

## The Impact of the Financial Regulatory Reform Legislation on the Life Insurance Industry

The financial regulatory reform legislation entitled the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Dodd-Frank Act" or the "Act") was signed into law on July 21, 2010 by President Obama. This *DechertOnPoint* examines the provisions in the Dodd-Frank Act that affect the life insurance industry, with a focus on the provisions relating to:

- Federal government oversight of significant nonbanks for financial stability;
- Federal orderly liquidation authority;
- Creation of a new Federal Insurance Office ("FIO");
- Harmonization of the standard of conduct for broker-dealers and investment advisers;
- Potential effects of the "Volcker Rule";
- Regulation of over-the-counter derivatives; and
- State regulation of indexed annuities (the "Harkin Amendment").

While explicit references to insurance companies form a small part of this comprehensive legislation, relative to the focus on the banking industry and "Wall Street," Congress has highlighted "enhanc[ing] Federal understanding of insurance issues" as one of the key goals of the legislation.<sup>1</sup> The potential impact of the Dodd-Frank Act on insurance companies and

their affiliates is significant and may expand over time as regulators move forward on the plethora of studies and rules called for by the Act.

### Introduction and Observations

The Dodd-Frank Act is intended to put in place a framework to address perceived weaknesses in the regulatory structure of the U.S. financial system that contributed to the financial crisis of 2008. As the most comprehensive legislation addressing financial institutions in many years, the Act impacts life insurance companies and their affiliates in ways that can be significant. Many of its provisions call for studies or rules, so the complete impact from the Act is not now known, and the regulatory developments set in motion by the Act, as well as potential "unintended consequences," will need continued attention. Here are some observations on the Act's potential effects on life insurance company complexes:

- **Federal vs. State Regulation of Insurance.** The role of the States in the regulation of insurance companies has been the subject of extensive policy and political debate for many years.<sup>2</sup> In the context of the Dodd-Frank Act, neither Congressional leaders

<sup>1</sup> See Joint Explanatory Report of the Committee of Conference.

<sup>2</sup> See Puretz, Jeffrey, *Background Information: A Primer on Insurance Products as Securities*, published in Practising Law Institute, *Securities Products of Insurance Companies in the Face of Regulatory Reform (2010)*, Section I.D., "Efforts to Increase Federal Regulation," describing studies, Treasury Department papers, and congressional bills to increase Federal regulation of insurance.

nor Obama administration officials chose to take on the fight of proposing Federal regulation of insurance. Thus, the Act leaves the current regime of State regulation largely intact, and, in one respect, strengthened by the Harkin Amendment's rebuff of the assertion of jurisdiction over indexed products by the Securities and Exchange Commission ("SEC"), as discussed herein. The Act does, however, pave the way for possible future Federal regulation of insurance by creating the new Federal Insurance Office, which is charged with the task of studying potential Federal regulation of insurance.

- **Potential Federal Prudential Supervision over Insurance Organizations as "Significant Nonbanks."** There is one important exception to this principle of the continuing primacy of State regulation: the Act gives potential regulatory authority to Federal banking and other regulators and the newly-formed Financial Stability Oversight Council ("Council") over large insurance complexes. The Act seeks to protect against possible threats to U.S. financial stability by extending strict prudential Federal supervision to certain financial companies that are not bank holding companies. The Act authorizes the newly-formed Council to determine that material distress at a nonbank financial company or the nature or operations of the company could pose a threat to financial stability, and to determine that the company should be supervised by the Board of Governors of the Federal Reserve System ("FRB") (such a designated company is referred to herein as a "Significant Nonbank"). The Council could designate an insurance organization (a parent holding company for an insurance complex or one or more insurance companies) as a Significant Nonbank. A company that is designated as a Significant Nonbank must register and file reports with the FRB and is subject to heightened prudential standards including capital and liquidity requirements.
- **Potential Federal Initiation of the Liquidation of an Insurance Organization.** Under Title II of the Act, the Secretary ("Treasury Secretary") of the Department of the Treasury ("Treasury") may under certain conditions initiate the liquidation of a Significant Nonbank or another company predominantly engaged in financial activities – which, in either case, could be an insurance company or a parent holding company of an insurance company complex. A liquidation of a Significant Nonbank that is not an insurance company generally would be conducted under a Federal receivership structure administered by the Federal Deposit Insurance Corporation ("FDIC"). In the case of an insurance company, upon a determination by the Treasury Secretary, liquidation or rehabilitation would be conducted under applicable State law, and initiated by a State insurance commissioner, or, if the insurance commissioner fails to act after 60 days, by the FDIC.
- **The "Volcker Rule."** This provision prevents proprietary trading as a principal, subject to certain exceptions, and restricts sponsorship and investment in hedge funds and private equity funds by "banking entities," a term broadly defined to include, among others, nonbank companies with an affiliated insured bank or savings association (an insured depository institution). If an insurance complex owns an insured depository institution, these prohibitions will apply to the entire complex, subject to certain exclusions for non-U.S. entities. An exception will allow insurance companies to conduct proprietary trading for their general accounts, and will allow banking entities to conduct proprietary trading for customers, among others. However, for an insurance complex that owns an insured depository institution, this measure could change proprietary trading practices and could seriously inhibit hedge fund and private equity fund formation and operation for any entity within the complex. Thus, insurance complexes that own an insured depository institution will want to study and assess their options from the potential impact of the Volcker Rule, which will not be fully developed until the relevant regulatory agencies conduct related studies and adopt implementing rules. In addition, even without being affiliated with an insured depository institution, a U.S. insurer designated as a Significant Nonbank could be subject to additional capital requirements and restrictions related to its proprietary trading and hedge and private equity fund activities.
- **Potential Fiduciary Duty for Broker-Dealers.** The Dodd-Frank Act calls for the SEC to study and consider rules to impose a fiduciary duty standard on broker-dealers for the purpose of harmonizing the standards of care owed by broker-dealers and investment advisers for personalized investment advice to retail customers. The subject of harmonization proved controversial during the legislative process, and many insurance industry advocates, among others, opposed adoption of a fiduciary duty standard for broker-dealers. The final version of the legislation, which requires a study but leaves rulemaking discretion in the SEC's hands, reflects a compromise. It includes language clarifying that receipt of compensation for the sale of securities shall not be considered a violation of any rules the SEC may adopt, and that broker-dealers that sell only proprietary products may do so with notice and consent. Yet, the SEC and the Financial Industry Regulatory Authority, Inc. ("FINRA") historically have been critics of certain sales practices

for variable products,<sup>3</sup> and the SEC ultimately approved a FINRA rule establishing customized sales practices and suitability standards for variable annuities.<sup>4</sup> The SEC study and potential rule-making bear watching for potential implications for the sale of variable products.

- **Regulation of Over-the-Counter Derivatives.** Title VII of the Dodd-Frank Act creates a comprehensive regulatory framework for the over-the counter (“OTC”) derivatives market. Many key provisions require further rulemaking by the SEC and the Commodity Futures Trading Commission (“CFTC”). Of interest to insurers will be whether they come within the definitions of categories of persons with significant activities in OTC swaps and other derivatives. One of these categories is a “major swap participant”, which would require registration with the SEC or CFTC, and would subject the insurer to new capital and margin requirements and various reporting obligations. Also of interest is whether derivatives transactions of insurers must be submitted for centralized clearance, or whether they would be eligible for an exception from clearance for certain persons who use OTC derivatives to hedge or mitigate commercial risk. Another item left unanswered in the final version of the legislation is whether stable value contracts will be considered “swaps” that would be subject to the substantive regulation of the OTC derivatives market. The Act calls for this determination to be made by the SEC and CFTC in a joint study to be published 15 months after enactment of the Act.

<sup>3</sup> See Joint SEC/NASD Report on Examination Findings regarding Broker-Dealer Sales of Variable Insurance Products, June 2004. See also BNA Securities Regulation and Law Report, Volume 25 Number 25, June 21, 2004, “Variable Annuities – Glassman Warns Insurance Companies – Brokers: SEC Focusing on Variable Annuities.” See also Statement by SEC Commissioner Annette Nazareth, Remarks Before NASD Spring Securities Conference, May 18, 2006, stating that “[v]ariable annuities have been a source of longstanding concern at the Commission, NASD, and other regulators...Therefore, I believe that variable annuity sales raise heightened investor protection concerns and that appropriate suitability determinations would go a long way to allaying these concerns.” See generally Wilkerson, Carl, *The Convergence of Regulatory and Industry Initiatives Governing Suitability, Supervision, Disclosure, and Credentialing in the Sale of Annuities*, published in Practising Law Institute, *Understanding the Securities Products of Insurance Companies (2009)*; and Wilkerson, Carl, *FINRA Rule 2821: Suitability and Supervision in the Sale of Variable Annuity Contracts*, published in Practising Law Institute, *Securities Products of Insurance Companies in the Face of Regulatory Reform (2010)*.

