SIDLEY GLOBAL INSURANCE REVIEW

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The insurance industry has a global reach. Insurers and reinsurers are critically important to the world economy. They assume and transfer all manner of risk from every corner of the earth and serve as an enormous investor base. Risk is increasingly shared globally among traditional and new market entrants. Risk generated in one part of the world is distributed immediately across multiple continents to other market participants, whether they be other insurers, reinsurers, private equity sponsors or capital market investors. This constantly evolving industry requires regulatory regimes and market participants to adapt on a frequent basis. Regulatory issues arising in one market may influence the way in which similar regulatory concerns are addressed in other markets. To understand the insurance industry, one must have a solid understanding of global developments.

We realize that no one publication could provide adequate coverage to each and every recent global development without becoming cumbersome. Accordingly, this publication attempts to provide an overview of major legal and market developments in the global insurance industry arising over the past year. We have focused on developments in the United States, United Kingdom, European Union, Asia and other markets with intense insurance activity, such as Bermuda.

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We hope you enjoy this edition of the *Sidley Global Insurance Review*.

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I. The Global Mergers & Acquisitions Market

A. U.S. MARKET

After a decline in mergers and acquisitions ("**M&A**") activity in the insurance industry over the last several years, 2014 marked the industry's busiest year since 2008, with a total of 390 transactions announced in 2014 having a combined total transaction value of nearly US$50 billion.[1] The announcement of several high profile transactions in early 2015 has prompted speculation that the momentum will continue. Of the total deal value in 2014, US$17 billion was attributable to property and casualty insurance and reinsurance transactions, making it the busiest year for the property and casualty sector since 2011.[2] In the life and annuity sector, a number of notable transactions demonstrated continued interest in the insurance industry on the part of private equity, pension funds and other non-traditional financial buyers.

1. Blockbuster Deals in the Property and Casualty Reinsurance Market

A sizable component of the spike in M&A activity in 2014 was concentrated in the property and casualty reinsurance market, a trend that shows no signs of slowing in early 2015. As has been widely discussed, the influx of alternative capital into the property and casualty reinsurance market has placed substantial pressure on traditional reinsurers, pushing pricing levels to multi-year lows. While the conversation continues as to whether the market is simply experiencing a difficult cycle or undergoing a long-term structural shift, numerous property and casualty reinsurers have opted to pursue balance sheet-expanding transactions as a way to strengthen their positions relative to the alternative-capital-backed competition and to each other. In addition to increasing their bargaining power with intermediaries and primary insurers, consolidating reinsurers are hoping to realize economies of scale benefits and achieve greater product line and geographic diversification. Looking ahead, consolidation momentum may ultimately emerge as the primary driver of further activity if traditional reinsurers heed Catlin Group Limited ("**Catlin**") CEO Stephen Catlin's advice not to end up "the ugly duckling" left without a partner at the M&A dance.

a. Validus Acquisition of Western World

The October 2014 closing of Bermuda-based reinsurer Validus Holdings Ltd.'s ("**Validus**") US$690M acquisition of U.S.-based excess and surplus lines insurer Western World Insurance Group Inc. ("**Western World**") (a transaction announced in June 2014) represented one of the first examples of the consolidation in the reinsurance market that came to dominate the headlines by year-end. As Validus has publicly noted, the acquisition was driven by a desire to obtain a U.S. platform. It may also reflect the dramatic shift in negotiating leverage between reinsurers and direct writers: Validus' Chairman and CEO Edward Noonan has candidly acknowledged that one attraction of the acquisition was the chance to obtain exposure to "the other side of the bet" in such negotiations. Given Western World's excess and surplus lines focus, the transaction, in a similar vein to the RenaissanceRe-Platinum Underwriters transaction discussed below, also appears to have been motivated in some measure by the opportunity to diversify into product lines less affected by alternative-capital-backed competitors.

b. RenaissanceRe Acquisition of Platinum Underwriters

RenaissanceRe Holdings Ltd.'s ("**RenaissanceRe**") announcement in November 2014 of its agreement to acquire fellow Bermuda-based reinsurer Platinum Underwriters Holdings Ltd. ("**Platinum Underwriters**") for a reported US$1.92 billion signaled the acceleration of the consolidation that has shaken up the reinsurance market (the transaction closed in March 2015). RenaissanceRe has historically focused on property catastrophe business, one of the market segments most affected by the influx of alternative capital, and its acquisition of casualty and specialty reinsurer Platinum Underwriters appears to reflect a desire to diversify into product lines less vulnerable to falling demand and depressed prices. Reports have suggested that RenaissanceRe may also be seeking to expand and diversify its way out of a group of similarly-sized Bermuda-based reinsurers in order to transform itself into a more attractive, full-service partner for primary insurers seeking traditional reinsurance placements.

c. XL's Acquisition of Catlin

In early January 2015, Bermuda and Ireland-based insurer and reinsurer XL Group Plc ("**XL**") announced an agreement to acquire Catlin, a leading Lloyd's of London participant, for a reported US$4.21 billion. The combined entity plans to operate under the "XL Catlin" trade name with XL Group Plc remaining the company's legal name. Similar to the AXIS Capital-PartnerRe merger discussed below, frequently articulated rationales for the acquisition include the ability to achieve significant cost savings (among other things, with respect to compliance and regulatory costs) and a desire for enhanced negotiating power with intermediaries and primary insurers. Given Catlin's international reach, the appeal of increased geographic diversification may have also played a role in XL's decision to re-enter the M&A market after several years on the sidelines.

d. AXIS Capital-PartnerRe Merger

The announcement in late January 2015 of the proposed US$11 billion "merger of equals" between Bermuda-based reinsurers AXIS Capital Holdings Ltd. ("**AXIS Capital**") and Partner Re Ltd. ("**PartnerRe**") reinforced the allure of the "size matters" school of thought among traditional reinsurance providers. According to published reports, upon the consummation of the transaction, PartnerRe will own 51.6% of the new combined entity and AXIS Capital will own 48.4%. Frequently cited motivations for the transaction include reduced costs as a result of increased scale (the parties predict at least US$200 million in cost savings in the first 18 months post-closing) and increased product diversification. The parties have also characterized the debt-free merger as the development of a more robust platform for further acquisitions. Amid predictions of the emergence of a two-tier market in the property and

1 *Size Matters in Bermuda as Reinsurance Deals Heat Up,* Bloomberg (January 27, 2015) (http://www.bloomberg.com/news/articles/2015-01-27/size-matters-in-bermuda-as-reinsurance-deals-heat-up-real-m-a).

2 *Size Matters in Bermuda as Reinsurance Deals Heat Up,* Bloomberg (January 27, 2015) (http://www.bloomberg.com/news/articles/2015-01-27/size-matters-in-bermuda-as-reinsurance-deals-heat-up-real-m-a).

casualty reinsurance sector—with the lion's share of business going to companies in the upper tier—upon closing, the AXIS Capital-PartnerRe merger will have effectively secured the combined entity's position in the top tier for the near future.

2. Asian Acquirers' Interest in the U.S. Market

Asian interest in U.S. targets represented a trend in 2014 that was evident in both the property and casualty and the life and annuity sectors. In the life and annuity sector, Japanese insurer Dai-ichi Life Insurance Company ("**Dai-ichi**") made a splash with the June 2014 announcement of its US$5.58 billion proposed acquisition of Protective Life Corp ("**Protective Life**"), which closed in February 2015. In the property and casualty sector, a leading Chinese investment group and conglomerate, Fosun International Holdings Ltd. ("**Fosun**"), had a very active year in the U.S. market, reaching an agreement to acquire a 20% stake in Ironshore Inc. ("**Ironshore**") for a reported US$463 million (subject to certain adjustments) in August and announcing an agreement to acquire Meadowbrook Insurance Group, Inc. ("**Meadowbrook**") for US$433 million in late December. Potential acquirers in both the Japanese and Chinese markets seem to be increasingly interested in accessing the growth opportunities and relative stability that the U.S. economy offers.

a. Dai-ichi Acquisition of Protective Life

With a purchase price of US$5.58 billion, which represented a 30% premium over Protective Life's stock price at the time of the June 2014 announcement, Dai-ichi's acquisition of Protective Life was something of an outlier from a transaction size perspective during a relatively quiet first half of the year. For Japanese life insurers such as Dai-ichi, the growth challenges posed by Japan's shrinking population and a low-yield domestic market are driving outbound acquisitions in larger markets such as in the United States and Europe. The acquisition created the thirteenth largest global insurer and has provided Dai-ichi with its first significant beachhead in the United States.

b. Fosun's U.S. Acquisitions

With two acquisitions in 2014, Fosun, whose businesses include insurance, industrial operations and asset management, expanded its insurance holdings into the U.S. market. In August 2014, Fosun reached agreement to acquire a 20% stake in Ironshore for a reported US$463 million (subject to certain adjustments). Then, on December 30, 2014, Fosun reached an agreement to acquire Meadowbrook, which had long been the subject of takeover speculation as it sought to stabilize its workers' compensation reserves. The purchase price for the proposed acquisition (which remains subject to regulatory approval) represented a 21% premium over Meadowbrook's stock price at the time of the deal announcement. In addition to offering access to the stability and growth opportunities afforded by the U.S. market, the acquisition of Meadowbrook would provide Fosun with exposure to U.S. management and operations expertise. Increased Chinese government support for outbound acquisitions has also been posited as a driver of Fosun's entry into the U.S. market with the Meadowbrook and Ironshore acquisitions.

3. Other Notable Life and Annuity Activity and Developments

a. Continued Interest by Financial and Non-Traditional Buyers

Private equity-backed buyers have in recent years driven the majority of deal activity in the life and annuity sector—and 2014 was no exception. Such buyers have viewed the insurance industry as a platform for growth with risks that are not correlated to the financial markets. Other non-traditional institutional buyers, such as pension funds, have also demonstrated a willingness to complete acquisitions with long-term commitments within the industry. In March 2014, the Canada Pension Plan Investment Board ("**CPPIB**") agreed to acquire U.S. life insurance and reinsurance provider Wilton Re Holdings Ltd. ("**Wilton Re**") for US$1.8 billion from a group of private equity firms led by Stone Point Capital, Kelso & Co, Vestar Capital Partners and FFL (the transaction was completed in June 2014). Having acquired several closed-block assets in recent years, Wilton Re has stated that it believes its new ownership will enable it to bolster its own acquisition strategy. Soon after the CPPIB's acquisition, Wilton Re completed its previously announced acquisitions of Conseco Life and Continental Assurance Co. and, later in the year, announced an agreement to acquire Aegon N.V.'s Canadian life insurance business, each of which is discussed further below.

After accounting for a significant share of activity in the life and annuity market in 2012 and 2013, Athene Holding Ltd. ("**Athene**") (an affiliate of Apollo Global Management LLC ("**Apollo**")) and Guggenheim Partners LLC ("**Guggenheim**") remained relatively quiet in 2014. However, in early 2015, Athene announced an agreement to acquire the German business of the Delta Lloyd Group, which looks to serve as an entry point for Athene into the German marketplace. It remains to be seen whether Athene, Guggenheim and other financial and non-traditional buyers will maintain the same level of activity as in prior years as the regulatory landscape continues to evolve.

b. NYDFS Changes to Regulation 52

In 2014, stemming from its concerns regarding private equity firms' acquisitions of life insurers writing fixed annuity contracts, the New York State Department of Financial Services ("**NYDFS**") adopted several changes to Regulation 52, which sets forth the regulatory requirements relating to the acquisition of control of New York domestic insurance companies. The amendments, which are described below in Section B.7 of "Global Regulatory and Litigation Developments," include a variety of measures that provide the NYDFS with expanded authority in connection with the review and approval of acquisitions of control of New York domestic insurance companies, including the discretion for the NYDFS to require certain acquirers to establish a trust account for the benefit of the target with backstop capital in an amount, and for a duration, to be decided by the NYDFS.

c. In-Force Life and Run-Off Transactions

One of the more notable transactions of the year involving life run-off businesses was XL's US$570 million sale of XL Life Reinsurance to GreyCastle Holdings, a reinsurance business that has been in run-off since 2009, which was announced in April 2014 and closed in July.

In addition, Wilton Re completed two acquisitions involving run-off blocks of life and annuity business in 2014: (i) in July 2014, Wilton Re completed its US$237 million acquisition of Conseco Life Insurance Company from CNO Financial (the transaction was announced in March 2014) (the Conseco Life Insurance Company business consists of closed blocks of individual traditional and interest-sensitive life insurance policies and deferred annuities), and (ii) in addition, in August 2014, Wilton Re completed a US$615 million transaction with CNA Financial Corporation ("**CNA**") in which it acquired the majority of CNA's payout annuity business, consisting primarily of in-force structured settlements and group annuities (the transaction was announced in February 2014). Finally, Reinsurance Group of America was involved in two substantial acquisitions in 2014: (i) in August 2014, Reinsurance Group of America, Incorporated ("**RGA**") announced its acquisition of a closed block of term life policies from Voya Financial representing US$104 billion of in-force term life policies issued by Voya subsidiaries ReliaStar Life Insurance Company and Security Life of Denver Insurance Company, and (ii) in October 2014, RGA announced an agreement to acquire Aurora National Life Assurance Company ("**Aurora**") from Swiss Re for an undisclosed amount (the Aurora business consists primarily of payout annuities but also has a significant portion of interest-sensitive life products).

d. Divestitures of Variable Annuity Business

In a transaction that was announced in April 2014 and closed in July 2014, The Hartford continued its departure from the life and annuity space with the sale of its Japanese subsidiary Hartford Life Insurance K.K. ("**HLIKK**"), which wrote fixed and variable annuity business in Japan, to ORIX Corporation ("**ORIX**") for US$963 million. In connection with the transaction, a subsidiary of Berkshire Hathaway agreed to provide reinsurance to ORIX with respect to HLIKK's variable annuity business following the closing. The transaction was indicative of the type of multi-buyer transactions that have become more common in recent years. The Hartford's management has discussed the transaction as another significant step in its broader strategy to reduce its risk profile and shift focus to its core property and casualty, group funds and mutual funds business segments.

e. Canadian Acquisitions

In September 2014, Canada's largest life insurer, Manulife Financial Corporation, announced an agreement to acquire the Canadian operations of UK insurer Standard Life plc for approximately C$4 billion following what was reportedly a highly competitive auction. The transaction closed in February 2015. In addition, following on the heels of its acquisitions of a number of life businesses in run-off, Wilton Re announced in October 2014 that it would acquire the majority of Aegon N.V.'s Canadian life insurance business for approximately C$600 million. The acquired business consists of individual life, annuity and segregated funds policies, as well as credit insurance products written and managed through Transamerica Life Canada, Canadian Premier Life, Legacy General Insurance Company, Aegon Capital Management, Aegon Fund Management, CRI Canada and Selient, Inc. and comes with an investment portfolio with C$10.6 billion in assets.

4. Other Notable Property and Casualty Activity

A number of other notable deals were announced or consummated in 2014 and early 2015. Following a pattern of recent private equity investments in insurance administration businesses, in January 2014, private equity firm TPG Capital, L.P. announced an agreement to acquire The Warranty Group, a warranty insurance writer and claims administrator, from Onex Corporation, another private equity firm, for US$1.5 billion (the transaction was completed in August 2014). Numerous acquisitions late in the year appeared to be driven by the opportunity to add onto existing homeowners' insurance business. In mid-December, Progressive Corp. announced an agreement to increase an existing stake in American Strategic Insurance Corp.'s parent company, ARX Holdings Corp., for a reported US$875 million. Just a few days later, ACE Ltd. ("**ACE**") announced an agreement to acquire the renewal rights to the personal lines business of the Fireman's Fund brand from Allianz Group for a reported US$365 million. For their respective acquirers, each transaction represents an expansion into the homeowners insurance segment of the U.S. market. The Fireman's Fund acquisition also provides ACE with increased access to the profitable high-net-worth personal lines market. For its part, although Progressive moved out of the homeowners' insurance market in the early 2000s, it appears to be newly committed to offering its customers a full-service experience given the continued importance of product bundling in personal lines businesses. Finally, in February 2015, Canadian-based property and casualty insurer Fairfax Financial Holdings Ltd. announced it had entered into an agreement to acquire specialty insurer and reinsurer Brit plc for approximately US$1.88 billion from private equity firms Apollo and CVC Capital Partners ("**CVC**"). The transaction follows Fairfax's acquisition of Brit's UK general insurance business from Apollo and CVC in June 2012. As is the case with XL's acquisition of Catlin, among other factors, Fairfax appears to have been motivated by a desire to gain entrance into the Lloyd's market. The acquisition also extends Fairfax's broader efforts to diversify into European markets, coming shortly after its December acquisition of the majority of QBE Insurance Group's Eastern European operations.

5. Outlook Ahead

Given the size and accelerating pace of M&A activity in the reinsurance sector in 2014, we anticipate further consolidation as the recent wave of deals increases the pressure on reinsurers to partner up. This may also afford companies like the combined AXIS Capital-PartnerRe entity with greater opportunities to pursue inorganic growth. Recent reports regarding the ongoing auction process for Bermuda-based reinsurer Montpelier Re Holdings Ltd., with final bidders reported to include Endurance Specialty Holdings Ltd., Hamilton Insurance Group and Fosun, suggest the reinsurance M&A trend is likely to continue while also confirming Fosun's emergence as an acquisitive international player.

In the direct market, following the acquisitions of Tower Group by AmTrust Financial Services (which was announced in January 2014 and closed in September 2014) and Meadowbrook by Fosun, we may see additional activity involving targets that have confronted reserving challenges in long-tail businesses such as workers' compensation and long-term care. In the life and annuity sector, it will be interesting to see whether the not inconsiderable level of

M&A activity involving variable annuity business in 2013 and 2014 increases in 2015 as potential acquirers of variable annuity business become more aggressive and increasingly confident in their ability to accurately assess and price variable annuity risk. Additionally, 2015 may see a rise in strategic acquisitions by companies that have been focused for the past few years on managing their capital positions and shedding unprofitable or non-core business segments. Having stabilized their balance sheets, these companies may seek to expand their profitable core businesses through M&A in the coming years.

B. EUROPEAN AND ASIAN MARKETS

1. Europe

M&A activity in the insurance sector in Europe, including the UK, has experienced an uptick in each of the last two years. The same factors which prompted that up-tick in activity have further pushed the premise that consolidation among underwriters in the European market and, in particular, the UK, remains an obvious path towards increasing profitability for an insurance or reinsurance carrier and, correspondingly, enhancing shareholder returns. As a consequence, activity within the insurance M&A sector in Europe, particularly the UK, where Lloyd's vehicles remain preferred platforms, is expected to further accelerate in 2015.

As referenced above in Section I.A, several significant transactions announced recently support the fact of the trend's acceleration. In January 2015, AXIS Capital and PartnerRe, each with a significant European presence, announced their agreement, subject to the receipt of regulatory approvals, to merge. The combined entity will constitute one of the largest reinsurers in the world with over US$10 billion in premiums, US$14 billion in capital and cash and invested assets of US$33 billion. The AXIS Capital-Partner Re merger follows shortly after the announcement of the proposed acquisition by XL of Catlin. The XL-Catlin transaction is viewed by the market as creating, on a combined basis, a leading worldwide writer of property and casualty insurance and reinsurance, on a scale materially greater than either carrier could achieve independently. Further, in merging, each has eliminated a competitor.

Lloyd's vehicles remain sought after due to the diversification of risk they provide, being generally uncorrelated with other risks. Hamilton Insurance Group, Ltd.'s announcement in November 2014 that it had entered into a definitive agreement to acquire Sportscover Underwriting Limited ("**Sportscover**") and Lloyd's broker Kinetic Insurance Brokers Limited from Wild Goose Holdings Group spotlights the continuing attractiveness of the Lloyd's platform: notwithstanding its subdued results of recent years, Sportscover's availability on the market triggered multiple bids.

As discussed above in Section I.A.1, the continuing soft market on the property and casualty side of the industry, in particular, has driven the acceleration of efforts to consolidate. With premium rates generally remaining stagnant or declining at the January 1, 2015 renewal date, and competition for business increasing—much of this competition sourcing from insurance-linked securities funds—the pressure on companies to find a means to grow the bottom line is acute. As a consequence of such bottom line pressure, there is a material focusing on the realization of scale-based efficiencies—translating into consolidation between competitors. Additionally, in the context of pressure to the bottom line and contracting margins, underwriting discipline may slacken, resulting in greater than anticipated losses, further depressing returns. These multiple dynamics are causing carriers with a market capitalization of less than US$10 billion to proactively seek consolidation within their peer group.

Increased familiarity by the market with the amendments proposed to regulatory regimes, most notably Solvency II, and indications from those leading the reform effort that the current proposals will be adopted and implemented in substantially the forms being circulated, have introduced an element of confidence among European market participants regarding capital requirements. Knowledge of capital requirements in turn has allowed crystallization of computations regarding the amount of capital required to continue to underwrite competitively, as well as the amount of capital that can be deployed in the acquisition context—both factors pushing the consolidation trend. Where greater amounts of capital are required, realizing efficiencies of scale becomes of paramount importance. Additionally, with global interest rates remaining low for an almost unprecedented period of time and there being a general industry-wide improvement in stock valuations of companies in the sector, the coming together of sellers and buyers has accelerated (AXIS Capital-PartnerRe; XL-Catlin) with the trend poised to continue.

Globalization of the insurance industry also continues as a trend further driving M&A activity across Europe and, in particular, the UK. For all but the most regional industry participants, remaining competitive requires a presence in all markets, including emerging markets in South America and Africa.

2. Asia Pacific

We also expect the trend of increased M&A activity in China and the pan-Asia market to continue through 2015. In part, the increasing momentum is driven by changes in local, regional and international underlying market fundamentals occurring in the post-2008 environment. Additionally, regulators in some Asian markets have adopted more stringent minimum capital requirements—the tightening of such regulatory requirements reflecting the interest of certain jurisdictions in enhancing market efficiency and competitiveness—leading to the same need for efficiencies of scale being experienced in the European market.

In this regard, the China Insurance Regulatory Commission ("**CIRC**") amended rules for insurance M&A in 2014 to allow domestic and foreign insurance companies to acquire stakes in insurers that operate in the same line of business. The amended rules also allow a company to take acquisition loans to finance transactions. The liberalization of the rules has enhanced the attractiveness of M&A transactions in China.

Other regulatory reform measures have made entrance into certain other Asian markets also more attractive. In Malaysia, regulators amended the foreign investment cap from 49% to 70% (2009), an action which drew new investment from companies such as MetLife, Inc. ("**MetLife**"), Prudential Financial, Inc., Liberty Mutual Insurance Group ("**Liberty Mutual**") and Tokio Marine Holdings, Inc. Liberty

Mutual's acquisition of a majority stake in Uni.Asia General Insurance Berhad in 2014 took advantage of the revised foreign investment limit.

Thus, driven by the same underlying economic fundamentals driving consolidation in Europe, including contracting margins, increased competitiveness and low investment return on portfolios, the Asian market continues to experience transaction activity, which is further promoted by regulatory reform.

Another M&A trend witnessed in the region is that of reinsurers acquiring stakes in primary writers, reflecting a strategy to gain access to markets and distribution. Because issuance of new reinsurance licenses is increasingly restricted in many jurisdictions, established global reinsurers' investment into the region through acquisition transactions affords the most direct avenue for expansion. In July 2014, Swiss Reinsurance Company Ltd reached agreement with RSA Insurance Group plc to buy Sun Alliance Insurance (China) Limited, which follows the acquisition by a Swiss Re affiliate of a 4.9% stake in New China Life Insurance Company Ltd. from Zurich Insurance Company Ltd. Also, in August 2014, Munich Reinsurance Company agreed to acquire Australia-based Calliden Insurance Limited.

Unevenness country-to-country within the Asian market, in terms of regulatory structures and the health of local economies, continues to make certain jurisdictions more attractive than others. Political stability is another factor distinguishing one jurisdiction from another, with M&A activity within countries with a sustained history of political stability predictably leading the jurisdictions targeted for M&A transactions.

