

Recent NAIC Corporate Governance Initiatives

By Michael K. McDonnell, Jennifer L. Chu and Richard J. Goldberg

As part of its Solvency Modernization Initiative, the National Association of Insurance Commissioners (the "NAIC") has in recent years asked various of its working groups to undertake projects aimed at bringing U.S. regulation of insurance in line with the insurance regulatory principles articulated by the International Association of Insurance Supervisors (the "IAIS Core Principles"). Some state insurance regulators and other industry participants believe that the U.S. lags behind other countries in its articulation and enforcement of industry-specific corporate governance standards. The International Monetary Fund's Financial Sector Assessment Program (FSAP) Report, published in May 2010, provided a mostly favorable review of the U.S. insurance regulatory framework but identified the paucity of specific legal requirements relating to the corporate governance of insurers as an area of deficiency.

In response, the NAIC's Corporate Governance (EX) Working Group (the "Working Group") has been charged in 2011 with developing a set of high-level corporate governance principles together with a suitable methodology for evaluating adherence with these principles. Although the ultimate purpose of these principles remains

a topic of deliberation within the NAIC and the insurance industry generally, it is possible that the NAIC may ultimately use the principles as the basis for a model corporate governance law. If and when enacted by the states, such a law could have a significant impact on insurance companies domiciled within the U.S. With that in mind, this article provides an overview of the NAIC's work to date on this topic and the NAIC's current draft corporate governance principles.

As part of its charge, the Working Group has undertaken an analysis of domestic and non-U.S. corporate governance best practices and is reviewing the IAIS Core Principles and standards related to corporate governance. In January 2011, the Working Group released for public comment a summary of existing state corporate governance law, including principles derived from case law, as well as a survey of corporate governance principles and standards currently operative in Australia, Canada, Switzerland and the U.K. and the Code of Conduct of the Bermuda Monetary Services Authority. Drawing on these sources, as well as the IAIS Core Principles, the Working Group presented a White Paper on High-Level Corporate Governance

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Principles for Use in U.S. Insurance Regulation (the "White Paper") at the NAIC's Spring 2011 National Meeting (the "Spring Meeting"), which was held at the end of March of this year.

The White Paper is organized into twenty corporate governance principles that are described as "essential, high-level requirements necessary for an insurer to provide minimum levels of consumer protection and capital adequacy." Each principle is supplemented with guidance intended to provide detail regarding how an insurer can comply with such principle. The White Paper notes that the principles included in it should be applied and measured in a manner proportionate to "the nature, scale and complexity" of an individual insurer: an insurer with a higher risk profile will require a more comprehensive corporate governance framework than an insurer with a lesser risk profile.

In presenting the White Paper, the Working Group chair cited as further justification for creation of a formal

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Release of Proposed Rules on Swap Capital and Margin Requirements under Title VII of the Dodd-Frank Act

By Satish M. Kini, Byungkwon Lim, Gregory J. Lyons, Emilie T. Hsu and Pratin Vallabhaneni

Editor's Note: Set forth below is an update that we sent recently to our clients and friends regarding recently proposed rules on swap capital and margin requirements under the Dodd-Frank Act. The proposed rules will be of interest to many of our financial institutions clients, and we believe it worthwhile to highlight them here. Since that update, the Commodities Futures Trading Commission ("CFTC") released its capital rule, which we will discuss in a future update. We hope that you find this update useful, and we will continue to

monitor the rule proposals to keep you informed of new developments.

Title VII of the Dodd-Frank Act requires the relevant regulatory agencies to establish capital and margin requirements for all swap dealers ("SD") and major swap participants ("MSP").¹ Under the legislative mandate, the Federal Reserve, Federal Credit Administration, Federal Deposit Insurance Corporation, Federal Housing Finance Authority, and the Office of the Comptroller of the Currency (collectively referred to as

the "Agencies") have the authority to promulgate the capital and margin requirements of SDs and MSPs for which each Agency is the prudential regulator. For SDs and MSPs without prudential regulators, the CFTC is to propose capital and margin requirements; similarly, the Securities Exchange Commission (the "SEC") is to propose capital and margin requirements for security-based swap dealers and major security-based swap participants.

