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May 18, 2011

VIA email

Honorable Susan Voss
Iowa Insurance Commissioner
Chair, NAIC Executive Committee

Honorable Christina Urias
Arizona Director of Insurance
Chair, Solvency Modernization Initiative Task Force

c/o Bruce Jensen, CPA
Financial Examination Manager, NAIC

Re: NAIC, insurance regulation, and corporate governance

Dear Commissioner Voss and Director Urias:

The National Association of Mutual Insurance Companies, representing 1,400 property/casualty insurers that underwrite 38% of the market, writes on behalf of its member companies to express their deep concern regarding the Corporate Governance Working Group's current initiative—the development of "corporate governance principles ... giving due consideration to development of a model law," by means of "analyz[ing] the requirements, regulatory initiatives and best practices of ... other countries ... to assist in principle development."

We would like to stress at the outset our beliefs that (a) the Working Group is operating in good faith within the charge (quoted above) that it was given, and (b) the Chair has led the proceedings in a thoughtful manner.

Our main concern lies less with the manner in which it project is being carried out¹ and more with the appropriateness of the project itself. We have concluded—and urge the NAIC to carefully consider—that the need for an initiative focused solely on developing corporate governance principles has never been established; that it shortchanges the very significant authority over relevant corporate governance activities that NAIC members possess under traditional insurance law and the particularly substantial financial regulatory reforms of recent years pertaining to corporate governance and internal controls; that the broad scope of the effort places NAIC members beyond the grant of their insurance regulatory purview; and/or that the

¹ We have previously stated one significant procedural concern with the Working Group's plan of attack—the bifurcation of the development of principles from the discussion of what they will be used for. But we believe that ultimately this issue is subsumed with the larger question that is the subject of this letter: whether a stand-alone corporate governance project should be pursued as a matter of first principle.

attempt to import foreign standards over the extensive body of existing American law and norms inevitably creates a significant mismatch between the two.

We therefore write to express our view that the Executive Committee and SMI Task Force would be well served to engage in a thorough discussion of first principles regarding corporate governance before any further work is performed on what we respectfully suggest may be an unnecessary, and perhaps even counterproductive, project.

In summary:

- We believe that the Working Group's charge to outline corporate governance principles for possible development of a model law is too broad because it is not tethered to specific regulatory processes and because neither the charge nor the Working Group has articulated a specific shortcoming that needs to be remedied before embarking on a major policy initiative.
- Compounding the problem, the charge's instruction to import "requirements, regulatory initiatives and best practices of ... other countries ... to assist in principle development" threatens to undermine and conflict with a well-settled balance in American corporate governance law, which establishes a thorough web of requirements with qualitatively different bases from European and other systems.
- Insurance regulators do have a legitimate though limited role to play in corporate governance, and they do currently have a variety of real and potent tools to enforce good corporate governance practices which demonstrably affect insurance regulatory outcomes. We respectfully object, however, to a sweeping effort by U.S. insurance regulators to broadly transform themselves into corporate governance regulators, which we believe this project plainly attempts. That is the role of other actors in the U.S. system. U.S. insurance companies are subject to extensive corporate governance requirements—in key ways stronger and more aggressively enforced than those in other countries—which are generally not enforced by insurance departments as a primary regulator. That should not be seen as a problem to be corrected—but rather as a legal reality with attendant lines of authority which should be respected for a number of reasons, including the potential of conflict with existing law.
- It is our sense that the current project is being carried out in response to perceptions about the FSAP process and international equivalence generally. We believe that American insurance regulators and the U.S. regulatory system have done well to date, both within FSAP and, more importantly, in what matters most—commissioners' discharge of their statutory responsibilities in their States. American insurance regulators have an excellent story to tell about corporate governance generally and insurance company corporate governance specifically. Specifically, a slew of well-established insurance code provisions provide regulators with substantial power to oversee and correct corporate governance and internal control deficiencies that affect carriers' regulatory performance. This includes bedrock NAIC requirements from the NAIC Biographical Affidavit to NAIC's Model Regulation To Define Standards And Commissioner's Authority For Companies Deemed To Be In Hazardous Financial Condition.

- NAIC has also prioritized and succeeded in promulgating major corporate governance initiatives in recent years: comprehensive additions to the Financial Condition Examiners Handbook, with dozens of pages of text devoted to corporate governance and internal controls; landmark and high profile revisions to the Model Audit Rule; and targeted and significant changes to the Insurance Holding Company System Regulatory Act. After a full decade of NAIC corporate governance reforms, our member companies respectfully suggest that the current initiative is not only substantively misplaced because of its sweep but is at this point markedly untimely even if that sweep had ever been appropriate.
- If NAIC wishes to pursue a corporate governance project, we therefore respectfully suggest it should proceed as follows.
 1. Analyze whether the existing tools discussed in this memo are deficient for achieving the statutory goals of U.S. insurance regulation, with specific reference to actual situations where regulators were legally blocked from achieving necessary corporate governance reforms that they sought, and with a specific conclusion as to what changes are necessary to achieve these stated ends.
 2. Analyze and determine whether the existing tools available to U.S. regulators are insufficient to allow NAIC to aggressively advocate that it should be considered equivalent under the relevant international regimes.
 3. Compare the results of the previous two inquiries. If U.S. regulators determine that changes would be required to meet the goals under the two inquiries, and that the changes mandated by the two inquiries are not the same, they should analyze the costs and benefits of making, or choosing not to make, the changes necessary to accommodate international review but unnecessary to achieve good U.S. statutory outcomes—with reference to the actual, tangible ramifications of a negative FSAP finding in this area.

