NAIC National Association of Insurance Commissioners

Existing U.S. Corporate Governance Requirements

Introduction

The NAIC's Corporate Governance (EX) Working Group (CGWG) within the Solvency Modernization Initiative (EX) Task Force has been charged with, *inter alia*, outlining high-level corporate governance principles for use in U.S. insurance regulation and developing regulatory guidance, including detailed best practices, for the corporate governance of insurers. In furtherance of these charges, and after extended consultation with interested parties, the CGWG agreed to review recent insurance regulatory reforms in the corporate governance area and to compile a summary of existing corporate governance requirements found within NAIC/insurance-specific sources and non-NAIC/insurance-specific sources.

This paper identifies existing corporate governance requirements, standards and regulatory monitoring practices that are applied to insurance entities in the United States within the structure of *The United States Insurance Financial Solvency Framework* (Framework), which was adopted by the NAIC in 2010. The starting point for the Framework is the U.S. regulatory mission, which is to protect policyholders/claimants/beneficiaries first and foremost, while also facilitating an effective and efficient marketplace for insurance products. Regulatory monitoring of corporate governance practices of insurers assists regulators in meeting both aspects of this mission.

The U.S. insurance regulatory system is unique in the world in that: 1) it relies on an extensive system of peer review, communication and collaborative effort that produce checks and balances in regulatory oversight; and 2) it includes a diversity of perspectives, with compromise that leads to centrist solutions. These, in combination with a risk-focused approach to regulation, form the foundation for insurance regulation. Financial solvency core principles underlie the active regulation that exists today. A core principle, for purposes of the Framework, is an approach, a process or an action that is fundamentally and directly associated with achieving the mission. These principles have been utilized to illustrate the corporate governance requirements, standards and regulatory monitoring practices that are currently in place within the U.S. insurance regulatory system.

In reviewing this paper, one should take into account that the U.S. corporate governance framework follows an exception-based model. Because the Framework includes conservatism in accounting, regulatory approval of significant transactions, restrictions on investments and ongoing monitoring of financial indicators of concern, the need for prescriptive corporate governance requirements is limited. Therefore, the U.S. model focuses on establishing expected outcomes and monitors an insurer's performance in meeting those expectations. If expectations are not met, regulators choose from a wide range of tools in determining the most effective way to encourage and/or require exceptions to those expectations to be corrected. This allows the U.S. system to ensure the effective governance of insurance entities without creating extensive, prescriptive requirements for the governance of insurers.

Principle 1: Regulatory Reporting, Disclosure and Transparency

Insurers are required to file standardized annual and quarterly financial reports that are used to assess the insurer's risk and financial condition. These reports contain both qualitative and quantitative information and are updated, as necessary, to incorporate significant common insurer risks.

A. Annual Statement Reporting

Extensive quarterly and annual financial reporting is required under U.S. insurance regulation through a transparent process that provides information to the public and to the regulator based upon applicability. Guidance for insurers in meeting financial reporting requirements is published by the NAIC in its *Annual Statement Instructions*. All statements require officer certification as to accuracy, and the financial statements and footnotes are required to be audited by independent certified public accountants (CPAs). Disclosures are required to be included in the annual statements regarding whether the board and management are maintaining the appropriate code-of-conduct standards and properly managing conflicts of interest. Other disclosures (general interrogatories) that are of a corporate governance nature include information about the holding company system and intercompany transactions; changes in charter, bylaws, etc.; revocation of certificate of authority, current jurisdictions the company has business in; foreign control; whether the insurer is a subsidiary of a bank holding company and the associated regulatory body; attestation and identification of an independent CPA, designation of an appointed actuary, asset custodians and investment advisors; mergers; and exemptions to NAIC's *Annual Financial Reporting Model Regulation* (#205). The interrogatories also include information about when the most recent financial regulatory examination occurred and, if requested, financial adjustments have been made. In addition, potentially abusive or significant transactions are identified, including the overreliance on an agency, loans to officers, reporting assets not within the entities' control, verifying that custodial agreements meet certain standards and identification of legal issues. Basic information about the results of the risk-based capital (RBC) calculation for the previous five years is also included in the annual statement.

Overall salary expense is disclosed in the annual statement. Insurers are required to disclose to regulators the annual compensation information for their most highly compensated executives through the Supplemental Compensation Exhibit of the annual statement, which is used to help evaluate the remuneration practices of each insurer. This information is regulator-only in most jurisdictions.

Quarterly and annual statement data are subject to a number of quality-assurance checks before being uploaded into the NAIC's Financial Data Repository[1]. After the data is uploaded, additional automated data cross-checks are performed and quarterly and annual filings are reviewed by the NAIC's data quality staff to ensure that the data is accurate. Data cross-check errors can result in a letter from the NAIC inquiring about apparent errors. Companies typically correct issues noted by data quality staff either by re-filing corrected data (provided the domiciliary state agrees) or explaining the noted issues. Regulators are notified of filing concerns and can follow up on issues noted during analysis. In addition, regulators review the filings to determine whether financial information is filed by established deadlines. If information is not filed within established deadlines, or if a state determines that a company has not complied with filing requirements or has filed a false or misleading sworn financial statement, a state may utilize one or more of the applicable preventative and corrective measures described within Principle 6.

B. Annual Financial Reporting Model Regulation

The NAIC's *Annual Financial Reporting Model Regulation* (#205) — commonly referred to as the Model Audit Rule — requires insurers to receive a statutory financial statement audit from an independent CPA on an annual basis and is required to be in place for an insurance department to meet NAIC accreditation standards. To ensure the independence of the CPA performing the audit, the lead audit partner's years of concurrent service on an insurer's audit are limited by the Model Audit Rule. Additionally, the CPA is prohibited from providing services to the insurer that would impair the auditor's independence. One required element of the financial statement audit is a general review of the entity's internal controls over financial reporting. If material weaknesses in internal controls are identified during the audit, as defined in Section 11 of the Model Audit Rule, they are required to be reported to the regulator.

The Model Audit Rule also requires each insurer to establish an audit committee, or appoint a parent's audit committee to fulfill that role. The Model Audit Rule sets specific responsibilities for the audit committee and establishes independence requirements for audit committee membership of insurers above certain premium thresholds subject to certain exemptions. By requiring audit committee functions, the insurer should be able to maintain an appropriate level of corporate governance oversight of the financial reporting and audit function within the organization.

The Model Audit Rule establishes guidelines relating to the conduct of directors and officers of an insurer in connection with the preparation of required reports and documents. For example, directors and officers are prohibited from making a materially false or misleading statement to a CPA in connection with any audit, review or communication required under the Model Audit Rule.

Finally, the Model Audit Rule requires insurers with more than $500 million in annual premium to file Management's Report of Internal Control over Financial Reporting, as defined in Section 16 of the Model Audit Rule, attesting to the effectiveness of controls put in place to ensure accurate financial reporting. This report is required to be signed by the entity's chief

[1] The Financial Database Repository (FDR) is an Oracle relational database of the NAIC used to receive, process, and store financial data submitted by insurance entities. The majority of the financial data is extracted from Annual Statements, Quarterly Statements, supplemental filings, and revisions submitted by insurance companies required to file with the NAIC by their respective state of domicile. The term "FDR" is often used as a general term to include everything related to this database: front-end applications, back-end applications, metadata, validations, processes, analytical calculations, and actual financial or demographic data.

executive officer (CEO) and chief financial officer (CFO) and to be supported by diligent inquiry in reviewing, documenting and testing the internal controls in place to ensure accurate financial reporting.

The provisions of the Model Audit Rule are reviewed through the financial analysis and financial examination functions of each insurance department. The Model Audit Rule does not outline any specific enforcement mechanisms, but insurance departments can use the general remedies available to them to enforce compliance with these requirements (see Principle 6).

C. Holding Company Reporting Requirements

Within the NAIC's *Insurance Holding Company System Regulatory Act* (#440), the "Registration of Insurers" section requires statements in the holding company registration filing indicating 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. Alternative wording is available, but both convey a similar expectation.