II. The Global Alternative Risk Transfer Market

A. LIFE INSURANCE MARKET

1. The State of the Reserve Financing Market

a. Adoption of the Rector Report and AG 48

As discussed in more detail in Section B.2.a of "Global Regulatory and Litigation Developments," the Principle-Based Reserving Implementation (EX) Task Force (the "**PBR Task Force**") of the National Association of Insurance Commissioners (the "**NAIC**") was focused almost exclusively on developing (and then implementing) interim rules specific to life insurance reserve financing transactions, pending the full implementation of Principles-Based Reserving ("**PBR**"). In August 2014, the NAIC adopted a framework (the "**Framework**"), based on the result of extended discussions among the PBR Task Force, its third-party consultant's (Rector & Associates, Inc.) third written report, dated June 4, 2014 (the "**Rector Report**"), insurance regulators and industry groups. The Framework sets forth the requirements for life insurers using affiliated captive reinsurers (each, a "**Captive**"), particularly for transactions financing life insurance companies' perceived excess reserves associated with blocks of level premium term insurance subject to Regulation XXX ("**Regulation XXX**" or "**XXX**") or universal life products with secondary guarantees subject to Actuarial Guideline XXXVIII (AXXX) ("**Regulation AXXX**" or "**AXXX**"). On December 16, 2014, the NAIC adopted Actuarial Guideline XLVIII—Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation ("**AG 48**"), which essentially codified the Framework, with some smaller changes, as discussed in more detail in Section V.B.2.a below.

AG 48 applies to transactions in which a ceding company cedes policies to a Captive that meet the definition of "Covered Policies." "**Covered Policies**" include those policies (i) written on or after January 1, 2015 or (ii) reinsured pursuant to a "New Reinsurance Agreement," where a "**New Reinsurance Agreement**" is defined as an agreement entered into (a) on or after January 1, 2015 or (b) prior to January 1, 2015 that is amended, renewed or restructured on or after January 1, 2015, with some exceptions. Although not specifically stated, the language regarding Covered Policies under clause (ii) in the previous sentence seems to imply that certain refinancing arrangements fall outside the scope of AG 48. Additionally, AG 48 provides exemptions from its requirements for certified reinsurers and operating accredited reinsurers that comply with statutory accounting and risk-based capital ("**RBC**") rules.

Pursuant to AG 48, if a transaction cedes Covered Policies to a Captive that is not otherwise exempt from AG 48, then reserves up to the level set forth in Standard Valuation Manual VM-20 Requirements for Principle-Based Reserves for Life Products ("**VM-20**"), as adjusted under the terms of AG 48, must be backed by "Primary Security." The concept of "**Primary Security**" includes hard assets (cash and securities listed by the Securities Valuation Office of the NAIC) and excludes synthetic letters of credit, contingent notes, credit-linked notes and other securities that operate in a manner similar to a letter of credit. For security held in connection with funds withheld and modified coinsurance reinsurance arrangements, AG 48 defines "Primary Security" as also including: (i) commercial loans in good standing (of CM3 quality and higher); (ii) policy loans; and (iii) derivatives acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks in the policies ceded pursuant to the reinsurance arrangement. Reserves that are required to be held by statute above the adjusted VM-20 level can be backed by "Other Security," meaning any asset acceptable to the commissioner of the ceding company's domiciliary state ("**Other Security**"). A number of questions regarding Primary Security and Other Security remain, such as whether there are any limitations on the ceding company's ability to draw on the Primary Security collateral and the method by which Primary Security and Other Security collateral must be posted.

In addition to outlining the types of security available to collateralize reserves, AG 48 provides guidance concerning the NAIC Actuarial Opinion Memorandum Regulation (the "**Memorandum**"). Section 3 of the Memorandum gives insurance commissioners authority to specify methods of actuarial analysis and assumptions necessary for an acceptable opinion to be rendered concerning adequacy of reserves. AG 48 requires that an opining actuary for a cedent must: (i) follow the methods and assumptions developed as individual components of the Framework to determine whether the cedent's net reserves are appropriate; and (ii) issue a qualified actuarial opinion if the cedent has entered into a reserve financing transaction that does not adhere to the Framework. It is still unknown whether this would result in an RBC charge.

Still under consideration in this new regime is the level of RBC charges associated with certain types of collateral, including Other Security. The applicable working groups at the NAIC are discussing the appropriate RBC charge for an insurer ceding policies subject to Regulation XXX or Regulation AXXX reserving when the assuming Captive does not file an RBC report using the RBC formula and instructions or maintains RBC levels of capital below a specified threshold. In the event that the Captive's RBC level is below company action level RBC, one proposal would require that the total adjusted capital of the ceding company be reduced by such shortfall.

The NAIC's Financial Condition (E) Committee has been charged with evaluating the risk-transfer rules applicable to Regulation XXX and Regulation AXXX reserve financing transactions to ensure that the regulations "appropriately apply to situations such as those where parental/affiliate guarantees are used, resulting in the risk effectively being kept within the holding company system even though the reinsurance arrangement involves an unrelated third party." As of the date of this publication, there has been no official proposal circulated.

b. New York State Litigation

Beyond the challenges faced from policymakers, recent litigation in the State of New York highlights the growing scrutiny from plaintiffs' attorneys over the use of captives in life reinsurance transactions. Two first impression class action lawsuits were filed in New York federal court in 2014.

In April 2014, plaintiff Andrew Yale (represented by Perkins Coie LLP) filed a complaint against AXA Life Insurance Company ("**AXA**") for knowingly violating New York Insurance Law Section 4226(a)(4), prohibiting insurers from making "any misleading representation, or any misrepresentation of the financial condition of any such insurer or of the legal reserve system upon which it operates" in connection with the sale of a policy. Whether the AXA litigation will be allowed to proceed remains to be seen. AXA argues, among other things, that the New York law at the center of the complaint is for the benefit of individual New York residents only (barring class action) and that the suit should be dismissed for the court's lack of subject matter jurisdiction.

The second class action suit, also brought by Yale (represented by Perkins Coie LLP), alleges similar claims against Metropolitan Life Insurance Company ("**Metropolitan Life**"). It also calls attention to Metropolitan Life's parent company, MetLife, having been designated a systemically important financial institution in December 2014—a designation that MetLife is contesting—and submits that by engaging in conduct that results in inadequate reserving, Metropolitan Life and its parent pose a threat to the financial stability of policyholders, beneficiaries and the public at large.

c. Federal Regulatory Developments

The issue of captive life reinsurance continues to receive heightened interest at the federal level. As discussed in the *Sidley Global Insurance Review (March 2014)*, the Modernization Report issued by the U.S. Department of the Treasury's Federal Insurance Office ("**FIO**") in December 2013 recommended that States implement reforms in favor of "uniform and transparent" oversight for the transfer of risk to captives. More recently, in its second annual report on the state of the insurance industry, the FIO noted a March 2014 report by economists associated with a state federal reserve bank that named the increased use of captive reinsurance as a source of risk in the life insurance sector. The FIO advised that it "will continue to monitor and report on regulatory treatment of this issue."

2. Embedded Value/Closed-Block Transactions

Prior to 2014, there had been little activity in the embedded value market since the financial crisis, other than the 2011 offering by Vecta I Limited, an indirect subsidiary of Aurigen Capital Limited ("**Aurigen**"), of C$120 million in embedded value linked notes that securitized profits from a closed block of life reinsurance business.

During the fourth quarter of 2014 and the first quarter of 2015 there has been an uptick in the embedded value market, with two transactions being completed. The first was an offering in December 2014 by Chesterfield Financial Holdings LLC, an indirect subsidiary of RGA, of US$300 million in embedded value linked notes sold in a 144A offering. The transaction securitized a closed block of policies assumed by RGA Reinsurance Company between 2006 and 2010. This offering of a single tranche of notes rated A- (sf) by S&P was the first securitization of U.S. life insurance embedded value since the financial crisis.

The second embedded value transaction occurred in mid-January 2015 and was a second embedded value transaction within the Aurigen group. This transaction was a private placement by Valins I Limited, an indirect subsidiary of Aurigen, of C$210 million in embedded value linked unrated notes, covering a closed block of Canadian life insurance policies reinsured by Aurigen Reinsurance Ltd. between 2008 and 2013. This structure allows for the increase and extension of the notes, providing Aurigen with the flexibility to add future new business to the deal and continuous access to capital funding to support its growth. A portion of the proceeds were used to redeem the notes issued by Vecta I Limited in 2011.

3. Outlook Ahead

The past year showed significant regulatory development in the reserve financing marketplace. With the NAIC's adoption of AG 48, the regulatory landscape for captive reserve financing deals has begun to crystallize after a period of uncertainty. Further, clarity will improve as guidelines relating to VM-20 calculations and RBC requirements are finalized.

Looking ahead to the latter part of 2015, we expect the pace of risk transfer transactions to continue. For reserve financings, the current financing structures will be modified in response to the new regulatory regime. Market participants will need to address the procurement of cash or of assets listed by the NAIC's Securities Valuation Office to fund the excess of the VM-20 level and the amount of economic reserves. We anticipate that the reserve levels that exceed the VM20 level will be financed using solutions developed since the financial crisis. Outside of Regulation XXX and Regulation AXXX transactions, we may see more activity in the U.S. embedded value securitization market on account of two significant transactions having been completed in 2014.

What may still be years away, however, is the establishment of PBR as the de facto reserving model for life insurers. Although actuarial analysis under AG 48 introduces a variation of the PBR VM-20 requirements in the context of reserve financing transactions, PBR will become fully operative only when legislation is adopted by at least 42 states, representing 75% of total life insurance premiums written in the United States. As of early March 2015, 20 states have enacted legislation to implement PBR requirements, representing approximately 36% of total U.S. premiums. Michigan is the most recent addition, having passed legislation on December 31, 2014. Another 12 states have begun the legislative process to enact PBR and/or are expected to begin the process this year. However, two key states representing a significant portion of total U.S. premiums, California and New York, have been and remain vocal in their opposition.

B. PROPERTY AND CASUALTY INSURANCE MARKET

The importance of alternative risk transfer ("**ART**") products in the property and casualty market proved once again to be on the rise in 2014, taking the trends of 2013 to new heights. In the catastrophe bond market, it was a groundbreaking year for deal activity, market size and innovation. Building on the prior year's themes of broadened investor demand and structural flexibility, 2014 also brought continued growth of third-party capital, sidecar capacity and hedge fund reinsurer activity. According to market sources, increasingly favorable pricing within the ART market was partially responsible for falling rates on line among traditional reinsurers. The following provides an overview of the global property and casualty ART market's highlights and trends of 2014.

1. Catastrophe Bonds

The issuance of catastrophe bonds continued to increase in 2014, reaching a total of US$8.3 billion, just clearing the record level of US$8.2 billion set in 2007. After seeing the catastrophe bond market contract for four straight years, beginning in 2008, the market has now seen three consecutive years of approximately 20% yearly growth. Total catastrophe risk capital outstanding at the end of 2014 was a record US$24.1 billion.[3]

The growth was mainly achieved during the first half of 2014 with close to US$6 billion of catastrophe bonds issued. The issuance slowed down significantly in the second half and was comprised exclusively of repeat sponsors during that period. Market sources reported 27 "public" 144A catastrophe bond transactions. The average issuance size was over US$300 million, which was roughly twice as large as in 2007.[4]

In addition to the "public" catastrophe bond transactions, approximately US$560 million of limit was transferred to the capital markets via 17 "private" catastrophe bond transactions.[5]

Seven new sponsors entered the "public" 144A catastrophe bond market in 2014. Of the seven, five were insurers, one was a reinsurer and one was a residual markets insurer. Indemnity coverage continued to dominate the market, accounting for 80% of the catastrophe bond transactions (compared to 30% in 2011).

Spreads continued to tighten during the first half of 2014 but maintained their relative stability through the second half of the year. As a result, interest payments to investors were lower on average than in prior years. The Aon Benfield All Bond ILS Index posted returns of 4.39% (compared to 11.16% in 2013).[6]

In terms of catastrophe bond features, annual aggregate bonds and expanded variable reset features became more prominent in 2014. Two catastrophe bonds had five-year terms. Three of the more distinctive deals are highlighted below.

- Residential Reinsurance 2014 Limited (Series 2014-I)

  The perennial Residential Reinsurance transaction (sponsored by USAA) added volcanic eruption and meteorite impact as new perils for their per occurrence and aggregate tranches. The variable reset option was also expanded to allow for more flexibility in connection with the resets.

- Tradewynd Re (Series 2014-1)

  The Tradewynd Re transaction (sponsored by AIG) was the seventh catastrophe bond providing reinsurance protection to AIG. This transaction continued AIG's objective to more closely align the catastrophe bond cover with its traditional reinsurance program and expanded the covered regions to include Mexico and Canada for named storms and, for earthquake, also the Caribbean. The transaction also provides cover for AIG's exposure to assessment from residual pools and features a cascading top layer which allows for the various classes to act as "one layer" to avoid gaps in coverage within an annual risk period.

- Everglades Re 2014

  2014 also saw the largest issuance ever placed, the US$1.5 billion issued by Everglades Re (sponsored by Florida Citizens Property Insurance). The transaction is the first annual aggregate cover that Citizens has placed in the catastrophe bond market.

- Nakama Re 2014-2

  The Nakama Re 2014-2 transaction (sponsored by Zenkyoren) was notable for including a class of notes that provided indemnity coverage on a multi-year aggregate basis (rather than the more typical annual aggregate basis), providing for aggregate coverage across a three-year risk period to be selected within a five-year time span.

On the regulatory side, the U.S. Commodity Futures Trading Commission ("**CFTC**") issued a no-action letter providing an exemption from the new regulations concerning commodity pool operators. Catastrophe bond issuers who prefer to use ISDA-

3 *See* Swiss Re Insurance-Linked Securities Market Update, January 2015.

4 *See* Willis Capital Markets & Advisory ILS Market Update, January 2015.

5 *See* Guy Carpenter Catastrophe Bond Update, Fourth Quarter 2014.

6 *See* Aon Benfield Securities Insurance-Linked Securities, Fourth Quarter 2014 Update.

based swap documentation for index and parametric triggered catastrophe bonds may now use swaps with a minimal regulatory burden (*see further* Section A.5.c of "Global Regulatory and Litigation Developments"). For developments relating to the Foreign Account Tax Compliance Act, *see* Section C of "Select Tax Issues Affecting Insurance Companies and Products."

2. Traditional Reinsurers in the Insurance-Linked Securities ("ILS") Market

New third-party capital continued to flow into the reinsurance market in 2014. Alternative reinsurance capacity reached over US$61 billion in 2014, representing an increase of almost 25% over 2013.[7] As of December 31, 2014, alternative reinsurance capacity represented approximately 18% of global property catastrophe limit (up from 15% as of December 31, 2013).[8] Market sources predict that alternative reinsurance capacity could reach US$150 billion by 2018.[9]

The use of industry loss warranties ("**ILWs**") decreased through 2014, as pricing for indemnity coverage continued to decline, making ILWs a less attractive alternative.[10] However, other forms of alternative capital (including sidecars and collateralized reinsurance) experienced growth in 2014. Sidecar capacity increased by approximately 50% from 2013 to 2014.[11] Recent sidecar transactions include additional capital raises by existing vehicles, Mt. Logan Re (sponsored by Everest Re) and Silverton Re (sponsored by Aspen), and the launch of new sidecar vehicles by Brit (Versutus), Munich Re (Eden Re and Eden Re II) and Validus (AlphaCat 2015). One regulatory consideration that has emerged with respect to sidecar transactions is compliance with the Alternative Investment Fund Managers Directive ("**AIFMD**") in European Union ("**EU**") countries. In marketing sidecar transactions, market participants should be sure to consider potential AIFMD implications.

Driven, in part, by competition from the robust catastrophe bond market and increased sidecar activity, reinsurance pricing further declined in 2014, with U.S. property catastrophe rates on catastrophe loss-free accounts decreasing by 10-15% year-over-year.[12] In the face of increased competition, some reinsurers relaxed and expanded the terms and conditions that they offered to cedents in order to better meet cedents' needs (e.g., extended hours clauses, improved reinstatement terms, addition of non-modeled lines and expanded coverage for terror exposures).[13] Some reinsurers have responded to this rate pressure by pulling back on catastrophe reinsurance business and growing other lines of business (e.g., RenaissanceRe reduced its catastrophe reinsurance premium, while growing its specialty lines of business).

As discussed above in Section A of "The Global Mergers & Acquisitions Market," the competitive landscape in the property and casualty reinsurance market has resulted in increased M&A activity among traditional reinsurers, with a focus on building scale and diversification across lines of business. Recent examples include AXIS Capital and PartnerRe's January 2015 announcement of their merger of equals, XL's January 2015 announcement of its acquisition of Catlin, RenaissanceRe's November 2014 announcement of its acquisition of Platinum Underwriters and Validus' October 2014 acquisition of Western World. In addition, as noted in Section I.A.5 above, Montpelier Re Holdings Ltd. is the subject of an ongoing auction process, with final bidders reported to include Endurance Specialty Holdings Ltd., Hamilton Insurance Group and Fosun. Further M&A activity is expected, with market sources identifying additional reinsurers as potential acquisition targets.

While third-party capital has created challenges for traditional reinsurers, it has also created opportunities. Many traditional reinsurers have continued to incorporate third-party capital into their own business models by developing or growing their own alternative capital programs, sponsoring catastrophe bonds and/or sidecar facilities, retroceding business to third-party capital providers and acting as transformers for "public" 144A and "private" catastrophe bonds. We expect to see this trend continue, as traditional reinsurers continue to explore new ways to use third-party capital to their benefit.

3. Investment Manager Activity

Investment manager-related reinsurance structures continued to gain traction in 2014. Arch Re partnered with JP Morgan's Highbridge Principal Strategies to create Watford Re, a Bermuda-domiciled reinsurer, which reinsures property casualty business written by Arch, as well as third-party business. Watford Re carries an A- financial strength rating from A.M. Best. Third Point Re recently announced that it will be expanding its operations with the formation of a new reinsurance subsidiary in the United States. Other investment managers have continued to express interest in participating in the establishment of offshore reinsurers; however, rating agencies are making it more difficult for newly-formed offshore reinsurers to obtain the A- rating necessary to write third-party property casualty reinsurance business.

4. Outlook Ahead

Catastrophe bond broker-dealers seem to be generally optimistic about 2015. However, nearly US$6.5 billion of catastrophe bonds will be redeemed in 2015 compared to just over US$4 billion last year. It will, therefore, take several fairly large transactions for the bond market to meet its potential US$7 billion to US$8 billion overall range in 2015. Some market sources believe that catastrophe bond sponsors could be less motivated by potential cost savings as falling traditional reinsurance rates have caught up with the catastrophe bond market. Others believe that the trend for large insurers to retain more risk could ultimately play out in favor of more industry loss index or other non-indemnity structures. We would expect that the trend

7 *See* Aon Benfield Securities Reinsurance Market Outlook, January 2015.

8 *See* Guy Carpenter "January 1, 2015 Renewals See Lower Pricing And Broader Coverage For Clients."

9 *See* Aon Benfield Securities Reinsurance Market Outlook, January 2015.

10 *See* Guy Carpenter "January 1, 2015 Renewals See Lower Pricing And Broader Coverage For Clients."

11 *See* Aon Benfield Securities Reinsurance Market Outlook, January 2015.

12 *See* Willis Capital Markets & Advisory ILS Market Update, January 2015.

13 *See* Guy Carpenter "January 1, 2015 Renewals See Lower Pricing And Broader Coverage For Clients."

to better match cover to existing reinsurance programs will continue as the demand for indemnity coverage under catastrophe bond transactions will continue to rise.

It should be kept in mind that the catastrophe bond market has not yet been tested by a major catastrophe. How investors will react may depend on whether losses would occur as expected (e.g., no significant undisclosed unmodeled losses or model errors). Short-term opportunistic investors who are mostly looking for extra yield could exit the market if there are more profitable alternatives, and longer-term investors, such as pension funds, may be more inclined to stay in the catastrophe bond market.

While traditional reinsurers are likely to see rate pressures persist, as a result of the consolidation described above, some may be better positioned in 2015 to ward off the competition. As in 2014, we expect that ART mechanisms in the property and casualty market will become more prevalent in the year ahead, and the insurance asset class, as a whole, will continue to attract new participants and new capital.

III. The Global Longevity Market

In its Global Insurance Market Report 2014, the International Association of Insurance Supervisors ("**IAIS**") identified the assumption of longevity risk as a potential area of growth for the insurance industry.[14] In the context of estimates of the global amounts of annuity and pension-related longevity risk exposure being as much as US$25 trillion, the IAIS commented that those exposed to longevity risk would have to pay over in aggregate an additional US$450 billion to US$1 trillion for each year they underestimate longevity.

The two principal sources of longevity risk are defined benefit pension schemes and books of annuity business written by life insurers. There has been an increased level of transaction activity in relation to the latter, with some European-based life insurance groups looking to hedge longevity exposure in light of the additional regulatory capital that may have to be held under Solvency II in respect of annuity business. However, it is the continuing demand from defined benefit pension schemes that has been the principal driver for the development of an active secondary market for longevity risk in which reinsurers have been the principal participants.

With increases in life expectancy in recent decades, pension schemes have increasingly been looking for methods to hedge against the risk that their members live longer than is currently predicted. The UK is the most mature market for the "de-risking" of pension schemes. This has been driven by the large number of defined benefit pension schemes in the UK and improvements in life expectancy and poor investment returns that have left many such schemes in deficit. This in turn has adversely affected the balance sheets of corporate sponsors who are liable for such deficits. The vast majority of transactions executed to date have taken the form of traditional bulk annuity deals either in the form of pension buy-outs or involving the issue of a buy-in policy. However, since their emergence in 2009, longevity swaps have also now become a well-established alternative option for hedging longevity exposure.

A. TRANSACTION STRUCTURES

To put into context our review of recent developments and transactions in the longevity market, we first briefly recap below the principal longevity risk transfer methods.

- Buy-Outs

  A pension buy-out involves an insurer taking over the liability to pay all or some of the member benefits from the trustees of the relevant pension scheme. This is achieved by the insurer issuing individual annuity policies to the relevant scheme members in return for a payment of premium by the trustees, usually effected by way of a transfer of assets from the pension scheme to the insurer. In the case of a buy-out, there is a direct insurance contract between the insurer and the individual scheme member; and in the event of a full buy-out, where individual policies are issued to all of the members of the pension scheme, the trustees can proceed to wind-up the scheme, with all future administration being performed by the insurer. The buy-out option is accordingly the ultimate form of pension scheme de-risking.

- Buy-Ins

  Pension buy-in solutions were developed as a de-risking option for pension schemes that were unable to afford the often prohibitive costs of a full buy-out. Under a pension buy-in, there is no direct contractual link between the insurer and the individual scheme members. Instead, the pension scheme trustees hold the buy-in policy in their name as an investment of the scheme, and the scheme continues to deal with the payment and administration of benefits. The trustees pay a premium (usually by transferring over an equivalent amount of pension scheme cash, bonds and other assets under management) and, in return, receive an income stream from the insurer to cover some or all of the scheme's liability to pay member benefits. In the case of some of the larger buy-in transactions, trustees will also require the insurer to post collateral or otherwise secure its obligations to make payments under the policy.

- Longevity Swaps

  In their purest form, longevity swaps are derivatives and not contracts of insurance. However, it is possible to achieve the same economic effect on an insurance basis, and there have been examples of insurers issuing policies to pension schemes structured in the same way as a longevity swap. Although it is clearly important to ensure that the contract is properly structured as a derivative or insurance policy according to whether the protection provider is a bank or insurer, in either case, the core economics are very similar. In return for the pension scheme paying a fixed monthly amount to the insurer or bank, the counterparty makes a payment

[14] *See* IAIS Global Insurance Market Report (GIMAR) 2014, dated December 17, 2014.

to the pension scheme on a monthly basis (the floating amount) referable to the benefit payable to a defined group of pensioners.

In cases where the front end arrangement involves a longevity swap with a bank as a counterparty, the longevity risk is in derivative form and not capable of being directly reinsured. In situations such as this, transformer vehicles (typically based offshore) are used to convert the derivative exposure into insurance risk that can then be reinsured.

Whereas buy-ins and buy-outs involve a transfer of inflation, interest rate, investment and longevity risk, longevity swaps offer a purer hedge against the risk of scheme members living longer than is actuarially predicted, and the fact that there is no upfront payment of a lump sum premium means that the investment, interest rate and inflation risk remain with the trustees. Accordingly, longevity swaps are typically a less expensive alternative to buy-ins and buy-outs, albeit more complex to structure and negotiate. Longevity swaps almost invariably require the two-way posting of collateral to protect against the possibility of early termination by reason of the other party's default or insolvency. The collateral is typically based upon the present value of the covered benefits and will also include a fee element payable to the insurer/bank in the event of termination arising by virtue of trustee default.

- Index-Based Trades

  A further alternative structure involves the purchase of longevity protection by reference to an index. Given the inherent basis risk that exists within these types of transactions, there have been relatively few index-based trades to date and these types of transactions are perhaps more likely to remain of greater interest to insurers and ILS investors than to pension schemes.

