NAIC Issues New Guidance for Review of Affiliated IMAs, "Form A" Applications, and Disclaimers of Affiliation

July 18, 2024

On July 16, 2024, the National Association of Insurance Commissioners ("NAIC") Financial Analysis Solvency Tools (E) Working Group ("FASTWG") adopted changes to the NAIC's *Financial Analysis Handbook* (the "Handbook") to provide additional guidance to regulators reviewing affiliated investment management agreements ("IMAs"). The new considerations, described below, are designed to help regulators assess whether the terms of such affiliated IMAs are fair and reasonable and to assess the level of oversight provided to the affiliated asset manager.

At the same meeting, the FASTWG also exposed, for a 30-day comment period, proposed revisions (the "Proposed Revisions") to the Handbook sections addressing regulatory review of Form As and disclaimers of affiliation to add new regulatory considerations and guidance to assist regulators in assessing complex ownership structures.

Affiliated Investment Management Agreements

In late 2022, several working groups of the NAIC submitted referrals recommending updates be made to the Financial Analysis Handbook and the Financial Condition Examiners Handbook to provide more guidance to regulators on reviewing affiliated investment management services and agreements. The referrals were part of a broader initiative to address the list of 13 "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers" adopted by the NAIC. Following a development period, the NAIC Risk-Focused Surveillance (E) Working Group finalized updated drafts of proposed revisions to these Handbooks, which have now been adopted by the FASTWG.

The revisions to the Handbooks added new considerations under the "Assessment of Form D – Prior Notice of a Transaction" section for regulators to use in evaluating the fairness and reasonableness of affiliated IMAs. The regulator is now recommended to consider whether the following new elements are appropriately included in the agreement:

Selection of Investments. It should be clear from the IMA how the investment adviser will select investments. This should be detailed through clear investment guidelines documented in the IMA, which are also in compliance with the insurer's investment strategy and applicable laws and regulations.

Authority for Transactions. IMAs should address the level of authority that will be given to the investment adviser in executing transactions.

Conflicts of Interest. To the extent that any conflicts of interest may be known to the insurer, the IMA should specifically indicate the manner in which such conflicts will be considered.

Fiduciary Responsibility. The IMA should acknowledge the investment adviser's role as a fiduciary in advising the insurer and, if applicable, confirm the adviser's registration as an investment advisor/manager with the SEC and/or state securities regulators.

Calculation of Fees. It is important that the manner in which fees are calculated is well defined in the IMA management agreement and that the structure of the fee is considered as management assesses the adviser's performance. Special attention should be paid to whether there are any performance or incentive fees over and above a base management fee.

Sub-Advisors. Does the investment manager have the authority to engage sub-advisors and, if so, is consent by the insurer required? Who is responsible for the fees of the subadvisor?

Reporting. Are expectations for the reporting of portfolio performance included in the IMA?

Termination. Are there appropriate termination provisions, both with and without cause?

Review of Performance and Compliance. Agreements should include consideration of information that will be provided to the company to permit the company to perform adequate review of the adviser's performance and execution of the investment strategy, including compliance with adopted investment guidelines.

Takeaway

Insurers entering into affiliated IMAs should consider the impact of these new considerations on the terms of the agreement and the level of regulatory review and timeframe for approval of the related Form D.

Form As and Disclaimers of Affiliation

By way of background, in July 2022, the NAIC Macroprudential (E) Working Group ("MWG") sent a referral to the Group Solvency Issues (E) Working Group concerning NAIC activities to develop regulatory considerations and guidance related to "complex ownership structures." The MWG referral included two considerations:

(1) Regulators may not be obtaining clear pictures of risk due to holding companies structuring contractual agreements in a manner to avoid regulatory disclosures and requirements. Additionally, affiliated/related party agreements impacting the insurer's risks may be structured to avoid disclosure (for example, by not including the insurer as a party to the agreement).

