CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

Insurance Reforms Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*

July 20, 2010

On July 15, 2010, the Senate voted in favor of adopting the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"). The Act is far-reaching in scope and represents the culmination of months of debate and intense lobbying. The Act was precipitated by the financial crisis that began in 2007 and, therefore, its primary goal is to prevent a recurrence. The focus of this Memorandum is Title V – "Insurance" – of the Act.

I. Subtitle A of Title V of the Act — Federal Insurance Office

Subtitle A ("**Subtitle A**") of Title V of the Act, referred to as the "*Federal Insurance Office Act of 2010*", establishes the Federal Insurance Office (the "**FIO**") within the Department of the Treasury. The FIO is the first federal office created that focuses solely on insurance and will be headed by a director (the "**Director**") appointed by the Secretary of the Treasury. Historically, the federal government has left the regulation of the insurance industry to the states. The creation of the FIO and the other provisions of Subtitle A of the Act described below may be an indication that the federal government intends to play a larger role in the regulation of the U.S. insurance industry.[1]

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* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

1 Companies engaged in insurance activities are potentially subject to Federal Reserve regulation under Title I of the Act as well. Under Title I, the Financial Stability Oversight Council (FSOC) may designate nonbank companies engaged in financial-in-nature activities (which would include an insurance company) as subject to heightened supervision by the Federal Reserve if the FSOC determines that the insurance company's activities are sufficiently economically significant to warrant such heightened supervision. For a discussion of the provisions of Title I, see the memorandum entitled *Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

The FIO is tasked with overseeing all lines of insurance except for (i) health insurance,[2] (ii) long-term care insurance (except long-term care insurance that is included with life or annuity insurance components)[3] and (iii) crop insurance.[4] The FIO has the authority to:

- monitor all aspects of 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 U.S. financial system;
- monitor the extent to which traditionally underserved communities and consumers, minorities and low- and moderate-income persons have access to affordable insurance products (except health insurance);
- recommend that the Financial Stability Oversight Council ("**FSOC**") designate an insurer (including its affiliates) as an entity that should be subject to regulation as a nonbank financial company supervised by the Board of Governors of the Federal Reserve System pursuant to Title I of the Act on the basis that such insurer (or affiliate) presents a potential risk to the U.S. financial system;[5]
- assist the Secretary of the Treasury in administering the terrorism insurance program established pursuant to the Terrorism Risk Insurance Act;
- coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, including representing the U.S. in the International Association of Insurance Supervisors;
- assist the Secretary of the Treasury in negotiating "covered agreements" between the U.S. and foreign governments or regulatory authorities (as discussed below); also, determine whether state insurance measures are preempted by any such covered agreements;
- consult with the states (and their insurance regulators) regarding insurance matters of national and international importance; and
- perform such other related duties and authorities as may be assigned to the FIO.

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[2] As determined by the Secretary of the Treasury in coordination with the Secretary of Health and Human Services based on section 2791 of the Public Health Service Act (42 U.S.C. 300gg–91).

[3] As determined by the Secretary of the Treasury in coordination with the Secretary of Health and Human Services.

[4] As established by the Federal Crop Insurance Act (7 U.S.C. 1501 *et seq.*).

[5] *See* footnote 1.

The FIO will also advise the Secretary of the Treasury on both domestic and international insurance policy issues and the Director will serve in an advisory capacity on the FSOC. In order to carry out the foregoing tasks, the FIO is empowered to, among other things, collect and gather data from insurers and the insurance industry, analyze and disseminate such data and issue reports on all lines of insurance (except health insurance overseen by the FIO).

A. Information Gathering

The FIO may require an insurer (or its affiliate) to submit information or data to it in order to carry out its prescribed functions; *provided*, *however*, certain "small" insurers that meet a minimum size threshold to be established by the FIO will be exempt from having to comply with any such information requests. Prior to requesting information directly from insurers, the FIO is required to coordinate with federal agencies and state insurance regulators (and any publically available sources) to determine whether the information that is the subject of the request can be obtained in another manner from another source. If such information is available from another source in a timely manner, the FIO will collect the information from such source instead of from the insurer. In the event that that nonpublic information is submitted by an insurer to the FIO, such submission (a) will not constitute a waiver of any privilege under federal or state law to which the information is otherwise subject and (b) will continue to be protected by any prior confidentiality agreements entered into that covers such information. Information that is gathered by the FIO may be shared with state insurance regulators through an information sharing agreement. Significantly, subject to certain requirements, the Director is granted the power to require by subpoena the production of any data that it requests as part of its information-gathering function.

