

DEWEY & LeBOEUF

**Transactional Trends and Developments
in the Insurance Sector**

2010
Year in Review

2010 Year in Review

In this year's review, we examine some of the more notable transactional trends and developments in the insurance sector in 2010, focusing particularly on developments in mergers and acquisitions, capital markets and insurance-linked securities, as well as corporate governance and regulatory developments affecting the sector.

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I. Developments in Mergers and Acquisitions

After a steep decline in 2009, M&A activity in the insurance industry staged an uneven comeback in 2010. While life sector transactions returned to historical levels, both in deal volume and aggregate deal value, property and casualty deal volume increased only slightly, with aggregate deal value remaining well below historical norms.

A. Life Sector M&A

1. Trends and Highlights

In 2010, life sector M&A activity was dominated by AIG's announcement of three large divestitures. First, on March 1, 2010, AIG disclosed it had entered into an agreement for the sale of its AIA Group to Prudential PLC for consideration valued at approximately \$35.5 billion. Second, on March 8, 2010, AIG announced the sale of its ALICO unit to MetLife for consideration valued at \$16.2 billion at closing. Third, on September 30 2010, AIG announced the sale of AIG Starr and AIG Edison to Prudential Financial for \$4.8 billion. A fourth transaction, the divestiture of Nan Shan Life, was announced by AIG in 2009 but failed to receive regulatory approval in Taiwan and, as a result, was terminated in 2010.

These three transactions established a prevalent theme for life sector M&A in 2010: the use of acquisitions by U.S. and European insurers to accelerate growth and seek geographic, distribution and product diversification in Asian markets. AIA is AIG's principal life insurer in China and Southeast Asia. ALICO writes business throughout the world, but has a significant focus on Japan. Starr and Edison are both Japanese insurers. Further evidence of this theme was provided by ACE Ltd.'s fourth quarter announcement that it had agreed to acquire New York Life's Hong Kong and Korea life insurance businesses for \$425 million.

The ALICO transaction closed in November 2010 and the Edison and Starr transactions are expected to close in the first quarter of 2011. The AIA transaction, however, was terminated in June 2010 after AIG refused to accept Prudential PLC's proposed \$5 billion purchase price reduction. According to press reports, Prudential had sought the reduction in order to placate shareholders who had threatened to vote against approval of the acquisition because they were unhappy with the original purchase price. Prudential, therefore, elected to terminate the transaction and pay AIG a £153 million termination fee. AIG subsequently completed a \$20.5 billion IPO of AIA. See "IV. Developments in Insurance Capital Markets, A. Equity, 3. EESA-Related Offerings" on page 18.

A transaction announced at the end of 2010 may suggest another trend in M&A: expanded outward reach by Asian insurers. In December, newly demutualized Dai-ichi Life disclosed that it will acquire Tower Australia Group Ltd. for \$1.2 billion. This acquisition is one of the biggest foreign takeovers by a Japanese company, and could be the first of many Japanese, Korean and Chinese insurers that are looking for significant growth outside their home markets.

Another noteworthy trend in life sector M&A in 2010 was the re-emergence of financial buyers in the marketplace for life insurance M&A. Three significant transactions involving private equity or hedge funds were announced during the year: Athene Holdings' acquisition of Liberty Life for \$628 million, Harbinger Capital's acquisition of Old Mutual's U.S. life operations for \$350 million and Guggenheim Partners' acquisition of Security Benefit for \$400 million. Financial buyers have become an increasingly viable option for sellers who are looking to divest operations that may not have the scale, product mix or other attributes necessary to attract interest from strategic buyers.

I. Developments in Mergers and Acquisitions (cont'd)

2. Allocation of Risk in AIA and ALICO Transactions

From a lawyer's perspective, the AIA and ALICO transactions are notable not only for their size and disparate outcomes, but for the different ways in which risk was allocated between a single seller and two very different buyers. Risk allocation, of course, reflects myriad factors, including competitive pressures in the sale process, negotiating leverage and the buyer's and seller's appreciation of, and tolerance for, uncertainty. These transactions, however, demonstrate there is more than one way to get from point "A" to point "B", even with the same seller, in life insurance M&A.

2 | The stock purchase agreement for the AIA transaction reflects a "public company" approach in a private sale context, with the buyer essentially committing itself to a non-recourse transaction at the time it signed the contract. AIG's representations and warranties were relatively light, at least by U.S. standards, and largely would expire at the closing. Further, the contract does not provide for any right to indemnification. As a result, Prudential generally would not have had any ability to recover damages from AIG if a representation, warranty or covenant had been breached. In addition, there was no financial statement-based purchase price adjustment, so Prudential would be allocated the risk of a decline (as well as receiving the benefit of any improvement) in AIA's financial position.

The stock purchase agreement for the ALICO transaction reflects a more typical "private sale" allocation of risk to the seller. AIG provided extensive representations and warranties and indemnification rights, including special indemnities to cover numerous identified exposures. In addition, in order to mitigate the consequences of an AIG bankruptcy, an indemnification collateral account was established to secure AIG's indemnification and other payment obligations under the stock purchase agreement. Further protection for MetLife was afforded by a special asset protection agreement pursuant to

which ALICO's parent agreed to partly reimburse MetLife for losses relating to certain assets in ALICO's investment portfolio. Finally, the stock purchase agreement contained numerous purchase price adjustments meant to protect MetLife from degradation in the value of ALICO, including a downward adjustment in the event that ALICO's risk-based capital was less than 400% at closing.

3. Impact of Regulations XXX/AXXX

Life insurance M&A increasingly is being complicated by Regulation XXX and Regulation AXXX. These regulations impose conservative methodologies and assumptions for the calculation of the required statutory reserves for life insurers that issue guaranteed-level premium term life insurance policies, in the case of Regulation XXX, and universal life insurance policies with no-lapse guarantees, in the case of Regulation AXXX. The result over the past 10 years has been a substantial increase in the reserves required to be held by life insurers on their statutory accounting statements for these policies. These statutory reserves are significantly in excess of the "economic reserves," which are the reserves that actuaries and accountants would determine are necessary to cover the future contractual obligations under these term and universal life policies. Economic reserves more closely approximate reserves calculated under GAAP. This excess, or "redundancy," survives for up to 20 or 30 years or more, depending upon the policy term, and increases for the first several years of the life of the policy before gradually declining thereafter.

In the M&A context, sellers of life insurance companies with significant blocks of Regulation XXX and Regulation AXXX business are faced with the challenge of determining how a prospective buyer will value a company that has such a large reserve strain on its books. Historically, these redundant reserves were either funded through the sale of securities to the capital markets—an option that has not been readily available since the beginning of the financial crises and downturn in the fortunes of the financial

guarantors that wrapped most of these transactions—or through the use of bank letters of credit, in each case by using a captive or other affiliate reinsurance company to reinsure the blocks of business from the ceding insurance companies.

If a seller has employed the capital markets structure in the past, the issue arises of how the proposed sale (and change in control of the ceding insurance company) affects the covenants in the underlying transaction agreements. This is especially relevant to the underlying financial guaranty agreements, under which the guarantors sought strict control over the ceding insurer and the ceded block of business. In many cases such a change in control would require the prior consent of the financial guarantor, as well as of the regulators of the captive reinsurer.

In the letter of credit structure, a similar problem exists with the lender, which often insists on similar change in control restrictions. Additionally, most letters of credit obtained in a Regulation XXX transaction are guaranteed by a parent holding company. If the parent sells the ceding insurer and/or the captive reinsurer, it will want to come “off risk” from the guarantee, usually through the replacement of the existing letters of credit with letters of credit provided by the buyer, or the replacement of the seller parent guaranty with a buyer parent guaranty. Even if this latter option is acceptable to a buyer, such a transfer may require the consent of the lender.

In order to come to agreement on a deal, buyers and sellers are being forced to develop innovative structures to address the funding of Regulation XXX and AXXX reserves following a change in control. The difficulty comes in devising a structure that accomplishes the goal of relieving the seller of its guaranty or other obligations with respect to the current funding but also provides the buyer with long-term reserve funding on terms that are commercially acceptable. Additional complications may arise depending on the size of the reserve funding

requirement and the capacity of the letter of credit banks and other funding solutions to accommodate these funding requirements. As non-recourse and other capital market funding solutions are developed, we would expect any capacity restraints to be alleviated.

4. Outlook

The AIG transactions represented unique opportunities in life insurance M&A that are unlikely to be replicated in 2011. Nevertheless, we believe that the “near-death” experience of the recent financial crisis has inspired prudent companies to sharpen their focus on their competitive positions, abilities to manage risk and prospects of creating long-term value for their shareholders. Large companies with strong capital positions and an ability to access additional capital will be well-positioned to take advantage of M&A opportunities as they arise. Smaller companies that need to conserve cash, are sub-scale or are selling commodity or unpopular products will be at a disadvantage.

We believe that three factors in particular may influence life sector M&A in 2011 and beyond. First, Solvency II is perhaps the most important among them. While the possible negative effect of Solvency II on European insurers’ regulatory capital appears to have been mitigated somewhat, the implementation of the regulation will cause some insurers to re-examine the wisdom of continuing to hold certain non-core, capital-intensive operations. See “VII. Insurance Regulatory Developments, C. European Developments, 1. Solvency II” on page 37 for further information. Second, Moody’s recent decision to reduce the equity component of hybrid securities in an insurer’s capital structure could have a negative impact on some insurers’ ratings, particularly if their 2010 earnings have not made up the difference in equity. Changes in the equity content of hybrids may also affect the composition and structure of acquisition financing for larger acquisitions in the sector. See “IV. Developments in Insurance Capital Markets, B. Debt Capital Markets, 3. Developments in

I. Developments in Mergers and Acquisitions (cont'd)

the Hybrid Securities Market” on page 19 for further information. Third, changes in U.S. GAAP accounting in 2011 for deferred acquisition costs will require insurers to expense a number of policy-acquisition costs that they formerly capitalized. The effect will be to cause certain insurers to write-down their U.S. GAAP DAC asset, resulting in a one-time reduction in shareholders’ equity and an on-going increase in acquisition expenses. The resulting reduction in an insurer’s book value may affect its stock market valuation on both an absolute and relative basis, which may make it a more likely target or acquirer, as the case may be.

B. Property and Casualty Sector M&A

1. Trends and Highlights

4 | The lingering effects of the financial crisis, the soft environment for property and casualty premium rates and the low market valuations placed on property and casualty insurers’ stock dampened deal making in this sector in 2010. There were no blockbuster transactions comparable to the large AIG life divestitures. Rather, companies that recently have become regular purchasers of insurance properties continued to add to their portfolios while other industry participants stayed out of the market. Fairfax Financial’s \$1.4 billion acquisition of workers’ compensation specialist Zenith National was one of the largest deals of the year in the property and casualty sector. Fairfax quickly followed the closing of that deal with the announcement of the acquisition of specialty insurer First Mercury for \$294 million and Malaysian medical insurer Pacific Insurer Berhad for \$64 million. Tower Group closed the acquisition of the personal lines business of OneBeacon for \$167 million and announced a small renewal rights transaction relating to commercial automobile insurance. Australian insurer QBE announced several transactions in the United States and Europe, including the acquisition of crop insurer NAU for \$565 million and the U.S. insurance operations (consisting primarily of crop and specialty insurance) of Renaissance

Re for \$275 million. Finally, ACE Limited announced two P&C acquisitions in 2010: Rain and Hail Insurance Service for \$1.1 billion and Jerneh Insurance Berhad of Malaysia for \$200 million.

Industry observers have long considered the Bermuda reinsurers to be ripe for consolidation. The capital and expense efficiencies associated with greater scale as well as the benefits of product diversification would seem to argue persuasively for deal-making, and Validus’ 2009 acquisition of IPC seemed to be the catalyst for a wave of activity. Notwithstanding, 2010 saw the announcement of only one transaction: the merger of Max Capital and Harbor Point to form Alterra.

2. Outlook

The outlook for property and casualty sector M&A in 2011 is uncertain. Many insurers have excess capital that needs to be deployed in order to improve their ROEs. Their options, however, are few: dividends, share repurchases or acquisitions. While this would logically suggest an increase in M&A activity, prospects are clouded by the low valuation levels at which property and casualty insurers currently trade. Many insurers have struggled to maintain stock prices at a premium to their GAAP book value. At current valuation levels, buyers will need to make a convincing case to their shareholders that the issuance of shares to finance a transaction or use as merger consideration is a better use of resources than a stock repurchase. From the seller’s perspective, it may be difficult for a board to accept or justify a transaction priced at a discount to current book value or to the value at which the company’s common stock traded only a few years ago. Until valuations increase, we expect property and casualty M&A activity to be subdued.

C. Hostile M&A Activity and Shareholder Activism

Hostile activity, reflected in unsolicited takeover bids and shareholder activism has been increasing significantly in the broader M&A market in recent years. In particular, activist shareholders have become quite aggressive in attempting to drive companies to replace directors, restructure themselves or engage in sale processes with the stated goal of unlocking value for shareholders. The insurance industry generally has been immune to hostile activity, primarily as a result of prior approved requests for change in control under state insurance holding

company acts. Industry participants, however, would be well advised to pay close attention to the SEC's new proxy access rules. These rules, which greatly facilitate an unwanted attempt to elect dissident directors, may enable activists and interlopers to avoid the strictures of the insurance holding company acts, thereby increasing the possibility for hostile activity in the insurance sector. For a discussion of these rules, see "II. Developments in Corporate Governance, Public Company Regulation and Shareholder Activism, A. Proxy Access" on page 6.