On April 12, 2011, the Agencies released their proposed capital and

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margin rules, and the CFTC released its proposed margin rule, which stated that the CFTC's proposed capital rule would be released in the near future and would allow commenters the opportunity to review both proposed margin and capital rules before commenting on either. The CFTC's proposed margin rule [was] published in the Federal Register [April 28, 2011]. The SEC has not released either proposed margin or proposed capital rules for security-based swap activities to date.

The Agencies take the view that the current capital regimes in place for prudentially regulated SDs and MSPs already account for swap activities. With respect to margin requirements, the Agencies' and CFTC's proposed rules are conceptually consistent and would require varying margin collection requirements keyed to an SD's or MSP's counterparty type: (i) an SD or MSP, (ii) a high-risk financial end user, (iii) a low-risk financial end user, and (iv) a nonfinancial end user². Further, the Agencies' proposed rule establishes a very narrow exception for swap activities that do not implicate any US-based entity, while the CFTC's proposed rule is silent on the issue. Comments to the Agencies' proposed rule are due by June 24, 2011. Comments to the CFTC's proposed rule are due by June 27, 2011.

Capital Requirements

The current capital regimes established by the Agencies already account for swap activities engaged in by the Agencies'

respectively regulated entities. As such, the Agencies have decided not to impose any additional capital requirements under their Title VII rulemaking authority. The Agencies state that they will continue to promulgate capital rules in line with relevant supervisory developments, such as new recommendations put forth by the Basel Committee on Banking Supervision with respect to swap activities. The U.S. proposals to implement Basel III are anticipated to be published this summer.

The CFTC and the SEC have yet to release their rules covering capital as of this publication date.

Margin Requirements

The Agencies and the CFTC have proposed margin regulations that operate by requiring the SDs and the MSPs to collect margin from their counterparties. While the Agencies and the CFTC use slightly different terminology for the categories of counterparties that an SD or an MSP may transact with, under the new regulatory regime, they are separated into four categories.

These counterparty categories are:

- counterparties that are themselves SD or MSP;
- counterparties that are high-risk financial end users;
- counterparties that are low-risk financial end users; and
- counterparties that are nonfinancial end users.

The Agencies' and CFTC's proposed rules establish requirements for the amount of margin to be collected, frequency of collection of variation

margin and certain segregation requirements for collected margin, all which vary depending on the counterparty category.

Under both proposed rules, to avoid unnecessary transfers of de minimis margin amounts, the Agencies and the CFTC permit a minimum transfer amount of \$100,000 for all margin transfers, whereby margin amounts below \$100,000 do not need to be transferred. However, once the transferable margin exceeds \$100,000 the full margin amount must be transferred.

Transactions with Other SDs and MSPs

The Agencies and the CFTC all propose that for swaps entered into between an SD or an MSP and another SD or MSP, each SD and MSP must collect both initial and variation margin (each as described in the next paragraph) from each other without any threshold below which no margin is transferred (subject to the \$100,000 minimum transfer amount). With respect to initial margin, both parties will have to collect the applicable amount without any offset of one party's initial margin amount against the other party's initial margin amount.

The Agencies' proposed rule creates heightened margin segregation requirements for transactions among SDs and MSPs subject to their regulation. Specifically, any Agencies-regulated SD or MSP must require its counterparty that is also an Agency-regulated SD or MSP to segregate any funds or collateral that the Agencies-regulated SD or

MSP has posted as initial margin for a non-cleared swap or non-cleared security-based swap transaction at an independent, third-party custodian. Further, the independent, third-party custodian must be:

- (i) prohibited by contract from rehypothecating or otherwise transferring any initial margin it holds for such SD or MSP;
- (ii) prohibited by contract from reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin under the Agencies' proposed rule; and
- (iii) located in a jurisdiction that applies the same insolvency regime as the Agencies-regulated SD or MSP. These segregation requirements would apply only to initial margin, not variation margin.

The CFTC's proposed rule also would require its regulated SDs and MSPs to hold initial margin collected at an independent, third-party custodian located in a jurisdiction that applies the same insolvency regime as the SD or MSP. Further, SDs and MSPs have to require their counterparties that are also SDs or MSPs to hold the posted initial margin at an independent, third-party custodian. With respect to the variation margin, the intent of the proposed rule is not entirely clear. On the one hand, the CFTC's proposed rule would permit a CFTC-regulated SD or MSP to hold variation margin directly; on the other hand, it suggests that a CFTC-regulated SD or MSP would have to offer its counterparty the opportunity to select a third-party custodian for all margin posting.