Thank you for your consideration of our views on this important matter. NAMIC members are thoroughly committed to both rigorous corporate governance business practices and to rigorous regulatory oversight (properly carried out by the proper overseer) of their corporate governance practices.

We thus hope that the main point of our detailed submission—that the American system of corporate governance is robust, in no small part due to the substantial efforts of the NAIC in recent years—is not lost in our friendly suggestion that SMI's direction should be reset in the corporate governance area, starting with a revision of the Working Group's charge.

What Is The Problem To Be Remedied?

The Working Group's charge does not identify a specific insurance regulatory problem to be remedied in the corporate governance of U.S. insurance companies, nor are we aware of any such problem which has been articulated before or during the Working Group's deliberations. Normally, this is the starting point for any policy initiative at the NAIC, and we think that such a

step would be particularly important when initiating a charge that is so sweeping that it appears to go beyond the insurance regulatory realm and into a separate bailiwick—corporate governance regulation.

In fact, issues of corporate governance go well beyond insurance regulatory oversight, and touch on the very operations of the health plan or insurer. These operations, and their oversight, are subject to a very substantial body of states' laws governing corporate organization and behavior. These rules are generally derived from state statutes and case law, which spell out the roles, responsibilities and duties of a company's board and management.

Current U.S. corporate governance requirements and protocols are quite robust, and NAIC has not identified any shortcomings or deficiencies in their application which detract from sound insurance regulation. We respectfully suggest that developing solutions to problems that have not yet been identified or analyzed may only itself create problems, particularly because these solutions may invariably conflict with or disrupt the legal underpinnings of current corporate governance requirements that have evolved over decades and form a well-documented framework of duties and responsibilities that are carefully allocated between a board and the company's management.

The Comparatively Rigorous U.S. Corporate Governance Regime

A very real way that this plays out in the current Working Group project can be demonstrated by comparing the far more developed oversight of U.S. corporate governance to that of Europe. Interested parties to date have expressed concerns that the Working Group and SMI Task Force have looked extensively to European standards for guidance. One of the problems with this, as discussed in detail further below, is that the basic corporate structures in Europe are often radically different than in the United States, and thus require different substantive oversight.

Another difference is that European companies are not subject to nearly the same accountability through the judicial system as their American counterparts. The role of lawsuits in the U.S. system is qualitatively and quantitatively different than in Europe.

There is a "greater development of the duty of loyalty in the U.S. In fact, in jurisdictions other than the U.S. ... there exist some enforcement-related features that prevent shareholders from suing directors and other insiders."² Also blunting judicial oversight of corporate governance, "European jurisdictions ... ha[ve] the 'loser pays' rule, ... [and] the ban on contingency fees."³ Thus,

the legal environment in the United States is uniquely hospitable to litigation against directors. Multiple features of the American legal system contribute to this unique environment. ... [T]he class action suit and the 'derivative' suit (litigation brought by shareholders on a company's behalf) are well-established

² Luca Enriques, Book Review of *The Anatomy of Corporate Law: A Comparative and Functional Approach*, *American Journal of Comparative Law*, Fall 2004, 52 *Am. J. Comp. L.* 1011.

³ *Id.*

devices for solving collective action problems. ... Class action certification is routinely available. ... [T]o a unique extent, the U.S. legal system treats plaintiffs' attorneys as entrepreneurs.⁴

These differences must significantly impact the first principle analysis of the necessity and wisdom of importing European corporate governance standards on to American insurance regulatory law. The "greater develop[ed] ... duty of loyalty in the U.S." is part and parcel of a thorough and holistic body of corporate law which provides significant protections for those with an interest in the effect of good corporate governance on the solidity of American corporations. Moreover, these protections include a high degree of accountability on the part of directors of American companies.

Thus comprehensive corporate governance reforms for insurance companies only based on European principles may (a) be unnecessary since American companies are already subject to far greater scrutiny in litigation than their European counterparts; and (b) may substantively conflict with the well developed thicket of supervision of American companies which is far more extensive than that in Europe.

The Strength Of U.S. Insurance Regulatory Corporate Governance Oversight

We believe that in launching its corporate governance initiative, NAIC has not given appropriate credence to the quite substantial tools—including those resulting from the laudable recent efforts of the NAIC itself—that U.S. insurance regulation can utilize to effect necessary discipline in corporate governance.

For starters, traditional U.S. insurance regulatory tools give American regulators solid foundation to provide relevant supervision of carriers' corporate governance to the extent that the companies' corporate governance practices impact insurance regulation.

Directors' and management's ability to properly supervise, control, and manage the corporation is a common prerequisite to obtaining and maintaining a certificate of authority under State insurance codes, such as:

- "General eligibility for certificate of authority. ... The office shall not grant or continue authority to transact insurance in this state as to any insurer the management, officers, or directors of which are found by it to be incompetent or untrustworthy; or so lacking in insurance company managerial experience as to make the proposed operation hazardous to the insurance-buying public; or so lacking in insurance experience, ability, and standing as to jeopardize the reasonable promise of successful operation."⁵
- "The office shall suspend or revoke an insurer's certificate of authority if it finds that the insurer ... [i]s using such methods and practices in the conduct of its business as to render

⁴ Brian Cheffins and Bernard Black, Outside Director Liability Across Countries, Texas Law Review, May, 2006, 84 Tex. L. Rev. 1385

⁵ Fla. Stat. 624.404.

its further transaction of insurance in this state hazardous or injurious to its policyholders or to the public."⁶