(2) Control is presumed to exist where ownership is 10% or more, but control and conflict of interest considerations may exist with less than 10% ownership. For example, a party may exercise a controlling influence over an insurer through Board and management representation or contractual arrangements, including non-customary minority shareholder rights or covenants, IMA provisions such as onerous or costly IMA termination provisions, or excessive control or discretion given over the investment strategy and its implementation. Asset management services may need to be distinguished from ownership when assessing and considering controls and conflicts.

As a result of these recommendations, the various NAIC working groups have put forth the Proposed Revisions to several sections of the Handbook addressing regulatory review of Form As and disclaimers of affiliation as described below.

Form As

The Proposed Revisions add the following guidance for reviewing a Form A:

- To identify the ultimate controlling person ("UCP") of a proposed acquiror, regulators should review the ownership documents/agreements and other information provided in the Form A application to understand its ownership structure, the terms of the documents/agreements, each party's rights and responsibilities conveyed by the documents/agreements, who has responsibility for decisions and who controls the insurer.

- Regulators should carefully scrutinize and understand complex organization and ownership structures:

    - Whether a simple corporate structure, or a unique or complex structure such as trusts, limited partnerships (LP) and limited liability corporations (LLC), review

the ownership documents and agreements to understand the terms of the structure, each party's rights and responsibilities conveyed by the agreement, who has responsibility for decisions and who controls the insurer. For LPs, also identify who has controlling interest in an LP's general partner and who has the right to unilaterally replace the general partner (if anyone). For trusts, also identify who has the ability to modify a trust.

- For structures with complex or unique share classes and voting carefully review the voting and non-voting share classes' respective rights and agreements to determine who has rights to control and vote to make decisions.

- Request and review corresponding investment, management or operational agreements as necessary to determine if any delegate control or decision making to another specific person or entity.

Importantly, the Proposed Revisions also include new considerations that historically were not part of a Form A analysis, including that regulators:

- review and assess the UCPs ability to provide future capital support to the insurer, if needed;

- review rating agency reports and public news sources to identify and assess comments or concerns that have been expressed regarding the acquiring entity (or group); and

- for non-U.S. acquiring parties: carefully evaluate Form A applications and supporting documentation received from non-U.S. acquiring entities to understand their ownership structure and identify the UCP, consider the impact of varying accounting and auditing standards utilized in other countries when evaluating financial data and results, identify and investigate the nature and extent of government control over or involvement with the acquiring entity, ask the parties involved in the transaction for the results of the Committee on Foreign Investment in the U.S. (CFIUS) review (if applicable) and communicate and coordinate with the group-wide supervisor regarding each jurisdiction's review of affiliated entity acquisitions, requesting assistance to verify biographical affidavits and understanding the roles, responsibilities, and expectations for post-acquisition solvency monitoring.

Lastly, the Proposed Revisions add a new section titled "Post-Closing Monitoring" including monitoring the following after the close of the acquisition:

- Ongoing commitments and capital support to the insurer from the new owner; and

- Review of subsequent Board minutes.
- Specific to an international acquisition:
  - monitor the Board and the International UCP's involvement and influence over the U.S. operations;
  - assess the implementation of how the U.S. business is incorporated into or decentralized from the non-U.S. operations;
  - access to the Group ORSA (as opposed to the US ORSA); and
  - actively participating in supervisory colleges and other international coordination efforts to evaluate the solvency position of the acquiring entity/group as appropriate.
- Monitor the ongoing financial condition of the acquiring entity/group by:
  - comparing actual results to pre-transaction projections to determine whether results of the acquisition/merger are meeting expectations. If not, gain an understanding of why projections have not been achieved and the company's planned actions to address issues;
  - requesting and reviewing information on the integration of company processes and systems (if applicable), as well as steps taken to ensure that adequate cybersecurity precautions are taken during the integration process; and
  - reviewing the impact of the acquisition on the risk profile of the insurer and assessing whether it has been incorporated into the group's ERM, ORSA and Form F reporting, including the overall assessment of group risk capital.