Transactions with High-Risk Financial End Users/ Financial Entities

Under both the Agencies' and the CFTC's regulatory regime, a financial end user or financial entity is an entity that is neither an SD nor an MSP and that is:

- a commodity pool;³
- a private fund;⁴
- an employee benefit plan;⁵
- a person predominantly engaged in activities that are in the business of banking or in activities that are financial in nature;⁶
- a person that would be a commodity pool or private fund if it were organized under the laws of the US or any state thereof;
- any government of any foreign country or any political subdivision, agency, or instrumentality thereof; and
- any other person as may be designated by either one of the Agencies or by the CFTC, as the case may be.

The Agencies and the CFTC all require the SDs and MSPs, subject to their respective regulations, to collect margin without any threshold below which no margin is transferred (subject to the \$100,000 minimum transfer amount).

The margin custody requirements, however, are less onerous than with SD and MSP counterparties. Although the Agencies' proposed rule would not impose any margin segregation requirements on swap transactions between Agencies-regulated SDs and MSPs and high-risk financial end users, the CFTC's proposed rule would require that initial margin collected from a financial entity to be

held at a third-party custodian at the request of the financial entity. The intent of the CFTC's proposed rule regarding variation margin is not clear with respect to financial entities – it could be held directly by the CFTC-regulated SD or MSP – but the counterparty would have to be offered the opportunity to select a third-party custodian.

Transactions with Financial End Users Deemed to Present "Low Risk"

The Agencies' proposed rule would permit a credit exposure threshold for margin collection from financial end users that the Agencies categorize as "low-risk financial end users." Under the Agencies' regime, a "low-risk financial end user" is a financial end user that (i) predominantly uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; (ii) does not have significant swap exposure;⁷ and (iii) is subject to capital requirements established by a prudential regulator or state insurance regulator.

Although an Agencies-regulated SD or MSP may impose the full margin requirements on a low-risk financial end user counterparty, the SD or MSP also is permitted to establish a credit exposure limit below which it would not collect initial and variation margin from the low-risk financial end user counterparty. The Agencies' proposed rule would limit each of the maximum initial and variation margin threshold

amount to the lower of (i) \$15 to \$45 million or (ii) 0.1 to 0.3 percent of the Agencies-regulated SD's or MSP's tier 1 capital. These initial and variation margin thresholds may be different from each other and will be set in the final rule.

The current capital regimes established by the Agencies already account for swap activities engaged in by the Agencies' respectively regulated entities. As such, the Agencies have decided not to impose any additional capital requirements under their Title VII rulemaking authority.

The CFTC's proposed rule, while not formally distinguishing financial entities as "high-risk" and "low-risk," would permit more lenient margin requirements for certain financial entities that meet similar, but not identical, requirements as imposed by the Agencies. To be such a comparably low-risk financial entity, the financial entity must represent to the CFTC-regulated SD or MSP that it (i) is subject to capital requirements established by a prudential regulator or state insurance regulator; (ii) does not have a significant uncleared swap exposure; and (iii) predominantly uses uncleared swaps to hedge or mitigate the risks of its business

activities, including interest rate, or other risk arising from its business. If a counterparty is such a low-risk financial entity, the CFTC's proposed rule would provide threshold amounts that are similar to those currently proposed by the Agencies, which is the lower of (i) \$15 to \$45 million or (ii) 0.1 to 0.3 percent of the CFTC-regulated SD's or MSP's regulatory capital.

Transactions with Nonfinancial End Users/Nonfinancial Entities

Under the Agencies' proposed rule, a nonfinancial end user is any end user that is not a financial end user. The Agencies' proposed rule would allow the regulated SD or MSP to impose the full margin requirements on a nonfinancial end user (as with low-risk financial end users) but would also allow such SD or MSP to establish a credit exposure limit, guided by its own credit policies and procedures, below which it would not collect initial and variation margin.