- "The Director shall not ... issue a Certificate of Authority for any company until he has found that (a) the company has submitted a sound plan of operation, and (b) the general character and experience of the incorporators, directors and proposed officers is such as to assure reasonable promise of a successful operation, based on the fact that such persons are of known good character."⁷
- "Whenever it appears to the Director that any person or company subject to this Code is conducting its business and affairs in such a manner as to threaten to render it insolvent, or that it is in a hazardous condition, or is conducting its business and affairs in a manner which is hazardous to its policyholders, creditors or the public, ... the Director may, without notice, and before hearing, issue and cause to be served upon such person or company an order requiring such person or company to forthwith cease and desist from engaging further in the acts, practices or transactions which are causing such conduct, condition or ground to exist."⁸
- "[I]f upon examination ... or at any other time it appears to or is in the opinion of the director that any insurance company is insolvent, or its condition is such as to render the continuance of its business hazardous to the public or to holders of its policies ... the director shall upon his determination ... [f]urnish to the insurance company a written list of the director's requirements to abate his determination, and ... [i]f the director makes a further determination to supervise he shall notify the insurance company that it is under the supervision of the department of insurance."⁹
- "The director may after a hearing refuse to renew or may revoke or suspend an insurer's certificate of authority ... if the insurer ... [i]s found by the director to be in unsound condition or in such condition as to render its further transaction of insurance in this state hazardous to its policyholders or to the people of this state."¹⁰
- "If the commissioner upon reasonable cause determines that a domestic insurer is in a condition as to render the continuance of its business hazardous to the public or to holders of its policies ... then the commissioner shall ... 2. Furnish to the insurer a written list of the commissioner's requirements to abate the determination. 3. If the commissioner makes a determination to supervise an insurer subject to an order under subsection 1 or 2, the commissioner shall notify the insurer that it is under the supervision of the commissioner."¹¹

⁶ Fla. Stat. 624.418.

⁷ Ill. Stat. 215-5/155.04.

⁸ Ill. Stat. 215-5/401.1.

⁹ Ariz. Stat. 20-169.

¹⁰ Ariz. Stat. 20-220.

¹¹ Ia. Stat. 507C.9.

- "The commissioner may refuse, suspend, or revoke an insurer's certificate of authority ... if the insurer ... [i]s found by the commissioner to be in such condition that its further transaction of insurance in this state would be hazardous to policyholders and the people in this state."¹²

The statutes quoted above are common and representative provisions. They provide the commissioner with significant powers from a company's initial licensure through its operation as a going concern to take action in response to poor operations—in plan or execution.

It is clear from the plain language of the statutes that not just poor financial results but also poor operations which impact the regulatory performance of the company may serve as a basis for regulatory action. The statutes regulate "[]competence," "managerial experience," a company's "plan of operation"—and give the commissioner enormous power to address "hazardous operation" generally, including to direct the company as to her "requirements to abate the determination." Certainly corporate governance and internal controls are well within the sweep of these statutes.

Widely used NAIC tools provide significant oversight and control of corporate governance as well. The NAIC Biographical Affidavit requires extensive disclosures of character and fitness information from the start of an individual's association with a company, and NAIC's own Model Regulation To Define Standards And Commissioner's Authority For Companies Deemed To Be In Hazardous Financial Condition incorporates significant authority for commissioners to act not just upon financial, but also operational, impairment of a company's operations—corporate governance specifically.

The following standards ... may be considered by the commissioner to determine whether the continued operation of any insurer ... might be deemed to be hazardous to its policyholders, creditors or the general public. The commissioner may consider: A. Adverse findings in financial condition and market conduct examination reports, audit reports, and actuarial opinions, reports or summaries. ... If the commissioner determines that the continued operation of the insurer ... may be hazardous ..., then the commissioner may ... issue an order requiring the insurer to: ... Correct corporate governance practice deficiencies, and adopt and utilize governance practices acceptable to the commissioner. ... Provide a business plan to the commissioner in order to continue to transact business in the state.

The Financial Condition Examiners Handbook, Corporate Governance, And Internal Controls

This Model's reference to "adverse findings in financial condition .. examination reports" as a trigger for regulatory action, including orders to "correct corporate governance practice deficiencies," is particularly significant in light of the recently adopted landmark revisions to the NAIC Financial Condition Examiners Handbook.

¹² Wash. Stat. 48.05.140.

These relevance and impact of these reforms to the Handbook, we believe, must be considered in depth by the NAIC in its evaluation of whether the current Working Group project is necessary. We submit, in fact, that the Handbook provides a well-conceived, thorough basis for insurance regulatory corporate governance regulation.

The Handbook's Preamble places its reforms in the context of a lengthy, considered project:

In order to improve the assessments of insurance companies, the Risk Assessment Working Group was formed in 2001. ... [T]he Risk Assessment Working Group recognized the need to develop modifications to this Handbook to incorporate an enhanced risk-assessment process.¹³

The Preamble explains the significance of the resulting changes.

Plenary ... adopted these revisions Dec. 12, 2006. ... [T]he revised handbook was presented to the Financial Regulation Standards and Accreditation (F) Committee during the 2007 NAIC Spring National Meeting. ... [A]pplication of this Handbook approach is now mandated as an accreditation standard.¹⁴

One of the "Key Concepts on the Use and Application of the Risk-Focused Approach" enumerated in the Preamble is the "Responsibility to Consider the Insurer's Corporate Governance and Risk Management Processes."¹⁵ The Handbook explains:

In order to complete an examination under the risk-focused surveillance approach, examiners must consider and evaluate the insurer's corporate governance and established risk management processes. ... [T]he examiner should determine whether effective controls are in place and mitigating the identified risks.¹⁶

This includes the "Consideration of 'Other than Financial' Risks."¹⁷

The Handbook revisions were explicitly designed to address concerns regarding the perceived connection between corporate governance and insurance regulatory financial needs.