B. Preemption of State Insurance Measures

The FIO may preempt state insurance measures,[6] but only if the Director determines that the measure (A) results in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. insurer domiciled, licensed, or otherwise admitted in that state; and (B) is inconsistent with a covered agreement. Prior to making any determination to preempt a state insurance measure, the Director must notify and consult with the applicable state and the United States Trade Representative, publish in the Federal Register notice of the potential inconsistency with a covered agreement (including a description thereof), provide a reasonable opportunity for interested parties to comment and consider such comments. If the Director concludes that

[6] State insurance measures are defined as any state law, regulation, administrative ruling, bulletin, guideline or practice relating to or affecting prudential measures applicable to insurance or reinsurance.

there is an inconsistency, the Director will then notify the state, establish a reasonable period of time (not less than 30 days) before the determination becomes effective, notify certain committees of Congress and publish a notice in the Federal Register. No state could then enforce insurance measures that were preempted by these provisions (although the decision to preempt could be appealed to a federal court). Subtitle A does not preempt, however, (A) any state insurance measure that governs any insurer's rates, premiums, underwriting, or sales practices, (B) any state coverage requirements for insurance, (C) the application of the antitrust laws of any state to the business of insurance, or (D) any state insurance measure governing the capital or solvency of an insurer, except to the extent that such state insurance measure results in less favorable treatment of a non-U.S. insurer than a U.S. insurer.

Note: ***Despite the preemption power, the Act is clear that nothing therein should be construed to provide the FIO or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance, which authority is intended to remain with state insurance regulators.***

C. Reports

Under the Act, the Director is tasked with providing certain reports on the U.S. and global reinsurance markets, including the following:

- Beginning on September 30, 2011 (and on an annual basis thereafter), the Director must submit to the President and to Congress a report on any actions taken by the FIO to preempt inconsistent state insurance measures.

- Beginning September 30, 2011 (and on an annual basis thereafter), the Director must submit to the President and Congress a report on the insurance industry and any other information the Director deems relevant or that is requested by certain committees of Congress.

- No later than September 30, 2012, the Director must submit to Congress a report describing the breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the U.S.

- No later than January 1, 2013 (and updated not later than January 1, 2015), the Director must submit to Congress a report regarding the ability

of state regulators to access reinsurance information for regulating companies in their jurisdictions.

- No later than 18 months after enactment, the Director must submit to Congress a report on how to modernize and improve the system of insurance regulation in the United States. This report is to be based on the following considerations, as well as any other considerations the Director determines are necessary and appropriate:
    - systemic risk regulation with respect to insurance;
    - capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk;
    - consumer protection for insurance products and practices, including gaps in state regulation;
    - the degree of national uniformity of state insurance regulation;
    - the regulation of insurance companies and affiliates on a consolidated basis;
    - international coordination of insurance regulation;
    - the costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance);
    - the feasibility of regulating only certain lines of insurance at the federal level, while leaving other lines of insurance to be regulated at the state level;
    - the ability of any potential federal regulation or federal regulators to eliminate or minimize regulatory arbitrage;
    - the impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance;
    - the ability of any potential federal regulation or federal regulator to provide robust consumer protection for policyholders; and
    - the potential consequences of subjecting insurance companies to a federal resolution authority, including the effects of any federal resolution authority: (i) on the operation of state insurance

guaranty fund systems, including the loss of guaranty fund coverage if an insurance company is subject to a federal resolution authority; (ii) on policyholder protection, including the loss of the priority status of policyholder claims over other unsecured general creditor claims; (iii) in the case of life insurance companies, on the loss of the special status of separate account assets and separate account liabilities; and (iv) on the international competitiveness of insurance companies.

