

July 13, 2010

Authors:

Diane E. Ambler

diane.ambler@klgates.com

+1.202.778.9886

András P. Teleki

andras.teleki@klgates.com

+1.202.778.9477

Collins R. Clark

collins.clark@klgates.com

+1.202.778.9114

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit www.klgates.com.

Financial Regulatory Reform Increases Federal Involvement in Insurance

K&L Gates published this alert prior to July 21, 2010, the date on which President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. However, this alert discusses the final version of the bill that would eventually be signed into law.

Two provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173) specifically target the insurance industry and are intended to promote a higher level of uniformity in the U.S. insurance industry regulatory landscape. First, the Federal Insurance Office Act of 2010 (“FIO Act”) creates a new Federal Insurance Office (“FIO”) within the Department of the Treasury and signals the beginning of a new era of federal involvement, at least at the macro level, in the U.S. insurance industry. Significantly, the FIO Act does not include a federal insurance charter provision, long sought by many in the insurance industry, and the states will remain the primary insurance regulatory authority. Second, the Nonadmitted and Reinsurance Reform Act of 2010 (“NRRRA”) changes how authority over some forms of insurance is allocated among the states.

In addition, a new provision regarding the treatment of “index annuities” under the Securities Act of 1933 was added to the Dodd-Frank bill during conference negotiations. This new provision directs the Securities and Exchange Commission (the “Commission”) to treat certain index annuity contracts as “exempt securities” and thus not subject to the registration requirements of the Securities Act. This provision would put an abrupt end to a battle that has been raging between the Commission and certain insurers regarding whether products known as “index annuities” are securities for purposes of the Securities Act and thus subject to regulation by the Commission as provided in its Rule 151A, which was challenged in court.

The House has passed the final reconciled version of the Dodd-Frank bill, and the Senate is expected to pass it in mid or late July.

Federal Insurance Office

Overview

The FIO, a creature of compromise to avoid direct federal insurance regulation, will: (i) monitor the U.S. insurance industry, (ii) coordinate federal efforts and policy relating to international insurance matters, (iii) determine which state insurance measures are preempted by international agreements, (iv) report to Congress annually on the state of the insurance industry, and (v) identify insurers that could pose a threat to financial stability. The FIO is generally authorized to gather data and information from any entity that writes insurance or reinsures risk in the United States. The FIO has subpoena power, provided that it first coordinates with state and federal regulators to determine whether they can obtain the information in a timely manner.

The FIO has authority, such as it is, over all lines of insurance other than health insurance, long-term care insurance, and crop insurance. As with its handling of many controversial issues, the Dodd-Frank bill calls for a study of, among other things, the costs and benefits of regulating insurance at the federal level, foreshadowing the possibility of future increases in federal authority over the insurance industry.

The Secretary of the Treasury will be responsible for appointing a Director to head the FIO. The Director must be a career employee and will serve in an advisory capacity on the Financial Stability Oversight Council, which is the new systemic risk watchdog.

Preemption of State Insurance Measures

The FIO Director will have the authority to determine when state insurance measures are inconsistent with international agreements relating to prudential measures for insurance or reinsurance. Inconsistent state insurance measures will be unenforceable if the FIO Director finds that they result in less favorable treatment to a foreign insurer than a U.S. insurer. Prior to making a preemption determination, the FIO Director will have to publish notice in the Federal Register, notify the appropriate state regulator and the U.S. Trade Representative (“USTR”), and consider any comments received.

Earlier drafts of the FIO Act considered by Congress would have authorized the FIO to negotiate and enter into international insurance agreements, but the final FIO Act only goes so far as to permit the FIO Director to assist the Secretary of the Treasury, who will negotiate these agreements jointly with the USTR.

Nonadmitted Insurance

The NRRA creates a uniform system for nonadmitted (or “surplus lines”) insurance premium tax (surplus lines insurance is an insurance policy from an insurance company that is not licensed in the policyholder’s state) by calling on the states to enter into an interstate compact. If the states are able to come to agreement, the interstate compact would create nationwide requirements, forms, and procedures for reporting, paying, collecting, and allocating premium taxes when risk is spread across

multiple states. By default, the general rule is that only the home state of the insured may require premium tax payments.

