Corporate Governance (EX) Working Group Interim Meeting

July 20, 2011
Omni Jacksonville Hotel, 245 Water Street
Jacksonville, Florida
# AGENDA

## Corporate Governance (EX) Working Group Interim Meeting
(Florida Ballroom A-C)

<table>
<thead>
<tr>
<th>1. Welcome and Introduction of Agenda</th>
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<tr>
<td>12:00 – 12:15 p.m.</td>
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<tr>
<td>Andrew Stolfi (Illinois), Chair of the CGWG</td>
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<tr>
<th>2. Discussion of Working Group Timeline and Next Steps</th>
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<tr>
<td>12:15 – 1:15 p.m.</td>
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<tr>
<td>Discuss the timeline for completion of the work assigned to the WG and the steps to meet the assigned deadlines.</td>
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<tr>
<th>3. Discussion of Corporate Governance Issues</th>
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<tr>
<td>1:15 – 1:45 p.m.</td>
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<tr>
<td>Discuss CG issues that have been identified by regulators during their solvency monitoring processes.</td>
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<th>Break: 1:45 – 2:00 p.m.</th>
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<th>4. Discussion of the Commissioner's Authority Over Corporate Governance</th>
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<tr>
<td>2:00 p.m. – 3:00 p.m.</td>
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<tr>
<td>Use of Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in Hazardous Financial Condition (#385) as enforcement tool.</td>
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<th>5. Discuss Existing Corporate Governance Requirements for Insurers</th>
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<tr>
<td>3:00 p.m. – 3:45 p.m.</td>
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<tr>
<td>1. NAIC/Insurance Regulatory Sources</td>
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<tr>
<td>• Model #385 (Hazardous Financial Condition)</td>
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<tr>
<td>• Model Audit Rule (#205)</td>
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<tr>
<td>• Model Insurance Holding Company System Regulatory Act (#440)</td>
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<td>• Financial Condition Examiners Handbook</td>
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<td>• Biographical Affidavits</td>
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<tr>
<td>2. Non-NAIC/Insurance Regulatory Sources</td>
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<tr>
<td>• SEC</td>
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<td>• PCAOB</td>
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<td>• Stock Exchange Requirements</td>
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### Break: 3:45 – 4:00 p.m.

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<tr>
<th>Time</th>
<th>Activity</th>
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<tbody>
<tr>
<td>4:00 p.m. – 4:45 p.m.</td>
<td>Discuss principles 1-20 of the NAIC White Paper and the comments received during the exposure period.</td>
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<tr>
<td>4:45 p.m. – 5:00 p.m.</td>
<td><strong>Andrew Stolfi (Illinois), Chair of the CGWG</strong></td>
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Original Timeline for CGWG Projects
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<tr>
<th>Dates/Meetings</th>
<th>Work to be Completed</th>
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<tr>
<td>2010 Summer NM</td>
<td>Review a summary of state corporate governance laws in place to identify areas for improvement.</td>
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<tr>
<td></td>
<td>Receive a presentation on CG best practices/principles from subject matter experts.</td>
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<tr>
<td>Sept. – Dec. 2010</td>
<td>Continue to review and provide feedback on the drafting of IAIS core principles relating to CG and risk management. The core principles need to be substantially complete for U.S. regulators to understand what is required internationally in the area of CG.</td>
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<tr>
<td>Sept. – Oct. 2010</td>
<td>Develop a summary of CG principles and standards placed upon insurers worldwide including information from the IAIS, FSA, Australia, Canada, Switzerland, etc. Compare existing U.S. standards to those identified in a tabular format.</td>
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<tr>
<td>2010 Fall NM</td>
<td>Review and discuss the summary comparison of international corporate governance principles. Utilize this comparison to identify areas for improvement in the U.S. system.</td>
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<tr>
<td>Nov. 2010 – Mar. 2011</td>
<td>Utilize the work performed on existing state law and international principles to develop corporate governance principles for use in U.S. insurance regulation.</td>
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<td>Release a draft of CG principles for public comment.</td>
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<tr>
<td>2011 Spring NM</td>
<td>Discuss comments received on a draft of CG principles for use in U.S. insurance regulation.</td>
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<tr>
<td></td>
<td>Determine how the principles should be implemented in the U.S. (Model Law, Examiners Handbook Guidance, etc.)</td>
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<tr>
<td>Apr. – Jul. 2011</td>
<td>If principles are to be implemented through an NAIC Model Law, draft and submit the request for Executive Committee approval of Model Law development.</td>
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<td></td>
<td>Determine how proportionality (size and type of insurer) will be considered in the application of CG principles.</td>
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<td></td>
<td>If principles are to be implemented through other means, begin drafting final compliance guidance in this area.</td>
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<tr>
<td>2011 Summer NM</td>
<td>If applicable, receive approval from Executive Committee on the development of a CG Model Law.</td>
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<tr>
<td></td>
<td>If principles are to be implemented through other means, expose the final compliance guidance for public comment.</td>
</tr>
<tr>
<td>Sept. – Oct. 2011</td>
<td>If applicable, draft model law and prepare for public exposure.</td>
</tr>
<tr>
<td>2011 Fall NM</td>
<td>If applicable, publicly expose draft of CG model law.</td>
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<td></td>
<td>If principles are to be implemented through other means, adopt the finalized principles and begin work on developing educational information for regulators and the industry.</td>
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<tr>
<td>2012 Spring NM</td>
<td>If applicable, review comments received during the model law exposure period. Make changes as necessary.</td>
</tr>
<tr>
<td>2012 Summer NM</td>
<td>If applicable, adopt model law. Begin work on developing educational guidance for regulators and the industry.</td>
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NAMIC Proposal for CGWG Timeline
SUGGESTED CORPORATE GOVERNANCE PROPOSAL

Introduction

We respectfully suggest that the Corporate Governance Working Group could fulfill its duties and provide an invaluable service to the NAIC's Solvency Modernization Initiative by focusing its efforts on producing a substantive work product along the lines described in this memo.

We have heard, understand, and respect the concerns expressed by regulators regarding the importance of the relationship between corporate governance and financial regulation in the discharge of U.S. insurance regulators' statutory responsibility, as well as their desire for the U.S. to be successful on the next FSAP review.

We appreciate the regulators’ consideration of industry’s concerns about the complexity of corporate governance issues, and their willingness to discuss ideas about how to best proceed with a thorough review in this area.

In that spirit we respectfully submit the following for the Working Group's consideration.

I. The Trades' Prior Statements And Suggestions Regarding Process

We believe that the Working Group's efforts can best be facilitated and advanced from an agreed starting point consisting of a thorough compilation of the tools that are available to American insurance regulators which have a nexus to corporate governance, followed by an analysis of whether those tools provide American regulators with the necessary guidance and authority they need to carry out their statutory responsibilities.

This compilation and analysis would serve as the necessary first step in the following comprehensive process as suggested by NAMIC in its letter of May 18:

If the 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.

This is consistent with the multiple trade letter of May 13, which raised a number of concerns and suggestions, including but not limited to the following:

- "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, [and] the problems that need to be solved, if any."
- "That a public discussion of the perceived deficiencies or issues be held to identify what the Working Group believes need to be evaluated."
- "No regulatory deficiencies have been identified."
- "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."

II. The Proposed Paper: A Rigorous And Substantial SMI Building Block

The first building block for what we believe would best serve NAIC members in this situation would be a paper such as generally outlined below.

A. The paper would generally do the following:

- Clearly define a common understanding of the nature and scope of “corporate governance” and its relationship to insurance regulation.

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1 Based on our discussions with regulators and other stakeholders since the NAMIC letter was submitted on May 18, we understand that this phase of the analysis, if and when performed, may include consideration of sources of corporate governance law beyond insurance regulation, sources which might be included in an ICP equivalence analysis. Central to our position, however, is our view that the consideration of the ICPs in those second and third phases suggested in the May 18 NAMIC letter should and must be preceded by the insurance regulatory review described in the first phase.
• Explain the importance of corporate governance in insurance regulation—both the perceived relationship between corporate governance weaknesses and financial risks and the limits of insurance regulators' appropriate role in an area of law primarily overseen in the U.S. by the courts and state legislatures.

• Provide guidance regarding the tools regulators have available to assess corporate governance as suggested by both the prior FSAP review and, as we understand it, asked for repeatedly by U.S. regulators.

• Explain that NAIC's commitment to corporate governance as a part of financial regulation and risk analysis predates the financial crisis and that NAIC has, starting in 2001 and continuing for a decade, methodically crafted a thorough web of cradle-to-grave oversight of an insurer's corporate governance, all carefully tethered to insurance regulatory needs. The result of these NAIC efforts:
  
  o specifically includes enforcement tools that directly empower regulators to order correction of regulatory significant corporate governance deficiencies;

  o is in large part only now being implemented for the first time, thus the full import and availability of many of these tools are not yet necessarily fully understood by rank and file regulators; and

  o is not currently catalogued in any comprehensive guide or resource which provides regulators with a unified understanding of these diverse, diffuse, far-flung, sometimes dense, and largely brand-new tools.

B. The bulk of the paper would then specifically:

• Identify all currently existing sources of insurance regulatory law that create obligations upon insurers and guidance and/or enforcement authority for regulators with respect to corporate governance; and would,

• For each such source:

  o Explain where this source can be found, with specific reference to state code reference and/or NAIC identifying codes and ordering information from the NAIC library/website/etc.

  o Identify specifically with reference to particular section numbers which of the source's provisions pertain to corporate governance.

  o Provide narrative explanations regarding the substance and relevance of the source's provisions that relate to corporate governance.

  o Quote liberally to relevant passages in such a way that demonstrates the purpose, scope, and basic thrust of the provision.
C. By way of example, the NAIC authorities which would be subject to such treatment would include, but not necessarily be limited to:

- The NAIC Biographical Affidavit, which requires that key company directors and officers must be vetted under a variety of character and fitness standards.

- Landmark revisions to the Model Audit Rule, just implemented this year, the purpose of which the NAIC/AICPA (E) Working Group described to the F Committee thusly: "These revisions ... require that insurers comply with certain business 'best practices' related to auditor independence, corporate governance and internal controls over financial reporting. ... [I]nsolvencies most commonly relate to some form of mismanagement. ... The NAIC strongly believes that increased auditor independence, strong corporate governance, and a robust internal control environment can help address and rectify certain forms of mismanagement."

- The NAIC Financial Condition Examiners Handbook, which describes the seven year process of its development as an accreditation standard effective in 2010; states that "examiners must consider and evaluate the insurer's corporate governance" because, "[h]istorically, many solvency problems have been caused by inadequate management oversight"; and provides scores of pages devoted to providing examiners with instructions and guidance for reviewing and evaluating the examinee's corporate governance—while using the phrase "corporate governance" more than 75 times.

- Revisions to the Insurance Holding Company System Regulatory Act, adopted less than one year ago, and which require the board's certification that it is responsible for corporate governance. The NAIC stated in a press release that these revisions "provide[ ] state regulators with important new tools for evaluating risks within insurance groups."

- Revisions to the Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition," adopted in 2009, which state that "The commissioner may consider ... [a]dverse findings in financial condition and market examination reports, audit reports, and actuarial opinions ... to determine whether the continued operation of any insurer ... might be deemed hazardous"; and, upon her determination that such a condition exists, grants the Commissioner the authority to "issue an order requiring the insurer to: ... Correct corporate governance practice deficiencies, and adopt and utilize corporate governance practices acceptable to the commissioner."

D. Such a work product could be used to, among other things:

- Respond in a tangible way to the general concerns that many voice regarding the importance of corporate governance in insurance regulation.
• Provide regulators with guidance on corporate governance practices and authorities, and a tool for the training of rank and file regulatory personnel.

• Serve as an organizing document for many SMI activities, which as many regulators and interested parties have correctly observed, contain natural overlap.

• Provide the basis for, and a necessary condition precedent to, any inquiry into the adequacy of the corporate governance regulatory tools currently at the disposal of insurance regulators in discharging their statutory responsibilities.

• Provide one of the bases for later evaluation of the ICPs—both their potential benefits and their potential clashes with and/or burden upon the U.S. system—in the context of the extensive regulatory tools developed by U.S. regulators during the last decade in processes tethered at every step to demonstrated regulatory needs within the American regulatory system, market, and established corporate structures.

• Serve as a positive, and wholly justified, document in which the NAIC can demonstrate—to FSAP reviewers, FIO, Congress, and any other overseers or stakeholders—that U.S. insurance regulators have been far ahead of the curve in recognizing the importance of corporate governance to their oversight of this important industry.

**Conclusion**

We thus respectfully suggest that the work product described herein can and should be the beneficial first step in the Working Group's efforts.

Thank you for your ongoing consideration of our views in what we believe has been a very productive dialog to date.
CG and RM Recommendations from FSAP
## U.S. Financial Sector Assessment Program (FSAP) Corporate Governance/Risk Management Related Recommendations

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<th>Source Doc.</th>
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<th>Recommendation</th>
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<tr>
<td>Ins. DAR p. 22</td>
<td>ICP 7: Suitability of Persons</td>
<td>Specific requirements in relation to individuals’ fitness and propriety should be adopted. Gaps in the requirements of departments should be filled—companies should have to notify the department of concerns about the fitness and propriety of key individuals and departments should be able to disallow functionaries from holding two positions that could result in material conflict.</td>
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<tr>
<td>Ins. DAR p. 22</td>
<td>ICP 9: Corporate Governance</td>
<td>As examiners gain experience, the NAIC and/or departments should consider issuing more guidance on good and bad practices in corporate governance for insurers. This would help examiners and firms to develop a clearer expectation of what constitutes effective governance for insurance business, including for groups.</td>
</tr>
<tr>
<td>Ins. DAR p. 22</td>
<td>ICP 10: Internal Controls</td>
<td>As examiners gain experience, the NAIC and/or departments should consider the scope for issuing guidance on good and bad practices in internal control. They should also make it a formal requirement for insurers to have an internal audit function. Such a function is now widely considered as an important part of a good control framework—similarly to audit committees, where there are now extensive requirements of all but the smaller insurers.</td>
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<tr>
<td>Ins. DAR p. 22</td>
<td>ICP 15: Enforcement or Sanctions</td>
<td>The insurance laws should be changed to provide the supervisory authority with powers to fine individual directors and senior managers of insurers, and to bar them from acting in responsible capacities in the future.</td>
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<tr>
<td>Ins. DAR p. 23</td>
<td>ICP 18: Risk Assessment and Management</td>
<td>The relevant laws, regulations or standards should be changed to include a requirement that an insurer have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling their risks.</td>
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<tr>
<td>Ins. DAR p. 23</td>
<td>ICP 19: Insurance Activity: Board Approval Requirement</td>
<td>The relevant laws or regulation should explicitly provide that an insurer must have in place strategic underwriting and pricing policies approved and reviewed regularly by the Board.</td>
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1 Recommendations provided by the IMF Team in the FSAP Financial System Stability Assessment (FSSA) and Insurance Detailed Assessment Report (DAR).
NAIC Legal Memo on Model #385
MEMORANDUM

To: Corporate Governance (EX) Working Group
From: NAIC Legal Division
Re: Regulatory authority to consider and correct corporate governance deficiencies

THE FOLLOWING DOES NOT CONSTITUTE LEGAL ADVICE ON A PARTICULAR STATE’S AUTHORITY UNDER ITS LAWS

Question Presented: What legal authority exists within current NAIC materials for the commissioner to require corrective action when corporate governance deficiencies are identified?

Brief Answer: The NAIC Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to Be in Hazardous Financial Condition (#385) permits the Commissioner to order an insurer to correct corporate governance practice deficiencies upon a finding that the continued operation of the insurer transacting an insurance business might be deemed to be hazardous to its policyholders, creditors or the general public. Other NAIC materials provide guidance on identifying and curbing corporate governance deficiencies.

Background: The Corporate Governance (EX) Working Group is charged with outlining high-level corporate governance principles for use in U.S. insurance regulation. This charge stems from the Solvency Modernization Initiative and the relevant findings as to the observation of the International Association of Insurance Supervisors’ Insurance Core Principles as assessed by the International Monetary Fund.

To this end, the Working Group is considering a draft white paper establishing high-level principles and supplementary guidance in these general areas:

- Sound corporate governance framework
- Board of Directors role and responsibility
- Board of Directors standards of care
- Suitability of board members and key personnel
- Reporting and transparency
- Risk management and internal controls systems
- Actuarial and internal audit functions
- Compliance with legal and regulatory obligations
- Regulatory power to require remedies of corporate governance deficiencies
The Working Group has requested feedback on the ability of state insurance regulators to use the principles identified in the white paper to assess and correct the corporate governance practices of insurance companies. Part of this analysis is whether state insurance regulators have any existing authority to enforce determinations as to appropriate corporate governance practices.

Analysis:

The Model Regulation on Hazardous Financial Condition addresses corporate governance as a criterion for corrective action and as an area for remedy. In Section 3, Standards, the model provides a list of factors the commissioner may consider to determine whether the continued operation of any insurer might be deemed to be hazardous. Subsections K and T are two of those factors:

3. The following standards, either singly or a combination of two or more, may be considered by the commissioner to determine whether the continued operation of any insurer transacting an insurance business in this state might be deemed to be hazardous to its policyholders, creditors or the general public. The commissioner may consider:

   K. Whether the management of an insurer, including officers, directors, or any other person who directly or indirectly controls the operation of the insurer, fails to possess and demonstrate the competence, fitness and reputation deemed necessary to serve the insurer in such position;
   
   T: Any other finding determined by the commissioner to be hazardous to the insurer’s policyholders, creditors or general public.

Subsection K. directly implicates the competence and fitness of the insurer’s management. It does not require any particular financial analysis and can be applied independently of any other factor. The plain language of the model indicates the standards may be considered either singly or in combination. This is reinforced by notes in the legislative history of the model. Therefore, although the finding is non-financial, it alone can be sufficient grounds for a Commissioner to take action under Section 4 of the model. All but three states have adopted this or similar language allowing for consideration of non-financial factors.