B. U.S. AND CANADIAN MARKET

Although the market in the United Kingdom is more developed than in the United States, the same concepts have begun to be used in the U.S. market as well. After the very large GM and Verizon deals in 2012, some market commentators predicted these transactions would mark the beginning of a trend towards a more active pension de-risking market in the United States. Even though there was no deal activity in 2013, a trickling of deals have occurred with the Motorola transaction and Bristol-Myers transaction in 2014 and the Kimberly-Clark transaction and Sun Life transaction, each in the first quarter of 2015, all of which are described below.

In 2014, Motorola Solutions, Inc. ("**Motorola**") purchased a $3.1 billion group annuity contract from The Prudential Insurance Company of America ("**Pru**"). Pursuant to the contract, Pru will pay and administer retiree pensions for approximately 30,000 eligible former U.S. employees of Motorola. Motorola will also offer eligible participants (approximately 32,000) the opportunity to apply for lump-sum pension payments. This transaction marks the third largest longevity transaction in the United States.

Also in 2014, Bristol-Myers Squibb Company ("**Bristol-Myers**") purchased a US$1.4 billion group annuity contract from Pru, pursuant to which Bristol-Myers will transfer to Pru pension obligations associated with approximately 8,000 U.S. retirees and their beneficiaries who began receiving monthly pension payments on or before June 1, 2014. No additional cash contributions by Bristol-Myers are required in connection with the transaction. Pursuant to the contract, Pru will assume full financial responsibility for making the annuity payments provided for under the contract.

On February 23, 2015, Kimberly-Clark Corp. ("**Kimberly-Clark**") announced that it has entered into an agreement with Pru and Massachusetts Mutual Life Insurance Company ("**MassMutual**") to purchase a US$2.5 billion group annuity contract for its retirees, thereby transferring pension obligations associated with approximately 21,000 retirees in the United States to Pru and MassMutual. Pru and MassMutual will each provide half of the monthly benefits to the group of retirees. Like the Motorola transaction, Kimberly-Clark will administer the group annuity payments and handle interactions with the retirees.

Effective as of January 1, 2015, Sun Life Financial Inc. ("**Sun Life**") and BCE Inc. ("**BCE**") entered into a longevity insurance agreement to transfer C$5 billion of pension plan liabilities associated with The Bell Canada Pension Plan ("**Bell Plan**") to Sun Life Assurance Company of Canada. Pursuant to the agreement, Sun Life will pay retiree benefits to current retirees, while BCE administers the Bell Plan and pays monthly premiums to Sun Life. Sun Life will receive reinsurance support from both RGA Life Reinsurance Co. of Canada and SCOR Global Life. This deal is the first longevity transaction in Canada and one of the largest transactions completed globally.

C. EUROPEAN MARKET

As we predicted last year, 2014 turned out to be a record year for UK pension de-risking transactions, with one deal alone (discussed below) transferring more longevity risk than the previous UK annual aggregate record of £12 billion in 2013.

We commented last year on the then-largest ever pension scheme longevity swap announced in March 2014 involving an innovative structure whereby £5 billion of liabilities of the Aviva Staff Pension Scheme (covering 19,000 lives) were insured by Aviva Life & Pensions UK Limited and simultaneously reinsured by Munich Re, Scor and Swiss Re.

That transaction was the first denoting what has become a well-established trend towards disintermediation in the longevity market, with a number of innovative new structures emerging that allow a transfer of longevity risk without the involvement of a bank or a third party fronting insurer transacting with the pension scheme. This in turn can reduce the ultimate cost to the pension scheme of buying longevity protection.

There are likely to be a number of further longevity transactions involving defined benefit pension schemes within insurance groups utilizing an in-house insurer to access reinsurance capacity on a similar basis to the Aviva transaction. However, of potentially far wider market impact (as this is not limited to insurers' own defined benefit pension schemes) is the transaction structure utilized in

the £16 billion longevity swap by which Pru assumed longevity exposure originating from the BT pension scheme. This transaction involved BT establishing a captive insurer which in turn secured longevity protection in reinsurance form from Pru. Since then, a number of market participants, including Towers Watson and Artex Risk Solutions, have launched Guernsey-based captive solutions to facilitate the transfer of longevity risk to the international reinsurance markets. Other recent transactions that have utilized the captive model to hedge longevity exposure include the £1.5 billion transaction between a captive established by the Merchant Navy Officers' Pension Fund and Pacific Life Re.

There has also been a significant increase in transactions involving the hedging of longevity risk by life insurance companies in the form of longevity reinsurance. Recent transactions include Rothesay Life hedging longevity exposure with Pru and Pacific Life Re; Delta Lloyd buying protection from RGA Life; AXA hedging with Hannover Re; L&G buying protection from Pru and Royal London hedging with RGA Life.

Factors fuelling the continuing growth of this market include the healthy levels of capacity within the reinsurance market. The demand from reinsurers has been driven by a number of factors, but perhaps the most significant for life reinsurers with catastrophe books is that longevity risk acts as a natural hedge against mortality exposure and can create diversification benefits for regulatory capital purposes.

This healthy competition is in turn driving more attractive pricing and encouraging more pension schemes to evaluate their de-risking options. This may well be accelerated by the announcement in last year's UK budget that from April 2015 investors in defined contribution pension schemes will have the option to withdraw the entirety of their accumulated investments in cash. It has been widely predicted that there will be a consequential reduction (perhaps as much 75%) in sales of new individual annuities. Some of the life insurers affected by these developments have already confirmed that they will be seeking to replace this lost income by acquiring more blocks of business through bulk annuity transactions. This in turn is likely to increase competition and potentially result in more attractive commercial terms for pension schemes looking to de-risk. Given that the aggregate pension deficits for FTSE 350 companies with defined benefit pension schemes has recently been estimated by Mercer to have almost doubled in a year to £107 billion, there is likely to be a healthy demand from pension schemes and corporate sponsors looking to take advantage of the competitive terms on offer.

The increased level of pension scheme de-risking activity, coupled with continuing demand from life insurers looking to hedge the longevity risk in annuity books, has fuelled an active secondary market for longevity risk. To date, the vast majority of that business has been written by reinsurers, and such has been the available capacity within the life reinsurance market that the pricing has been competitive and there have been relatively few opportunities for the capital markets, ILS funds and others attracted by an asset class that is largely uncorrelated to the financial markets. However, with the strong growth in demand for longevity hedging, some are predicting that within the medium term, traditional reinsurance capacity may well become fully utilized, creating opportunities for new entrants to this market.

IV. The Global Capital Markets

A. U.S. MARKETS

In 2014, the pace of capital markets transactions has slowed for initial public offerings ("**IPOs**"), remained fairly constant for traditional debt offerings, and increased significantly in the case of funding agreement-backed note issuances.

A limited number of IPOs in the U.S. market closed in 2014; however, ING has followed through with its plans to spin off its European insurance business and fully divest its remaining Asian businesses through the closing of a €1.5 billion (approximately US$2 billion) IPO of its subsidiary NN Group, which handles those businesses. Additionally, the US$10 million IPO of GWG Holdings, Inc., a leader in the secondary life insurance market that purchases life insurance policies directly from consumers, was the most notable purely U.S. IPO.

A number of traditional debt offerings occurred in 2014 in the form of senior note offerings, including W.R. Berkley Corporation's issuance of US$350 million 4.75% senior notes due in 2044, Everest Reinsurance Holdings, Inc.'s issuance of US$400 million 4.868% senior notes due in 2044 and Assured Guaranty US Holdings Inc.'s issuance of US$500 million 5% senior notes due in 2024 and guaranteed by Assured Guaranty Ltd. In addition to these more customary debt offerings, at least one subordinated note offering (American Financial Group, Inc. issued US$150 million 6.25% subordinated debentures due in 2054) and one surplus note offering (The Guardian Life Insurance Company of America issued US$450 million 4.875% surplus notes due in 2064) closed in 2014.

Life insurance companies continue to use funding agreement-backed note programs to fund a portion of their institutional spread business through private placement securitization vehicles, such as global medium term note ("**GMTN**") programs. The total issuance in 2014 of approximately US$18.7 billion marked the largest number of issuances in a single year since 2008 and well surpassed the total issuance in 2013 of US$12.3 billion, according to Standard & Poor's.[15] GMTN programs provide a life insurance company with flexibility in that it can issue GMTNs both to investors outside the United States pursuant to Regulation S and to "qualified institutional buyers" within the United States pursuant to Rule 144A. 2014 saw a rise in the number of life insurance companies participating in the funding agreement-backed notes market, in addition to the usual participants (which include MetLife, New York Life, Massachusetts Mutual and Principal Life). One such example is American International Group, Inc.'s return to the market with the establishment of a funding agreement-backed GMTN of AIG Global Funding, a newly organized Delaware statutory trust established to issue notes collateralized by funding agreements issued to it by American General Life Insurance Company, the primary life insurance subsidiary of the AIG Life and Retirement group of companies. AIG Global Funding's initial issuance of US$450 million 1.65% fixed rate notes due in 2017 closed at the end of 2014. Additionally, Reliance Standard Life Insurance Company entered the market with the establishment of a funding agreement-

15 *See* Standard & Poor's report, dated January 21, 2015, entitled "U.S Funding Agreement-Backed Note Issuance Totals $18.7 Billion in 2014."

backed GMTN of Reliance Standard Life Global Funding II, whose initial issuance of US$500 million Series 2014-1 2.5% fixed-rate notes due in 2019 also occurred in 2014.

B. LEGAL AND OTHER DEVELOPMENTS

Various legal developments over the past year have had an impact on capital markets transactions in the United States. The Staff (the "**Staff**") of the U.S. Securities and Exchange Commission (the "**SEC**") has continued to provide comment letters to insurance holding company registrants focusing on the following areas:

- Transactions with Captive Subsidiaries

  The Staff has requested expanded disclosure regarding the nature, purpose and number of captive transactions, as well as the impact of captive subsidiaries on the insurer's financial statements and uncertainties associated with captive subsidiaries.

- Reinsurance Receivables

  The Staff has asked for enhanced disclosure relating to the credit quality of reinsurance receivables and allowances for credit losses associated with reinsurance receivables.

- Reserve and Loss Adjustment Expense

  The Staff has emphasized enhanced disclosure regarding the key methods and assumptions used to derive loss adjustment expense and related reserves, and a discussion of the reasons behind any changes therein.

- Deferred Acquisition Costs

  The Staff has asked for disclosure about the composition of an insurer's deferred acquisition costs, as well as for information regarding the presentation of ceding commission income in the income statement that serves as a recovery of acquisition costs.

- Disclosure Compliance

  The Staff has continued to focus on compliance with existing disclosure requirements regarding statutory capital, surplus and dividend restrictions.

V. Global Regulatory and Litigation Developments

In 2014, participants in the global insurance industry contributed to the continuing discussion of difficult questions regarding the interpretation and intersection of U.S. federal, state and non-U.S. insurance regulations. In the United States, state and federal regulators continued to tackle ongoing initiatives, including implementation of principle-based reserving, life insurers' use of affiliated captive reinsurers to finance reserves, standards that should apply to insurance company acquisitions by private equity firms, standards that should apply in the global reinsurance marketplace, establishing corporate governance standards for insurance companies, the effect of healthcare reform implementation on the U.S. health insurance marketplace, regulation of insurer investments and financial solvency and achieving consistency with international regulatory standards. In the UK, key developments pertain to Solvency II and the establishment of new capital standards for (re) insurers. In China, key developments pertain to a new solvency regime and the liberalization of the insurance market. These and other important insurance regulatory topics are discussed in more detail below.

A. U.S. FEDERAL ACTIVITY

1. Treasury/FSOC Activities

In December 2014, the Financial Stability Oversight Council (the "**FSOC**") designated MetLife as a systemically important non-bank financial institution ("**SIFI**"). In January 2015, MetLife filed suit in federal court to appeal the FSOC's final determination. In order to defeat the designation, MetLife will have to prove that the FSOC acted arbitrarily and capriciously in issuing MetLife's SIFI designation. MetLife is the most recent company to receive a final determination from the FSOC and the first company to appeal its SIFI designation. In 2013, the FSOC issued final determinations designating American International Group, Inc., General Electric Capital Corporation and Prudential Financial, Inc. as SIFIs. *See* Section V.C.1.c.ii for a related discussion from the perspective of the IAIS.

A company designated as a SIFI becomes subject to supervision by the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**") and to the enhanced "prudential standards" approved by the Federal Reserve Board. The Federal Reserve Board has yet to issue final rules governing the capital standards that will apply to insurers designated as SIFIs. One concern has been that final rules would subject such insurers to federal bank capital rules. On December 18, 2014, President Obama signed into law the Insurance Capital Standards Clarification Act of 2014, which amends the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") to, among other things, provide the Federal Reserve Board with flexibility to promulgate a final rule that would not subject such insurers to federal bank capital rules.

The FSOC was established under the Dodd-Frank Act to provide recommendations to the Federal Reserve Board concerning risks to U.S. financial stability caused by the activities of large bank holding companies and non-bank financial companies.

2. Federal Insurance Office

The FIO issued the following reports in 2014:

a. 2014 Annual Report

In September 2014, the FIO issued its Annual Report on the Insurance Industry (the "**2014 Report**"). The 2014 Report discusses the financial performance of U.S. insurers and insurance industry capital markets and addresses several insurance regulatory developments that received attention in 2014, including, among others, the following:

- Insurance Acquisitions by Private Equity Firms

  On the subject of private equity acquisitions of insurance companies, the 2014 Report notes that "some" believe

private equity firm business models are inconsistent with the long-term view required for annuity business. In this regard, the FIO notes efforts by NAIC to address concerns, as well as regulatory restrictions imposed by two states (New York and Iowa) in connection with recent transactions. However, the 2014 Report stops short of making recommendations on how states or the NAIC should address private equity acquisitions of insurance companies and does not suggest federal involvement. *See* also Section V.B.7.

- Life Insurance Excess Reserve Transactions

  Concerning life insurance excess reserve transactions, the 2014 Report points to the FIO's prior recommendations that states develop a "uniform and transparent" solvency oversight regime for the transfer of risk to captives. Although the FIO does not endorse the captive moratorium recommended by the NYDFS, the FIO points out that, since December 2013, there has been an increase in regulators' concerns expressed over the use of affiliated captives. The 2014 Report does not address the NAIC's final adoption of a framework for XXX and AXXX reserve transactions (discussed in Section V.B.2.a) and does not suggest federal involvement in this area.

- Reinsurance Collateral Requirements

  On the topic of reinsurance collateralization, the FIO reiterates its prior recommendation that reinsurance collateral is one area that warrants direct federal involvement. In its 2014 Report, the FIO points to state inconsistencies in implementing reinsurance collateral reform and questions the wisdom of relying on credit rating agency assessments of insurers as opposed to "risk-based empirical factors" to establish collateral requirements. The FIO's Director, Michael McRaith, has remarked at speaking engagements that the FIO and the Office of the United States Trade Representative (the "**USTR**") are working together on plans for negotiating bilateral reinsurance collateral agreements with regulators in Europe and will likely seek approval from Congress in early 2015 to proceed with negotiations. Pursuant to Title V of the Dodd-Frank Act, such agreements must be jointly submitted by the FIO and USTR to the House Financial Services, House Ways and Means, Senate Banking and Senate Finance committees (on a day that the House and Senate are in session) within 90 days of their effective date.

- National Registry of Insurance Producers

  Finally, the FIO supports legislation to create a national registry of insurance producers and ensure state uniformity in producer licensing. The FIO expressed concern regarding the declining number of licensed life insurance agents, who consumers traditionally rely on for advice regarding the purchase of life and annuity products. The FIO reported that it would monitor the situation in order to ascertain whether policymakers should consider additional efforts "to encourage producer licensing and to promote access to essential insurance products." For a related discussion of a national registry, *see* Section V.A.4.

b. 2014 Global Reinsurance Report

In December 2014, the FIO published its report on the global reinsurance market (the "**2014 Reinsurance Report**"). The FIO had been working on the report since first publishing a notice soliciting comments in June 2012. The notice requested input from regulators and industry concerning the breadth and scope of the global reinsurance market, the effect of domestic and international regulation on U.S. reinsurance, coordination of reinsurance supervision and the role and impact of government reinsurance programs. The report notes that although many states have passed reinsurance collateral reforms (discussed in Section V.B.3), the structure or implementation of collateral requirements is still not uniform. There are also concerns that state laws depend too heavily on credit rating agency assessments of reinsurers.

In the 2014 Reinsurance Report, the FIO describes the global reinsurance market and various international and regulatory initiatives affecting the market. In addition to outlining the history of reinsurance and its various functions, the report describes how global reinsurers are vital to the U.S. insurance market and economy generally and their effect specifically on insurance availability and affordability, increasing underwriting capacity, stabilizing underwriting results and risk diversification. The 2014 Reinsurance Report also emphasizes the importance of global reinsurers following natural disasters and other catastrophes. As expected, the 2014 Reinsurance Report reiterates the FIO's prior recommendation that reinsurance collateral requirements is a topic that warrants direct federal involvement.

c. Insurance for Terrorism Risk Report

The FIO coordinated development of a report to Congress from the President's Working Group on Financial Markets ("**PWG**") entitled "The Long-Term Availability and Affordability of Insurance for Terrorism Risk." Under the Terrorism Risk Insurance Act ("**TRIA**"), the PWG is required to conduct ongoing analysis on the long-term availability and affordability of insurance covering terrorism risk. The findings in the report included: (1) terrorism risk insurance is currently available, affordable and has not changed appreciably since 2010; (2) pricing varies considerably depending on a policyholder's industry and risk location; (3) prices have declined since TRIA was enacted and, in the aggregate, currently approximate 3% to 5% of commercial property insurance premiums; (4) take-up rates have improved since adoption of TRIA and are roughly stable at 60% in the aggregate; (5) the market was tightening when it was uncertain whether TRIA would be renewed; (6) the private market does not have the capacity to provide reinsurance for terrorism risk to the extent currently provided by TRIA; and (7) in the absence of TRIA, terrorism risk insurance likely would be less available and available coverage would likely be more costly and/or limited in scope. As noted in Section V.A.3 below, although a reauthorization bill was not signed before TRIA expired on December 31, 2014, a bill was ultimately signed on January 12, 2015 extending the TRIA program for six years.

3. Extension of TRIA

On January 12, 2015, President Obama signed a bill reauthorizing TRIA and extending the TRIA program for six years, until December 31, 2020. Congress' failure to pass an extension bill before TRIA expired on December 31, 2014 caused widespread concern, particularly among regulators, insurers and the commercial real estate industry. The new law makes certain changes in the TRIA program, including, among others:

Increasing (over the course of five years) the trigger amount from US$100 million to US$200 million.

Increasing mandatory recoupment through policy surcharges of the federal share (the percentage of losses to be paid by the federal government) from 133% to 140%.

Applying an insurer deductible of 20% of the insurer's direct earned premium for the preceding calendar year and setting the federal share of reimbursement at 85% of insured losses exceeding insurer deductibles until January 1, 2016 (after which time the federal share will decrease by 1% each calendar year until it reaches 80%).

Requiring that the Secretary of the Treasury (rather than the Secretary of State) certify acts of terrorism in consultation with the Secretary of Homeland Security.

Setting an insurance marketplace aggregate retention amount at the lesser of US$27.5 billion, increasing annually by US$2 billion until it equals US$37.5 billion, and the aggregate amount of insured losses for the calendar year for all insurers. In the calendar year following the calendar year in which the marketplace retention amount equals US$37.5 billion, and beginning in calendar year 2020, it is the lesser of the annual average of the sum of insurer deductibles for all insurers participating in the TRIA program for the prior three calendar years as such sum is determined by the Secretary of the Treasury by regulation.

4. NARAB II

The new law reauthorizing TRIA included language creating a national registry of insurance producers (a provision often referred to as "**NARAB II**"). NARAB II reflects a longstanding effort by legislators, industry and trade groups to ensure uniformity among states with respect to insurance producer licensing procedures. Under the law, by mid-April 2015, President Obama must appoint a 13-member board (consisting of eight insurance commissioners and five industry leaders with professional expertise in producer licensing) to issue multi-state licenses to producers in accordance with standards established by state regulators, thus creating a centralized licensing process. Guidelines for the board will need to be developed for national licensing. The board will establish criteria for insurance producers to obtain non-resident authority to sell, solicit or negotiate insurance outside their home state of licensure. Insurance producers are not required to obtain licensing through NARAB II, as producers may continue to obtain licenses on a state-by-state basis.

The concept of such a federal licensing board originated with the 1999 Gramm-Leach Bliley Act, which threatened federal implementation of a national system if a majority of states did not pass a uniform licensing procedure. To avoid the federal licensing scheme, the law required that at least 50% of states enact a uniform producer licensing law by November 2002. This was accomplished by the deadline when over 35 states adopted the NAIC Producer Licensing Model Act. Nevertheless, concerns over uniformity continued, especially as certain states with large insurance markets were not among those states that adopted uniform procedures.

5. Derivative Transactions

During 2014, international regulators continued their efforts to implement regulation of the over-the-counter ("**OTC**") derivatives markets worldwide. In Europe, the EU regulators have continued their movement towards mandatory clearing and margin requirements for uncleared trades, but, unlike the United States, none of these regulatory changes have become effective yet. In the United States, the CFTC continued its implementation of new regulations and continued to refine its existing regulations through the issuance of no-action letters and staff guidance with respect to "swap" transactions under the CFTC's jurisdiction. Additionally, the SEC moved towards implementation of its regulation of "security-based swap" transactions by proposing, or reproposing draft regulations for comment. However, given the more deliberate approach of the SEC, it is unlikely that its implementation of the security-based swap regulatory scheme will occur before late 2015 or the beginning of 2016, at the earliest.

During 2014, insurance companies that engage in OTC derivatives trading in the United States, whether for hedging or replication purposes, found themselves subject to new CFTC requirements with respect to swap execution facility ("**SEF**") and exchange trading for certain interest rate swaps and index credit default swaps. Insurance companies also learned of new margin requirements for uncleared trades based on proposed rules published by the CFTC, as well as the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "**Prudential Regulators**"). In addition, insurance companies received new guidance and relief from the CFTC with respect to certain commodity pool and commodity pool operator issues.

a. Dodd-Frank SEF & Exchange Trading

Pursuant to the Dodd-Frank Act, swap counterparties are required to not only clear their OTC derivatives transactions through a central clearinghouse, but swaps that are required to be cleared are also required to be executed on either a designated contract market ("**DCM**") (commonly referred to as an exchange) or through one of the newly created SEFs. Under Section 723 of the Dodd-Frank Act, financial entities, including insurance companies, are required to comply with both the clearing and DCM/SEF requirements, whereas non-financial end-users and operating companies are exempt from these requirements. Although the clearing mandate became effective for certain interest rate swaps and index credit default swaps in 2013 for insurance companies, the DCM/SEF execution requirement did not become effective until February 2014 when the first "made-available-to-trade" determinations became effective for the applicable interest rate swaps and index credit default swaps.

As a result of the SEF "made-available-to-trade" effectiveness in February 2014, financial entities, including insurance companies, are now only permitted to execute the specified types of interest rate swaps and index credit default swaps that are required to be cleared through a central clearinghouse on an SEF or DCM. Such trades may no longer be executed on a bilateral or direct basis with swap dealers or other counterparties. Although the migration to SEF/DCM execution was intended to streamline the trading process and make execution more transparent, for a multitude of reasons, the simplification and transparency of the market has yet to be fully realized.

b. Dodd-Frank Proposed Margin for Uncleared Trades

In September and October of 2014, the Prudential Regulators and CFTC, respectively, re-proposed their respective rules for margin that apply to all uncleared trades (the "**Margin Rules**"). Although the rules proposed by the Prudential Regulators and CFTC are similar, there are some differences that, if finally adopted as proposed, would result in different rules applying to swap dealers that are regulated by the Prudential Regulators (i.e., banks), in which case the Prudential Regulators version of the margin rules will apply, and swap dealers that are not regulated by the Prudential Regulators (i.e., non-banks), in which case the CFTC's version of the margin rules will apply.

Under the Margin Rules, OTC derivatives market participants will be divided into one of four categories: (i) Covered Swap Entities ("**CSEs**"); (ii) Financial End Users with Material Swap Exposure ("**FEUMSEs**"); (iii) Financial End Users without Material Swap Exposure ("**FEUs**"); and (iv) everyone else ("**End Users**"). Uncleared trades between CSEs and FEUMSEs will be required to comply with both the minimum initial margin ("**IM**") and variation margin ("**VM**") requirements, whereas trades between CSEs and FEUs will only be required to comply with the VM requirements. Trades with End Users will not be subject to any regulatory IM or VM requirements, and any exchange of collateral between an End User and a CSE will be purely a point of negotiation. Financial End Users are defined to include a wide range of specific financial entities, which expressly include insurance companies, investment advisers, investment companies, private funds, commodity pools, commodity pool operators, commodity trading advisors and collective investment vehicles, among others.