Historically, many solvency problems have been caused by inadequate management oversight. ... Solvency issues generally result from business risks that were not mitigated to an acceptable level by company controls. Inadequately controlled operating risks may take several years to be reflected in the company's financial statements.¹⁸

¹³ National Association of Insurance Commissioners, Financial Condition Examiners Handbook, 2010 Edition, P. 3.

¹⁴ Id.

¹⁵ Id. at 4.

¹⁶ Id.

¹⁷ Id.

¹⁸ Id. at 9.

Corporate governance oversight was at the very top of the list of the enumerated reforms designed to address these concerns.

The enhancements included in the risk-focused surveillance process intend to provide the following benefits: (1) Strengthen regulatory understanding of the insurer's corporate governance function by documenting the composition of the insurer's board of directors and the executive management team as well as the quality of guidance and oversight provided by the board and management. (2) Enhance evaluation of risks through assessment of inherent risks and risk management process regarding weaknesses of management's ability to identify, assess and manage risk.¹⁹

The Handbook identifies the "Goals of Risk-Focused Examinations" as follows:

The purpose of the risk-focused surveillance process in a risk-focused examination is to determine areas of higher risk to enable more efficient use of examiner resources. Key goals of this process during the examination are to assess the quality and reliability of corporate governance to identify, assess and manage the risk environment facing the insurer in order to identify current or prospective solvency risk areas....²⁰

After having left no doubt about the importance of corporate governance and internal controls in the examination process, the Handbook spells out in great detail how to review and evaluate the insurer's effectiveness in this area. "Understanding the Corporate Governance Structure" identifies no less than 13 "[c]omponents of effective corporate governance programs,"²¹ and provides nearly five full pages of directions regarding "Board of Directors," "Audit Committee," "Other Committees," "Management," and "Financial Officers."²²

The Handbook then provides an eight page section entitled "Identify and Evaluate Risk Mitigation Strategies (Controls),"²³ which is focused, again, on corporate governance and internal controls.

Risk mitigation strategies/controls are generally based on five overarching principles, which are applicable to all key activities: (1) An active board and senior management oversight. (2) Adequate risk management, monitoring and management information systems. (3) Adequate and clear policies, authorization limits and procedures. (4) Comprehensive internal controls. (5) Processes to ensure compliance with applicable laws and regulations.²⁴

¹⁹ Id. at 10.

²⁰ Id. at 13.

²¹ Id. at 126.

²² Id. at 126-130.

²³ See id. at 142-149.

²⁴ Id. at 142.

Then the Handbook provides six more pages on "Understanding the Corporate Governance Structure"²⁵ with an exhibit designed "to assist the examiner in documenting the understanding and assessment of an insurer's board of directors, senior management and organizational structure, as well as a review of the risk management function."²⁶ Organizes under the title headings "Assessing the board of directors," "Understanding the organizational structure," "Understanding the assignment of authority and responsibility," "Assessing management competence," "Reviewing the risk management function," and "Documentation," these instructions provide a thorough roadmap for learning about, assessing, and evaluating the insurer's corporate governance functions on insurance regulatory issues.

We respectfully but firmly suggest that it is unnecessary—even strange—that, just a few years after having developed a comprehensive revision to the Financial Examiners Handbook (an accreditation standard no less), focused on corporate governance and internal controls and spanning dozens of pages, that NAIC now feels that—despite the absence of any insurance regulatory evidence of necessity correlated to specific insurance regulatory or solvency issues—it is necessary to embark on a sweeping corporate governance project designed to outline high-level corporate governance principles with an eye toward promulgating a model law in this area.

Put another way, we simply urge you to read and consider the dozens of pages of the Handbook devoted to corporate governance and internal controls—and to consult with the E and F Committees, asking them specifically what shortcomings in the Handbook need to be remedied in order to further specific insurance regulatory goals—before deciding whether the current initiative will provide a missing piece of the regulatory puzzle.

Other NAIC Corporate Governance Reforms

The NAIC/AICPA Working Group, reporting to the Financial Condition (E) Committee, recently put forth a substantial rewrite of the Model Audit Rule which NAIC has adopted. That Working Group's web page describes these changes thusly: "The revisions relate to auditor independence, corporate governance, and internal control over financial reporting."²⁷

According to an NAIC copyrighted presentation given to the Financial Summit 2008 Leadership Initiatives, the 2006 Model Audit Rule revisions are "currently required for accreditation," and "involve three main topics": "Auditor independence," "corporate governance," and "internal control over financial reporting."²⁸

The NAIC described the Model Audit Rule revisions in a June 12, 2006 press release entitled "NAIC Adopts Enhanced 'Model Audit Rule':

The ... NAIC ... has voted to amend its ... Model Audit Rule. The amendments relate to auditor independence, corporate governance, and internal control over

²⁵ Id. at 521-526.

²⁶ Id. at 521.