<sup>4</sup> FINRA Conduct Rule 2821.

## Federal Government Oversight for Financial Stability

At the heart of the Dodd-Frank Act are provisions that represent a response to the expenditure of Federal dollars in 2008 and 2009 to support ailing financial institutions. Title I of the Dodd-Frank Act deals with financial stability and creates a new Financial Stability Oversight Council and gives the Council considerable power to promote stability in financial institutions. These powers could be exercised over life insurance companies and other types of insurance companies and their affiliates.

### The Financial Stability Oversight Council

The Dodd-Frank Act creates the Council, which is charged with identifying and responding to emerging risks throughout the financial system. The purposes of the Council are: (i) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, inter-connected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (ii) to promote market discipline, by eliminating expectations on the part of the shareholders, creditors and counterparties of such companies that the Federal government will shield them from losses in the event of failure; and (iii) to respond to emerging threats to the stability of the United States financial system.<sup>5</sup>

In addition to other duties, the Council is charged with monitoring domestic and international financial regulatory proposals, including insurance and accounting issues. The Council is to advise Congress and make recommendations in areas that will enhance the integrity, efficiency, competitiveness, and stability of the financial markets. Interestingly, the Act specifically called out insurance issues as one of the areas for which the Council is to monitor and provide advice.

The Council will consist of 15 members – ten voting and five nonvoting – consisting of the heads of many of the agencies that oversee financial matters and financial institutions.<sup>6</sup> Significantly, the director of the FIO and a State insurance commissioner are nonvoting members.

<sup>5</sup> Section 112 of the Dodd-Frank Act.

<sup>6</sup> The ten voting members are: (i) the Treasury Secretary, who serves as chairman; (ii) Chairman of the FRB; (iii) Comptroller of the Currency; (iv) Director of the Bureau of Consumer Financial Protection, which is created by the

## Supervision by the FRB

Under the Act, the Council, by a vote of no fewer than 2/3 of its members then serving, including an affirmative vote of the chairperson, has the authority to designate any “U.S. nonbank financial company” as a Significant Nonbank that will be supervised by the FRB and be subject to enhanced supervision and regulatory standards developed by the FRB (“prudential standards”). To reach this determination, the Council must determine that the company’s material financial distress, or the nature, scope, size, scale, concentration, interconnect- edness, or mix of the activities, could pose a threat to the financial stability of the United States. Upon an affirma- tive vote to treat a company as a Significant Nonbank, the “financial activities” of the organization are subject to prudential supervision.<sup>7</sup> The FIO, discussed below, will have the authority to recommend to the Council that it designate an insurer as a Significant Nonbank.

The definition of “U.S. nonbank financial company” in the Dodd-Frank Act includes companies that are incorpo- rated or organized under the laws of the United States or any State. Accordingly, any insurance company that is “predominantly engaged” in financial activities and

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Act; (v) Chairman of the SEC; (vi) Chairperson of the FDIC; (vii) Chairperson of the CFTC; (viii) Director of the Federal Housing Finance Agency; (ix) Chairman of the National Credit Union Administration Board; and (x) an independent member with insurance expertise, appointed by the Presi- dent, by and with the consent of the Senate. The five non- voting members are: (i) the Director of the Office of Finan- cial Research; (ii) the director of the FIO, discussed below; (iii) a State insurance commissioner; (iv) a State banking supervisor; and (v) a State securities commissioner.

The State insurance commissioner to serve on the Council will be selected pursuant to a selection process determined by the State insurance commissioners and can only serve for a term of two years. The non-voting members may not be excluded from any proceedings, meetings, discussions or deliberations of the Council, except by the chairperson of the Council, upon the vote of the member agencies, when necessary to safeguard and promote the free exchange of confidential supervisory information.

<sup>7</sup> The term “financial activities” is defined to include: (i) activities that are financial in nature as defined in Sec- tion 4(k) of the Bank Holding Company Act (“BHC Act”); and (ii) the ownership or control of one or more insured depository institutions. The term “financial activities” does not include internal financial activities conducted for the company or its affiliates, including internal treasury, investment and employee benefit functions. Nonfinancial activities of a company shall not be subject to supervision or imposition of prudential standards of the FRB. Note that under Section 113(c)(3) of the Act, a nonbank financial company may establish or may be required by the FRB to establish an intermediate holding company that would hold all entities engaging in financial activities.

incorporated or organized under the laws of any State could be eligible for designation as a Significant Nonbank.<sup>8</sup>

## Considerations

In making a determination that a company, including an insurance company, is a Significant Nonbank, and thus will be subject to FRB supervision, the Council is required to consider:

- The extent of leverage of the company;
- The amount and nature of the company’s financial assets;
- The amount and type of liabilities of the company, including the degree of reliance on short-term funding;
- The extent and type of off–balance sheet exposure of the company;
- The extent and type of the company’s interrela- tionships with other significant financial compa- nies;
- The importance of the company as a source of credit for households, businesses, and State and local governments, and as a source of liquidity for the U.S. financial system;
- The importance of the company as a source of credit for low-income, minority or underserved communities, and the impact that the failure of the company would have on the availability of credit in those communities;
- The extent to which the company’s assets are managed rather than owned and the breadth of the dispersion of the ownership of assets under management;
- The nature, scope, size, scale, concentration, interconnectedness and mix of the company’s activities;

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<sup>8</sup> A company is “predominantly engaged” in financial activities if: (i) the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature and from insured depository institutions represent 85% or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature and related to the ownership or control of insured depository institutions represent 85% or more of the consolidated assets of the company.

- The degree to which the company is already regulated by one or more primary financial regulatory agencies; and
- Any other factors the Council deems appropriate.

The Council is required to consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for designation as a Significant Nonbank before the Council makes a determination. The “primary financial regulatory agency” for insurance companies is the “State insurance authority of the State in which an insurance company is domiciled.”<sup>9</sup>

Nonbank financial companies determined by the Council to be Significant Nonbanks must register with the FRB within 180 days after the date of a final Council determination, and will be subject to reporting requirements prescribed by the FRB.

### Procedural Requirements

The Council must provide written notice to the nonbank financial company of a proposed determination of Significant Nonbank status, including an explanation of the basis for the proposed determination. The nonbank financial company may request an opportunity for a written or oral hearing before the Council to contest the proposed determination.

A nonbank financial company determined to be a Significant Nonbank has 30 days after the receipt of the notice of final determination to bring an action for an order requiring that the final determination be rescinded. However, judicial review is limited to whether the final determination was arbitrary and capricious.

### Prudential Standards

The FRB is responsible for establishing prudential standards and reporting and disclosure requirements applicable to Significant Nonbanks, subject to input from the Council. Historically the FRB has imposed supervision on banks through supervision of bank holding companies, and this pattern may be repeated for large insurance complexes. Accordingly, an insurance company or its parent holding company could be a Significant Nonbank. In either event, the FRB is required to supervise the Significant Nonbank and may establish prudential standards for:

- Risk-based capital requirements and leverage limits, unless the FRB, in consultation with the Council, determines that such requirements are not appropriate for a company subject to more stringent prudential standards because of the activities of such company (such as investment company activities or assets under management) or structure, in which case, the FRB shall apply other standards that result in similarly stringent risk controls;
- Liquidity requirements;
- Overall risk management requirements;
- Resolution plan and credit-exposure reporting requirements; and
- Concentration limits, including the prohibition from having credit exposure<sup>10</sup> to any affiliated company that exceeds 25% of its capital stock and surplus (or such lower amount as the FRB may determine by regulation to be necessary to mitigate risks to the financial stability of the United States).

The FRB may establish additional prudential standards for Significant Nonbanks, including:

- A contingent capital requirement that the Significant Nonbank maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress;
- Enhanced public disclosures to support market evaluation of the Significant Nonbank’s risk profile, capital adequacy and risk management capabilities;
- Short-term debt limits,<sup>11</sup> including the off-balance sheet exposures that may be accumulated by the Significant Nonbank; and

<sup>10</sup> For this purpose, “credit exposure” to a company means: (i) all extensions of credit to the company, including loans, deposits, and lines of credit; (ii) all repurchase agreements and reverse repurchase agreements with the company, and all securities borrowing and lending transactions with the company, to the extent that such transactions create credit exposure for the nonbank financial company; (iii) all guarantees, acceptances or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company; (iv) all purchases of or investment in securities issued by the company; (v) counterparty credit exposure to the company in connection with derivative transactions; and (vi) any other similar transactions that the FRB, by regulation, determines to be a credit exposure.