Under the CFTC's proposed rule, a nonfinancial entity is an entity that is not an SD, an MSP or a financial entity. The CFTC's proposed rule would not require a CFTC-regulated SD or MSP to collect margin from nonfinancial entities. If margin is nevertheless collected, the CFTC-regulated SD or MSP and the nonfinancial entity would be able to set their own margin requirements, the frequency of margin calls and thresholds as mutually agreed. Further, while no margin would need to be collected, the CFTC's proposed rule would require all of its regulated SDs and MSPs to calculate daily the hypothetical amounts of initial and variation margins that would be callable from

the nonfinancial entity counterparty as if margin requirements applied.

Initial Margin Calculation

The Agencies' proposed rule would permit an Agencies-regulated SD or MSP to select from two alternative methods to calculate initial margin requirements. First, it could calculate the initial margin using a standardized "lookup" table (to be provided by the Agencies) that specifies the minimum initial margin that would need to be collected, expressed as a percentage of the notional amount of the swap or security-based swap. However, the lookup table recognizes no offsetting exposures, diversification or other hedging benefits. Second, it could calculate its minimum initial margin requirements using an internal margin model that meets certain criteria that has been approved by the relevant prudential regulator, and which could better account for offsetting exposures, diversification or hedging benefits.

The CFTC also proposes two alternative methods to calculate initial margin, but the alternatives differ from those proposed by the Agencies. The first method permits the use of a risk-based model: the CFTC-regulated SD or MSP could use a risk-based model approved by the CFTC, which conforms with a number of standards⁸ and must be (i) currently used by a derivative clearing organization for margining cleared swaps, (ii) currently used by an entity subject to regular assessment by a prudential regulator for margining uncleared swaps, or

(iii) made available for licensing to any market participant by a vendor. The second method requires initial margins to be keyed to cleared swap instrument analogues, where the CFTC-regulated SD or MSP would (1) convert the uncleared swap into units of reference cleared swaps or futures that most closely approximate the uncleared swap, and (2) determine the initial margin of the uncleared swap by applying a multiplier to the corresponding amount of margin that the derivatives clearing organization would require for the reference cleared swaps or cleared futures; such multiplier is 2x for uncleared swaps that were converted to cleared swaps and 4.4x for uncleared swaps that were converted to cleared futures.

Variation Margins Calculation and Collection

The Agencies' proposed rule would generally require an Agencies-regulated SD or MSP to collect (or adjust as relevant) variation margins in an amount that is at least equal to (i) the cumulative mark-to-market change in value to such SD or MSP of a swap or security-based swap, as measured from the date it is entered into, less (ii) the value of all variation margin previously collected but not returned by such SD or MSP with respect to such swap or security-based swap. In other words, each Agencies-regulated SD or MSP would adjust variation margin based on the change in the value of the swap to it (i.e., how much it is "in the money").

The collection frequency of variation margin under the Agencies' proposed rule varies based on counterparty type. Agencies-regulated SDs and MSPs would collect variation margins from counterparties that are themselves SDs, MSPs or financial end users at least once per business day. Agencies-regulated SDs and MSPs may collect variation margins from counterparties that are nonfinancial end users on a weekly basis.

The CFTC's proposed rule would require a CFTC-regulated SD or MSP to calculate variation margins using a methodology specified in the relevant credit support arrangement between the relevant parties. The

methodology would need to be stated with sufficient specificity to allow the counterparty, the CFTC and any applicable prudential regulator to calculate the margin independently, and at any time the CFTC could require the CFTC-regulated SD or MSP to provide further data or analysis concerning such calculation methodology.

The CFTC's proposed rule would require daily collection of variation margin from other SDs, MSPs and financial entities. As described above, CFTC-regulated SDs and MSPs can agree to the frequency of variation margin collection with their counterparties that are nonfinancial entities.

Margin Requirements for Agencies-regulated SDs and MSPs		
Counterparty Type	Initial Margin*	Variation Margin
SD or MSP	Collected. Posted collateral must be segregated with independent, third-party custodian.	Collected.
High-risk Financial End User	Collected.	Collected.
Low-risk Financial End User	Collected. Subject to the following discretionary threshold: the lesser of (i) \$15 to \$45 million and (ii) 0.1% to 0.3% of the SD's or MSP's Tier 1 capital.	Collected. Subject to the following discretionary threshold: the lesser of (i) \$15 to \$45 million and (ii) 0.1% to 0.3% of the SD's or MSP's Tier 1 capital.
Nonfinancial End User	Collected. Subject to an initial margin credit exposure threshold set by the Swap Entity.	Collected. Subject to a variation margin credit exposure threshold set by the Swap Entity.