Model #440 contains a specific enforcement mechanism whereby, whenever it appears to the commissioner that any person has committed a violation that makes the continued operation of an insurer contrary to the interests of policyholders or the public, the commissioner may suspend, revoke or refuse to renew the insurer's license or authority to do business for such period as the commissioner finds is required for the protection of policyholders or the public.

Principle 2: Off-site Monitoring and Analysis

Off-site solvency monitoring is used to assess, on an ongoing basis, the financial condition of the insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance. The results of the off-site analysis are included in an insurer profile for continual solvency monitoring. Many off-site monitoring tools are maintained by the NAIC for regulators, such as the Financial Analysis Solvency Tools (FAST).

A. Financial Analysis

One of the key financial analysis tools is the NAIC's *Financial Analysis Handbook* (Handbook). The Handbook assists regulators in performing risk-focused financial analysis of insurers and groups in a uniform manner, which includes both qualitative and quantitative analysis techniques. This Handbook is utilized in some capacity by every state and serves as the minimum baseline with regard to annual and quarterly analysis for compliance with the NAIC's Financial Regulation Standards and Accreditation Program.

With regard to corporate governance, the Handbook prompts analysts to consider corporate governance considerations in Level One[2] and Supplemental Procedures[3] based on the appearance of risk considerations. Specifically, analysts are encouraged to consider Supplemental Procedures on Management Considerations[4] if the insurer (and/or group) is a priority or troubled insurer. These procedures outline various risk considerations related to corporate governance to help the analyst assess potential risks and determine the level of surveillance that might be warranted as a result of these risk considerations.

If concerns are identified in the corporate governance review performed during the analysis process, the analyst may request additional information or explanation from the insurer and/or propose a financial examination to investigate the matter further. If management of an insurer fails respond to inquiries relative to the condition of the insurer or has furnished false and misleading information concerning an inquiry, a state may utilize one or more of the applicable preventative and corrective measures described within Principle 6.

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[2] The Level One procedures for financial analysis provide for an overall analysis of the insurer and its operations from a quantitative and qualitative perspective.

[3] The Supplemental Procedures are quantitative and qualitative procedures an analyst would consider when reviewing supplemental filings (e.g., Management's Discussion and Analysis).

[4] The Supplemental Procedures on Management Considerations are qualitative procedures an analyst would consider when performing an overall assessment of company management and management practices.

Principle 3: On-site Risk-focused Examinations

U.S. insurance regulators carry out risk-focused, on-site examinations in which the insurer's corporate governance, management oversight and financial strength are evaluated, including the system of risk identification and mitigation, both on a current and prospective basis. The reported financial results are assessed through the financial examination process and a determination is made of the insurer's compliance with legal requirements.

A. Background

The *Model Law on Examinations* (#390) allows a state insurance department to conduct an examination of any company as often as the commissioner deems appropriate, but not less frequently than once every five years. Model #390 grants the insurance department access to all books, records, accounts, papers, documents and any or all computer or other recordings relating to the property, assets, business and affairs of the company being examined. In conducting the examination, the examiner shall observe the guidelines and procedures set forth in the NAIC's *Financial Condition Examiners Handbook* (Examiners Handbook).

A key element of the procedures outlined in the Examiners Handbook is a review and assessment of the corporate governance, risk management and control processes in place at an insurer. Deficiencies identified in these areas may be included in an examination report, if they are findings of fact or such conclusions and recommendations as the examiners find reasonably warranted from the facts. Upon the issuance of an examination report, the insurance department may issue an order requiring the insurer to take corrective actions to address the findings included in the report. To the extent that deficiencies identified are not considered findings of fact, they are often communicated to the insurer through a management letter that is considered to be part of the examination workpapers and kept confidential.

B. Suitability

On an ongoing basis, the suitability of individuals is reviewed during the financial examination, with the focus being on the background and experience of individuals. Interviews of C-level individuals (CEO, CFO, etc.) and board members are performed to gather information regarding suitability. The Examiners Handbook provides examiners with guidance on how to conduct interviews and topics to be covered in Exhibit Y – Examination Interviews. If problems with the suitability of individuals are identified, a state may utilize one or more of the applicable preventative and corrective measures described within Principle 6.

C. Corporate Governance Assessment

The corporate governance practices of insurers are reviewed during on-site examinations. During the initial stages of the examination, the insurer is asked to provide information on a wide range of corporate governance-related topics through Exhibit B – Examination Planning Questionnaire. The examiner reviews this information, performs interviews of individuals as discussed above, and obtains other evidence of corporate governance activities (e.g., board minutes and packets, enterprise risk management (ERM) documentation, etc.) performed at the insurer to make an overall assessment of the insurer's corporate governance practices. Guidance for the examiner to utilize in reviewing governance practices and reaching an overall assessment is included in the Examiners Handbook at Exhibit M – Understanding the Corporate Governance Structure. If deficiencies in corporate governance are identified during the examination, the regulator has a number of options, including communicating the issue through an exam report or management letter (as discussed above), utilizing the authority granted through the NAIC's *Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to Be in Hazardous Financial Condition* (#385) to require correction of the deficiency as discussed in Principle 6, or adjusting the ongoing supervisory plan to perform more in-depth analysis and more frequent examinations.

D. Risk Management and Internal Controls

In conjunction with the review of corporate governance performed during an examination, the examiner is also expected to review the overall risk-management function of an insurer. Exhibit M also provides guidance for the examiner in performing this review. In addition, the insurer's individual risk-mitigation strategies and internal controls are reviewed in detail throughout the risk-focused examination process. This process requires that individual solvency risks of the insurer be identified and assessed, related mitigation strategies and controls be identified and assessed, and a residual risk rating be made to determine the extent of detail examination procedures to be performed. Through this process, the examiner gathers a great deal of information on the effectiveness of individual risk-mitigation strategies and controls, which assist in confirming the initial overall assessment of corporate governance and risk management. When deficiencies are identified, the regulator has a number of options for correcting the situation, as described above.

Internal and external audit functions are also reviewed during the financial examination through use of the Examiners Handbook's Exhibit E – Audit Review Procedures, to determine whether reliance can be placed on audit work and to identify recommendations for improvement when deemed appropriate. Executive compensation is typically identified as a significant risk to be addressed during an examination and is subjected to the risk-focused process described above. In addition, all material outsourced functions are reviewed during examination to determine whether adequate controls over outsourced functions are in place. In the event that adequate controls over managing general agents (MGAs), controlling producers or other third-party administrators are not in place, the examiner may take enforcement action as outlined under Principle 6.

Principle 4: Reserves, Capital Adequacy and Solvency

To ensure that legal obligations to policyholders, contract holders and others are met when they come due, insurers are required to maintain reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety. The most visible measure of capital adequacy requirements is associated with the RBC system. The RBC calculation uses a standardized formula to benchmark specified level of regulatory actions for weakly capitalized insurers.

A. Reserves

An insurance company's audit committee and board of directors have a fiduciary responsibility for overseeing the financial condition of the company. Accuracy of reserve liabilities is crucial to the reliability of financial statements. These reserve liabilities are not known quantities, but require significant training and expertise to quantify. Actuaries are utilized for estimates of the loss reserves and evaluation of uncertainty inherent in the determination. Actuaries are also utilized in three main processes: 1) the annual audit; 2) the annual actuarial opinion; and 3) the risk-focused examination process (i.e., financial analysis and examination).

(1) In the annual independent audit, the auditor is required to opine on the reserves posted in the financial statement. To assist in obtaining evidence in this area, the auditor will typically utilize the services of an actuarial specialist to perform an independent review of carried reserves. These actuaries are generally required to be independent from the insurer and to meet professional standards qualifying them to fulfill this role. At the conclusion of the independent audit, the auditor is required to report results of the engagement to the insurer's audit committee that would typically address reserves, including a discussion of management's use of estimates and any disagreements with management regarding accounting treatment.