<sup>11</sup> “Short-term debt” is defined to include such liabilities with short-dated maturity that the FRB identifies, by regulation, except that such term does not include insured deposits.

<sup>9</sup> Section 2(12)(D) of the Dodd-Frank Act.

- Such other prudential standards as the FRB shall deem appropriate.<sup>12</sup>

The FRB is required to submit an annual report to Congress regarding the implementation of the prudential standards required, including the use of such standards to mitigate risks to the financial stability of the United States.

### Resolution Plan and Credit Exposure

Each Significant Nonbank will be required to have a plan for rapid and orderly resolution in the event of material financial distress or failure, which shall include:

- Information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- Full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company; and
- Identification of the cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged.

Each Significant Nonbank is required to report periodically to the FRB, the Council and the FDIC on: (i) the nature and extent to which the company has credit exposure to other significant nonbank financial companies and significant bank holding companies; and (ii) the nature and extent to which other Significant Nonbanks or large bank holding companies have credit exposure to that company.<sup>13</sup>

<sup>12</sup> These prudential standards are set forth in Section 165 of the Dodd-Frank Act.

<sup>13</sup> If a credible plan is not submitted in a timely manner, the FRB and the FDIC may jointly impose more stringent capital, leverage, or liquidity requirements or restrictions on the growth, activities or operations of the company or any subsidiary, until a credible plan is submitted. The FRB and the FDIC, in consultation with the Council, may direct a Significant Nonbank to divest certain assets or operations identified by the FRB and the FDIC to facilitate an orderly resolution of such company under the Bankruptcy Code. The reference to the Bankruptcy Code in Title I does not provide an exemption for insurance companies, which generally are subject to State liquidation or conservation authority. In contrast, allowance is made for State insolvency proceedings for insurance companies in Title II, described in "Orderly Liquidation Authority," below.

### Risk Committee

Each Significant Nonbank that is publicly traded is required to establish a risk committee within one year of the final determination of Significant Nonbank status. The risk committee must: (i) be responsible for the oversight of the enterprise-wide risk management practices of the Significant Nonbank, presumably with a focus on financial risk management; (ii) include such number of independent directors as the FRB may determine appropriate, based on the nature of the operations, size of assets, and other appropriate criteria related to the Significant Nonbank; and (iii) include at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

### Stress Testing

The FRB, in coordination with the appropriate primary financial regulatory agency and the FDIC, is required to conduct annual analyses in which Significant Nonbanks are subject to evaluation of whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. The FRB: (i) is required to provide for at least three different sets of conditions under which the evaluation shall be conducted, including baseline, adverse and severely adverse; (ii) may require stress tests in addition to the annual test requirement; (iii) may develop and apply such other analytic techniques as are necessary to identify, measure and monitor risks to the financial stability of the United States; (iv) may require companies to update their resolution plans as the FRB determines necessary based on an analysis of the results; and (v) shall publish a summary of the test results.

In addition, a Significant Nonbank must conduct semiannual stress tests. The company must submit a report to the FRB and its primary financial regulatory agency at such time, in such form, and containing such information as the primary financial regulatory agency shall require.

### Early Remediation

The FRB, in consultation with the Council and the FDIC, is authorized to prescribe regulations to establish early remediation requirements for Significant Nonbanks that are experiencing financial distress, which could include limits on capital distributions, acquisitions, and asset growth, and capital-raising requirements, among others.<sup>14</sup>

<sup>14</sup> Dodd-Frank Act, Section 166.

## Orderly Liquidation Authority

### Systemically Important

Title II of the Dodd-Frank Act grants the Treasury Secretary authority to initiate an orderly liquidation for certain systemically important “financial companies.” This authority is similar to the FDIC model for liquidation of depository institutions. This Title is intended to provide authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.<sup>15</sup>

Financial companies that are subject to this authority include bank holding companies, Significant Nonbanks, as described in the prior section, and companies that are predominantly engaged in activities that the FRB has determined are “financial in nature or incidental thereto.”<sup>16</sup> Generally, the Act authorizes the Treasury Secretary to appoint the FDIC as receiver for a financial company.<sup>17</sup> However, in the case of insurance companies that are financial companies, or financial companies for which the largest United States subsidiary is an insurance company, the director of the FIO, described below, and the FRB, at the request of the Treasury Secretary or

<sup>15</sup> Section 204(a) provides that the orderly liquidation authority shall be exercised in a manner that best fulfills such purpose, so that: (i) creditors and shareholders will bear the losses of the financial company; (ii) management responsible for the condition of the financial company will not be retained; and (iii) the FDIC and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the financial condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

<sup>16</sup> In particular, this would be limited to companies whose activities the FRB has determined are “financial in nature or incidental thereto” for purposes of Section 4(k) of the BHC Act. Financial companies may also include any subsidiary of any of the aforementioned financial companies that itself is predominantly engaged in activities that are financial in nature or incidental thereto for purposes of Section 4(k) of the BHC Act. However, no company shall be predominantly engaged in activities that the FRB has determined are financial in nature or incidental thereto for purposes of Section 4(k) of the BHC Act, if the consolidated revenues of such company from such activities constitute less than 85% of the total consolidated revenues of such company.

<sup>17</sup> The Treasury Secretary may request that the FDIC or FRB consider making a written recommendation for liquidation to the Secretary, or the FDIC and FRB may initiate a written recommendation to the Secretary on a vote of 2/3 of the members of the FRB and 2/3 of the directors of the FDIC.

on their own initiative, shall consider whether to recommend orderly liquidation. Such recommendation shall be made upon a vote of not fewer than 2/3 of the FRB then serving and the affirmative vote of the FIO director, and in consultation with the FDIC.

A recommendation that a financial company be subject to orderly liquidation shall contain:

- An evaluation of whether the financial company is in default or in danger of default;
- A description of the effect that the default of the financial company would have on financial stability in the United States;
- A description of the effect that the default of the financial company would have on economic conditions or financial stability for low income, minority or underserved communities;
- A recommendation regarding the nature and the extent of actions to be taken under Title II of the Dodd-Frank Act regarding the financial company;
- An evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company;
- An evaluation of the effects on creditors, counterparties and shareholders of the financial company and other market participants; and
- An evaluation of whether the company satisfies the relevant definition of financial company.

### Commencement of Orderly Liquidation

The Treasury Secretary can commence an orderly liquidation of a financial company if, upon the recommendation described above, the Treasury Secretary (in consultation with the President) determines that:

- The financial company is in default or in danger of default;
- The failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States;
- No viable private sector alternative is available to prevent the default of the financial company;
- Any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken is appropriate, given the

impact that any action taken would have on financial stability in the United States;

- Any action related to an orderly liquidation would avoid or mitigate such adverse effects, taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to Treasury's general fund and the potential to increase excessive risk taking on the part of the creditors, counterparties and shareholders in the financial company;
- A Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and
- The company satisfies the relevant definition of financial company.

There is a procedure for judicial review of the Treasury Secretary's determination to commence liquidation proceedings for a financial company that does not acquiesce to the appointment of the FDIC as receiver. The Secretary is required to petition under seal the U.S. District Court for the District of Columbia for an order authorizing the appointment. The subject company has the right to a hearing; however, the court has only 24 hours to review the petition, after which it becomes automatic by operation of law.

### Orderly Liquidation of Insurance Companies

The liquidation or rehabilitation of an insurance company (including an insurance company that is a subsidiary of a financial company) shall be conducted under State law.<sup>18</sup>

The State insurance authority must file the appropriate judicial action in the appropriate State court to place an insurance company into orderly liquidation under the laws and requirements of the State within 60 days of the Treasury Secretary determining that orderly liquidation is appropriate.<sup>19</sup> If the appropriate regulatory agency fails to file, the FDIC has the authority to stand in the place of the appropriate regulatory agency and file an action in the appropriate State court.

<sup>18</sup> An insurance company's subsidiary that is not itself an insurance company is excepted from liquidation under State law and instead would be liquidated under the Federal receivership structure established by Title II.

<sup>19</sup> Compare the 60-day allowance for insurance companies with the time allowed for other types of financial companies: 24 hours.

## Federal Insurance Office

Title V of the Dodd-Frank Act establishes the FIO, or Federal Insurance Office, within the Treasury Department.<sup>20</sup> The Treasury Secretary is responsible for appointing a director to head the FIO.<sup>21</sup> The Treasury Secretary, not the FIO, has authority to issue orders, regulations, policies and procedures to implement the requirements of Title V. The FIO director has limited powers, including, as discussed below, the power to subpoena certain information and the power to determine that certain State insurance measures are pre-empted.