²⁷ http://www.naic.org/committees_e_naic_aicpa_wg.htm

²⁸ http://www.naic.org/documents/frs_summit_presentations_22.pdf

financial reporting. ... "This was a substantial effort between the NAIC and the insurance industry that represents the important work we as state insurance regulators do when we develop models that deal with highly contentious issues," said ... NAIC President Alessandro Iuppa. "The adoption of this regulation strengthens the integrity of the insurance industry's statutory financial reporting." The adoption followed an extensive vetting process by the Financial Condition (E) Committee, which took up the Model Audit Rule in March 2006 after an lengthy and deliberate process that dates back to 2003 by the NAIC/AICPA (E) Working Group.²⁹

The NAIC, in December, 2010, adopted significant amendments to the Insurance Holding Company System Regulatory Act. According to a recent NAIC webinar announcement, "corporate governance" requirements were one of the six main elements of the revised Act.³⁰ The new Model requires a statement that the board of directors is responsible for and oversees corporate governance and internal controls and that the insurer's senior management has approved and implemented and is maintaining and monitoring corporate governance and internal control procedures.

And the NAIC Market Regulation Handbook, promulgated under the auspices of the Market Regulation and Consumer Affairs (D) Committee, also mandates an evaluation of corporate governance. For instance, examiners are instructed to review board of directors records to "ensure the board has proper oversight of the company's operations and activities."

The Relevance Of The Robust Current System And Recent Reforms

We thus respectfully submit that (1) the traditional insurance regulatory statutes provide significant authority for regulators to oversee corporate governance relevant to insurance regulatory goals; and (2) NAIC has put tremendous effort in recent years into developing further reforms that have extraordinary relevance to the Corporate Governance Working Group's work which do not seem to have been taken into account in developing the charge for the Working Group's broad project.

The most important result of this is on the merits. American insurance companies are subject to rigorous oversight of corporate governance—through general corporate governance law, through traditional insurance code provisions, and through the myriad of recent NAIC reforms. This should be the starting point for evaluating the necessity for a broad-based corporate governance project: Is there a regulatory need for additional corporate governance requirements based on the statutory role of the insurance commissioner? We believe that any finding in the affirmative in response to that question must be coupled with a thorough explanation of how all the sources of authority cited herein, and how all of the NAIC's efforts in the last decade, are lacking.

Also relevant to the NAIC, we understand, is the perception of the international community. We believe that the story that can be told, outlined above, is compelling.

²⁹ http://www.naic.org/Releases/2006_docs/enhanced_model_audit_rule.htm

³⁰ http://www.naic.org/documents/education_schedule_holding_company_act_webinar.pdf

We also believe that the results of the FSAP reports to date are not cause for alarm. For instance, the July, 2010 FSAP report on IAIS Insurance Core Principles entitled Report on Standards and Codes³¹ acknowledges progress made by U.S. regulators on these issues. With respect to "ICP 9—Corporate Governance," it states "Departments have been increasing their focus on governance issues," and with respect to "ICP 10—Internal Controls," it references "Sarbanes-Oxley provisions provid[ing] a general framework of detailed control requirements and testing of controls," with respect to which it notes, "From January 1, 2010, much of this framework will be extended to most other insurers."³²

Exhibit F to the Working Group's draft White Paper includes excerpts that recommend that "As examiners gain experience, the NAIC and/or departments should consider issuing more guidance on good and bad practices in corporate governance for insurers," and that, "As examiners gain experience, the NAIC and/or departments should consider the scope for issuing guidance on good and bad practices for internal control."³³ We respectfully suggest, however, that by the NAIC's own reckoning, it has met these goals in the reforms discussed above:

- "Responsibility to consider the insurer's corporate governance and risk management processes. In order to complete an examination under the risk-focused surveillance approach, examiners must consider and evaluate the insurer's corporate governance and established risk management processes."³⁴
- "The guidance within the handbook requires examiners to obtain and utilize information documented by the insurer to understand their corporate governance structure and internal controls as well as external risk audit risk assessments and test work on internal controls and the financial statement accounts."³⁵
- "Understanding the corporate governance structure. This section's purpose is to assist the examiner in documenting the understanding and assessment of an insurer's board of directors and management."³⁶
- "Assessing the adequacy of the audit function. ... The following guidelines direct the assessment of insurer audit activities."³⁷
- "The internal control structure: This Handbook requires the examiners to gain an understanding of controls as they relate to specific control objectives for an insurer."³⁸

³¹ http://www.treasury.gov/resource-center/international/standards-codes/Documents/ROSC_Insurance_Final_For%20Publication_7%2029%2010.pdf

³² Id. at 9.

³³ Id. at 11.

³⁴ NAIC Financial Condition Examiners Handbook at 4.

³⁵ Id. at 5.

³⁶ Id. at 126.

³⁷ Id. at 130.

³⁸ Id. at 133.

- "Revisions to Model Audit Rule. ... Revisions involve three main topics. Auditor independence. Corporate governance. Internal control over financial reporting."³⁹
- "Revisions to Model Audit Rule. Section 14 of the MAR, certain standards for audit committees. ... Section 15 of the MAR, certain standards for directors and officers. ... Section 16 of the MAR, certain standards for management's reporting on internal control over financial reporting."⁴⁰

We believe that the NAIC's landmark corporate governance reforms in the last decade, touched on above, make the United States an international leader in this area, and we suggest that American regulators need not embark on a new project in this area designed to preemptively try to address perceived international pressures.

The Difference Between Past, Well-Founded NAIC Corporate Governance Initiatives And The Current Project

We emphasize that, while we may not agree with every provision of these changes, we all support the NAIC's efforts the last several years to strengthen regulatory-based oversight of insurer corporate governance. The reforms discussed above were developed in response to specific regulatory concerns identified by standing NAIC oversight committees, and all were tethered to specific regulatory functions and outcomes.