(2) Regulators also require companies to appoint a qualified actuary, called an appointed actuary, to opine on the reasonability or appropriateness of company reserves on an annual basis. Qualifications for the appointed actuary are defined in the actuarial opinion laws and in the U.S. actuarial professional standards. Actuaries are required to be a member in good standing of specific actuarial organizations, to abide by actuarial standards of practice, and to report to the board of directors on their actuarial opinion. All appointed actuaries must meet specific education and experience requirements established by the Actuarial Standards Board in the "Qualification Standards for Actuaries Issuing Statements of Actuarial Opinion in the United States." Corporate governance around the actuarial function relating to the required annual actuarial opinion can be found in the NAIC's *Standard Valuation Law* (#820), the *Actuarial Opinion and Memorandum Regulation* (#822) and the financial statement instructions for the property/casualty Statement of Actuarial Opinion.

(3) Each state insurance department is required to have actuarial resources (either internal or external) to review the actuarial functions of its domestic insurers during financial analysis and examination. NAIC accreditation standards require the states to utilize the services of a credentialed actuary[5] when examining a property and casualty insurer with long-tailed lines of business or a life insurer with large amounts of interest sensitive business.

[5] Credentialed actuary refers to one who has achieved the designation of associate or fellow in the Society of Actuaries (ASA or FSA) or who has achieved the designation of associate or fellow in the Casualty Actuarial Society (ACAS or FCAS).

If it is determined that the insurer 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, a state may utilize one or more of the applicable preventative and corrective measures described within Principle 6.

B. Risk-Based Capital

The NAIC's *Risk-Based Capital (RBC) for Insurers Model Act* (#312) or *Risk-Based Capital (RBC) for Health Organizations Model Act* (#315) — collectively referred to as the RBC models — require insurers at an RBC action level to file a plan with the commissioner. The RBC plan would contain proposals for corrective actions and projections of future financial results. The commissioner then determines whether the plan can be implemented or whether it is judged to be unsatisfactory.

If the RBC plan is judged to be unsatisfactory (subject to the company's right to a hearing), the commissioner can retain, at company expense, actuaries, investment experts or other consultants to examine or analyze the assets, liabilities and operations of the insurer in order to formulate a corrective order for corrective actions to be taken by the insurer. If an RBC control level is triggered under either of the RBC models, the commissioner may place, or be required to place, the insurer under regulatory control.

The RBC models also give non-domiciliary regulators authority to request an RBC plan from an insurer. Failure to file an RBC plan would be grounds for a commissioner to issue a cease-and-desist order from writing new insurance business in the state. A mandatory control level event could trigger the liquidation of property found in the state using rehabilitation and liquidation statutes.

The RBC formula that is completed by the insurer includes a jurat page where the company officers, as required by the state of domicile, attest that the RBC was completed in accordance with the RBC instructions. If it is determined that the RBC filing was not completed in accordance with the RBC instructions, the RBC models permit a state to take appropriate regulatory action.

For life or fraternal companies doing additional C-3 Phase 1 interest rate risk RBC cash flow testing, the RBC submission is to be accompanied by a statement from the appointed actuary certifying that, in his or her opinion, the assumptions used for the C-3 Phase 1 calculations are not unreasonable for the products, scenarios and purpose being tested.

For life or fraternal companies doing C-3 Phase 2 modeling for variable annuities with guarantees, certification of the work done to set the RBC level submitted with the RBC filing. The certification is not addressing the adequacy of the company's surplus or its future financial condition, but the actuary will note any material change in the model or assumptions from that used previously and the impact of such changes. If hedging is reflected in the stochastic modeling, additional certifications are required from an actuary and a financial officer of the company.

In addition to the C-3 Phase 2 actuarial certification, an actuarial memorandum would be constructed documenting the methodology and assumptions upon which the required capital is determined. The memorandum also includes sensitivity tests that the actuary feels appropriate given the composition of their block of business. This memorandum is confidential and available to regulators upon request.

Principle 5: Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities

The regulatory framework recognizes that certain significant, broad-based transactions/activities affecting policyholders' interests must receive regulatory approval. These transactions/activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance.

A. License Application Process

The license application process requires a biographical affidavit to be submitted for all officers, directors, key managerial personnel and individuals with a 10% or more beneficial ownership in the applicant and the applicant's ultimate controlling parent. The states utilize this report to verify employment, education and military service for the past 10 years, domestic and internationally. Litigation, criminal, Uniform Commercial Code and bankruptcy records must be searched for 10 years, domestically and internationally. Regulators rely on background investigative reports to verify the information provided on the biographical affidavits and to note discrepancies. Regulators determine suitability of officers based on the biographical affidavit and background reports, including the number and severity of any discrepancies noted. The suitability of officers and key managerial individuals for their positions are closely evaluated and are integral to the approval of an insurance company's license. The insurer may choose to remove or replace the officer or key managerial personnel, and the state may reevaluate the foreign insurer's application. Regulators may deny an application for license based on the lack of suitability of an officer or key managerial individual. Insurers must notify the regulator of changes in officers or directors and file new biographical affidavits as required, and, in some states, upon request. The states may require biographical affidavits be updated annually for key officers and directors for domestic insurers. State regulators have entered into memorandums of understanding (MOUs) that allow for open communication during the licensing process when insurers apply for expanded licensure in foreign states.

Another critical element of the license application process is the submission and review of an insurer's plan of operation. The plan of operation is required to be filed with the license application and includes three basic components: a brief narrative, pro-forma financial statements/projections and a completed questionnaire. Regulators review the plan of operation when considering an application for license, and, if the plan is incomplete, inconsistent or unreasonable, the regulator will take appropriate action, including denial of the license. The regulator may request a revised plan from the insurer when reviewing an application, and a plan of operation that evidences deficiencies in material licensing qualifications including fairness and honesty of methods of doing business, would be grounds for denial of the insurer's license. Requirements for filing a Uniform Certificate of Authority Application (UCAA) are outlined in the NAIC's *UCAA Manual*. Guidelines for regulators to consider in reviewing license applications are outlined in the NAIC's *Company Licensing Best Practices Handbook*.

B. ***Insurance Holding Company System Regulatory Act*** **(#440) and** ***Insurance Holding Company Model Regulation*** **(#450)**

The NAIC's *Insurance Holding Company System Regulatory Act* (#440) includes a section related to standards and management of an insurer within an insurance holding company system that contains optional language with regard management of domestic insurers subject to registration, including the following:

- 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.

- 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. The Act contains an exemption, however, for domestic insurer subsidiaries if controlled by an entity that itself complies with the management requirements set forth in the Act. Further, smaller companies that meet threshold requirements may request a waiver and any insurer may request a waiver from the management requirements "based upon unique circumstances".

- 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.

The NAIC's *Insurance Holding Company System Model Regulation* (#450), which is a companion to Model #440, includes requirements relating to transactions subject to prior notice and approval. These transactions include arrangements for cost-sharing services and management services, such as requiring oversight for functions provided to the insurer by the affiliate. The annual registration statement also requires the reporting of certain transactions and agreements between the registrant and its affiliates. Several important sections of both Model #440 and Model #450 are required to be substantially similar for purposes of complying with the NAIC's Financial Regulation Standards and Accreditation Program.

With regard to acquisition of control or merger with a domestic insurer, Model #450 requires the filing of information to allow a regulator to assess the suitability of applicants, such as a biographical affidavit, including a third-party background check, as well as other requirements. The NAIC's Form A Database and other communication channels allows the states to share information with each other regarding a potential acquiring person.

If it appears to the commissioner that any person has committed a violation of Model #440 that makes the continued operation of an insurer contrary to the interests of policyholders or the public, the commissioner may suspend, revoke or refuse to renew the insurer's license or authority to do business in his/her state for such period as the commissioner finds is required for the protection of policyholders or the public.