D. Covered Agreements

Subtitle A authorizes the Secretary of the Treasury and the United States Trade Representative to jointly negotiate and enter into covered agreements on behalf of the U.S. A "*covered agreement*" is defined generally as an agreement regarding prudential measures with respect to the business of insurance or reinsurance entered into between the U.S. and a foreign government, authority or regulatory entity that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation. Before entering into a covered agreement, certain technical requirements must be followed, including a consultation with Congress regarding (a) the nature of the agreement, (b) how and to what extent such agreement would achieve the purposes, policies, priorities and objectives of Subtitle A and (c) the implementation of the agreement, including the general effect of the agreement on existing state laws.

II. Subtitle B of Title V of the Act — State-Based Insurance Reform

A. Nonadmitted Insurance

Part I of Subtitle B ("**Subtitle B**") of Title V of the Act is referred to as the "*Nonadmitted and Reinsurance Reform Act of 2010.*" Subtitle B reforms the regulation of the nonadmitted property/casualty insurance markets and the reinsurance markets. Nonadmitted insurance refers to casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer[7] eligible to accept such insurance. The term "*surplus lines broker*" means an individual, firm, or corporation which is licensed in a state to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a state with nonadmitted insurers.

[7] A "nonadmitted insurer" is defined as "with respect to a state, an insurer not licensed to engage in the business of insurance in such state but does not include a risk retention group, as that term is defined in section 2(a)(4) of the Liability Risk Retention Act of 1986."

Subtitle B provides certain consumer protections to policyholders by prohibiting a state, other than the home state of the insured, to require any premium tax be paid for nonadmitted insurance (although the states may establish procedures to allocate among the states the premium taxes paid by an insured to an insured's home state). The term "home state" generally means (i) the state in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence or (ii) if 100% of the insured risk is located out of the state referred to in clause (i), the state to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated. Congress expressed its intent in Subtitle B of the Act that each state adopt nationwide uniform requirements, forms and procedures that provide for the reporting, payment, collection and allocation of premium taxes for nonadmitted insurance. The states are authorized to require surplus lines brokers and insurers to annually file tax allocation reports with the insured's home state detailing the portion of the nonadmitted insurance policy premium attributable to properties, risks, or exposures located in each state.

Subtitle B also provides that, except as otherwise stated therein, the placement of nonadmitted insurance is subject to the statutory and regulatory requirements solely of the insured's home state. Also, no state, other than the insured's home state, may require a surplus lines broker to be licensed in order to sell, solicit or negotiate nonadmitted insurance with respect to such insured. In connection with the foregoing, any law, regulation, provision or action of any state that applies to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home state is another state is preempted; *provided*, *however*, that there is a workers' compensation exception to this preemption for any law, rule or regulation that restricts the placement of workers' compensation insurance or excess insurance for self-funded workers' compensation plans with a nonadmitted insurer.

1. *Uniform Standards*

In order to promote uniform laws and regulations regarding the licensure of surplus lines brokers, Subtitle B prohibits a state from collecting any fees relating to licensing of a surplus lines broker unless such state has in effect within two years after the enactment of Subtitle B, laws and regulations that provide for participation by the state in the national insurance producer database of the National Association of Insurance Commissioners ("**NAIC**") or another equivalent uniform database. Also, in an attempt to provide for uniformity, a state is prohibited from imposing eligibility criteria for nonadmitted insurers domiciled in the U.S. except in

conformance with the requirements and criteria in Sections 5A(2) and 5C(2)(a) of the Non-Admitted Insurance Model Act (which provides for certain minimum capital and surplus requirements), unless the state adopts "nationwide uniform requirements, forms and procedures." In addition, a state may not prohibit a surplus lines broker from placing nonadmitted insurance with a nonadmitted insurer domiciled outside the U.S. that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.