* No margin is collected for any counterparty type until the aggregate transfer amount exceeds \$100,000.

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Counterparty Refusal

The Agencies' and the CFTC's proposed rules place the burden on the regulated SDs and MSPs to police their counterparties' payments of variation margin. The proposed rules require the SDs and MSPs to (i) make the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or to be able to otherwise demonstrate, upon request to the satisfaction of the relevant agency, that it has made appropriate efforts to collect the required variation margin; or (ii) commence termination of the swap or security-based swap with the counterparty if the variation margin was not paid.

Eligible Collateral

The Agencies' proposed rule

provides that eligible collateral for both the initial margin and variation margin be (i) immediately-available cash funds or (ii) certain high-quality, highly-liquid U.S. government and agency obligations. With respect to initial margin only, eligible collateral may also include certain government-sponsored enterprise obligations, subject to specified minimum "haircuts" for purposes of determining their value for margin purposes.

The CFTC's proposed rule is similar to those proposed by the Agencies, with eligible collateral for initial margin being limited to (i) immediately-available cash funds denominated in U.S. dollars or the currency in which payment obligations under the swap is required to be settled; (ii) any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the U.S. or

an agency of the U.S.; or (iii) certain high-quality, highly-liquid U.S. government and agency obligations. For variation margin, eligible collateral would be either cash or U.S. Treasury securities.

Trade Documentation

The Agencies' proposed rule would require its regulated SDs and MSPs to keep rigorous trade documentation with each counterparty. Items that must be addressed in the trade documentation include: (i) credit support arrangements that grant Agencies-regulated SDs and MSPs the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the Agencies' proposed rule; (ii) the methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements; (iii) the procedures by which any dispute concerning the valuation of swaps or security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved; and (iv) the treatment of certain segregated collateral.

The CFTC's proposed rule also requires CFTC-regulated SDs and MSPs to keep proper documentation regarding the credit support arrangements, which must include the methodology used for the calculation of initial and variation margins and any applicable threshold amounts. If the CFTC-regulated SD

Margin Requirements for CFTC-regulated SDs and MSPs

Counterparty Type	Initial Margin*	Variation Margin
SD or MSP	Collected. Posted collateral must be segregated with independent, third-party custodian.	Collected.
Financial Entity	Collected.	Collected.
"Low-risk" Financial Entity	Collected. Subject to the following discretionary threshold: the lesser of (i) \$15 to \$45 million and (ii) 0.1% to 0.3% of the SD's or MSP's regulatory capital.	Collected. Subject to the following discretionary threshold: the lesser of (i) \$15 to \$45 million and (ii) 0.1% to 0.3% of the SD's or MSP's regulatory capital.
Nonfinancial Entity	Not collected.	Not collected.

* No margin is collected for any counterparty type until the aggregate transfer amount exceeds \$100,000.

or MSP does not use the risk-based model to calculate initial margin, the SD or MSP must include, in its trade documentation, the reference cleared swaps or futures that are used for the calculation.

Extraterritorial Application

U.S. Agency Covered Swap Entities Transacting with Foreign Counterparties

The Agencies' proposed rule would require U.S. Agency Covered Swap Entities to collect margin from their foreign counterparties in line with the Agencies' proposed rule without regard to the counterparty's domicile.

Foreign Agency Covered Swap Entities Transacting with Foreign Counterparties

The Agencies' proposed rule would establish a limited exception to its reach for those swap activities that are significantly outside of the direct interests of any U.S.-based entity. Specifically, the Agencies propose that the margin requirements would not apply to any "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign covered swap entity." The Agencies' proposed rule, in turn, defines a "foreign non-cleared swap or foreign non-cleared security-based swap" as a non-cleared swap or non-cleared security-based swap with respect to which:

- the counterparty to the foreign Agency Covered Swap Entity is not a company organized in the United States, not a branch or office of a company organized in the United States, and not a person resident in the United

States; and

- the performance of the counterparty's obligations to the foreign Agency Covered Swap Entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is a company organized in the United States, a branch of a company organized in the United States, or a person resident in the United States.