C. Model Investment Laws

As investing activities are so critical to an insurer's potential solvency, regulatory requirements have been put in place to outline the amount of oversight required by the board of directors to an insurer's investment function. These requirements are included in one of two NAIC model laws for investments of insurers: *Investment of Insurers Model Act (Defined Limits Version)* (#280) and the *Investment of Insurers Model Act (Defined Standards Version)* (#283). The adoption of legislation that is substantially similar to one of the two models is required by the NAIC's Financial Regulation Standards and Accreditation Program. In addition, the NAIC's *Derivative Instruments Model Regulation* (#282) sets the standards for the prudent use of derivative instruments by insurers. Model #280 and Model #283 both include standards outlining requirements for corporate governance and board oversight of investments.

Model #280 provides definitions for investment types and terminology for consistent application by insurance reporting entities. It also sets forth certain limits on the amounts or relative proportions of different investments that insurers can hold to ensure adequate diversification and limit associated investment risk. Under this model, an insurer's board of directors is required to adopt a written plan for acquiring and holding investments that specifies guidelines as to the quality, maturity and diversification of investments and other specifications including investment strategies intended to assure that the investments are appropriate for the business conducted by the insurer. The board is also required to formally document, on an annual basis, that it has determined whether all investments have been made in accordance with delegations, standards, limitations and investment objectives prescribed within the written plan. The model outlines a number of prohibited investments and specific limitations that are placed upon insurers with regard to various investment classes including: securities lending, repurchase, reverse repurchase and dollar roll transactions. If an insurer violates any of the standards of the model, the commissioner may require the insurer to eliminate the condition causing the noncompliance within a specified time. If an insurer fails to comply with the commissioner's requirement, the insurer is deemed to be in hazardous financial condition, and the commissioner shall take one or more of the actions authorized by law as to insurers in hazardous financial condition. Overall, investments held by insurers that are not in compliance with this model are considered nonadmitted assets.

Model #283 utilizes what is known as the "prudent person" approach. Conceptually, this approach allows insurers greater discretion in terms of their allocation of investments if they can demonstrate they have a sound investment plan and that they adhere to that plan. Under this model, the board of directors is required to exercise prudent judgment and care in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of their capital. The insurer is also required to establish and implement internal controls and procedures to ensure compliance with investment policies and procedures. Standards for assessing the prudence of investment decisions are included for the regulator, as well as some high-level investment prohibitions and limitations. If the commissioner determines that an insurer's investment practices do not meet the provisions of the model, the commissioner may order the insurer to make changes necessary to comply with the provisions. If the commissioner determines that by reason of the financial condition, current investment practice, or current investment plan of an insurer, the interests of insureds, creditors or the general public are endangered, the commissioner may impose reasonable additional restrictions upon the admissibility or valuation of investments or may impose restrictions on the investment practices of an insurer, including prohibition or divestment.

Model #282 provides guidelines and other requirements applicable to the investment in derivative instruments for the purposes of hedging and income generation transactions by the insurer. Before an insurer is allowed to engage in a derivative transaction, the insurance company shall establish written guidelines that must be approved by the commissioner. The written guidelines must specify the objectives and strategies, as well as all applicable risk constraints and credit risk limits. The guidelines must also establish counterparty exposure limits and credit quality standards. The policy must define the permissible derivative transactions and the relationship to insurer operations. Internal control processes must be in place for compliance with the guidelines and adherence with these guidelines must be addressed by the internal control implemented. The insurer is also required to have a written policy addressing determination of effectiveness of the hedging transactions. In addition, the policy must describe the credit risk-management process and the system for over-the-counter derivative transactions that measure the credit risk exposure. The board of directors must approve the guidelines' methodology and policies and procedures established and determine whether the insurer has adequate professional personnel, technical expertise and required systems in place to implement the policies and practices required. The board must also review the guidelines for compliance and take action to correct any deficiencies in internal controls. The adopted guidelines must be approved by the commissioner. Once approved, the insurer is required to maintain appropriate documentation and comply with the model's trading requirements.

D. Credit for Reinsurance

As noted in the discussion of the NAIC's holding company models above, insurers are required to submit significant reinsurance contracts to their domestic regulator for approval. In addition, those reinsurance contracts are required to include specific elements, and assuming insurers are required to meet certain requirements, as outlined in the NAIC's *Credit for Reinsurance Model Act* (#785) and *Credit for Reinsurance Model Regulation* (#786). Credit for reinsurance contracts is not granted unless the contracts and assuming insurers meet the requirements outlined within the models. Other reporting requirements that relate to the governance of reinsurance transactions are described below.

<u>Reinsurance Attestation</u>

In conjunction with the filing of the financial annual statement, the CEO and CFO are required to attest, under penalties of perjury, with respect to all reinsurance contracts for which the reporting entity is taking credit on its current financial statement, that to the best of their knowledge and belief after diligent inquiry:

- Consistent with *SSAP No. 62R—Property and Casualty Reinsurance*, there are no separate written or oral agreements between the reporting entity (or its affiliates or companies it controls) and the assuming reinsurer that would under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract, other than inuring contracts that are explicitly defined in the reinsurance contract except as disclosed herein;

- For each such reinsurance contract entered into, renewed or amended on or after Jan. 1, 1994, for which risk transfer is not reasonably considered to be self-evident, documentation concerning the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment, as required by SSAP No. 62R, is available for review;

- The reporting entity complies with all the requirements set forth in SSAP No. 62R; and

- The reporting entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of SSAP No. 62R.

If there are any exception(s), that fact must be noted in the Reinsurance Attestation Supplement filed electronically with the NAIC and in hardcopy with the domestic regulator (excluding the details of the exceptions). The details of the exceptions must be filed in a separate hard copy supplement (Exceptions to the Reinsurance Attestation Supplement) with the domestic regulator.

<u>General Interrogatories and Reinsurance Summary</u>

The General Interrogatories and financial statement disclosures require the company to provide certain information regarding its reinsurance program and agreements. One of the specific disclosures requires the company to indicate whether it has taken financial statement credit for reinsurance for any agreement that includes one or more features that could potentially limit the transfer of insurance risk. If the company indicates that it has accounted for such an agreement as reinsurance and taken credit for the reinsurance in its financial statements, the Reinsurance Summary requires the company to provide additional information with respect to the agreement, including the contract terms, business purpose and financial statement impact. If the regulator determines that significant information included in the General Interrogatories and Reinsurance Summary has not been properly disclosed, a state may utilize one or more of the applicable preventative and corrective measures described within Principle 6.

E. Outsourcing of Functions

A number of NAIC models and guidelines address the outsourcing of critical functions including services provided by MGAs, producers, controlling producers, investment custodians, reinsurance intermediaries and other third-party administrators. The NAIC's *Managing General Agents Act* (#225) and its *Business Transacted with Producer Controlled Property/Casualty Insurer Act* (#325) are required for compliance with the NAIC's Financial Regulation Standards and Accreditation Program. In general, these NAIC models contain provisions requiring adequate oversight of outsourced functions, including formal contracts adopted by the insurer's board of directors and periodic on-site audits. If the insurer or its service providers do not meet the requirements contained within the models, the commissioner has the authority to invoke penalties or fines and/or suspend or revoke the certificates of authority or licenses of the offending parties.

Principle 6: Preventive and Corrective Measures, Including Enforcement

The regulatory authority takes preventive and corrective measures that are timely, suitable and necessary to reduce the impact of risks identified during on-site and off-site regulatory monitoring. These regulatory actions are enforced as necessary.

A. Hazardous Financial Condition Model

The NAIC's *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. Model #385 lists standards (mostly financial in nature) that can be utilized in determining whether a company is in a hazardous financial condition. However, a suitability standard for the board of directors and senior management is explicitly included, as well as the results of on-site examinations. The language of the model indicates the standards may be considered either singly or in combination with one another. Therefore, even if a finding is non-financial, it alone can be sufficient grounds for a commissioner to take action under Model #385. Therefore, regulators have the authority to determine that an insurer is in a hazardous financial condition based solely on concerns over corporate governance deficiencies.