Additional authority is found in Subsection T, which allows consideration of “any other finding determined by the commissioner to be hazardous to the insurer’s policyholders, creditors or general public.” Again, this standard is not confined to the financial condition of the insurer but broadly encompasses any kind of hazard that satisfies the description.

More key language relating to corporate governance is found in Subsections (9) and (10) of Section 4.B, which allow the Commissioner to take the following specific actions:

B. If the commissioner determines that the continued operation of the insurer licensed to transact business in this state may be hazardous to its policyholders, creditors or the general public, then the commissioner may, upon a determination, issue an order requiring the insurer to:

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¹ The legislative history for the model regulation provides that “The drafters believed that any one of the tests in Section 3 or any combination thereof could, in a specific case, cause regulatory concern sufficient to warrant the acts set out in Section 4. The standards and regulatory responses are purposefully qualitative rather than quantitative to provide flexibility in prescribing suitable remedies in specific cases.”
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.

Neither the first paragraph of Section 4.B. nor Subsections (9) and (10) within it refer to any particular financial condition or finding. The subsections deal entirely in corporate governance issues and grant authority to require the insurer to correct deficiencies and provide documentation.

The plain language in these sections allows the Commissioner to consider corporate governance deficiencies in making the determination that operation of the business is hazardous. It also allows the Commissioner to require correction of those corporate governance deficiencies. The Commissioner may separately consider financial factors and order corresponding corrections (for instance, increase capital and surplus), but the text contains no direct statement or implication that the Commissioner is required to make financial findings in addition to identifying corporate governance deficiencies.

The Hazardous Financial Condition model language offers the strongest authority to identify corporate governance deficiencies and order corrective action. The NAIC’s Financial Condition Examiners Handbook also provides a structure within which to evaluate effective management of an insurer’s operations:

One of the increased benefits of the enhanced risk-focused approach is the expansion of the examiner’s consideration from the retrospective verification of financial condition, to include consideration of other than financial risks that could impact the insurer’s future solvency… The consideration of other than financial risks can extend throughout the entire examination process and Exhibit V – Prospective Risk Assessment may assist examiners in assessing prospective risks. Financial Condition Examiners Handbook, 2011 Edition, p. 4-5.

The Handbook is a regulatory tool frequently referenced in state law. Other state law provisions allow insurance commissioners to exercise oversight over corporate governance deficiencies through the revocation or suspension of the insurer’s certificate of authority. For instance, in Illinois the Director of Insurance shall not issue a certificate of authority without a finding that the general character and experience of the directors and officers is such as to assure reasonable promise of a successful operation.²

Taken together, the Hazardous Financial Condition model regulation, the Financial Condition Examiners Handbook and various state requirements related to the Certificate of Authority establish that Commissioners are empowered to identify and curb corporate governance deficiencies.

² 215 ILCS 5/155.04
Model Regulation to Define Standards and Commissioner’s Authority for Companies Deemed to be in a Hazardous Financial Condition - #385
MODEL REGULATION TO DEFINE STANDARDS
AND COMMISSIONER’S AUTHORITY FOR COMPANIES
DEEMED TO BE IN HAZARDOUS FINANCIAL CONDITION

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Section 1. Authority
Section 2. Purpose
Section 3. Standards
Section 4. Commissioner’s Authority
Section 5. Judicial Review
Section 6. Separability
Section 7. Effective Date

Section 1. Authority

This regulation is adopted and promulgated by [title of supervisory authority] pursuant to Section [insert reference to section authorizing the commissioner to adopt regulations and a reference to the state equivalent of the NAIC Insurer's Rehabilitation and Liquidation Model Act and any other section where the term hazardous financial condition or a similar term is used] of the [insert state] Insurance Code.

Section 2. Purpose

The purpose of this regulation is to set forth the standards which the commissioner may use for identifying insurers found to be in such condition as to render the continuance of their business hazardous to their policyholders, creditors or the general public.

This regulation shall not be interpreted to limit the powers granted the commissioner by any laws or parts of laws of this state, nor shall this regulation be interpreted to supercede any laws or parts of laws of this state.

Section 3. Standards

The following standards, either singly or a combination of two or more, may be considered by the commissioner to determine whether the continued operation of any insurer transacting an insurance business in this state might be deemed to be hazardous to its policyholders, creditors or the general public. The commissioner may consider:

A. Adverse findings reported in financial condition and market conduct examination reports, audit reports, and actuarial opinions, reports or summaries;

B. The National Association of Insurance Commissioners Insurance Regulatory Information System and its other financial analysis solvency tools and reports;

C. Whether the insurer has made adequate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flows required by the contractual obligations and related expenses of the insurer, when considered in light of the assets held by the insurer with respect to such reserves and related actuarial items including, but not limited to, the investment earnings on such assets, and the considerations anticipated to be received and retained under such policies and contracts;
D. The ability of an assuming reinsurer to perform and whether the insurer's reinsurance program provides sufficient protection for the insurer's remaining surplus after taking into account the insurer's cash flow and the classes of business written as well as the financial condition of the assuming reinsurer;

E. Whether the insurer's operating loss in the last twelve-month period or any shorter period of time, including but not limited to net capital gain or loss, change in non-admitted assets, and cash dividends paid to shareholders, is greater than fifty percent (50%) of the insurer's remaining surplus as regards policyholders in excess of the minimum required;

F. Whether the insurer's operating loss in the last twelve-month period or any shorter period of time, excluding net capital gains, is greater than twenty percent (20%) of the insurer's remaining surplus as regards policyholders in excess of the minimum required;

G. Whether a reinsurer, obligor or any entity within the insurer's insurance holding company system, is insolvent, threatened with insolvency or delinquent in payment of its monetary or other obligations, and which in the opinion of the commissioner may affect the solvency of the insurer;

H. Contingent liabilities, pledges or guaranties which either individually or collectively involve a total amount which in the opinion of the commissioner may affect the solvency of the insurer;

I. Whether any “controlling person” of an insurer is delinquent in the transmitting to, or payment of, net premiums to the insurer;

J. The age and collectibility of receivables;

K. Whether the management of an insurer, including officers, directors, or any other person who directly or indirectly controls the operation of the insurer, fails to possess and demonstrate the competence, fitness and reputation deemed necessary to serve the insurer in such position;

L. Whether management of an insurer has failed to respond to inquiries relative to the condition of the insurer or has furnished false and misleading information concerning an inquiry;

M. Whether the insurer has failed to meet financial and holding company filing requirements in the absence of a reason satisfactory to the commissioner;

N. Whether management of an insurer either has filed any false or misleading sworn financial statement, or has released false or misleading financial statement to lending institutions or to the general public, or has made a false or misleading entry, or has omitted an entry of material amount in the books of the insurer;

O. Whether the insurer has grown so rapidly and to such an extent that it lacks adequate financial and administrative capacity to meet its obligations in a timely manner;

P. Whether the insurer has experienced or will experience in the foreseeable future cash flow or liquidity problems;
Q. Whether management has established reserves that do not comply with minimum standards established by state insurance laws, regulations, statutory accounting standards, sound actuarial principles and standards of practice;

R. Whether management persistently engages in material under reserving that results in adverse development;

S. Whether transactions among affiliates, subsidiaries or controlling persons for which the insurer receives assets or capital gains, or both, do not provide sufficient value, liquidity or diversity to assure the insurer's ability to meet its outstanding obligations as they mature;

T. Any other finding determined by the commissioner to be hazardous to the insurer's policyholders, creditors or general public.

Section 4. Commissioner's Authority

A. For the purposes of making a determination of an insurer’s financial condition under this regulation, the commissioner may:

(1) Disregard any credit or amount receivable resulting from transactions with a reinsurer that is insolvent, impaired or otherwise subject to a delinquency proceeding;

(2) Make appropriate adjustments including disallowance to asset values attributable to investments in or transactions with parents, subsidiaries or affiliates consistent with the NAIC Accounting Practices And Procedures Manual, state laws and regulations;

(3) Refuse to recognize the stated value of accounts receivable if the ability to collect receivables is highly speculative in view of the age of the account or the financial condition of the debtor;

(4) Increase the insurer's liability in an amount equal to any contingent liability, pledge, or guarantee not otherwise included if there is a substantial risk that the insurer will be called upon to meet the obligation undertaken within the next twelve-month period.

B. If the commissioner determines that the continued operation of the insurer licensed to transact business in this state may be hazardous to its policyholders, creditors or the general public, then the commissioner may, upon a determination, issue an order requiring the insurer to:

(1) Reduce the total amount of present and potential liability for policy benefits by reinsurance;

(2) Reduce, suspend or limit the volume of business being accepted or renewed;

(3) Reduce general insurance and commission expenses by specified methods;

(4) Increase the insurer’s capital and surplus;

(5) Suspend or limit the declaration and payment of dividend by an insurer to its stockholders or to its policyholders;
and Commissioner’s Authority for Companies
Deemed to be in Hazardous Financial Condition

(6) File reports in a form acceptable to the commissioner concerning the market value of an insurer’s assets;

(7) Limit or withdraw from certain investments or discontinue certain investment practices to the extent the commissioner deems necessary;

(8) Document the adequacy of premium rates in relation to the risks insured;

(9) File, in addition to regular annual statements, interim financial reports on the form adopted by the National Association of Insurance Commissioners or in such format as promulgated by the commissioner.

(10) Correct corporate governance practice deficiencies, and adopt and utilize governance practices acceptable to the commissioner.

(11) Provide a business plan to the commissioner in order to continue to transact business in the state.

(12) Notwithstanding any other provision of law limiting the frequency or amount of premium rate adjustments, adjust rates for any non-life insurance product written by the insurer that the commissioner considers necessary to improve the financial condition of the insurer.

If the insurer is a foreign insurer the commissioner’s order may be limited to the extent provided by statute.

C. An insurer subject to an order under Subsection B may request a hearing to review that order. The notice of hearing shall be served upon the insurer pursuant to [cite the applicable rules of civil or administrative procedure]. The notice of hearing shall state the time and place of hearing, and the conduct, condition or ground upon which the commissioner based the order. Unless mutually agreed between the commissioner and the insurer, the hearing shall occur not less than ten (10) days nor more than thirty (30) days after notice is served and shall be either in [insert proper county] county or in some other place convenient to the parties designated by the commissioner. The commissioner shall hold all hearings under this subsection privately, unless the insurer requests a public hearing, in which case the hearing shall be public.

Section 5. Judicial Review

Any order or decision of the commissioner shall be subject to review in accordance with [cite applicable provision of the state administrative code] at the instance of any party to the proceedings whose interests are substantially affected.

Note: Consideration should be given to the practice and procedure in each state.

Section 6. Separability

If any provisions of this regulation be held invalid, the remainder shall not be affected.
Section 7. Effective Date

This regulation shall become effective [insert date].

Chronological Summary of Action (all references are to the Proceedings of the NAIC).

1985 Proc. II 11, 23, 243, 244-247 (adopted).
2008 Proc. 3rd Quarter 10-86 to 10-91 (adopted).
Excerpts from Annual Financial Reporting
Model Regulation - #205 (Model Audit Rule)
ANNUAL FINANCIAL REPORTING MODEL REGULATION

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Section 1. Authority

This regulation is promulgated by the commissioner of insurance pursuant to Sections [insert applicable sections] of the [insert state] insurance law.

Section 2. Purpose and Scope

The purpose of this regulation is to improve the [insert state] Insurance Department’s surveillance of the financial condition of insurers by requiring (1) an annual audit of financial statements reporting the financial position and the results of operations of insurers by independent certified public accountants, (2) Communication of Internal Control Related Matters Noted in an Audit, and (3) Management’s Report of Internal Control over Financial Reporting.

Every insurer (as defined in Section 3) shall be subject to this regulation. Insurers having direct premiums written in this state of less than $1,000,000 in any calendar year and less than 1,000 policyholders or certificateholders of direct written policies nationwide at the end of the calendar year shall be exempt from this regulation for the year (unless the commissioner makes a specific finding that compliance is necessary for the commissioner to carry out statutory responsibilities) except that insurers having assumed premiums pursuant to contracts and/or treaties of reinsurance of $1,000,000 or more will not be so exempt.

Foreign or alien insurers filing the Audited financial report in another state, pursuant to that state’s requirement for filing of Audited financial reports, which has been found by the commissioner to be
reasonable place designated by the commissioner. The insurer shall require that the accountant retain the audit workpapers and communications until the insurance department has filed a report on examination covering the period of the audit but no longer than seven (7) years from the date of the audit report.

C. In the conduct of the aforementioned periodic review by the insurance department examiners, it shall be agreed that photocopies of pertinent audit workpapers may be made and retained by the department. Such reviews by the department examiners shall be considered investigations and all working papers and communications obtained during the course of such investigations shall be afforded the same confidentiality as other examination workpapers generated by the department.

Section 14. Requirements for Audit Committees

This section shall not apply to foreign or alien insurers licensed in this state or an insurer that is a SOX Compliant Entity or a direct or indirect wholly-owned subsidiary of a SOX Compliant Entity.

A. The Audit committee shall be directly responsible for the appointment, compensation and oversight of the work of any accountant (including resolution of disagreements between management and the accountant regarding financial reporting) for the purpose of preparing or issuing the Audited financial report or related work pursuant to this regulation. Each accountant shall report directly to the Audit committee.

B. Each member of the Audit committee shall be a member of the board of directors of the insurer or a member of the board of directors of an entity elected pursuant to Subsection E and Section 3C.

C. In order to be considered independent for purposes of this section, a member of the Audit committee may not, other than in his or her capacity as a member of the Audit committee, the board of directors, or any other board committee, accept any consulting, advisory or other compensatory fee from the entity or be an affiliated person of the entity or any subsidiary thereof. However, if law requires board participation by otherwise non-independent members, that law shall prevail and such members may participate in the Audit committee and be designated as independent for Audit committee purposes, unless they are an officer or employee of the insurer or one of its affiliates.

D. If a member of the Audit committee ceases to be independent for reasons outside the member’s reasonable control, that person, with notice by the responsible entity to the state, may remain an Audit committee member of the responsible entity until the earlier of the next annual meeting of the responsible entity or one year from the occurrence of the event that caused the member to be no longer independent.

Drafting Note: In determining independence, the commissioner shall consider utilizing guidance provided in the SEC’s Final Rule No. 33-8220, Standards Relating to Listed Company Audit Committees adopted April 9, 2003.

E. To exercise the election of the controlling person to designate the Audit committee for purposes of this regulation, the ultimate controlling person shall provide written notice to the commissioners of the affected insurers. Notification shall be made timely prior to the issuance of the statutory audit report and include a description of the basis for the election. The election can be changed through notice to the commissioner by the insurer, which shall include a description of the basis for the change. The election shall remain in effect for perpetuity, until rescinded.
F. (1) The Audit committee shall require the accountant that performs for an insurer any audit required by this regulation to timely report to the Audit committee in accordance with the requirements of SAS 61, *Communication with Audit Committees*, or its replacement, including:

(a) All significant accounting policies and material permitted practices;

(b) All material alternative treatments of financial information within statutory accounting principles that have been discussed with management officials of the insurer, ramifications of the use of the alternative disclosures and treatments, and the treatment preferred by the accountant; and

(c) Other material written communications between the accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.

(2) If an insurer is a member of an insurance holding company system, the reports required by Subsection F(1) may be provided to the Audit committee on an aggregate basis for insurers in the holding company system, provided that any substantial differences among insurers in the system are identified to the Audit committee.

G. The proportion of independent Audit committee members shall meet or exceed the following criteria:

<table>
<thead>
<tr>
<th>Prior Calendar Year Direct Written and Assumed Premiums</th>
<th>Over $300,000,000 - $500,000,000</th>
<th>Over $500,000,000</th>
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</thead>
<tbody>
<tr>
<td>$0 - $300,000,000</td>
<td>Majority (50% or more) of members shall be independent. See also Note A and B.</td>
<td>Supermajority of members (75% or more) shall be independent. See also Note A.</td>
</tr>
<tr>
<td>No minimum requirements. See also Note A and B.</td>
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<td></td>
</tr>
</tbody>
</table>

Note A: The commissioner has authority afforded by state law to require the entity’s board to enact improvements to the independence of the Audit committee membership if the insurer is in a RBC action level event, meets one or more of the standards of an insurer deemed to be in hazardous financial condition, or otherwise exhibits qualities of a troubled insurer.

Note B: All insurers with less than $500,000,000 in prior year direct written and assumed premiums are encouraged to structure their Audit committees with at least a supermajority of independent Audit committee members.

Note C: Prior calendar year direct written and assumed premiums shall be the combined total of direct premiums and assumed premiums from non-affiliates for the reporting entities.

H. An insurer with direct written and assumed premium, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, less than $500,000,000 may make application to the commissioner for a waiver from the Section 14 requirements based upon hardship. The insurer shall file, with its annual statement filing, the approval for relief from Section 14 with the states that it is licensed in or doing business in and the NAIC. If the nondomestic state accepts
Section 15. Conduct of Insurer in Connection with the Preparation of Required Reports and Documents

A. No director or officer of an insurer shall, directly or indirectly:

(1) Make or cause to be made a materially false or misleading statement to an accountant in connection with any audit, review or communication required under this regulation; or

(2) Omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in light of the circumstances under which the statements were made, not misleading to an accountant in connection with any audit, review or communication required under this regulation.

B. No officer or director of an insurer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any accountant engaged in the performance of an audit pursuant to this regulation if that person knew or should have known that the action, if successful, could result in rendering the insurer's financial statements materially misleading.

C. For purposes of Subsection B of this section, actions that, “if successful, could result in rendering the insurer's financial statements materially misleading” include, but are not limited to, actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead or fraudulently influence an accountant:

(1) To issue or reissue a report on an insurer's financial statements that is not warranted in the circumstances (due to material violations of statutory accounting principles prescribed by the commissioner, generally accepted auditing standards, or other professional or regulatory standards);

(2) Not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

(3) Not to withdraw an issued report; or

(4) Not to communicate matters to an insurer's Audit committee.