"Material Swap Exposure" status is triggered if a Financial End User entity and all if its "Affiliates" collectively have an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, FX forwards and FX swaps with all counterparties in June, July and August of the prior calendar year that exceeds US$3 billion. As drafted, this definition does not allow any exclusion for interaffiliate trades nor are there any jurisdictional boundaries for the "Affiliates," and, thus, worldwide activities would be included. For purposes of determining who is an "Affiliate," the Margin Rules define an "Affiliate" as any company that controls, is controlled by or is under common control with another company, where "control" is deemed to exist if there is (A) ownership, control or power to vote 25% or more of a class of voting securities of the company, directly or indirectly or acting through one or more persons; (B) ownership or control of 25% or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (C) control in any manner of the election of a majority of the directors or trustees of the company. This low threshold to determine "control" and, thus, which entities are "Affiliates" of an insurer, is likely to result in issues for insurers (especially those with active private equity investment strategies), as a single entity could be deemed the "Affiliate" of four or more entities that have invested in it. This is an issue that has been raised with the regulators and will, hopefully, be addressed in the final rules. If not, FEUs may find themselves spending a substantial amount of time tracking their "Affiliates" in order to identify whether or not they are FEUMSEs.

FEUMSEs and CSEs that are subject to the IM requirements will be entitled to apply an US$65 million threshold before any IM will be required to be exchanged. However, such threshold is required to be shared across "Affiliated" entities. In other words, if two "Affiliated" entities are both FEUMSEs and are trading with the same CSE, then only one US$65 million threshold will apply across the two "Affiliated" FEUMSE entities. The Margin Rules do not address how such a single threshold will be allocated across multiple "Affiliates." Presumably, it will be the subject of negotiation between the parties, but it could also raise conflict of interest issues for the "Affiliated" entities if they are not wholly-owned affiliates. Additionally, the level of IM that must be posted by each FEUMSE and CSE will be determined either as (1) a percentage of a notional amount by reference to a table set forth in the regulations (ranging from 1-15% of a notional amount, based on the type of trade and duration) or (2) a model that is approved by the CFTC and Prudential Regulators. ISDA is currently working with market participants to develop such a model, which will hopefully result in more applicable IM calculations than the straight percentage of notional amounts proposed by the CFTC and Prudential Regulators. Finally, the types of collateral permitted as IM include not only cash, but also a number of different securities, including U.S. treasuries, U.S. agency securities, certain corporate securities, as well as gold. All IM posted is required to be held on a segregated basis and may not be rehypothecated.

FEU and CSE counterparties that are subject to the VM requirements will be required to post collateral bilaterally on a daily basis, based on a zero threshold, but with a US$650,000 "Minimum Transfer Amount." Additionally, only USD cash, or the applicable currency of a transaction, may be posted as collateral for VM. There are no regulatory requirements relating to segregation or rehypothecation of VM.

As proposed, the VM requirements would become effective for all applicable market participants as of December 1, 2015, whereas the IM requirements would be phased in over a four-year period commencing December 1, 2015 and will be based on the average daily notional amount of uncleared trades of a party during June, July and August of each year. However, because the Margin Rules are still only in proposed form, the closer that regulators are to adopting the final rules as such dates approach, the more likely it is that the effective dates will be pushed back in order to allow sufficient time for parties to implement the new requirements without disrupting the market.

c. Commodity Pool and Commodity Pool Operator Issues

As a result of the amendments to the Commodity Exchange Act (the "**CEA**") under the Dodd-Frank Act, "swaps" became regulated under the CEA. As a result, many of the CEA provisions that historically only applied to futures activities were expanded to cover swaps as well. An example of such expansion extends to commodity pool operators. Historically, commodity pools, which are akin to a registered investment company under the U.S. Investment Company Act of 1940, as amended, were limited to only collective investment funds that engaged in futures trading activity. With the expansion of CEA to include swaps, commodity pools now included collective investment funds that engage in either futures or swap trading activity. Additionally, through staff interpretation letters, the CFTC has noted that the presence of a single, static swap as a hedge for assets held in a collective investment fund could cause the fund to be viewed as a commodity pool, potentially requiring a registered commodity pool operator. This broad interpretation of a commodity pool by the CFTC, coupled with its revocation of certain exceptions to the commodity pool operator requirements, has led many entities to be faced with potential commodity pool status, and, thus, subject to the registered commodity pool operator requirements. In response to the CFTC's broad interpretation of commodity pools, many market participants have sought, and obtained, relief from the CFTC for specific situations. For instance, in 2012, the CFTC issued a series of no-action letters that provided relief from the commodity pool issue for a variety of different securitization and asset-backed securitization ("**ABS**") structures. During 2014, there were two commodity pool letters issued by the CFTC that are relevant to the insurance industry:

- General Accounts – CFTC Staff Letter 14-113

  It is common for insurance company families to centralize certain investment functions through the general account of one of the insurers. The collective nature of investment activity in the general fund on behalf of multiple affiliates when coupled with the regular use of swaps in connection with such investment activities began to raise questions as to whether the general account may be viewed as a commodity pool for CFTC purposes. In order to resolve this issue, the American Counsel of Life Insurers sought clarification from the CFTC that this common practice of affiliated insurers investing through a single general account would not cause the general account to be deemed a commodity pool. In CFTC Staff Letter 14-113, it was clarified that the general account of a U.S.-domiciled insurance company would not be construed to be a commodity pool if (i) the general account only receives contributions from other insurers that are under common control with the insurer that holds the general account and (ii) under no circumstances are assets from a separate account invested in, or contributed to, the general account. Thus, affiliated insurers may continue this common collective investment approach without fear of needing a registered commodity pool operator.

- CPO Relief for ILS – CFTC No-Action Letter 14-154

  Because the original line of CFTC 2012 no-action letters with respect to securitization and ABS only addressed fixed-income situations and not situations where risk is synthetically distributed to the capital markets (such as through catastrophe bonds or other similar ILS structures), the Securities Industry and Financial Markets Association sought relief from the CFTC for the commodity pool issues associated with catastrophe bond and ILS structures. In December 2014, after a lengthy process and numerous discussions with CFTC staff, the CFTC finally granted no-action relief from the requirement to have a registered commodity pool operation ("**CPO**") for catastrophe bond and ILS transactions that meet the requirements set out in the letter, which include: (i) securities issued by the issuing entity are exempt from registration under the U.S. Securities Act of 1933, as amended; (ii) the issuing entity at all times meets a *de minimis* test that is satisfied if the net notional amount of the swap does not exceed 100% of the liquidation value of the issuing entity; (iii) the investors in the catastrophe bond or ILS are all accredited investors or "qualified eligible persons;" (iv) the commodity pool operator files a notice of eligibility for exemption from CPO registration with the National Futures Association; (v) the issuer is operated such that (A) there is no active management of its assets and liabilities, (B) the collateral held by the issuer is in the form of cash or cash equivalent highly liquid assets, and (C) the collateral has a maturity date that is on or before the termination date of the related risk transfer contract, or is convertible to cash upon demand; (v) the issuer monitors its collateral and takes specified actions upon any deficiency in value; (vi) the payment obligations of the issuer are secured in the collateral; (vii) the collateral is maintained such that it is available to be distributed in the form of cash when a payment becomes due under the risk transfer contract; and (viii) the issuer is structured to be bankruptcy remote. Although the regulatory relief obtained in CFTC No-Action Letter 14-154 does not classify catastrophe bond and ILS issuers as non-commodity pools, it does allow them to continue to operate as commodity pools, but without a registered commodity pool operator. This results in the ability of catastrophe bond and ILS issuers to continue to operate with minimal interference of the CFTC's commodity pool regulatory requirements.

B. U.S. NAIC AND STATE ACTIVITY

1. Principle-Based Reserving

a. State Activity – PBR Legislation

It has been over two years since the NAIC approved PBR through adoption of the NAIC Standard Valuation Manual (the "**Valuation Manual**") in December 2012. Since then, as discussed above in Section II.A.3, states continue to introduce and adopt legislation that would allow for PBR. However, PBR will not become operative until legislation is adopted by 42 states representing 75% of total U.S. life insurance premiums, and it may be several years before this threshold is reached. In the meantime, state insurance regulators continue

working through the NAIC to address the mechanics of implementing PBR and to consider related issues, such as the appropriate use of reinsurance captives for life insurance reserve transactions pending implementation of PBR.

b. NAIC Activity – PBR Implementation

The NAIC continues to address PBR implementation issues primarily through its PBR Task Force, which serves as the coordinating body for NAIC technical groups involved with PBR implementation. Pursuant to a PBR Implementation Plan adopted by the NAIC's Executive (EX) Committee in 2013, the PBR Task Force also consults with state insurance departments and insurers regarding the appropriate resources, training and regulatory/actuarial guidance that will be necessary when PBR is effective. Within the past year, the PBR Task Force has addressed the PBR-implementation initiatives discussed below.

i. Small Company Exemption

On February 12, 2015, the PBR Task Force adopted an exemption for small insurers to the requirements set forth in VM-20 relating to exclusion tests (the "**Small Company Exemption**") and, in March 2015, the NAIC's Life Actuarial (A) Task Force adopted implementing language for the Valuation Manual. Although VM-20 currently allows less risky products to be exempt from additional reserve calculations, qualifying for the exemption was purportedly burdensome and costly for small life insurers. Therefore, the American Council of Life Insurers proposed the new Small Company Exemption for small companies which demonstrate they have sufficient capital and an unqualified opinion on reserves. Under the Small Company Exemption, any universal life insurance with secondary guarantees issued by such a company after PBR is implemented would meet the definition of a "non-material secondary guarantee" (such definition to be added to the Valuation Manual) and would be exempt from PBR. "Small Company" is defined as one with less than US$300 million of ordinary life insurance premiums (direct and assumed from non-affiliates) and, if the company is a member of an NAIC group of life insurers, the group has combined ordinary life premiums of less than US$600 million.

The Small Company Exemption has political origins and implications. Although a small company exemption was not included in the NAIC's adoption of PBR in 2012, lawmakers sponsoring PBR legislation in some states have been including such exemptions in order to make PBR more palatable to state legislatures. Opponents of the Small Company Exemption (such as the NYDFS) argued against such an exemption on the grounds that it has no actuarial basis and was already rejected when the NAIC adopted PBR in 2012.

ii. PBR Operative Date

The "operative date" of the Valuation Manual (which enables PBR) depends on states passing "legislation including substantially similar terms and provisions." The PBR Task Force is in the process of evaluating what will satisfy this requirement. As guidance, the PBR Task Force is using sections of the Standard Valuation Law that were presented to the NAIC's Financial Regulation Standards and Accreditation (F) Committee as meeting the "substantially similar" requirements for purposes of state insurance department accreditation under the NAIC Financial Regulation Standards and Accreditation Program ("**NAIC Accreditation**"). NAIC Accreditation requires that states adopt specified NAIC model acts or initiatives, or provisions that are "substantially similar."

2. Affiliated Captive Insurers and Reserve Transactions

a. New Framework for Captive Reserve Transactions

Throughout 2014, the PBR Task Force was focused almost exclusively on developing (and then implementing) interim rules specific to life insurance reserve financing transactions, pending the full implementation of PBR. The rules relate to the proper use of captive reinsurers in financing reserves associated with blocks of level premium term insurance required pursuant to Regulation XXX, or with universal life products with secondary guarantees required under Regulation AXXX. As discussed above in Section II.A.1.a, in August 2014, the NAIC adopted the Framework, setting forth the requirements for life insurers using affiliated captive insurers, particularly for XXX and AXXX reserve transactions. The final version of the Framework was the result of extended discussions among the PBR Task Force, its third-party consultant (Rector & Associates), insurance regulators and industry groups. The Framework will ultimately be documented in amendments to the NAIC Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786) (together, the "**CFR Model Laws**").

In keeping with its general opposition to PBR (and concerns regarding captive insurers), the NYDFS voiced its objections to the Framework throughout the adoption process. While the NYDFS acknowledges that the current formulaic approach to reserve calculations may result in excess reserves, it prefers maintaining the current formulaic approach and making targeted adjustments to formulas where supported by strong empirical evidence. For example, in February 2015, the NYDFS proposed reducing by 15% the reserve requirements applicable to universal life insurance policies with secondary guarantees.

As outlined in Section II.A.1.a, the Framework requires that the portion of the cedent's reserves determined by the "Actuarial Method" (the current VM-20 reserves with certain adjustments) for the XXX or AXXX book of business be backed by collateral consisting of hard assets—assets that satisfy a new "Primary Security" definition—while the portion of reserves exceeding such level can be collateralized by assets that fall within the new definition of "Other Security." The Framework also provides for enhanced disclosures in the cedent's financial statements, requires that at least one party to the XXX/AXXX transaction maintain a related risk-based capital cushion (the "**RBC Cushion**"), and requires that the entire transaction be approved by the cedent's domiciliary regulator. In addition, the cedent's actuary is required to issue an opinion as to whether the transaction follows the Framework.

Since adoption of the Framework, various NAIC task forces and working groups have been working on these various requirements as follows:

- Blanks Reporting

  The Framework requires that cedents (life insurers and fraternal benefit societies) file a new Supplemental XXX/AXXX Reinsurance Exhibit (the "**XXX/AXXX Reinsurance Exhibit**") with their annual statements. The exhibit must provide information about assets and reserves pertaining to policies subject to XXX/AXXX reserving and is meant to enhance transparency, especially in cases where the assuming reinsurer is not subject to public disclosure requirements. Before year-end 2014, a XXX/AXXX Reinsurance Exhibit was adopted by the NAIC on an expedited basis so that it could be used for 2014 annual statements. A more expansive version of the exhibit was adopted by the PBR on March 16, 2015. The new exhibit includes interrogatories which address information about collateral and assets, such as whether collateral is a letter of credit or other security that operates in a similar manner, and whether an asset is being guaranteed by an affiliate.

- AG 48 and Related Guidance

  As noted above in Section II.A.1.a, on December 16, 2014, the NAIC adopted AG 48 which provides guidance concerning the NAIC Actuarial Opinion Memorandum Regulation, Section 3 of which gives insurance commissioners authority to specify methods of actuarial analysis and assumptions when necessary for an acceptable opinion to be rendered concerning adequacy of reserves. AG 48 requires that an opining actuary for a cedent must: (i) follow the methods and assumptions developed as individual components of the Framework to determine whether the cedent's net reserves are appropriate; and (ii) issue a qualified actuarial opinion if the cedent has entered into a reserve financing transaction that does not adhere to the Framework. AG 48 sets forth the "Actuarial Method" for establishing the required level of "Primary Security," which varies for (a) term life insurance and (b) universal life with secondary guarantees.

  The Actuarial Method is to be applied on a gross basis to reserves ceded with respect to all Covered Policies. "Covered Policies" are defined in AG 48 as those (1) issued on or after January 1, 2015; or (2) issued prior to January 1, 2015, but ceded pursuant to a "New Reinsurance Agreement" on or after January 1, 2015, in either case, assuming the policies are required to be valued under Section 6 or 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (#830) and are not exempt. A "New Reinsurance Agreement" is defined in AG 48 as an agreement (A) entered into on or after January 1, 2015; or (B) entered into prior to January 1, 2015 that is amended, renewed, or restructured on or after January 1, 2015, with some exceptions.

  To implement the Framework's requirement that economic reserves be backed by assets qualifying as "Primary Security" (and excess reserves by "Other Security"), AG 48 defines "Primary Security" and "Other Security." After considerable debate, the definition of "Primary Security" was limited to cash and securities listed with the Securities Valuation Office of the NAIC and specifically excludes letters of credit, contingent notes, credit-linked notes or other securities that operate in a manner similar to a letter of credit. For security held in connection with funds withheld and modified coinsurance reinsurance arrangements, AG 48 defines "Primary Security" as also including (i) commercial loans in good standing (of CM3 quality and higher), (ii) policy loans, and (iii) derivatives acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks in the policies ceded pursuant to the reinsurance arrangement. AG 48 defines the term "Other Security" as any asset (including one meeting the definition of "Primary Security") acceptable to the commissioner of the ceding insurer's domiciliary state. AG 48 also provides for an advisory group's review of captive transactions to determine whether the transaction should be exempt from AG 48.

- Capital Adequacy and Risk-Based Capital Matters

  Pursuant to the Framework, the Life RBC Working Group (on referral from the Capital Adequacy Task Force) is currently developing the appropriate RBC Cushion for an insurer ceding policies subject to XXX/AXXX reserving when the assuming reinsurer does not file an RBC report using the RBC formula and instructions. It is also working on appropriate asset charges for the forms of "Other Security" used by insurers under the Framework (which charges will be considered for incorporation into the RBC Cushion), and evaluating whether the current RBC C-3 treatment of qualified actuarial opinions is adequate for purposes of the risks of XXX/AXXX reinsurance transactions that are subject to qualified actuarial opinions.

- Amendments to CFR Model Laws

  The NAIC's Reinsurance Task Force will create a new Credit for Reinsurance Model Regulation to establish requirements regarding the reinsurance of policies subject to XXX/AXXX reserving. Exhibit 4 to the Framework will be considered for this model regulation, modified as deemed appropriate by the PBR Task Force. The Reinsurance Task Force will also amend the Credit for Reinsurance Model Act (#785) to reference the new regulation.

b. Risk-Transfer Charge

The NAIC's Financial Condition (E) Committee has been charged with evaluating the risk-transfer rules applicable to XXX/AXXX reserve financing transactions to ensure that they "appropriately apply to situations such as those where parental/affiliate guarantees are used, resulting in the risk effectively being kept within the holding company system even though the reinsurance arrangement involves an unrelated third party." As of this writing, there has been no official discussion of this charge due to the focus on getting major aspects of the Framework in place. Sources with statutory accounting and reinsurance expertise will be key drivers of the discussion once it begins.

3. Reinsurance

a. Credit for Reinsurance Update

It has been more than three years since the NAIC amended the CFR Model Laws in November 2011. As amended, the CFR Model Laws allow for a reduction in posted collateral from an unauthorized reinsurer that is approved by states as a "certified reinsurer." In deciding whether to certify a reinsurer, state insurance regulators evaluate a number of factors, including whether a reinsurer is domiciled in a jurisdiction the state considers to be a "qualified jurisdiction" (i.e., one that "effectively" regulates reinsurers domiciled in the jurisdiction).

The amount of collateral required from certified reinsurers depends on the rating tier assigned to the reinsurer. There are currently six financial strength tiers in the CFR Model Laws with corresponding collateral requirements (Secure-1 through 5 and Vulnerable, with collateral requirements ranging from 0% through 100% of reinsurance liabilities). A certified reinsurer's collateral requirements are, however, subject to change and in the last two years, some certified reinsurers have been required to increase their collateralization (i.e., following a downgrade), while others have been allowed additional decreases in collateralization after being placed in a better financial strength tier.

i. State Activity

States continue passing key provisions of the CFR Model Laws to allow for a reduction in posted collateral from unauthorized reinsurers that have been approved by states as "certified reinsurers." At the time the NAIC adopted the CFR Model Laws, two states had already effected changes to collateral requirements—New York and Florida (the latter, for property-casualty reinsurance only). As of early March 2015, an additional 21 states have adopted some form of the CFR Model Laws and have (or will) begin accepting applications from reinsurers seeking certified reinsurer status.

Currently, the NYDFS has processed more certified reinsurer applications than any other state. Beginning in late 2014, there was a jump in the number of states accepting certified reinsurer applications, as insurance departments finalized their internal application procedures and updated their websites to accommodate applications. Most states are not requiring a specific application form and will accept submissions that address the state's regulations concerning certified reinsurers and/or the NAIC's Uniform Application Checklist for Certified Reinsurers (discussed below in Section V.B.3.a.ii(a)). Also, as discussed below, a state that approves a certified reinsurer may then (at the reinsurer's request) submit the reinsurer's application to the NAIC for a multi-state review, leading to the certified reinsurer's status being "passported" into other states.

ii. NAIC Activity

Although it passed the CFR Model Laws in 2011, the NAIC remains active in assisting state insurance regulators with procedural aspects of the laws. Through the NAIC's Reinsurance (E) Task Force and its Reinsurance Financial Analysis Working Group ("**RFAWG**"), the NAIC provides a forum for multi-state review of certified reinsurer applications. The NAIC also assists states in determining what constitutes a "qualified jurisdiction" and after significant review, it has placed a number of countries on the NAIC List of Qualified Jurisdictions, effective January 1, 2015.

a. Certified Reinsurer Application Review

RFAWG continues to provide a forum for multi-state review of certified reinsurer applications and for "peer review" by state insurance regulators of decisions made by other states on such applications. Peer reviews allow states to access diligence already conducted by other states during the approval process. RFAWG has reported that, as of year-end 2014, it had recommended twenty-seven certified reinsurer applications for passporting. The NAIC is close to adopting a Uniform Application Checklist for Certified Reinsurers ("**Uniform Application**"). The Uniform Application will facilitate the process of "passporting," wherein a reinsurer applies to an initial (lead) state for certification as a certified reinsurer and, after consideration by RFAWG, another state can choose to defer to the lead state's recommendation concerning certification. Once it receives its certification by a lead state, the reinsurer can then utilize the Uniform Application to seek a "passport" to certification in other states.

b. Qualified Jurisdiction Process

To assist states in determining whether a reinsurer's domicile is a "qualified jurisdiction," the NAIC adopted a written process in August 2013 for developing and maintaining a list of qualified jurisdictions (the "**Qualified Jurisdiction Process**"). In drafting the Qualified Jurisdiction Process, the NAIC recognized the importance of consistency among states and took into account that some states (e.g., Florida and New York) had already, in effect, made decisions on certain countries when they certified 29 reinsurers domiciled in Bermuda, the UK, Switzerland and Germany. An "expedited review" was used for jurisdictions that have already been vetted by states that granted certified reinsurer status to reinsurers domiciled in those jurisdictions. Jurisdictions placed on the NAIC's List of Qualified Jurisdictions are subject to evaluation every few (generally, five) years.

As of early March 2015, the following jurisdictions (and their insurance regulatory authorities) have been granted "qualified jurisdiction" status, with specified states acting as the lead state for regulatory cooperation:

- France: Autorité de Contrôle Prudential et de Résolution ("**ACPR**"), with California as the lead state for regulatory cooperation, until New York signs a bilateral Memorandum with the ACPR.
- Germany: Federal Financial Supervisory Authority, with California as the lead state.
- United Kingdom: PRA of the Bank of England, with New York as lead state.
- Ireland: Central Bank of Ireland, with Delaware as the lead state.
- Japan: Financial Services Agency of Japan, with California as the lead state.

- Switzerland: Financial Market Supervisory Authority, with Connecticut as the lead state.
- Bermuda: Bermuda Monetary Authority, with Florida as lead state. "Qualified Jurisdiction" status applies only to (re) insurers of Class 3A, Class 3B and Class 4, and long-term insurers of Class C, Class D and Class E.

c. Re-Examination of Collateral Requirements

In 2014, the NAIC's Reinsurance (E) Task Force began re-examining the current collateral requirements set forth in the CFR Model Laws to determine whether changes were needed (to raise or lower collateral amounts). When the CFR Model Laws were drafted, new collateral amounts were established with the intent that they be reviewed within two years of their use by certified reinsurers. Among other things, the Reinsurance (E) Task Force has been surveying regulators and industry to obtain views on how the amended collateral requirements set forth in the CFR Model Laws are working. While most respondents believe that collateral amounts are reasonable, some believe there are problems with the current tier ratings and that it may be helpful to have an additional tier added to the current six tiers.