### Functions and Powers

The Dodd-Frank Act does not establish or provide the FIO or the Treasury with general supervisory or regulatory authority over the business of insurance. Rather the FIO will have the following powers and functions for all lines of insurance, except health insurance, crop insurance, and long-term care insurance that is not included with life or annuity components:<sup>22</sup>

- Monitoring 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;
- Advising the Treasury Secretary on major domestic and prudential international insurance policy issues;
- Recommending to the Council that it designate an insurer (including the insurer's affiliates) as an entity subject to regulation as a Significant Nonbank (which is supervised by the FRB);

<sup>20</sup> While Title V affects entities engaged in many lines of insurance, except as noted herein, this *DechertOnPoint* focuses on provisions of the legislation that will affect life insurance companies. We generally do not address Subtitle B of Title V, entitled the "Nonadmitted and Reinsurance Reform Act of 2010." The Nonadmitted and Reinsurance Reform Act of 2010 affects the regulation of the nonadmitted property/casualty insurance market (commonly referred to as excess and surplus lines) and the reinsurance industry.

<sup>21</sup> As discussed below, the FIO director will serve in an advisory capacity on the Council.

<sup>22</sup> The Treasury Secretary is required to coordinate with the Secretary of the U.S. Department of Health and Human Services to determine what qualifies as "health insurance" or "long-term care insurance" and, therefore, is excluded from FIO authority.

- Coordinating Federal efforts and developing Federal policy on prudential aspects of international insurance matters, including assisting the Treasury Secretary in negotiating certain international insurance treaties referred to as “Covered International Agreements” and representing the United States in the International Association of Insurance Supervisors (or a successor entity);<sup>23</sup>
- Determining whether State insurance measures are preempted by Covered International Agreements under the Dodd-Frank Act’s preemption provisions;
- Consulting with the States, including State insurance regulators, regarding insurance matters of national importance and prudential insurance matters of international importance;
- Monitoring the extent to which traditionally underserved communities and consumers, minorities and low- and moderate-income persons have access to affordable insurance products;
- Assisting the Treasury Secretary with administering the Terrorism Risk Insurance Program established under the Terrorism Risk Insurance Act of 2002;
- Advising the Treasury Secretary on major domestic and prudential international insurance policy issues; and
- Performing such other duties as may be assigned by the Treasury Secretary.

The FIO may employ personnel, facilities and any other Treasury resources available to the Treasury Secretary to carry out the FIO’s functions. The Treasury Secretary shall dedicate specific personnel to the FIO.

### FIO’s Information-Gathering Powers

The FIO will be empowered to: (i) request and collect data, including financial data, on and from the insurance industry and insurers,<sup>24</sup> including reinsurers, and their

<sup>23</sup> “Covered International Agreements” are agreements between the United States and one or more foreign governments that relate to the recognition of prudential regulation of the business of insurance or reinsurance and provide protections for consumers of insurance and reinsurance that are substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation.

<sup>24</sup> For the purpose of the data collection provisions only, “insurer” would be defined as any person that is authorized to write insurance or reinsure risks and issue contracts or policies in one or more States.

affiliates;<sup>25</sup> (ii) enter into information-sharing agreements; (iii) analyze and disseminate data and information; and (iv) issue reports regarding all lines of insurance except health insurance. The FIO could require an insurer or its affiliate to submit such data or information as the FIO may reasonably require to accomplish the above functions.

Insurers are, of course, subject to information-gathering powers of other regulatory authorities, including State insurance commissioners, which require information for market conduct and financial exams, and the SEC, which conducts examinations of regulated entities. Perhaps in recognition of these other regulatory burdens, the Act imposes some hurdles on the FIO’s ability to collect information from insurers. Before collecting data and information from insurance companies or their affiliates, the FIO is required to coordinate with each relevant Federal agency and State insurance regulator (or other relevant Federal or State regulatory agency in the case of an affiliate of the insurer) to determine whether the information to be collected is publicly available or available from other sources. If the information is available, the FIO director is required to obtain the information from such source(s). If the FIO director determines that such information is not available, the FIO director may collect the information from an insurance company or its affiliate, but must comply with the requirements of the Paperwork Reduction Act.<sup>26</sup>

Finally, if information is determined to be required to carry out the FIO’s functions, the Dodd-Frank Act grants the FIO director subpoena power, provided the director makes a written finding that the information sought is required to carry out the FIO’s functions and that the FIO

<sup>25</sup> The data collection authority would not apply to any insurer or affiliate whose size is below a minimum threshold to be established by the FIO.

<sup>26</sup> The Act provides that submission of nonpublicly available information to the FIO under this provision will not constitute a waiver or affect any privilege under Federal or State law to which the information is otherwise subject. The Act specifies that legal or contractual confidentiality or privacy requirements applicable to the information will not be affected by the provision of the information. The information submitted to the FIO by an insurer or its affiliate is subject to the Freedom of Information Act. However, the Freedom of Information Act generally does not require agencies to make publicly available commercial or financial information that is privileged or confidential. In addition, the FIO may enter into information-sharing agreements with State insurance regulators regarding non-publicly available data, provided that the agreements comply with applicable Federal law and do not constitute a waiver of or affect privilege under Federal or State law.

has coordinated with other regulators or agencies as required.

### Covered International Agreements and Preemption

The Treasury Secretary and the U.S. Trade Representative (“USTR”) are jointly authorized to negotiate and enter into “Covered International Agreements,” defined above, on behalf of the United States. Before initiating negotiations for these agreements, during the negotiations, and before entering into a Covered International Agreement, the Treasury Secretary and the USTR must jointly consult with certain Congressional Committees.

The FIO is empowered to preempt any State insurance measure, which would include regulations, orders, and other actions by State insurance authorities, to the extent the FIO director determines that the State insurance measure: (i) is inconsistent with a Covered International Agreement; or (ii) results in less favorable treatment of a non-U.S. insurer that is subject to a Covered International Agreement than a U.S. insurer domiciled, licensed or otherwise admitted in the State.<sup>27</sup> The preemption determination must be limited to the subject matter in the Covered International Agreement and achieve protection for consumers of insurance or reinsurance that is substantially equivalent to the protection provided under State law.

Before making any determination of preemption of a State insurance measure, the FIO director must: (i) notify and consult with the relevant State regulator; (ii) notify and consult with the USTR; (iii) publish notice of the issue in the Federal Register; (iv) provide interested parties an opportunity to submit written comments; and (v) consider the comments received. The FIO director must establish a reasonable period of time (at least 30 days) before the determination becomes effective and follow certain additional notice procedures once the determination has become effective.<sup>28</sup>

<sup>27</sup> The Dodd-Frank Act will not allow preemption that would: (i) preempt any State insurance measure governing any insurer’s rates, premiums, underwriting, or sales practices, State insurance coverage requirements, the application of any State antitrust laws to the business of insurance, or any State insurance measure governing the capital or solvency of an insurer, except to the extent the State insurance measure results in less favorable treatment of a non-U.S. insurer than a U.S. insurer; (ii) affect any provision of the Consumer Financial Protection Agency Act of 2010; or (iii) affect the preemption of any State insurance measure otherwise inconsistent with and preempted by Federal law.

<sup>28</sup> Determinations of inconsistency with a Covered International Agreement will be subject to the Administrative Procedure Act, with the exception, added as part of the

If a measure has been preempted, no State may enforce it.

### Study on How to Modernize and Improve Insurance Regulation

A provision in the Dodd-Frank Act requires that the FIO director conduct a study and submit a report to Congress within 18 months of enactment on how to modernize and improve insurance regulation in the United States. The Act requires that the report consider: (i) effective systemic risk regulation; (ii) capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk; (iii) consumer protection for insurance products and practices, including gaps in State regulation; (iv) the degree of national uniformity of State insurance regulation; (v) the regulation of insurance companies and affiliates on a consolidated basis; and (vi) international coordination of insurance regulation.

Significantly, the Dodd-Frank Act requires the report to examine the following additional factors relating to potential Federal regulation of the insurance industry: (i) the costs and benefits of potential Federal regulation of insurance across various lines of insurance (except health insurance); (ii) the feasibility of regulating only certain lines of insurance at the Federal level while leaving other lines for State regulation; (iii) the ability of potential Federal regulation of insurance to eliminate or minimize regulatory arbitrage; (iv) the impact that developments in the regulation of insurance in non-U.S. jurisdictions might have on the potential Federal regulation of insurance; (v) the ability of potential Federal regulation to provide robust consumer protection for policyholders; (vi) the potential consequences of subjecting insurance companies to a Federal resolution authority; and (vii) such other factors the FIO director determines are necessary or appropriate.