Drafting Note: In determining what types of sanctions or penalties could be assessed for violations of items included in Subsections A through C, each state should refer to its individual authority provided by state statutes.


A. Every insurer required to file an Audited financial report pursuant to this regulation that has annual direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, of $500,000,000 or more shall prepare a report of the insurer’s or Group of insurers’ Internal control over financial reporting, as these terms are defined in Section 3. The report shall be filed with the commissioner along with the Communication of
Internal Control Related Matters Noted in an Audit described under Section 11. Management’s Report of Internal Control over Financial Reporting shall be as of December 31 immediately preceding.

B. Notwithstanding the premium threshold in Subsection A, the commissioner may require an insurer to file Management’s Report of Internal Control over Financial Reporting if the insurer is in any RBC level event, or meets any one or more of the standards of an insurer deemed to be in hazardous financial condition as defined in (include reference to Corrective Action statute).

C. An insurer or a Group of insurers that is

(1) directly subject to Section 404;

(2) part of a holding company system whose parent is directly subject to Section 404;

(3) not directly subject to Section 404 but is a SOX Compliant Entity; or

(4) a member of a holding company system whose parent is not directly subject to Section 404 but is a SOX Compliant Entity;

may file its or its parent’s Section 404 Report and an addendum in satisfaction of this Section 16 requirement provided that those internal controls of the insurer or Group of insurers having a material impact on the preparation of the insurer’s or Group of insurers’ audited statutory financial statements (those items included in Section 5B through 5G of this regulation) were included in the scope of the Section 404 Report. The addendum shall be a positive statement by management that there are no material processes with respect to the preparation of the insurer’s or Group of insurers’ audited statutory financial statements (those items included in Section 5B through 5G of this regulation) excluded from the Section 404 Report. If there are internal controls of the insurer or Group of insurers that have a material impact on the preparation of the insurer’s or Group of insurers’ audited statutory financial statements and those internal controls were not included in the scope of the Section 404 Report, the insurer or Group of insurers may either file (i) a Section 16 report, or (ii) the Section 404 Report and a Section 16 report for those internal controls that have a material impact on the preparation of the insurer’s or Group of insurers’ audited statutory financial statements not covered by the Section 404 Report.

D. Management’s Report of Internal Control over Financial Reporting shall include:

(1) A statement that management is responsible for establishing and maintaining adequate Internal control over financial reporting;

(2) A statement that management has established Internal control over financial reporting and an assertion, to the best of management’s knowledge and belief, after diligent inquiry, as to whether its Internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles;

(3) A statement that briefly describes the approach or processes by which management evaluated the effectiveness of its Internal control over financial reporting; and
(4) A statement that briefly describes the scope of work that is included and whether any internal controls were excluded;

(5) Disclosure of any unremediated material weaknesses in the Internal control over financial reporting identified by management as of December 31 immediately preceding. Management is not permitted to conclude that the Internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles if there is one or more unremediated material weaknesses in its Internal control over financial reporting;

(6) A statement regarding the inherent limitations of internal control systems; and

(7) Signatures of the chief executive officer and the chief financial officer (or equivalent position/title).

E. Management shall document and make available upon financial condition examination the basis upon which its assertions, required in Subsection D above, are made. Management may base its assertions, in part, upon its review, monitoring and testing of internal controls undertaken in the normal course of its activities.

(1) Management shall have discretion as to the nature of the internal control framework used, and the nature and extent of documentation, in order to make its assertion in a cost effective manner and, as such, may include assembly of or reference to existing documentation.

(2) Management’s Report on Internal Control over Financial Reporting, required by Subsection A above, and any documentation provided in support thereof during the course of a financial condition examination, shall be kept confidential by the state insurance department.

Drafting Note: It is the recommendation that the company officer responsible for financial reporting would not be a member of the Audit committee and that the independent committee members would meet periodically, with no management present, with the independent certified public accountant to discuss the strengths and weaknesses of the insurer’s or Group of insurers’ internal control environments.

Section 17. Exemptions and Effective Dates

A. Upon written application of any insurer, the commissioner may grant an exemption from compliance with any and all provisions of this regulation if the commissioner finds, upon review of the application, that compliance with this regulation would constitute a financial or organizational hardship upon the insurer. An exemption may be granted at any time and from time to time for a specified period or periods. Within ten (10) days from a denial of an insurer’s written request for an exemption from this regulation, the insurer may request in writing a hearing on its application for an exemption. The hearing shall be held in accordance with the regulations of the [insert state] Department of Insurance pertaining to administrative hearing procedures.

B. Domestic insurers retaining a certified public accountant on the effective date of this regulation who qualify as independent shall comply with this regulation for the year
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Excerpts from Insurance Holding Company System Regulatory Act - #440
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SECTION 1. Definitions

As used in this Act, the following terms shall have these meanings unless the context shall otherwise require:

A. “Affiliate.” An “affiliate” of, or person “affiliated” with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

B. “Commissioner.” The term “commissioner” shall mean the insurance commissioner, the commissioner’s deputies, or the Insurance Department, as appropriate.

Drafting Note: Insert the title of the chief insurance regulatory official wherever the word “commissioner” appears.

C. “Control.” The term “control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 4K that control does not exist in fact. The commissioner may determine, after furnishing all persons in interest notice
(d) Guarantees or undertakings for the benefit of an affiliate which result in an actual contingent exposure of the insurer's assets to liability, other than insurance contracts entered into in the ordinary course of the insurer's business;

(e) All management agreements, service contracts and all cost-sharing arrangements;

(f) Reinsurance agreements;

(g) Dividends and other distributions to shareholders; and

(h) Consolidated tax allocation agreements;

(4) Any pledge of the insurer’s stock, including stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system;

(5) If requested by the commissioner, the insurer shall include financial statements of or within an insurance holding company system, including all affiliates. Financial statements may include but are not limited to annual audited financial statements filed with the U.S. Securities and Exchange Commission (SEC) pursuant to the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended. An insurer required to file financial statements pursuant to this paragraph may satisfy the request by providing the commissioner with the most recently filed parent corporation financial statements that have been filed with the SEC;

(6) Other matters concerning transactions between registered insurers and any affiliates as may be included from time to time in any registration forms adopted or approved by the commissioner;

Drafting Note: Neither option below is intended to modify applicable state insurance and/or corporate law requirements.

(7) Statements that the insurer’s board of directors oversees corporate governance and internal controls and that the insurer's officers or senior management have approved, implemented, and continue to maintain and monitor corporate governance and internal control procedures; and

Alternative Section 4B(7):

(7) Statements that the insurer's board of directors is responsible for and oversees corporate governance and internal controls and that the insurer's officers or senior management have approved, implemented, and continue to maintain and monitor corporate governance and internal control procedures; and

(8) Any other information required by the commissioner by rule or regulation.

C. Summary of Changes to Registration Statement. All registration statements shall contain a summary outlining all items in the current registration statement representing changes from the prior registration statement.
L. Enterprise Risk Filing. The ultimate controlling person of every insurer subject to registration shall also file an annual enterprise risk report. The report shall, to the best of the ultimate controlling person's knowledge and belief, identify the material risks within the insurance holding company system that could pose enterprise risk to the insurer. The report shall be filed with the lead state commissioner of the insurance holding company system as determined by the procedures within the Financial Analysis Handbook adopted by the National Association of Insurance Commissioners.

M. Violations. The failure to file a registration statement or any summary of the registration statement or enterprise risk filing required by this section within the time specified for filing shall be a violation of this section.

Section 5. Standards and Management of an Insurer Within an Insurance Holding Company System

A. Transactions Within an Insurance Holding Company System

(1) Transactions within an insurance holding company system to which an insurer subject to registration is a party shall be subject to the following standards:

(a) The terms shall be fair and reasonable;

(b) Agreements for cost sharing services and management shall include such provisions as required by rule and regulation issued by the commissioner;

(c) Charges or fees for services performed shall be reasonable;

(d) Expenses incurred and payment received shall be allocated to the insurer in conformity with customary insurance accounting practices consistently applied;

(e) The books, accounts and records of each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties; and

(f) The insurer’s surplus as regards policyholders following any dividends or distributions to shareholder affiliates shall be reasonable in relation to the insurer’s outstanding liabilities and adequate to meet its financial needs.

(2) The following transactions involving a domestic insurer and any person in its insurance holding company system, including amendments or modifications of affiliate agreements previously filed pursuant to this section, which are subject to any materiality standards contained in subparagraphs (a) through (g), may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction at least thirty (30) days prior thereto, or such shorter period as the commissioner may permit,
B. Dividends and other Distributions

No domestic insurer shall pay any extraordinary dividend or make any other extraordinary distribution to its shareholders until thirty (30) days after the commissioner has received notice of the declaration thereof and has not within that period disapproved the payment, or until the commissioner has approved the payment within the thirty-day period.

For purposes of this section, an extraordinary dividend or distribution includes any dividend or distribution of cash or other property, whose fair market value together with that of other dividends or distributions made within the preceding twelve (12) months exceeds the lesser of:

(1) Ten percent (10%) of the insurer’s surplus as regards policyholders as of the 31st day of December next preceding; or

(2) The net gain from operations of the insurer, if the insurer is a life insurer, or the net income, if the insurer is not a life insurer, not including realized capital gains, for the twelve-month period ending the 31st day of December next preceding, but shall not include pro rata distributions of any class of the insurer’s own securities.

In determining whether a dividend or distribution is extraordinary, an insurer other than a life insurer may carry forward net income from the previous two (2) calendar years that has not already been paid out as dividends. This carry-forward shall be computed by taking the net income from the second and third preceding calendar years, not including realized capital gains, less dividends paid in the second and immediate preceding calendar years.

Notwithstanding any other provision of law, an insurer may declare an extraordinary dividend or distribution which is conditional upon the commissioner’s approval, and the declaration shall confer no rights upon shareholders until (1) the commissioner has approved the payment of the dividend or distribution or (2) the commissioner has not disapproved payment within the thirty-day period referred to above.

Drafting Note: The following Subsection C entitled “Management of Domestic Insurers Subject to Registration” is optional and is to be adopted according to the needs of the individual jurisdiction.

C. Management of Domestic Insurers Subject To Registration.

(1) Notwithstanding the control of a domestic insurer by any person, the officers and directors of the insurer shall not thereby be relieved of any obligation or liability to which they would otherwise be subject by law, and the insurer shall be managed so as to assure its separate operating identity consistent with this Act.

(2) Nothing in this section shall preclude a domestic insurer from having or sharing a common management or cooperative or joint use of personnel, property or services with one or more other persons under arrangements meeting the standards of Section 5A(1).
(3) Not less than one-third of the directors of a domestic insurer, and not less than one-third of the members of each committee of the board of directors of any domestic insurer shall be persons who are not officers or employees of the insurer or of any entity controlling, controlled by, or under common control with the insurer and who are not beneficial owners of a controlling interest in the voting stock of the insurer or entity. At least one such person must be included in any quorum for the transaction of business at any meeting of the board of directors or any committee thereof.

(4) The board of directors of a domestic insurer shall establish one or more committees comprised solely of directors who are not officers or employees of the insurer or of any entity controlling, controlled by, or under common control with the insurer and who are not beneficial owners of a controlling interest in the voting stock of the insurer or any such entity. The committee or committees shall have responsibility for nominating candidates for director for election by shareholders or policyholders, evaluating the performance of officers deemed to be principal officers of the insurer and recommending to the board of directors the selection and compensation of the principal officers.

(5) The provisions of Paragraphs (3) and (4) shall not apply to a domestic insurer if the person controlling the insurer, such as an insurer, a mutual insurance holding company, or a publicly held corporation, has a board of directors and committees thereof that meet the requirements of Paragraphs (3) and (4) with respect to such controlling entity.

(6) An insurer may make application to the commissioner for a waiver from the requirements of this subsection, if the insurer’s annual direct written and assumed premium, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, is less than $300,000,000. An insurer may also make application to the commissioner for a waiver from the requirements of this subsection based upon unique circumstances. The commissioner may consider various factors including, but not limited to, the type of business entity, volume of business written, availability of qualified board members, or the ownership or organizational structure of the entity.

D. Adequacy of Surplus. For purposes of this Act, in determining whether an insurer’s surplus as regards policyholders is reasonable in relation to the insurer’s outstanding liabilities and adequate to meet its financial needs, the following factors, among others, shall be considered:

(1) The size of the insurer as measured by its assets, capital and surplus, reserves, premium writings, insurance in force and other appropriate criteria;

(2) The extent to which the insurer’s business is diversified among several lines of insurance;

(3) The number and size of risks insured in each line of business;

(4) The extent of the geographical dispersion of the insurer’s insured risks;

(5) The nature and extent of the insurer’s reinsurance program;
Excerpts from Financial Condition Examiners Handbook on Corporate Governance
EXHIBIT A  
EXAMINATION PLANNING PROCEDURES CHECKLIST

COMPANY NAME ______________________________________________________________

PERIOD OF EXAMINATION ____________________________________________________

An examination performed in accordance with the risk-focused surveillance approach focuses on those areas considered to have greater risk. In order to focus on areas considered high risk, the examiner must assess the control environment of the issuer. Risk-focused examinations consist of a seven-phase process, of which Phase 1 up to Phase 5 relate to the planning process of the exam. The following checklist details the components of these phases as well as other information that should be considered during the planning process. (Examiners should utilize the narrative guidance within the Handbook to fully understand the risk-focused surveillance process.)

### Pre-planning Procedures

<table>
<thead>
<tr>
<th>Examiner</th>
<th>Date</th>
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1. At least six months prior to the as-of date, notify the company and its external auditors, with company personnel’s assistance, that an examination will take place and that the auditor workpapers will be requested when the exam begins.

2. If the examination is to be performed on a company that is part of a holding company group, send an informal notification at least six months prior to the as-of date to other states that have domestics in the group.

3. Call the examination in the Exam Tracking System (ETS) at least 90 days prior to the exam start date.
   
   a. If the examination is to be performed on a company that is part of a holding company group, document your attempts to coordinate the exam with the Coordinating State and other domestic states within your group. Utilize Exhibit Z – Examination Coordination to assist with this process.

### Phase 1 – Understand the Company and Identify Key Functional Activities to be Reviewed

#### Part 1: – Understanding the Company

**Step 1. Gather Necessary Planning Information**

1. Complete, or have company personnel complete, as early as practical the Examination Planning Questionnaire and Information Technology Planning Questionnaire.

2. Request a copy of the in-house financial analyst’s reports on the company’s financial condition and operating results since the last examination.

3. Request copies or originals of relevant information filed with the department for review and analysis. Such information generally includes:
Assess the Effects of External Environmental Conditions

1. Assess the effects of external environmental conditions and factors. Focus on conditions which affect the company’s operations, primary lines of business and investments. Changes in ratings, ownership/management/corporate structure, business strategy or plan, CPA reports or independent audit and legal or regulatory status are all changes in the internal/external environment that should be considered by the examiner.

Step 4. Consideration of Information Technology Risks

1. Consider IT risks at the company including:
   a. The overall IT environment.
   b. IT systems supporting the financial reporting process including risks of access controls, authorizations, availability and timeliness of information, confidentiality, and recoverability controls.
   c. Probability and impact of failures at each significant location and their potential impact to the overall organization. Consider various IT processing locations and/or business units within the company.

2. Consider the completed Information Technology Planning Questionnaire.

Step 5. Update the Insurer Profile Summary

1. Update any significant initial findings in the Insurer Profile Summary. The Insurer Profile Summary can be updated throughout the examination process.

Part 2: Understand the Corporate Governance Structure

1. Assess risk management activities other than those that result in financial statement line item verifications, including the board of directors’ effectiveness and corporate governance activities. A corporate governance framework should be:
   a. Approved and overseen by an active board of directors.
   b. Implemented and supported by diligent executive management.
   c. Aimed at identification and fulfillment of sound strategic and financial objectives.
   d. Supported by relevant business planning and proactive resource allocation.
   e. Built by reliable risk management processes across business, operations and control functions.
   f. Reinforced by firm adherence to sound principles and segregation of duties.
   g. Independent in assessment of these programs and in obtaining assurance as to their reliability.
h. Objective in reporting findings to the board of directors or appropriate committees thereof.

2. Obtain an understanding of the audit committee. The audit committee is generally charged with monitoring the compliance of management and staff with policies of the board of directors and with laws and regulations. The examiner should consider whether the audit committee:

   a. Has established and maintains a written charter that explains the purpose and requirements of the audit committee.

   b. Coordinates the activities of the internal audit department, the external auditors and the compliance function.

   c. Includes members that are competent and independent.

   d. Monitors performance against the charter.

Part 3: Assessing the Adequacy of the Audit Function

Meet with Internal and External Auditors

1. Conduct a meeting with the external auditors to review both the financial statement audit workpapers and any Sarbanes-Oxley workpapers to discuss the scope of the audits (e.g., materiality, risk assessment and significant accounts/processes).

   a. Review relevant prior year audit workpapers if current year audit is in progress.

   b. Review pertinent management letters.

2. Well-planned, properly structured auditing programs are essential to strong risk management systems and comprehensive internal control systems. Examiners should assess and draw conclusions about the adequacy of internal and external audits as part of the risk assessment process. Utilize Exhibit E – Audit Review Procedures, to assist with this process.

3. When assessing the company’s internal audit department, consider the following:

   a. The internal audit department’s role in the internal control structure, including the reporting relationship and any changes in the internal audit department such as personnel or approach.

   b. The internal audit department’s activities that provide evidence about the design and effectiveness of internal control policies and procedures pertaining to the entity’s ability to record, process, summarize and report financial data consistent with the assertions embodied in the financial statements, or that provide direct evidence about potential misstatements of such data.

   c. The work of the internal audit department and if it could reduce the examiner's detailed procedures.
EXHIBIT B
EXAMINATION PLANNING QUESTIONNAIRE

The Examination Planning Questionnaire contains procedures and questions that are designed to assist the examiner in gathering necessary planning information and obtaining an understanding of the insurer’s organization. The examiner or company personnel should complete this questionnaire as early in exam planning as practical. If company personnel complete this exhibit, identification of who completed each request as well as supporting documentation should be provided to the examination team and the responses to this questionnaire should be critically evaluated by the examiner. The substance of the information collected during the completion of this questionnaire should be incorporated into the Examination Planning Memorandum. The questionnaire responses should be considered when identifying the inherent risks of the insurer. They should also impact the planned examination approach, and the nature, timing and extent of examination procedures performed.

