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U.S. Insurance Holding Company Model Law Amendment Resulting from Kingsway

by John Dembeck

The National Association of Insurance Commissioners ("NAIC") is considering amendments to its model law, the Insurance Holding Company System Regulatory Act (the "Model Act"), in response to the outcome of a dispute between the Pennsylvania Insurance Department ("PID") and Kingsway Financial Services, Inc. ("Kingsway") over whether Kingsway violated Pennsylvania law, including the Pennsylvania insurance holding company statute, by disposing of its ownership interest in its subsidiary, Lincoln General Insurance Company, by delivering to each of 20 charities a stock certificate representing 5% of the outstanding common shares of the parent of Lincoln General Insurance Company, Walshire Assurance Company. The dispute was the subject of an article titled "U.S. Insurance Holding Company Litigation: Kingsway and the Pennsylvania Insurance Department" appearing in the May 2010 issue of the *Debevoise & Plimpton Financial Institutions Report* available at www.debevoise.com.

On April 1, 2010, the Commonwealth Court of Pennsylvania held that Kingsway did not violate Pennsylvania law in effecting the disposition. The PID has filed a notice of appeal to the Pennsylvania Supreme Court.

In response to the financial crisis, in 2009, the NAIC embarked on various initiatives to modernize state insurance regulation. One of these initiatives involves changes to the Model Act and the companion Insurance Holding Company System Model Regulation With Reporting Forms and Instructions (the "Model Regulation"). The NAIC Group Solvency Issues (EX) Working Group (the "Working Group") had been well along considering many proposed changes to the Model Act and Model Regulation when the PID proposed, on May 7, 2010, an additional amendment to address a disposition like Kingsway.

The May 7, 2010 PID proposal would have required that any person disposing of a domestic insurer file with the domestic State insurance regulator a "Form A" Statement Regarding the Acquisition of Control of or Merger with a Domestic Insurer, if the acquiring person(s) do not otherwise file the Form A, and obtain approval of the transaction from the domestic State insurance regulator prior to effecting the transaction.

At a June 4, 2010 public hearing on proposed amendments to the Model Act and Model Regulation, the Working Group settled on the following new Model Act language (§ 3.A(2)), to address divestitures:

> *For purposes of this section, any controlling person of a domestic insurer seeking to divest its controlling interest in the domestic insurer, in any manner, shall file with the Commissioner, with a copy to the Insurer, confidential notice of its proposed divestiture at least thirty (30) days prior to the execution of the transaction. The Commissioner shall determine those instances in which the party seeking to divest or the party(ies) seeking to acquire, will be required to file for and obtain approval of the transaction in the manner prescribed in this Act. The information shall remain confidential until conclusion of the transaction or at the commissioner's discretion.*
>
> *If a Form A is otherwise filed, then this subsection shall not apply.*

While this new requirement would certainly address a Kingsway-type disposition, it also potentially applies to any initial public offering of an insurance company, whether

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WHAT'S INSIDE

Highlights from the UK Financial Services Act 2010

by Jeremy Hill and Edite Ligere

The Financial Services Act 2010 ("FS Act") received Royal Assent on 8 April 2010. It introduces a number of amendments to the Financial Services and Markets Act 2000 ("FSMA") as well as other potentially far-reaching changes. One such change is the establishment of a Council for Financial Stability consisting of the Chancellor of the Exchequer (as Chairman), the chair of the Financial Services Authority (the "FSA") and the Governor of the Bank of England. The majority of the changes introduced by the FS Act, including new rules on remuneration, apply to all FSA "authorised persons," not just banks. The FS Act which also includes various consumer protection measures extends to the whole of the UK, i.e. England, Wales, Scotland and Northern Ireland.[1] The driving force behind the FS Act, one of the last pieces of legislation to be passed by the UK's Labour government, was the perceived need to strengthen financial regulation following the credit crisis.

The FSA's new powers and duties

The FS Act confers new powers and duties on the FSA. These include:

(a) a new statutory objective to contribute to the UK's financial stability.

This is in addition to the FSA's existing regulatory objectives of "market confidence," "the protection of consumers" and "the reduction of financial crime." The FS Act replaces one of the existing statutory objectives of "public awareness" with "enhancing public understanding of financial matters" (which involves the establishment of a consumer financial education body). In considering the financial stability objective, the FSA must have regard to:

(i) the economic and fiscal consequences for the UK of

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instability in the UK's financial system;

(ii) the effects (if any) on the growth of the UK's economy of any regulatory action taken to meet the financial stability objective; and

(iii) the impact (if any) on the stability of the UK's financial system of events or circumstances outside the UK (as well as in the UK).