4. Corporate Governance/Solvency Initiatives

a. Corporate Governance Annual Disclosure Model Act and Model Regulation

The NAIC adopted the Corporate Governance Annual Disclosure Model Act and Model Regulation (the "**Corporate Governance Models**"), which require an insurer to provide an annual disclosure regarding its corporate governance practices to its lead state and/or domestic regulator. The requirements of the Corporate Governance Models are intended to be effective January 1, 2016, with the first annual disclosure scheduled to be due by June 1, 2016. The Corporate Governance Models permit an insurer to report on corporate governance at the level of the ultimate controlling parent, an intermediate holding company and/or the individual insurance company, depending on the level at which corporate governance decisions, oversight and accountability occur with respect to the insurer's insurance activities.

b. Updated Model Audit Rule Requiring Internal Audit Function for Larger Companies

The NAIC adopted amendments to the Annual Financial Reporting Model Regulation (also known as the Model Audit Rule) to add an internal audit function for large insurers. The new requirement applies to individual insurers writing at least US$500 million or insurance groups writing at least US$1 billion in annual premiums (the same thresholds that apply for purposes of determining whether an insurer is required to file a summary report under the Risk Management and Own Risk and Solvency Assessment Model Act). The revisions require such insurers to "establish an internal audit function providing independent, objective and reasonable assurance to the audit committee and insurer management regarding the insurer's governance, risk management and internal controls." The internal audit function must be "organizationally independent," and the head of the internal audit function is required to report to the audit committee regularly, but no less than annually. If an insurer is a member of an insurance holding company system or included in a group of insurers, the insurer may satisfy the internal audit function requirements on a legal entity or aggregate basis. The revisions include a drafting note that encourages companies exempt from the new internal audit function requirements to review their business to determine whether an internal audit function is warranted in light of the potential benefits assessed against the costs.

c. Enterprise Risk Management

Although the NAIC adopted enterprise risk management ("**ERM**") provisions in 2010 as part of the revisions to the NAIC Insurance Holding Company System Regulatory Model Act and Regulation (the "**Amended Holding Company Model Laws**"), the NAIC remains active in assisting states and the insurance industry on ERM issues, mostly through ERM education programs. In the meantime, states continue to adopt the revised NAIC Holding Company Model Laws, which address ERM. ERM filings must be made by the ultimate controlling person of each insurance company subject to registration under the state's insurance holding company laws. ERM reports must identify material risks within such holding company system that "could pose enterprise risk to the [insurance] company."

While most states' laws closely follow the provisions of the Amended Holding Company Model Laws regarding ERM, the law as adopted in some states (such as New York) differs from the Amended Holding Company Model Laws in certain key areas. For example, in April 2014, the NYDFS promulgated an emergency regulation detailing requirements applicable to ERM ("**Regulation 203**"), which generally followed the ERM provisions in New York's July 2013 amendments to the NY Insurance Law ("**NYIL**"). While the Amended Holding Company Model Laws require that ERM reports be filed with the "lead state" of an insurance holding company system, the NYIL and Regulation 203 require that the ultimate holding company of any authorized insurer in New York (not just New York-domiciled insurers) that is part of a holding company system adopt a formal ERM function and file an ERM report with the NYDFS. Additionally, Regulation 203 requires that an ERM report be signed by the chief risk officer of the ultimate holding company attesting to the best of his or her knowledge and belief that the report identifies any material risks within the holding company system that could pose enterprise risk to any insurer within the system and that a copy of the report has been provided to the holding company's board of directors or the appropriate committee thereof.

Most companies regulated by states that have adopted the Amended Holding Company Model Laws filed their first ERM reports in 2014. In other states (such as Illinois) the first ERM filing will be due in 2015. Filing dates in most states correspond to the date on which the annual registration statement (Form B) is filed.

d. Risk Management and Own Risk and Solvency Assessment Model Act

There has been a sizeable increase in states adopting laws based on the NAIC Risk Management and Own Risk and Solvency Assessment ("**ORSA**") Model Act (#505), which requires insurers to assess the adequacy of its risk management and solvency positions under both normal and severe stress scenarios. As of February 2015, 21 states had adopted such laws (up from eight in early 2014). For domestic

insurers in states that adopt the ORSA requirements with an effective date on or before January 1, 2015, generally, the first ORSA summary report must be filed during 2015. Although it adopted the ORSA Model Act in 2012, the NAIC remains active in assisting states and the insurance industry on implementation issues, particularly through its "Feedback Pilot Project," through which regulators provide insurers with feedback in the form of observations and recommendations with respect to ORSA summary reports voluntarily submitted for such review by insurers.

e. Capital Adequacy

Pursuant to the NAIC's August 2014 adoption of the Framework addressing affiliated excess reserve life reinsurance transactions (discussed in Section V.B.2.a above), the Capital Adequacy (E) Task Force (the "**CA Task Force**") was assigned charges related to RBC aspects of the Framework, including establishment of the RBC Cushion discussed above. In addition to the RBC Cushion, the CA Task Force must develop appropriate asset charges for the form of "Other Security" used by insurers under the Framework (the charges then to be added to the RBC Cushion) and determine whether the current RBC C-3 treatment of qualified actuarial opinions is adequate for the purposes of the risks of XXX/AXXX reinsurance transactions that receive qualified actuarial opinions. The CA Task Force assigned each of these charges to its Life RBC Working Group. For a discussion of the Life RBC Working Group's actions on these charges, *see* the discussion in Section V.B.2.a.

During 2014, the CA Task Force directed its Investment RBC Working Group to analyze the effect of including investment risk in the RBC formula applicable to insurers other than life insurers. Life insurers are unique in that they hold an asset valuation reserve ("**AVR**"), which is the liability set aside in life insurers' annual statements to protect statutory surplus against large fluctuations in asset value. To date, much of the Investment RBC Working Group's analysis has focused on insurers that are subject to AVR. In a memorandum to the CA Task Force, the Investment RBC Working Group noted that although it generally takes the view that asset risk is the same regardless of the holder of the investment (e.g., life, health, property-casualty insurer, etc.), there may be cases where asset risk factors would be different among insurers, such as life insurers holding AVR and, therefore, the Investment RBC Working Group is examining the degree to which asset risk factors should be adjusted due to differences in reserve requirements. The Investment RBC Working Group is also investigating other dissimilarities in investment characteristics driven by the difference in a liability's duration or capital structure or in statutory accounting requirements.

Also during 2014, the CA Task Force adopted changes to RBC Filing Guidance and Instructions that would prohibit an insurer whose domestic regulator has granted it an RBC permitted practice from applying that permitted practice in RBC calculations. Specifically, the Management Discussion and Analysis RBC Instructions will provide that permitted practices are not allowed for RBC and that RBC requirements, Total Adjusted Capital ("**TAC**") and RBC factors cannot be modified for the calculation of Authorized Control Level RBC. These changes are intended to address concerns of the CA Task Force that some states had been granting domestic insurers certain RBC-permitted practices (allowing the insurers to modify the RBC requirement for calculation of Authorized Control Level RBC).

The CA Task Force's Operational Risk Subgroup continues its discussions on adding an "operational risk" component to RBC formulas for health, life and property-casualty insurers. The Subgroup recognizes the difficulty in quantifying operational risk (as opposed to evaluating it on a qualitative basis). Operational Risk has been defined as "the risk of financial loss resulting from operational events, such as the inadequacy or failure of internal systems, personnel, procedures or controls, as well as external events. Operational risk includes legal risk but excludes reputational risk and risk arising from strategic decisions." Operational risk is currently addressed through other NAIC-led initiatives, such as the requirement that insurers conduct an ORSA and prepare ORSA summary reports and enhanced corporate governance standards, which require analysis of risks that include underwriting, credit, market, liquidity, as well as operational risk. An operational risk charge would account for operational risks other than those that are already reflected in existing RBC risk categories. The Operational Risk Subgroup is in the process of drafting a list of "event types" that could fall within the category "operational risk." The Operational Risk Subgroup will also examine ORSA summary reports filed by insurers in order to identify the types of operational risks reported by insurers. In March 2015, the Life RBC Working Group began working on a proposal for establishing an operational risk component.

In 2014, the CA Task Force's Property-Casualty RBC Working Group exposed various proposals, including one that would change the methodology for calculating the reinsurance credit risk charge ("**R3**") used in the RBC formula relating to credit-related assets (the "**R3 Proposal**"). Under the proposal, the R3 credit risk charge would vary according to a reinsurer's creditworthiness; the proposed methodology would apply different factors for calculating RBC based on the reinsurer's financial strength ratings and collateral offsets. The Property-Casualty RBC Working Group also began considering proposals to assess the potential impact of fees established pursuant to healthcare reform with respect to the calculation of TAC and the potential impact on an insurer's RBC ratio due to the risk of incorrect estimation of the risk adjustment and risk corridor under healthcare reform. It is also considering an affiliate investment proposal that would alter the RBC charge applied to "investment affiliates"—entities that own or manage an insurer's investments. The current RBC charge is based on the RBC of the underlying assets of the investment affiliate, which is currently prorated based on the degree of ownership on the assumption that the charge should be the same as if the insurer held the assets directly. The Property-Casualty RBC Working Group is questioning this approach because the underlying assets of the investment affiliate cannot be easily determined and are difficult to verify.

5. Unclaimed Property

a. 2014 State Bills Based on National Conference of Insurance Legislators Model Unclaimed Life Insurance Benefits Act

During 2014, seven states enacted legislation based on the National Conference of Insurance Legislators ("**NCOIL**") Model Unclaimed Life Insurance Benefits Act (the "**NCOIL Model**") to require insurers to perform searches of the Social Security Administration's Death Master File (the "**DMF**") in order to become aware of potentially deceased insureds, annuitants and owners of polices, annuities or retained asset accounts. Of the seven states (Georgia, Indiana, Iowa, Kentucky, Mississippi, Rhode Island and Tennessee), Kentucky amended its prior law, while the others enacted new legislation.

With respect to the other six states, three (Indiana, Iowa and Rhode Island) enacted laws that apply retroactively (i.e., to existing life insurance policies); two (Georgia and Mississippi) enacted laws that apply prospectively (i.e., to life insurance policies issued after the effective date of the laws); and one (Tennessee) enacted a law that applies asymmetrically. "Asymmetric" application refers to laws providing that insurers that did not use the DMF prior to a specified date (usually the law's effective date) need only perform comparisons of the DMF with respect to insureds, annuitants and owners of policies, annuities or accounts issued on or after the specified date. For all other insurers, the law would apply retroactively to policies, annuities and accounts that had been issued before the specified date.

The 2014 enactments brought the total number of states expressly requiring use of the DMF to fifteen (four states enacted new laws in 2012, five enacted new laws in 2013 and six enacted new laws in 2014). Of the 15 states' laws, 10 are retroactive, three are prospective, and two are asymmetric.

During 2014, two states (Louisiana and Wisconsin) issued written guidance on DMF use by insurers. Wisconsin's Department of Revenue clarified in April 2014 that there is no requirement under Wisconsin's unclaimed property law to use the DMF to determine whether an insured or annuitant has died. The Louisiana Insurance Commissioner issued an advisory letter in September 2014 recognizing that insurers are not currently subject to any Louisiana statutory requirement to use the DMF.

In a move to assist consumers who are potential beneficiaries, a growing number of states have implemented "lost policy finder" services which permit potential beneficiaries to provide data through a website that is used to poll all insurers writing insurance in such state for any matching policy information. Published advice on searching for lost life insurance has also become available on the websites of numerous state insurance regulators and insurance trade groups.

b. 2014 Changes to the NCOIL Model

In November 2014, NCOIL amended the NCOIL Model for the third time since 2011, when NCOIL originally adopted it. The 2014 amendments:

- add a defined term for "Knowledge of Death" in order to better coordinate the unclaimed life insurance benefits laws with states' unclaimed property laws;
- define "Retained Asset Accounts;"
- clarify that insurers are not responsible for comparisons of insureds under group policies or contracts unless the insurer performs the defined "Record-Keeping Services" for the group master policyholder;
- expressly require comparisons of the DMF with respect to annuitants and owners of retained asset accounts, in addition to insureds under life insurance policies;
- permit insurers to use the full DMF once and thereafter to use the DMF update files;
- require insurers to implement procedures to account for inexact DMF search results, such as nicknames, transposed names or dates, incomplete Social Security numbers (so-called "fuzzy matches"); and
- clarify that in order to be an unfair trade practice, a violation of the law must be done with "such frequency as to constitute a general business practice," which coordinates the NCOIL Model with many states' unfair trade practices laws.

Finally, the amendments provide that the laws shall take effect "no less than one year after the date signed into law," in order to provide insurers with lead time to implement compliance systems and procedures.

c. NAIC Considers Development of Unclaimed Life Insurance Benefits Model Law

The NAIC Unclaimed Life Insurance Benefits Working Group plans to develop a new model to address the issue of unclaimed life insurance proceeds. While it will have one year to work on this charge, a number of states have already enacted laws to expressly require insurance companies to make comparisons of their in-force business to the DMF to potentially identify deceased insureds whose beneficiaries have not filed a claim. Most of such states have enacted, and others are considering enacting, legislation based on the NCOIL Model (*see* Section V.B.5.a). A difficult issue for multi-state life insurers is the lack of consistency in the requirements from state to state. This is as yet unresolved and, with bills currently pending in a number of states, may remain an open compliance issue.

d. Settlements and Litigation Dealing with Unclaimed Life Insurance Matters

Following significant activity on this front in the last three years, during the last few months of 2014, an additional three life insurance companies or affiliated groups entered into multi-state insurance regulatory settlements with insurance regulators. The same companies also entered into multi-state settlements with unclaimed property agencies and auditors. This brings the total publicly announced multi-state settlements to 16 insurance regulatory and 21 unclaimed property agency settlements, with two insurer groups having been determined to be in compliance (and therefore, no

insurance regulatory settlements were entered into). In addition to the multi-state settlements, some states are individually pursuing similar investigations of life and annuity insurers.

A number of lawsuits initiated in prior years reached appellate courts in 2014. In *Feingold v. John Hancock Life Ins. Co.*, 753 F.3d 55 (1st Cir. 2014), the U.S. Court of Appeals for the First Circuit affirmed the decision of a federal district court in Massachusetts to dismiss a putative class action filed by a beneficiary who alleged that a life insurer violated state law by failing to use the DMF to identify deceased insureds. The district court had held that "[b]oth the insurance policy and state law allowed John Hancock to hold the policy proceeds until Feingold provided proof of his mother's death."

In *Thrivent Fin. for Lutherans v. State of Florida Dep't of Fin. Servs.*, 145 So.3d 178 (Fla. Ct. App. 2014), the Florida Court of Appeals rejected a declaratory statement issued by Florida's Department of Financial Services (the "**FLDFS**") that (i) life insurance funds are "due and payable" under Florida's Unclaimed Property Law ("**UPL**") upon the death of the insured, and (ii) that the UPL obligates insurers to affirmatively search databases, such as the DMF, to determine if any of their insureds have died. The court held that the FLDFS' position was clearly erroneous because it conflicted with Florida's Insurance Code, which provides that every life insurance contract must state that "settlement shall be made upon receipt of due proof of death and surrender of the policy," and does not contemplate settlement at the time of death. Further, the court held that the FLDFS' position conflicted with Florida's statutory mortality limiting age, which provides that a life insurance policy that is not matured by actual proof of death may be matured upon the insured's attainment of the mortality limiting age, and does not contemplate maturity at the time of death.

In *Total Asset Recovery Servs. v. MetLife, Inc.*, 2010-CA-3719 (Fla. Cir. Ct. Aug. 20, 2013), *aff'd. per curiam*, No. 1D13-4420 (Fla. App. Ct. Sept. 19, 2014), a Florida trial court had dismissed a lawsuit brought by an asset recovery firm against a number of insurers, arguing that the insurers violated the False Claims Act by failing to search the DMF to identify deceased insureds and report unclaimed benefits to the state. The trial court rejected that argument, holding that "Florida has adopted no law imposing an obligation on [insurers] to engage in elaborate data mining of external databases . . . in connection with payment or escheatment of life insurance benefits." The Florida Court of Appeals affirmed in a *per curiam* order.

In *United Ins. Co. of Am. v. Kentucky*, 2013–CA–000612, 2014 WL 3973160 (Ky. Ct. App. Aug. 15, 2014), a group of life insurers challenged the retroactive enforcement of Kentucky's version of the NCOIL Model, which expressly requires insurers to search the DMF for deceased insureds and to escheat policy proceeds for any unclaimed DMF matches. The insurers argued that applying these requirements to life insurance policies issued prior to the law's effective date would violate Kentucky's presumption against retroactive laws and the Contract Clauses of the Kentucky and U.S. Constitutions. The Kentucky Court of Appeals unanimously reversed the trial court's decision and held that Kentucky's presumption against retroactive laws prohibits the law from being enforced retroactively. The appellate court held that the new obligations the law imposes on insurers are a "substantive and not a remedial alteration of the contractual relationship between insurers and insureds" because the law shifts the burden of obtaining evidence of death and locating beneficiaries from the insured's beneficiaries and estate to the insurer." Because the Kentucky law affected these "substantive" rights of insurers, the court held that it was unlawful to apply the law to life insurance policies issued prior to the law's effective date. The Kentucky Department of Insurance has sought discretionary review by the Kentucky Supreme Court.

6. Health Insurance Regulation

The Patient Protection and Affordable Care Act and its companion, the Health Care and Education Reconciliation Act of 2010 (together, the "**ACA**") will continue to garner significant attention in 2015, notwithstanding the fact that healthcare reform implementation efforts were largely completed upon the effectiveness of many operative provisions of the ACA in 2014. Topics of new and continuing importance include the following:

- Implementing New ACA Requirements in 2015

  Effective January 1, 2015, employers with more than 100 full-time employees are required to offer health insurance coverage to their employees or pay a fee. The employer mandate applicable to employers with less than 50 full-time employees is not scheduled to take effect until January 1, 2016. Under another newly effective provision of the ACA, the federal match rate under the Children's Health Insurance Program is scheduled to increase effective October 1, 2015.

- New ACA Challenge in the U.S. Supreme Court

  The U.S. Supreme Court's decision in *King v. Burwell* will determine whether premium subsidies are available to individuals who use a federal health insurance exchange to enroll in a healthcare plan. At issue is language in the ACA that permits premium subsidies for individuals that enroll on exchanges "established by the state." Currently, the federal government operates the health insurance exchanges (via a federally-facilitated exchange or a federal-state partnership exchange) in a majority of the states, with only 14 states operating state-based exchanges and an additional three states operating a federally supported state-based exchange. If the Court decides to strictly construe the language in the ACA, individuals who enroll via a federally operated exchange will not be eligible for premium subsidies, which could make health insurance unaffordable for such individuals, making it politically undesirable to enforce the individual mandate. Thus, the Court's decision could significantly impact the continued viability of the ACA.

- Liquidation of CoOportunity Health

  The financial soundness of Consumer Operated and Oriented Plans ("**CO-OPs**"), created pursuant to the ACA and funded and approved by the U.S. Department of Health and Human Services, Centers for Medicare & Medicaid Services, has been called into question in light of the recent liquidation of CoOportunity Health, a CO-OP that was an Iowa domestic insurance company licensed to transact health insurance

in Iowa and Nebraska. CoOportunity Health experienced cash flow problems when the U.S. Congress adopted an appropriations law in December 2014 that delayed federal payments for certain risk mitigation programs under the ACA (i.e., the "Three R's"—risk corridors, risk adjustment and reinsurance) until the second half of 2015. The Iowa Commissioner of Insurance is the statutory liquidator of CoOportunity Health. Supporters of the ACA have pointed to CO-Ops as one of the ways in which the ACA has benefitted consumers by expanding consumer choice and potentially driving down prices. Critics of the ACA have pointed to the liquidation of CoOportunity Health as an indication that the ACA is founded on unsound financial principles.

- Medical Provider Network Adequacy

  In an attempt to manage costs in the post-ACA health insurance marketplace, some insurers have offered health plans with limited provider networks. In some states, consumers have complained of scheduling difficulties with in-network providers, distance to travel to access in-network providers and incorrect listings of in-network providers in the insurer's provider directory. In response, the California Department of Insurance has issued the Emergency Medical Provider Network Adequacy Regulation (effective on January 30, 2015 and expiring on July 30, 2015) "to require health insurers to maintain adequate medical provider networks to meet the healthcare needs of their policyholders, maintain accurate provider directories, and require disclosure of out-of-network providers who may participate in a patient's planned care." Complying with these provisions will undoubtedly increase insurer costs, and given the ACA's limitations on increasing health insurance rates, the financial burden could prove to be significant, especially if other states follow California's lead and impose similar requirements on insurers.

7. Private Equity Issues – Amendments to New York Insurance Regulation 52

Effective November 12, 2014, the NYDFS adopted amendments to its insurance holding company system regulation ("**Amended Regulation 52**"), which expand the scope of information that an applicant must include in the notification statement ("**Form A Statement**") filed with the New York Superintendent of Financial Services (the "**Superintendent**") to obtain approval of an acquisition of control of a New York domestic insurance company. Amended Regulation 52 also expressly authorizes the NYDFS to impose additional conditions on an acquisition of control of a New York domestic insurer. Although the NYDFS has recently expressed concern regarding private equity firms' acquisitions of insurance companies (and acquisitions of life insurers writing fixed and indexed annuity contracts, in particular), Amended Regulation 52 generally applies to all acquisitions of New York domestic insurers, not just to applicants identified as being associated with private equity firms.

Amended Regulation 52 effects the following notable changes to the Form A Statement process in New York:

- Item 2 of the Form A Statement now requires the applicant to provide additional identifying and background information about its controlling persons, including such persons' financial statements and future plans for the domestic insurer. If any of the applicant's controlling persons is a limited partnership, limited liability partnership or limited liability company, the Form A Statement must include a copy of any operating agreement, management agreement, partnership or limited partnership agreement or any other contract or agreement that establishes the control relationship.

- Item 4 of the Form A Statement now requires more expansive disclosure regarding the nature, source and amount of consideration for the proposed acquisition. A new catch-all provision for the types of funds that must be disclosed requires disclosure of funds borrowed or otherwise obtained for the purposes of effecting the acquisition of control. Materials that must be filed as exhibits to the Form A Statement now include offering memoranda, private placement memoranda, any investor disclosure statements and any other investor solicitation materials related to the nature, source and amount of consideration for the proposed transaction.

- Item 5(a) of the Form A Statement now requires the applicant to describe its plans or proposals to liquidate the domestic insurer, to sell its assets to or merge it with any other persons or to make any other material change in its business operations or corporate structure in the ***next five years*** and adds to the list of actions to be disclosed any plans or proposals to declare any dividends or to change the insurer's investment portfolio. Further, Amended Regulation 52 prohibits an applicant from modifying or amending such plans or proposals within five years of the date of the acquisition of control without the Superintendent's prior written approval.

- Item 5(b) of the Form A Statement now requires an applicant to submit a detailed plan of operation, including five-year financial projections, relating to the domestic insurer. In practice, the Superintendent has always required, and applicants have always submitted, these materials with their Form A Statement, so this amendment may be considered a clarification of existing requirements. However, Item 5(b) of the Form A Statement also includes a new requirement that if the domestic insurer seeks to enter into certain enumerated transactions or agreements within five years of the date of the acquisition of control, the insurer must notify the Superintendent and, at the Superintendent's request, the domestic insurer must submit new five-year financial projections. Further, under Amended Regulation 52, if the Superintendent determines that the new projections show that the domestic insurer will not have adequate capital, then the domestic insurer must obtain additional capital in an amount and of a quality sufficient to remedy the deficiency as determined by the Superintendent.

- Amended Regulation 52 grants the Superintendent specific authority to require the applicant or any holding company in the domestic insurer's holding company system to establish a trust account with backstop capital in an amount, and for a duration, to be decided by the Superintendent if the Superintendent determines (based on, among other things, consideration of certain enumerated factors) that, absent such action, the acquisition is likely to be hazardous or prejudicial to the insurer's policyholders or shareholders. Although Amended Regulation 52 provides that this authority applies with respect to a life insurer only, the NYDFS interprets the authority to apply even where a non-life insurer is being acquired.

Historically, in connection with a Form A Statement, the NYDFS has also required an applicant to execute commitments (in a form prescribed by the NYDFS) agreeing (i) not to have the domestic insurer declare or pay any dividends (including ordinary dividends) for the first two years after the closing of the acquisition of control, (ii) to remove any officer or director of the domestic insurer whom the NYDFS finds to be untrustworthy upon conclusion of its background investigation of such person, and (iii) to notify the NYDFS if the applicant plans to make any significant deviations to the business plan and pro forma financial projections that were submitted with the Form A Statement. Although there is some overlap between the commitments and some of the new requirements imposed by Amended Regulation 52 as described above, we expect that the NYDFS will continue to require applicants to file executed commitments in connection with the Form A Statement.