All questions should be completely addressed, using additional sheets if necessary.

I. OWNERSHIP AND MANAGEMENT INFLUENCES

A. Concentration of Ownership
   1. Provide documentation explaining:
      a. The concentration of ownership.
      b. The approximate number of shareholders.
      c. Any significant shareholders.
      d. Changes in ownership.
      e. Whether shares are actively traded.
      f. The extent of management’s ownership interest.

B. Board of Directors
   1. Provide documentation describing the makeup of the board of directors, including number of directors, affiliations of outside directors, relationship of each director to the organization and number of years as a director. If biographical summaries are available for the directors, these should also be included. Include information on board members who served at any time during the period under examination.

C. Audit Committee
   1. Provide information on the audit committee. This information should include:
      a. The number of members that serve on the committee.

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b. The names of the members of the audit committee that could qualify as financial experts, in that they hold an accounting certification (CPA, CFE, etc.) and have previously been employed in a financial oversight role.

c. The number of members that are not part of company management and do not have business relationships with the company.

d. How often the committee meets.

e. Whether each member of the audit committee is a member of the board of directors and considered independent. (Independent members are individuals who are not part of company management and who do not have business relationships with the company.)

f. Whether the audit committee has an established charter. If so, provide a copy.

g. Whether minutes of meetings are prepared and retained.

D. Duties of the Board and Its Committees

1. Provide the excerpt from the articles of incorporation and bylaws that provides a description of the duties assigned and performed by the board of directors, its audit committee and any other committees of the board. Include a current list of committees and the members as of the examination date.

2. Provide an inventory of policies promulgated (and in effect as of 12-31-XX) by the board and its committees for oversight of the insurer and describe how compliance with these policies is reported on by management.

3. Describe the following board activities and provide supporting documentation:

   a. How does the board monitor professional ethics and independence from issuers of audit reports?

   b. How does the board consult with external auditing firms on accounting and auditing questions?

   c. How does the board supervise audit work (internal and external)?

   d. How is the board involved with the oversight of the hiring, professional development and advancement of personnel?
e. To what extent is the board responsible for the acceptance and continuation of audit engagements?

4. Describe the following audit committee activities and provide supporting documentation:

   a. To what extent is the committee responsible for approving all audit and non-audit services provided by the company’s issuer of audit reports?

   b. To what extent is the committee responsible for establishing procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal controls or auditing matters?

   c. To what extent is the committee responsible for establishing procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters?

   d. Which member(s) of the committee is a financial expert?

E. Corporate Planning

1. Advise whether the company has developed a long-term strategic plan. Summarize the company’s business strategy, if applicable, and provide the following information:

   a. How often are the strategic and business plans reviewed and updated?

   b. How does management obtain and use information to stay abreast of changes in the competitive, technological and regulatory environments? What resources are used?

   c. What is the scope of the established compliance and ethics program and how does it integrate with the company’s overall business strategy?

F. Use of Specialists

1. List any key consultants whose services were used during the examination period. State the specialist’s relationship, if any, to the company.

G. Culture

1. Provide the company’s formal mission statement, noting the elements regarding compliance, ethics and values.
2. How does the board and management set the “tone at the top” and communicate compliance, ethics, values, mission and vision?

3. Discuss how employees and other stakeholders understand that the organization is serious about its compliance and ethics responsibility.

II. ORGANIZATION AND PERSONNEL PRACTICES

A. Organization

1. Provide details of the company structure, including:

   a. Corporate structure chart (by legal/business unit).
   
   b. Personnel organization chart.
   
   c. Organizational chart detailing the structure of key business activities, including the individuals responsible for each activity, areas of responsibility and lines of reporting and communication.
   
   d. A list of critical management and operating committees and their members.

2. Provide formal position descriptions for administrative and financial personnel.

3. Provide a copy of the formal conflict of interest policy. Provide information on the following elements regarding the conflict of interest policy:

   a. Does the conflict of interest policy require periodic declarations by officers, directors and key employees?
   
   b. Describe the system used to monitor compliance with the conflict of interest policy.
   
   c. What position in the organization provides oversight and leadership in the compliance/ethics function, and where does this position fall in the organization chart?

4. Does the company have a written corporate governance framework? If so, describe how the corporate governance framework is:

   a. Approved and overseen by the board of directors.
   
   b. Implemented and monitored by executive management.
c. Aimed at the identification and fulfillment of sound ethical, strategic and financial objectives.

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d. Supported by business planning and resource allocation.

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e. Built by reliable business planning and proactive resource allocation.

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f. Reinforced by firm adherence to sound principles of segregation of duties.

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g. Independent in the assessment of these programs. Is the assessment of these programs performed by the internal audit and/or by the independent certified public accountants?

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h. Objective in reporting of findings to the board or appropriate committees thereof.

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B. Personnel

1. Describe the investigation of backgrounds and references during the recruitment and selection process for new employees in the administrative and financial areas.

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2. Describe any significant turnover in management.

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3. For each member of the company’s key management, please provide:

   a. The member’s length of service with the company, as well as length of service in his/her current position.

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   b. The member’s specific industry experience.

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   c. The member’s biographical information.

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4. List any officers that have been associated with a company that has become insolvent or placed in receivership, suffered a revocation of license or ordered to cease and desist from violations of insurance law or regulations.

   a. If applicable, have the officers describe their roles in the insolvency, receivership, etc.

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5. How are personnel policies, including hiring, evaluation and termination, documented and communicated to employees?

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6. Are employees who handle cash, securities, and other valuable assets bonded? List those covered, the amount of coverage and deductible.

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<td>7.</td>
<td>Are any related persons employed within the company? If yes, provide their names, job titles and relationship.</td>
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<td>To what extent is rotation of duties enforced by mandatory vacations? Explain.</td>
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<td>9.</td>
<td>To what extent is job performance periodically evaluated and reviewed with each employee?</td>
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<td>10.</td>
<td>To what extent are there formal training programs for administrative and financial personnel? Provide documentation describing the training provided.</td>
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<td>11.</td>
<td>Describe the organization structure of your compliance and ethics management team.</td>
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<td>12.</td>
<td>How often, and by what methods, does management communicate the mission and vision of the compliance and ethics program to employees and other stakeholders?</td>
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III. INTERNAL AUDIT ACTIVITIES AND INTERNAL CONTROLS

A. Use of Internal Audit Departments

1. To what extent are internal audit departments used?

2. Is the scope of internal audit activities planned in advance with senior management, the board of directors or the audit committee? If so, which? If activities are planned with senior management, describe how the internal audit department remains independent.

3. To what extent do internal auditors prepare and follow written audit programs? How do these programs:

   a. Provide objective, independent reviews and evaluations of insurer activities, internal controls and management information systems?

   b. Help maintain or improve the effectiveness of insurer risk management processes, controls and corporate governance?

   c. Provide reasonable assurance about the accuracy and timeliness with which transactions are recorded and the accuracy and completeness of financial regulatory reports?

4. Provide documentation describing the normal duties of the internal auditors, including the extent of financial audits and operational audits. Include the following information:
a. Size and organization of the staff (including ratio of supervisors to staff).

b. Prior experience of staff members.

c. Number of CPAs and CIAs.

d. Scope restrictions. If any, consider internal audit’s independence from management.

5. Do internal auditors have direct access to:

a. Senior management?

b. Board of directors?

c. Audit committee?

d. Appropriate executives?

6. How are responses to internal audit recommendations communicated and documented?

7. How is the implementation of internal audit recommendations monitored?

8. Are there training programs for internal auditors? Describe the training programs available for internal auditors, as well as any established continuing educational requirements.

9. Are any internal auditors or members of their families related to other employees? If so, explain.

IV. MONITORING PROCEDURES

A. Budgets

1. Does management develop an annual budget and financial plan based on corporate goals and objectives? If so, please provide.

2. How are budget expectations communicated to those affected?

3. Are estimates included in financial data and statements reviewed by knowledgeable persons independent of the estimation process? If yes, who performs this review?

a. Are the entries supported by explanation and/or documentation?
g. Treatment of policyholders in benefit settlement matters.

h. Disposal of real estate acquired by foreclosure.

i. Permitted non-insurance activities.

j. Foreign operations.

k. Reporting.

l. Others not already discussed above.

4. Describe any government restrictions or regulatory requirements that pertain specifically to the company, including any permitted practices.

5. Provide copies of any limited scope examinations and audits by regulatory or other government agencies. Discuss any IRS revenue agents’ reports, deficiency assessments and developments in IRS examinations in progress.

6. Has the company complied with all debt covenants and other agreements?

7. Describe whether there are any material contingent liabilities or commitments.

VI. CODE OF CONDUCT

1. Does the company have an established code of conduct? If so, provide a copy and advise what the code of conduct addresses and who receives it.

2. Does the company distribute the code of conduct and confirm that employees receive and understand the code and other policies? If so, please describe this process.

3. Does the company have a process for updating policies and procedures? If so, please describe this process.

4. Can any requirements established by the code of conduct and other policies be waived or overridden? If so, please describe this process.

5. Under the code of conduct, can employees, agents and other stakeholders raise issues regarding compliance and ethics-related matters? If so, please describe this process.

6. Does the code of conduct have an established procedure to address compliance and ethics issues that arise? If so, please describe this process and how the company scrutinizes the source of compliance failures.
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<td>Does the code of conduct provide guidance to take action against violators of the code? If so, please describe how consistently this has been applied or whether other provisions are in place to address this issue.</td>
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<td>Is there a process for determining which issues are escalated to the board and for informing the board when issues are resolved? If so, please describe this process.</td>
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<td>9.</td>
<td>Are there ongoing processes in place to monitor the effectiveness of the compliance and ethics program? If so, please describe.</td>
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<td>10.</td>
<td>Does the organization engage an external law firm or consultant to audit compliance and ethics program elements? If so, please list the firm or consultant.</td>
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<td>Is the company a member of the Insurance Marketplace Standards Association and/or other best practices organizations? If so, please list.</td>
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ii. Competitive environment

iii. Regulatory changes

d. Obtain an understanding of the company’s operations by line or book of business based on discussion with management.

**Step 4: Consideration of Information Technology Risks**

The examiner-in-charge should also become familiar with the general controls surrounding the company’s IT environment. Due to technological advancement (e.g., Internet, Intranet, and e-commerce), internal control risks could be more pervasive within the IT environment than in other areas within the company. IT requires more technology insight to understand how it impacts the company’s operations. Properly assessing IT risk requires appropriate IT training, experience, and technological insight. The examiner-in-charge may want to consider consulting with a specialist who has experience in reviewing IT general controls.

Section 1, Part III, A. of this Handbook outlines the process in which an IT control environment should be reviewed. Exhibit C, Part II, also located in this Handbook, is one tool the examiner can utilize while conducting the IT review. During the IT review, the examiner will identify risks that are relevant to the company based on their understanding of the company.

Once risks have been identified, the examiner will request control information from the company and test the appropriate controls within the IT environment. In the event an IT specialist is utilized, communication with the examiner-in-charge is critical throughout the review of IT General Controls, especially when it comes to communicating findings of the review and the impact on the financial examination. If necessary, the specialist may need to assist in completing the work for the financial examination, such as testing IT application controls.

**Step 5: Update the Insurer Profile Summary**

Based upon the review and analysis performed up to this point, update any significant initial findings in the Insurer Profile Summary. The Insurer Profile Summary can be updated throughout the examination process.

**B. Part 2: 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. A favorable overall assessment of governance does not, by itself, serve to reduce the scope or extent of examination procedures; rather, specific governance controls need to be assessed for their adequacy in managing specific risks, in conjunction with other controls designed to manage the same. See Exhibit M – Understanding the Corporate Governance Structure for additional guidance in understanding the corporate governance structure of the company.

Effectively structured and competent governance independently involved in a company’s risk management activities is an essential element in creating and nurturing a self-sustaining risk management culture. The use of specific corporate governance features may be different for entities that are the ultimate parent corporation from those of subsidiary companies. Components of effective corporate governance programs include:

1. Adequate competency (industry experience, knowledge, skills) of members of the board of directors;

2. Independent and adequate involvement of the board of directors;

3. Multiple, informal channels of communication between board, management and internal and external auditors to create a culture of openness;

4. A code of conduct established in cooperation between the board and management, which is reviewed for compliance and is formally approved by senior management;
5. Identification and fulfillment of sound strategic and financial objectives, giving adequate attention to risks;

6. Support from relevant business planning and proactive resource allocation;

7. Support by reliable risk management processes across business, operations and control functions;

8. Reinforcement of corporate adherence to sound principles of conduct and segregation of authorities;

9. Independence in assessment of programs and assurance as to their reliability;

10. Objective and independent reporting of findings to the board or appropriate committees thereof;

11. Adoption of Sarbanes-Oxley provisions, whether or not mandated, including, but not limited to, auditor independence and whistle-blower provisions; and

12. Board oversight and approval of executive compensation and performance evaluations.

**Board of Directors**

The control environment and “tone at the top” are influenced significantly by the entity’s board of directors and audit committee. Factors include the board or audit committee’s independence from management, experience and stature of its members, extent of its involvement and scrutiny of activities, and the appropriateness of its actions. Another factor is the degree to which difficult questions are raised and pursued with management regarding plans or performance. Interaction of the board or audit committee with internal and external auditors is also a factor affecting the control environment.

The examiner-in-charge and appropriate insurance department personnel may wish to meet or otherwise converse with the board or the audit committee at the commencement of an exam or any other appropriate juncture. Various factors may warrant such a meeting and include but are not limited to:

- Significant fraud uncovered at the company;
- Significant senior management changes or turnover;
- Questions the examiner-in-charge may have after reviewing the board meeting minutes; and
- Changes in the external auditor.

Specific factors do not have to exist to warrant such meetings. A meeting with the board or audit committee may take place to obtain an overview of their general functions and responsibilities. These meetings may also facilitate cooperation by management during the exam and assist in the understanding of the company and is another benefit of a top down approach. Examiners should consider the overall structure and operations of the board of directors or audit committee in determining whether a meeting would be beneficial to the examination process.

Because of its importance, an active and involved board of directors, board of trustees or comparable body – possessing an appropriate degree of management, technical and other expertise coupled with the necessary stature and mindset so that it can adequately perform the necessary governance, guidance and oversight responsibilities – is critical to effective internal control. And, because a board must be prepared to question and scrutinize management’s activities, present alternative views and have the courage to act in the face of obvious wrongdoing, it is necessary that the board contain outside directors. Although officers and employees are often highly effective and important board members that bring knowledge of the company to the table, there must be a balance. Although small and even mid-size companies may find it difficult to attract or incur the cost of having a majority of outside directors, it is important that the board contain at least a critical mass of outside directors. The number should suit the entity’s circumstances, but more than one outside director would normally be needed for a board to have the requisite balance. A board composed entirely (or principally) of officers of the company (or relatives or friends of the owner or management) cannot be viewed as capable of sufficient, independent oversight of the insurer operations.

Management is accountable to the board of directors or trustees, which provides governance, guidance, and oversight. By selecting management, the board has a major role in defining what it expects in integrity and ethical values, and can
confirm its expectations through its oversight activities. Similarly, by reserving authority in certain key decisions, the board can play a role in high-level objective setting and strategic planning. In addition, with the oversight that the board provides, the board is pervasively involved in internal control.

Effective board members are objective, capable and inquisitive. They have a working knowledge of the entity’s activities and environment, and commit the time necessary to fulfill their board responsibilities. They should utilize resources as needed to investigate any issues they deem important. They should also have an open unrestricted communication channel with all entity personnel, including the internal auditors, and with the external auditors and legal counsel. The sufficiency of the diligence of the board is reflected in the substance of the minutes or supporting documentation.

Many boards of directors carry out their duties largely through committees. Their use and focus vary from one entity to another, but often include audit, compensation, finance, nominating, and employee benefits. Each committee can bring specific emphasis to certain components of internal control. For example, the audit committee has a direct role in internal control relating to financial reporting, and the nominating committee plays an important role in internal control by its consideration of qualifications of prospective board members. In fact, all board committees, through their oversight roles, are an important part of the internal control system. Where a particular committee has not been established, the related functions are carried out by the board itself.

Audit Committee
Over the years, attention has been given by a number of regulatory and professional bodies to establishing audit committees. Although audit committees have received increased emphasis over the years, they are not universally required, nor are their specific duties and activities prescribed. Audit committees of different entities have different responsibilities, and their levels of involvement vary.

Although some variations in responsibilities and duties are necessary and appropriate, certain characteristics and functions generally are common to all effective audit committees. Management is responsible for the reliability of the financial statements, but an effective audit committee plays an important role. The audit committee (or the board itself, where no audit committee exists) has the authority to question top management regarding how it carries out its financial reporting responsibilities, and also has authority to ensure that corrective action is taken. The audit committee, in conjunction with or in addition to a strong internal audit function, is often in the best position within an entity to identify and act in instances where top management overrides internal controls or otherwise seeks to misrepresent reported financial results. Thus, there are instances where an audit committee, or board, must carry its oversight role to the point of directly addressing serious events or conditions.

There have been longstanding audit committee requirements for public companies as set forth by SOX; however, recent modifications to the NAIC Annual Financial Reporting Model Regulation (#205 – also known as the Model Audit Rule or MAR) have set forth audit committee requirements for non-public insurers that exceed an annual premium threshold. The requirements set forth by both SOX and MAR require an audit committee be formed, that external auditors report to that audit committee, as well requiring certain levels of independence within the Audit Committee. Examiners should ensure that insurers are complying with these regulations as part of their examination procedures.

Other Committees
There may be other committees of the board which oversee specific functional areas of the company, such as underwriting, strategic planning, ethics, public policy or technology. Generally, these committees are established only in certain large organizations, or in other enterprises due to particular circumstances of the entity.