II. Developments in Corporate Governance, Public Company Regulation and Shareholder Activism

2010 was a year of many developments in the regulation of public companies. Legislative and regulatory efforts to solve the problems that caused the financial crisis and to improve corporate governance resulted in a host of new rules and requirements, most notably those under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The most notable changes affecting insurance holding companies and other public companies are discussed below.

A. Proxy Access

After a number of years in which proxy access always seemed to be just around the corner, the Securities and Exchange Commission (SEC) finally adopted a proxy access rule in 2010.

6 | New Rule 14a-11 under the Securities Exchange Act of 1934 (Exchange Act) will allow holders of an aggregate of at least 3% of a company's stock, which have held such stock for at least three years, to have their candidates for election to the company's board be included in the company's proxy statement. The rule will thereby spare shareholders from one of the greatest disincentives to nominating a candidate for elections to the board: the expense and difficulty of producing, printing and mailing separate proxy materials. Together with the proxy access rule, the SEC has also amended Rule 14a-8 to permit shareholders to make proposals directed at changing a company's governing documents regarding director nomination procedures or disclosures relating to shareholder nominations. Taken together, these rule changes have the potential to result in an increase in shareholder activism.

A number of questions surround Rule 14a-11 as it will apply to insurance holding companies. The new rule is not available to shareholders seeking to change control of the issuer; however, the concepts of control defined in the SEC's release (such as causing the issuer to merge with another company) are narrower in scope than the

notions of control familiar to those who have dealt with the Model Insurance Holding Company Act. The new rule does permit companies to exclude candidates from their proxy statements if the nominee's candidacy, or board membership, would violate controlling state law. This provision may give insurance holding companies the means to exclude unwanted candidates proposed by shareholders. Depending on the facts, representation on the board (or even a related proxy solicitation) may be seen by insurance regulators as requiring the filing of a Form A or of a disclaimer, which may be too great a disincentive for many stockholders to pursue board seats. Much will depend on the identities of the nominee and the shareholder and the regulator's willingness to take action.

The implementation of new Rule 14a-11 (and of the changes to Rule 14a-8) has been stayed pending the resolution of a Federal court case that challenges the SEC's adoption of the rule. As a result, proxy access will not be effective for the upcoming proxy season. However, given the long history of the issue, proxy access appears unlikely to go away, even if this challenge is successful.

B. Presidential Life Proxy Battles

2010 saw what is probably the final chapter in the efforts by Herbert Kurz, the founder and former CEO of Presidential Life, to retake control of that company. On August 18, shareholders of Presidential Life voted in favor of all eight nominees for the company's board of directors. Kurz filed proxy materials to propose his own slate of directors. However, Kurz did not put forth his nominees at the stockholders meeting, following the preliminary finding of the New York Insurance Department that Kurz was "untrustworthy" and, therefore, not eligible to control an insurance company domiciled in New York. A department investigation found improprieties at the Kurz Family Foundation concerning expenses that were not legitimate charitable activities, and also found that

relatives of Kurz who were not employees of Presidential Life had been put on the Presidential Life health plan when Kurz was CEO.

Perhaps the most interesting thing about the Presidential Life situation is that it provides a model for how proxy access situations could play out for insurance holding companies. A shareholder seeks representation on the board; a relevant insurance department finds that such representation would constitute control, and further finds that the controlling person would not meet required standards of trustworthiness; and, finally, the insurgent backs down. Although new Rule 14a-11 simply controls whether a company must include nominees in management's proxy statement, an adverse finding on the question of whether election of the nominees would violate state law may also effectively foreclose the insurgent from circulating its own proxy statement in support of its nominees.

C. "Say-on-Pay"

Among the most notable features of the Dodd-Frank Act is the requirement, under Section 951 of the Act, for public companies to hold an advisory vote of their stockholders on executive pay. Such "say-on-pay" votes have been the goal of a number of shareholder activists for several years (although notably the Carpenters' Union, a leading activist voice, has on several occasions criticized say-on-pay votes as actually decreasing the potential for stockholders and board members to have a meaningful dialogue about compensation). In addition, nearly 300 public companies were required to hold say-on-pay votes as a condition to receiving TARP funds. Say-on-pay votes have also been required in other jurisdictions for a while, notably in the United Kingdom. On October 18, 2010, the SEC issued proposed rules to implement the say-on-pay provisions of the Dodd-Frank Act.

Proposed Rule 14a-21(a) calls for stockholders to approve the compensation of each public company's named executive officers as disclosed pursuant to Item 402 of

Regulation S-K, including the Compensation Disclosure and Analysis, the compensation tables and the other required narratives. Such votes are non-binding, merely expressing the advisory position of the shareholders. There is no required format for the vote item or items to be included under the proposed Rule. Companies may present the whole matter as one vote item (and it is expected that most will), or break it into a set of votes covering the required subject matter.

Say-on-pay votes must be held at least once every three years. Moreover, at least once every six years, issuers must permit their stockholders to vote on how frequently to hold say-on-pay votes—i.e., whether to hold them at each annual meeting, every two years or every three years. This vote also is advisory; as a result, state law considerations of the voting standard to be met in adopting any particular frequency for the vote are irrelevant. It is expected that issuers will be guided by the choice of a plurality of the voters.

Institutional Shareholder Services (ISS), a leading proxy advisory firm, has announced that in most cases its first step in the event it believes that an issuer has poor pay practices will be to recommend a vote against the issuer's say-on-pay resolution. It has also endorsed holding say-on-pay votes every year, as opposed to every two or three years. In practical terms, in many cases the result may be that issuers will continue to be largely guided by ISS's views of what constitute poor pay practices, and little guided by specific input from their stockholders. A "yes" vote on say-on-pay as an overall matter will provide little incentive for an issuer to discuss specific aspects of its pay approach with its stockholders. In the view of the Carpenters' Union (and other like-minded activists), say-on-pay has the potential (especially if it becomes a routine matter, like the approval of auditors) to actually reduce engagement with stockholders, as compared to other, more specific, types of proposals or activism. The real world impact, of course, remains to be seen.

II. Developments in Corporate Governance, Public Company Regulation and Shareholder Activism (cont'd)

D. Say on Golden Parachutes

Section 951 of the Dodd-Frank Act also requires issuers to hold a separate advisory vote on golden parachute compensation arrangements in connection with mergers and similar transactions. The SEC has proposed a new Item 402(t) to set forth the disclosure requirements in connection with such votes. Under this Item, the disclosure presented would have to quantify any agreements or understandings, whether written or unwritten, between each named executive officer of the acquiring company or the target company and those companies, concerning any type of compensation, whether present, deferred or contingent, that is based on or otherwise relates to an acquisition, merger, consolidation, sale or other disposition of all or substantially all assets. Such disclosure is required to be made in a prescribed table format, together with narrative describing any material conditions or obligations applicable to the receipt of payment. For this purpose, golden parachute payments do not include amounts payable by the acquiring company to the NEOs of the target.

Issuers may avoid a separate say on a golden parachute vote at the time of a merger if they have included the relevant Item 402(t) disclosure in an annual meeting proxy statement as to which an overall say-on-pay vote has been held. This exception applies whether or not the Item 402(t) benefits are the subject of a separate say-on-pay vote item, and whether or not the say-on-pay vote has a positive or negative outcome. However, the exception only applies if the golden parachute arrangements at the time of the merger or other transaction are the same as those described in the annual meeting proxy statement; if there are any changes, even if not material, the prior vote is not adequate, at least as to the new items.

There is significant overlap between the information called for by Item 402(t), and the information as to payments upon termination that is required by Item 402(j) of Regulation S-K. Although Item 402(t) requires information

to be presented in an easy-to-read tabular format, many issuers already present Item 402(j) information in this manner anyway, so meeting the Item 402(t) requirements in the annual proxy statement should not be hard. As a result, the exception described above may end up being fairly useful.

E. Mandatory Clawback

Another feature of the Dodd-Frank Act is a provision relating to the recovery, or clawback, of executive compensation in certain circumstances. Clawback provisions began with the Sarbanes-Oxley Act of 2002 (SOX); in the wake of corporate frauds such as Worldcom and Enron, legislators and activists began pursuing the return of bonuses and other incentives that were paid based on misstated financial results. Under Section 304 of SOX, if an issuer “is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws,” the CEO and the CFO shall reimburse the issuer for all incentive-based compensation earned during the 12-month period following the public release of financial information. In 2010, the SEC became more aggressive in its use of Section 304, for the first time pursuing a case in which the CEO had never been accused of wrongdoing. Although four top executives of CSK Auto Corporation had been charged by the SEC with securities law violations in connection with restatements in 2004 and 2007, the CEO never was. There is no private right of action under Section 304 of SOX.

Following the adoption of SOX, a number of companies have adopted some form of clawback policy (the prevalence of these policies appears to be higher among larger companies). However, those policies often leave significant discretion in the hands of the board of directors as to whether or not to pursue a recovery of funds.

The Dodd-Frank Act adds new Section 10D to the Exchange Act, which extends clawback well beyond Section 304 of SOX or most existing corporate policies. Under Section 10D, if an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer “will” recover, from any current or former executive officer who received incentive-based compensation during the three years preceding the date on which the issuer is required to prepare the restatement, the excess compensation received over what would have been paid under the restated financials. Failure to do so will result in delisting.

Although the SEC has yet to propose rules required to implement Section 10D, the differences it appears to present are several. Unlike SOX 304, Section 10D appears to impose strict liability; it has no reference to “misconduct.” Section 10D covers all current *and former* executive officers, not just the CEO and the CFO. The relevant period is three years, rather than 12 months (though it is not clear how the three years is to be measured). Finally, unlike many corporate policies, Section 10D appears to be mandatory, not discretionary, regardless of the executive’s personal circumstances or role in the improper accounting.

From time to time, questions have been raised in the insurance trade press about whether certain insurers were managing their earnings by overreserving in good years and releasing reserves to improve their reported results in bad years. Use of reinsurance has been another means by which some commentators have believed financial statements to be artfully buffed up. Restatements relating to these types of matters have been relatively uncommon. However, to the extent that any company is engaged in these types of maneuvers, new Section 10D, when finally implemented, will raise the stakes involved.

F. Trends in Shareholder Activism

Somewhat surprisingly, the overall level of shareholder activism in 2010 declined as compared to 2009. According to information compiled by Georgeson (with respect to the members of the S&P 1500 Supercomposite Index), the total number of corporate governance proposals voted on declined from 371 to 342, or 8%; the number of directors receiving a “withhold” vote of 15% or more declined from 1,027 to 748, or 27%; and the number of U.S. proxy fights (where the dissidents distributed a separate proxy card) declined from 57 to 36, or 37%. The reasons for these declines have been variously cited as the continuing adoption by companies of changes commonly requested by activists, such as majority voting for directors and say-on-pay votes, the improved share prices of many companies in 2009 and in the beginning of 2010 and losses by dissidents in some high profile proxy contexts in recent years.

According to Georgeson, the most common shareholder proposals in 2010 were again those related in one way or another to executive compensation. The substantial majority of these proposals involved say-on-pay or minimum holding periods for management equity. The next most common were board-related proposals, principally requests to separate the roles of the CEO and the Chairman, institute majority voting for directors, repeal classified boards and institute cumulative voting. Other notable categories include proposals addressing shareholders’ rights to call a special meeting or to act by written consent, and the elimination of supermajority charter and by-law provisions. It is worth noting that, other than proposals to implement majority voting, repeal classified boards, eliminate supermajority provisions and permit action by written consent, which generally do obtain a majority of the shares voting, most other types of proposals do not receive a majority of the vote.

II. Developments in Corporate Governance, Public Company Regulation and Shareholder Activism (cont'd)

The reduction in withhold votes for directors was surprising, in part, given that 2010 was the first year in which broker non-votes could not be included in vote totals for director nominees. Although this NYSE rule change had a meaningful effect on vote totals, it did not offset the other factors that drove the overall reduction in withhold votes.

On the proxy fight/M&A front, institutional stockholders continued to assess proposals carefully. For example, Barnes & Noble stockholders rejected the three directors proposed by insurgent Ronald Burkle. This outcome occurred notwithstanding ISS's recommendation in favor of the Burkle-led slate. Other notable announced or possible M&A deals were held up by stockholder resistance in 2010, such as Prudential PLC's proposed acquisition of AIA from AIG, which fell through due to lack of support from Prudential PLC's stockholders. In addition, in a number of publicized situations, including some possible management-led buyouts, deals fell through when hedge funds or PE funds decided the timing or proposed price was inadequate.

Looking ahead, it seems probable that activist activity will be lower yet again in the 2011 proxy season. The reforms under the Dodd-Frank Act, the continued improvements in share prices in 2010 and the continued movement by companies to adhere to the guidelines of ISS and other

proxy advisory firms appear likely to hold down activist proposals to some extent. It seems unlikely, however, that this reduction will be a long-term trend; absent some draconian regulation of the proxy advisory firms resulting from the SEC's proxy plumbing initiative, it seems likely their voices will only grow stronger as time goes by.

G. Other Changes

Although a full discussion would require more space than is available here, other developments in 2010 worth noting include:

- The SEC's proposed new "whistleblower" rules under Section 922 of the Dodd-Frank Act (discussed in "III. Public Company Regulatory and Disclosure Developments, A. Significant SEC Rulemaking, 3. Whistleblower Bounty Provisions" on page 13);
- The elimination of broker non-votes in director elections and in the approval of compensation plans; and
- Requirements applicable to financial institutions within the meaning of the Dodd-Frank Act, principally the establishment of a risk committee.

