single beneficiary reinsurance trust (a "Regulation 114 Trust") will no longer have to limit the permissible trust assets to those permitted under New York Regulation 114; (2) cessions to unauthorized reinsurers that post collateral in the form of a letter of credit or a Regulation 114 Trust will no longer have to conform the permitted uses for

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that collateral to the New York list of permitted uses; (3) New York's life reinsurance risk transfer rules (which vary from those in the Life and Health Reinsurance Agreement Model Regulation adopted by the NAIC), and interpretations thereof by the New York Insurance Department will no longer apply; and (4) the New York "mirror reserve" rule will no longer apply for life, health and annuity risk cessions to unauthorized reinsurers.

Benefits for Unauthorized Reinsurers. At least one state (Florida) allows its domestic ceding insurers to obtain credit for reinsurance ceded to certain unauthorized reinsurers with less than 100% of reinsurance liabilities being secured by collateral. If the reinsurer meets certain standards, the collateral requirements are on a sliding scale; there are none for AAA-rated reinsurers and various collateral discounts apply to other well-rated reinsurers. New York circulated draft amendments to its Regulation 20 which sought to achieve a similar effect to the Florida rules but has not taken final action to put them into effect. The NAIC has been working on extending this concept throughout the U.S. but the main barrier has been that achieving uniform state rules requires each state to enact uniform rules. As a result, the NAIC is pursuing a federal legislative approach. While the Reinsurance Reform Provision does not (and under U.S. constitutional provisions, could not) compel uniform rules, they do preempt non-domestic state rules so that what remains is deference to the domestic state rules. In the case of a Florida domestic ceding insurer, the ceding insurer may accept less than 100% collateral from qualified unauthorized reinsurers and still obtain 100% credit for the ceded reinsurance. Even if the Florida ceding insurer is licensed in New York (which currently would not allow less than 100% collateral), the New York reinsurance credit rules will no longer apply to the Florida ceding insurer. As a result, an unauthorized reinsurer of a Florida domestic ceding insurer may be eligible for a haircut in the amount of collateral but the same reinsurer of a New York domestic ceding insurer would not.

Preemption of Other Extraterritorial State Laws

The scope of the preemption afforded by the Reinsurance Reform Provision does not end with non-domestic state reinsurance credit laws and regulations. There are four other categories of non-domestic state laws and regulations that are preempted (other than those with respect to taxes and assessments on insurers or insurance income).

Arbitration. Non-domestic state laws and regulations are preempted to the extent that they restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration to the extent such contractual provision is not inconsistent with the provisions of Title 9 of the United States Code (the Federal Arbitration Act).

Reinsurance Contract Disputes. Non-domestic state laws and regulations are preempted to the extent that they require that a certain state's law must govern disputes arising from a reinsurance contract or requirements of a reinsurance contract.

Enforcement. Non-domestic state laws and regulations are preempted to the extent that they attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract to the extent that the contract terms are not inconsistent with the Reinsurance Reform Provision.

Other Laws. Non-domestic state laws and regulations are preempted to the extent that they otherwise apply the laws of the state to reinsurance agreements of non-domestic ceding insurers.

Consequences. The last of these four additional preemptions may be of great benefit to reinsurance that is utilized as a vehicle for an insurance M&A asset acquisition transaction – either indemnity or assumption reinsurance of an in-force block of business of a life insurer.

When a life insurer seeks to sell a block of in-force business by indemnity reinsurance, laws in states like California, New York and Wisconsin may require that the reinsurance agreement be filed and approved by the state insurance regulator even if the ceding insurer is not domiciled in the state. Since non-domestic state laws and regulations will be preempted to the extent that they otherwise apply the laws of the state to reinsurance agreements of non-domestic ceding insurers, these state laws will be preempted after the Effective Date as they apply to reinsurance agreements entered into by non-domestic ceding insurers. In such a transaction, the only state insurance regulatory consent to the reinsurance agreement that will remain applicable will be any consent of the

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ceding insurer's domestic state insurance regulator.

There are two other kinds of laws that may be affected by this additional preemption: (1) reinsurance affiliate transaction filing requirements applicable to commercially domiciled insurers; and (2) non-domestic state filing and approval requirements for assumption reinsurance.

The insurance holding company laws of 6 states (including New York, as to life insurers, and California, as to all insurers) impose their holding company regulatory requirements, including "Form D" pre-filing of material affiliate reinsurance agreements, on non-domestic insurers that do such a significant amount of business in the state as to be deemed a domestic insurer (i.e., a commercially domiciled insurer). However, since non-domestic state laws and regulations will be preempted to the extent that they otherwise apply the laws of the state to reinsurance agreements of non-domestic ceding insurers, these state laws should also be preempted after the Effective Date as they apply to reinsurance agreements entered into by non-domestic ceding insurers.

Lastly, a question arises whether this preemption extends to assumption reinsurance. Assumption reinsurance seeks to substitute a new insurer for the original insurer under a block of insurance policies. The Reinsurance Reform Provision defines the term "reinsurance" to mean "the assumption by an insurer of all or part of a risk undertaken originally by another insurer." Since this definition does not cast reinsurance as a contract of indemnity (which an assumption reinsurance agreement probably is not) but merely as an assumption of risks (which an assumption reinsurance agreement arguably is), the Reinsurance Reform Provision may also extend to non-domestic state regulatory filing and approval of assumption reinsurance agreements.

In the insurance M&A world, a multitude of state insurance regulatory consents may delay completion of the transaction and may add regulatory risk that one or more states may impose conditions to their consent that are unacceptable to one or both of the parties, thereby presenting a risk to completing the transaction. The removal of non-domestic state insurance regulatory consents to entering into an indemnity or assumption reinsurance agreement will likely reduce the time it takes to get from signing the transaction to closing the transaction and also reduce regulatory risk that the transaction will not be completed.

Reinsurer Solvency Regulation

Reinsurer Definition. For purposes of this portion of the Reinsurance Reform Provision, a "reinsurer" is defined as an insurer to the extent that the insurer (1) is principally engaged in the business of reinsurance, (2) does not conduct significant amounts of direct insurance as a percentage of its net premiums and (3) is not engaged on an ongoing basis in the business of soliciting direct insurance. The Reinsurance Reform Provision provides that a determination of whether an insurer is a reinsurer shall be made under the laws of the domestic state of the reinsurer. Most U.S. professional reinsurers will meet these standards.

Preemption—Domestic State Deference. Under the Reinsurance Reform Provision, if the professional reinsurer's domestic state is NAIC-accredited, (1) the domestic state will be solely responsible for regulating the financial solvency of the reinsurer and (2) no non-domestic state may require the reinsurer to provide any additional financial information other than the information the reinsurer is required to file with its domestic state. Since all states are now NAIC-accredited, following the Effective Date, these rules will govern the regulation of the financial solvency of reinsurers in the U.S.

Consequences. Many reinsurers are licensed in all states to assure that all their ceding insurer customers may obtain credit for reinsurance ceded in all applicable states, both the ceding insurer's domestic state and any other state in which the ceding insurer is licensed which applies its reinsurance credit rules to non-domestic ceding insurers. Since reinsurers often do not sell direct products and reinsurance contracts are subject to limited regulation in the U.S., the principal purpose of regulating reinsurers is solvency regulation. Since solvency regulation of U.S. insurers is predominately a function of the insurer's domestic state, this element of the Reinsurance Reform Provision merely codifies what is generally true in practice and removes all other redundant and burdensome solvency regulation of reinsurers by non-domestic states. ■

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