The board may have a compensation committee which makes recommendations for the compensation (including salary, bonuses and stock options) of senior management of the company. If such a committee is established, it should be composed of outside directors.

Management
Interviews with senior management at the “C” level may be used at the beginning of the examination or at any time during the examination as necessary. “C” level management may include the CEO (Chief Executive Officer), CFO (Chief Financial Officer), COO (Chief Operating Officer), CIO (Chief Information Officer), CRO (Chief Risk Officer),
Controller, Chief Actuary or other appropriate executive level management. Examiners should consider the size of the organization in determining which individual would provide the examiner with the most beneficial information regarding the company for the stage of the examination. This interview process is a key step in the “top down” approach, beginning with senior management and then drilling down through the various levels of management to obtain a thorough understanding of the organization to assist in scoping the examination. Topics of these high-level interviews should include, but not be limited to (1) corporate strategic initiatives; (2) external/environmental factors of concern to management; (3) political/regulatory changes that might affect business; (4) competitive advantages/disadvantages; (5) management of key functional activities; and (6) how management establishes and monitors the achievement of objectives.

The examiners should consider which individuals should be interviewed and the sources of data to be evaluated to complete each planning step. In order to select the individuals to interview, the examiners should obtain an organizational chart from the company and compile a list of potential interviewees. In addition to accounting department personnel, the interview list should include managers of key functional business units (depending on the company structure, lines of business or revenue centers might be more appropriate). Because all companies have different organizational structures, it is important that the interview schedule and the examination plan match the company. Examiners should form their objectives, or what they want to get out of the interview, prior to conducting the interview. In order to accomplish this, the examiner should have a basic knowledge of the job function of the person that they are interviewing. This will allow the examiner to ask relevant questions and get the most information possible in one setting, as it may be difficult to coordinate multiple contacts with a “C”-level interviewee or a member of the board of directors. The information contained in Exhibit Y – Examination Interviews provides some basic questions that an examiner may consider when conducting “C”-level interviews. Exhibit Y, however, does not provide examples for functional positions at the insurer (e.g., claims handling, sales and marketing, etc.). These functional interviews are typically best documented in a narrative format and may be done in conjunction with walkthroughs or other control documentation procedures.

Management’s philosophy and operating style affect the way the enterprise is managed, including the kinds of business risks accepted. An entity that has been successful taking significant risks may have a different outlook on internal control than one that has faced harsh economic or regulatory consequences as a result of venturing into dangerous territory. An informally managed company may control operations largely by face-to-face contact with key managers. A more formally managed company may rely more on written policies, performance indicators and exception reports.

Other elements of management’s philosophy and operating style include attitudes toward financial reporting, conservative or aggressive selection from available alternative accounting principles, conscientiousness and conservatism with which accounting estimates are developed, and attitudes toward information systems and accounting functions and personnel.

Management is directly responsible for all activities of an entity, including its internal control system. Naturally, management at different levels in an entity will have different internal control responsibilities. These will differ, often considerably, depending on the entity’s characteristics.

The chief executive has ultimate ownership responsibility for the internal control system. One of the most important aspects of carrying out this responsibility is to ensure the existence of a positive control environment. More than any other individual or function, the chief executive sets the “tone at the top” that affects control environment factors and other components of internal control. The influence of the CEO on an entire organization cannot be overstated. What is not always obvious is the influence a CEO has over the selection of the board of directors. A CEO with high ethical standards can go a long way in ensuring that the board reflects those values. On the other hand, a CEO who lacks integrity may not be able, or willing, to obtain board members who possess it. Effective boards and audit committees also will look closely at top management’s integrity and ethical values to determine whether the internal control system has the necessary critical underpinnings.

The chief executive’s responsibilities include seeing that all the components of internal control are in place. The CEO generally fulfills this duty by:

1. Providing leadership and direction to senior managers. Together with them, the CEO shapes the values, principles and major operating policies that form the foundation of the entity’s internal control system. For example, the
CEO and key senior managers will set entity-wide objectives and broad-based policies. They take actions concerning the entity’s organizational structure, content and communication of key policies, and the type of planning and reporting systems the entity will use.

2. Meeting periodically with senior managers responsible for the major functional areas — sales, marketing, production, procurement, finance, human resources, etc. — to review their responsibilities, including how they are controlling the business. The CEO will gain knowledge of controls in their operations, improvements required and status of efforts under way. To discharge this responsibility, it is critical that the CEO clearly define what information he or she needs.

Senior managers in charge of organizational units have responsibility for internal control related to their units’ objectives. They guide the development and implementation of internal control policies and procedures that address their units’ objectives and ensure that they are consistent with the entity-wide objectives. They provide direction, for example, on the unit’s organizational structure and personnel hiring and training practices, as well as budgeting and other information systems that promote control over the unit’s activities. In this sense, in a cascading responsibility, each executive is effectively a CEO for his or her sphere of responsibility.

Senior managers usually assign responsibility for the establishment of more specific internal control procedures to personnel responsible for the unit’s particular functions or departments. Accordingly, these subunit managers usually play a more hands-on role in devising and executing particular internal control procedures. Often, these managers are directly responsible for determining internal control procedures that address unit objectives, such as developing authorization procedures. They will also make recommendations on the controls, monitor their application and meet with upper level managers to report on the controls’ functioning.

Depending on the levels of management in an entity, these subunit managers, or lower level management or supervisory personnel, are directly involved in executing control policies and procedures at a detailed level. It is their responsibility to take action on exceptions and other problems as they arise. This may involve investigating data entry errors or transactions appearing on exception reports, or looking into reasons for departmental expense budget variances. Significant matters, whether pertaining to a particular transaction or an indication of larger concerns, are communicated upward in the organization.

With each manager’s respective responsibilities should come not only the requisite authority, but also accountability. Each manager is accountable to the next higher level for his or her portion of the internal control system, with the CEO ultimately accountable to the board.

Although different management levels have distinct internal control responsibilities and functions, their actions should coalesce in the entity’s internal control system.

**Financial Officers**

Of particular significance to monitoring functions are finance and controllership officers and their staffs, whose activities cut across, up and down the operating and other units of an enterprise. These financial executives are often involved in developing entity-wide budgets and plans. They track and analyze performance, often from operations and compliance perspectives, as well as from a financial perspective. These activities are usually part of an entity’s central or “corporate” organization, but they commonly also have “dotted line” responsibility for monitoring division, subsidiary or other unit activities. As such, the chief financial officer, chief accounting officer, controller and others in an entity’s financial function are central to the way management exercises control.

The importance of the role of the chief accounting officer in preventing and detecting fraudulent financial reporting was emphasized in the Treadway Commission report: “As a member of top management, the chief accounting officer helps set the tone of the organization’s ethical conduct; is responsible for the financial statements; generally has primary responsibility for designing, implementing and monitoring the company’s financial reporting system; and is in a unique position regarding identification of unusual situations caused by fraudulent financial reporting.” The report noted that the chief financial officer or controller may perform functions of a chief accounting officer.
When looking at the components of internal control, it is clear that the chief financial (or accounting) officer and his or her staff play critical roles. That person should be a key player when the entity’s objectives are established and strategies decided, risks are analyzed and decisions are made on how changes affecting the entity will be managed. He or she provides valuable input and direction, and is positioned to focus on monitoring and following up on the actions decided.

C. Part 3: Assessing the Adequacy of the Audit Function

Well-planned, properly structured audit programs are essential to a strong corporate risk management process. Effective internal and external audit activities create a critical monitoring control against fraud, provide vital information to the board of directors (or audit committee) about the effectiveness of internal control systems and mitigate operating and financial reporting risk. Examiners should assess and draw conclusions about the adequacy of internal and external audit as part of the corporate risk management process. The conclusions reached from the assessment will significantly influence the scope and the extent of examination activities at the insurer. The guidance in this section pertains to both external and internal audit functions unless specifically identified.

The following guidelines direct the assessment of insurer audit activities:

1. The board of directors and senior management cannot delegate their responsibilities for establishing, maintaining, and operating effective audit activities (e.g., establishment of an annual audit plan that is reviewed by the audit committee).

2. Examiners must assess the adequacy of an insurer’s audit function.

3. Insurer audit activities will be performed by independent and competent staff that is objective in assessing and evaluating the insurer’s risks and controls.

Effective audit functions have these characteristics:

1. Provide objective, independent input on operating and financial reporting risks and internal controls, including management information systems.

2. Help maintain or improve the effectiveness of insurer risk management processes, controls and corporate governance.

3. Provide reasonable assurance about the accuracy and timeliness with which transactions are recorded and the accuracy and completeness of financial regulatory reports.

4. Provide assistance, guidance or suggestions in areas where needed.

Audit functions may comprise several individual audits that provide various types of information to the board of directors (or audit committee) about the insurer’s financial condition and effectiveness of internal control systems. The most common types of audits are financial, operational, compliance, and information technology audits.

One of the objectives of this Handbook is to develop an efficient risk-focused examination approach that provides for more timely detection of potentially troubled insurance companies by focusing examination resources on those companies, or areas within companies, that have a higher likelihood of material adjustment to surplus. Examiners can enhance efficiency in the examination through appropriate communications with the company’s auditors, including but not limited to the nature, extent and timing of their audit procedures, any internal control testing and attestations performed (e.g., Sarbanes-Oxley, Model Audit Rule) and their views of the company and its risks. The extent to which the examiner chooses to consider the work of an auditor in performance of the examination is a matter of judgment by the examiner. See Exhibit E – Audit Review Procedures for additional guidance to follow when considering the amount of reliance that can be placed on the work performed by auditors.
The purpose of this exhibit is 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. A favorable overall assessment of governance does not, by itself, serve to reduce the scope or extent of examination procedures; rather, specific governance controls need to be assessed for their adequacy of the management of specific risks, in conjunction with other controls designed to manage the same.

A. ASSESSING THE BOARD OF DIRECTORS

An assessment of the board of directors may be determined through discussions with the board of directors and through gaining an understanding of the board’s oversight role. As a general guideline, the following areas should be considered in the assessment of the board of directors:

1. Are membership criteria and terms for the board of directors sufficient to enable the effective monitoring and oversight of management?

2. Does the board of directors effectively monitor and oversee management activities?

3. Is the board of directors sufficiently independent from management such that, when necessary, difficult and probing questions are raised? If not independent, what compensating factors, if any, exist to ensure that, when necessary, difficult and probing questions will be raised with or considered by management?

4. What is the frequency and timeliness with which meetings are held with chief financial and/or accounting officers, internal auditors and external auditors?

5. Is the information provided to the board of directors or committee members sufficient and timely enough to allow monitoring of management’s objectives and strategies, the entity’s financial position and operating results, and terms of significant agreements?

6. Is there a formal process through which the board of directors or audit committee is apprised of sensitive information, investigations and improper acts (e.g., travel expenses of senior officers, significant litigation, investigations of regulatory agencies, defalcations, embezzlement or misuse of corporate assets, violations of insider trading rules, political payments, illegal payments) sufficiently and in a timely manner?

An active and effective board of directors, or underlying committee, provides an important oversight function. In addition, because of management’s ability to override system controls, the board of directors plays an important role in ensuring effective internal control, setting the “tone at the top” and setting other management standards that may affect the risk analysis for the company’s activities. Key components include:

1. Independence from management such that, when necessary, difficult and probing questions are raised. For example, consider:
   a. Whether the board of directors constructively challenges management’s planned decisions (e.g., strategic initiatives and major transactions) and probes for explanations of past results (e.g., budget variances).
   b. Whether a board of directors that consists solely of an entity’s officers and employees (e.g., a small corporation) questions and scrutinizes activities, presents alternative views and takes appropriate action if necessary.
   c. The leadership structure of the board. Have there been changes during the exam period? Has the company chosen to combine or separate the principal executive officer from the Chairman of the Board? Why or why not?
   d. If there is a lead independent director. What role does that person play in the leadership of the company?
e. If there are any other arrangements intended to ensure that, when necessary, difficult and probing questions are raised with or considered by management. If so, what are they?

2. The use of board committees, where warranted, by the need for more in-depth or directed attention to particular matters. For example, consider whether:
   a. Board committees exist.
   b. They are sufficient, in subject matter and membership, to deal with important issues adequately.

3. The knowledge and experience of directors. For example, consider:
   a. Whether directors have sufficient knowledge, applicable industry experience and time to serve effectively.
   b. A review of biographical data on background and experience from Holding Company Act filings, SEC filings, exam planning questionnaires, additional information gathered as a result of the risk-focused surveillance framework, etc.
   c. Changes in board composition during the examination period, including those that have broadened the experience of the directors as a whole.
   d. The criteria for identifying board of director candidates.

4. The frequency and timeliness with which meetings are held with chief financial and/or accounting officers, internal auditors and external auditors. For example, consider whether:
   a. The audit committee meets privately with the chief accounting officer and internal and external auditors to discuss the reasonableness of the financial reporting process, system of internal control, significant comments and recommendations, and management’s performance.
   b. The audit committee reviews the scope of activities of the internal and external auditors annually.

5. The sufficiency and timeliness with which information is provided to the board of directors or committee members, to allow monitoring of management’s objectives and strategies, the entity’s financial position and operating results, and terms of significant agreements. For example, consider whether:
   a. The board of directors regularly receives key information, such as financial statements, major marketing initiatives, significant contracts or negotiations.
   b. Directors believe they receive the proper information.

6. The oversight in determining the compensation of executive officers and head of internal audit, and the appointment and termination of those individuals. Smaller or non-public companies are less likely to have the types of compensation policies and practices of larger, publicly traded companies, so the examination should take that fact into consideration. Some examples to consider may include:
   a. Whether the compensation committee, or board, approves executives’ incentive compensation plans.
   b. The general design philosophy of compensation and incentive programs.
   c. Whether the board or compensation committee considers how to eliminate, reduce, or manage material adverse risks to the company that may arise from compensation practices.
   d. Whether there have been any changes in executive compensation plans during the exam period. Review applicable SEC filings and the NAIC Supplemental Compensation Exhibit.
   e. The nature and extent of services provided by compensation consultants during the exam period. Are all services approved by the board of directors or compensation committee? How are independent compensation consultants selected and to whom do they report?
   f. How are management compensation programs reviewed for effectiveness?
   g. What is the process by which changes in compensation programs are approved?

7. The board’s role in establishing the appropriate “tone at the top.” For example, consider whether:
   a. The board and audit committee are involved sufficiently in evaluating the effectiveness of the “tone at the top.”
   b. The board of directors takes steps to ensure an appropriate tone.
   c. The board of directors specifically addresses management’s adherence to the code of conduct.
8. The actions that the board of directors or committee takes as a result of its findings, including special investigations, as needed. For example, consider whether:
   a. The board of directors has issued directives to management detailing specific actions to be taken.
   b. The board of directors oversees and follows up as needed.

B. UNDERSTANDING THE ORGANIZATIONAL STRUCTURE

The organizational structure should not be so simple that it cannot adequately monitor the enterprise’s activities, nor so complex that it inhibits the necessary flow of information. Executives should fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions. Key components include:

1. The appropriateness of the entity’s organizational structure, and its ability to provide the necessary information flow to manage its activities. For example, consider whether:
   a. The organizational structure is appropriately centralized or decentralized, given the nature of the entity’s operations.
   b. The structure facilitates the flow of information upstream, downstream and across all business activities.

2. The adequacy of the definition of key managers’ responsibilities, and their understanding of these responsibilities. For example, consider whether:
   a. Responsibilities and expectations for the entity’s business activities are communicated clearly to the executives in charge of those activities.

3. The adequacy of knowledge and experience of key managers in light of responsibilities. For example, consider whether:
   a. The executives in charge have the required knowledge, experience and training to perform their duties.

4. The appropriateness of reporting relationships. For example, consider whether:
   a. Established reporting relationships—formal or informal, direct or indirect—are effective and provide managers with information appropriate to their responsibilities and authority.
   b. The management of the business activities has access to senior operating executives through clear communication channels.
   c. The internal audit function reports directly to the board of directors or to the audit committee.

5. The extent to which modifications to the organizational structure are made in light of changed conditions. For example, consider whether:
   a. Management periodically evaluates the entity’s organizational structure in light of changes in the business or industry.

6. Sufficiency in the number of employees, particularly in management and supervisory capacities. For example, consider whether:
   a. Managers and supervisors have sufficient time to carry out their responsibilities effectively.
   b. Managers and supervisors work excessive overtime and/or are fulfilling the responsibilities of more than one employee.

C. UNDERSTANDING THE ASSIGNMENT OF AUTHORITY AND RESPONSIBILITY

The assignment of responsibility, delegation of authority and establishment of related policies provide a basis for accountability and control, and set forth individuals’ respective roles. Key components include:
1. The assignment of responsibility and delegation of authority to deal with organizational goals and objectives, operating functions and regulatory requirements, including responsibility for information systems and authorizations for changes. For example, consider whether:
   a. Authority and responsibility are assigned to employees throughout the entity.
   b. Responsibility for decisions is related to assignment of authority and responsibility.
   c. Proper information is considered in determining the level of authority and scope of responsibility assigned to an individual.

2. The appropriateness of control-related standards and procedures, including employee job descriptions. For example, consider whether:
   a. Job descriptions, for at least management and supervisory personnel, exist.
   b. The job descriptions, or other standards and procedures, contain specific references to control-related responsibilities.

3. The appropriateness of staff size, particularly with respect to information systems and accounting functions, with the requisite skill levels relative to the size of the entity and nature and complexity of activities and systems. For example, consider whether:
   a. The entity has an adequate workforce—in numbers and experience—to carry out its mission.

4. The appropriateness of delegated authority in relation to assigned responsibilities. For example, consider whether:
   a. There is an appropriate balance between authority needed to “get the job done” and the involvement of senior personnel where needed.
   b. Employees at the appropriate level are empowered to correct problems or implement improvements, and empowerment is accompanied by appropriate levels of competence and clear boundaries of authority.