Our prior client alerts cover all of these topics. A full list of our client alerts can be found at www.dl.com.

III. Public Company Regulatory and Disclosure Developments

A. Significant SEC Rulemaking

The SEC engaged in extensive rulemaking in 2010 that affects all publicly held companies, including insurance and reinsurance companies.

1. Short-Term Borrowings Disclosure

In September 2010, the SEC (i) issued interpretative guidance on the presentation of liquidity and capital resources disclosures in the management's discussion and analysis of financial condition and results of operation (MD&A) and (ii) proposed rules that would require companies to provide, in a separately captioned subsection of the MD&A, a comprehensive explanation of their short-term borrowings, including both quantitative and qualitative information. The guidance and proposed rules seek to address some companies' practice to reduce their debt shortly before the end of a reporting period, a practice referred to as balance sheet "window dressing."

Interpretative Guidance

The interpretative guidance, which became effective on September 28, 2010, addresses companies' obligations under existing MD&A requirements.

In the guidance, the SEC specifies additional issues management should consider in identifying trends, demands, commitments, events and uncertainties affecting liquidity that may need to be disclosed in the MD&A, namely:

- difficulties in accessing the debt markets;
- reliance on commercial paper or other short-term financing arrangements;
- maturity mismatches between borrowing sources and the assets funded by those sources;
- changes in terms requested by counterparties;
- changes in the valuation of collateral; and
- counterparty risk.

The SEC explained that additional narrative disclosure may be required in the MD&A if a company's financial statements do not adequately convey the company's financing arrangements or their impact on liquidity. For example, under certain circumstances, a company may be required under existing MD&A rules to disclose intra-period variations in borrowings if the amounts of borrowings during the reporting period are materially different from the period-end amounts recorded in the financial statements. The guidance also clarifies that disclosure about repurchase agreements, securities lending or similar transactions may be required where such a transaction will result in (or is reasonably likely to result in) a material increase or decrease in the company's liquidity, particularly if the transaction is not otherwise disclosed as an off-balance sheet transaction or in the contractual obligations table.

The guidance states that companies, in particular banks, consider describing in the MD&A their cash management and risk management policies that are relevant to an assessment of their financial condition.

Disclosure of capital or leverage ratios that are non-GAAP financial measures must follow the SEC's rules and guidance on the inclusion of non-GAAP financial measures in SEC filings. In addition, any ratio or measure included in an SEC filing should be accompanied by a clear explanation of the calculation methodology and the reasons why including the measure is useful to an understanding of the company's financial condition.

Finally, the guidance reminds companies that the purpose of the contractual obligations table in the MD&A is to present a meaningful snapshot of cash requirements arising from contractual payment obligations. Companies should resolve any uncertainties about what to include in the table or how to allocate amounts over different periods with that purpose in mind. The guidance also recommends that companies highlight any changes in

III. Public Company Regulatory and Disclosure Developments (cont'd)

presentation that are made in the table and to include additional disclosure in footnotes if necessary to explain what the tabular data include and do not include.

Proposed Rules

The proposed rules, if adopted, would require quantitative and qualitative disclosures about a company's short-term borrowings in order to provide information to investors about a company's funding needs and financing activities.

Short-term borrowings would be defined to include amounts payable for short-term obligations that are:

- federal funds purchased and securities sold under repurchase agreements;
- commercial paper;
- borrowings from banks;
- borrowings from factors or other financial institutions; and
- any other short-term borrowings reflected on the company's balance sheet.

Quantitative information about short-term borrowings would be required in tabular form in a new section of the MD&A, including, for each type of short-term borrowing, information on:

- the amount outstanding at the end of the reporting period and the weighted average interests rate on those borrowings;
- the average amount outstanding during the period and the weighted average interest rate on those borrowings; and
- the maximum amount outstanding during the period.

The rules would distinguish between financial companies and other companies. The term "financial company" would be defined to include an entity that is (or is a holding company of) a bank, a savings association, an insurance company, a broker or dealer, a business development company, an investment adviser, a futures

commission merchant, a commodity trading advisor, a commodity pool operator or a mortgage real estate investment trust. Financial companies would be required to calculate the average amount of short-term borrowings outstanding on a daily average basis and to disclose the maximum amount outstanding on any day in the period. Non-financial companies would be permitted to calculate averages using an averaging period not to exceed one month and to disclose the maximum month-end amount during the period.

The following qualitative disclosures about short-term borrowings would be required:

- a general description of the short-term borrowing arrangements included in each category and the business purpose of those arrangements;
- the importance to the company of its short-term borrowing arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits;
- the reasons for the maximum reported level for the reporting period; and
- the reasons for any material differences between average short-term borrowings and period-end short-term borrowings.

For domestic companies, the new disclosure would be required for both annual and interim periods. The proposed disclosure about short-term borrowings is similar to the annual disclosure currently required by bank holding companies under Industry Guide 3, Statistical Disclosure by Bank Holding Companies.

Finally, the proposing release also seeks comment on whether the SEC should extend to all reporting companies leverage ratio disclosure requirements currently applicable only to bank holding companies.

2. Say-on-Pay

The SEC issued proposed rules on the “say-on-pay” requirements of the Dodd-Frank Act, which are discussed in “II. Developments in Corporate Governance, Public Company Regulation and Shareholder Activism, C. ‘Say-on-Pay’” on page 7.

3. Whistleblower Bounty Provisions

On November 3, 2010, the SEC proposed a new whistleblower rule. The rule is intended to provide a framework for the payment by the SEC of substantial awards to whistleblowers in connection with enforcement actions. To be eligible for an award, a whistleblower must voluntarily provide the SEC with original information leading to the successful enforcement by the SEC of an action in which it obtains sanctions totaling more than one million dollars. Whistleblowers that provide such information in compliance with the rule are eligible to receive an award of 10 to 30 percent of any monetary sanctions collected in connection with the SEC enforcement action, or with a related action, as defined by the rule.

B. SEC Disclosure Comments

The SEC staff has continued its policy of reviewing Exchange Act periodic reports on an ongoing basis. This review is focused on the financial statements and footnotes and the disclosure surrounding MD&A, but covers the entirety of the periodic reports. Set forth below is a summary of the key disclosure “hot topics” for the insurance industry that were raised by the SEC in 2010.

1. Repurchase Agreements and Securities Lending Transactions

In March 2010, the SEC issued a letter to certain registrants asking for information on the accounting for repurchase agreements, securities lending transactions or other transactions involving the transfer of financial

assets with an obligation to repurchase the transferred assets. In the letter, the SEC asked the recipients whether they accounted for any of their repurchase agreements as sales for accounting purposes in their financial statements. For those registrants who answered in the affirmative, the SEC requested, among other things, information regarding the quantity of repurchase agreements entered into, including the average quarterly balance of such agreements, a detailed analysis supporting the use of sales accounting for the repurchase agreements and a description of the business reasons for structuring the repurchase agreements as sales transactions versus collateralized financings. In addition, the SEC asked each registrant whether it had any securities lending transactions that it accounted for as sales pursuant to the guidance in ASC 860-10.

In May 2010, James L. Kroeker, the SEC’s chief accountant, stated in testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services that no information came to the attention of the SEC based on the request letters that would lead the SEC to conclude that inappropriate practices with respect to the accounting for repurchase agreements and securities lending transactions were widespread. However, the SEC asked several companies to enhance their disclosure about their accounting for such transactions and to expand their discussions of off-balance sheet arrangements. In addition, in September 2010, the SEC issued an interpretive release on liquidity and capital resources. The SEC also has proposed amendments to the disclosure rules to enhance the disclosure that registrants present about short-term borrowings. See “III. Public Company Regulatory and Disclosure Developments, A. Significant SEC Rulemaking, 1. Short-Term Borrowings Disclosure” on page 11.

III. Public Company Regulatory and Disclosure Developments (cont'd)

2. Investment Disclosure

Another frequent comment from the SEC staff in 2010 related to the specificity of disclosure in the investments footnote included in the company's financial statements. The SEC staff focused on the adequacy of disclosure regarding how a company determines whether impairments are temporary or other than temporary. While the staff acknowledged a company's intent to hold such securities until their prices recover, they asked for additional information on the extent of the decline in value and when the company expects the prices to recover. In addition, the SEC noted that a number of registrants did not appear to comply fully with note 6 to Rule 7-03(a) (1) of Regulation S-X, which requires disclosure of the name and aggregate amount invested in each person and its affiliates that exceeds 10% of a company's total stockholders' equity.

3. Executive Compensation

In 2010, the SEC staff continued to focus on disclosure regarding executive compensation. The comments were focused on enhanced disclosure of the metrics used to determine performance-based awards, including how such metrics were chosen. For those companies that did not disclose such information, the SEC asked the company to supplementally provide such information and to specifically describe how the disclosure of such information would provide competitors with information that would allow them to gain an unfair competitive advantage versus the registrant. Absent such competitive disadvantage, the staff requires that detailed disclosure be provided regarding such metrics.

4. Filing of Exhibits

The SEC staff also has been focused on compliance with Item 601(b)(10) of Regulation S-K, which requires that all material contracts be filed as exhibits to a registrant's Exchange Act periodic reports. The SEC staff asked registrants to either (i) file the material agreements in their entirety as exhibits or (ii) provide reasons why they believed the agreement did not need to be filed. In addition, with respect to the filing of material contracts as exhibits, the SEC staff stated that companies are required to file the entire agreement, including all exhibits, schedule appendices and any documents which are incorporated in the contract. The staff further stated that the sole ground for omitting portions of the schedules or exhibits was pursuant to a confidential treatment request consistent with Rule 24b-2 of the Exchange Act.

C. Regulation FD Enforcement Actions

The SEC brought several enforcement actions in 2010 for violations of Regulation FD.

In October 2010, the SEC announced that it had settled Regulation FD charges against Office Depot, its CEO and its former CFO. According to the complaint, Office Depot and the two executives violated Regulation FD by selectively disclosing to analysts that Office Depot would not meet analysts' quarterly earnings estimates. Significantly, Office Depot did not directly communicate to the analysts that it would not meet earnings expectations. Rather, the message was "signaled" by using references to recent public statements of comparable companies about the impact of the slowing economy on their earnings. The analysts immediately lowered their estimates and Office Depot's stock price dropped 7.7%. Office Depot filed a Form 8-K six days after the calls to analysts began and disclosed that its earnings would be

“negatively impacted due to continued soft economic conditions.” Office Depot agreed to pay a \$1 million penalty and the CEO and former CFO each agreed to pay \$50,000 to settle the case.

In March 2010, the SEC announced the settlement of an enforcement action against Presstek, Inc. for violations of Regulation FD. The SEC alleged that Presstek’s former CEO had selectively disclosed negative material non-public information regarding Presstek’s financial performance during the third quarter of 2006 to the managing partner of a registered investment advisor. The investment advisor immediately sold all of the shares of Presstek stock held by investment funds it managed. Presstek’s stock price dropped 19% that day. At about 12:01 a.m. the next day, Presstek announced that its financial performance was below its prior estimates for the third quarter. Presstek agreed to pay \$400,000 to settle the case. In agreeing to the settlement, the SEC took into account certain remedial measures subsequently taken by Presstek, including (i) revisions to Presstek’s corporate communications policy and corporate governance principles, (ii) the replacement of Presstek’s management team and the appointment of new independent board members and (iii) the creation of a whistleblower hotline.

D. Disclosure About Certain Loss Contingencies

In July 2010, the Financial Accounting Standards Board (FASB) published a new exposure draft with proposed amendments to the disclosure requirements applicable to certain loss contingencies contained in FASB’s Accounting Standards Codification Subtopic 450-20 (formerly included in Statement of Financial Accounting Standards No. 5, Accounting for Contingencies). The new proposal was significantly scaled back from the FASB’s initial proposal in 2008, which was strongly criticized by public companies, auditors and the legal community.

The new proposal again generated a flurry of significant negative comments. In October 2010, the FASB decided that it needed more time to analyze the comments and determined that the proposed amendments, if eventually adopted by the FASB, would not be effective for the 2010 calendar year-end reporting period. It remains to be seen what further actions, if any, the FASB will take on the proposed amendments.

In a related development, the SEC staff emphasized during the year that it continues to focus on loss contingency disclosures and companies’ compliance with the existing disclosure requirements, in particular the requirement to disclose, if significant, the amount or range of reasonably possible losses in excess of the accrual.

E. *Morrison v. National Australia Bank Ltd.*

In *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), the Supreme Court considered and limited the extraterritorial reach of the key antifraud provisions of the Exchange Act. The Morrison Court specifically rejected the conduct and effects tests previously used by most federal appellate courts to evaluate the application of antifraud provisions to securities transactions outside of the United States. Instead, the Court concluded that §10(b) of the Exchange Act, and SEC Rule 10b-5, applied “only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.” Shortly after the Morrison decision, the Dodd-Frank Act reversed Morrison in part and restored the extraterritorial effect of the securities laws in fraud-based enforcement actions brought by the SEC, or the United States, subject to a statutorily codified version of the conduct and effects test. The Dodd-Frank Act did not alter the applicability of Morrison to fraud-based private actions, but did direct the SEC to study the potential impact of applying the conduct and effects test to private actions.