By contrast, we believe, the Corporate Governance Working Group, per its charge, is embarking on a task of proposing corporate governance reforms for possible codification in a model law through a process not tethered to the functions of insurance regulatory oversight. Instead, it is, without specific reference to demonstrated regulatory needs, asking whether European and other foreign corporate governance standards should be grafted upon the U.S. insurance regulatory system.

We observe that both of the initiatives which have triggered stakeholder concern in the last year⁴¹ have been undertaken not by standing working groups and task forces under substantive regulatory committees, like the E Committee, but rather by subsidiaries of the Executive Committee. With respect, we suggest that this overreach is not a coincidence, but rather correlates with and is a result of a general committee pursuing a general topic that has a scope that goes far beyond insurance regulation—in contrast to the reforms, including pertaining to corporate governance, produced in the financial arena by committees like the E and F Committee.

As discussed above and below, United States insurance companies are subject to a comprehensive system of financial oversight in which corporate governance plays an integrated,

³⁹ NAIC presentation on Corporate Governance, supra note 28, at slide 15.

⁴⁰ Id. at slides 17-19.

⁴¹ Many interested parties filed comments with similar concerns in response to last year's NAIC Solvency Modernization (EX) Task Force's Consultation Paper on Corporate Governance and Risk Management. See http://www.naic.org/documents/committees_ex_isftf_corp_gov_consultation_paper.pdf

thoughtful, and proper role. We believe that the current project, by the nature of its very charge, will veer toward proposing standards not conceived of in reaction to demonstrated regulatory needs—which will head it down an inevitable path of potential conflict with the established corporate law frameworks under which American insurers operate.

Fundamental Differences Between U.S. And Foreign Corporate Structure And Oversight

It is simply not feasible to subtly pick and choose standards from foreign corporate governance systems which holistically and fundamentally differ from those found in the United States.

American and European systems of corporate structure are so different that they are known by directly opposite labels—"the insider and outsider systems." Insider systems like Continental Europe "are those in which the corporate sector has controlling interests in itself" through "block ownership." In the U.S., ownership is far more dispersed with "few controlling shareholdings."⁴²

The difference in institutional versus broad-based ownership also leads to the labels "bank-based" and "market-based" systems. Continental Europe is a "bank-based system" where "companies raise most of their external finance from banks that have close, long-term relationships with their corporate customers."⁴³ The U.S., "[b]y contrast," is a "market-based system ... characterized by arm's-length relationships between corporations and investors." In the U.S. system, competition between market actors is prized, whereas in Europe there is more cooperation and overlap.

The structure of many Continental European corporations leads to results that are simply unrecognizable to the American observer. "[I]n nearly 85% of the German firms there were at least one shareholder owning more than 25%; and almost 80% of the French companies had at least one shareholder with more than 25% ownership."⁴⁴ "Such large shareholdings tend to be held either by the founding family or by other corporations."⁴⁵ By contrast, "Slightly less than half of the [listed U.S.] companies have no 5%+ blockholder."⁴⁶

Not surprisingly, radically different corporate governance standards result from these radically different ownership paradigms. "[T]hese differences in ownership systems give rise to very different forms of corporate control."⁴⁷ "The different patterns of ownership ... create different incentives and corporate control mechanisms. ... In short, different forms of ownership would appear to be suited to promoting different types of activity."⁴⁸

⁴² Julian Franks and Colin Mayer, *Corporate Ownership and Control in the U.K, Germany, and France*. Studies in International Corporate Finance and Governance Systems 290.

⁴³ *Id.* at 281.

⁴⁴ *Id.* at 283.

⁴⁵ *Id.* at 296.

⁴⁶ Marco Becht, *Beneficial Ownership in the United States, The Control of Corporate Europe* 288.

⁴⁷ Franks and Mayer 290

⁴⁸ *Id.* at 296.

There are a number of ways that corporate governance oversight fundamentally differs between the United States and Europe, only a few of which we will mention. "On central issues, such as the structure of the board or the participation of employees in the management of the firm, European corporate law regimes continue to exhibit widely different approaches."⁴⁹

A significant manifestation of these differences is the higher frequency of two-tier board of directors in Europe. In this system, the company has a supervisory board and a managing board. The latter board performs a wholly different function than an American board of directors because it is expected to play a direct role in the day-to-day management of the firm, rather than just a supervisory role.

And in some jurisdictions boards institutionally contain a heavy labor and/or governmental participation. For instance, in

the German corporate governance model[,] [f]irms with more than 500 employees are required to utilize a two-tier board structure, with a supervisory board providing oversight and general corporate strategy, and a management board providing day-to-day management oversight function. If the firm has more than 2,000 employees, 50 percent of the supervisory board members must consist of employee representatives. ... This is in stark contrast to the structure of corporate boards in the United States where the board structure is single-tier and labor has no specific right of representation. In fact, board members in the United States are required to act in the best interest of the corporation and its shareholders and thus may not specifically represent any particular constituency.⁵⁰

Simply put, foreign corporate governance frameworks are radically different from the United States in core, material ways. The foreign corporate governance rules which are under review have been formed in response to different systems and different needs.

Many of the premises underlying these foreign governance rules are wholly anathema to the complex, well developed system of corporate governance that U.S. insurers operate under as American corporations, regardless of being insurers. This thorough system places significant duties on all American boards, and as a practical matter incentivizes capable watchdogs to enforce those duties. And with respect to insurance regulation specifically, as discussed above, U.S. regulators have already incorporated those corporate governance rules that have been identified as specifically contributing to the insurance regulatory function.