A "foreign covered swap entity," for this purpose, is defined as an Agency Covered Swap Entity that is not:

- a company organized in the United States;
- a branch or office of a company organized in the United States;
- a U.S. branch, agency or subsidiary of a foreign bank; and
- controlled, directly or indirectly, by a company that is organized in the United States.

Based on these definitions, a swap activity would be exempt from the Agencies' proposed rule only if the Agency Covered Swap Entity is located outside of the United States and organized under foreign law, and its counterparty is not a U.S.-organized-or-domiciled entity or controlled by a U.S.-organized-or-domiciled entity and the transaction is not guaranteed by a U.S. party. An example of such an exempt swap might be a European-based and organized swap dealer engaged in swap transactions with an Asian-based and organized counterparty, in which case, neither entity is controlled by a U.S. company and for which the transaction is not guaranteed by a U.S.-based entity.

Foreign Agency Covered Swap Entities Transacting with U.S. Counterparties

The Agencies' proposed rule text does not expressly address how a foreign swap entity would be treated with respect to its swap transactions with a U.S. counterparty that is not an Agency Covered Swap Entity; that is, the proposed rule neither expressly requires margin nor expressly exempts margin. However, the Agencies, in a footnote to the preamble of their proposed rule, clarify their intent and assert that "swap and security-based swaps with U.S. counterparties are subject to the proposed rule's margin requirements regardless of whether the covered swap entity is U.S. or foreign." This footnote demonstrates the Agencies' broad interpretation of the reach of the proposed rule. ■

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1. Please refer to our client update "A Defining Moment: SEC And CFTC Release Joint Proposed Rule On Key Definitions In Title VII Of The Dodd-Frank Act," dated December 28, 2010, for a discussion of the definitions of "swap dealer"

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- and “major swap participant.”
2. The CFTC’s analogue to the Agencies’ defined term “financial end user” is the “financial entity,” while its analogue to the Agencies’ defined term “nonfinancial end user” is the “nonfinancial entity.” The CFTC does not use different terminology to separate financial entities into high- and low-risk types, but does so through the application of its financial entity rule.
 3. See 7 U.S.C. 1a(5).
 4. See 15 U.S.C. § 80-b-2(a).
 5. See 29 U.S.C. § 1002.
 6. See 12 U.S.C. § 1843(k).
 7. “Significant swap exposure” is defined as swap positions that equal or exceed either of the following thresholds: (i) \$2.5 billion in daily average aggregate uncollateralized outward exposure, or (ii) \$4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure. For purposes of this definition, the terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure each has the meaning specified for them in the tests used for the definition of “major swap participant” for purposes of calculating substantial counterparty exposure under that definition.
 8. The standards applicable to the model include that it must (i) have a sound theoretical basis and significant empirical support, (ii) use factors sufficient to measure all material risks, (iii) when available, use at least one year of historic price data and incorporate a period of significant financial stress to the relevant swap, (iv) benefit only from portfolio offsets or reductions that have a sound theoretical basis and significant empirical support, (v) set margin to cover at least 99% of price changes by product and by portfolio over at least a 10-day liquidation time horizon, (vi) be validated by an independent third party before being used, and again annually thereafter, and (vii) be stated with sufficient specificity to allow the counterparty, the CFTC and any applicable prudential regulator to calculate the margin independently.

NAIC Corporate Governance Initiatives

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corporate governance framework (i) the commitment to the G-20 by the United States to achieve compliance with the IAIS Core Principles and (ii) the necessity of adhering to the recommendations of a bipartisan congressional committee formulated as a response to the financial crisis.

The White Paper divides the principles into eight categories, each of which is briefly summarized as follows:

1. Corporate Governance. As an overarching principle, the White Paper states that insurers must establish and maintain corporate governance frameworks that recognize and protect the interests of their policyholders. Corporate governance is broadly defined as a framework of systems, policies and procedures through which an insurer provides for the sound and prudent management of its business, creates security and long-term value for its policyholders and other key stakeholders and establishes accountability for its board members and senior managers.