Under the NRRA, the insured’s home state will have exclusive authority over the placement of nonadmitted insurance and licensing of surplus lines brokers. States must, however, establish eligibility requirements consistent with the Non-Admitted Insurance Model Act. States may not prohibit a surplus lines broker from placing nonadmitted insurance with or procuring nonadmitted insurance from a foreign nonadmitted insurer listed by the National Association of Insurance Commissioners (“NAIC”) as an alien insurer. Within two years of enactment, states are encouraged to participate in a national insurance producer database. As an incentive, states that do not participate would be prohibited from collecting licensing fees from surplus lines brokers.

Subject to certain conditions, surplus lines brokers are exempt from state due diligence requirements when large commercial purchasers of insurance request that the broker use a nonadmitted insurer.

Reinsurance

The NRRA also expands the ability of reinsurers to operate across state lines. If a state accredited by the NAIC recognizes credit for reinsurance for an insurer’s ceded risk, no other state may deny such credit. The home state of the ceding insurer is granted exclusive regulatory authority; the application of related laws beyond the home state’s borders is preempted. A reinsurer’s solvency is regulated solely by the state in which it is incorporated or licensed, if such state is NAIC-accredited.

Status of Index Annuities under Section 3(a)(8) of the Securities Act of 1933

During conference negotiations to reconcile the House and Senate versions of the bill, the conferees unexpectedly added a provision that directs the Commission to treat certain index annuity contracts as “exempt securities” under Section 3(a)(8) and thus not subject to Commission jurisdiction. The provision will effectively limit federal regulation and oversight of index annuities.

To be considered exempt under this provision, the annuity contract: (i) must have a value that does not vary according to the performance of a separate account, (ii) must satisfy state nonforfeiture laws or, in the absence of applicable standard nonforfeiture laws, satisfy the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities or any successor model law, and (iii) be offered by (a) an insurance company subject to suitability requirements that meet or exceed those of the NAIC or (b) an insurance company that adopts and implements practices on a nationwide basis for the sale of any insurance contract that meets or exceeds the minimum requirements established by the NAIC Suitability in Annuity Transactions Model Regulations and is therefore subject to examination by the state of domicile of the insurance company or by any other state where the insurance company conducts sales of such products.

This provision brings to a sudden close a long battle regarding the status of index annuities under the Securities Act and leaves regulation of these types of products firmly in the hands of the states.

This client alert is part of a series of alerts focused on monitoring financial regulatory reform.

Anchorage Austin Beijing Berlin Boston Charlotte Chicago Dallas Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Miami Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco Seattle Shanghai Singapore Spokane/Coeur d'Alene Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit www.klgates.com.

K&L Gates is comprised of multiple affiliated entities: a limited liability partnership with the full name K&L Gates LLP qualified in Delaware and maintaining offices throughout the United States, in Berlin and Frankfurt, Germany, in Beijing (K&L Gates LLP Beijing Representative Office), in Dubai, U.A.E., in Shanghai (K&L Gates LLP Shanghai Representative Office), in Tokyo, and in Singapore; a limited liability partnership (also named K&L Gates LLP) incorporated in England and maintaining offices in London and Paris; a Taiwan general partnership (K&L Gates) maintaining an office in Taipei; a Hong Kong general partnership (K&L Gates, Solicitors) maintaining an office in Hong Kong; a Polish limited partnership (K&L Gates Jamka sp. k.) maintaining an office in Warsaw; and a Delaware limited liability company (K&L Gates Holdings, LLC) maintaining an office in Moscow. K&L Gates maintains appropriate registrations in the jurisdictions in which its offices are located. A list of the partners or members in each entity is available for inspection at any K&L Gates office.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2010 K&L Gates LLP. All Rights Reserved.