We also note that, within the European Union itself, there is considerable disagreement about whether uniformity in corporate governance is a worthy goal, as evidenced by comments from the Institute of Chartered Accountants in England and Wales regarding a recent European Commission Green Paper on Corporate Governance. "Good governance is important to all

⁴⁹ Jens C. Dammann, Freedom of Choice in International Law, Yale Journal Of International Law, Summer 2004, 29 Yale J. Int'l L. 477.

⁵⁰ Timothy L. Fort and Cindy A. Schipani, Adapting Corporate Governance for Sustainable Peace, Vanderbilt Journal of Transnational Law, March, 2003, 36 Vand. J. Transnat'l L. 377.

organisations [sic] but one size does not fit all and caution is needed for any developments that may stifle competitiveness of European markets."⁵¹

Moving Forward

We want to emphasize that we do understand the broader picture that NAIC is attempting to address. As stated in the Working Group's Jan. 24 memo,

commentators should be cognizant of the new core principles and standards being developed by the IAIS which will form the basis for the Financial Sector Assessment Program and may provide a means for other countries to determine U.S. equivalence. Comments should address how the NAIC can achieve substantial compliance with the IAIS standards ... without placing an overly excessive burden upon the insurance industry.⁵²

We believe that before proceeding further, NAIC must focus on the last part of that passage: "without placing an overly excessive burden upon the insurance industry." Any broad corporate governance model law—particularly but not only one incorporating major segments of foreign corporate governance standards—would not only result in an "overly excessive burden" on the industry but likely cause harm by placing new requirements upon carriers that conflict with the well established corporate governance framework established by other sources of law in the U.S. system.

Achieving equivalence for equivalence's sake does not justify such a burden. NAIC members are insurance regulators. They regulate the U.S. market and their first obligation is to U.S. consumers and the stability of the U.S. industry. Grafting foreign corporate standards upon our insurance codes in this way is not in those best interests. And as the largest, most important, and best regulated market in the world, we respectfully suggest that U.S. regulators should not feel that they have to take such a radical step not grounded in insurance regulatory need for the benefit of foreign interests.

Insurance regulatory need should be the cornerstone for analysis of the current matter. The NAIC made substantial insurance regulatory improvements in the last decade in corporate governance, internal controls, and audit functions in direct response to insurance regulatory concerns. A central purpose of this letter is to remind NAIC of its labor in this area and to suggest that layering the current, stand-alone corporate governance project on top of these comprehensive reforms is unnecessary and counterproductive.

We therefore request that NAIC not proceed any further until it attempts to articulate a true regulatory need for this project, and considers whether traditional insurance code provisions and the massive recent NAIC reforms pertaining to corporate governance address the actual regulatory need that might be identified.

⁵¹ <http://www.icaew.com/en/about-icaew/newsroom/press-releases/2011-press-releases/icaew-comments-on-ec-green-paper-on-corporate-governance>

⁵²http://www.naic.org/documents/committees_ex_isftf_corp_gov_110124_exposure_intl_cg_standards.pdf

We also respectfully suggest that NAIC efforts toward making international bodies comfortable with respect to U.S. corporate governance would be better directed toward explaining to those bodies the features and protections of U.S. corporate governance law generally and insurance regulatory law specifically that provide American consumers with excellent regulatory protection.

We thus believe that, if it wishes to pursue a corporate governance initiative at this time, NAIC should follow the three step process suggested in the last dot point of the executive summary of this letter:

- First, analyze whether the existing tools discussed in this memo are deficient for achieving the statutory goals of U.S. insurance regulation, with specific reference to actual situations where regulators were legally blocked from achieving necessary corporate governance reforms that they sought, and with a specific conclusion as to what changes are necessary to achieve these stated ends;
- Second, analyze whether the tools currently found in U.S. law are insufficient to achieve international equivalence upon a ggressive U.S. advocacy in favor of its system, and failing that, what changes would need to be made to achieve equivalence; and
- Third, if it is determined that what is needed to achieve the goals of the first two inquiries are not the same, carefully consider whether the benefits of achieving equivalence for equivalence's sake would outweigh the costs of doing so.

We hope and request that NAIC leadership and leading SMI regulators will be willing to engage in a dialog with us regarding the substance of this letter. We believe that we have raised important questions of first principle that must be confronted before such a potentially invasive project such as that currently tasked to the Corporate Governance Working Group is further pursued.

Sincerely,

Neil Alldredge
Senior Vice President – State & Policy Affairs
NAMIC

Nat Shapo
Partner
Katten, Muchin, Rosenman, LLP
Representing NAMIC

Cc: Dr. Vaughan
Mr. Stolfi



May 13, 2011

Via Email

Honorable Christina Urias
Arizona Director of Insurance
Chair, Solvency Modernization Initiative Task Force

Andrew R. Stolfi, Chair
Corporate Governance Working Group
Attention: Bruce Jenson, CPA
Financial Examination, Manager
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Re: Comments on the Draft White Paper on High-Level Corporate Governance Principles for Use in U.S. Insurance Regulation

Dear Director Urias and Mr. Stolfi:

The undersigned organizations, representing a significant portion of the life, health, property/casualty and reinsurance industry doing business in the U.S., would like to thank the Corporate Governance Working Group for its work and open process in addressing corporate governance issues. We look forward to our continued collaboration as this project moves forward and to discussing the issues raised below during the meeting scheduled for May 26. We appreciate your willingness to review the parameters of this project.