8. Sharing Economy Issues

Since adopting its charges at the Fall 2014 National Meeting, the NAIC's Sharing Economy Working Group has been developing a white paper, *Transportation Network Company Insurance Principles for Legislators and Regulators*, to be proposed for adoption at the Spring 2015 National Meeting. At the same time, regulatory activity involving ridesharing continues unabated, as transportation network companies ("**TNCs**"), such as Uber and Lyft, continue to increase in popularity. Four states and the District of Columbia and more than 15 municipalities have adopted laws regulating TNCs, including insurance requirements. Most of such laws break down ridesharing activity into three distinct periods: the period beginning when a driver logs into an application and continuing until a ride request has been accepted ("**period one**"); the period beginning when a ride request has been accepted by a driver and continuing until the passenger is picked up ("**period two**"); and the period beginning when a passenger is picked up and continuing until the passenger arrives at his or her destination ("**period three**"). The primary insurance issue being debated is whether period one constitutes commercial activity such that a TNC driver's typical personal auto policy will exclude coverage. TNCs take the position that period one activity may include ordinary course driving to work and school, while personal lines insurers argue that period one activity increases their risk when compared to a driver's original rating. All interested parties agree that period two and period three must be covered by a separate insurance policy purchased by either the TNC or the TNC driver. Additionally, products for TNC drivers have been introduced by insurers in some markets that add coverage through an optional endorsement to a driver's existing personal auto policy. To date, the largest TNCs provide some coverage for period one contingent on coverage not being available under the TNC driver's personal insurance. Other insurance issues include the appropriate limits of insurance for TNC drivers and whether coverage from surplus lines insurers should be permitted. Following its work on ridesharing, the working group will next consider insurance issues raised by house sharing.

9. Post-Election Leadership Changes at State Insurance Departments

Due to a combination of the results of gubernatorial elections in November 2014, insurance commissioner retirements and voluntary commissioner resignations, a significant number of state insurance commissioner positions have (or will soon have) new occupants for 2015. Among the states with a change in insurance department leadership for 2015 are Arkansas, Connecticut, Idaho, Illinois, Kansas, Maryland, Massachusetts, Pennsylvania, South Dakota, Texas and Wyoming, along with the U.S. Virgin Islands. In particular, the change in Pennsylvania affected NAIC leadership because the former commissioner, Michael Consedine, was to have been the president-elect during 2015. On February 8, 2014, NAIC members elected Missouri Insurance Director John M. Huff to fill the vacant position of the office of President-Elect.

10. Mortgage Guaranty Insurance – Update Regarding NAIC Model

During 2014, the NAIC Mortgage Guaranty Insurance Working Group (the "**MGI Working Group**") continued its charge to modify the Mortgage Guaranty Insurance Model Act (#630) ("**Model #630**") to address issues facing the industry as a result of the recent mortgage crisis.

Wisconsin was tasked with preparing a first draft of Model #630, which was exposed for comment in March 2014. The industry group responded with the submission of a full redraft, in which the industry group identified a number of high-level comments, including proposing the deletion of contingency reserves, the proposed use of a risk-based capital formula for mortgage guaranty insurance companies and the ongoing work of the Oliver Wyman consultants on a new capital model. In light of the comments received to the conceptual draft, the MGI Working Group determined to move forward by taking a thorough, line-by-line review of both drafts of Model #630.

The MGI Working Group has made significant progress and extensive changes have been made over the past year to the draft of Model #630. Only a handful of major issues remain open prior to finalizing Model #630. One such issue is reinsurance and at the Fall 2014 NAIC National Meeting, Commissioner John Finston of California recommended that the reinsurance section more closely parallel the Credit for Reinsurance Model Act. In addition, Commissioner Finston expressed concern that Section 10 of the draft states cumulative reserves not be less than 100% of the required reserves "except that a reinsurer that is not a mortgage guaranty insurance company is not required to establish a contingency reserve" and suggested that the language be revised to ensure that the contingency reserve is maintained by either the reinsurer or the mortgage insurer itself. There was also discussion over whether review and approval for

certificates of mortgage guaranty insurance would be required by only the Domiciliary Commissioner (as defined in the draft of Model #630). Concern over the format of Model #630 has been expressed by MGI Working Group members, with some suggesting that the more detailed requirements be moved to into a procedures manual or other guidance document.

At the Fall 2014 NAIC National Meeting, as the timeline for completing the modifications to Model #630 was coming to a close, the Financial Condition (E) Committee granted the MGI Working Group's request for an extension to continue its work to update Model #630. The MGI Working Group hopes to have a revised draft for exposure by the Summer 2015 NAIC National Meeting.

11. Activity During 2014 Relating to FHLB Loans to Insurance Companies

During 2014, the Federal Home Loan Bank Legislation (E) Subgroup (the "**FHLB Subgroup**") of the Receivership and Insolvency (E) Task Force completed a new chapter for the *Receiver's Handbook for Insurance Company Insolvencies* to assist receivers in understanding and addressing issues involving insolvent insurance companies with outstanding federal home loan bank ("**FHLB**") loans and advances on their books. The chapter includes background information on FHLB loan programs, as well as checklists for receivers. In addition, the FHLB Subgroup prepared another chapter containing guidance for receivers regarding qualified financial contracts and their treatment under Section 711 of the Insurer Receivership Model Act. The Receivership and Insolvency (E) Task Force also adopted both sets of guidance, and the FHLB Subgroup, having completed its charges, was disbanded.

Following up on enhanced financial statement disclosure regarding FHLB loans and advances, which was first implemented during 2014, the NAIC analyzed the disclosures for the first two quarters of 2014 and provided them to the Statutory Accounting Principles (E) Working Group ("**SAPWG**"). NAIC staff noted several reporting issues for SAPWG's review, including:

- in some cases, the amount borrowed at the end of a reporting period is greater than the "maximum" borrowed for the period;
- the "maximum borrowing capacity" may be less than the amount currently borrowed; and
- the sum of the FHLB outstanding stock may not agree with the reported total.

In September, 2014, the Federal Housing Finance Agency ("**FHFA**"), which supervises the FHLBs, proposed a series of amendments to the regulations governing admission to membership in the FHLB system. One proposal would require members to hold, on an ongoing basis rather than only at the time of application, 1% (or more if the threshold were to be raised in ensuing years) of assets in home mortgage loans. Another key change would require, "where applicable," that members have at least 10% of assets in residential mortgage loans. Under the FHFA rules, "residential mortgage loans" are defined to include a number of home- or housing-related loans in addition to "home mortgage loans." Furthermore, the proposed amendments to the regulations would define "insurance company" in such a way that captive insurance companies would likely be excluded from FHLB membership, although existing captive members could maintain their membership for five years, with certain restrictions on access to advances. Comments were due in January 2015; insurers and insurance trade groups strenuously opposed certain of the proposals. If adopted, such proposals could restrict certain insurance companies' ability to obtain or maintain FHLB memberships.

12. NAIC Activity Re: International Insurance Activities

a. Amendments to Insurance Holding Company System Regulatory Act Regarding Group-Wide Supervisors for Internationally Active Insurance Groups

The NAIC adopted amendments to the Insurance Holding Company System Regulatory Act (the "**GWS Amendments**") that address the authority of an insurance commissioner to act as group-wide supervisor for an Internationally Active Insurance Group ("**IAIG**") or to acknowledge another regulatory official to so act. The GWS Amendments require the insurance commissioner to consider five enumerated factors, which are generally consistent with the lead state factors from the NAIC's Financial Analysis Handbook, in determining a single regulatory authority that is appropriate to act as group-wide supervisor for an IAIG. Under the GWS Amendments, the designated group-wide supervisor would have the authority to, among other things, take certain actions to assess enterprise risks within an IAIG and to coordinate and share information about members within the IAIG with other relevant state, federal and international regulatory officials. Although the definition of IAIG included in the GWS Amendments matched the international activity and size criteria included in a version of the IAIS Common Framework for the Supervision of IAIGs ("**ComFrame**"), the Group Solvency Issues (E) Working Group charged with drafting the GWS Amendments asserted that the GWS Amendments are not intended to adopt ComFrame. Therefore, in the event that the NAIC adopts (and states enact) the GWS Amendments and the NAIC later chooses to adopt portions of ComFrame, it is possible that insurers may find themselves navigating different standards under different sets of laws and related regulatory guidance.

b. NAIC Considers Development of Group Capital Standards for IAIGs

Through its ComFrame Development and Analysis (G) Working Group (the "**ComFrame Working Group**"), the NAIC is exploring group capital standards for U.S.-based IAIGs. Regulators intend for these group capital standards to act as an indicator of the financial strength of a consolidated insurance group and to enhance existing regulatory assessment of group risks and capital adequacy. The NAIC's suggested methodologies for the group capital standards, as set forth in the NAIC U.S. Group Capital Methodology Concepts Discussion Paper (the "**Capital Standards Discussion Paper**"), which was released on November 16, 2014, include (i) an RBC plus methodology, (ii) a cash flow methodology, and (iii) a hybrid of the RBC plus and cash flow methodologies.

The RBC plus standard would utilize the current RBC framework, starting with RBC-type risk factors for asset and liability segments, with adjustments to recognize risks not currently reflected in the RBC formulas. The cash flow approach would be "accounting independent," making it applicable in any jurisdiction and avoiding issues related to marking assets at either market or book value. Cash flows would be projected on an annual basis and all risks would be taken into consideration for both assets and liabilities. While the hybrid approach has not yet been formally proposed, a combination of both the cash flow and RBC plus methodologies could be developed. Such approach would likely consist of a factor-based approach (RBC plus) as the minimum group capital requirement, together with a cash flow approach that would supplement the minimum group capital requirement. In considering the advantages and disadvantages of the three methodologies, interested parties commented that it would be difficult for property and casualty companies to use the cash flow methodology. An interested party also suggested that there is an advantage to using an RBC-based methodology due to industry's and regulators' years of experience interpreting the results and understanding the impact of regulatory changes on RBC (noting the absence of such experience in connection with the cash flow methodology).

During a conference call held on December 30, 2014, the ComFrame Working Group summarized the comments it received on the Capital Standards Discussion Paper. Approximately 10 responses were submitted, with roughly half of the comments coming from trade groups and the other half from individual firms. In whole, the responses generally supported a hybrid approach that would leverage elements of each methodology appropriate for both life and non-life companies. The Chair, Commissioner Kevin McCarty of Florida, also noted that a hybrid approach would mirror what is being done at the IAIS.

The comments also noted concern by some in creating a U.S. capital standard that would vary greatly from the IAIS insurance capital standard and would put an additional burden on companies. One commentator also requested that each group be subject to only one group capital requirement and one group supervisor. Comments also considered whether this capital standard will act as a "minimum" standard or a "prudence" standard, noting that factor-based approaches are better suited for a "minimum" requirement and cash flow approaches are more reliable as target measures. Finally, the comments also recommended that, rather than the capital requirements specifying certain courses of action, any breach be addressed by the supervisory colleges.

C. INTERNATIONAL (NON-U.S.) INSURANCE ISSUES

1. Solvency II & IAIS International Capital Standard Update

a. Introduction

Regulatory pressure on insurers' capital requirements in Europe have two key sources: (i) the imminent introduction of the Solvency II regime; and (ii) the development of a global insurance capital standard ("**ICS**") by the IAIS, each of which are discussed below.

b. Solvency II

2015 is a transitional year for insurers operating in the EU, as they work to move Solvency II compliance into the 'business as usual' environment ahead of the January 1, 2016 implementation date.

The Prudential Regulation Authority ("**PRA**") has published, and continues to publish, guidance to help the UK insurance industry prepare for Solvency II. In addition, the PRA has been sending letters to directors of life and general insurance firms (the latest update having been issued on February 12, 2015), which set out information relating to the UK's implementation of Solvency II, the immediate priorities for firms and key dates to note. The PRA's latest update indicates a high level of industry confidence with firms' Solvency II preparations. Also in the UK, Lloyd's published a report in December 2014 on its ongoing approach to Solvency II, which sets out expected timescales for completion of the key transitional activities to be undertaken (*see* Section V.C.2 below for more information).

i. Delegated Acts and Technical Standards

The detail of the Solvency II project will be set out in "delegated acts" and binding technical standards, which will be issued by the European Commission. A delegated act, which details requirements for individual insurance undertakings, as well as for groups based on the overarching provisions of Solvency II, and which will make up the core of the single prudential rulebook for insurance and reinsurance undertakings in the EU, was published by the European Commission on October 10, 2014 and came into force on January 18, 2015.

ii. Equivalence Update

As noted in the *Sidley Global Insurance Review (March 2014)*, three jurisdictions (Bermuda, Switzerland and Japan—in Japan's case for reinsurance only) have actively engaged in a formal "full equivalence" assessment process. The European Insurance and Occupational Pensions Authority ("**EIOPA**"), which is an independent advisory body to the European Parliament, the European Council and the European Commission, is specifically tasked with assisting the European Commission in preparing equivalence decisions.

EIOPA initially provided the European Commission with three draft reports in October 2011 regarding the Solvency II equivalence of the supervisory regimes of Bermuda, Switzerland and Japan. In February 2014, EIOPA was requested by the European Commission to update this advice. On March 11, 2015, EIOPA subsequently published its final reports on each of these three countries. As expected, the reports provide that these jurisdictions meet the criteria set out in EIOPA's methodology for equivalence assessments under Solvency II, subject to certain caveats. The final reports are expected to allow the European Commission to take fully-informed decisions this year on whether the solvency and prudential regimes in Bermuda, Switzerland and Japan are equivalent to Solvency II.

c. IAIS Global Insurance Capital Standard Project

We reported in the *Sidley Global Insurance Review (March 2014)* that, in a seemingly separate move, the IAIS, of which the PRA is a member, is introducing new capital requirements for (re)insurers and a group-wide global capital standard.

i. Status of the Project

The development of the basic capital requirements ("**BCR**"), which will apply to globally systemically important insurers ("**G-SIIs**") from 2016, is the first step of the IAIS project. On October 23, 2014, the IAIS published a document setting out the BCR. The BCR is currently being privately reported by G-SIIs to group-wide supervisors.

The BCR will form the basis of the next two steps of the project being: (i) the development of the "higher loss absorbency" ("**HLA**") requirements to apply to GSIIs (due to be completed by the end of 2015); followed by (ii) the development of a risk-based group-wide global ICS, to apply to Internationally Active Insurance Groups (due to be completed by the end of 2016).

From 2019, G-SIIs must hold capital at least equivalent to the BCR plus the HLA. The HLA will initially be based on the BCR and, following refinement and final calibration in 2017 or 2018, the ICS. While the scheduled ICS adoption date is October 2018, the transition from BCR to ICS as the foundation for HLA will ultimately depend upon the time required for jurisdictions to develop and implement the necessary frameworks for implementation of the ICS.

ii. (Re)insurer Designations as G-SIIs

In addition to the SIFI designation discussed above in Section V.A.1, insurers are also subject to a G-SII designation. The IAIS published a methodology for identifying G-SIIs and policy measures that will apply to G-SIIs, consistent with the policy framework published by the Financial Stability Board ("**FSB**") in 2011. Using this methodology, in July 2013, the FSB designated nine companies G-SIIs: European insurers Allianz, Axa, Aviva, Generali and Prudential PLC, U.S.-based American International Group, Inc., MetLife and Prudential Financial, Inc. and China-based Ping An Insurance. This initial list of G-SIIs was reconfirmed by the FSB in November 2014. The FSB will review its designations annually. As noted above in Section V.A.1, MetLife has filed an action in U.S. federal court to have its status overturned.

An initial list of reinsurers classified as G-SIIs was originally anticipated in July 2014, but the FSB confirmed in its November 2014 update that it has postponed a decision on the G-SII status of reinsurers pending further development of the methodology.

iii. Role of the Insurance Industry in the Project

It remains unclear how the BCR/ICS regime will sit with Solvency II requirements. It is therefore crucial that insurers actively engage with IAIS's completion of the next two steps of the project in order to minimize the risk of negating the work already completed, modeled and tested for Solvency II.

2. Lloyd's Developments and Solvency II Preparations

a. Overview – A Transitional Year

On December 23, 2014 Lloyd's published guidance notes ("**2015 Guidance Notes**") on its approach this year to bringing the Solvency II requirements into the 'business as usual' environment by January 1, 2016. The 2015 Guidance Notes set out expected timescales for completion of the key transitional activities to be undertaken.

Key transitional activities include: (i) rating reviews and decisions; (ii) introducing Lloyd's Market Oversight Framework, with updated Minimum Standards; (iii) Pillar 3 preparations; and (iv) a new process for approving model changes, each of which are discussed below.

b. Ratings for Solvency II Preparations

In November 2014, as part of a coming-into-line process, Lloyd's rated all managing agents as either "red" or "green" in order to reflect whether they were on track in their preparedness for the Solvency II regime; two-thirds of which were rated red. A further re-rating exercise was conducted in January 2015, following which managing agents of red-rated syndicates had a month within which to undertake any final remediation before final ratings are set in March 2015.

New syndicates and/or new agents have 24 months to build a fully-compliant Solvency II internal model, during which time they will be "amber"-rated. A green or red rating will be allocated at the end of the 24-month period.

c. Lloyd's Market Oversight Framework and Updated Minimum Standards

In Q1 2015, Lloyd's will publish the final details of its Market Oversight Framework, the purpose of which is to enable Lloyd's to form an aggregate view of each managing agent operating at Lloyd's.

Lloyd's Minimum Standards—consisting of statements of business conduct with which managing agents are expected to comply to operate at Lloyd's—form a key element of this Framework and, as of January 1, 2015, updated Minimum Standards apply. Since 2014, managing agents have been reviewing their compliance with the Minimum Standards and the exercise is scheduled for completion in 2016. A managing agent's ability to remedy any shortfall within agreed timescales may influence its Solvency II preparation rating. Lloyd's will expect managing agents to reconfirm their compliance with the Minimum Standards in order to satisfy the regulatory requirement for continued explicit compliance with Solvency II.

d. Pillar 3 Preparations

Pillar 3 preparation, which relates to Solvency II disclosure and reporting requirements, is another key focus of Lloyd's for 2015. As a PRA-authorized firm, Lloyd's must submit to the PRA aggregated Pillar 3 data, which reflects both syndicate-level data received from managing agents and information held centrally in respect of the Corporation, Central Fund and members' funds at Lloyd's.

The managing agent's role in Pillar 3 preparation will involve submitting to Lloyd's:

- two Solvency II balance sheets, one showing the position of a syndicate as at December 31, 2014 (due March 5, 2015) and the other as at June 30, 2015 (due September 3, 2015); and
- interim Pillar 3 quantitative and qualitative reporting as at December 31, 2014 (due April 16, 2015) and September 30, 2015 (due November 5, 2015).

Further detail of Lloyd's approach to Pillar 3 preparation is set out in its 2015 Guidance Notes. Lloyd's also published, in December 2014, instructions on the interim Pillar 3 reporting requirements, including its expectations from syndicates in respect of the qualitative reporting.

Pillar 3 workshops in June and October this year are intended to assist managing agents' entry into full Solvency II Pillar 3 reporting, and Lloyd's has recommended that managing agents conduct a dry run of their Pillar 3-compliance. In any event, managing agents must submit to Lloyd's a Pillar 3 'status' template by June 30, 2015, and Lloyd's has stated in its 2015 Guidelines that a thematic review of managing agents' progress with Pillar 3 preparations will likely take place in Q3 2015.

e. Modeling Platform Changes

As managing agents work to transition their existing modeling platforms to Solvency II-compliant platforms, managing agents should note the new model change approval process introduced by Lloyd's. As of January 1, 2015, all major model changes (including where the combination of minor changes result in a major change) must be pre-approved by Lloyd's Standards Assurance Group in accordance with Lloyd's Model Change policy. Managing agents are expected to discuss planned model changes and their impact on Solvency Capital Requirements with their Risk Assurance Account Manager and the relevant Market Oversight team before making a formal submission.

3. Enactment of the Insurance Act 2015

The Insurance Act 2015, enacted on February 12, 2015, will overhaul certain fundamental areas of UK insurance law and will apply to both insurance and reinsurance contracts. The reforms will come into force in August 2016, giving the industry a period of 18 months to prepare. The Insurance Act 2015 seeks to address certain longstanding aspects of the current law considered to be unjust or not reflective of market practice, although commercial parties will be free to contract out of most of the provisions. Overall, the reforms have received support within the industry since they are seen as reflecting good practice and should help to maintain the UK insurance market's international competitiveness.

The key reforms, which relate to the law of warranties and the insured's duty of disclosure, are summarized below:

- Warranties: abolition of basis of the contract clauses

  Basis of the contract clauses turn all factual statements by the insured into warranties as to the truth of those statements, breach of which will discharge the insurer from all future liability under the policy under the current law. Accordingly, basis of the contract clauses can allow insurers to avoid liability as a result of very minor inaccuracies or mistakes in the information provided to them.

  In the consumer insurance context such clauses have already been abolished by the Consumer Insurance (Disclosure and Representations) Act 2012. The clauses are still common in non-consumer insurance policies, although they are often not enforced by insurers, and have been upheld as valid in recent cases. The Act now provides that basis of the contract clauses will be rendered void in non-consumer insurance contracts.

- Warranties: the insurer's remedy for breach is that its liability is suspended, not discharged

  Under the existing law, where an insured is required to comply with a particular warranty during the period of the insurance, for example a warranty that it will maintain a fire alarm in operation, breach of that warranty can discharge the insurer from all future liability, even in respect of losses occurring after the insured has rectified the breach, for example by reinstalling the fire alarm. The insurer is discharged automatically as from the date of the breach (this was confirmed in the 1991 case *Bank of Nova Scotia v Hellenic Mutual War Risks Association (The Good Luck)*).

  The Insurance Act 2015 addresses this by providing that a breach of a warranty will only affect the insurer's liability for events occurring after the breach and before the breach has been rectified. In other words, the insurer's liability will be suspended during the period when the breach is occurring, but if that breach is rectified so that the insured is in compliance, the insured would be entitled to claim for subsequent events.

- Warranties: remedy for breach of warranty now contingent on relevance

  Under the existing law, insurers are, as a general rule, discharged from all liability under a contract of insurance following a breach of a warranty by the insured, irrespective of the subject matter of the warranty. This is codified in Section 33(3) of the Marine Insurance Act 1906, which states that a warranty "must be exactly complied with, whether it be material to the risk or not." The principle technically applies to both consumer and non-consumer contracts, although consumers are afforded a degree of protection under the Financial Conduct Authority's claims handling rules, which prohibit insurers from rejecting a claim where the breach is unconnected to the circumstances of the claim, other than in the case of fraud.

  The Insurance Act 2015 now provides that the insurer will be unable to rely on a breach of warranty by the insured if the breach is irrelevant to the risk of loss. An insured will be able to make a claim, despite having breached a warranty, where it can show that its breach would not have increased the risk of the loss occurring. For example, where an insured suffers loss through burglary, but has breached a warranty that it would maintain a fire alarm in working order, the insured should be able to show that had the alarm been operational, it would have made no difference to the risk of burglary and, accordingly, the insured should be able to make a claim under the policy.

- Duty of disclosure: proportionate remedies

- In the non-consumer context, the law currently provides insurers with the "all or nothing" remedy of avoiding the contract ab initio for breach by the insured of its duty of disclosure. This will now be superseded by a regime that is intended to be more proportionate.

- The Insurance Act 2015 introduces a new "duty of fair presentation" on commercial insureds. Before entering into an insurance contract, insureds will be required either (i) to disclose all material circumstances which the insured knows or ought to know, or (ii) to disclose sufficient information to put a prudent insurer on notice that it needs to make further enquiries.

- The existing statutory duty of disclosure under Section 18 of the Marine Insurance Act 1906 requires the insured to disclose every material circumstance. The application of the lower threshold (sufficient information to put the insurer on notice) reflects developments in case law but will now be clarified in statute. This is intended to help ease confusion among insured businesses which often have difficulties judging how to comply with the current disclosure requirement given that the onus is on the insured to know which circumstances are material to the insurer and to volunteer all such information.

- If the insured deliberately or recklessly breaches the duty of fair presentation, the insurer will still be entitled to avoid the policy and refuse all claims and will not be required to return any premium. However, if the breach is not deliberate or reckless:

    i. where the insurer would not have entered into the contract on any terms, the insurer will still be entitled to avoid the policy and refuse all claims, returning the premium;

    i. if the insurer would have entered into the contract but would have charged a higher premium, the insurer will not be entitled to avoid the policy but will have a right to reduce any claim payment proportionately; and

    i. where the insurer would have entered into the contract on different terms, other than premium terms, the insurer will again not be entitled to avoid the policy but will have a right to treat the contract as though entered into on those different terms.

  In the consumer context, a similar regime already applies under the Consumer Insurance (Disclosure and Representations) Act 2012.

The reforms will take effect as a default regime for non-consumer insurance contracts. Parties to non-consumer insurance contracts will be able to contract out of most of the provisions of the Insurance Act 2015, provided that the insurer takes sufficient steps to draw the relevant contracting-out term to the attention of the insured before the contract is entered into if it disadvantages the insured party. The term must also be clear and unambiguous as to its effect. As an exception, insurers will not be permitted to contract out of the provision abolishing basis of the contract clauses and any term purporting to do so will be void. Parties to consumer insurance contracts will not be able to contract out of any applicable provisions of the Insurance Act 2015 to the detriment of the consumer.