III. Public Company Regulatory and Disclosure Developments (cont'd)

F. Other Developments

In 2010, there were a number of additional important developments that affect or will soon affect public insurance companies. A full discussion would require more space than is available here, but we have addressed these topics separately in client alerts referenced below. These topics include:

- Dodd-Frank Act compensation and corporate governance requirements, including:
 - Independence of compensation committee and its advisors,
 - Pay vs. performance and internal pay equity disclosure,
 - Disclosure about employee hedging,
 - Disclosure regarding chairman and CEO structures,
 - Compensation clawbacks,
 - Covered financial institution board risk committees and compensation arrangements, and
 - Beneficial ownership reporting,¹

- Amendments to NYSE Rule 452, eliminating broker non-votes in the election of directors and on executive compensation matters,²
- The SEC's concept release on the U.S. proxy system,³ and
- The repeal of the exemption for rating agency consents in Securities Act Rule 436(g) by the Dodd-Frank Act.⁴

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¹ For more information about the Dodd-Frank Act compensation and corporate governance provision, see Dewey & LeBoeuf client alert "Dodd-Frank Act: Executive Compensation and Corporate Governance Provisions" of July 19, 2010, available at www.dl.com.

² For more information, see Dewey & LeBoeuf client alert "Dodd-Frank Act: Executive Compensation and Corporate Governance Provisions" of July 19, 2010, available at www.dl.com.

³ For more information, see Dewey & LeBoeuf client alert "SEC Issues 'Proxy Plumbing' Concept Release to Seek Comment on the U.S. Proxy Voting System" of July 27, 2010, available at www.dl.com.

⁴ For more information, see Dewey & LeBoeuf client alert "Coping with the Repeal of Rule 436(g): Staff Provides Guidance and No-Action Relief Regarding Inclusion of Credit Ratings in Offering Materials" of July 22, 2010, available at www.dl.com.

IV. Developments in Insurance Capital Markets

Insurance company security issuances in 2010 were up from 2009, with the life insurance industry alone raising \$15 billion in 2010, an 18% increase compared to 2009. Unsurprisingly, the majority were debt offerings (74%), then funding agreement-backed notes (20%), surplus notes (5%) and capital securities (1%). The life insurance industry was the most active in the capital markets (54%), followed by property and casualty (37%), reinsurance (5%) and brokerage (4%).

A. Equity

1. IPOs

The year was a quiet one in terms of insurance industry initial public offerings, particularly as concerns grew in the latter part of the year that the economic recovery from the longest recession since the Great Depression was slowing.

However, a few insurance IPOs involving holdings of large investors came to the market during the year. Notable transactions included Citigroup's \$320 million spin-off of Primerica in March, which involved a concurrent private sale of stock and warrants to Warburg Pincus. The offering was a success, with more stock being sold than originally expected and at a higher price than targeted. In January, Symetra, a financial services company in the life insurance industry focusing on selected group health, retirement, life insurance and employee benefits markets, completed a \$364 million IPO. Symetra had been preparing an IPO for some time, but due to unfavorable market conditions, had been kept out of the market. As a vote of confidence in the long-term view of the business, White Mountains and Berkshire Hathaway each retained over 20% of the public company following the offering.

In May, Liberty Mutual commenced the registration process for the anticipated \$1.3 billion IPO of common stock of Liberty Mutual Agency Corp. However, as the year went on and investors' enthusiasm with the rate of

economic recovery started to recede, the choppy market caused demand for the offering to be less than expected and in September it was put on hold.

Finally, in the fourth quarter, Fortegra completed its \$66 million IPO. Fortegra provides distribution and administration services and insurance-related products to insurance industry participants. IPO issuances in the U.S. in late December were marked by heavy volume and weaker pricing on the whole, as companies struggled to finish deals before the winter hiatus. Despite the absence of an accommodative market, Fortegra was ultimately able to successfully execute the transaction.

In November, ING informed the European Commission that it intends to take both its U.S. and European insurance subsidiaries public in the next couple of years. This separation of its insurance and banking units was a condition of the \$13.8 billion government bailout ING received in 2008 from the Dutch government.

2. Other Equity Offerings

The beginning and middle of 2010 saw more activity in the equity markets, with a number of insurance companies taking the opportunity to raise capital, as the continued improvement in the economy bred more confidence.

In August, in one of the largest common stock offerings by a non-TARP recipient since the onset of the global financial crisis, MetLife raised approximately \$3.6 billion from the public offering of 86.25 million shares. This transaction was part of the acquisition financing for MetLife's \$16.2 billion acquisition of ALICO from AIG, which closed in the fourth quarter.

Other notable equity deals in 2010 include a \$1.0 billion common stock offering by Prudential Financial in November and a \$335 million common stock offering by Lincoln National in June.

IV. Developments in Insurance

Capital Markets (cont'd)

In addition, the year witnessed several large equity offerings by mortgage insurers. Since 2007, as a result of the decline in housing prices and the related recession, the private mortgage insurance industry has endured a sustained period of turmoil, with increased levels of delinquencies and claims, the financial difficulties of Freddie Mac and Fannie Mae and the significantly increased competitive position of the Federal Housing Administration. Throughout 2009, mortgage insurers' ability to raise capital in the public markets was restricted due to concerns stemming from the continued ill-health of the housing sector. However, in the second quarter of 2010, several of the major players in the industry were able to execute successful capital markets transactions. First, MGIC completed a \$699 million offering of common stock, closely followed by a \$478 million offering by PMI and a \$550 million offering by Radian Group.

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As the economic recovery continued to gain momentum in 2010, the Department of the Treasury took the opportunity to sell off the remaining \$713 million warrant position it held in The Hartford and the \$216 million warrant position it held in Lincoln National, ending the financial connection between the two insurers and the federal government that began with the grant of aid under TARP. Although six insurance companies received initial approvals to participate in TARP's Capital Purchase Program under the Emergency Economic Stabilization Act, these two companies were the only insurers to seek those funds; The Hartford received \$3.4 billion and Lincoln National received \$950 million. The Hartford and Lincoln National had already repurchased the preferred stock they had exchanged for the injections of capital during the financial crisis.

AIG is the only remaining insurer still financially tied to the federal government; however, it too has been conducting extensive sales of assets to reduce its debt, including through capital markets transactions. In the first quarter AIG completed a \$451 million disposition of part of its holding of Transatlantic. In the aftermath of the break-up of the \$35.5 billion sale of AIA to Prudential PLC, in the third quarter, AIG completed a \$20.5 billion IPO of AIA, following which it retained an approximately 33% holding of the company. Under the terms of an agreement with the underwriters in the offering, AIG is precluded from selling any of its remaining shares of AIA until late 2011 and more than half of its remaining shares of AIA until April 2012.

B. Debt Capital Markets

Insurance debt capital markets were quite busy in 2010. Some of the offerings were conducted to raise funds for pending acquisitions or XXX financings. In addition, many insurance companies took advantage of a particularly low market interest rate environment to refinance maturing debt and to raise capital for the medium- to long-term. Interestingly, the 10-year maturity was the most popular (42%), followed by 5-year (33%), but with a significant amount of 30-year paper being issued (25%), perhaps to lock in those historically low rates.

1. Note Offerings

As part of the ALICO acquisition financing, in August MetLife executed a four-tranche offering of fixed and floating rate senior notes with maturities of between 3 and 30 years that netted the company \$3.0 billion of proceeds.

A number of other insurers completed debt offerings during the year in a mixture of registered transactions and private placements, including Aflac (\$750 million),

AIG (\$2.0 billion), Aon (\$1.5 billion), Aspen (\$250 million), Endurance (\$85 million), Genworth (\$800 million), Ironshore (\$250 million), Manulife (\$1.1 billion), Ohio National (\$300 million), Prudential Financial (\$2.3 billion), RenRe (\$250 million), Travelers (\$1.3 billion) and WR Berkley (\$300 million).

In December, CNO Financial (formerly Consec) issued \$275 million of senior secured notes in a Rule 144A/Regulation S offering, the proceeds of which were used, along with an immediate \$375 million drawdown under the company's new senior secured credit facility, to pay down all of the outstanding borrowings under its prior credit agreement. This debt restructuring allowed CNO Financial to renegotiate several of the restrictive covenants it was subject to under the prior agreement in order to ensure that the new terms more properly reflected the continuing improvement to the health of the company.

The convertible notes market saw significant activity and several of the main players in the mortgage insurance industry were active in issuing these securities. These issuers tied their equity offerings in the second quarter of 2010 to concurrent sales of convertible notes, \$300 million in the case of MGIC and \$261 million in the case of PMI. Radian, which had also benefited from a second quarter equity raise, approached the market again in the fourth quarter with a \$400 million convertible note offering.

2. Surplus Notes

The surplus note market continued to be active in 2010. Following the 2009 surplus note issuances by several companies, including Guardian (\$400 million), National Life (\$200 million), Nationwide (\$700 million), New York Life (\$1.0 billion) and, right at the close, the \$2.0 billion surplus note offering by TIAA-CREF, the start of 2010 witnessed a \$1.75 billion issuance by Northwestern Mutual, the first issuance of securities in that company's

153 year history, and the rest of the year included Penn Mutual's \$200 million offering of Surplus Notes in June and a \$300 million offering by Mutual of Omaha in October.

3. Developments in the Hybrid Securities Market

In July 2010, Moody's published the long-awaited changes to its Hybrid Toolkit, which were prompted by the performance of hybrid securities in the financial crisis. Moody's concluded that many of the features of these securities that had been designed to enhance their loss absorption characteristics did not prove as effective as previously thought.

Under the revised Toolkit, Moody's basket system has remained intact, but the new classification system is based on the benefits a hybrid security can offer for a going concern and those for an entity in which a company-wide default is imminent (a "gone" concern). For example, a non-cumulative preferred security may absorb losses for a going concern, and is, therefore, eligible for Basket D treatment (75% equity credit), but a cumulative preferred security, which may absorb losses for a "gone" concern, is eligible for Basket C treatment (50% equity credit), at best. Subordinated debt is now only eligible for Basket B treatment, while in the past it may have been eligible for Basket C or, depending on the other features of the securities, even Basket D.

Under the new Toolkit, Moody's defines preferred securities as those that (i) are deeply subordinated securities and generally the most junior instrument in an issuer's capital structure, (ii) cannot default or cross default other than at maturity, if the hybrid is dated and (iii) have limited ability to influence the outcome of a bankruptcy proceeding or a restructuring outside bankruptcy. If these thresholds are not met, Moody's will treat the hybrid security as subordinated debt, regardless of its designation.

IV. Developments in Insurance Capital Markets (cont'd)

On a going forward basis, Moody's will no longer be as concentrated on replacement language in their analysis, and instead they will factor the timing of the hybrid security's likely redemption, the intended replacement security and the available equity cushion into the overall credit analysis of the issuer. In general, alternative payment mechanisms (under which issuers are required to settle any deferred coupons through the issuance of common stock or certain types of preferred securities) will now be viewed as cumulative rather than non-cumulative in Moody's analysis. The same general framework will now apply to both non-convertible and convertible hybrid securities.

While, at present, S&P has not modified any of its hybrid rating or classification criteria, it is currently seeking comment on proposed new criteria relating to the equity content classification of certain bank hybrid capital instruments and, although this is not currently planned to extend to insurance companies, it may provide an indication of what direction S&P may move in the future.

In response to these changes and ongoing capital retention concerns, in 2010 issuers actively investigated potential restructurings, repurchases or redemptions of their outstanding hybrid securities. One of the limiting factors in companies' ability to repurchase or redeem their outstanding hybrid securities is that so many of them are subject to replacement capital covenants (RCCs), pursuant to which the issuer promises to the holders of a series of its outstanding senior notes that it will repurchase or redeem its hybrid securities using only the applicable percentage of proceeds from new issuances of equity or hybrid instruments. As new issuances of equity or hybrid securities often are not attractive to issuers, most of the time repurchases of hybrid securities are coupled with a consent solicitation to the senior noteholders to amend or terminate the existing RCCs and remove the limitations on replacement securities.

In June, Progressive completed a tender offer for approximately 35% of a series of its hybrid securities, which was conditioned on the success of a consent solicitation of the holders of the covered debt under the replacement capital covenant that was entered into in connection with the issuance of the hybrid securities. The company terminated the replacement capital covenant, thereby removing the restrictions that the covenant placed on it in the ability to raise additional capital to repurchase the remaining hybrid securities.

In November, Travelers completed a tender offer and consent solicitation for any and all of a series of its hybrid securities, which resulted in almost 90% of those securities being tendered by investors. Travelers combined the tender offer with a related RCC consent solicitation. The funding for these transactions was generated by concurrent offerings of senior notes with a lower coupon.

This looks like a trend that will continue in 2011, as other issuers seek to re-adjust their capital structure following the loss of high equity credit for their outstanding hybrid securities.

4. Funding Agreement-Backed Securities

In 2010, the market for funding agreement-backed notes regained traction from the decrease in activity witnessed in 2009, but remained well below the levels seen between 2003 and 2008. According to data published by S&P, \$9.3 billion of funding-agreement-backed notes rated by S&P were issued by the end of the third quarter of 2010, \$3.4 billion more than S&P rated for the same period in 2009.

Funding agreement-backed notes are issued in a series of private placement transactions in reliance on Rule 144A and Regulation S under the Securities Act, by SPVs that use the proceeds of the offerings to acquire a similar term funding agreement issued by an insurance company. The

SPV issuer immediately assigns the funding agreement to the indenture trustee to secure the performance of the issuer's obligations under the notes. The credit quality of the notes is based on the ability of the insurance company to satisfy its obligations under the funding agreement.

Since 2008, certain companies have exited the funding agreement-related spread business completely, with no new entrants coming forward to take their place. Since

the beginning of 2009, four companies accounted for all new funding agreement-backed note issuances: MassMutual, MetLife, New York Life and Prudential Financial. In 2010, three players dominated the market: MassMutual (\$1.3 billion), MetLife (\$6.0 billion) and New York Life (\$2.9 billion).