D. ASSESSING MANAGEMENT COMPETENCE

A quality assessment of the board of directors and management may be determined through discussions and observations of the governance processes. As a general guideline, the following areas should be included in the assessment of management competence.

1. How long has key management been with the company in their current positions, and what specific industry experience do they have?

2. Has there been significant turnover in management?

3. Have members of management ever been officers, directors, trustees, key employees or controlling stockholders of an insurance company that, while they occupied any such position or served in any such capacity with respect to it:
   a. Became insolvent or was placed in conservation?
   b. Was placed into supervision or rehabilitation?
   c. Was enjoined from, or ordered to cease and desist from, violating any securities or insurance law or regulation?
   d. Suffered the suspension or revocation of its certificate of authority or license to do business in any state?

In addition to the assessment of management competence, examiners should make an assessment of management's performance. The following areas should be considered when assessing management performance.

1. Does management periodically review information to adequately assess the impact of changes in competition, technology, regulation, environment and general economic trends that may impact the company’s business?

2. Does management have adequate financial and operating information to identify trends or variations from budgets that may impact the statutory financial statements?
3. Does management effectively analyze and investigate financial and operating information and trends such that significant adverse trends or misstatements in the Annual Statement could reasonably be expected to be identified and rectified on a timely basis?

4. Do management, supervisors and agents have appropriate knowledge and experience to capably and effectively administer management’s policies and procedures?

5. Does the company maintain effective controls to ensure that potential short-term liquidity problems, long-term capital needs and other significant fund management variations/needs are identified and rectified on a timely basis?

6. Do adequate physical safeguards exist over company assets, and are all officers and their employees appropriately bonded (see Exhibit R for assistance)?

7. Does management have a positive attitude toward internal controls (including controls over the information systems)?

8. Does management have adequate financial and operating information to identify, on a timely basis, potential liabilities, commitments and/or contingencies that may require recording and/or disclosure in the Annual Statement?

As an expansion of the sample evaluative guidance above, the philosophy and operating style of management will normally have a pervasive effect on an entity. These are intangibles, but one can look for positive and negative signs. Key components include:

1. The nature of business risks accepted (e.g., whether management often enters into particularly high-risk ventures or is extremely conservative in accepting risks). For example, consider whether:
   a. Management moves carefully, proceeding only after carefully analyzing the risks and potential benefits of a venture.

2. Personnel turnover in key functions (e.g., operating, accounting, information systems, internal audit). For example, consider whether:
   a. There has been excessive turnover of management and supervisory personnel.
   b. Key personnel have quit unexpectedly or on short notice.
   c. There is a pattern to turnover (e.g., inability to retain key financial or internal audit executives) that may be an indicator of the emphasis that management places on control.

3. Management’s attitude toward the information systems and accounting functions, and concerns about the reliability of financial reporting and safeguarding of assets. For example, consider whether:
   a. The accounting function is viewed as a necessary group of checks and balances, or as a vehicle for exercising control over the entity’s various activities.
   b. The selection of accounting principles used in financial statements always results in the highest reported income.
   c. Operating unit accounting personnel also have the responsibility to report to or communicate with central financial officers.
   d. Valuable assets, including intellectual assets and information, are protected from unauthorized access or use.

4. Frequency of interaction between senior management and operating management, particularly when operating from geographically removed locations. For example, consider whether:
   a. Senior managers frequently visit subsidiary or divisional operations.
   b. Group or divisional management meetings are held frequently.

5. Attitudes and actions toward financial reporting, including disputes over the application of accounting treatments (e.g., selection of conservative vs. liberal accounting policies; whether accounting principles have been
misapplied, important financial information not disclosed, or records manipulated or falsified). For example, consider whether:

a. Management avoids obsessive focus on short-term reported results.
b. Personnel do not submit inappropriate reports to meet targets.
c. Managers do not ignore signs of inappropriate practices.
d. Estimates do not stretch facts to the edge of reasonableness and beyond.

E. REVIEWING THE RISK MANAGEMENT FUNCTION

A review of the entity’s risk management function should be conducted through discussions with senior management and the board of directors and through gaining an understanding of the risk management function including inspection of relevant risk management documentation. As a general guideline, the following areas should be considered in conducting a review of the risk management function:

1. What kind of risk-management culture is demonstrated throughout the organization? What does the culture indicate regarding the importance of risk management to the organization?

2. How are risk tolerances and “appetites” defined and communicated throughout the organization?

3. How are existing risks identified, tracked, assessed and mitigated?

4. How are emerging and/or prospective risks identified, tracked, assessed and managed?

5. How does the organization use the risk information it gathers to determine its capital needs? Are internal models utilized and regularly updated to ensure appropriate risk-management decisions?

6. How are responsibilities for risk-management functions delegated and monitored within the organization?

7. What is the involvement of the board of directors in the risk management function of the organization?

An effective risk management function is essential in providing effective corporate governance over financial solvency. During the latter phases of the risk-focused examination, the examiner will document a review of the entity’s individual risk-management functions within the system. However, during a review of the entity’s corporate governance the examiner should document the review of the entity’s risk-management function as a whole, as well as its place and importance in the entity’s corporate governance structure.

F. DOCUMENTATION

The examination team should document its understanding and assessment of the entity’s governance, as well as its assessment on the related impact on the examination. This summary should include a description of any unique examination procedures, including special inquiries that are considered necessary to any significant risks identified as a result of the assessment.

The Risk Assessment Matrix, as the central documentation tool, should be utilized for the identification and assessment of risks. Documentation on the assessment of management is at the discretion of the examiner. For smaller, low-risk insurance companies, a memorandum may be sufficient documentation. For example, a memorandum could summarize the attributes and techniques supporting the examiner’s overall evaluation, any resulting examination scope implications and the approach used to validate the more significant attributes and techniques.
Excerpts from UCAA Manual – Biographical Affidavits
12. Public Records Package

Most states have requirements to disclose information to the public under a Public Records Act. To meet these public disclosure requirements certain items must accompany the application. While these documents may or may not be part of the substantive review, please be sure to include the required documents with the application. Please see the Public Records Package chart on the UCAA Web site for each state’s document list. The chart contains requirements for financial and operational filings. A company seeking to redomesticate should provide both financial and operational documents for the application state. An applicant that is seeking to form a new insurer should include all documents listed in the operational section of the chart for the application state. Submit all documents required by the application state as Item 12 of the application.

13. NAIC Biographical Affidavit (Biographical Affidavit)

A. The applicant is required to submit a Biographical Affidavit in connection with pending or future application(s) for licensure or a permit to organize with a department of insurance in one or more states. The applicant must submit a Biographical Affidavit on behalf of all officers, directors and key managerial personnel of the applicant and individuals with a ten percent (10%), or more, beneficial ownership in the applicant and the applicant’s ultimate controlling parent (Affiant).

B. The Biographical Affidavit requests information with respect to employment history, education, personal information and character. The Biographical Affidavit also includes the Disclosure and Authorization Concerning Background Reports. (Disclosure & Authorization Form). The Disclosure & Authorization Form permits an Independent Third Party (as defined in paragraph (i)) to conduct a background investigation on the Affiant.

C. The Biographical Affidavit includes three versions of the Disclosure & Authorization Form since certain state laws, regulations and rules require different kinds of disclosures and wording within such form. An Affiant must sign the corresponding Disclosure & Authorization Form(s) for the respective state(s) where the affiant has lived or worked within the last ten years. Refer to the Disclosure & Authorization Forms for additional information.

D. The Biographical Affidavit is used to evaluate the suitability of the Affiant in connection with an applicant’s pending or future application(s) for licensure or a permit to organize with a department of insurance in one or more states.

The Independent Third Party uses information contained in the Biographical Affidavit as a tool to perform a background investigation where certain items must be verified. The background investigation may contain information bearing on the Affiant’s character, general reputation, personal characteristics, mode of living and credit standing. The Independent Third Party shall use the background investigation to create a background report (Background Report).
E. The Disclosure & Authorization Form is valid for a maximum of one year and, in certain instances, only valid for one pending application. Additionally, an Affiant may revoke the authorization at any time by delivering a written revocation to the applicant. Refer to the Disclosure & Authorization Form for further information.

F. The Background Reports are subject to the Fair Credit Reporting Act (FCRA). Pursuant to FCRA, the state departments of insurance and an applicant who is seeking admission are “users” of consumer reports. The FCRA requires that the applicant provide the Affiant with a copy of the “Summary of your Rights Under the Fair Credit Reporting Act.” Applicants should provide a copy of the “Summary of your Rights under the Fair Credit Reporting Act” to each Affiant. This summary is located on the Federal Trade Commission (FTC) Web site at www.ftc.gov/os/2004/07/040709fcrappxf.pdf

Applicants and state departments of insurance are required to comply with FCRA, especially as it relates to information confidentiality contained in such consumer reports. To the extent required by law, the states and Third-Party Vendors should maintain the Background Reports procured under the Disclosure & Authorization Form as confidential. A copy of the FCRA is located at http://www.ftc.gov/os/statutes/031224fcra.pdf

G. Any state department of insurance where an applicant files, or intends to file an application, and the applicant, may receive the Background Report. An Affiant who desires a Background Report copy, may request a copy from the applicant or the Consumer Reporting Agency (CRA), as indicated on the Disclosure & Authorization Form. Refer to the Disclosure & Authorization Form for additional information.

H. Please check state-specific requirements in the chart referenced on the UCAA home page for those states requiring additional background information, such as fingerprints, in place of or in addition to, Biographical Affidavits. If applying in one of those states, include the necessary fingerprint cards and processing fees.

I. An Independent Third Party is defined as:
   (a) A consumer reporting agency (CRA) by the Federal Trade Commission (FTC) and therefore subject to the FCRA,
   (b) One that has the ability to perform international background investigations,
   (c) One whose officers and directors have no material affiliation with the applicant other than stock ownership amounting to less than 1% of total stock outstanding, unless prior approval is given by the department of insurance to which application is being made, and
   (d) One that is acceptable to such state(s) where an application is being made.

Refer to the UCAA Web site for a list of independent third-party vendors/CRAs.
Biographical Affidavits must be current and the affiant shall not sign the Affidavits more than one year before the application filing date.

Submit original Biographical Affidavits that contain the Disclosure & Authorization Form to the State Department(s) of Insurance as Item 13 of the application.

14. State-Specific Information

Some jurisdictions may have additional requirements met by applicants before the Certificate of Authority is issued. Before completing a UCAA Primary Application, the applicant should review the list of requirements for the application state. State-specific requirements are on the UCAA Web site. Submit state-specific requirements as Item 14 of the application.

Primary Application Section III
Filing Requirements – Redomestications Only

The requirements of this section are only for those insurers seeking to redomesticate from one state to another and are in addition to the requirements of Section II, items 1 through 14 of the Primary checklist. A redomestication is the process whereby any insurer organized under the laws of any state may become a domestic insurer that transfers its domicile to another state by merger or consolidation or any other lawful method. The applicant files the Primary Application with the insurer’s new state of domicile when used for a redomestication.

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1. Annual Statements with Attachments
2. Quarterly Financial Statements
3. Risk-Based Capital Report
4. Independent CPA Audit Report
5. Reports of Examination
6. Certificate of Compliance

1. Annual Statement with Attachments

Include a copy of the applicant’s most recent annual statement as filed in the current state of domicile including all statements and supplements in accordance with the Annual Statement Instructions, including the Statement of Actuarial Opinion and Management’s Discussion and Analysis. The annual statement should be signed and verified, and include an original certification from the state insurance regulatory agency of the applicant’s domiciliary state.

Include one copy of the applicant’s annual statement for the two (2) preceding years in addition to the most recent annual statement.

Property and casualty insurers must attach the Insurance Expense Exhibit, Accident and Health Policy Experience Exhibit and/or Schedule P to the annual statement.

Life insurers must include a Certificate of Valuation from the domiciliary state insurance regulatory agency.
**BIOGRAPHICAL AFFIDAVIT**

To the extent permitted by law, this affidavit will be kept confidential by the state insurance regulatory authority.

(Print or Type)

Full Name, Address and telephone number of the present or proposed entity under which this biographical statement is being required (Do Not Use Group Names).

________________________________________________________________________

In connection with the above-named entity, I herewith make representations and supply information about myself as hereinafter set forth. (Attach addendum or separate sheet if space hereon is insufficient to answer any question fully.) IF ANSWER IS “NO” OR “NONE,” SO STATE.

1. Affiant’s Full Name (Initials Not Acceptable). ____________________________________________________________________________

2. a. Are you a citizen of the United States?

   b. Are you a citizen of any other country, if so, what country? ____________________________________________________________________________

3. Affiant’s Occupation or Profession. ____________________________________________________________________________

4. Affiant’s business address. ____________________________________________________________________________

   Business telephone. ____________________________________________________________________________

5. Education and Training:

<table>
<thead>
<tr>
<th>College/ University</th>
<th>City/ State</th>
<th>Dates Attended (MM/YY)</th>
<th>Degree Obtained</th>
</tr>
</thead>
<tbody>
<tr>
<td>Graduate Studies:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Training:</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Note: If affiant attended a foreign school, please provide full address and telephone number of the college/university. If applicable, provide the foreign student Identification Number in the space provided in the Biographical Affidavit Supplemental Information.)
6. List of memberships in professional societies and associations.

<table>
<thead>
<tr>
<th>Name of Society/Association</th>
<th>Contact Name</th>
<th>Address of Society/Association</th>
<th>Telephone Number of Society/Association</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
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</tr>
</tbody>
</table>

7. Present or proposed position with the applicant entity. ______________________________________________
   ____________________________________________________________________________________________

8. List complete employment record for the past twenty (20) years, whether compensated or otherwise (up to and including present jobs, positions, partnerships, owner of an entity, administrator, manager, operator, directorates or officeships). Please list the most recent first. Attach additional pages if the space provided is insufficient. It is only necessary to provide telephone numbers and supervisory information for the past ten (10) years.

<table>
<thead>
<tr>
<th>Beginning/Ending Dates (MM/YY)</th>
<th>Employer’s Name</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
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<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

© 2011 National Association of Insurance Commissioners
Applicant Name (Company) ___________________ NAIC No.: _____________
FEIN: _____________

9. a. Have you ever been in a position which required a fidelity bond? _______ If any claims were made on the
bond, give details. _____________________________________________________________________
___________________________________________________________________________________

b. Have you ever been denied an individual or position schedule fidelity bond, or had a bond canceled or
revoked? If yes, give details. _____________________________________________________________________
___________________________________________________________________________________

10. List any professional, occupational and vocational licenses (including licenses to sell securities) issued by any
public or governmental licensing agency or regulatory authority or licensing authority that you presently hold or
have held in the past. For any non-insurance regulatory issuer, identify and provide the name, address and
telephone number of the licensing authority or regulatory body having jurisdiction over the license(s) issued.
If your professional license number is your Social Security Number (SSN) or embeds your SSN or any
sequence of more than five numbers that are reasonably identifiable as your SSN, then write SSN for that
portion of the professional license number that is represented by your SSN. (For example, “SSN”, “12-SSN-
345” or “1234-SSN” (last 6 digits)). Attach additional pages if the space provided is insufficient.

________________________________________________________________________________________
Organization/Issuer of License _________________________  Address ______________________________________
City ___________________ State/Province _______________  Country _________________  Postal Code __________
License Type ________________  License # ___________________  Date Issued (MM/YY)____________________
Date Expired (MM/YY) _______________  Reason for Termination ________________________________________
Non-insurance Regulatory Phone Number (if known) ____________________________________________________

________________________________________________________________________________________
Organization /Issuer of License ________________________  Address ______________________________________
City ___________________ State/Province _______________  Country ________________ Postal Code __________
License Type ________________ License # ___________________  Date Issued (MM/YY) ___________________
Date Expired (MM/YY) _______________  Reason for Termination ________________________________________
Non-insurance Regulatory Phone Number (if known) ____________________________________________________

11. In responding to the following, if the record has been sealed or expunged, and the affiant has personally verified
that the record was sealed or expunged, an affiant may respond “no” to the question. Have you ever:

a. Been refused an occupational, professional, or vocational license or permit by any regulatory authority, or
any public administrative, or governmental licensing agency? _____________________________________________________________________________
___________________________________________________________________________________

b. Had any occupational, professional, or vocational license or permit you hold or have held, been subject to
any judicial, administrative, regulatory, or disciplinary action? _____________________________________________________________________________
___________________________________________________________________________________

c. Been placed on probation or had a fine levied against you or your occupational, professional, or vocational
license or permit in any judicial, administrative, regulatory, or disciplinary action? _____________________________________________________________________________
___________________________________________________________________________________

d. Been charged with, or indicted for, any criminal offense(s) other than civil traffic offenses? _____________________________________________________________________________
___________________________________________________________________________________

e. Pled guilty, or nolo contendere, or been convicted of, any criminal offense(s) other than civil traffic
offenses? _____________________________________________________________________________
___________________________________________________________________________________

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f. Had adjudication of guilt withheld, had a sentence imposed or suspended, had pronouncement of a sentence suspended, or been pardoned, fined, or placed on probation, for any criminal offense(s) other than civil traffic offenses? ________________________________________________________________________

_____________________________________________________________________________________

g. Been subject to a cease and desist letter or order, or enjoined, either temporarily or permanently, in any judicial, administrative, regulatory, or disciplinary action, from violating any federal, state law or law of another country regulating the business of insurance, securities or banking, or from carrying out any particular practice or practices in the course of the business of insurance, securities or banking? ________________________________________________________________________

_____________________________________________________________________________________

h. Been, within the last ten (10) years, a party to any civil action involving dishonesty, breach of trust, or a financial dispute? ________________________________________________________________________

_____________________________________________________________________________________

i. Had a finding made by the Comptroller of any state or the Federal Government that you have violated any provisions of small loan laws, banking or trust company laws, or credit union laws, or that you have violated any rule or regulation lawfully made by the Comptroller of any state or the Federal Government? ________________________________________________________________________

_____________________________________________________________________________________

j. Had a lien or foreclosure action filed against you or any entity while you were associated with that entity? ________________________________________________________________________

_____________________________________________________________________________________

If the response to any question above is answered “Yes”, please provide details including dates, locations, disposition, etc. Attach a copy of the complaint and filed adjudication or settlement as appropriate. ________________________________________________________________________

_________________________________________________________________________________________

12. List any entity subject to regulation by an insurance regulatory authority that you control directly or indirectly. The term “control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person.__________________________________________________

_________________________________________________________________________________________

If any of the stock is pledged or hypothecated in any way, give details._________________________________

_________________________________________________________________________________________

13. Do [Will] you or members of your immediate family individually or cumulatively subscribe to or own, beneficially or of record, 10% or more of the outstanding shares of stock of any entity subject to regulation by an insurance regulatory authority, or its affiliates? An “affiliate” of, or person “affiliated” with, a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. If the answer is “Yes”, please identify the company or companies in which the cumulative stock holdings represent 10% or more of the outstanding voting securities. ________________________________________________________________________

_________________________________________________________________________________________

If any of the shares of stock are pledged or hypothecated in any way, give details. ________________________

_________________________________________________________________________________________

14. Have you ever been adjudged a bankrupt? ________  If yes, provide details. ___________________________

_________________________________________________________________________________________
15. To your knowledge has any company or entity for which you were an officer or director, trustee, investment committee member, key management employee or controlling stockholder, had any of the following events occur while you served in such capacity? If yes, please indicate and give details. When responding to questions (b) and (c) affiant should also include any events within twelve (12) months after his or her departure from the entity.

a. Been refused a permit, license, or certificate of authority by any regulatory authority, or Governmental-licensing agency?

b. Had its permit, license, or certificate of authority suspended, revoked, canceled, non-renewed, or subjected to any judicial, administrative, regulatory, or disciplinary action (including rehabilitation, liquidation, receivership, conservatorship, federal bankruptcy proceeding, state insolvency, supervision or any other similar proceeding)?

c. Been placed on probation or had a fine levied against it or against its permit, license, or certificate of authority in any civil, criminal, administrative, regulatory, or disciplinary action?