2. *Streamlined Application for Commercial Purchasers*

States are prohibited from requiring a surplus line broker that is placing nonadmitted insurance for an "exempt commercial purchaser" from making a due diligence search to determine whether the full amount or type of insurance sought by such commercial purchaser can be obtained from admitted insurers if (a) the broker producing it has disclosed to the purchaser that such insurance may or may not be available from an admitted market that may provide greater protection with more regulatory oversight and (b) the commercial purchaser has requested in writing thereafter that the broker produce or place such insurance from a nonadmitted insurer. For purposes of above, an exempt commercial purchaser is defined as follows:

(a) a purchaser of insurance who employs or retains a qualified risk manager to negotiate insurance coverage;

(b) has paid aggregate nationwide commercial property and casualty insurance premiums in excess of $100,000 in the immediately preceding 12 months; and

(c) (i) meets at least one of the following criteria:

(I) possesses a net worth in excess of $20,000,000;

(II) generates annual revenues in excess of $50,000,000;

(III) employs more than 500 full-time or full-time equivalent employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate;

(IV) is a not-for-profit organization or public entity generating annual budgeted expenditures of at least $30,000,000; or

(V) is a municipality with a population in excess of 50,000 persons.

(ii) Effective on the fifth January 1 occurring after the date of the enactment of the Act and each fifth January 1 occurring thereafter, the amounts noted in subclauses (I), (II), and (IV) of clause (c)(i) above will be adjusted to reflect the percentage change for such five-year period in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics of the Department of Labor.

3. *Study of NonAdmitted Insurance Market*

The Comptroller General, in consultation with the NAIC, is required to conduct a study of the impact of Subtitle B of the Act on the size and market share of the nonadmitted insurance market for providing coverage typically provided by the admitted insurance market. In particular, the study will address:

- the change in size and market of the nonadmitted insurance market and in the number of insurance companies and insurance holding companies providing such business;
- the extent to which insurance coverage typically provided by the admitted insurance market has shifted to the nonadmitted insurance market;
- the consequences of any change in the size and market share of the nonadmitted insurance market, including differences in the price and availability of coverage available in both the admitted and nonadmitted insurance markets;
- the extent to which insurance companies and insurance holding companies that provide both admitted and nonadmitted insurance have experienced shifts in the volume of business between admitted and nonadmitted insurance; and

- the extent to which there has been a change in the number of individuals who have nonadmitted insurance policies, the type of coverage provided under such policies, and whether such coverage is available in the admitted insurance market.

B. Reinsurance

1. *Regulatory Reform*

Part II of Subtitle B ("**Part II**") of the Act contains certain provisions preempting state law governing reinsurance arrangements. Part II provides that if the state of domicile of the ceding insurer (*i.e.*, the insurer purchasing reinsurance) is an NAIC-accredited state (or has financial solvency requirements substantially similar to those imposed by the NAIC) and recognizes credit for reinsurance, then no other state may deny such credit for reinsurance. Furthermore, Part II preempts laws, regulations, provisions or other actions of a state that is not the domiciliary state of the ceding insurer (other than those with respect to taxes and assessments on insurance companies or insurance income) to the extent that they:

- restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration to the extent such contractual provision is not inconsistent with the provisions of Title 9, United States Code;

- require that a certain state's law shall govern the reinsurance contract, disputes arising from the reinsurance contract, or requirements of the reinsurance contract;

- attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract itself, to the extent that the terms are not inconsistent with this part; or

- otherwise apply the laws of the state to reinsurance agreements of ceding insurers not domiciled in that state.

2. *Regulation of Reinsurer Solvency*

Part II provides that if the state of domicile of a reinsurer is an NAIC-accredited state or has financial solvency requirements substantially

similar to those imposed by the NAIC), (i) such state is then the only state responsible for regulating the solvency of such reinsurer and (ii) no other state may require that the reinsurer provide any additional financial information other than the information the reinsurer is required to file in its domiciliary state (although nothing precludes a state from receiving a copy of the financial information filed with the domiciliary state).

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

Jennifer Donohue	+020 7170 8628	jennifer.donohue@cwt.com
Angus Duncan	+020 7170 8640	angus.duncan@cwt.com
Steven Lenkowsky	+1 212 504 6127	steven.lenkowsky@cwt.com
David S. Miller	+1 212 504 6318	david.miller@cwt.com
Frank Polverino	+1 212 504 6820	frank.polverino@cwt.com
Ira Schacter	+1 212 504 6035	ira.schacter@cwt.com
Malcolm P. Wattman	+1 212 504 6222	malcolm.wattman@cwt.com
Neil J. Weidner	+1 212 504 6065	neil.weidner@cwt.com