V. Developments in the ILS Market

Return to Normalcy

The catastrophe bond market froze for a few months in 2008 following the collapse of Lehman Brothers, which acted as collateral counterparty for several then outstanding bonds. However, the market gained much needed momentum in 2009 with the development of enhanced collateral arrangement technology, such as triparty repurchase agreements and money market fund structures. Building on that progress, the recovery was in full swing in 2010 with over \$5 billion in aggregate principal amount of new issuances. Below is a summary of some notable developments in the insurance-linked securities (ILS) market in 2010 from a legal perspective.

A. Regulatory Developments

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In the wake of the global financial crisis, the SEC has proposed and adopted various new regulations that impact the issuance of ILS. In particular, in 2010 the SEC (i) enacted Rule 17g-5 under the Exchange Act, which regulates the provision of information to nationally recognized statistical rating organizations (NRSROs) in the context of structured finance transactions, and (ii) proposed changes to Regulation AB, which could create enhanced disclosure and other requirements for structured finance products issued pursuant to Rule 144A under the Securities Act of 1933 (Securities Act). In addition, it is possible that the SEC could propose additional regulations (or revise existing proposals) in light of the Dodd-Frank Act, which was signed into law in July 2010.

1. Rule 17g-5

Rule 17g-5 requires each hired NRSRO to obtain a representation from the issuer, sponsor or underwriter of a structured finance product that it will (i) maintain a password-protected website that permits access by non-hired NRSROs and (ii) post on such website all

information provided to the hired NRSRO for the purpose of determining the initial credit rating of such security at the same time such information is provided to the hired NRSRO. The purpose of the new requirements is to enable non-hired NRSROs to rate structured finance products in order to mitigate any inherent conflict of interest that hired NRSROs have by virtue of being paid a rating fee.

Since Rule 17g-5 went into effect in June 2010, the rating agencies have typically required ILS issuers (including issuers of catastrophe bonds and similar securities) to represent in their engagement letters that the issuer will perform all actions necessary for Rule 17g-5 compliance. In order to meet these new obligations, many issuers have implemented a Rule 17g-5 protocol at the start of the transaction process. Pursuant to such protocol, the issuer typically establishes and maintains a separate Rule 17g-5 website on Intralinks for the rating agencies (similar to the websites that have been used to provide information to investors). In addition, the transaction parties have generally not communicated directly with hired NRSROs, but instead have posted any communications (including presentations, draft documents and answers to questions) on the Rule 17g-5 website. While the Rule 17g-5 protocol has added an extra wrinkle in the documentation process, we believe that such protocol is becoming routine and will not add a material amount of time and effort to the execution of a transaction.

2. Regulation AB

In April 2010, the SEC proposed significant changes to its rules regulating the offer and sale of asset-backed securities. In particular, the SEC proposed creating an enhanced disclosure regime for “structured finance products” offered under Rule 144A. For a structured finance product to be eligible for resale under Rule 144A, the proposal would require that “an underlying transaction agreement grant any initial purchaser, any

security holder or any prospective purchaser designated by a security holder the right to obtain from the issuer promptly, upon the request of the purchaser or security holder, information as would be required if the offering were registered on Form S-1 or Form SF-1 under the Securities Act and any ongoing information regarding the securities that would be required by Section 15(d) of the Exchange Act if the issuer were required to file reports under that section.”

Although comments provided by prominent organizations have discussed the negative impact that such disclosure requirements would have on the markets for privately-issued structured finance products, it is difficult to predict whether and to what extent the SEC will enact this aspect of its proposal, including the scope of its applicability. If applicable, the new disclosure regime for Rule 144A offerings could add significant transaction costs for ILS issuances and may require sponsors to provide enhanced disclosure about themselves (for instance, if the SEC classifies the sponsor as a “significant obligor” of the SPV issuer).

As currently written, the SEC’s new disclosure requirements would apply to “structured finance products,” which would be of broader application than the current definition of “asset-backed securities,” and includes a catch-all provision that covers “a security that at the time of the offering is commonly known as an asset-backed security or a structured finance product.” The catch-all suggests that the SEC is trying to use the broadest possible definition. Although there are strong arguments that could be made to distinguish ILS from more traditional structured finance products, more guidance is needed from the SEC to ascertain how wide of a net it intends to cast.

B. Developments in Transaction Structure

1. Collateral Arrangements

In 2010, collateral arrangements for U.S. dollar denominated catastrophe bond offerings have trended toward two main solutions: (i) investing the proceeds from issuance in U.S. Treasury-backed money market funds and eliminating the LIBOR component of interest to investors and (ii) utilizing a triparty repurchase agreement accompanied by daily margining of assets.

On the one hand, investing in money market funds is the simpler of the two structures. For investors with an insurance background, or those with a new-found aversion to overly structured products, money market funds eliminate many of the complexities found in the total return swap or triparty repurchase agreement structures. Money market fund investments can be very attractive for catastrophe bonds as an asset class because they showcase the catastrophe risk nature of the security, which is not necessarily correlative to market events.

On the other hand, because of the low investment yield generated by U.S. Treasury-backed money market funds, investors in these transactions will not receive an interest rate that is pegged to LIBOR. Some investors may price this lower yield into the interest spread component of the security, which will increase the cost to the sponsor. The principal advantage of the triparty repurchase agreement structure is that it enables the issuer to fund a LIBOR component of interest. In addition, unlike the older total return swap technology, transactions that utilize triparty repurchase agreements employ daily margining of assets and eliminate certain categories of securities (such as mortgage-backed securities, CDOs and securities issued by specified sovereigns) from the definition of permitted investments.

V. Developments in the ILS Market (cont'd)

For euro-dominated transactions, the alternatives are similar. Some have employed triparty repurchase agreements, while others have invested bond proceeds in highly liquid conservative assets, paying investors the investment yield earned on such assets. A third option for euro-dominated transactions has been the purchase of a floating rate structured note from quasi-public entities such as The European Bank for Reconstruction and Development or The International Reconstruction and Development Bank.

In the first six months of 2010, nearly all U.S. dollar denominated catastrophe bond offerings used a money market fund collateral structure. However, the triparty repurchase agreement became more prevalent in the fourth quarter of 2010, as at least four transactions employed such a collateral structure to generate LIBOR-linked returns for investors. It will be interesting to see if these alternatives will continue to co-exist in 2011, or if one collateral arrangement will begin to predominate, much like the total return swaps prior to 2009.

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2. Springing Trusts

For U.S. sponsors desiring credit-for-reinsurance treatment, the catastrophe bond market has begun to settle on a “springing trust” mechanic in lieu of depositing bond proceeds in a trust account throughout the life of the transaction. This means that the proceeds of the bond issuance are initially deposited in a collateral account, which is charged or pledged under applicable law to the indenture trustee for the benefit of the cedant and the other relevant transaction parties. If there is a catastrophe event triggering SPV obligations under the reinsurance agreement, assets in the collateral account will be liquidated and transferred to the trust account (for which the cedant is the sole beneficiary) in compliance with applicable credit-for-reinsurance rules. Depending on the needs of the cedant, the “springing trust” mechanic can be set such that all assets are transferred

upon the occurrence of a catastrophe event (e.g., when the first event notice is given) or only to the extent of loss payments owed by the SPV under the reinsurance agreement (i.e., as obligations are owed).

The springing trust mechanic is intended to enhance the collateral bond structure in two primary ways. First, it permits the structure to invest the bond proceeds in highly rated assets that may not necessarily be compliant with applicable credit-for-reinsurance rules, such as securities issued by non-U.S. domiciled issuers. For instance, in the case of a money market fund collateral structure, there may be tax reasons why investors do not want the bond proceeds to be invested in U.S. domiciled funds. In the case of a triparty repurchase agreement, there are often logistical and cost reasons why using a collateral account is more efficient. Second, the springing trust mechanic addresses an investor concern that U.S. cedants can withdraw funds from a trust account even when there has not been a loss on the bond (although the cedant would have to return such withdrawn amounts together with any accrued interest). U.S. cedants would not have this right to the extent that funds are in a collateral account.

C. Loss Trigger Developments

There are several new index options available to sponsors that reduce the loss development period and provide different mitigation techniques for basis risk. Below is a brief summary of two such indices - PERILS and Paradex. As these indices become better known and accepted by investors and sponsors alike, they have the potential to expand the amount of total issuances and to enhance the overall efficiencies of ILS coverage as an alternative to traditional reinsurance.

PERILS is an insurance industry initiative aimed at improving the availability of catastrophe insurance market data. In 2010, total placements of insurance risk transactions based on the PERILS loss index exceeded

\$1 billion. The PERILS Industry Loss Index Service allows the use of PERILS industry loss estimates as triggers in ILS exposed to European windstorm and related perils. The index currently covers Belgium, Denmark, France, Germany, Ireland, Luxembourg, the Netherlands, Switzerland and the United Kingdom. Within each of these countries, loss data are available per CRESTA zone, which allows sponsors to customize the index to better match their underlying policy exposures. The loss index is based on actual insured loss information collected directly from insurance companies writing property business in the covered territories. The PERILS loss index differs from other available industry loss triggers in that it is based on a bottom-up approach, where factual post-event loss information supplied by insurance companies is aggregated by the PERILS system and extrapolated to the industry level. The final loss estimate is generally released 12 months after the event.

Paradex, which is offered by Risk Management Solutions (RMS), is another index that is available for use in catastrophe bonds. Paradex is a parametric loss index that estimates industry insured loss for windstorms in Europe, earthquakes and hurricanes in the United States and earthquakes and typhoons in Japan. Catastrophe bonds structured using Paradex as the trigger are based on hazard parameters, such as hurricane wind speed or earthquake ground shaking. From those parameters, RMS derives industry loss indices by region and line of business. Hazard-to-index lookup tables translate the hazard into index values. All indices can be tailored to specific regions to help minimize basis risk. For all perils, RMS issues an event bulletin within two business days of a catastrophe, and a final index value within four months of an event.

D. Developments in Covered Risks

To date, most catastrophe bonds have been based on property and casualty risks. However, there were two key transactions in 2010 that expanded the catastrophe bond structure to non-P&C risks. In December 2010, Swiss Re announced the completion of the first longevity trend catastrophe bond. The deal transfers \$50 million of longevity trend risk through the Kortis Capital Ltd. securitization program. Kortis provides cover to Swiss Re against a divergence in mortality improvements experienced between two selected populations. The bond is based on population data and would trigger in the event there is a large divergence in the mortality improvements experienced between male lives aged 75-85 in England and Wales and male lives aged 65-75 in the United States. The risk period is measured over an eight-year period.

In June 2010, Swiss Re completed a \$50 million catastrophe bond covering mortality exposure in the United States and the United Kingdom through its Vita Capital IV Ltd. program. The trigger is based on a percentage of expected mortality rates during the four-year risk period. The transactions provide Swiss Re coverage for events that could cause mass mortality, such as pandemics, epidemics, war, nature and man-made catastrophes and terrorist attacks. While Swiss Re has issued several mortality bonds over the past few years, the market for this class of risk is still developing, and there have only been a few such issuances to date.

As an alternative to a catastrophe bond, other companies have entered into mortality risk swaps with financial institutions. One advantage of the swap structure is that the sponsor does not have any of the structuring or underwriting fees that are incurred with a bond structure. The obligations of the counterparty can be collateralized to minimize credit risk.

V. Developments in the ILS Market (cont'd)

E. Developments in Fund Formation

Two regulatory changes affecting sponsors of private funds in general will have an important impact on most sponsors of ILS-focused funds in 2011 and beyond. First, the Dodd-Frank Act has imposed a dramatic increase in the number of private fund sponsors required to register as investment advisers with the SEC. Previously, many sponsors of private funds were able to rely on Section 203(b)(3) of the Investment Advisers Act of 1940, which essentially exempted from registration any adviser who had fewer than 15 clients and did not hold itself out generally to the public as an investment adviser. “Clients” for this purpose reflected the number of funds advised, not the number of investors therein, so many sponsors were able to limit the number of funds they advised to fewer than 15 clients. The Dodd-Frank Act has eliminated this exemption and requires almost all sponsors managing assets equal to or greater than \$150 million to register no later than July 2011. This registration obligation for many sponsors of ILS-focused funds will carry with it significant compliance and filing obligations on an ongoing basis.

The second change, which will not be felt as immediately but will also have a significant impact, was the approval of the Directive on Alternative Investment Fund Managers by the European Parliament in November. This directive will regulate the marketing of any fund by an EU-based manager, and the marketing of interests in any fund to EU residents or interests in any EU-based fund by a non-EU-based manager. While the Directive is technically effective in the first quarter of 2011, it is not required to be actually implemented by the EU member states until January 1, 2013. In the interim, all ILS-focused fund sponsors that are located in the EU, have funds located in the EU or market in the EU will need to review their obligations under the Directive to ensure that they currently are able to comply or begin to take steps to come into compliance before 2013.

VI. Developments in the Swaps and Derivatives Markets

Title VII of the Dodd-Frank Act accomplishes a sweeping reform of the previously largely unregulated derivatives market. Much of the Dodd-Frank Act remains to be implemented by rules to be issued by the Commodity Futures Trading Commission (CFTC) and the SEC (the SEC and the CFTC are each referred to as a Commission or, collectively, as the Commissions). Since enactment of the Dodd-Frank Act on July 21, 2010, the Commissions have issued a series of proposed rules, and while most have not been adopted, they shed light on how the Dodd-Frank Act is likely to be implemented by the Commissions.