Note: If an affiant has any doubt about the accuracy of an answer, the question should be answered in the positive and an explanation provided.

Dated and signed this __________________ day of ______  20_____ at ______________________ I hereby certify under penalty of perjury that I am acting on my own behalf, and that the foregoing statements are true and correct to the best of my knowledge and belief.

_____________________________________________
(Signature of Affiant)

State of ___________________ County of ___________________

The foregoing instrument was acknowledged before me this ______day of ______, 20______ By __________________________, and:

☐ who is personally known to me, or

☐ who produced the following identification:_________________________________

[SEAL] Notary Public

Printed Notary Name

My Commission Expires
# Fingerprint and Biographical Affidavit Requirements

## “√” Updates to the State-Specific Information

<table>
<thead>
<tr>
<th>State</th>
<th>Requirements For Licensure</th>
<th>Requirements After Licensure (Non-Domestic)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>NAIC biographical affidavit and Third-Party Verification.</td>
<td>If requested a NAIC biographical affidavit is required for new officers, within 15 days of request.</td>
</tr>
<tr>
<td>Alaska</td>
<td>NAIC Biographical Affidavit and Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Arizona</td>
<td><strong>Primary:</strong> NAIC Biographical Affidavit and Fingerprint Cards. Affidavit must be originally executed. Contact the Financial Affairs Divisions at: (602) 364-3999 to request fingerprint cards and instructions. <strong>Expansion:</strong> NAIC Biographical Affidavit and Third-Party Verification.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Arkansas</td>
<td>NAIC Biographical Affidavit and Third-Party Verifications.</td>
<td>NAIC biographical affidavit is not required for new officers or a director, assuming the domestic state is reviewing changes.</td>
</tr>
<tr>
<td>California</td>
<td>Fingerprint and biographical affidavits, please contact California's Department of Insurance directly at (415) 538-4035 to request the necessary fingerprint cards and affidavit forms.</td>
<td>A state specific biographical affidavit is required for new officers or directors within a reasonable time. <a href="http://www.insurance.ca.gov">www.insurance.ca.gov</a></td>
</tr>
<tr>
<td>Colorado</td>
<td>NAIC Biographical Affidavit and fingerprint cards for all domestic companies per 10-3-112 C.R.S. NAIC Biographical Affidavits and Third Party Verification reports for all foreign companies.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>State</td>
<td>Requirements For Licensure</td>
<td>Requirements After Licensure (Non-Domestic)</td>
</tr>
<tr>
<td>-----------------------</td>
<td>-------------------------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Connecticut</td>
<td>The State of Connecticut requires the NAIC Biographical Affidavits and as of 10/01/07 will require third-party background investigations.</td>
<td>A NAIC biographical affidavit is required for new officers/directors as soon as possible.</td>
</tr>
<tr>
<td>Delaware</td>
<td>NAIC Biographical Affidavit and Third-Party Verification for Delaware domestic companies.</td>
<td>A NAIC biographical affidavit is required for new officers or directors listed on the NAIC Jurat page of the annual statement within a reasonable time frame.</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Florida</td>
<td>NAIC Biographical Affidavit, Third-Party Verification and Fingerprint Cards. Please contact the Office of Insurance Regulation at (850) 413-2575 to request the necessary fingerprint cards or <a href="mailto:appcoord@fldfs.com">appcoord@fldfs.com</a> Effective August 16, 2007, Florida no longer requires credit reports with the background investigations.</td>
<td>A NAIC biographical affidavit is required for new key officers.</td>
</tr>
<tr>
<td>Georgia</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>Hawaii</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification Sally D. Bautista — Phone #: (808) 586-7414</td>
<td>NAIC biographical affidavit is required for new officers when filing for Mergers and Acquisitions only.</td>
</tr>
<tr>
<td>Idaho</td>
<td>NAIC Biographical Affidavit and Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Illinois</td>
<td>NAIC Biographical Affidavit</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>Indiana</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>A NAIC biographical affidavit and Third-Party Verification report is not required for new officers or directors. Notification of a change in officers or directors is required within 30 days.</td>
</tr>
<tr>
<td>Iowa</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Kansas</td>
<td>NAIC Biographical Affidavit certified by an Independent Third-Party.</td>
<td>NAIC biographical affidavit is required for new President or Secretary.</td>
</tr>
<tr>
<td>Kentucky</td>
<td>NAIC Biographical Affidavit and Third-Party Verifications</td>
<td>NAIC biographical affidavit is required for new President’s only, within 30 days.</td>
</tr>
<tr>
<td>Louisiana</td>
<td>NAIC Biographical Affidavits, Investigative Reports and Fingerprint Cards.</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>State</td>
<td>Requirements For Licensure</td>
<td>Requirements After Licensure (Non-Domestic)</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Maine</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Maryland</td>
<td>NAIC Biographical Affidavit certified by Independent Third-Party Verification.</td>
<td>NAIC biographical affidavit is required for new officers or directors.</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Michigan</td>
<td><strong>Primary:</strong> NAIC Biographical Affidavit and fingerprint cards. Please contact the Office</td>
<td>NAIC biographical affidavit is not required for new officers.</td>
</tr>
<tr>
<td></td>
<td>of Financial and Insurance Regulation - at (517) 335-2062 to request the necessary fingerprint cards.</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Expansion:</strong> The State of Michigan requires NAIC Biographical Affidavits and Third-Party Verifications.</td>
<td></td>
</tr>
<tr>
<td>Minnesota</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verifications.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Mississippi</td>
<td>NAIC Biographical Affidavit</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>Missouri</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>Montana</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Nebraska</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Nevada</td>
<td>NAIC Biographical Affidavit</td>
<td>A letter is required indicating new officers within 90 days.</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>New Jersey</td>
<td><strong>Primary:</strong> New Jersey has a state specific biographical affidavit form and will require</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td></td>
<td>a criminal history record check by the New Jersey State Police. The biographical affidavit form</td>
<td></td>
</tr>
<tr>
<td></td>
<td>is available on the Department’s web site. However, the criminal history record check is a</td>
<td></td>
</tr>
<tr>
<td></td>
<td>yellow form from the State Police and must be supplied by the New Jersey</td>
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</tr>
<tr>
<td>State</td>
<td>Requirements For Licensure</td>
<td>Requirements After Licensure (Non-Domestic)</td>
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<tr>
<td>--------------</td>
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<td>--------------------------------------------</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Department of Banking and Insurance.&lt;br&gt;&lt;strong&gt;Expansion:&lt;/strong&gt; NAIC Biographical Affidavit</td>
<td></td>
</tr>
<tr>
<td>New Mexico</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification</td>
<td>NAIC biographical affidavit is required for new officers, as soon as possible.</td>
</tr>
<tr>
<td>New York</td>
<td>NAIC Biographical Affidavit and Fingerprint Cards</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>North Carolina</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>North Dakota</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Ohio</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td>Biographical affidavit for all officers and directors of the company as listed on the jurat page of the filed statement.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>Pennsylvania requests verification of primary application biographical affidavits, we do not require third-party party verification of foreign applicants.</td>
<td>Contact state for requirements.</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Rhode Island will no longer require the Independent Third-Party Verifications. Rhode Island will only require the NAIC Biographical Affidavit.</td>
<td>NAIC biographical affidavit is required for new officers and directors within a reasonable time frame.</td>
</tr>
<tr>
<td>South Carolina</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>South Dakota</td>
<td>&lt;strong&gt;DO NOT SUBMIT&lt;/strong&gt; Biographical Affidavits or employee organizational charts for foreign insurance companies. They are not required of foreign companies at any time.</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Tennessee</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit, with original signatures and notarization is required within 90 days for new officers or directors.</td>
</tr>
<tr>
<td>State</td>
<td>Requirements For Licensure</td>
<td>Requirements After Licensure (Non-Domestic)</td>
</tr>
<tr>
<td>------------------</td>
<td>--------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>Texas (cont)</td>
<td>Submit biographical information pursuant to UCAA instructions and requirements. Submit fingerprint cards for each biographical affidavit that is submitted with the application. For fingerprint card information, please see <a href="http://www.tdi.state.tx.us/bulletins/2006/cc26.html">http://www.tdi.state.tx.us/bulletins/2006/cc26.html</a>. Texas strongly recommends submitting digital fingerprint cards, as the cards are accurate and processing time is much faster. Ink print cards require longer processing times and are very susceptible to inaccuracies that may require multiple submissions.</td>
<td>NAIC biographical affidavit and fingerprint card are required for new key officers within 30 days.</td>
</tr>
<tr>
<td>Utah</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>A letter is required listing changes for removals if removed for a cause.</td>
</tr>
<tr>
<td>Vermont</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Virginia</td>
<td>NAIC Biographical Affidavit and Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Washington</td>
<td>NAIC Biographical Affidavit and Third-Party Verification</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>West Virginia</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit is not required for new officers or directors.</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>NAIC Biographical Affidavit</td>
<td>NAIC biographical affidavit is not required for new officers, please notify changes in writing.</td>
</tr>
<tr>
<td>Wyoming</td>
<td>NAIC Biographical Affidavit and Independent Third-Party Verification.</td>
<td>NAIC biographical affidavit is required for new president, only within 90 days.</td>
</tr>
</tbody>
</table>
White Paper – Exposure Draft
Introduction

The Corporate Governance Working Group (CGWG) within the Solvency Modernization Initiative Task Force has been charged with, *inter alia*, drafting high-level corporate governance principles for use in U.S. insurance regulation. In furtherance of this charge, and based on recommendations from interested parties, the CGWG produced summaries of existing state corporate governance law, including case law (*see* Exhibit A), and international corporate governance principles and standards in place in Australia, Canada, Switzerland, and the U.K. (*see* Exhibit B). The CGWG also received a Code of Conduct from the Bermuda Monetary Services Authority (*see* Exhibit C).

On January 24, 2011, the CGWG exposed its state and international corporate governance summaries along with Bermuda’s Code of Conduct for public comment on the following issues:

- Which principles and standards from the summaries should be considered for use in U.S. insurance regulation;
- Which principles and standards adopted or under development by other jurisdictions should be considered for use in U.S. insurance regulation; and
- What general considerations should U.S. insurance regulators take into account in developing corporate governance standards?

The CGWG asked that, in developing comments, interested parties be cognizant of the relevant insurance core principles, standards, and guidance under development by the International Association of Insurance Supervisors (IAIS) because such principles will form the basis for the
Financial Sector Assessment Program (FSAP) and may provide a means for other countries to assess U.S. equivalence. The most recent versions of the relevant IAIS principles – ICP 5 on Suitability, ICP 7 on Corporate Governance, and ICP 8 on Risk Management and Internal Control Systems – are attached as Exhibit D. The CGWG also asked that comments address how U.S. insurance regulators may achieve substantial compliance with the IAIS insurance core principles without placing an overly excessive burden on the insurance industry. Comments were received from the American Council of Life Insurers, America’s Health Insurance Plans, the BlueCross BlueShield Association, Motil Consulting, Inc., the National Association of Mutual Insurance Companies, and the Reinsurance Association of America. See Exhibit E.

This paper is organized into corporate governance principles (stated in bold type and numbered as 1, 2, 3, etc.) and corresponding guidance (set below the principles as 2.1, 2.2, etc.). Principles are essential, high-level requirements necessary for an insurer to provide minimum levels of consumer protection and capital adequacy. Guidance supports the principle it follows and provides detail regarding what may be expected from or how an insurer can comply with a specific principle.

In developing the principles and guidance in this paper, the CGWG was mindful of the recent corporate governance and risk management recommendations provided by the IMF in the FSAP Financial System Stability Assessment and Insurance Detailed Assessment Report. See Exhibit F. The principles and guidance will be utilized by the CGWG as it fulfills its next charge in determining what changes may be required to the U.S. insurance regulatory structure in order to evaluate adherence with such principles. Although some of the principles in this paper reflect existing legal or regulatory requirements, this paper is not intended on its own to impose any binding legal or regulatory obligations.
**Principle of Proportionality**

Individual insurers operate under varying risk profiles depending on the nature, scale, and complexity of their business. In order to conduct business in a sound and prudent manner for the benefit of policyholders and other stakeholders, an insurer with a higher risk profile (e.g. an international commercial insurer with high premium volume) requires a more comprehensive corporate governance framework than an insurer with a lesser risk profile (e.g. a small county mutual). Accordingly, the principles should be applied and measured in a proportionate manner relative to the nature, scale, and complexity of an insurer.

The nature, scale and complexity of an insurer should be considered individually and collectively in reaching these determinations. For example, an insurer who is relatively small but who offers multiple, complex products should implement an appropriately robust risk management function to manage those products. In determining whether and to what extent the principles must be satisfied, insurers and Commissioners should also take account of whether an insurer is subject to the premium threshold included in Section 16 of the NAIC’s Annual Financial Reporting Model Regulation (#205).

**Corporate Governance**

1. **Insurers must establish and maintain a sound corporate governance framework that adequately recognizes and protects the interests of policyholders.**

   1.1 Corporate Governance is a framework of systems, policies and procedures through which an insurer effectively and efficiently: provides for sound and prudent management and oversight of the insurer’s business; creates security and long-term value for policyholders, beneficiaries, and other stakeholders; exercises its corporate authority; and holds its Board members, Senior Management, and Key Persons in Control Functions accountable. It is also the framework through which an insurer seeks to
comply with the laws and regulations governing its relationship with each of its stakeholders.

1.2 Corporate governance includes an insurer’s certificate of incorporation, bylaws, corporate discipline and ethics, accountability, responsibility, compliance, and oversight.

**Board of Directors**

2. **The ultimate responsibility for the effective governance of an insurer rests with its Board.**

2.1 The Board is responsible for ensuring that appropriate corporate governance systems, policies, and procedures are implemented and applied in a sound and prudent manner and for approving and overseeing the implementation of an insurer’s business objectives and strategies. Delegation of authority by the Board to its committees, Senior Management, Key Persons in Control Functions, or external parties does not absolve the Board from its responsibilities in these regards.

2.2 The Board should have appropriate systems, policies, and procedures for its own internal governance to assure that the Board’s decisions objectively fulfill its duties of loyalty and care and that the Board remains accountable to policyholders, beneficiaries, and other stakeholders. The Board should at least annually review and assess the effectiveness and adequacy of its systems, policies, and procedures.

3. **The Board must be composed of a sufficient number of members who are independent, participate actively, and collectively have an adequate level of knowledge, skills and expertise. The Board must have the power and resources necessary to properly fulfill its governance and oversight responsibilities.**
3.1 The Board should be composed of a sufficient number of members with relevant experience to ensure that it can act independently of management and properly perform its oversight responsibilities through thoughtful and diligent decision-making. The Board should collectively be composed of members with the experience and competence necessary to fulfill its roles and responsibilities.

3.2 The Board should establish clear and objective criteria defining independence. These criteria should define independence in terms of relationships that may compromise an individual director’s independence and in terms of the Board membership as a whole.

3.3 There should be a formal, documented process for nomination, selection, and removal of Board members.

3.4 Committees of the Board should have clearly defined mandates and the authority and independence necessary to carry out their respective functions.

4. **Individual members of the Board must comply with the duties of loyalty, care, and candor, acting in good faith to advance the best interests of the insurer and its policyholders or beneficiaries.**

4.1 The duty of loyalty generally requires a Board member to sublimate any personal interest that is not in best interest of the insurer, its shareholders, and its policyholders or beneficiaries. A member of the Board is placed in a position of trust and confidence and should not use her position to further private interests. Board members should exert all reasonable and lawful efforts to ensure that the insurer is not deprived of any advantage to which it is entitled.

4.2 The duty of care generally requires a Board member to discharge her roles and responsibilities in a manner as would be expected of a reasonably careful and prudent person in a similar position. A Board member should act on a fully informed basis,
considering all material information reasonably available in making business decisions and continually seek and acquire information as necessary.

4.3 The duty of candor generally requires Board members to convey to those charged with making a decision or taking an action for or on behalf of an insurer all information material to that decision. Information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in light of the total mix of information available.