Of the various actions that can be taken as a result of a hazardous financial condition determination, including requiring capital infusions or suspension of a license, the most relevant remedy is to require the insurer to "correct corporate governance practice deficiencies, and adopt and utilize governance practices acceptable to the commissioner." As such, Model #385 gives the commissioner broad authority to require corrective action for corporate governance deficiencies identified through financial analysis or examination processes. The NAIC's Financial Regulation Standards and Accreditation (F) Committee recently voted to make this provision an accreditation requirement requiring states to adopt the corporate governance corrective action provision no later than Jan. 1, 2014.

Most state laws contain provisions similar to the NAIC's *Administrative Supervision Model Act* (#558), which provides the states with the authority to place insurance companies under immediate administrative supervision if the commissioner determines the company to be in a hazardous financial condition.

B. Other Powers of the Commissioner

The process of certifying compliance with the NAIC's Financial Regulation Standards and Accreditation Program includes a legal review to verify that each accredited state maintains laws and regulations sufficient to effectively regulate its domestic insurance industry. The required authority is frequently derived from NAIC model laws and regulations, many of which are discussed in other sections of this document. The legal review portion of the accreditation process confirms that the commissioner is granted certain powers under state law to prevent or correct practices that may cause harm to policyholders or the public.

Accreditation requirements relating to the commissioner's authority include:

- Authority to examine companies whenever it is deemed necessary, including complete access to books and records and the ability to examine officers, employees and agents under oath. Similar authority to order production of records exists for examinations of holding companies.
- Authority to require minimum capital or surplus amounts and further authority to require additional capital or surplus based on the type, volume and nature of insurance business transacted.
- Authority to order a company to take corrective action or cease-and-desist certain practices that, if not corrected, could place the company in a hazardous financial condition.
- Authority to require insurers to limit or withdraw from certain investments or discontinue certain investment practices if the commissioner determines that the continued operation of the insurer might be hazardous.
- Authority to require insurers to designate an independent CPA (who will be subject to certain partner rotation requirements) and to designate an audit committee.
- Authority, upon reasonable cause to believe that an insurer has engaged in practices that would subject it to delinquency proceedings, to issue orders necessary to correct, eliminate or remedy such conduct.
- Authority to petition the court for a rehabilitation order and subsequently, upon a belief that further attempts to rehabilitate an insurer would increase the risk of loss to policyholders, to petition the court for a liquidation order.

C. Troubled Insurance Companies

The NAIC's *Troubled Insurance Company Handbook* is a regulator-only publication that assists insurance departments in dealing specifically with troubled insurance companies by providing guidance for identifying regulatory courses of action, among other guidance. With regard to corporate governance, the Handbook addresses causes of trouble arising from management and control considerations, provides related case studies and guidance on possible regulatory courses of action, when such issues exist.

Principle 7: Exiting the Market and Receivership

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines solvency and establishes a receivership scheme to ensure the payment of policyholder obligations of insolvent insurers subject to appropriate restrictions and limitations.

A. Market Withdrawal Plans

In any particular state, an insurer may determine a need to withdraw from a line of business or the entire state for a variety of reasons. Many of the states have requirements for an insurer to meet in order to withdraw from one or more lines of business within a state. Companies need to file their withdrawal plans according to state requirements and the insurance department must review and ultimately agree with the plan or deny the request. State requirements may include related rate, rule, form, producer termination or reporting requirements.

B. Receivership

Receiverships are instituted against an insurance company by an insurance department for the purpose of conserving, rehabilitating or liquidating an insurance company. All require a court order. With regard to corporate governance, rehabilitation has served as an effective process for handling corporate governance issues, as it generally involves the transfer of all operational authority from insurance company management to the receiver, with the objective of initiating a rehabilitation plan. The NAIC's *Receiver's Handbook for Insurance Company Insolvencies* provides guidance to regulators acting in this capacity.

Other Related Processes

Other corporate governance requirements, standards and regulatory monitoring practices reside outside of *The United States Insurance Financial Solvency Framework*. A description of some of these items is included below.

A. Market Conduct

The non-financial regulatory activities performed by a state insurance department include producer licensing, rate regulation, policy form review, consumer assistance, antifraud, market analysis and examinations. These broad-based activities constitute the many functions that insurance regulators conduct for the protection of consumers under the broad auspices of market conduct regulation.

State insurance departments license the business entities (agencies) and individual producers (agents and brokers) selling the insurance products of companies. The producer-licensing process ensures that individuals selling, soliciting or negotiating insurance have the appropriate knowledge and are of good moral character. This is carried out through the administration of pre-licensing education requirements, examinations and background checks. Finally, once licensed, producers must continue their education by fulfilling continuing education (CE) requirements. The NAIC's *State Licensing Handbook* assists regulators in licensing these entities by providing current guidelines and recommended best practices in the insurance licensing process.

Insurance departments also review the rates that companies charge and the forms they use. With rate review, the general standard of review is to determine if the rates are adequate. At the same time, the rates must not be unfairly discriminatory or excessive. In general, that states have four different frameworks for rate and form review: 1) prior approval, in which rates must be preapproved prior to use; 2) file and use, in which rates are filed and then may be used; 3) use and file, in which rates may be used and then filed no later than 15 days following implementation; and 4) open competition, through which the marketplace sets the rates.

Because insurance contracts are complicated contracts, state insurance departments review forms to ensure consumers are provided with the necessary protections an insurance policy is intended to provide. As part of this process, a state insurance department will check for compliance with applicable statutes, rules and regulations; readability; and prohibited provisions and exclusions.

Once the companies, producers and products are in the marketplace, state consumer service personnel monitor the way in which the marketplace operates by handling consumer inquiries and consumer complaints. The consumer service representatives in state insurance departments are truly the "front line" regulators, as they interact with consumers on a daily basis. In addition to responding to specific consumer concerns, state consumer service representatives also conduct educational outreach efforts.

Antifraud efforts are another important aspect of state insurance regulation. Insurance fraud falls into several different categories, from individuals committing fraud against consumers to individuals committing fraud against insurance companies. To deal with specific issues involving criminal activity, many state insurance departments have antifraud and criminal investigators, while others rely on their state attorney general's office or state police. These individuals carry out the following functions: investigate suspected fraudulent acts, prosecute fraudulent acts and engage in fraud-prevention efforts.

State insurance regulators also monitor how companies and agents operate in the marketplace through market analysis and market conduct examinations by identifying and correcting insurer operating practices that are in conflict with contract provisions, state laws, rules, regulations or orders of the commissioner. Market analysis is the process through which the states collect and analyze data to determine how company practices compare to each other. Market conduct examinations involve the direct contact with a company to discuss and correct an identified problem. The NAIC's *Market Regulation Handbook* provides regulators with one comprehensive source of reference material for the continuum of regulatory responses to potential market concerns, including market analysis and market conduct examinations. A market conduct examination may cover one or all of the following areas:

- Company Operations and Management: Designed to provide an overview view of the legal entity type and how it operates.
- Marketing and Sales: Designed to evaluate representations made by an insurance company or producer about its product(s) or services.
- Underwriting and Rating: Designed to provide an overview of how an insurance company treats applicants and policyholders and whether that treatment is in compliance with applicable statutes, rules and regulations.
- Policyholder Service: Designed to test compliance with applicable statutes, rules and regulations regarding notice/billing, delays/no response, and premium refund and coverage questions.
- Claim Handling: Designed to provide an overview of how an insurance company treats claimants and whether treatment is in compliance with applicable statutes, rules, and regulations.
- Complaints: Designed to review the insurance company's procedures for processing consumer complaints.
- Producer Licensing: Designed to test an insurance company's compliance with state producer licensing laws.