The provisions of the Dodd-Frank Act will have a significant impact on all insurance companies, and this summary discusses certain of the major potential effects. It is possible that certain insurance products will be regulated as swaps by the relevant Commission to the exclusion of state insurance commissioners.⁵ Since insurance companies do not qualify for the so-called end-user exemption, insurance companies will be required to clear and trade on an exchange or swap execution facility all swaps that the relevant Commission determines are required to be cleared. The Dodd-Frank Act requires certain swap market participants, whose positions pose a high degree of risk, to register as major swap participants, and certain persons whose activities in connection with a general availability to enter into swaps on their terms to register as swap dealers. Although it is likely that many insurance companies will not be required to register as a major swap participant or swap dealer, it is possible that certain insurance companies will be required to be registered as a major swap participant and/or swap dealer for one or more categories of swaps.

⁵ The Act addresses both “swaps” and “security-based swaps.” Where the provisions relating to the different types of swaps and related actors are similar, we use the terms “swaps,” “swap dealers” and “major swap participants” to refer to both types of swaps and actors.

A. Definition of Swap Potentially Encompasses Insurance Products

Clause (A)(ii) of the definition of “swap” in the Dodd-Frank Act includes any contract that “provides for any purchase, sale, payment, or delivery ... that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.” The language is clearly broad enough to capture many traditional life and property and casualty insurance products, and no exclusion from the definition encompasses such products. The language adopted by the Dodd-Frank Act is not new, and is based on the Gramm-Leach-Bliley Act (GLBA), which intentionally broadly defined swaps because the intent of the definition under the GLBA was to establish a broad exclusion for swaps from the definition of security under the Securities Act and the Exchange Act. This broad definition had little unintended consequence until the enactment of the Dodd-Frank Act, due to the largely unregulated nature of the swap market.

The characterization of a swap as an insurance product now has the effect of bringing regulation of a product characterized as a swap within the exclusive jurisdiction of the relevant Commission because the Dodd-Frank Act provides that if an insurance product is a swap or a security-based swap, the contract may not be regulated as insurance under state law.

The consequences of this definitional (and jurisdictional) issue have been raised with the Commissions in comment letters by the National Association of Insurance Commissioners, the American Council of Life Insurers, the Property Casualty Insurers Association of America and many others. Commentators have argued that the Dodd-Frank Act is ineffective to divest states of jurisdiction over insurance products because the Dodd-Frank Act lacks the specificity required by the McCarran-Ferguson Act,

VI. Developments in the Swaps and Derivatives Markets (cont'd)

which states that “[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance...unless such Act specifically relates to the business of insurance.” Other commentators have argued that nothing in the Congressional debate suggested an intent that the Commissions should have the authority to regulate insurance, and, by way of example, the Federal Insurance Office was not given general supervisory or regulatory authority over insurance.

Several commentators (in certain cases at the urging of the Commission) have suggested tests for determining what contracts should not be characterized as swaps. One commentator suggested the distinction be based on the lack of requirement in swaps of insurable interest or actual loss as a condition of payment -- a distinction that has been the basis on which state insurance regulators have not asserted jurisdiction over credit default swaps. Other commentators have proposed alternative tests, while pointing out the insufficiency of the “actual loss” distinction to take into account a wide swath of insurance products in which payment is not based on actual loss, such as variable life products, long-term care policies and disability policies.

Currently, the question of whether the scope of the definition of swap encompasses insurance products is unresolved.

B. Clearing Requirement

A fundamental change for insurance companies under the Dodd-Frank Act will be the requirement to clear certain swaps through a clearing organization. The Dodd-Frank Act makes it unlawful for any person to engage in a swap if the swap is required to be cleared unless the swap is submitted to a clearing organization. The determination of whether a swap or class of swaps is required to be cleared is to be made by the relevant Commission. Most standardized products, such as rate and credit swaps,

are expected to be required to be cleared. If the swap is required to be cleared, it must also be traded on an exchange or a swap execution facility.

An end-user exemption from the clearing requirement exists for an entity which is not a “financial entity,” uses swaps to hedge commercial risks and notifies the Commission as to how it generally meets its financial obligations under non-cleared swaps. Insurance companies are not eligible for this exemption because the definition of “financial entity” includes entities predominantly engaged in activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act, which definition includes “insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing in any state.”

1. How Clearing Works

Under the Dodd-Frank Act, only a futures commission merchant (FCM) registered with the CFTC is permitted to hold margin for cleared swaps on behalf of a customer; therefore, insurance companies will have to clear through a FCM that is a member of a clearing organization in order to clear through that clearing organization.⁶ Following the futures model, the FCM acts as agent and guarantor on behalf of the customer vis-à-vis the clearing organization. The customer is responsible for performing its obligations under the cleared swap, but if it fails to perform, the FCM is responsible for the customer’s obligations.

The CME Group has developed documentation for the clearing of swaps. Under this documentation, two parties will enter into a bilateral contract, whereby one of the parties (generally the broker dealer) will act as the executing party. The executing party will submit the

⁶ This applies only to swaps under the Commodity Exchange Act. It is yet unclear whether this requirement will apply to security-based swaps.

swap for clearing and the other party (the customer) will affirm or reject the submission. If the customer affirms the submission, the FCM can accept or reject the swap for clearing. If the FCM accepts the swap, the customer will be deemed to have entered into a swap with the clearing organization via the FCM and will no longer have any obligations with respect to the executing party.

2. Increased Margin Costs

Central clearing will in many cases increase margin requirements for insurance companies and, as a result, the cost of hedging. Each counterparty to a cleared swap will be required to post initial margin and variation margin with its FCM. Variation margin will be passed through to the clearing organization, and, depending on the rules of the clearing organization, initial margin may be held by the clearing organization or the FCM. Initial margin is collateral that is required to be posted at the beginning of the transaction and, in the futures world, is calculated based on the maximum estimated change in the value of the swap within a trading day. Many insurance companies are not required to post initial margin for their over-the-counter (OTC) swaps. Variation margin is based on the current exposure of the customer's position, and is netted at the FCM level. The clearing organization will determine the appropriate levels of margin based on pricing data provided by the FCMs. Separately, each FCM may require excess margin from its customers, to the extent it finds the margin levels set by the clearing organization to be insufficient to hedge the risk of default.

Margin costs may also increase due to limitations on netting. Insurance companies will not be able to net margin posted with respect to their cleared swaps against margin posted for uncleared, customized OTC products with a counterparty which is an affiliate of the FCM through which it clears. Moreover, an insurance company will likely clear through several clearing organizations if, as seems to be the case, different clearing organizations specialize in different products, and so the inability to

net will be exacerbated. Lastly, insurance companies are likely to want to have contractual relationships with more than one FCM at each clearing organization through which they clear to ensure portability in case a FCM become bankrupt. To the extent this "back-up" FCM position is active, it will result in further non-nettable margin positions.

3. Documentation Costs

Insurance companies will need to negotiate new futures style clearing documentation with each FCM and each FCM is likely to have its own standard forms. The documentation will include an agreement governing the relationship between a customer and a FCM; a give-up agreement governing the process for submitting a swap for clearing; and the clearing organization's rules.

4. FCM Risk

Insurance companies will face a different risk profile than in the past for their cleared swaps. Whereas before they would face the collateralized credit risk of their counterparty, they will now face the credit risk of their FCM to the extent the FCM's positions are undercapitalized at the clearing organization. If a FCM becomes insolvent, depending on the clearing organization rules, either the gross initial margin or the net portion after netting positions across customers is at risk to pay the obligations of the FCM to the clearing organization, after assets of the FCM at the clearing organization have been exhausted.

C. Regulation as a Swap Dealer or Major Swap Participant

The Dodd-Frank Act establishes two categories of entities, swap dealers and major swap participants, that are required to register with the Commission. In general, a person is a swap dealer if that person holds itself out as a swap dealer, makes a market in swaps, regularly enters into swaps in the ordinary course of business or engages

VI. Developments in the Swaps and Derivatives Markets (cont'd)

in an activity causing it to be commonly known as a dealer. A major swap participant is a person who is not a swap dealer and (a) maintains a “substantial position” in a major category of swaps excluding positions hedging or mitigating commercial risk and positions maintained by an employee benefit plan hedging or mitigating the risks associated with the plan; (b) whose swaps create “substantial counterparty exposure” that could have serious systemic risks; or (c) is a highly leveraged financial entity that is not subject to federal banking capital requirements that maintains a “substantial position” in a major category of swaps.

In addition to the registration requirements, swap dealers and major swap participants will be subject to capital, margin, recordkeeping and business conduct requirements to be further defined by the Commission.

30 | 1. Major Swap Participant

As discussed above, characterization as a major swap participant generally requires that there be either (1) a “substantial position” in a major category of swaps other than positions for hedging or mitigating commercial risk, or (2) swaps positions that create “substantial counterparty exposure” with potentially serious systemic risks. In making a determination as to these issues, the Commission is required to consider a party’s position in non-cleared as opposed to cleared swaps, and may take into consideration the value and quality of collateral held against counterparty exposure. Since U.S. property and casualty and life insurance companies are currently restricted by state insurance laws to the use of derivatives for hedging purposes and, to a lesser extent, replication transactions and swaps for income generation purposes, these considerations should be helpful.

On December 21, 2010, the CFTC and the SEC issued a joint proposed rule further defining the terms “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant” and

other related terms (Proposed Rule). The Proposed Rule emphasizes that the characterization as a major swap participant is to be limited to those entities that pose a high degree of risk through their swap activities.

The Proposed Rule takes a two-pronged approach to the definition of “substantial position.” The first prong is the aggregate of a party’s uncollateralized mark-to-market exposure (using industry standard measures) in each major category⁷ of swaps (other than swaps held for hedging commercial risk⁸), taking into account the effect of master netting agreements (including netting over securities lending and borrowing, securities margin lending and repurchase and reverse repurchase agreements, to the extent permitted by the netting agreements). Positions in cleared swaps would presumably be treated as fully collateralized for the purpose of this calculation. The Commissions are proposing to set the current uncollateralized threshold at a daily average of \$1 billion in any applicable category of swaps, except that the threshold for the rate swap category would be \$3 billion.⁹

The second prong of the test is designed to capture the risk that current exposure may move in the other direction, and may do so rapidly. This second “potential future or outward exposure” test uses analytical methods similar to bank capital models. In general, the exposure measure would be based on the aggregate notional amount of swap positions, adjusted for certain risk

7 The Proposed Rule establishes four major categories of swaps: (1) rate swaps (including interest and currency), (2) credit swaps, (3) equity swaps and (4) any other commodity swaps. It also establishes two categories of security-based swaps: (i) swaps based on instruments of indebtedness, or a credit event relating to one or more issuers or securities and (ii) and other security-based swaps.

8 The Proposed Rule clarifies that financial entities (such as insurers) may avail themselves of the exclusion for commercial hedges so long as the swap relates to hedging the business risks of the insurance company. In order to qualify for this exclusion, a security-based swap would have to be “economically appropriate” to the reduction of risk of the enterprise.

9 The Proposed Rule states that the swap positions of majority-owned subsidiaries are to be aggregated at the parent level, although it is not clear at what level any resulting capital, margin or business conduct requirements should be imposed.

factors and the duration of the position, and would reflect master netting agreements consistent with bank capital standards. Downward risk adjustments of 20% would be made for central clearing and collateralization after taking into account other risk adjustments. Combining the two prongs of the test, the “substantial position” threshold for the purpose of a major swap participant (or major security-based swap participant) would be \$2 billion in daily average mark-to-market uncollateralized exposure plus aggregate potential future or outward exposure, except that for the rate swaps category the daily average would be \$6 billion.¹⁰

The second test of the major swap participant definition addresses entities whose swaps create “substantial counterparty exposure.” Unlike the first test, the second is not analyzed by major category of swap, nor does it take into account whether swaps are entered into for hedging purposes. The Commissions propose the same two sets of calculations as for the first test, but on an aggregate basis across all categories of swaps and without exclusion for hedging commercial risk or ERISA positions. For a major swap participant, the threshold for current uncollateralized exposure is \$5 billion, and the combined threshold with potential future exposure is \$8 billion, in each case across the entirety of such entity’s swap positions. For a major security-based swap participant, the proposed thresholds are \$2 billion and \$4 billion, respectively.

Finally, the Commissions do not propose, but request comment on the possibility, that certain types of entities, including state-regulated insurers, be excluded, conditionally or unconditionally, from the definition of major swap participant.

¹⁰ Although the complete details of the risk adjustments are not set forth in the Proposed Rule, an example is given to illustrate that an entity that does not have any uncollateralized current exposure would have to have \$20-billion in credit derivatives (0.10 risk adjustment is proposed for credit derivatives) to meet the \$2-billion threshold, and the permissible notional amount of credit derivatives would increase to \$100-billion, if the swaps are cleared or subject to mark-to-market margining.

Based on the Proposed Rule, it would appear that U.S. property and casualty and life insurance companies, the swap activities of which are largely confined to hedging the risk of their insurance business, will not be subject to registration and regulation as major swap participants.¹¹ Although the Commissions may not agree that all positions an insurance company considers to be hedging are such (for example, the Proposed Rule does not reach a conclusion on macro hedges), the thresholds in most cases should be sufficient to absorb controversial positions without tripping major swap participant characterization.

2. Swap Dealer

The Dodd-Frank Act provides that a person may be designated as a swap dealer for one or more types, classes or categories of swaps, security-based swaps or activities without being so designated for others. The Proposed Rule proposes a definition for “category,” but not for “type” or “class.”