5. The Board must clearly define its roles and responsibilities and the roles and responsibilities of Senior Management and Key Persons in Control Functions. The Board must also properly oversee Senior Management’s execution of its duties.

5.1 The Board is responsible for approving an insurer’s business objectives and strategies and for overseeing the overall strategy and direction of an insurer, including its proper overall management, while day-to-day management of an insurer is the responsibility of Senior Management and other key executives. The Board should ensure that an insurer’s governance structure provides for the effective separation of oversight and management functions.

5.2 Specific oversight responsibilities of the Board, or a committee thereof, include the following:

5.2.1 Code of Conduct/Ethics – The Board is responsible for establishing the “tone at the top” of the insurer and should be actively involved in establishing and enforcing a code of conduct that sets the insurer’s fundamental corporate values.

5.2.2 Strategic Planning and Risk Management – The Board should approve the strategic business plan governing the insurer as well as the insurer’s corporate mission and
provide oversight in respect of the design and implementation of sound risk management and internal control systems and functions.

5.2.3 Oversight of Senior Management – The Board should ensure there are adequate policies and procedures in place regarding the hiring, dismissal, and orderly succession of Senior Management; monitor whether Senior Management is managing the insurer in accordance with any strategies and policies set or approved by the Board; and regularly meet with Senior Management to discuss and critically review Senior Management’s operation of the insurer.

5.2.4 Control Functions – The Board should provide oversight to the insurer’s control functions by receiving and reviewing reports from those functions on a regular basis. In addition, the Board should interact with Senior Management to resolve questions and collect any additional information regarding the control functions it deems necessary.

5.2.5 Director Education and Performance Evaluation – Board members should complete an orientation program describing the obligations and responsibilities of Board members and receive continuing education on significant industry developments and risks on a regular basis. To ensure that a Board is properly fulfilling its responsibilities, there should be a formal process to review the performance and effectiveness of the overall Board as well as individual members.

5.2.6 Succession planning – To ensure that qualified Board members and Senior Management are available to govern the insurer on an ongoing basis, a succession plan should be in place enabling an orderly transition of qualified individuals when vacancies occur.
6. **Insurers must implement a remuneration policy which does not induce excessive or inappropriate risk taking.**

6.1 An insurer’s remuneration policy should be in line with the identified risk appetites and long term interests of the insurer and have proper regard to the interests of its stakeholders. The remuneration policy should, at a minimum, cover those individuals who are members of the Board, Senior Management, Key Persons in Control Functions, and other employees whose actions may have a material impact on the risk exposure of the insurer.

6.2 Appropriate consideration should be given to the relevant elements of the remuneration policy and structure, such as:

6.2.1 Components of the overall remuneration policy, particularly the use and balance of fixed and variable components and the provision of other benefits;

6.2.2 Performance criteria and their application for the purposes of determining remuneration payments;

6.2.3 The individual remuneration of the members of the Board and Senior Management, and the structure of remuneration of other employees whose actions may have a material impact on the risk exposure of the insurer;

6.2.4 Reports or disclosures on the insurer’s remuneration practices provided to the Commissioner or the public; and

6.2.5 Potential conflicts of interest that may exist in the development and implementation of a remuneration policy and structure.

6.3 Where an insurer includes variable remuneration as part of a remuneration package, it should be structured in a manner that does not create incentives for inappropriate risk taking and is properly aligned with the time horizon of risks. In addition, when variable
remuneration includes share-based components, appropriate safeguards should be implemented to align incentives and the longer-term interest of the insurer.

6.4 Where an insurer provides discretionary severance payments as part of a remuneration package, it should subject such payments to appropriate governance controls and limits.

**Senior Management**

7. **Senior Management must effectively carry out the day-to-day operations of an insurer in accordance with the insurer’s strategies, policies, and procedures and provide the Board with adequate and timely information to enable it to carry out its duties and functions.**

7.1 Senior Management is responsible for managing and executing the day-to-day operations of the insurer, subject to all applicable laws and regulations and in accordance with the business objectives, strategies, risk appetites, and internal policies of the insurer.

7.2 Senior Management should provide recommendations on strategic plans, objectives, and key policies and procedures to the Board for its evaluation and approval. Senior Management should assist the Board with its oversight responsibilities by ensuring that the Board has accurate and timely information, allowing the Board to conduct robust and candid discussions on operational performance, strategy, and major policies, and to appraise the performance of management.

7.3 Senior Management should ensure that key functions performing corporate governance responsibilities are supported with adequate resources to execute and discharge their duties.

7.4 Senior management should also assume responsibility in establishing the “tone at the top” of the insurer regarding the importance of ethical conduct throughout the
organization. Senior Management should be held accountable to meet ethical standards by signing and agreeing to a formal code of conduct that has been approved by the Board.

**Suitability of Individuals**

8. **Board members, Senior Management, and Key Persons in Control Functions must have and retain the competence and integrity necessary to fulfill their respective roles.**

8.1 Members of the Board, Senior Management and Key Persons in Control Functions should possess the appropriate professional qualifications, knowledge and experience necessary to enable the individual to perform the duties required of her position.

8.2 Competence relates to an individual’s professional or formal qualifications and knowledge or relevant experience within the insurance and financial industries or other related businesses.

8.3 Competence of the Board should also include an appropriate diversity of qualities and variety of skills in order to promote the effective functioning of the Board as a whole. Competence for Board members also includes having the appropriate level of commitment to perform a role, including a commitment to prepare for and attend all corporate, board, or committee meetings, to stay informed about issues relevant to the company, to consult with management as needed, and to respond to emergencies as required.

8.4 Integrity may be demonstrated through both personal behavior and business conduct. Personal behavior may be assessed by examining criminal indicators (such as conviction of an offense involving dishonesty, misappropriation of assets, embezzlement, or fraud), financial indicators (such as improper conduct in financial accounting or bankruptcy or insolvency proceedings), and regulatory indicators (such as regulatory action taken
against the individual for withholding information from public authorities or market
count transgressions).

8.5 The presence of any one indicator may, but need not in and of itself, be indicative of a
person’s suitability.

9. A Significant Owner should have the integrity to fulfill her role and the financial
soundness to obtain her status.

9.1 An owner’s financial soundness is based upon an ability to support the insurer in
meeting all of its applicable financial solvency requirements. Integrity may be
demonstrated through both personal behavior and business conduct.

10. Insurers must demonstrate initially and thereafter, when requested by the
Commissioner, the suitability of Board members, Senior Management, Key Persons in
Control Functions, and Significant Owners. Insurers should notify the Commissioner
of any changes in Board members, Senior Management, Key persons in Control
Functions and Significant Owners on a timely basis.

10.1 The suitability assessment of Board members, Senior Management, Key Persons in
Control Functions and Significant Owners of an insurer should be conducted as part of
the licensing procedure before an insurer is permitted to operate. Where an insurer is
already licensed, the insurer should demonstrate to the Commissioner when requested
the suitability of Board members, Senior Management, Key Persons in Control
Functions, and Significant Owners.

10.2 An insurer should make available to the Commissioner the structures, policies, and
procedures it has adopted to ensure the suitability of Board members, Senior
Management, Key Persons in Control Functions, and Significant Owners.
10.3 The information to be made available and the Commissioner’s assessment of such information may differ depending on the position of the person being assessed in relation to the interests to be safeguarded. At a minimum, a résumé indicating the professional qualifications as well as previous and current positions and experience of the individual should be made available along with any other information deemed necessary to assist in the assessment.

10.4 Insurers should notify the Commissioner in a timely manner of any circumstances that may materially adversely affect the suitability of its Board members, Senior Management, Key Persons in Control Functions and Significant Owners.

**Reporting and Transparency**

11. Insurers must maintain a reliable financial reporting process supported by clearly defined roles and responsibilities of the Board and Senior Management.

11.1 An insurer must have adequate systems and controls to ensure that its financial reports present a balanced and accurate assessment of the insurer’s business and general financial health and viability as a going concern.

11.2 The insurer may appoint an Audit Committee of the Board to provide oversight to the financial reporting process. Where a separate Audit Committee is not practical, the Board, as a whole, is responsible for this function.

12. Insurers must regularly share material information on its governance processes with the Commissioner and relevant stakeholders.

12.1 Information that may be appropriate for communication on at least an annual basis to the Commissioner and relevant stakeholders includes:
12.1.1 the insurer’s overall strategic objectives, covering existing or prospective lines of business and how they are being or will be achieved;

12.1.2 the insurer’s governance structures, including the allocation of responsibilities between the Board and Senior Management, as well as information on the organizational structure and reporting lines;

12.1.3 background information on members of the Board and its committees, including their respective expertise, qualifications, track-record, other positions held by such members, and whether such members are regarded as independent;

12.1.4 the general design, implementation and operation of the insurer’s remuneration policy; and

12.1.5 major ownership and group structures, and any significant affiliations and alliances.

12.2 Information submitted to the Commissioner regarding the insurer’s corporate governance as well as the operations of the insurer’s corporate governance function should be subject to review and assessment during the financial condition examination or analysis.

Risk Management and Internal Controls Systems

13. Insurers must implement and operate within effective risk management and internal controls systems as part of an overall governance framework.

13.1 An insurer’s risk management system should be designed to identify, assess, monitor, manage and report on reasonably foreseeable material risks. The risk management system should take into account the probability, potential impact, and time duration of risks. It should also take into account the insurer’s overall business strategy, objectives, and risk appetite, contain appropriate processes and tools for identifying, assessing,
monitoring, managing, and reporting on risks, and define the limits on the risks that the insurer accepts or retains to ensure that it is able to continue to operate following an extreme loss event.

13.2 The risk management system should take into account relevant current and emerging local or business specific risks, as well as enterprise-wide risks, and be embedded in the organizational structure and strategic oversight process of the insurer.

13.3 The risk management system should develop policies and procedures to manage, mitigate, and report on risks that are clearly articulated, transparent, and communicated throughout the insurer. Policies and procedures should describe the links between an insurer’s risk appetite, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk.

13.4 An insurer should have an adequate and effective internal controls system that is designed and operates to provide reasonable assurances over the insurer’s key policies and procedures and relevant risk management and compliance measures.

13.5 The insurer should regularly review the risk management and internal controls systems to help ensure that necessary modifications and improvements are identified and performed in a timely manner.

Control Functions

14. Insurers must implement and maintain effective control functions with the necessary authority, independence, and resources to achieve their objectives.

14.1 Control functions add to the governance checks-and-balances of an insurer and are a source of support for the Board in the fulfillment of its duties.

14.2 A control function should be led by a person of appropriate seniority and expertise. While Senior Management has primary responsibility for executing internal controls,
having Key Persons in Control Functions is essential to provide expertise, leadership, objectivity and independence.

14.3 Insurers should position each control function and its associated reporting lines into the insurer’s organizational structure in a manner that enables such function to operate and carry out its responsibilities effectively.

15. **Insurers must implement and maintain a risk management function capable of properly identifying, assessing, monitoring, managing, and reporting on the risks it faces.**

15.1 The risk management function should be sufficiently independent and avoid conflicts of interest with other management functions. Day-to-day management and oversight of the risk management function should be provided by Senior Management.

15.2 The risk management function should establish its own risk tolerances through the adoption of a formal risk tolerance statement. The statement should set out the insurer’s overall quantitative and qualitative tolerance levels and define tolerance limits for each relevant and material category of risk, taking into account the relationships between risk categories. The insurer should embed the risk tolerances into its ongoing risk management efforts to assist in making appropriate risk management decisions.

15.3 The risk management function should include provisions for the quantification of risk for a sufficiently wide range of outcomes and be responsive to change using appropriate techniques. Its measurement of risk should be supported by accurate documentation providing appropriately detailed descriptions and explanations of risks.

15.4 The risk management function should allow the insurer to gain and maintain an aggregated view of its risk profile at a solo and group level. Risks that should be considered and documented within a risk management function include underwriting
risks, market risks, credit risks, operational risks, liquidity risks, legal risks, counterparty risks, reputational risks, reserving risks, and business contagion risks.

15.5 The risk management function should be utilized by the insurer to determine the level of internal economic capital that should be held for solvency purposes. The quantification of risks as well as the scenario analysis and stress testing performed should be utilized by the insurer in making these decisions.

15.6 The risk management function should require that strategic decisions be made consistent with established risk management policies and tolerances after giving due consideration to the risks quantified and the amount of capital maintained for risk management purposes. Individuals responsible for strategic decisions should be subject to the oversight of and held accountable by the Board.

15.7 Information regarding the risk management function of an insurer and its economic capital needs should be shared with the Commissioner on a regular basis through the filing of an Own Risk and Solvency Assessment (ORSA) and be subject to review and assessment during the financial condition examination process.

16. Insurers must implement and maintain an effective compliance function capable of assisting the insurer in meeting its legal and regulatory obligations.

16.1 The compliance function should establish, implement, and maintain appropriate mechanisms and activities to promote and sustain a corporate culture of compliance and integrity within the insurer. The function should identify, assess, report on, and address all key legal and regulatory obligations.

16.2 The head of the compliance function should have the authority and obligation to promptly inform the Board directly in the event of: (1) any major non-compliance by a
member of management; or (2) a material non-compliance by the insurer with an external obligation.

17. Insurers must implement and maintain an effective actuarial function capable of evaluating and providing advice to the insurer regarding reserves, premium and pricing activities, and compliance with relevant statutory and regulatory requirements.

17.1 The actuarial function should have access to and periodically report to the Board on the performance of its duties, and have the authority and obligation to promptly inform the Board of any circumstance that may have a material adverse effect on the insurer from an actuarial perspective.

17.2 The Appointed Actuary should not hold positions within or outside of the insurer that may create conflicts of interest or endanger her independence. If any such conflicts exist, the Board should subject them to appropriate controls.

17.3 If the Appointed Actuary resigns or is removed by an insurer, the insurer should provide notification to the Commissioner which includes the reasons why the Appointed Actuary resigned or was replaced.

18. Insurers must implement and maintain an effective internal audit function capable of providing the Board independent assurance in respect of the insurer’s governance, risk management, and internal controls.

18.1 The internal audit function should provide independent assurance to the Board through general and specific audits, reviews, testing and other techniques in respect of matters such as asset protection, financial reporting, IT systems and the overall effectiveness of internal controls.
18.2 To help ensure independence and objectivity, the internal audit function should be free from conditions that threaten its ability to carry out its responsibilities in an unbiased manner. For example, the head of the internal audit function should have direct and unrestricted access to Senior Management and the Board and those performing the internal audit function should not be involved operationally in the insurer’s business units. Threats to the independence of the internal audit function should be managed at the individual auditor, engagement, functional, and organizational levels.

18.3 The internal audit function’s ultimate responsibility should be to the Board, not Senior Management. The internal audit function should report regularly to the Board.

19. Material functions or activities that are outsourced must be subject to the same level of oversight and accountability as if those functions or activities were performed internally.

19.1 When an insurer outsources functions either externally to third parties or internally to other affiliated entities, it should have oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the insurer’s own standards on corporate governance and internal controls. The insurer should also ensure that the service agreement includes terms on compliance with jurisdictional laws and regulations, cooperation with regulators, and access to data and records in a timely manner.

19.2 Before an insurer enters into material service contracts, the Board should ensure there is an appropriate assessment of the risks of such outsourcing, ensure such outsourcing is subject to appropriate controls, and approve of the outsourcing agreement. Ongoing outsourcing arrangements should be subject to periodic reviews, with reports thereon to be made available to management and the Board.
Regulatory Oversight

20. The Commissioner may require an insurer to demonstrate the adequacy and effectiveness of its corporate governance framework and has the power to require an insurer to remedy any identified deficiencies.

20.1 An insurer bears the burden of demonstrating, to the satisfaction of the Commissioner, that its corporate governance framework is adequate and effective.

20.2 The Commissioner should assess whether an insurer’s overall corporate governance framework is effectively implemented and remains adequate by undertaking periodic on-site inspections and other reviews as appropriate to the nature, scale and complexity of an insurer’s business and its risk profile. Where significant changes in an insurer’s corporate governance framework are identified, including through information provided by the insurer, the Commissioner should update its assessment.

20.3 The Commissioner should have the power to impose various measures of a preventive and corrective nature in respect of an insurer whose corporate governance framework is inadequate or ineffective.

Definitions

“Commissioner” means the chief insurance regulatory official of a State, or the Commissioner’s representatives. Other commonly used titles for this position include superintendent, director and administrator.

“Control Functions” means those functions serving a risk, control, or governance checks-and-balances role, such as the risk management, compliance, internal audit, and actuarial functions.
“Key Persons in Control Functions” means decision making individuals in control functions such as the heads of the risk management, compliance, internal audit and actuarial functions, as well as the appointed actuary if such person is not the head of the actuarial function.

“Senior Management” means the body responsible for executing decisions made by the Board and for managing the insurer on a day-to-day basis.
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NAMIC Comments on White Paper Exposure
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 out 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


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 onto American insurance regulatory law. The "greater developed ... 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

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."\(^8\)

- "If 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 ... furnish to the insurance company a written list of the director's requirements to abate his determination, and ... if 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 ... is 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.
• "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." 

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 N AIC 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

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

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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" 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." 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." 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."

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
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 ... N AIC 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
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 Codes 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."

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." 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."  
- "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." 
- "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." 
- "Assessing the adequacy of the audit function. ... The following guidelines direct the assessment of insurer audit activities." 
- "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."

32 Id. at 9.
33 Id. at 11.
35 Id. at 5.
36 Id. at 126.
37 Id. at 130.
38 Id. at 133.
• "Revisions to Model Audit Rule. ... R evisions involve three main topics.  A uditor independence. Corporate governance. Internal control over financial reporting."\textsuperscript{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."\textsuperscript{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-Grounded 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 year\textsuperscript{41} 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,

\textsuperscript{39} NAIC presentation on Corporate Governance, supra note 28, at slide 15.

\textsuperscript{40} Id. at slides 17-19.

\textsuperscript{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_isfftf_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., "by 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

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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 Becht 288.

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


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


\textsuperscript{52} http://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 aggressive 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
Interested Party Comments on White Paper Exposure
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
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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 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 ICs, 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