The Dodd-Frank Act expressly requires consideration in the report of the effects of any Federal resolution authority: (i) on the operation of State insurance guaranty fund systems, including the loss of guaranty systems 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

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House-Senate conference negotiations, that in any action for judicial review of a determination of inconsistency, a court will determine the matter *de novo*.

separate account liabilities; and (iv) on the international competitiveness of insurance companies.

The FIO director must consult with State insurance regulators, consumer organizations, representatives of the insurance industry and policyholders and other organizations and experts as appropriate.

### Annual Reports

The Dodd-Frank Act requires that the FIO director submit annual reports to the President, the House Committees on Financial Services and Ways and Means, and the Senate Committees on Banking, Housing, and Urban Affairs and Finance. The annual reports must include: (i) a report detailing any actions taken to preempt State insurance measures; and (ii) a report on the insurance industry and other information the FIO director deems relevant or the Committees request. The requirement to submit annual reports begins on September 30, 2011.

## Harmonization of the Standard of Conduct for Broker-Dealers and Investment Advisers

Currently, the standard of conduct broker-dealers must use in recommending a security for sale is that the security must be suitable for the investor.<sup>29</sup> Investment advisers, on the other hand, are subject to a fiduciary standard: “The Investment Advisers Act of 1940 ... reflects a congressional recognition of ‘the delicate fiduciary nature of an investment advisory relationship,’ as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.”<sup>30</sup> The Dodd-

<sup>29</sup> This standard is set forth in NASD Rule 2310, which provides: “In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.” It further provides: “Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer’s financial status; (2) the customer’s tax status; (3) the customer’s investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.”

<sup>30</sup> *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963).

Frank Act includes a provision that could lead to the harmonization of the fiduciary duties of broker-dealers and investment advisers and result in a more stringent standard of conduct for sellers of insurance/securities products.

### Study of Existing Legal or Regulatory Standards of Conduct

The Dodd-Frank Act requires that the SEC conduct a study of (i) the effectiveness of existing legal or regulatory standards of care for broker-dealers, investment advisers, persons associated with broker-dealers and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers;<sup>31</sup> and (ii) whether there are legal or regulatory gaps, shortcomings or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for broker-dealers, investment advisers, persons associated with broker-dealers and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.<sup>32</sup> The SEC is required to submit the report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services within six months of the enactment of the Dodd-Frank Act. The SEC is required to seek and consider public comment to prepare the report.<sup>33</sup>

### Rulemaking

Following the study, the SEC is authorized to promulgate rules as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the SEC may by rule provide) to address the legal or regulatory standards of care for broker-dealers, investment advisers, persons associated with

<sup>31</sup> A “retail customer” is defined as a natural person, or the legal representative of such natural person, who: (i) receives personalized investment advice about securities from a broker-dealer or investment adviser; and (ii) uses such advice primarily for personal, family or household purposes.

<sup>32</sup> Rather than requiring that the SEC conduct a study, the House Bill mandated that the SEC adopt rules specifying that the standard of conduct for broker-dealers must be the same as the standard of conduct for investment advisers when providing personalized investment advice to a retail customer about securities.

<sup>33</sup> On July 27, the SEC issued a request for public comment to inform its study, which will remain open for 30 days following publication of the release in the Federal Register. SEC Release 34-62577.

broker-dealers and persons associated with investment advisers, for providing personalized investment advice and recommendations about securities to retail customers. In promulgating rules, the SEC is required to consider the findings, conclusions, and recommendations of the study discussed above.

The Act specifically authorizes the SEC to promulgate rules that establish that broker-dealers providing personalized investment advice to a retail customer (and such other customers as the SEC may provide by rule), shall be subject to the same standard of conduct as that applicable to an investment adviser under Section 211 of the Investment Advisers Act of 1940 (the “Advisers Act”).<sup>34</sup> Pursuant to this standard, a broker-dealer or investment adviser providing investment advice would be required to act in the best interest of the customer without regard to the financial or other interest of the broker-dealer or investment adviser. Any material conflicts of interest must be disclosed and may be consented to by the customer.

The Dodd-Frank Act provides that the receipt of compensation based on “commission or other standard compensation” for the sale of securities shall not, in and of itself, be considered a violation of such standard applied to a broker or dealer. The Dodd-Frank Act also provides that the rulemaking authority given to the SEC shall not require a broker-dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice.

Where a broker-dealer sells only proprietary or other limited range products (as determined by the SEC), the SEC may require that such broker-dealer provide notice to each retail customer and obtain the consent or acknowledgement of the customer. The Act states that the sale of only proprietary or other limited range products by a broker-dealer shall not, in and of itself, be considered a violation of the fiduciary standard.

## Enforcement

The Dodd-Frank Act amends Section 15 of the Securities Exchange Act of 1934 (“Exchange Act”) to provide that the SEC has enforcement authority with respect to violations of the standard of conduct by broker-dealers. The Dodd-Frank Act instructs the SEC to prosecute and sanction violations of the standard of conduct applicable to a broker-dealer providing personalized investment advice about securities to a retail customer to the same

<sup>34</sup> Section 211 authorizes the SEC to adopt rules necessary and appropriate to exercise the functions and powers conferred on the SEC under the Advisers Act.

extent as the SEC prosecutes and sanctions violators of the standard of conduct applicable to investment advisers under the Advisers Act.

## The Volcker Rule

Life insurance companies and their affiliates may also be affected by Section 619 of the Dodd-Frank Act, which is known as the “Volcker Rule” after its principal proponent, former FRB Chairman Paul Volcker.<sup>35</sup> This provision generally prohibits “banking entities” from engaging in “proprietary trading” and restricts their sponsorship of and investments in hedge funds and private equity funds. A banking entity, for purposes of the Volcker Rule, includes not only insured depository institutions but also any holding company for an insured depository institution and any subsidiary or affiliate of the holding company.<sup>36</sup> The breadth of these provisions would render the Volcker Rule applicable to an insurance complex, including its nonbank affiliates, if there is a depository institution in the structure.<sup>37</sup>

Subsection (a)(1)(A) of the Volcker Rule prohibits “proprietary trading” by banking entities, with exceptions for certain permitted activities. For these purposes, “proprietary trading” means engaging as a principal for the entity’s trading account in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, derivative, contract of sale of a commodity for future delivery, option on any such security, derivative, or contract, or other security or financial instrument that the appropriate Federal banking agencies, the SEC, and the CFTC may, by rule, determine (collectively, “covered instruments”). The term “trading account,” in turn, means any account for acquiring or taking positions in

<sup>35</sup> The Volcker Rule is reflected in a new Section 13 added to the BHC Act (12 U.S.C. 1841 et seq.), entitled “Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds.”

<sup>36</sup> The term “banking entity” is defined as “any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) (but excludes limited purpose FDIC insured trust banks that meet certain requirements), any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.”

<sup>37</sup> Section 619 further provides that the FRB is authorized to adopt rules to require Significant Nonbanks, which, as described above, could include insurance companies and their affiliates, to be subject to additional capital requirements and quantitative limits in connection with their proprietary trading or hedge/private equity fund sponsorship.

covered instruments principally for the purposes of selling in the near term, or otherwise with the intent to resell in order to profit from short-term price movements, and any such other accounts as the appropriate Federal banking agencies, the SEC, and the CFTC may by rule determine.

As originally introduced as part of the Restoring American Financial Stability Act of 2010, this provision was of great concern to the insurance industry, as it had the potential to alter the fundamental way in which many insurance companies with ancillary banking entities conduct their day-to-day business activities. However, the final version of the Volcker Rule contained in the Dodd-Frank Act contains an exception for insurance companies with respect to their general accounts.<sup>38</sup> Specifically, the Volcker Rule as enacted permits “[t]he purchase, sale, acquisition, or disposition of [covered instruments] by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate of such regulated insurance company, provided that such activities by any affiliate are solely for the general account of the regulated insurance company.” This exception for insurance company general accounts is contingent upon:

(1) compliance with investment laws and guidance for insurance companies under the respective State insurance code for the jurisdiction in which the insurance company is domiciled; and (2) there being no determination by the appropriate Federal banking agencies, after consultation with the Council and the relevant insurance commissioners, that a particular law, regulation or written guidance described in (1) is insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States.