The FSA must determine and review its strategy relating to the financial stability objective in consultation with Her Majesty's Treasury;

(b) an extension of the FSA's powers to write general rules and to alter firms' regulatory permissions so that the FSA's powers can be used to meet each of the FSA's statutory objectives;

(c) enhanced powers to control short selling;

The driving force behind the FS Act, one of the last pieces of legislation to be passed by the UK's Labour government, was the perceived need to strengthen financial regulation following the credit crisis.

(d) a power to make consumer redress scheme rules (which is to be commenced at a date not yet known);

(e) a number of new disciplinary powers (the FS Act also affects the use of the FSA's existing enforcement powers);

(f) a new power to gather information that is relevant to financial stability;

(g) a duty to make rules in relation to remuneration; and

(h) a duty to make rules in relation to Recovery and Resolution Plans ("RRPs").

Many of these powers require the FSA to publish rules or statements of policy regarding its intended use of these powers. In April 2010, the FSA published Consultation Paper 10/11 entitled "Implementing Aspects of the Financial Services Act 2010" which consults on the implementation of the FS Act. The Consultation period ends on 25 June 2010.

Remuneration of the executives of "authorised persons" (not just banks)

Duty on the FSA to make rules about remuneration

The FS Act amends FSMA by imposing a duty on the FSA to make general rules requiring each FSA authorised person to have and act in accordance with a remuneration policy.

"Remuneration policy"

A "remuneration policy" is defined as a policy about the remuneration by the FSA authorised person of:

(a) officers,

(b) employees, and

(c) other persons of a specified description set out in the FSA's rules.

When making rules about remuneration policy, the FSA is required to have regard to international standards about the remuneration of individuals working in the financial sector.

FSA's powers to rewrite remuneration clauses in employment contracts and prohibit persons from being remunerated in a certain way

Her Majesty's Treasury is given the power, after consulting the FSA, to direct the FSA to consider whether certain authorised firms' remuneration policies comply with the FSA's rules. If the FSA considers that a remuneration policy is not compliant with its rules, it may take such steps as it considers appropriate to deal with the failure.

One of the steps that the FSA may take includes requiring the remuneration policy to be revised. Further, section 6 of the FS Act provides that the FSA's general rules may:

(a) prohibit persons (or persons of a specified description) from being remunerated in a specified way;

(b) provide that any provision in an agreement that contravenes such a prohibition is void;[2] and

(c) provide for the recovery of any payment made, or other property transferred, in pursuance of a provision that is void by virtue of paragraph (b).

The FSA may only impose a prohibition of remuneration in a specified manner for the purpose of ensuring that the provision of remuneration is consistent with:

(a) the effective management of risks; or

(b) the Implementation Standards for Principles for Sound Compensation

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Practices issued by the Financial Stability Board on 25 September 2009.

Her Majesty's Treasury's power to make regulations for relevant executives' remuneration reports

The FS Act enables Her Majesty's Treasury to make regulations about the preparation, approval and disclosure of the authorised person's executives' remuneration reports. The regulations may provide for such reports to be filed with the Registrar of Companies or the FSA, and for the FSA to publish any reports filed with it. Her Majesty's Treasury has the power to create offences in relation to remuneration reports equivalent to those under the Companies Act 2006 in relation to directors' remuneration reports, with comparable penalties.

"Executives of an authorised person"

The following are defined as the executives of an authorised person:

(a) officers of the authorised person;

(b) employees of the authorised person, and

(c) other individuals who have a prescribed connection with the authorised person. Such other individuals may include individuals who provide services, or whose services are provided (directly or indirectly) to the authorised person; or individuals who are officers or employees of a member of the same group as the authorised person.

"Remuneration report"

An executives' remuneration report is defined as a report containing information about:

(a) the remuneration of relevant executives of an authorised person (plainly, this captures a very wide spectrum of persons); or

(b) anything connected with the remuneration of relevant executives of an authorised person.

The majority of provisions in the FS Act which increase the FSA's already broad information gathering, disciplinary and enforcement powers apply to all FSA authorised persons, not just banks.