2. Board of Directors. Stating that the ultimate responsibility for the effective governance of an insurer rests with its board of directors, the White Paper sets forth a number of principles relating to the composition of the board, the duties and responsibilities of board members, the skills and knowledge they should possess and the remuneration policy that should be implemented by the board. The specific responsibilities of the board include (i) establishing a code of conduct, (ii) strategic planning and risk management, (iii) oversight of senior management, (iv) monitoring the insurer’s internal control functions, (v) staying current with industry developments and risks and (vi) succession planning. The accompanying guidance recommends at least annual review of the board’s systems, policies and procedures.

3. Senior Management. This principle describes the role and responsibilities of senior management with respect to the day-to-day operations of the insurer and its interaction with the board. Among

other things, senior managers are expected to “set the tone” at the insurer by emphasizing ethical conduct in all aspects of a company’s operations. Senior managers must ensure that adequate resources are allocated to the persons at the insurer responsible for carrying out corporate governance functions.

4. Suitability of Individuals. The White Paper includes a principle that board members, senior managers, and other key persons (including significant owners) at an insurer must possess “competence” and “integrity”. Competence should be determined on the basis of an individual’s formal qualifications, knowledge and relevant experience in the insurance industry or related industries. Integrity should be determined on the basis of an individual’s behavior and business conduct. Prior criminal activity involving dishonesty or fraud, improper financial conduct or bankruptcy or regulator censure can all demonstrate a lack of integrity. The White Paper also states that an assessment of suitability should be

conducted as part of the licensing procedure for insurers and that insurers should be required to demonstrate suitability upon the request of their relevant insurance regulator.

5. Reporting and Transparency.

The White Paper states that insurers must maintain an effective financial reporting process and must regularly disclose material information about their governance processes to regulators and stakeholders. Specifically, at least annually, an insurer must share information about (i) its overall strategic objectives relating to existing and prospective lines of business, (ii) how responsibilities between the board and senior management are allocated, (iii) biographical information of board and committee members, (iv) the design and operation of the insurer's remuneration policy and (v) major ownership structures, including significant affiliations and alliances.

6. Risk Management and Internal Control Systems.

The White Paper includes a principle that, as part of an overall corporate governance framework, insurers must implement risk management systems capable of identifying, assessing, and managing reasonably foreseeable material risks, taking into account relevant current and emerging business-specific risks and enterprise-wide risks. The risk management system should include policies and procedures to manage, mitigate and report on risks. An insurer should also have an internal controls system that provides reasonable assurances over the insurer's key policies and procedures and risk management and compliance measures.

7. Control Functions. The White Paper states that insurers must implement risk management, compliance, actuarial and internal audit "control functions". The related principles and guidance in this section of the White Paper describe the purposes of these control functions as well as their position in an insurer's organizational structure. Each control function should be led by an individual with an appropriate level of seniority and expertise. Control functions and activities may be outsourced to affiliates of an insurer or third parties, but they must be subject to oversight and accountability to the same degree as if they were performed internally.

8. Regulatory Oversight. The White Paper concludes with the principle that an insurance regulator may require an insurer to demonstrate the effectiveness of its corporate governance framework and remedy any identified deficiencies. The regulator should perform periodic onsite inspections and other reviews, and the regulator should have the power to impose various preventative and corrective measures on an insurer whose corporate governance framework is ineffective or inadequate.

The White Paper suggests in various places that insurer adherence to many of these corporate governance principles can best be monitored by review and assessment during the mandated financial condition examinations already conducted by regulators.

At the Spring Meeting, objections to the White Paper were voiced by several industry associations and followed on from comments received

to the summaries released by the working group in January. Some industry participants, in particular, have suggested that the principles have been developed without identification and discussion of the regulatory defects they were purporting to address. Others have questioned the need to modify existing corporate governance laws in the first place, pointing out that the U.S. already has a detailed and well-developed legal framework to regulate the corporate governance of business organizations. Parties also expressed concerns about potential conflicts with existing state law.

At the Spring Meeting, the Working Group voted to expose the White Paper to a forty five day public comment period. Comments to the NAIC are due on May 13, 2011. As noted at the outset of the White Paper, the Working Group's next charge is to determine the changes to the insurance regulatory structure needed in order to evaluate adherence to this set of corporate governance principles. Although the outcome of the NAIC's deliberations remains to be seen, the NAIC's efforts in this area bear close watching by insurance companies and other interested parties in the U.S. ■

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