The Volcker Rule also excludes from the prohibitions on proprietary trading transactions in certain types of securities and certain categories of transactions. Proprietary trading for customers is permitted. The proprietary trading restrictions do not apply to such activities that are conducted solely outside the United States by a banking entity that is not directly or indirectly controlled by a banking entity organized under United States law. The appropriate Federal banking agencies, the SEC, and the CFTC are authorized to adopt rules imposing additional capital requirements and quantita-

<sup>38</sup> Interestingly, no comparable exception is provided for insurance company separate accounts, though it could be argued that an insurer is acting as principal in trading for a separate account since the assets of a separate account are assets of the sponsoring insurer. Presumably, if Congress had intended for the Volcker Rule to impede an insurer’s ability to offer and manage variable contracts, such a profound prohibition would have been discussed.

tive limitations, including diversification requirements, if determined to be appropriate to protect the safety and soundness of a banking entity engaging in such permitted activities.

Subsection (a)(1)(B) of the Volcker Rule further prohibits a banking entity from acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or a private equity fund (“private fund activities”), subject to the exception described below. “Sponsoring” is defined as “(A) serving as a general partner, managing member, or trustee of the fund; (B) in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund; or (C) sharing with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.” An exception to the general ban allows a banking entity to organize and offer a private equity or hedge fund if certain conditions are met. A banking entity may invest in a private equity or hedge fund that it organizes and offers for the purpose of (i) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment; provided that a banking entity shall actively seek unaffiliated investors to reduce or dilute the investment of the banking entity to meet the following limitations on the size of investments: (1) not later than one year after the date of establishment of the fund, investments by the banking entity must be reduced through redemption, sale, or dilution to an amount that is not more than three percent of the total ownership interests of the fund; and (2) investments by the banking entity must be immaterial to the banking entity, but in no case may the aggregate of all of the interests of the banking entity in all such funds exceed three percent of the Tier 1 capital of the banking entity. Unlike the ban on proprietary trading, the restrictions of the Volcker rule on private fund activities do not provide an exception specific to insurance companies.

In addition, subsection (a)(2) of the Volcker Rule provides that Significant Nonbanks shall be subject to additional capital requirements for, and additional quantitative limits with regards to, taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or private equity fund, according to rules to be adopted by Federal banking agencies, the SEC, and the CFTC.

The Act requires the Council to conduct a study and make recommendations on implementing the Volcker Rule within six months after its enactment. The implementation recommendations must be designed to

promote and enhance the safety and soundness of banking entities; minimize risks to taxpayers, consumers, and to financial stability from unsafe and unsound activities of covered entities; and achieve other specified goals related to the purpose of the legislation. One of the specified goals is to “appropriately accommodate the business of insurance within an insurance company subject to regulation in accordance with State insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system.” Within nine months after completion of the study, the appropriate Federal banking agencies, the SEC, and the CFTC are required to consider the findings and adopt rules to carry out the provisions of the Volcker Rule. The agencies are required to issue rules relating to the entities under their jurisdiction, but are directed to coordinate with each other, and the Council is charged with responsibility for this coordination.

The provisions of the Volcker Rule take effect the earlier of 12 months after the issuance of the final rules described above or two years after enactment. Banking entities or Significant Nonbanks would then be required to bring their activities into compliance with the requirements of this section not later than two years after the date on which the requirements become effective or two years after the date on which the entity or company becomes a Significant Nonbank.<sup>39</sup> The FRB may, by rule or order, extend this two-year period for not more than one year at a time, if, in its judgment, such an extension is consistent with the purposes of this section and would not be detrimental to the public interest. Such extensions may not exceed an aggregate of three years.

## Regulation of Over-the-Counter Derivatives

Title VII of the Dodd-Frank Act establishes a new regulatory framework for the over-the-counter derivatives market.<sup>40</sup> It requires, among other things, clearing and exchange trading for many OTC derivatives contracts and registration with the SEC or CFTC of “swap dealers” and “major swap participants,” which would also be subject to capital and margin requirements and various reporting

<sup>39</sup> There are also detailed provisions relating to divestiture of illiquid funds and other transition matters.

<sup>40</sup> For a more complete discussion of derivatives regulation under Title VII, please see [http://www.dechert.com/library/FS\\_17\\_07-10\\_Dodd-Frank\\_The\\_Regulatory\\_Reset.pdf](http://www.dechert.com/library/FS_17_07-10_Dodd-Frank_The_Regulatory_Reset.pdf).

and record-keeping obligations.<sup>41</sup> Title VII allocates jurisdiction over the OTC derivatives markets largely between the SEC, for “security-based swaps,” and the CFTC, for all other “swaps.” Significant portions of Title VII are subject to rulemaking by the SEC and the CFTC.

Life insurance companies can be large consumers of derivatives, which can help insurers reduce risks they assume in managing general account assets and making guarantees to contract and policy holders.<sup>42</sup> If an insurance company or an affiliate meets the definition of major swap participant or swap dealer, its OTC derivatives activities will be heavily regulated.

### What Products Are Covered by the New Regulatory Regime?

Title VII addresses “swaps,” which are defined broadly to cover most commonly traded OTC derivatives, including: options on interest rates, currencies, commodities, securities, indices, and various other financial or economic interests or property; contracts in which payments and deliveries are dependent on the occurrence or non-occurrence of certain contingencies (e.g., a credit default swap); and swaps on rates and currencies, total return swaps and various other common swap transactions.<sup>43</sup>

Foreign exchange (“FX”) swaps and forwards will be considered “swaps” and subject to regulation under the Act unless the Secretary of the Treasury determines that such transactions should not be regulated under Title VII and have not been structured to evade the reach of the Act.

<sup>41</sup> For ease of reference, the terms “swap,” “swap dealer” and “major swap participant” will be used to include, respectively, the terms “security-based swap,” “security-based swap dealer” and “major security-based swap participant,” unless the context otherwise distinguishes the terms.

<sup>42</sup> The American Council of Life Insurers (“ACLI”) has stated that hedging activities by insurers do not create systemic risks to the economy, and expressed the view that these activities are strictly and conservatively regulated under State insurance laws and regulations. ACLI News Release, dated June 25, 2010.

<sup>43</sup> The swap definition excludes, among other products, commodity futures and physically settled sales of non-financial commodities for deferred shipment. The swap definition also excludes any agreement that is based on a security and entered into with an underwriter for the purpose of raising capital, unless the agreement is entered into to manage a risk associated with capital raising.

## Stable Value Products May Be Considered Swaps In the Future

Stable value products, often used as a conservative investment for pension plans, were originally classified as swaps in earlier versions of the legislation. However, the final version left the question unanswered and mandated that the SEC and CFTC conduct a joint study within 15 months after the legislation is enacted to “determine whether stable value contracts fall within the definition of a swap.”<sup>44</sup> The Act further calls for the two Commissions to determine whether an exemption for stable value funds is necessary should they find that the products are swaps. The final language also provides grandfather protection for stable value contracts in existence prior to the Commissions’ issuance of regulations implementing their findings. Designating stable value wrap contracts as swaps would likely make them more complex and costly to issue, which could lower returns.<sup>45</sup>

The definition of “stable value contract” in the Act is broad. Section 719(d)(2) defines stable value contracts as any contract, agreement, or transaction that provides a crediting interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity offered by a bank, insurance company, or other State or Federally regulated financial institution for the benefit of certain employee benefit plans. The breadth of this definition could conceivably encompass certain guaranteed investment contracts (“GICs”) and synthetic GICs. The Commissions’ study and determinations about stable value contracts will be very important to insurers in the business of issuing those contracts in the pension market.

## What OTC Derivatives Are Not Covered?

The swap definition excludes, among other products, commodity futures and physically settled sales of non-

<sup>44</sup> The two Commissions are required to consult with the Department of Labor, the Department of the Treasury, and the State entities that regulate the issuers of stable value contracts.

<sup>45</sup> Reports show that Insurers and banks, the issuers of these contracts, have been more reluctant to enter into these contracts due to the financial turmoil experienced over the past couple of years. “How the financial crisis has affected, among other things, stable value wrap provider stability and capacity, pricing and contract operation, and underlying investment parameters is a topic of considerable discussion throughout the industry.... There certainly has been a significant contraction in the availability of wrap capacity in the stable value market...” See statement by Warren Howe, managing sales director for MetLife’s Stable Value Markets team at <http://insurancenewsnet.com/article.aspx?id=178177&type=lifehealth>.

financial commodities for deferred shipment. The swap definition also excludes any agreement that is based on a security and entered into with an underwriter for the purpose of raising capital, unless the agreement is entered into to manage a risk associated with capital raising.