The FSA's extended information gathering powers

The FS Act endows the FSA with wide powers to require information and documents from *persons*, (including service providers and persons who have a legal or beneficial interest in any of the assets of a relevant investment fund, including any persons *connected* with such persons) that the FSA considers are *or might* be relevant to one or more aspects of the UK financial system.

Approved persons — extension of the FSA's disciplinary powers

The FS Act inserts a new section 63A into FSMA which provides that where the FSA is satisfied that *a person* has at *any time* performed a controlled function without the FSA's approval, and that at the material time the person knew, or could reasonably be expected to have known, that he was performing a controlled function without such approval, the FSA may impose a penalty on the person of such an amount as it considers appropriate. The FSA must also consider whether it should take action against the relevant authorised firm, rather than (or in addition to) the individual concerned.

The FS Act places the FSA under a duty to prepare and publish (in a way which appears to the FSA to be "best calculated to bring it to the attention of the public") a policy statement on the penalties under *section 63A of FSMA*, including the amount of such penalties. The FSA is required to publish such details of its decision notices as it considers appropriate, unless it considers that publication would be unfair to the relevant persons or against the interests of consumers. In determining the amount of the penalty, the FSA's policy must, amongst other things, have regard to:

(a) the conduct of the person on whom the penalty is to be imposed;

(b) the extent to which the person could reasonably be expected to have known that a controlled function was being performed without approval;

(c) the length of the period during which the person performed a controlled function without approval; and

(d) whether the person on whom the penalty is to be imposed is an individual.

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Limitation period for the imposition of a financial penalty on approved persons

The FS Act provides for a limitation period of three years, beginning with the day on which the FSA knew that the person concerned had performed a controlled function without approval, for the imposition of a financial penalty. The FSA is deemed to know that a person has performed a controlled function without approval if it has information from which that can be reasonably inferred.

Recovery and Resolution Plans ("RRPs") – "living wills"

The FS Act requires the FSA to make rules obliging authorised persons to produce and maintain a resolution and recovery plan, a so-called "living will." This requirement can apply to all authorised firms, or the FSA can exercise discretion over which authorised firms are required to produce a RRP, by specifying the firms to which the rules apply. This discretion is likely to allow for gradual implementation of RRPs, focusing on the largest, most complex and systemically significant firms first.

In short, a recovery plan aims to reduce the likelihood of a firm failing by setting out what the authorised person would do in (or prior to it becoming subject to) stressed circumstances that would affect its ability to carry on all or a specified part of its business. A recovery might include the restructuring, scaling back or the sale of certain business lines or assets of the authorised person in question.

A resolution plan should cover action to be taken in the event of the failure of all or part of the business.

Where the FSA considers that a RRP fails to make satisfactory provision in relation to the matters that the plan is required to cover, it may take such steps as it considers appropriate to deal with the failure. This could include requiring the revision of the RRP.

Short selling

The FS Act endows the FSA with a new power to make rules to prohibit, or require disclosure of, short selling. The FS Act inserts a new Part 8A into FSMA, which provides that:

(a) the FSA may make rules banning short selling in relation to certain financial instruments by prohibiting persons from engaging in this practice; and

(b) the FSA may make rules requiring the disclosure of information relating to short selling in relation to specified financial instruments. These rules may apply in relation to short selling engaged in before the rules are made where the resulting short position is still open when the rules are made.

Both of the above sets of rules (the short selling rules) would apply to all persons, whether authorised by the FSA or not insofar as they relate to UK financial instruments. The definition of short selling for the purposes of the FS Act includes any circumstances in which a person sells a financial instrument which that person does not own, and will make a profit if the price of that instrument falls before the person has to buy the instrument to deliver it to the buyer or to return to the lender.

The FS Act enables the FSA to make short selling rules without prior consultation if it considers it necessary in order to maintain confidence in the UK financial system or protect its stability. Initially, these emergency short selling rules may last for no more than three months. However, the FSA is given the power to extend these rules for a further three months provided that it still considers them to be necessary. The FSA may censure or fine persons who contravene the short selling rules.

Conclusion

The majority of provisions in the FS Act which increase the FSA's already broad information gathering, disciplinary and enforcement powers apply to all FSA authorised persons, not just banks. Consequently, authorised firms, FSA approved persons and persons who are contemplating the performance of one or more controlled functions should get to grips with the provisions of the FS Act sooner rather than later. The FSA has shown itself increasingly willing to adopt a more intrusive, interventionist approach to regulation. Assuming that the FSA is not abolished by the UK's new coalition government, there is no reason to think that its more intrusive approach will not continue. ■

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[1] It does not apply to the Channel Islands.