4. UK Senior Insurance Managers Regime

On November 26, 2014, the PRA issued a consultation paper on a new Senior Insurance Managers Regime ("**SIMR**") for individuals (CP26/14). The paper sets out proposed changes to the PRA's Approved Persons Regime to implement certain measures under Solvency II that relate to governance and the fitness and propriety of relevant individuals, and to include some aspects of the Senior Managers Regime proposed for banks. Although the scope of the SIMR will be broadly aligned with the regime for banks, it will be tailored to the insurance industry, recognizing that an insurer's business model and the risk its poses to the PRA's objectives are different to those of banks.

The Financial Conduct Authority (the "**FCA**") has published a separate consultation paper with proposals to amend its own approved persons regime to incorporate the Solvency II framework.

a. Scope of the SIMR

The new regime will apply to (re)insurers and UK branches of third-country undertakings within the scope of Solvency II, as well as to the Society of Lloyd's and managing agents.

The aim of the proposed SIMR is to ensure that senior individuals who are effectively running insurers, or who have responsibility for other key functions at those firms, behave with integrity, honesty and skill. These key individuals are responsible and accountable for the sound and prudent management of their firms. In order to achieve this, the SIMR will cover:

- senior insurance managers, who are subject to pre-approval by the PRA for a controlled function; and

- "key function holders," who are all other senior persons effectively running an insurer or who have responsibility for other key functions at the insurer and who will also need to be assessed as fit and proper by the PRA.

The PRA has narrowed the list of individuals who will be subject to regulatory pre-approval for a controlled function (to be known as a Senior Insurance Management Function ("**SIMF**")) to those who perform a critical role within an organization. It also identifies the individuals who will be held responsible for ensuring the ongoing safety and soundness of their firms. The list of proposed SIMFs include: the Chief Executive Officer, Chief Finance Officer, Chief Risk Officer, Head of Internal Audit, Chief Actuary, Chief Underwriting Officer, Group Entity Senior Insurance Manager and Third Country Branch Manager.

Given the granular and role-specific focus of the PRA's controlled functions, the FCA is proposing to incorporate certain other controlled functions, which the PRA will not maintain, into the scope of its own approved persons regime, as FCA Significant Influence Functions and those individuals will therefore be subject to the FCA's pre-approval.

b. Allocation of Responsibilities

One of the PRA's proposals to reinforce the concept of good governance will be for firms to allocate certain prescribed core responsibilities to one or more individuals who have been approved for a controlled function. Such core responsibilities include:

- ensuring that the firm has complied with the obligation to satisfy itself that persons performing a key function are fit and proper;
- production and integrity of the firm's financial information and regulatory reporting; and
- allocation and maintenance of the firm's capital and liquidity.

This approach is designed to ensure that responsibility for certain significant activities relating to effective governance and the ongoing safety and soundness of a firm are allocated to a designated senior person.

c. Governance Map

A new rule has been proposed requiring firms to compile and maintain a document, known as a "Governance Map" recording the names and positions of those who effectively run the firm as well as those with responsibility for a key function. This document is also intended to record the allocation of significant management responsibilities and reporting lines for each of these senior individuals within the firm and group.

d. Conduct Standards

The conduct standards set out in the PRA's Handbook under the Statements of Principle and Code of Practice for Approved Persons ("**APER**") are set to be revised with the intention to align the standards for individuals at both insurers and banks. The proposals include three generic standards relevant to those performing a key function and a further five conduct standards that are relevant to senior insurance managers and "key function holders."

e. Fit and Proper Assessment

Individuals within the SIMR will be assessed to determine their fitness and propriety to carry out their function. Those performing a PRA-controlled function will be subject to PRA pre-approval. "Key function holders" and those individuals performing a key function will need to be assessed by their firms, on an ongoing basis, with respect to their fit and proper status. In addition, under current proposals "key function holders" not exercising a PRA- or FCA-controlled function, will be assessed by the PRA in terms of their fitness and propriety after the firm has made the determination with a further requirement for firms to notify the PRA of information relevant to a fit and proper assessment of a key function holder and senior insurance manager.

f. Non-Executive Directors

Neither the PRA nor the FCA's consultation papers addressed the treatment of non-executive directors ("**NED**"), other than to the extent necessary to implement Solvency II, instead promising a further consultation paper on the issue. On February 23, 2015, the PRA confirmed that it will now apply the SIMR to the following NEDs: Chairman, Senior Independent Director, and Chairs of the Risk Committee, Audit Committee and Remuneration Committee. The focus is therefore on NEDs with specific roles in areas or committees directly relevant to a firm's safety and soundness. Those NEDs within the scope of SIMR will be held individually accountable for their areas of responsibility.

g. Next Steps

The consultation period on the SIMR closed on February 2, 2015. A second technical paper will be published early in 2015, which will cover consequential changes and transitional arrangements from the existing approved persons regime to the proposed new regime for insurers. The intention is for an initial tranche of rules to be made by March 31, 2015 and commenced from January 1, 2016 to ensure an "operationally effective regime."

The initial tranche will include: notification requirements of those taking up the position of senior insurance manager or "key function holder;" the compilation of a Governance Map; and the criteria for the fit and proper assessment.

Implementation of the remaining rules will be outlined in the PRA's timetable later this year.

5. EU/UK Regulatory Section - Insurance Distribution Directive

The Insurance Distribution Directive ("**IDD**")—set to replace the Insurance Mediation Directive 2002/92/EC ("**IMD**") and introduce refreshed minimum regulatory standards for insurance sales in the EU—is currently in trilogue negotiations between the European Parliament, Council of the EU and European Commission. The IDD should be finalized during the first half of 2015.

The IMD has been part of the EU regulatory landscape since January 14, 2005. An overhaul of the IMD provisions was prompted by: inconsistency in the way the IMD regime had been implemented by member states; development of a more complex insurance market and product offerings since the IMD was enacted; and a greater focus on consumer protection across all financial sectors since the 2008 financial crisis.

a. Key Changes under the IDD

The IDD, like the IMD, will be a minimum harmonization directive. This means that the IDD will set a threshold that national legislation must meet but, beyond which, member states are free to maintain or introduce stricter provisions relating to insurance selling.

i. Direct Sellers to be in Scope

The IDD will apply not only to intermediaries but also to insurance undertakings that sell directly to their customers, including sales through aggregator websites, and certain ancillary sales ("**distributors**"). This extension of scope reflects the view that consumer protection should be the same regardless of the channel through which customers buy an insurance product.

Merely introducing customers to distributors and claims management, loss adjusting and expert claims appraising are out of scope.

ii. "Customer's Best Interests" Principle; Conflict Management and Product Governance Rules

The IDD will introduce a new principle that all distributors must act "honestly, fairly and professionally in accordance with the best interests of its customers," and distributors are not to remunerate, incentivize or assess the performance of their employees in a way that conflicts with this duty.

The IDD further requires insurance undertakings and any intermediaries that design insurance products—other than those relating to large risks—to maintain, operate and periodically review a product approval process. Where a distributor advises on or proposes an insurance product that it did not manufacture, such distributor must have in place adequate arrangements to obtain the information it needs in order to understand the product characteristics and its identified target market.

The existing UK regulatory framework on management of conflicts of interest (including the FCA's "Treating Customers Fairly" Principle) already embraces the high-level provisions proposed under the IDD. However, distributors in the UK should note:

- the FCA's renewed focus in this area (*see*, for example, its report on conflicts of interest and intermediary remuneration published in May 2014); and
- the IDD proposes empowering the European Commission to: (i) prescribe steps for identifying, preventing, managing and disclosing conflicts of interest, and (ii) establish criteria for determining the types of conflict which might adversely impact customers.

iii. Enhanced Professional Requirements and Internal Policies

The IDD will require distributors to undertake continuing professional development. Competency and continuing professional development requirements must match the complexity of the activities connected with the insurance product being sold and the type of distributor (e.g., commercial broker, tied agent, etc.).

Further, insurance undertakings must implement, document and regularly review internal policies and procedures for ensuring that the "good repute" (carried over from the IMD) and enhanced competency and continuing development requirements under the IDD are met by the relevant employees involved in insurance distribution.

iv. New Remuneration Disclosures

Prior to conclusion of a contract, insurance intermediaries must disclose to customers the nature of any remuneration received in relation to the contract and whether the contract works on the basis of a fee, commission or other type of arrangement (including any financial or non-financial advantage, offered or given in respect of insurance distribution activities). Where the fee is payable directly by the customer, the insurance intermediary must provide the amount of the fee or, where this is not possible, the method for calculating it.

The new remuneration provisions will not apply to mediation of large risks, mediation by reinsurance intermediaries or reinsurance undertakings, or in relation to "professional customers." The list of "professional customers" includes a catch-all provision that the customer possesses the experience, knowledge and expertise to make his own decisions and properly assess the risks that he incurs.

In the UK, the IDD's remuneration provisions will principally impact brokers' dealings with retail customers in the context of non-investment insurance contracts, where currently no such remuneration disclosure requirements under the *Insurance: Conduct of Business Sourcebook (UK)* apply.

v. Enhanced Sales Standards for Insurance-Based Investment Products

Similar to the sales standards applicable to non-insurance investment products under the *Markets in Financial Instruments Directive 2004/39/EC*, these will include:

- Increased disclosure requirements relating to the nature and risks associated with the insurance-based investment product and all costs and associated charges, with such information to be given to customers in a comprehensible form such that they can reasonably be expected to understand the product offered and make an informed decision.
- For non-advised sales, a requirement to assess the appropriateness of an insurance-based investment product for each customer or, where the customer does not provide the information needed for such assessment, warn the customer that a determination on appropriateness cannot be made.
- For advised sales, suitability assessment and suitability statement requirements, and a requirement to inform customers whether a periodic suitability assessment in respect of a recommended product will be conducted.
- Provision of periodic reports to customers, taking into account the type and complexity of the insurance-based investment product.

vi. New Cross-Selling Rules

In the context of the IDD, a "cross-selling practice" will be where an insurance service or product is offered together with another service or product as part of a package or as a condition of taking another agreement or package. The IDD will require distributors to inform the customer whether it is possible to buy products within a package separately, and, if so, provide an adequate description of the different components of the package, as well as information on the costs and charges of each component. It must also be clear to customers how insurance coverage varies depending on whether the product is sold in or out of the package. Furthermore, EIOPA may issue guidelines on cross-selling practices and examples of practices that may fall short of the "customers' best interests" principle.

Cross-selling practices have been a regulatory focus in the UK since 2011. Following an investigation into add-on insurance sales last year, the FCA confirmed that UK rule changes were necessary to achieve the right outcomes for add-on customers and promote effective competition. Finalized rules for guaranteed asset protection insurance will be published by the FCA in June 2015 and come into effect on September 1, 2015. New rules covering the use of the add-on mechanism in other UK insurance sales will then follow.

6. EU/UK Competition Law Enforcement Activity

2014 was a period of relative calm in terms of EU-level insurance-related competition enforcement activity. However, competition authorities in the EU's Member States, particularly in the UK, have more than made up for the relative lack of enforcement at the EU-level.

a. EU-Level Enforcement by the European Commission

In the fall of 2014, the European Commission launched a consultation on the functioning and future of the EU's Insurance Block Exemption Regulation ("**BER**"), which will expire on March 31, 2017. The BER allows certain agreements among insurers (and among reinsurers) to benefit from an exemption from the prohibition of anti-competitive agreements under EU competition rules. The purpose of the consultation was to assess whether such a sector-specific block exemption for the insurance sector continues to be justified, and, if it is to be renewed, in what form it ought to be renewed. It is too early to know for certain how the European Commission's review process will pan out, but there is a reasonable chance that the BER will not be renewed, a move that would force insurers and reinsurers to "self-assess" the compatibility with EU competition rules of arrangements that might previously have benefited from the safe harbor created by the BER. Although the initial consultation period ended in November 2014, there will be industry roundtable discussions and a further consultation on policy options in the course of 2015 before the European Commission submits its report and recommendations to the European Parliament and Council by March 2016.

b. National Level Enforcement in the UK

Although the European Commission did not initiate any EU-level insurance-related cases in the course of 2014, there has continued to be significant enforcement activity at a national level, especially in the UK. The UK's main competition authority, the Competition and Markets Authority ("**CMA**"), has continued its insurance-related investigations while its fellow regulator, the FCA, has also stepped up its own competition law investigations into the insurance sector. With the FCA set to assume full, *"concurrent"* powers to enforce EU and UK competition rules on April 1, 2015, there is likely to be a further uptick in insurance-related enforcement activity in the coming year.

i. Implementing Measures in Car Insurance Market Investigation

On September 24, 2014, the CMA published the final report in its investigation into the private motor insurance industry. The CMA's report includes a number of measures with which insurers, brokers and price comparison websites will need to comply. Most notably, the CMA's report prohibits certain agreements between price comparison websites and insurers that contain "most-favored nation" clauses preventing insurers from offering lower prices for the same cover on other platforms. The CMA also recommended that there be improvements in the provision of information to insureds (particularly in relation to no-claims bonuses) and that the FCA review how insurers provided such information.

The CMA also concluded that the conduct of the insurers of not-at-fault drivers served to increase costs for the insurers of at-fault drivers in such a way that premiums as a whole were inflated. Somewhat unusually, the CMA accepted that it could not conceive of an effective and proportionate remedy to address the perceived problem, but it did express support for the efforts of some insurers to make the market work better (e.g., by reconsidering the benchmarks used).

ii. FCA General Insurance "Add-On" Market Study

In July 2014, the FCA published the final report in its market study regarding general insurance "add-ons" (e.g., travel insurance, gadget/device insurance, personal accident insurance, guaranteed asset protection insurance (usually offered around car sales), and home emergency insurance). The FCA's market study compared the sales of add-on insurance products with sales of similar products sold on a stand-alone basis in order to assess how such products were being sold and whether competition was working effectively. The FCA concluded that selling add-ons with a primary product had clear impacts on consumer behavior: it affected consumers' decision-making, weakened their engagement and strengthened the sellers' structural point-of-sale advantages.

The FCA proposed four remedies in its market study. The first proposed remedy was to impose a deferred opt-in for add-ons for guaranteed asset protection insurance. On December 12, 2014, the FCA published a consultation on proposed changes around the rules governing the sale of guaranteed asset protection insurance. The FCA intends for its new rules to come into force in September 2015. Consultations on the three remaining remedies (banning deferred opt-outs (e.g. pre-ticked boxes) for add-ons, exploring potential improvements to how price comparison websites provide add-on options and pricing, and requiring firms to publish claims ratios) are expected in the first half of 2015.

iii. FCA Review of Annuities and Retirement Income Market Study

Following publication of its thematic review into annuities in early 2014, the FCA has continued to focus on competition in the annuities sector, launching a further thematic review, this time into sales practices, and initiating a market study into retirement incomes more broadly. The thematic review is considering whether annuity sales practices contribute to customers not shopping around or switching providers, while the retirement income market study is focusing on how market conditions might evolve after changes made by the 2014 Budget take effect in April 2015.

On December 11, 2014, the FCA published the provisional findings in its market study. Consistent with previous findings, the interim market report concluded that competition in the retirement income market

is not working well; many consumers were not shopping around for their annuity at all, while other consumers were not purchasing the best annuity for their circumstances. The FCA has proposed five possible remedies, including requiring firms to provide a quote comparison to their customers setting out how their offer on annuities compares with their competitors' quotes available on the open market.

iv. Concurrent Competition Law Powers for the FCA

From April 1, 2015, the FCA will have full concurrent competition powers. These new powers will give the FCA the ability to take the full range of enforcement actions in relation to breaches of EU or UK competition rules. The FCA will also be able to refer markets to the CMA for in-depth investigation and will become a full member of the UK's Competition Network. In addition to bolstering its position among the UK's competition enforcers, having full concurrent competition powers will put the FCA in a better position to engage effectively with the European Commission and with other enforcers in EU Member States.

On January 15, 2015, the FCA launched a consultation setting out draft guidance on how it intends to use its concurrent competition powers. The consultation also includes a draft legislative instrument relating to changes to the FCA's regulatory handbook. Most notably, the FCA is seeking comments on changes to the supervisory rules that will explicitly require regulated firms proactively to disclose competition law infringements to the FCA.

7. China Regulatory

a. China Risk Oriented Solvency System: On Course for Implementation in 2015

The China Risk Oriented Solvency System ("**C-ROSS**") has been in development since the CIRC announced its launch in 2012. Modeled on other second-generation solvency regimes, C-ROSS has been designed to reflect individual insurers' risk profiles more accurately than under the current regime, which is based on premium volume, and to incentivize prudent risk management. C-ROSS includes three pillars: (i) quantitative requirements based on insurance, market, credit and macro elements; (ii) risk management and assessment; and (iii) disclosure and reporting requirements.

CIRC Vice Chairman Chen Wenhui recently stated that the new framework will result in a net decrease in required capital, freeing up some CNY550 billion in excess reserves (US$88 billion), of which CNY500 billion is in the life sector and CNY50 billion is in the property and casualty sector. According to Mr. Chen, around two-thirds of insurers will see reduced capital solvency ratios with one-third facing higher solvency ratios.

Following consultation and impact assessments during 2013 and 2014, the CIRC has now released detailed technical standards supplementing the framework outlined above. For a transitional period, which started in February 2015, insurers will be expected to report to the CIRC under both the new technical standards and the existing reporting regime. The CIRC will determine when to fully implement the new regime based on the results. While there is still scope for the CIRC to make further revisions, the CIRC expects to have completed the construction of the new regime by the end of 2015.

One aspect that has attracted international comment is the capital charges applied to unsecured reinsurance under the counterparty default module. The capital charges are greater for reinsurance taken out with overseas reinsurers than they are for reinsurance taken out with domestic reinsurers, which has prompted objections from several international trade associations representing reinsurers. Lloyd's has also warned syndicates which operate in the Chinese reinsurance market that they may be required to provide collateral once the regime comes into force.

C-ROSS constitutes an extensive risk-based solvency regime, built on a three-pillar approach that bears some resemblance to the three-pillar approach of Solvency II. Recently, Karel Van Hulle, the former head of Insurance and Pensions at the European Commission, commented that China would likely be a candidate for provisional equivalence under Solvency II. If granted by the EU, provisional equivalence would mean that the Chinese regime would be deemed equivalent for the purpose of group and subsidiary solvency capital calculations. Provisional equivalence would be granted for a period of 10 years, with the possibility of renewal.

Nevertheless, the CIRC has been keen to limit the regulatory burden imposed on what is a relatively young industry in China. The quantitative rules are somewhat less complex than those of Solvency II, and for the time being the CIRC has not opted to allow insurers to develop their own approved quantitative models, making for a more streamlined process of implementation as the regulator will not need to review and approve individual models.

b. Regulatory Developments in the Chinese Market

i. Relaxation of Financial and Competition Restrictions on Acquisitions

Over recent months the CIRC has continued its gradual liberalization of the Chinese insurance market. Direction was provided by the Chinese government in August 2014 in a State Council paper, *Guiding Opinions Regarding Accelerating the Development of Modern Insurance Services*, which sets out the government's vision for the insurance industry in the coming years. The paper includes encouragement for Chinese insurers to seek markets overseas and envisages market-based reform of premium rates. Below is a summary of significant regulatory developments.

Reforms taking effect in June 2014 relaxed the rules on financing M&A transactions. The new rules are contained in the Administrative Measures for the Merger and Acquisition of Insurance Companies and apply to overseas as well as domestic investors. Previously, acquisitions of holdings in insurance companies could not be effected through debt finance. Now an investor that acquires at least one third of the equity and becomes the largest shareholder may finance up to 50% of the acquisition price through loans and other financing methods. The acquirer must have been investing in the company for at least three years, although this requirement may be waived with the approval of the CIRC.

In addition, in a relaxation of the general prohibition on ownership of interests in more than one PRC insurer engaging in similar lines of insurance business, insurers have now been allowed to acquire competing insurance companies, provided approval is granted by the CIRC.

ii. Price Liberalization of the Life and Motor Markets

The CIRC has announced that it aims to end pricing controls on life insurance by the end of the year, starting with universal life insurance policies, which has been approved by the State Council. The CIRC has also announced that it will now scrap the upper limit of 2.5% on minimum guaranteed interest rates for universal life policies, with rates over 3.5% requiring CIRC approval. The cap on guaranteed interest rates offered under standard life policies was removed in 2013.

The CIRC recently also announced that it would also be piloting price liberalization of the motor insurance market in selected provinces, subject to sanction by the State Council.

iii. Developments in the Shanghai Free Trade Zone

In May 2014, the CIRC delegated powers to the Shanghai marine insurance association for the purpose of streamlining regulation for (re)insurers operating in the Shanghai Free Trade Zone ("**SFTZ**"), launched in September 2013. As a result, marine (re)insurers wishing to establish branches in the SFTZ have been able to do so without the need for prior approval. The industry awaits the possibility of further advantageous policies for insurers in the zone. There are now eight marine (re)insurance companies operating in the zone, with three more reported to be in the process of setting up there.

Until recently, insurers had only established themselves in the SFTZ through opening branches, but in September 2014 a group of 10 investors set up Shanghai Life Insurance Company, the first (re)insurer to be incorporated there.

In December 2014, Arthur J. Gallagher and Jiang Tai Insurance Brokers revealed plans to establish the first broking joint venture company in the SFTZ. Jiang Tai Re is expected to commence activities in the first half of 2015, following regulatory approval, and will focus on reinsurance and specialty.

iv. Insurers Now Permitted to Invest in Preference Shares

In recent years, the CIRC has broadened the range of asset classes in which Chinese-regulated insurers are permitted to invest and has allowed greater access to overseas investment markets. In a further expansion, the CIRC announced in October 2014 that insurers would now be permitted to invest in preference shares, subject to certain conditions. The issuer must be rated at least "A" by an approved rating agency, and the insurer must have appropriate investment decision-making and control processes in place. This reform came at the same time as the Bank of China issued US$6.5 billion of preference share stock, a first for a listed Chinese issuer, with others expected to follow.

VI. Cyber Risk

A. INTRODUCTION

Cyber risk seems now to be firmly established as one of the top five global risks. 2014 saw an unprecedented number of high-profile cyber attacks. Already in January this year, health insurance company Anthem Blue Cross Blue Shield ("**Anthem**") has reported suffering a massive data breach. Anthem is the second-largest health insurance company in the United States, and it is estimated that as many as 80 million customers and employees were affected by the breach. These attacks send a clear message to businesses: cyber security and risk management must be infused into an organization's DNA. Yet organizations grapple, still, with the unfamiliar concept and potentially costly effects of a cyber breach.

Increased regulatory and media interest in cyber incidents have had a knock-on effect. As the risk of reputational damage and the likelihood of claims against businesses increase, senior managers are more likely to face blame and, in some sectors, financial consequences for failing to prevent the loss or harm. Investors, too, are paying more attention to an organization's cyber risk profile and cyber security strategy before making investment decisions. Cyber preparedness, where embedded into the organization's risk strategy, can be a competitive advantage.

Cyber incidents range from "home team" failures in software and protection of data, on the one hand, to externally induced disruption through denial of service attacks, extortion, hacktivism, state-sponsored espionage and terrorist attacks against critical infrastructure, on the other. Cyber risk impacts all organizations regardless of sector and size.

In this section, we discuss: (i) the legal and regulatory considerations for directors from both a U.S. and UK perspective, and the potential consequences for directors where cyber security risk management is not taken seriously; and (ii) what basic cyber governance means for any director, irrespective of location.

B. CYBER RISK GOVERNANCE AND THE DIRECTOR'S ROLE

Cyber security, incident response and crisis management planning should form an integral part of the corporate governance and risk management of companies. Leaving the information technology department to direct and manage the company's cyber risk strategy is not the answer. Directors should take ownership of the issue themselves.

Legal requirements relating to directors and cyber risk governance vary depending on jurisdiction, but ultimately cyber security issues fall squarely within any director's wider responsibility to ensure all risks of the company are properly managed. U.S. regulators have been especially proactive in investigating the cyber security practices of the companies they regulate, and where the United States goes, other countries often follow.

In this section, we consider the legal and regulatory considerations for directors from both a U.S. and UK perspective, and the potential consequences for directors where a breach has occurred.

1. Legal and Regulatory Considerations for U.S. Directors

In the United States, directors face requirements with respect to the duties they owe to their respective companies (*see*, for example, Delaware's law on directors' fiduciary and other duties). Directors' general duties include a duty of care (which requires a director to pay attention, ask questions and act diligently in order to become and remain fully informed and to bring relevant information to the attention of other directors) and a duty of loyalty (which requires a director to make decisions based on the company's best interest and not on any personal interest). The business judgment rule protects directors' actions where they have acted on an informed basis, in good faith and with a reasonable belief that the action was in the best interests of the company. Ensuring proper cyber risk management and that effective and robust systems are in place is an important part of a U.S. director's duties.