Compliance and internal audit processes are separate functions and are mutually exclusive. Some state insurance laws specifically require companies to perform self-audits for market regulation activities.

If there are identified problems with a company, state insurance departments have enforcement authority to implement corrective action and assure future compliance with state insurance laws. The key NAIC models addressing consumer protection are listed in chronological order, based on the year of initial adoption by the NAIC.

Unfair Trade Practices Model Act (#880) – 1948

The purpose of this model is to regulate trade practices in the business of insurance by defining all such practices that constitute unfair methods of competition or unfair or deceptive acts or practices and prohibiting such practices. In broad terms, the model prohibits misrepresentation and false advertising, defamation, coercion and unfair discrimination by insurance companies. The model also requires insurance to maintain complaints, claims, rating, underwriting and marketing records in a manner that is retrievable for examination by state insurance regulators.

Model Law on Examinations (#390) – 1956

This model establishes an effective, efficient system for examining the activities, operations, financial condition and affairs of all persons transacting the business of insurance by authorizing the state insurance commissioner to conduct examinations whenever it is deemed necessary.

Unfair Claims Settlement Practices Act (#900) – 1972

The purpose of this model is to set forth standards for the investigation and disposition of claims. This model requires insurance companies to promptly investigate claims and settle claims in good faith by effectuating prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear.

Long-Term Care Insurance Model Act (#640) – 1987

The purpose of this model is to protect applicants for long-term care insurance from unfair or deceptive sales or enrollment practices, to establish standards for long-term care insurance, to facilitate public understanding and comparison of long-term care insurance policies, and to facilitate flexibility and innovation in the development of long-term care insurance coverage.

Producer Licensing Model Act (#218) – 1988

This model governs the qualifications and procedures for the licensing of insurance producers and provides specific guidance regarding the causes for which a state insurance department may place on probation, suspend, revoke or refuse to issue or renew an insurance producer's license or levy a civil penalty.

Improper Termination Practices Model Act (#915) – 1995

The purpose of this model is to protect policyholders from improper terminations of insurance coverage and to set forth standards for the regulation and disposition of terminations of policies or certificates of insurance.

Life Insurance Illustrations Model Regulation (#582) – 1995

The purpose of this regulation is to provide rules for life insurance policy illustrations that will protect consumers and foster consumer education. The regulation provides illustration formats, prescribes standards to be followed when illustrations are used, and specifies the disclosures that are required in connection with illustrations. The goals of this regulation are to ensure that illustrations do not mislead purchasers of life insurance and to make illustrations more understandable.

Health Carrier External Review Model Act (#75) – 1999

The purpose of this model is to provide standards for the establishment and maintenance of external review procedures to assure that covered persons have the opportunity for an independent review of an adverse determination or final adverse determination regarding health care coverage.

Privacy of Consumer Financial and Health Information Regulation (#672) – 2000

The purpose of this regulation is to govern the treatment of nonpublic personal health information and nonpublic personal financial information about individuals by all licensees of the state insurance department. This regulation requires insurance companies to provide notice to individuals about its privacy policies and practices; describes the conditions under which insurance companies may disclose nonpublic personal health information and nonpublic personal financial information about individuals to affiliates and nonaffiliated third parties; and provides methods for individuals to prevent an insurance company from disclosing that information.

Suitability in Annuity Transactions Model Regulation (#275) – 2003

The purpose of this regulation is to require insurers to establish a system to supervise recommendations and to set forth standards and procedures for recommendations to consumers that result in transactions involving annuity products so that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed.

Other Corporate Governance Standards/Requirements Outside of Insurance Regulation

Beyond state-based insurance regulation, there are other corporate governance requirements, standards and practices that are applicable either to all insurers through state corporate laws (and their interpretation by the courts) or to certain insurers (primarily public companies and their subsidiaries) through federal law. In addition, other bodies (such as stock exchanges) have established minimum corporate governance standards that their members must follow. A description of some of these standards is included here.

A. State Law

State corporate governance requirements applicable to insurance companies include state insurance codes and state corporate law, the latter of which is an extraordinarily expansive body of law separate and distinct from state insurance codes. State insurance codes and state corporate laws applicable to business, non-stock, nonprofit and mutual companies reflect the public policy concerns of a state and address critical aspects of corporate governance, including the governance relationship between the owners (or members) and management. Provisions include content and amendment of organizational documents, rights of shareholders and policyholders, conflicts of interest, decision-making authority and votes required to authorize particular action, the size of the board, the election and removal of directors, the meeting-notification process and related procedural protections, delegation of authority to officers and committees, the committee process and actions outside of meetings by governing bodies. These laws generally apply to basic formation, operational and governance issues, and they vary from state to state. In many of the states, these laws are based on model corporation acts developed by the American Bar Association.

The fiduciary duties (including the duties of care and loyalty) owed by management and governing board members of business corporations, non-stock corporations, nonprofit corporations, mutual companies and other forms of business enterprises are derived from a well-developed body of common law that is regularly interpreted by the courts. It provides reliable and consistent guidance to governing boards and management of all relevant legal entities on the scope of their fiduciary duties. A thorough examination of the fiduciary duties owed by members of a board and officers is outside the scope of this project.

B. Federal Law

A significant number of corporate governance requirements can be found in federal laws, regulations and other sources. These requirements typically apply to public companies and are enforced by federal financial regulators. Relevant excerpts of each law are listed in the appendix.

<u>The Securities Act of 1933</u>

The Securities Act of 1933 requires that investors receive financial and other significant information concerning securities being offered for public sale, and prohibits misrepresentations and fraud in the sale of such securities. The Act accomplishes these goals by requiring the disclosure of important financial and other information through the registration of securities. Specific requirements of the Act relating to a registrant's corporate governance, director and officer liability and responsibility include:

- Liability for false registration statement for directors, partners and every person who signed the registration statement.
- Registration Statement, Schedule A: Requires disclosure of any management contract or contract providing for special bonuses or profit-sharing arrangement.
- Balance sheet must include any loan in excess of $20,000 to any officer or person under direct or indirect common control with the issuer.
- Regulation S-K, Integrated Disclosure System:
    - Item 304 – Changes In and Disagreements With Accountants on Accounting and Financial Disclosure: After resignation or dismissal of an independent CPA, registrant must state whether the decision to change CPAs was recommended or approved by any audit (or similar) committee of the board of directors, or the board of directors if the issuer does not have an audit committee, and whether the audit committee or board of directors discussed the subject matter of any disagreements with the former CPA.
    - Item 307 – Disclosure Controls and Procedures: Disclose the conclusions of the registrant's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures.
    - Item 308 – Internal Control over Financial Reporting: Must provide an annual report of management on the registrant's internal control over financial reporting, including attestations and assessments of the effectiveness of internal controls.
    - Item 401 – Directors, Executive Officers, Promoters and Control Persons: Must identify directors and director nominees. Include names; ages; all positions and offices with registrant; term of office as director;

description of any arrangement or understanding between any director and any other person pursuant to which he or she was or is to be selected as a director or nominee.