Takeaway

The NAIC's continued focus on determining the UCP and understanding complex ownership structures may impact how insurance acquisitions are structured, and parties to insurance transactions should consider how these new Form A review and post-acquisition monitoring considerations may lead to more intrusive reviews of upper tier entities and owners as well as ongoing commitments than those imposed by regulators in previous insurance company acquisitions. As the Proposed Revisions note, "[f]or all of these structures and unique situations, it is important to identify an individual ultimate controlling person (UCP) at the top of the organizational structure, i.e., to trace the ownership/control to the top person/entity. It is at the UCP level that financial

statements and other insurance holding company filings will be required to be submitted to the department, although other controlling entities (e.g., minority owners) may also be asked to provide such information when appropriate."

Disclaimers of Affiliation

Section 4K of the NAIC Insurance Holding Company System Regulatory Act (Model #440) outlines specific requirements for filing a disclaimer of affiliation (a "Disclaimer") by any member of an insurance holding company system or other person that wishes to disclaim "control" over the insurer and, upon approval of the Disclaimer, be relieved from having to file a Form A or be subject to other provisions of Model #440.

The Proposed Revisions give a few examples of situations that may require additional regulatory inquiry and a deeper review of a Disclaimer to determine if control exists, if the Disclaimer should be approved or denied, or if any conditions or stipulations should be placed on the approval. "Consideration should be given to situations where a disclaiming party may exert influence or control over the insurer such as: over management decisions, or the operations of the insurer; where there is a minority owner; where lending agreements may result in ownership of the insurer in the event of default; where non-voting shareholders have protective rights affording them the opportunity to acquire control in certain circumstances; any non-voting arrangement or contract that may convey an element of control (e.g., investment management, reinsurance, administrative service, employment); or passive investment companies with more than 10% ownership of voting shares within funds they manage, where the actions and activities do not support the investment company's assertion that it does not exert control."

The Proposed Revisions list the following new "Best Practices" (among others):

- If the Disclaimer approval includes stipulations or conditions, consider the following:
    - In situations where ownership percentages may fluctuate, require a condition whereby the Disclaiming party must reapply for the Disclaimer if the percentage ownership exceeds a specified percentage.
    - Require 30-day notice to the Department if a "passive owner" is acting counter to management recommendations for proxy voting.
    - Require that the domestic insurer is responsible for notifying the Department if any of the conditions/stipulations in the Disclaimer approval are violated.

- Include in the Disclaimer approval letter what the consequences will be for violating the conditions/stipulations (e.g., the Disclaimer would be rescinded).

- If a Disclaimer is requested for tax purposes and is relied upon by the tax authority (or similar situation where the Department has concerns that another regulatory authority may be unduly relying on the Disclaimer), consider including a statement in the Disclaimer approval letter that makes it clear that the approval is for state insurance law purposes only.

- In situations such as reinsurance side car or other similar arrangements where a third party appears to have influence through operational management, investment management or other agreements (e.g., the Disclaimer is requested for tax purposes):

  - As part of the approval of the Disclaimer, require the service agreements between the domestic insurer and the third party be submitted for Department approval.

Lastly, the Proposed Revisions include a new section titled "Post-Disclaimer Considerations" that includes various suggested requirements to be imposed as a condition for approval of a Disclaimer such as:

- The disclaiming person/entity should:

  - Provide notice before taking action on any of the rights and privileges of the non-voting shares.

  - Provide notice before transferring non-voting shares.

  - Provide notice before taking any position at the insurer or its affiliates.

  - If the facts and circumstances for which the approval of the Disclaimer was based on change, they must notify the state insurance regulator.

Takeaway

If adopted, the Proposed Revisions could herald an environment of heightened scrutiny of Disclaimers, both before and after approval is granted by state regulators.

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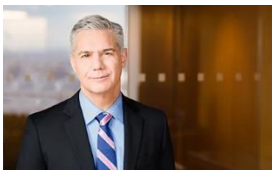
Please do not hesitate to contact us with any questions.



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