With respect to the White Paper, and as we have previously discussed with Director Urias, the undersigned remain unclear whether the paper is attempting to articulate existing “principles” of corporate governance, if it is intended to be the basis for proposed legislation or regulation, or if it is to be used as a basis for changes to the existing system. We believe it is important that regulators and industry representatives have a clear and common understanding of what corporate governance issues need to be addressed, the problems that need to be solved, if any, and the subsequent proposed solutions before undertaking to draft principles of corporate governance.

The NAIC's Solvency Modernization Initiative (SMI) Roadmap calls for a self-examination and update of the U.S. insurance solvency regulation framework, including a review of corporate governance and risk management. The Roadmap includes directions to "evaluate the existing U.S. laws, study international corporate governance principles and standards, document high-level corporate governance principles, and determine whether such principles should be supported through a model or other means." The SMI Task Force charged the Working Group with addressing these issues:

Outline high-level corporate governance principles. Determine the appropriate methodology to evaluate adherence with such principles, giving due consideration to development of a model law

- Analyze the requirements, regulatory initiatives and best practices of the states, other countries and regulators, and the insurance industry, to assist in principle development.
- Develop additional regulatory guidance including detailed best practices for the corporate governance of insurers.

As currently drafted, the White Paper contains twenty "high-level corporate governance principles" with corresponding detailed guidance, along with attachments that include a summary of nine states' laws regarding duties of directors to shareholders and a summary of corporate governance standards in Australia, Canada, Switzerland and the U.K. However, the White Paper offers no indication of where its corporate governance principles were derived. Most importantly, the paper lacks context for this discussion as the Working Group has not conveyed nor does the White Paper identify the specific issues or perceived deficiencies the NAIC is trying to address through this process.

The White Paper does not provide a complete discussion of all the existing potential sources of corporate governance laws in this country and overlooks areas that are being addressed elsewhere by the NAIC or other regulatory bodies (e.g. the SEC) or through legislation (e.g. Sarbanes-Oxley Act). And, we are greatly concerned about the possible importation of other countries' corporate governance laws that is not preceded by a comprehensive, deliberate and public discussion of its necessity.

In preparation for our upcoming meeting, the following represents our collective concerns and requests of the Working Group:

1. That the Working Group develop a working definition of "corporate governance" to clarify the scope of the issues to be addressed by this process.
2. That a public discussion of the perceived deficiencies or issues be held to identify what the Working Group believes needs to be evaluated. For example, if the purpose is to address Financial Sector Assessment Program (FSAP) comments regarding corporate governance and to evaluate whether the U.S. will be in compliance with new relevant Insurance Core Principles (ICPs), then these and any other concerns that regulators would like to address should be specifically articulated.

3. That the charge directing the Working Group to evaluate existing U.S. requirements with respect to corporate governance be fully carried out. To date, there has not been a thorough evaluation of the extensive bodies of existing U.S. corporate governance laws (statutory and common law) and regulations and which types of companies are subject to those laws and regulations. No regulatory deficiencies have been identified. The White Paper merely summarizes some of the corporate governance laws in nine states but does not evaluate these laws or the marketplace in which these laws apply. It also does not evaluate other important sources of existing U.S. corporate governance law and regulation, including insurance specific laws and regulations, such as the NAIC Model Audit Rule (including recent revisions relating to auditor independence, corporate governance, and internal controls), the Financial Condition Examiners Handbook (including recent comprehensive additions devoted to corporate governance and internal controls for the review of the corporate governance and compliance programs of existing (re)insurers as a matter of course as part of the on-site examination process), the Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition, the Market Regulation Handbook and other SMI projects, including the revisions to the Model Insurance Holding Company System Regulatory Act and the development of the Own Risk Solvency Assessment (ORSA). In recent years, the NAIC has made substantial improvements to corporate governance, internal controls, and audit functions in direct response to insurance regulatory concerns, and these improvements should be addressed and evaluated.

The White Paper also does not address relevant requirements from the Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), New York Stock Exchange (NYSE) or the Sarbanes-Oxley Act. Nor does it take into consideration any Internal Revenue Service corporate governance standards applicable to non-profit entities. We believe that an evaluation of these and other requirements will demonstrate that U.S. insurance companies are currently subject to appropriately rigorous oversight.

We ask that the Working Group review and evaluate all sources of U.S. corporate governance requirements and identify any deficiencies state regulators believe currently exist in U.S. regulation of the insurance industry. We are concerned that the White Paper and the draft principles are premature in the absence of this comprehensive evaluation.

4. That the Working Group conduct a review of the IAIS ICPs, including the new ICPs, relative to all applicable corporate governance laws and regulations in the U.S. to identify any deficiencies and assess how the U.S. will fare in the next FSAP review.
5. We are very concerned about any discussion regarding incorporating other jurisdictions' corporate governance standards into the U.S. that is not preceded by a comprehensive, deliberate and public discussion about its necessity and appropriateness for the U.S. system.
6. We are concerned that the Working Group is developing principles that are too detailed and conflict or overlap with other SMI work product.

Understanding that we will have the opportunity to provide detailed written comments on the draft White Paper if necessary, we appreciate this opportunity to express some initial concerns and look forward to the May 26 meeting and further discussions.

Sincerely,

America's Health Insurance Plans
American Council of Life Insurers
American Insurance Association
Blue Cross Blue Shield Association
Property Casualty Insurers Association of America
Reinsurance Association of America

cc: Honorable Susan Voss
Iowa Insurance Commissioner
NAIC President and Chair, NAIC Executive Committee

Dr. Therese M. Vaughan
NAIC Chief Executive Officer