## Major Swap Participants

An issue for insurance companies is the possibility of being swept into the definition of major swap participant. The Act defines a “major swap participant” as any person who is not a Swap Dealer, and:

- who maintains a “substantial position” in swap transactions, excluding positions held for hedging or mitigating the participant’s commercial risk and positions held by employee benefit plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
- whose outstanding swaps create “substantial counterparty exposure” that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- who is a financial entity that: (A) is “highly leveraged relative to the amount of capital it holds” and is not subject to capital requirements established by an appropriate Federal banking agency and (B) maintains a substantial position in outstanding swaps transactions (a “Covered Financial Entity”).<sup>46</sup>

## What Does “Substantial Position” Mean?

The Commissions are required to define “substantial position” as the amount the Commissions determine to be prudent for the effective oversight of market participants that are “systemically important or can significantly impact the financial system of the United States.” Title VII states that the Commissions may take into account the value and quality of collateral held against counterparty exposure as part of this analysis. Thus, prudent collateralization practices could affect the perspective of the Commissions in deciding whether certain persons, which could include insurers or their affiliates, are major swap participants.

In addition, there is no indication as to whether the “substantial position” will be determined across affiliated entities or whether it will be determined on an entity-by-

<sup>46</sup> Title VII includes a substantially similar definition for a “major security-based swap participant,” which is essentially a major swap participant with positions in security-based swap transactions.

entity basis (e.g., long positions against short positions within a single portfolio). Nor is it apparent how common structures such as separately managed accounts will be treated under the definition. Finally, aside from questions surrounding the “substantial position” definition, the determination of what will constitute “substantial counterparty exposure” is also unclear and the Commissions are not charged with providing a definition.

## Swap Dealers

Under Title VII, banks, dealers and other financial institutions active in the derivatives markets may be considered “swap dealers,” which, like major swap participants, are subject to capital, margin, reporting and record-keeping requirements in their over-the-counter derivatives activities. A swap dealer is defined as any person who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties in the ordinary course of business for its own account; or
- engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.<sup>47</sup>

Unknown at this point is what may constitute a person “hold[ing] itself out as a dealer in swaps” or purchasing or selling swaps in the “ordinary course of business.”

## Exemptions from the Swap Dealer Definition

The following entities are expressly exempt from the swap dealer definition:

- an insured depository institution to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer;
- an entity that buys or sells swaps for such person’s own account, either individually or in a fiduciary capacity, and not as “part of a regular business;” and

<sup>47</sup> As with the major swap participant definition, Title VII includes a substantially similar definition for a “security-based swap dealer,” subject to SEC jurisdiction, which deals primarily in security-based swap transactions.

- an entity that engages in a “*de minimis* quantity” of swap dealing in connection with transactions with or on behalf of its customers.

The CFTC and SEC are charged with promulgating regulations to establish factors in making the determination of a “*de minimis* quantity.”

## ***Consequences of Being a Swap Dealer or Major Swap Participant***

### Registration

Each swap dealer and major swap participant is required to register with the CFTC or SEC, depending on whether such swap dealer’s or major swap participant’s derivatives business involves swaps or security-based swaps. The Commissions are charged with developing the form and manner of this registration. Commission rules must provide for the registration of swap dealers and major swap participants within one year after the date of enactment of the Act.

Swap dealers and major swap participants will be required to submit on-going reports containing such information relevant to their swaps business as the Commissions may require. Moreover, the CFTC and SEC are authorized to take actions that “limit the activities” of market participants registered with the Commissions. Title VII, however, does not indicate what actions the Commissions may take in limiting the derivatives trading of market participants.

### New Regulatory Capital and Margin Requirements

Each registered swap dealer and major swap participant, and any swap dealer or major swap participant for which there is a prudential regulator, such as the FRB or the FDIC, must meet new minimum capital standards and initial and variation margin requirements for non-cleared swaps. (Cleared swaps will be subject to existing margin requirements mandated by the relevant clearinghouse.)

In terms of the amount of any such additional regulatory capital required, the Act mandates that such amounts must help ensure the safety and soundness of the market participant and be appropriate for the risk associated with the non-cleared swaps in the market participant’s trading book. Title VII’s compulsory capital and margin requirements are intended to remove a substantial degree of leverage and risk-taking from the derivatives markets.

## New Reporting and Record-keeping Obligations

Each swap dealer and major swap participant will be required to provide reports to the Commissions regarding its transactions, positions and financial condition. Daily trading records will need to be maintained and all related records, recorded communications (such as email, instant messaging and recorded telephone calls) for such period of time as the Commissions may require.

Each swap dealer and major swap participant will also be required to maintain books and records of all activities related to its business in such form and manner and for such period of time as the Commissions may require. These books and records must be available for inspection by the relevant Commission, the Department of Justice, appropriate Federal banking agencies, and other regulators.

## New Business Conduct Standards for Swap Dealers and Major Swap Participants

Title VII also seeks to ensure that market participants will comply with adequate business conduct standards in the operation of their OTC derivatives trading. These standards are similar to FINRA Rules of Conduct in many respects. Each swap dealer and major swap participant will be required to satisfy business conduct standards adopted by the Commissions that will:

- establish a duty to verify that any counterparty meets certain eligibility standards;
- require disclosure to any counterparty to a transaction of:
  - material risks and characteristics of the swap transaction;
  - any material incentives or conflicts of interest that the swap dealer or major swap participant may have;
  - a daily mark of the transaction.<sup>48</sup>

## Clearing Requirements for Swaps

Title VII requires clearing of all swap transactions that are acceptable to a “derivatives clearing organization” (“DCO”) for clearing, subject to an exception described

<sup>48</sup> The Commissions must also establish a duty for swap dealers and major swap participants to communicate in a fair and balanced manner based on principles of fair dealing and good faith, among other things.

below. A DCO must submit to the SEC or CFTC for prior approval any type of swaps the DCO seeks to clear.

Parties to a swap that is not accepted by a DCO will be required to report the swap to a “swap data repository” or “SDR.”<sup>49</sup> Swaps entered into before the date of enactment of the Act are exempt from the clearing requirements provided these swaps are reported to an SDR.

## Exemption for Commercial Users

Title VII does not require a swap to be cleared if one of the counterparties to the swap: (i) is not a “financial entity”; (ii) is using swaps to hedge or mitigate commercial risk (also discussed below); and (iii) notifies the relevant Commission how it meets its financial obligations under the non-cleared swap. A “financial entity” is defined as a swap dealer, major swap participant, commodity pool, certain private funds, an ERISA plan, and certain banking entities. Interestingly, insurance companies are not a “financial entity” for these purposes.<sup>50</sup> The CFTC is given authority to adopt a rule to define “commercial risk.” Accordingly, if an insurer is not a swap dealer or a major swap participant, and is using a swap for hedging purposes, the Act seems to contemplate that the insurer may choose not to clear the swap. Of course, it will be important to monitor any guidance on commercial risk and perhaps on hedging for these purposes, and the precise nature of the hedging and risk mitigation activity may be important for relying on this exception to the clearing requirements in the Act.

In a June 30, 2010 letter (the “Dodd Lincoln Letter”), Senator Christopher Dodd (D-Conn) and Senator Blanche Lincoln (D-Neb), a proponent of Title VII, attempted to address concerns that Title VII would make it more difficult for non-financial businesses to continue ordinary physical trading and to manage their commercial risks through OTC derivatives. The Dodd Lincoln Letter states

<sup>49</sup> An SDR is generally any person that collects, calculates and prepares information or records related to transactions or positions in, or the terms and conditions of, swaps entered into with third parties. The data collection and data maintenance standards for SDRs will be determined by the SEC

and CFTC. Swaps entered into before the enactment of the Act will be required to be reported to an SDR within 30 days of issuance of an interim final rule on the reporting of swaps, which in turn must be promulgated by the SEC and CFTC within 90 days of the effective date of the Act.

<sup>50</sup> In contrast, an insurance company can be a Significant Nonbank for purposes of Title 1 of the Act, as described above under “Federal Government Oversight for Financial Stability.”

that Congress “created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk....These entities did not get us into this crisis and should not be punished for Wall Street’s excesses.” The Letter recognized that “derivatives are an important tool businesses use to manage costs and market volatility.” The Dodd Lincoln Letter stated that “[i]t is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.” “End users who hedge their risks may find it challenging to use a standard derivatives contract to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction.” Thus, the intent of these two Senators to exempt entities that use swaps to hedge or mitigate commercial risk is clear. It is, of course, unclear what weight will be given to this letter by the Commissions and ultimately by the courts.