[2] This will not apply to agreements made before the new rules come into force, although any later amendments to those agreements will be affected.

The NAIC Produces Revised Climate Change Risk Disclosure Survey

by Stuart Hammer and Derek Alexander

The plenary session of the National Association of Insurance Commissioners ("NAIC") on March 28 was the setting for a vigorous debate, culminating in adoption of a weakened Insurer Climate Risk Disclosure Survey. Twenty-seven state regulators voted in favor of the survey as revised, with twenty-two states voting against it. The last-minute skirmish and resulting changes to the collection standards of the survey – years in the works and unanimously adopted the previous year in stronger form – surprised observers and many commissioners alike.

The survey's questions were retained, however, and continue to focus on insurers' risk management and investment management policies with respect to climate change and insurers' assessments of climate change risks. The NAIC has recommended that the survey initially be directed to insurers with direct written premiums over $500 million with a return date of May 1, 2010. Subsequent annual surveys would be required of insurers with direct written premiums over $300 million.

The original survey questions were retained, but as now adopted, the survey's collection and disclosure standards recommended to the states have been revised (i) to provide that responses are not to be in the public record, but confidential, (ii) to emphasize that requirements for completion are at the discretion of each state, (iii) to disclaim any opinion on the existence of climate change and (iv) to guarantee that survey responses will not affect regulatory consideration of an insurer's proposed rate changes. The last provision is important as many insurers are already seeking to raise certain rates in response to what they see as potential increases in risks from climate change.

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The skirmish over the insurance regulators' survey emphasizes the complexity of the climate change issues facing the insurance industry. Climate change is a source of casualty risk and an opportunity for additional or different insurance policies. The confusion and last-minute changes are suggestive of challenges facing the NAIC in coordinating regulatory initiatives to modernize insurance industry oversight among the states, as well as the renewed focus on climate change issues by legislators and regulators highlighted, for example, by the recent publication of a discussion draft of the Senate's American Power Act (the "APA"), which includes a cap on greenhouse gas emissions from certain sources. For additional information on the APA, please see our client update titled "Senators Unveil Climate Change And Energy Legislation," available at www.debevoise.com.

It is not yet clear which states will use the survey as adopted, which states will modify the survey to suit their preferences, and whether some states will ignore the survey altogether. For example, states that opposed the confidentiality provision may implement the survey without any such protection. Furthermore, states such as California that are implementing climate change initiatives have suggested they might require all licensed insurers – no matter what state they are based in – to complete their survey. This would effectively implement the survey on a nationwide basis, notwithstanding the lack of consensus among state regulators. ■

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privately held, such as by one or more private equity funds, or whether a subsidiary of a publicly traded company.

This new requirement also raises a number of issues:

1. The process is unclear. While the disposing person must give 30 days prior notice of the divestiture, the State insurance regulator is not required to act within any stated time frame. If, prior to the end of the 30-day notice period, the State insurance regulator requires that the disposing person file for and obtain approval of the transaction, must that filing and approval be completed prior to completion of the divestiture, in which case the divestiture may have to be held up pending completion of the filing and approval process? What happens if the state insurance regulator takes no action during the 30 day period? May the divesting parties complete the divestiture or does it run a risk of a post facto determination that an approval should have been obtained?

2. The following Form A elements will not be particularly meaningful for a disposition since there will be no new controlling person: the method of acquisition of control, the identity of the applicant seeking to acquire control, and biographical information on the directors and executive officers of the applicant seeking to acquire control. In addition, it is not clear how the disposing party will be able to provide the following Form A disclosure for the acquiring persons: nature and source of consideration used in effecting the acquisition of control, the future plans that the acquiring person has for the insurer being acquired, and financial statements of the acquiring persons. In other words, the Form A is not well suited for this required disclosure since it is designed to be completed by an acquiring and not by a disposing person.

The Working Group at one point was considering a new Model Regulation Form F for use with a divestiture but to date such a form has not been circulated by the Working Group.

It is hoped that the Working Group will give further consideration to this new divestiture process and the content of any filing that may have to be made by a disposing person. ■

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