The Proposed Rule sets forth different analytical tests for swap dealers and security-based swap dealers. The test for a swap dealer is a facts-and-circumstances test with focus on a “holding out” in the market as a dealer, a “general availability” to enter into swaps to facilitate the interest of others, a custom of determining the terms of the swaps it enters into, and a tendency to create customized or new types of swaps. On the other hand, because security-based swaps may be used to hedge the risk of owing securities and to gain exposure to certain of the indicia of ownership of a security, the SEC states that it views it appropriate to use the same factors as applied to determine dealer status under the Exchange Act. The Proposed Rule sets forth factors that may be indicative for both swap dealers and security-based swap dealers, including: contacting potential counterparties, developing

¹¹ This discussion is limited to the traditional hedging and investment activities of U.S. property and casualty and life insurance companies. The analysis with respect to financial guaranty insurance companies having portfolios of leveraged credit default swaps, and other specialty insurance companies, is beyond the scope of this Year in Review.

VI. Developments in the Swaps and Derivatives Markets (cont'd)

new types of swaps and informing potential counterparties about the availability of such swaps, providing marketing materials about the types of swaps the entity is willing to enter into, membership in an association as a dealer, and generally expressing a willingness to offer a range of financial products. The Commissions rejected the suggestions that such activities be continuous or that dealing should only apply to those who quote a “two-way” market.

The Dodd-Frank Act requires the Commissions to exempt from designation as a swap dealer or a security-based swap dealer a person who engages in a de minimus quantity of dealing. The size of the de minimus exemption proposed in the Proposed Release is quite small, however, and raises some concern about how broadly the Commissions will apply the swap/security-based designations.

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The factors to be met to satisfy the de minimus test are as follows:

- The aggregate effective¹² notional amount of swaps/security-based swaps in connection with dealing activity over twelve months may not exceed \$100 million.
- The aggregate effective notional amount of swaps/security-based swaps where the counterparty is a “special entity” over the prior twelve months may not exceed \$25 million.
- The aggregate number of counterparties may not exceed 15 over the prior 12 months, other than other swap/security-based swap dealers.
- The number of swaps/security-based swaps entered into as dealer during the prior 12 months cannot exceed 20.

¹² To the extent the stated notional amount is leveraged or enhanced by its structure, the enhanced notional amount captures the increase.

Based on the Proposed Rule, it would appear that most insurance companies would not be subject to regulation as swap dealers in connection with their ordinary business activities. However, to the extent that any product offered by an insurance company, including stable value contracts¹³, are determined to be swaps, insurance companies which engage in the business of entering into or selling such products might be designated as swap dealers in the product.

D. Conclusion

Currently, it is yet unresolved whether traditional life and property and casualty insurance products will be regulated as swaps. It appears to be the case that most U.S. property and life companies will not be subject to registration and regulation as major swap participants or swap dealers. However, significant uncertainty remains about the application of the Dodd-Frank Act in connection with the selling of insurance products. The most significant impact of the Dodd-Frank Act to many insurance companies will likely arise from the increased margin costs in connection with clearing swaps that the Commissions require to be cleared. Many details on clearing and margining are yet to be determined by the Commissions through rulemaking. As the Commissions are required to promulgate rules and regulations to effectuate the Dodd-Frank Act by July 21, 2011, 2011 is expected to bring about many changes in the landscape of the derivatives market.

¹³ Section 719(d) of the Act requires the SEC and the CFTC jointly to determine within fifteen months after the enactment of the Act if stable value contracts (as defined in Section 719(d)(2), which are stable value contracts available as investments in ERISA plans) fall within the definition of “swaps,” and if so, if an exemption from such definition is appropriate.

VII. Insurance Regulatory Developments

The most important theme to emerge from a review of insurance regulatory developments during 2010 is the persistent tension between the U.S. based system of state insurance regulation and the regulation of most other U.S. financial institutions at a national level. Federal oversight and influence over insurers has increased through the Federal Insurance Office and the Financial Stability Oversight Council created by the Dodd-Frank Act, the surplus lines and reinsurance collateral reforms enacted under the Nonadmitted and Reinsurance Reform Act, and the ongoing implementation of the Patient Protection and Affordable Care Act. The lack of a coordinated group regulator for U.S.-based insurance holding company systems is likely to adversely affect the federal government's assessment of state-based regulation and foreign governments' assessment of the United States under Solvency II and like regimes. Severe state budget shortfalls have constrained the resources available to many insurance departments and 16 new insurance commissioners have been elected or appointed since July 2010. The NAIC has attempted to fill gaps by proposing changes to holding company regulation designed to assess group risks outside of pure insurance operations, but individual states pursue their own agendas. Many of the matters discussed below will warrant close watch during 2011, as their impacts continue to develop.

A. Federal Developments

1. Dodd-Frank Wall Street Reform and Consumer Protection Act

In July, the Dodd-Frank Act was signed into law. Although the law does not make any dramatic changes to the state-based system of insurance regulation, it does directly affect the business of insurance and reinsurance through the establishment of a Federal Insurance Office (FIO) within the Department of the Treasury, and adoption of the Nonadmitted and Reinsurance Reform Act (NRRRA). The FIO is intended, in part, to remedy

the current lack of insurance expertise at the federal level. The authority granted to the FIO is well short of a regulatory role, however, as neither the FIO nor the U.S. Treasury is empowered to exercise general supervision over insurance companies. The FIO's oversight extends to all lines of insurance (except health insurance, long-term care insurance that does not include a life or an annuity component and federal crop insurance). The FIO will be headed by a Director appointed by the Secretary of the Treasury.

The Dodd-Frank Act also created a Financial Stability Oversight Council (FSOC), which has the authority to determine that nonbank financial companies (such as insurance companies) present systemic risk to the U.S. financial system. Such a determination by the FSOC, which requires a two-thirds vote including the affirmative vote of the Secretary of the Treasury, would result in the nonbank financial company becoming supervised by the Federal Reserve Board and subject to heightened prudential standards. The FIO Director will be a non-voting advisory member of the FSOC. Such heightened prudential standards may potentially include risk-based capital requirements; leverage limits; liquidity requirements; resolution plan and credit exposure report requirements; concentration limits; a contingent capital requirement; enhanced public disclosures; short-term debt limits; and overall risk management requirements. The U.S. Treasury will be developing rules during 2011 that set out criteria to be used for the designation of nonbank financial companies for heightened supervision and regulation. Dealmaking activity could be prompted by efforts by some companies to eliminate units or lines of business that they think make them potential targets for designation under these rules.

The FIO is tasked with monitoring all aspects of, and gathering information on, the insurance industry, including "identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system," and issuing

VII. Insurance Regulatory Developments (cont'd)

reports to Congress. In addition to annual reports on the industry, the FIO is also required to deliver to Congress a study on modernization of insurance regulation in the U.S. and a report on the U.S. and global reinsurance market. The modernization study will examine the degree of national uniformity of state insurance regulation, the costs and benefits of potential federal regulation of insurance across various lines of insurance and the feasibility of regulating only certain lines of insurance at the federal level, while leaving other lines to be regulated at the state level. The report will be read closely by proponents of a federal charter for insurance companies, as well as state insurance regulators who want to be perceived as responsive to the identified shortcomings of the current state-based system of regulation.

34 | The FIO's most substantial authority, however, is in the area of international agreements, where the FIO will have authority to negotiate agreements with foreign governments relating to the recognition of prudential matters with respect to the business of insurance or reinsurance. In implementing such agreements, the FIO will have the authority to preempt state law if it determines that the state law is inconsistent with the international agreement and treats a non-U.S. insurer less favorably than a U.S. insurer. While this preemption authority is limited, legislative history of the statute suggests that Congress intends it to be used to resolve the dispute over state-level reinsurance collateral requirements. Judicial review of any such preemption by the FIO will be on a de novo basis.

The NRRRA, which becomes effective on July 21, 2011, addresses inefficiencies in the regulation of surplus lines insurance and reinsurance. With respect to surplus lines insurance, the NRRRA provides that the home state of the insured will have exclusive authority to regulate the placement of nonadmitted insurance and to collect premium taxes on nonadmitted reinsurance. The NRRRA contemplates a uniform system for allocation of premium tax obligations through an interstate compact or other

procedures established by the states. The NRRRA also establishes uniform standards for surplus lines eligibility criteria and preempts state diligent search requirements for certain sophisticated commercial purchasers. At present, competing proposals to allocate surplus lines taxes among states remain in play.

With respect to reinsurance, the NRRRA provides that a ceding insurer's state of domicile will be the single point of regulation with respect to credit for reinsurance so long as the state is NAIC-accredited or has similar financial solvency requirements, thus eliminating extraterritorial application of credit for reinsurance rules by states. The ceding insurer's state of domicile will also regulate rights of the parties to provide for alternative dispute resolution; choice of law; and imposition of any standard terms different than those in the reinsurance agreement.

2. Court Challenges to the Patient Protection and Affordable Care Act

During 2010, Federal District courts heard cases on the constitutionality of the "Minimal Essential Coverage Provision" of the Patient Protection and Affordable Care Act (ACA), known colloquially as the "individual mandate." While two courts previously upheld constitutionality (*Thomas More Law Center v. Obama*, E.D. Mich., Oct. 7, 2010; and *Liberty University v. Geithner*, W.D. Va., Nov. 30, 2010), one recently held that the individual mandate provision is unconstitutional (*Cuccinelli v. Sebelius*, E.D. Va., Dec. 13, 2010).

The court in *Cuccinelli* held that the Congress's power to regulate activities substantially affecting interstate commerce under the Commerce Clause cannot be extended to "inaction" – namely, a failure to purchase health insurance from a private entity. The court also held that the individual mandate was not a legitimate exercise of Congress's taxation power under the General Welfare Clause. Of importance to the industry, the court also ruled that the individual mandate provision may be

severed from the remainder of the ACA. This is particularly problematic as insurers have long argued that they can afford to cover persons with chronic conditions only by requiring the healthy to have coverage. The court did not, however, halt the implementation of the ACA, given that appellate review of its decision will take place before the individual mandate becomes effective on January 1, 2014. Other lawsuits regarding the constitutionality of the ACA remain pending. The pending suits (which likely will reach the U.S. Supreme Court), together with the election of a Republican-controlled House of Representatives that the pundits predict may withhold federal funding necessary to allow the ACA to function as intended, create tremendous uncertainty as to whether the ACA ultimately will be implemented as contemplated when enacted.

B. State Developments

1. Amendments to New York Regulation 20 (Credit for Reinsurance)

In November, the New York Insurance Department amended Regulation 20 to grant the Superintendent discretion to allow a reduction in collateral that unauthorized reinsurers must post in order for New York-domiciled ceding insurers to receive full financial statement credit for reinsurance. The permissible reduction in collateral is available to both property and casualty and life reinsurers with respect to contracts entered into, renewed or having an anniversary date on or after January 1, 2011 and applies to all reserves, whenever ceded. While no formal process or application requirements for reduced collateral have been published, the New York Department has indicated in informal discussions that it will use the criteria listed in subsection (h) of Regulation 20 as a checklist when evaluating applications for reduced collateral status for reinsurers. For non-U.S. reinsurers, there must also be a Memorandum of Understanding in place between the Superintendent and the applicant's domiciliary regulator.

As amended, Regulation 20 is generally consistent with the collateral reduction approach taken by Florida and the legislation currently pending in New Jersey.

2. *Kramer* Decision Regarding Life Settlements

In November, New York's highest court ruled in *Kramer v. Phoenix Life Insurance Co.* that stranger-owned life insurance does not violate the insurable interest provisions of the New York Insurance Law so long as the insured is the applicant for the policy. Because the decision is based on the precise language of the New York statute and because stranger-owned life insurance is prohibited under the new life settlement law that went into effect in New York in May 2010, the ruling may have only a limited impact. Still, the decision is important because many policies sold in the life settlement market were originated in New York prior to 2010, and the case should cut off debate about their legitimacy.

3. New York Regulation 194 and Circular Letter No. 18 (Producer Compensation Transparency)

In November, the New York Insurance Department issued Circular Letter No. 18 to provide guidance to producers and authorized insurers in complying with Regulation 194, which became effective January 1, 2011. Regulation 194 provides that producers must provide an initial standard disclosure to purchasers of insurance that includes: their role in an insurance transaction; whether they will receive compensation from the insurer or a third party in connection with the transaction; that compensation may vary depending on a number of factors; and that the producer will provide additional information upon request. If requested, the following additional information must be provided within five business days: a description of the nature, amount and source of compensation; a description of any alternative quotes presented, including coverage, premium and compensation that would have

VII. Insurance Regulatory Developments (cont'd)

been received upon the sale of such alternative coverage; a description of material ownership interests the insurer has in the producer or *vice versa*; and a statement as to whether the producer is prohibited by law from altering the amount of compensation received.

The Circular Letter addresses a number of practical and interpretive issues regarding Regulation 194 and also states that, while the New York Department expects full compliance, it will focus its enforcement efforts within the first six months on willful or egregious violations or violations that demonstrate a pattern or practice of wrongdoing. While certain producer trade groups continue to contemplate a challenge, for most of the industry the regulations, together with amendments to broker settlement agreements with the New York Attorney General permitting payment and acceptance of contingent commissions and the overturning of employee bid-rigging convictions, bring a measure of closure to the questions about permissible forms of broker compensation that commenced with the Eliot Spitzer investigations.