In February 2014, the National Institute for Standards and Technology ("**NIST**") launched its voluntary "Cyber Security Framework" for the nation's 16 critical infrastructure sectors (including financial services, communications and energy providers), which is widely viewed as setting the U.S. federal standard for private sector security. The U.S. Federal Trade Commission has also pursued several "unfair and deceptive trade practices" cases on the basis that it is: (a) "unfair" for a company to have inadequate information security; and (b) "deceptive" for a company not to keep its own cyber security promises.

U.S. directors must also adhere to federal sector-specific cyber security requirements (particularly if they act in regulated sectors of the U.S. economy (e.g., healthcare, defense, etc.)), some of which are quite detailed. U.S. directors must also be conscious of a proliferation of state-issued cyber security requirements, which can create a less uniform approach to cyber risk than in the UK. Massachusetts, for example, is presently known in the United States for prescribing some of the most detailed information security regulations for general U.S. companies.

Moreover, U.S. corporate governance regulations and the expectations of U.S. directors are often influenced by shareholder activism and class litigation based on novel common law theories. The recent court actions brought against directors of Target Corporation ("**Target**") (for inadequate cyber security controls) and Wyndham Worldwide Corp. (for inadequate data security standards) serve as good examples. For companies operating in the United States, on the one hand, and in jurisdictions where cyber law and regulation are perhaps less advanced, on the other hand, the prudent approach may be for boards to adopt the more stringent of the applicable regimes in its cyber security practices.

The NAIC also recognized that cyber security is a crucial issue for insurers and at its Fall 2014 National Meeting appointed a new Cyber Security (EX) Task Force (the "**Cyber Security Task Force**") to monitor developments in the area of cyber security and advise, report and make recommendations on cyber security issues affecting insurance companies in response to the many recent, high-profile data breaches. Following the Anthem breach, the NAIC has called for a multi-state examination of Anthem and its affiliates. The NAIC notes that it anticipates all 56 states and territories will sign on to the examinations given the scope of the breach and the number of consumers who were impacted. The examination will be led by California, Indiana, Maine, Missouri, New Hampshire, North Dakota and South Carolina. The Cyber Security Task Force will be monitoring the states' efforts and will determine whether regulatory action is warranted. NAIC President and Montana Commissioner of Securities and Insurance, Monica J. Lindeen, issued a statement regarding the Anthem security breach noting, that "[s]tate regulators take the issue of cyber security very seriously" and "affected regulators will be monitoring the situation closely." The statement continued that the NAIC "is committed to addressing cyber security in the insurance sector."

In addition, on February 8, 2015, the NYDFS issued a press release and report which addresses its survey of insurers and their cyber security programs. The survey covered 43 entities representing a cross-section of the NYDFS' regulated insurance companies and was conducted in 2013–2014 in response to the increasing number of cyber security attacks. According to the report, 95% of surveyed insurers believed that they already have adequate staffing for information security, while only 14% of chief executive officers receive monthly briefings on information security. The NYDFS plans to initiate a number of measures to strengthen cyber security at regulated insurers, such as including cyber security preparedness as part of an insurer's examination process and proposing enhanced regulations imposing heightened cyber security standards. The report also found most insurers did not specifically identify or discuss cyber security as a stand-alone material risk in their annual ERM reports filed with the NYDFS or addressed it more broadly as part of "operational risk." The NYDFS expects that "future ERM filings will include more frequent explicit references to cyber security."

2. Legal and Regulatory Considerations for UK Directors

Company directors in England and Wales are already familiar with the Companies Act 2006 ("**CA 2006**") general duties they owe to the company—including to act within their powers, to promote the success of the company, to exercise independent judgment and to exercise reasonable care, skill and diligence in the discharge of their functions. These duties include ensuring that the company's reputation and effective management practices are maintained, so a company's approach to cyber risk will be relevant to the assessment of how well (or badly) company directors perform their role.

The CA 2006 general duties have broad application, capturing persons who act as company directors without official appointment and also, in certain circumstances, "shadow directors" in accordance with whose directions or instructions the directors of a company are accustomed to act.

In addition, the directors of firms authorized by the FCA and/or the PRA (collectively, the "**UK Regulators**") must satisfy the "fit and proper" test. The criteria are the candidate's: (a) honesty, integrity and reputation; (b) competence and capability; and (c) financial soundness. A company's operational risk management practices (which will include how it addresses cyber risk) are seen as a key

safety and soundness issue, so a director's competence and capability will likely be reflected in his or her careful engagement in operational and cyber risk issues.

Directors of UK companies with a premium listing of equity shares on the London Stock Exchange will also be familiar with the UK Corporate Governance Code, which includes a section on "risk management and internal control." The revised UK Corporate Governance Code, published by the Financial Reporting Council in September 2014, includes risk management and internal control provisions relating to directors. Directors are expected to carry out a robust assessment of the principal risks facing the company, be able to explain how they have assessed the company's prospects, over what period they have done so and whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities, and explain how identified risks are being managed and mitigated. The "comply or explain" principle underpinning the UK Corporate Governance Code will make it very difficult for directors of UK companies listed on the London Stock Exchange to justify weak management of cyber risk issues.

In June 2014, the UK Government launched its voluntary "Cyber Essentials Scheme," offering businesses the opportunity to be certified as having a basic level of cyber security. Prudent directors ought to ensure their organizations meet these measurable minimum standards. *See* Section VI.B.3 below for more information on the Cyber Essentials Scheme.

Expected changes at the European level will also redefine the performance expectations of UK directors:

- Under the proposed EU Data Protection Regulation (expected to be adopted by the European Parliament by the end of 2015), organizations will have to report security breaches "without undue delay" to its supervisory authority. Organizations will also be under an obligation to have security policies in place containing a process for regularly testing, assessing and evaluating the effectiveness of such policies and ensuring the ongoing effectiveness, confidentiality, integrity, availability and resilience of the organization's systems.
- Under the draft Network and Information Security Directive, operators in the energy, transport, water production and supply, financial market infrastructure, food supply chain and internet exchange point will be required to: (i) assess the risks they face; (ii) adopt appropriate and proportionate measures to ensure network and information security; and (iii) report without undue delay to the competent authority or to the single point of contact any incidents which have a significant impact on the continuity of the core services they provide.

3. Consequences for Directors

The focus by governments and regulators on cyber security preparedness highlights that the director's role is an evolving one, the parameters of which change over time as new perils emerge extending the scope of corporate governance expectations. The consequences of underestimating the importance of corporate governance issues such as cyber risk can be severe. These include, for example, removal from office by the company's shareholders and, in the United States, potential derivative actions which may name board members personally.

In the case of companies regulated by the FCA and/or the PRA, a director's "fit and proper" status can be revoked and the UK Regulators may also make a prohibition order such that the individual cannot perform functions relating to specified regulated activities. Banks operating in the UK will also be familiar with the PRA's new clawback regime, which requires firms to clawback awards made to "Senior Managers" from January 1, 2015 where there is reasonable evidence of the individual's misbehavior or material error, or where the firm or relevant business unit suffers a material failure of risk management.

Moreover, the forthcoming power to fine a company up to 5% of its global annual turnover or €100 million, whichever is the highest, for non-compliance with a proposed data protection regulation underlines the expectation that directors should focus on data protection safeguards and cyber security measures in their day-to-day oversight of the company's products, services and operations.

Sound cyber governance involves boards developing, among other things, cyber risk management arrangements that reflect any cyber-related legal and regulatory requirements that apply in the jurisdictions in which an organization operates. Boards should also monitor the development of, and consider participating in, any voluntary government schemes that can demonstrate externally that their organization has a basic level of cyber hygiene.

VII. Select Tax Issues Affecting Insurance Companies and Products

A. PROSPECTS FOR TAX REFORM

The prospect for near-term comprehensive tax reform appears weak. While Congressional leaders of both parties continue to endorse in broad outlines the concept of a 1986-style tax reform effort that would reduce the corporate tax rate and achieve revenue neutrality by broadening the corporate tax base, there seems to be little agreement on specifics. The corporate reform plans offered in the past by former Senate Finance Committee Chairman Baucus and former House Ways and Means Committee Chairman Camp remain the most comprehensive examples of possible paths to reform, but neither appears to have gained significant traction.

Former Chairman Baucus' 2013 proposal addressed the international tax system. In broad outline, the Baucus draft aimed to end deferral for new corporate earnings, moving to a system in which the income of foreign subsidiaries is either taxed immediately when earned, or is exempt from U.S. tax. The Baucus bill also incorporates a version of the so-called "Neal Bill" that has been discussed for many years. This proposal would disallow deductions for certain reinsurance premiums paid by a U.S. ceding company to a foreign affiliate.

Former Chairman Camp's 2014 reform effort contained provisions addressing the domestic and international tax systems. With respect to the domestic life industry, the Camp proposal would, among other things, impose new taxes on company-owned life insurance, repeal the small life insurance company deduction, change the interest rate

used in computation of life insurance reserves to a rate based on the average Federal mid-term rate over the prior five years, plus 3.5%, and simplify and increase the amount of deferred acquisition cost capitalization. With respect to the domestic property and casualty industry, the Camp proposal would repeal the special status of Blue Cross Blue Shield organizations, and would modify the loss reserve discounting rules under Section 846 of the Code. Like the Baucus bill, Chairman Camp's proposal contained a provision similar to the Neal Bill.

Neither the Baucus nor the Camp proposals seems likely to come to a vote in the near term—more interesting, perhaps, is the shift in how these proposals will be "scored" by the Congressional Budget Office. One of the first actions by the new Republican majority in the Senate was to require congressional analysts to use so-called "dynamic scoring" when assessing the costs and benefits of major tax bills. Generally, dynamic scoring takes into account predicted economic benefits or detriments arising as a result of changes in tax law. Proponents of dynamic scoring suggest this change will ease the path of fundamental tax reform, arguing that the economic growth arising out of a rationalized tax system will offset lost tax revenue. Opponents have argued such predictions are too uncertain.

B. ALTERNATIVE REINSURANCE

At a February 3, 2015 Congressional hearing, the Internal Revenue Service ("**IRS**") Commissioner John Koskinen was pressed for a specific date by which the IRS would issue further guidance on whether so-called "hedge fund reinsurer" ventures would be subject to the tax regime for a passive foreign investment company ("**PFIC**"). Koskinen said: "Let's say we'll do our best to do this in 90 days. It helps to have a deadline out there."

The term "hedge fund reinsurer" has been used to describe reinsurance structures paired with investment strategies seeking yields greater than those traditionally associated with insurance businesses, including strategies employed by hedge fund managers. Investments of such a venture may include a mix of more traditional and more aggressive investments. The reinsured liabilities that fit most naturally with such strategies are the most predictable and longest-term liabilities, including fixed annuities, although a number of ventures in the property and casualty reinsurance industry have been launched as well, attracting significant notice in the business press.

For some of these ventures, a key issue is whether U.S. investors may be subject to the federal income tax rules for shareholders of a PFIC. A U.S. taxpayer receiving either dividends or redemption/sale proceeds on stock of a corporation classified as a PFIC is not eligible for the benefit of any special lower federal income tax rates for dividend or long-term capital gain income, and must pay the IRS the equivalent of interest on any tax deferral enjoyed during the period when the U.S. investor held stock and the foreign corporation earned profits but did not distribute them.

Foreign corporations owning primarily financial assets are PFICs unless an exception applies, and the structures mentioned above are generally intended to come within an exception for corporations "predominantly engaged in the active conduct of [a reinsurance] business." IRS Notice 2003-34, 2003-1 C.B. 990, signaled that the IRS would scrutinize such a venture and its U.S. shareholders, especially if the company was overcapitalized relative to the volume of its reinsurance business. However, no further guidance has ever been issued, leaving significant uncertainty.

In the past year, legislative and regulatory proposals have been discussed that would finally attempt to bring some clarity to this area. Such proposals have generally focused on the amount of premium income relative to total gross receipts (problematic for any entity that has gone into runoff), and the amount of total assets relative to insurance-related liabilities (problematic for a reinsurer focused on providing catastrophe cover). Commentators have said it would be very difficult to craft hard and fast rules in this area without turning some legitimate reinsurance businesses into PFICs.

The industry will be watching closely to see whether the IRS can meet an informal "deadline" to issue guidance by early May, and what approach such guidance may take.

C. FATCA

The provisions commonly known as the Foreign Account Tax Compliance Act ("**FATCA**") generally went into effect in 2014. FATCA generally imposes a 30% withholding tax on any "withholdable payment" made to (i) a foreign financial institution ("**FFI**") that does not register with the IRS and satisfy certain due diligence, reporting, withholding, and other requirements with respect to its account holders or (ii) a non-financial foreign entity ("**NFFE**") that does not provide a certification to withholding agents regarding its substantial U.S. owners (if any) or meet an applicable exception. In general, a non-U.S. insurance company will be an FFI only if it issues, or is obligated to make payments with respect to, annuity contracts or other products having cash value. Otherwise, non-U.S. insurance companies generally will be NFFEs under FATCA.

Withholdable payments include a wide variety of payments of U.S. source income, including insurance and reinsurance premiums, as well as the gross proceeds from the sale or other disposition (including a redemption) after December 31, 2016 of stock, debt obligations, or other property of a type that can produce U.S. source interest or dividend income. Under a transition rule, however, withholdable payments do not include certain payments of U.S. source income made prior to January 1, 2017 with respect to an offshore obligation.

The United States has signed, or agreed in substance to, intergovernmental agreements on the implementation of FATCA ("**IGAs**") with over 100 jurisdictions. The IGAs facilitate the implementation of FATCA by alleviating conflicts with local laws and, in jurisdictions that have entered into a "Model 1 IGA," permitting FFIs to report accounts to local authorities rather than the IRS. However, the IGAs generally require implementation through local law, which in many jurisdictions is still developing and remains a key outstanding aspect of FATCA implementation.

D. INVERSION GUIDANCE

The IRS released guidance this year that could significantly impede the ability of foreign insurance companies to acquire U.S. target companies using stock consideration.

Under current law, if a domestic corporation is acquired by a foreign company in a transaction in which the former shareholders of the domestic corporation come to own 80% or more of the combined entity, the acquiring foreign corporation will be treated as a domestic corporation subject to U.S income tax—such transactions are termed "inversions."

IRS Notice 2014-52 ("**Notice**") provides that the IRS intends to promulgate regulations that expand the universe of transactions that will be treated as "inversions" by providing special rules for calculating the 80% ratio in the case of so-called "cash box" acquirers: that is, acquirers that hold significant amounts of passive investment-type assets. The Notice provides that when a foreign-acquirer corporation has more than 50% investment-type assets, the "denominator" of the 80% fraction will be determined by excluding stock of the foreign acquirer attributable to the passive-type assets. This will tend to increase the proportion of stock of the foreign acquiring entity treated as being owned by former shareholders of the domestic target, increasing the likelihood that the transaction will be treated as an inversion.

By their nature, banking, finance and insurance companies are required to hold large amounts of passive assets in the ordinary course of their operations, and the Notice provides special rules of application for determining when a foreign-acquirer banking, finance or insurance company will be subject to the cash box rules. While it is encouraging that the IRS had the foresight to consider how these rules would apply to non-tax motivated acquisitions by insurance companies, the specific guidance offered by the IRS on this score is narrower than one might hope. The Notice provides that assets that give rise to certain exempt insurance income under the controlled foreign corporation ("**CFC**") insurance company rules will not count toward the 50% cash box limit. The CFC insurance company rules are quite narrow, however—in particular, only a company with predominantly "home country" risks will qualify. Thus, for example, a reinsurance company that accepts risk from a number of different countries might not satisfy the narrow requirements of this exception and, as a result, would be treated as a "cash box" acquirer.

The Notice incorporates the CFC insurance company rules rather than the somewhat more lenient PFIC rule for active insurance companies. Curiously, the Notice provides that in the context of banking and finance companies, as opposed to insurance, foreign acquiring companies may rely on the PFIC *and* the CFC exceptions to avoid being treated as a cash box. Thus, the Notice takes two different approaches in the same guidance to solve what appears to be an analytically similar problem: the treatment of operating foreign businesses that are required to hold large amounts of passive assets for ordinary and legitimate business purposes.

A number of groups have provided comments to the IRS criticizing the decision to allow only the narrow CFC exception to insurance companies. It remains to be seen how the IRS will react to these suggestions in crafting final guidance.

E. CASCADING FEDERAL EXCISE TAX

On February 20, 2015, a three-judge panel of the U.S. Court of Appeals for the D.C. Circuit heard oral argument in *Validus Reinsurance, Ltd. v. United States*, which is the first case to involve a challenge to the IRS's position on the "cascading" application of the federal excise tax ("**FET**") to reinsurance agreements between foreign parties covering U.S. insurance risks. In early 2014, the lower court ruled in favor of Validus on the narrow ground that, although the statute authorizes imposition of the FET on "reinsurance," it does not do so with respect to "retrocessions."

Validus also argued that even if the FET statute applies to retrocessions, it cannot be applied on an extra-territorial basis to wholly foreign transactions without violating longstanding principles of territoriality, international law and the U.S. Constitution. The lower court did not reach any of these alternative arguments in its decision, and it is uncertain whether the D.C. Circuit will do so. *Amicus curiae* briefs were submitted to the D.C. Circuit on behalf of the International Underwriting Association of London, Ltd., and the International Insurance Brokers' Association, urging that the lower court result be affirmed on the basis of extra-territoriality.

Insurance companies that have been paying federal excise tax on foreign-to-foreign retrocessions should consider filing claims for refund to preserve their ability to seek a refund of such taxes. The D.C. Circuit's decision, expected mid-year, will certainly be an item of interest to the industry.

F. LIMITATIONS ON WHAT CONSTITUTES INSURANCE FOR TAX PURPOSES

The pending case of *R.V.I. Guaranty Co. Ltd. v. Commissioner*, T.C. No. 27319-12, involving whether "residual value insurance" constitutes insurance for tax purposes, will continue to be watched with interest in the industry. In this form of business, an owner of assets subject to a long-term lease (e.g., equipment or real estate) buys protection against the possibility that the "snapshot" residual value of the asset at the conclusion of the lease term may be lower than a target amount. In this litigation, the IRS takes the position that the policyholder's economic risk involved in this type of business is not an "insurance risk" and that any claims the insurer must pay do not arise from a casualty event. The case was tried in September 2014 before Tax Court Judge Lauber, who heard three days of testimony from multiple expert witnesses for both sides. The case is now fully briefed and awaiting decision by the court.

In *Securitas Holdings v. Commissioner*, T.C. Memo 2014-225 (Oct. 29, 2014), the Tax Court rejected the IRS's long-asserted interpretation of the "risk distribution" requirement for classifying a transaction as "insurance" for tax purposes. The IRS has long taken the position that risk distribution (or risk "pooling") must be assessed from the standpoint of the insured, and that an arrangement must involve a certain minimum number of insured persons each of which contributes a substantial volume of insured risks and premiums to the

pool. *See, e.g,* Revenue Ruling 2005-40, 2005-2 C.B. 4. In *Securitas*, the Tax Court rejected this position and held that risk distribution is properly assessed from the standpoint of the insurer. If the insurance risks involved are sufficiently numerous, similar and independent of one another, the number of insured persons is not relevant, according to the Tax Court. The appeal period in *Securitas* expired without appeal by the IRS.

G. INSURANCE ISSUES IN THE OECD BEPS PROJECT

The Organisation for Economic Co-operation and Development ("**OECD**") is a Paris-based organization, consisting of 34 member countries (including the United States), that develops policy for member and "partner" countries, with a stated goal of improving global economic and social well-being. Since 2012, OECD has worked to develop policy prescriptions for eliminating the so-called base erosion and profit shifting ("**BEPS**") arising from "[g]aps and mismatches in . . . tax rules [that] can make profits 'disappear' for tax purposes, or allow the shifting of profits to no- or low-tax locations where the business has little or no economic activity."

OECD issued a report in 2013 containing 15 separate action points to address BEPS. In September 2014, OECD released the first of three scheduled groups of "deliverables" in the form of reports (with varying degrees of finality) on seven of the 15 agreed actions. The 2014 deliverables consist of reports on:

- the effect of the digital economy on BEPS;
- hybrid mismatch arrangements (i.e., arrangements under which a tax is never levied, either because a deduction is claimed in one jurisdiction while profits are not included in income in a second jurisdiction, a deduction is claimed for the same item in two jurisdictions, or the use of a third jurisdiction leads to similar results);
- efforts to combat identified harmful tax practices;
- treaty abuse (particularly the exploitation of "double taxation" provisions);
- transfer pricing aspects of intangibles;
- transfer pricing documentation and country-by-country reporting; and
- development of a multilateral instrument to address BEPS.

While insurance was not highlighted in the general action plan, the 2014 proposals regarding treaty protections contained insurance-specific proposals. The 2014 proposals would provide that insurance companies would be deemed to have a "permanent establishment" in a state where they collect premiums through a dependent agent established in the state, or insure risks in that state through such an agent. No explanation was given as to why special rules are necessary for the insurance sector.

Some guidance slated for release in 2015 can be expected to address insurance issues as well. One of the key BEPS goals is to "limit base erosion via interest deductions and other financial payments." OECD has identified "captive and other insurance arrangements" among the items that will be addressed in forthcoming transfer pricing guidance regarding the pricing of related party financial transactions. OECD has also indicated that insurance transactions may be addressed in the context of controlled foreign corporation rules and general transfer pricing rules.

Finally, the BEPS project includes an overall focus on information sharing and disclosure requirements as part of the ongoing efforts among OECD members to coordinate enforcement of BEPS. Special attention will be warranted to determine how these provisions will apply to the particular concerns of the insurance industry.

H. VAT AND CROSS-BORDER SUPPLIES OF SERVICES

In September 2014 the European Court of Justice gave its ruling on the much-anticipated *Skandia America Corp. (USA)* case.[16] The judgment has brought into question the value-added tax ("**VAT**") treatment of, and thereby the potential costs relating to, supplies of services by international insurance groups from a head office to a branch located in another jurisdiction.

The ECJ's judgment came as a surprise to many, ruling that in circumstances where the head office of a non-EU entity provides services to its EU branch, and such EU branch is a member of a VAT group, such supplies are potentially within the scope of VAT. The crucial aspect of the *Skandia* case was the fact that the supply was considered to be made to the VAT group of which the EU branch was a member, and not to the EU branch itself. As a result, the supply was treated as being made to a separate taxable person and therefore within the charge to VAT.

On the basis that many international insurance groups will not be in a position fully to recover any VAT which is suffered within the international group, the possibility of VAT being charged on intra-group supplies is cause for significant concern and could result in significantly increased operating costs.

The true impact of the *Skandia* judgment will be told in how various EU taxing authorities respond to the ruling. In October 2014 HM Revenue & Customs ("**HMRC**") published a policy paper (*Revenue & Customs Brief 37 (2014)*) stating that it is 'carefully reviewing' the *Skandia* decision and may update its guidance in due course, if required. However, HMRC does note that the UK VAT grouping rules differ from those in Sweden. It has been argued that there is sufficient difference between the Swedish and UK VAT grouping rules that there should be no need to change the current UK position. However, uncertainty will remain until HMRC clarifies its thinking on the issue.

1. Financial Transactions Tax

Following a meeting of the Council of the EU (the "**Council**") on December 9, 2014, the Presidency of the Council provided an update on the status of the proposed EU financial transaction tax ("**FTT**"). In summary, the Presidency of the Council noted that further work is required with respect to a number of areas, in particular the taxation principles underlying the FTT (for instance, whether the residence and/or the issuance principle should be applied) and the tax collection mechanism to be used.

16 Judgment of the Court (Second Chamber) of 17 September 2014; *Skandia America Corp. (USA), filial Sverige v Skatteverket;* Case C-7/13.

The timing for the introduction of the FTT (if introduced at all) remains uncertain. Although the Italian Presidency of the Council had hoped that agreement would be reached in 2014, this did not materialize.

Notwithstanding, there appears to continue to be political will amongst the 11 participating members states to introduce a form of the FTT at the beginning of 2016. In late January 2015, the finance ministers of France and Austria wrote a joint letter to their counterparts involved in the ongoing negotiations, with the hope to "breathe new life into talks on the FTT." The letter urges the adoption of a tax "with the widest possible base and low rates," echoing comments made by the President of the Republic of France, François Hollande, earlier in January 2015.

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