- Item 403 – Security Ownership of Certain Beneficial Owners and Management: Furnish specific information on ownership shares by anyone the registrant knows to be the beneficial owner of more than 5% of any class of the registrant's voting securities, and each class of equity securities of the registrant or any of its parents or subsidiaries, including directors' qualifying shares, beneficially owned by all directors and nominees, and executive officers of the registrant.
- Item 404(a): Requires disclosure of any transactions with related persons, which includes any director, executive officer, nominee for director, immediate family member of a director, executive officer or nominee for director. A transaction includes but is not limited to, any financial transaction, arrangement or relationship, including any indebtedness or guarantee of indebtedness.
- Item 405 – Compliance with Section 16(a) of the Exchange Act: Must identify each person who, at any time during the fiscal year, was a director, officer, beneficial owner or more than 10% of any class of equity securities, or any other person subject to Section 16 of the Exchange Act, that failed to file on a timely basis reports required by section 16(a) of the Exchange Act.
- Item 406 – Code of Ethics: Disclose whether registrant has adopted a code of ethics that applies to the registrant's principal officers. If the registrant has not adopted a code of ethics, it must explain why it has not done so. The registrant must file a copy of its code of ethics as an exhibit to its annual report, post the text of such code of ethics on its Internet website, and disclose, in its annual report, its Internet address and the fact that it has posted such code of ethics on its Internet Web site or provide to any person without charge, upon request, a copy of such code of ethics.
- Item 407 – Corporate Governance:
    - Director independence. Identify and provide information for each director and nominee for director that is independent under the defined independence standards.
    - Board meetings and committees; annual meeting attendance. Provide required information regarding the total number of meetings of the board of directors (including regularly scheduled and special meetings), and director attendance at such board and committee meetings.
    - Nominating, audit and compensation committees. Provide required information regarding the registrant's nominating, audit and compensation committees or committees performing similar functions.
    - Shareholder communications. Provide required information relating to the registrant's board of directors' process for security holders to send communications to the board of directors.

<u>Securities Exchange Act of 1934</u>

With the Securities Exchange Act of 1934 (Exchange Act), the U.S. Congress created the U.S. Securities and Exchange Commission (SEC). The Exchange Act empowers the SEC to require periodic reporting of information by companies with publicly traded securities. Companies with more than $10 million in assets and whose securities are held by more than 500 owners must file annual and other periodic reports with the SEC, and make such reports available publicly. The Exchange Act also governs the disclosure in materials used to solicit shareholders' votes in annual or special meetings held for the election of directors and the approval of other corporate action. This information, contained in detailed proxy materials, must be filed with the SEC in advance, and must disclose all important facts concerning the issues on which shareholders are asked to vote. The Exchange Act further prohibits fraudulent activity of any kind in connection with the offer, purchase or sale of securities, including insider trading by a person in possession of material non-public information, and requires public disclosure of material non-public information by a company with publicly traded securities when such non-public information is disclosed to holders of the securities or certain investment professionals, brokers and dealers.

<u>Sarbanes-Oxley Act</u>

The responsiveness of the current U.S. corporate governance structure to important public policy considerations is well-demonstrated by the enactment by the U.S. Congress of the Sarbanes-Oxley Act of 2002. The Act was a comprehensive response to the corporate and accounting scandals that enveloped the United States during the early 2000s. The Act established new corporate governance, disclosure, audit and conflict of interest standards applicable to directors, as well as issuers, officers, employees, auditors and investment banks. Its impact on the U.S. corporate governance model is hard to overestimate. Sarbanes-Oxley principles have been adopted by governing boards of companies large and small, across industry lines, regardless of the form of incorporation or type of legal entity. Although directly applicable only to publicly traded companies, its core principles of financial accountability, integrity of financial statements and increased governance oversight has had a substantial "spillover effect" on the corporate governance principles affecting non-public companies, including health insurance companies (regardless of the form of entity). More particularly, the Act has served to dramatically enhance the role and function of corporate directors, especially with respect to their responsibility to provide oversight of the conduct of management.

Rule 10A-3 under the Exchange Act was adopted pursuant to the Sarbanes-Oxley Act. It requires:

- Each listed company must have an audit committee composed of independent directors
- Members of boards of directors may not accept a consulting, advisory or compensatory fee from issuer or any subsidiary during term.
- Members must not be affiliated with the issuer or subsidiary.
- Audit committee must establish complaint procedure regarding accounting, internal accounting controls or auditing matters.
- Issuer must have at least one audit committee financial expert serving or must publicly disclose the reason why it does not have such an expert.

Additional requirements under the Sarbanes-Oxley Act include:

- Public company must disclose who is subject to its code of ethics or any reason why it has not adopted a code of ethics.
- A domestic company must promptly disclose the nature of any amendment to the code of ethics that applies to principal officers and the nature of any waiver from the code of ethics, including an implicit waiver, that applies to principal officers.
- The CEO and CFO must certify that their periodic reports comply with statutory requirements and that the information fairly reflects the financial condition of the company. Any CEO or CFO who knowingly misrepresents the financial condition is subject to fine and imprisonment.
- Detailed certifications are required with each annual and quarterly report assuring that the CEO and CFO have reviewed the report, it is accurate and all proper disclosures have been made.
- Companies may not extend credit or arrange for a personal loan to a director or executive officer. Credit arrangements prior to July 31, 2002, are grandfathered in, but may not be renewed.
- The CEO and CFO of a company that restates financial statements as a result of misconduct will forfeit bonuses, equity-based compensation and profits on sales of company stock.
- The SEC can freeze extraordinary payments to directors or officers during an investigation.
- Directors and executive officers may not buy or sell equity securities during a pension fund blackout period (more than three consecutive business days during which at least 50% of participants are unable to buy or sell).
- Changes in beneficial ownership must be reported by directors, officers and 10% shareholders within two days following the transaction.
- Auditors shall not be coerced, manipulated, misled or fraudulently influenced.
- The SEC must review disclosures and financial statements made by each public company at least once every three years.
- If an off-balance sheet agreement is likely to have a material effect on the company's financial condition, the company must disclose this.
- Any publicly released non-GAAP financial measure must include the comparable generally accepted accounting principles (GAAP) measure and reconciliation to GAAP.
- The company must evaluate any change in internal controls over financial reporting quarterly and must issue extensive report annually, including the attestation report of the auditing public accounting firm. Under the Dodd-Frank Act, this requirement does not extend to issues with less than $75 million in worldwide public-float.

Dodd-Frank Act

Another example of how federal legislation can have a broad direct, and indirect, impact on corporate governance is the Dodd-Frank Wall Street Reform and Consumer Protection Act, adopted by the U.S. Congress July 21, 2010. The sweeping provisions of the Dodd-Frank Act include changes relating to compensation, board leadership structures, independence, and whistleblower incentives and protections. While primarily focused on financial regulatory reform and consumer financial protections, it contains a number of corporate governance provisions. The Dodd-Frank Act will have a spillover effect on most U.S. companies, both public and private (including insurance companies) — especially to the extent it introduces important new governance concepts.

Specific Dodd-Frank Act requirements include:
- Stock exchanges must impose independence requirements for compensation committee membership.
- Periodic, nonbinding, shareholder vote on executive compensation must be held at least once every three years.
- Issuers must disclose incentive-based compensation policies and enact "clawback" policies to recover compensation in the case of noncompliance with any financial reporting requirement.
- Companies must disclose in proxy statements the relationship between executive compensation paid and the financial performance of the company.
- On a quarterly basis, the company must evaluate any change in internal controls over financial reporting, and it must issue an extensive report on an annual basis, including the attestation report of the auditing public accounting firm. Under the Dodd-Frank Act, this requirement does not extend to issues with less than $75 million in worldwide public float.
- Brokers may not vote on executive compensation or election of directors, unless the broker has received voting instructions from the beneficial owner.

As to foreign issuers:
- A foreign private issuer is not required to have an independent compensation committee, provided it discloses the reason why it does not.
- The SEC has authority to exempt foreign private issuers from listing standards if the issuers follow corporate governance practices in their home country (differences from U.S. standards must be disclosed).
- Exemption from auditor attestation requirement for issuers with less than $75 million in worldwide public float extends to foreign issuers.

As to whistleblowers:
- Employee is no longer subject to the reasonability of belief standard in order to be protected from retaliation.
- Statute of limitations is now 180 days (previously 90 days).
- Whistleblowers suing for retaliation are now entitled to a trial by jury in federal district court.
- Retaliation protection extends to employees of subsidiaries and affiliates.
- Whistleblower compensation in cases involving penalties of more than $1 million are between 10% and 30% of the amount of the penalty within discretion of the SEC.

<u>18 U.S.C. § 1033-1034</u>

This section of the U.S. Code addresses crimes by or affecting persons engaged in the business of insurance. The law establishes punishment for individuals engaged in the business of insurance that commit criminal acts. In addition, the law prohibits those convicted of various criminal acts from working in the business of insurance.