The legislation further provides commercial end users with the option to choose their clearinghouse or clearing agency and the option to segregate margin with an independent third-party custodian.

Title VII of the Act will likely have profound effects on the regulation of the OTC derivatives markets, primarily through the institution of comprehensive market transparency, deleveraging and risk-reduction. The full impact of Title VII and its effects on insurers, however, will not be known until rulemaking by the Commissions has been finalized.

## State Regulation of Equity-Indexed Annuities

In a measure that presumably was intended to apply to indexed annuity contracts, Section 989J of the Dodd-Frank Act (the “Harkin Amendment”) requires the SEC to treat an insurance, endowment, annuity, or optional annuity contract as an “exempt security described under Section 3(a)(8) of the Securities Act of 1933” (the “Securities Act”), if it meets a three-part test. First, the value of the contract does not vary according to the performance of a separate account. Second, the contract (i) satisfies standard nonforfeiture laws or similar requirements of the applicable State at the time of issue; or (ii) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or Model Standard

Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners (“NAIC”).

Third, the insurance or endowment policy, annuity contract or optional annuity contract must be issued: (i) on or after June 16, 2013, in a State or issued by an insurance company that is domiciled in a State, that (a) adopts rules that govern suitability requirements in the sale of an insurance or endowment policy, annuity contract or optional annuity contract, which shall substantially meet or exceed the minimum requirements established in the Suitability in Annuity Transactions Model Regulation adopted by the NAIC in March 2010;<sup>51</sup> and (b) adopts rules that substantially meet or exceed the minimum requirements of any successor modifications to these model regulations within five years of the adoption by the NAIC; or (ii) by an insurance company that adopts or implements practices on a nationwide basis for the sale of any insurance or endowment policy, annuity contract or optional annuity contract that meet or exceed the minimum requirements established by the NAIC Suitability in Annuity Transactions Model Regulation, and any successor thereto, and is therefore subject to examination by the State of domicile of the insurance company, or by an other State where the insurance company conducts sales of such products, for the purpose of monitoring compliance with Section 989J.

The amendment effectively prevents the SEC from implementing Rule 151A under the Securities Act. In January 2009, the SEC adopted Rule 151A, which deemed indexed annuities to be securities subject to SEC oversight. A group of insurance companies and State insurance regulators filed suit to block enforcement of Rule 151A and argued that the SEC should have no control over what has traditionally been a State-regulated product. In July 2009, the U.S. Court of Appeals for the District of Columbia ruled that the SEC has the authority to regulate indexed annuities as securities.<sup>52</sup> However, the court determined that the SEC had failed to conduct a study as to whether Rule 151A supported capital formation, efficiency and competition as required by

<sup>51</sup> In March 2010, the NAIC updated its 2006 Suitability in Annuity Transactions model regulation to ensure that annuity transactions are suitable for investors and to prevent abusive sales and marketing practices. They also were revised to mirror the suitability standards required by FINRA. The NAIC’s Executive Summary of the “Suitability in Annuity Transactions Model Regulation” is available at [http://www.naic.org/documents/committees\\_a\\_suitability\\_reg\\_guidance.pdf](http://www.naic.org/documents/committees_a_suitability_reg_guidance.pdf).

<sup>52</sup> *American Equity Investment Life Insurance Co. et al vs. SEC*, (DC Cir) (decided July 21, 2009 and reissued July 12, 2010).

statute. On July 12, 2010, the U.S. Court of Appeals for the District of Columbia vacated the proposed regulation because the SEC had failed to conduct the required study.

The Harkin Amendment may have implications for other products that have securities attributes, possibly including annuity contracts with a market value adjustment. This will require, among other things, an analysis of whether the annuity contract “satisfies” the relevant State nonforfeiture laws.

While the Harkin amendment seems to resolve the fate of Rule 151A, the language of the amendment raises a number of interpretive issues. First, the requirement that the SEC treat the contracts as “exempt securities as described under Section 3(a)(8)” of the Securities Act appears to leave open the question of how individuals, entities, courts and regulators other than the SEC should treat them. Second, it is not clear whether treating the contracts as exempt securities under the Securities Act contemplates treating them as excluded from the reach of the Act for all purposes, including the anti-fraud provisions, as has been the historical interpretation of contracts that fall within Section 3(a)(8). Finally, the Harkin Amendment does not address treatment of the contracts as securities, exempt or otherwise, under the Securities Exchange of 1934. Treatment under the Exchange Act would presumably affect whether FINRA rules apply to sales of the contracts, and whether the anti-fraud provisions of Rule 10b-5 are relevant.<sup>53</sup>

## Other Provisions Relevant to Life Insurance Companies

The Dodd-Frank Act has many other provisions that could be relevant to a life insurer or its affiliates. These include the following:

- **Study on Financial Planners and Use of Financial Designations.** Section 919C of the Act requires the Comptroller General of the United States to conduct a study and report to Congress on the effectiveness of Federal and State regulations to protect

<sup>53</sup> FINRA even applies many of its Conduct Rules to transactions in securities that are exempt under the Exchange Act (other than municipal securities), including group variable annuity contracts sold exclusively to qualified plans. FINRA Rule 0150. See also Letter from Jeffrey S. Holik, Vice President and Acting General Counsel, NASD Regulation, Inc., to Katherine A. England, Assistant Director, SEC’s Division of Market Regulation (Jan. 26, 2001) (asserting FINRA has jurisdiction over exempt securities other than municipal securities).

investors and other consumers from individuals who hold themselves as financial planners through misleading titles or marketing, and on any gaps in the regulation of individuals offering financial planning services to consumers. The report is due not later than 180 days from enactment.

- **Clarification of SEC Authority to Require Point of Sale Disclosures.** Section 919 of the Act provides that the SEC may issue rules designating disclosures that must be provided by a broker-dealer to a retail investor before the purchase of an investment product or service by the retail investor. If adopted, such rules could cover insurance products that are treated as securities under the Federal securities laws. This provision does not require the SEC to issue point of sale disclosure rules, either in general or for any particular product, and in some respects circumscribes the SEC’s authority to do so. The Act requires that in developing any rules under this provision, the SEC must consider whether the rules will promote investor protection, efficiency, competition and capital formation, and prescribes certain aspects of the form and content of disclosure that could be required under such rules. Any required disclosure must be in summary format and contain clear and concise information about (i) investment objectives, strategies, costs, and risks and (ii) any compensation or other financial incentive received by a broker, dealer, or other intermediary in connection with the purchase of retail investment products.
- **Pre-dispute Arbitration.** Section 921 of the Act authorizes the SEC to adopt rules that prohibit or restrict the use of broker dealer or investment adviser agreements that require customers or clients to arbitrate future disputes arising under the Federal securities laws or rules of any self-regulatory organization.
- **Regulation of Credit Risk Retention.** Section 941 of the Act requires Federal banking agencies and the SEC jointly to prescribe regulations requiring any “securitizer” of asset-backed securities—defined as a person who issues an asset-backed security or organizes and initiates an asset-backed securities transaction—to retain a portion of the credit risk for any asset transferred to a third party by means of the asset-backed security. This would affect insurance companies or their affiliates that may qualify as “securitizers” through their sponsorship of asset-backed securities transactions. The deadline for these regulations is no later than 270 days from enactment.
- **Participation in National Producer Database.** Pursuant to Section 523 of the Act, after two years from the date of enactment, a State may not collect fees relating to licensing of an individual or entity as a surplus lines broker in the State unless

the State has in effect laws that provide for participation by the State in the national insurance producer database of the NAIC for the licensure of surplus lines brokers and the renewal of such licenses.

- **Senior Investor Protections.** Section 989A of the Act provides for a program under which Federal grants totaling \$8 million for each of fiscal years

2011 through 2015 can be provided to States, State securities commissions, State insurance commissions, or a State consumer protection agency (collectively, the “agencies”) for enhanced protection of seniors from being misled by false designations. The legislation specifically notes that the grants can be used, among other things, to bring and prosecute cases involving misleading or fraudulent marketing, which is defined as using a misleading designation that implies a salesperson or adviser has special certification in advising or servicing seniors. The legislation also allows States to use the money to enhance State law to provide protection for seniors against misleading or fraudulent marketing about senior specific desig-

nations. This measure could provide incentive for a State to enact the NAIC Model Regulation on Suitability in Annuity Transactions.

- **Regulation of Advisers to Hedge Funds.** Section 403 of the Act requires SEC registration for a broader range of investment advisers by eliminating: (i) the “private investment adviser” exemption in Section 203(b)(3) of the Advisers Act; and (ii) the intrastate registration exemption for investment advisers with any private fund client.



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