4. California Department of Insurance Directive on Iranian Investments

In February, the California Department of Insurance issued a directive to all insurers admitted in California requiring them, as of March 31, 2010, to non-admit investments in certain entities identified by the California Department as doing business with the Iranian oil and natural gas, nuclear and defense sectors. The directive also requested that such insurers agree not to invest in such entities in the future. The directive is notable in its attempt to impose sanctions at a state regulatory level, a subject typically reserved for the federal government. On March 29, 2010, pursuant to the California Administrative Procedures Act, which empowers the California Office of Administrative Law (OAL) to review and determine, upon petition, whether specific agency actions constitute unenforceable “underground regulations,” several industry organizations

submitted a petition to the OAL regarding the directive. In October, the OAL issued an opinion ruling that the directive constituted a regulation which required notice, a hearing and other procedural requirements which had not been followed by the California Department and was, therefore, unenforceable. The California Department has announced that it plans to appeal the OAL’s decision.

5. Amendments to NAIC Model Insurance Holding Company System Regulatory Act and Regulation

In late 2010, the NAIC adopted changes to the Model Insurance Holding Company System Regulatory Act (Model Act) and related regulation that it had been considering throughout 2009 and 2010 to respond to perceived gaps in the regulation of insurance holding companies. These changes, which will not be effective until enacted by the various state legislatures and regulators, will increase group-level reporting to state insurance regulators.

Among other changes, an ultimate controlling person will be required to submit as part of the insurer’s annual registration statement a report identifying the material risks within the insurance holding company system that could pose “enterprise risk” to the insurer. “Enterprise risk” has been defined as “any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse affect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole, including, but not limited to, anything that would cause the insurer’s Risk-Based Capital to fall into company action level . . . or would cause the insurer to be in hazardous financial condition” A drafting note was included in the Model Act that an insurer may satisfy its enterprise risk management reporting requirements in the annual registration statement by providing the commissioner with the most recently filed parent corporation SEC reports, if appropriate.

The Model Act also includes optional provisions requiring outside directors on an insurer's board, compensation and nominating committees (unless the insurer's parent has a board of directors meeting these requirements), and requires that the insurer's annual registration statement include statements acknowledging that the insurer's board of directors oversees corporate governance and internal controls and that the insurer's officers or senior management have approved, implemented and continue to maintain and monitor corporate governance and internal control procedures. Additionally, in response to the *Kingsway* case as described below, the Model Act includes a requirement that any controlling person of a domestic insurer obtain prior regulatory approval when such controlling person seeks to divest control of an insurer and an acquiring party has not already obtained approval.

6. Kingsway Financial Services Decision Regarding Divestiture of Control of an Insurer

In April, the Commonwealth Court of Pennsylvania held that the sole shareholder of a Pennsylvania-domiciled insurance company did not violate Pennsylvania insurance law when it disposed of 100% of its ownership interests in the insurer without first obtaining approval of the Pennsylvania Insurance Department. In the fall of 2009, Kingsway Financial Services, Inc., a Canadian corporation, divested its entire interest in Lincoln General Insurance Company by donating 5% interests in the common stock of Lincoln General's parent company to twenty unaffiliated New York-based charities. Both Kingsway and Lincoln General had been experiencing significant financial distress. In November 2009, the Pennsylvania Department filed suit for declaratory and injunctive relief against Kingsway over the divestiture.

The acquisition of control provisions at issue in the case provide that the acquisition by a person of "control" of a Pennsylvania domestic insurer requires the prior

approval of the Pennsylvania Department, and that control is presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote or holds proxies representing 10% or more of the voting securities of a domestic insurer. The Court held that Kingsway's disposition of Lincoln General did not violate the acquisition of control provisions because the disposition did not result in any of the charities acquiring 10% or more of Lincoln General's voting securities. The Pennsylvania Department has indicated that it will appeal the decision. While notable mostly for the boldness of Kingsway's actions, it seems unlikely that the decision will motivate others to take similar actions.

C. European Developments

While there were other developments in individual countries, the major European regulatory issue in 2010 was Solvency II and its implications for both EU and non-EU insurers.

1. Solvency II

In July, the European Union's Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) recommended to the European Commission that Bermuda, Switzerland and Japan be the first countries assessed for equivalence with EU insurance regulations under Solvency II. Solvency II empowers the European Commission to assess whether the insurance regulatory regime of a non-EU country is equivalent to Solvency II for three purposes: (i) reinsurance, (ii) group solvency and (iii) group supervision. The intention is to ascertain whether the non-EU country's system of insurance regulation provides a similar level of policyholder and beneficiary protection as Solvency II. Japan is being considered for equivalence solely in relation to reinsurance, whereas Bermuda and Switzerland are being considered for equivalence in relation to all three areas. The equivalence assessments will affect reinsurance collateral requirements for non-EU reinsurers that reinsure EU cedents, as well as group

VII. Insurance Regulatory Developments (cont'd)

capital requirements and other compliance requirements generally for non-EU groups with EU subsidiaries and non-EU subsidiaries of EU groups. However, a finding of non-equivalence of a non-EU jurisdiction could also potentially impact the corporate structure and supervision of an insurance group headed there. In these cases, Solvency II would allow the insertion of a sub-holding company in a non-EU jurisdiction that is deemed equivalent, and for that equivalent regime to be applied in relation to the sub-group that results. Absent such a step, Solvency II provides for two possibilities. Either (i) the principles of group solvency and group supervision set out in Solvency II shall be applied to the entire group or (ii) the EU supervisors may apply “other methods” to ensure appropriate supervision of the insurers in the group. These “other methods” are not specified, but an example is given of a requirement to establish an EU insurance holding company and so create an EU sub-group that is subject to the group solvency and group supervision requirements contained in Solvency II, including the requirement for an EU group supervisor. The most noteworthy omission from the recommended first wave of countries to be assessed is the United States. CEIOPS based its recommendation that the United States be excluded from the first wave of equivalence assessments on the fact that day to day regulation of the insurance industry remains at the individual state, rather than the federal, level.

Transitional arrangements for eligible countries not included in the first wave of equivalence assessments are expected to be adopted as part of the “Omnibus II” directive, which is expected to be proposed imminently. Countries included in the transitional arrangements are expected to receive the same benefits as if a positive finding on equivalence had already been made. The United States is expected to be a primary candidate for inclusion in the transitional arrangements.

As of January 1, 2011, the European Insurance and Occupational Pensions Authority (EIOPA) replaced CEIOPS. Solvency II is scheduled to become effective on December 31, 2012.

2. United Kingdom — New Prudential Regulator

In the United Kingdom, the new coalition government announced its plan to reform the regulation of the UK’s financial services industry. The proposals were based on the Conservative party’s pre-election proposals and survived to become coalition government policy. Seen as a response to the financial crisis, the proposals involve the abolition of the UK’s Financial Services Authority (FSA) and the establishment in its place of a new system based on the following components: a new macro prudential regulator, the Financial Policy Committee (FPC), to be established within the Bank of England, responsible for setting macro financial services policy and monitoring systemic risks; a new prudential regulator, the Prudential Regulation Authority (PRA), to be established as a subsidiary of the Bank of England with the intention that it can draw on the financial sector expertise of the Bank but remain operationally independent; a new conduct of business regulator, called the Consumer Protection and Markets Authority (CPMA) to focus on ensuring confidence on the wholesale and retail financial markets with particular focus on protection of consumers; and the creation of a new single agency responsible for tackling serious economic crime.

The division of responsibilities between these new organizations has yet to be worked out in detail and proposals for new legislation will come forward into 2011. There are indications that Lloyd’s insurance market will be subject to regulation solely by the PRA but other insurance entities are likely in the future to have to deal

with a multiple set of regulators, including the PRA for prudential matters such as solvency capital levels and new authorizations; the CPMA for conduct of business issues; and the new financial crime agency. Further, while insurers may well argue that they do not pose the same level of systemic risk as the banking industry does, they should nonetheless monitor the work of the new FPC and assess the effects of macro economic policy on the industry.

It is intended that the FSA will continue to operate pending the implementation of the new regime although internally it will move to a shadow PRA and shadow CPMA structure in the spring of 2011. The current CEO of the FSA, Hector Sants, will become a member of the FPC and CEO of the PRA, ensuring a degree of continuity between the old and the new regime.

3. New EU Block Exemption Regulation for Insurance Sector

In April, a new competition block exemption regulation (BER) for the insurance sector became effective in the EU. The new BER exempts only two of the four categories of agreements previously given a safe harbor from the EU competition rules under the predecessor Insurance BER (358/2003): namely, joint compilations, tables and studies; and setting up and operating coinsurance and reinsurance pools. The agreements no longer covered are: provisions on standard policy conditions; and models and agreements on security devices. Such agreements will now be subject to self-assessment by the parties.

The new BER applies only to the joint compilation and distribution of information that is “necessary” for the calculation of compilations and the construction of tables, which should not contain any indication of the level of commercial premiums and should generally be made available on request on a reasonable, affordable and nondiscriminatory basis to consumer or customer organizations. The definition of “new risks” for coinsurance and reinsurance pools has been widened to include risks which have objectively changed so materially that it is not possible to know in advance what subscription capacity will be necessary to provide cover. For risks which are not new, the new BER, like its predecessor, applies to pools if the aggregate market share (based, if possible, on gross premium income) held by the undertakings inside/outside the pool does not exceed 20% for coinsurance pools and 25% for co-reinsurance pools.

The new BER does not represent a major change in the enforcement policies of the European Commission in the insurance industry but is in line with the European Commission’s general move away from industry specific exemptions. The European Commission has however indicated that it intends to ensure that pools do in fact satisfy all the requirements of the BER, where parties intend to rely on the BER. This warning comes against the background of a previous European Commission finding that companies were “blindly” relying on the BER. The new BER will expire on March 31, 2017.

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Worldwide Offices

New York

1301 Avenue of the Americas
New York, NY 10019-6092
T +1 212 259 8000
F +1 212 259 6333

London

1 Minster Court
Mincing Lane
London EC3R 7YL
T +44 20 7459 5000
F +44 20 7459 5099

Washington, DC

1101 New York Avenue, NW
Washington, DC 20005-4213
T +1 202 346 8000
F +1 202 346 8102

Abu Dhabi

Al Odaid Tower, 10th Floor
Airport Road
P.O. Box 126883
Abu Dhabi
T +971 2 414 6744
F +971 2 414 6600

Doha

Qatar Financial Centre Branch
Al Fardan Office Tower
8th Floor
61 Al Funduq Street
P.O. Box 31316
Doha
T +974 4410 1717
F +974 4410 1500

Madrid

Calle de Velázquez, 57
28001 Madrid
T +34 91 781 55 00
F +34 91 577 90 48

Milan

Via F.lli Gabba 4
20121 Milan
T +39 02 3030 9330
F +39 02 3030 9340

Albany

99 Washington Avenue
Suite 2020
Albany, NY 12210-2820
T +1 518 626 9000
F +1 518 626 9010

Dubai

Unit 501, Level 5
Precinct Building 2
Dubai International
Financial Centre
P.O. Box 506675
Dubai
T +971 4 425 6300
F +971 4 425 6301

Moscow

Nikitsky Pereulok 5
125009 Moscow
T +7 495 737 5000
F +7 495 737 5050

Almaty

Ken Dala Business Center
5th Floor
Prospekt Dostyk, 38
Almaty 050010
T +7 727 250 7575
F +7 727 250 7576

Frankfurt

Skyper
Taunusanlage 1
60329 Frankfurt
T +49 69 3639 30
F +49 69 3639 3333

Paris

51, rue Pierre Charron
75008 Paris
T +33 1 53 93 77 00
F +33 1 42 56 08 06

Riyadh

Khalid A. Al-Thebity Law Firm
affiliated office
King Fahad Road
Sky Towers - 8th Floor
P.O. Box 300807
Riyadh 11372
T +966 1 416 9990
F +966 1 416 9980

Beijing

Beijing Kerry Center
South Tower
Suite 1429
No. 1 Guanghai Road
Beijing 100020
T +86 10 6583 9500
F +86 10 6583 9600

Hong Kong

Citibank Plaza
2008, ICBC Tower
No. 3 Garden Road
Central, Hong Kong
T +852 3697 7000
F +852 3697 7099

Rome

Via Giovanni Battista De Rossi, 30
00161 Rome
T +39 06 4520 6220
F +39 06 4520 6230

Boston

260 Franklin Street
Boston, MA 02110-3173
T +1 617 748 6800
F +1 617 439 0341

Houston

RRI Energy Plaza
1000 Main Street
Suite 2550
Houston, TX 77002
T +1 713 287 2000
F +1 713 287 2100

San Francisco

One Embarcadero Center
Suite 400
San Francisco, CA 94111-3619
T +1 415 951 1100
F +1 415 951 1180

Brussels

Schuman 11 Building
Rond Punt Schuman 11
B-1040 Brussels
T +32 2 227 0900
F +32 2 227 0909

Johannesburg

The Forum Building, 11th floor
2 Maude Street (cnr Fifth Street)
P.O. Box 781033
Sandton, 2146
Johannesburg
T +27 11 911 4300
F +27 11 784 2855

Silicon Valley

1950 University Avenue
Suite 500
East Palo Alto, CA 94303-2225
T +1 650 845 7000
F +1 650 845 7333

Chicago

Two Prudential Plaza
180 North Stetson Avenue
Suite 3700
Chicago, IL 60601-6710
T +1 312 794 8000
F +1 312 794 8100

Los Angeles

333 South Grand Avenue
Suite 2600
Los Angeles, CA 90071-1530
T +1 213 621 6000
F +1 213 621 6100

Warsaw

Stock Exchange Building
ul. Książęca 4
00-498 Warsaw
T +48 22 690 6100
F +48 22 690 6222

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