<u>IRS Governance Guidelines for Tax-Exempt Organizations</u>

There is a strong focus on corporate governance by the Internal Revenue Service (IRS), pursuant to its jurisdiction over corporations to which tax-exempt status has been granted. The IRS' basic interest addresses governance practices intended to enhance compliance with tax laws relating to such matters as private inurement, excess private benefit and excess benefit transactions. While most insurance companies are not directly subject to this particular jurisdiction, there is an indirect application as the core governance expectations and guidelines formulated by the IRS for exempt organizations are highly consistent with general themes of effective corporate governance as promulgated by other statutes and regulatory schemes. This is especially the case with respect to the development of governance and legal compliance guidelines and standards to prevent matters such as self-dealing, fraud and conflict of interest, as well as to promote effective and independent board composition, oversight, decision-making and transparency. In addition, the governance perspectives of insurance regulators and state attorneys general are often informed by the extensive technical publications, guidelines and other reference material and protocols published by the IRS on corporate governance and tax compliance, making them a ready resource for regulators and insurance companies alike.

C. Other Sources

New York Stock Exchange Listing Requirements

The New York Stock Exchange (NYSE) has established corporate governance standards for its listed companies. These standards are aimed at boosting public confidence in NYSE companies, promoting prompt disclosure of material events and enhancing corporate ethics. Companies must comply with these corporate governance standards as an ongoing condition to being listed with the NYSE. While some of these requirements mirror those imposed by the SEC, they are, in fact, independent contractual obligations. A company must ensure that it satisfies both SEC and NYSE requirements. Some of the significant NYSE listing requirements pertaining to corporate governance are as follows:

- A majority of the board members of an NYSE company must qualify as independent directors. In addition, all members of the three core board committees (audit, compensation, and nominating and governance) must be independent directors.
- An audit committee must consist of at least three independent directors, with each member being required to be financially literate. At least one member must have accounting or related financial management expertise.
- Audit committees must adopt a written charter that addresses the committee's purpose, as well as duties and responsibilities.
- Each company is required to maintain an internal audit function, although the function may be outsourced to a third-party other than the company's external auditor.
- A compensation committee must consist of at least three independent directors and must be governed by a written charter that addresses purpose and responsibilities, CEO goals, performance and compensation, non-CEO executive compensation and an annual self-evaluation.
- A nominating and governance committee must consist of at least three independent directors and must be governed by a written charter that addresses purpose and responsibilities, and an annual self-evaluation.
- Each company must develop, maintain and post to its website for public disclosure: its corporate governance guidelines, its code of business conduct and ethics, and its core committee charters.
- Each company's CEO will annually certify to the NYSE that he or she is unaware of any violation of NYSE's corporate governance standards. On an ongoing basis, the CEO must promptly notify the NYSE in writing if any executive officer of the company becomes aware of noncompliance with the NYSE's corporate governance standards.

NASDAQ Stock Exchange Listing Requirements

NASDAQ corporate governance standards parallel NYSE in many respects, but provide greater flexibility for less mature companies. Companies must comply with these corporate governance standards as an ongoing condition to being listed with NASDAQ. While some of these requirements mirror those imposed by the SEC, they are, in fact, independent contractual obligations. A company must ensure that it satisfies both SEC and NASDAQ requirements. Some of the significant NASDAQ listing requirements pertaining to corporate governance are as follows:

- A majority of the board members of the company must be independent. Independent directors will meet regularly in executive sessions, without management or other directors present.
- Each company must have an audit committee consisting of at least three directors, all of whom must be independent. All audit committee members must be financially literate and at least one member must be financially sophisticated.
- The audit committee must be governed by a written charter that requires the committee to oversee the external auditor, preapprove non-audit services, set procedures for whistleblower complaints, retain advisors and review all related-party transactions.
- An independent compensation committee, or a majority of the independent directors, must be governed by a written charter requiring the committee to determine, or recommend to the board for determination, compensation for the CEO and other executive officers.

- An independent nominating committee, or a majority of the independent directors, must be governed by a written charter requiring the committee to select, or recommend to the board for selection, all director nominations, except for those board seats where a third party has the contractual or other right to nominate a director.
- Each company must adopt and publicly disclose a code of conduct that covers all its directors, officers and employees.
- Each company must promptly notify NASDAQ if an executive officer of the company becomes aware of any material noncompliance by the company with NASDAQ's corporate governance standards.

Appendix
List of Relevant Laws, Rules, Regulations, Guidelines and Handbooks

Principle 1: Regulatory Reporting, Disclosure and Transparency

Annual Statement Instructions
Annual Financial Reporting Model Regulation (#205)
Insurance Holding Company System Model Act (#440)

Principle 2:Off-site Monitoring and Analysis

Financial Analysis Handbooks

Principle 3: On-site Risk-focused Examinations

Model Law on Examinations (#390)
Financial Condition Examiners Handbook
Exhibit B – Examination Planning Questionnaire
Exhibit M – Understanding the Corporate Governance Structure
Exhibit Y – Examination Interviews
Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to Be in Hazardous Financial Condition (#385)

Principle 4: Reserves, Capital Adequacy and Solvency

Standard Valuation Law (#820)
Actuarial Opinion and Memorandum Regulation (#822)
Annual Statement Instructions – Property/Casualty
Risk-Based Capital (RBC) for Insurers Model Act (#312)
Risk-Based Capital (RBC) for Health Organizations Model Act (#315)

Principle 5: Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities

Uniform Certificate of Authority Application (UCAA) Manual
Company Licensing Best Practices Handbook
Insurance Holding Company System Regulatory Act (#440)
Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (#450)
Investments of Insurers Model Act – Defined Limits Version (#280)
Investments of Insurers Model Act – Defined Standards Version (#283)
Derivative Instruments Model Regulation (#282)
Credit for Reinsurance Model Act (#785)
Credit for Reinsurance Model Regulation (#786)
Managing General Agents Act (#225)
Producer Licensing Model Act (#218)
Business Transacted with Producer Controlled Property/Casualty Insurer Act (#325)
Model Act on Custodial Agreements and the Use of Clearing Corporations (#295)
Model Regulation on Custodial Agreements and the Use of Clearing Corporations (#298)
Reinsurance Intermediary Model Act (#790)
Registration and Regulation of Third-Party Administrators (#1090)

Principle 6: Preventive and Corrective Measures, Including Enforcement

Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in a Hazardous Financial Condition (#385)
Administrative Supervision Model Act (#558)
Troubled Insurance Company Handbook

Principle 7: Exiting the Market and Receivership

Receiver's Handbook for Insurance Company Insolvencies

Other Non-Solvency Related Processes

State Licensing Handbook
Market Regulation Handbook
Unfair Trade Practices Model Act (#880)
Model Law on Examinations (#390)
Unfair Claims Settlement Practices Act (#900)
Long-Term Care Insurance Model Act (#640)
Producer Licensing Model Act (#218)
Improper Termination Practices Model Act (#915)
Life Insurance Illustrations Model Regulation (#582)
Health Carrier External Review Model Act (#75)
Privacy of Consumer Financial and Health Information Regulation (#672)
Suitability in Annuity Transactions Model Regulation (#275)

Other Corporate Governance Standards/Requirements Outside of Insurance Regulation

American Bar Association – Model Business Corporation Act
American Bar Association – Model Nonprofit Corporation Act
The Securities Act of 1933
The Securities Exchange Act of 1934
The Sarbanes-Oxley Act of 2002
The Dodd-Frank Wall Street Reform and Consumer Protection Act
18 U.S.C. § 1033
Internal Revenue Service – Governance and Related Topics - 501(c)(3) Organizations
New York Stock Exchange Listed Company Manual – Section 303A.00 Corporate Governance Standards
NASDAQ Stock Market Listing Rules – 5600. Corporate Governance Requirements

