SULLIVAN & CROMWELL LLP

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New York State Department of Financial Services: Proposed Regulation Addressing Private Equity Investment in Insurers

The New York State Department of Financial Services Issues Proposed Amendments to Regulation Governing Acquisitions of New York Domestic Insurance Companies

SUMMARY

Citing a trend in recent years of private equity firms acquiring insurers, particularly life insurers writing fixed and indexed annuity contracts, the New York State Department of Financial Services on May 14, 2014 released for public comment proposed amendments to its regulations governing the approval process for the direct or indirect acquisition of control of insurance companies domiciled in New York. The proposed amendments seek to reduce "the possibility that any person seeking to acquire control of a New York domestic insurer has interests that conflict with the interests of policyholders, shareholders or the public" and "minimiz[e] the potential for harm to a domestic insurer" by introducing a set of enhanced requirements as part of the approval process. While most of these new requirements appear to be focused on private equity firms acquiring life insurers, the scope of the proposed regulation is broader and it includes provisions applicable to all potential buyers of New York domestic insurers. Among other items, the proposed amendments require applicants seeking to acquire any domestic insurer to submit five-year financial projections for the insurer and a detailed plan of operations, including any plans to declare dividends or change the insurer's investment portfolio, which plans may not be changed, including post-closing, without the prior approval of the New York Superintendent of Financial Services. In the case of a proposed acquisition of control of a life insurer, the applicant will also be required to establish a trust account to provide additional protections to policyholders if the Superintendent

determines that, absent such action, the acquisition is likely to be hazardous or prejudicial to the insurer's policyholders or shareholders.

AMENDMENTS TO REGULATION 52

On May 14, 2014, the New York State Department of Financial Services ("DFS") published a notice of proposed rulemaking in the New York State Register,[1] proposing certain amendments (the "Proposed Amendments") to the provisions of New York State Department of Financial Services Regulation 52 (11 NYCRR part 80) which set forth the information required to be furnished in applications (so-called "Form A") to the DFS seeking approval to acquire control of New York domestic insurers. The Proposed Amendments and the regulatory impact statement ("Impact Statement") accompanying the Proposed Amendments are available on the DFS' website.[2]

Background

In the Impact Statement, the DFS expressed concern over a growing trend in recent years of private equity and similar firms acquiring insurers, particularly life insurers writing fixed and indexed annuity contracts. The DFS noted that private equity-controlled insurers now account for nearly 30% of the indexed annuity market and 15% of the total fixed annuity market (up from 7% and 4% respectively one year ago). In particular, the DFS stated that it "is concerned that private equity firms, and other investors with a similar investment horizon, focus on maximizing their short-term financial returns rather than ensuring that long-term policyholders receive the insurance benefits for which they have paid."

The Proposed Amendments follow two acquisitions (the "2013 Approvals") of annuity insurers by affiliates of private equity firms in 2013 in which the DFS imposed various additional conditions for approval of the transactions, including heightened capital standards; the establishment of a separate, additional "backstop" trust account to replenish ("top up") the insurer's RBC levels in the event such levels fall below an agreed upon percent; enhanced regulatory scrutiny of investments, operations, dividends, and reinsurance; and other strengthened disclosure and transparency requirements.[3] Certain of the conditions imposed as part of the 2013 Approvals, or conditions similar thereto, are part of the Proposed Amendments.

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1 See New York State Register May 14, 2014/Volume XXXVI, Issue 19, 37-39.

2 See http://www.dfs.ny.gov/insurance/rproindx.htm.

3 The 2013 Approvals were not made publicly available. According to the DFS press releases announcing the 2013 Approvals, the acquirors agreed to, among other things, maintain risk-based capital (RBC) levels of the target insurers at not less than 450% and file RBC reports with the DFS quarterly, rather than just annually as required under the New York Insurance Law.

Proposed Amendments

The Proposed Amendments make changes to the enumerated list of items an applicant seeking approval to acquire control of a domestic New York insurance company must submit in its application to the DFS pursuant to 11 NYCRR 80-1.6 ("Application").[4] In particular, the Proposed Amendments require applicants and their controlling persons to submit information relating to any plans or proposals concerning changes to the target insurer's business operations over a five-year period following the proposed acquisition, and to provide financial statements, investor solicitation materials and their operating, management, partnership, or limited partnership agreement. In addition, the Proposed Amendments add an express reference to limited partnerships, limited liability partnerships and limited liability companies to the list of persons with respect to which information in response to the various items of the Application must be provided, largely codifying current DFS practice.[5]

Current Item 5 in the Application, titled "Objectives in Acquisition of Control," requires that the applicant describe the objectives of the acquisition and any plans to liquidate the target insurer, sell its assets or make any change to its business operations or corporate structure. The Proposed Amendments broaden the type of information the applicant must include in Item 5, including any plans the applicant may have for the next five years to declare any dividends or "change the insurer's investment portfolio," and prescribe that such plans may not be modified or amended without the prior written approval of the New York Superintendent of Financial Services ("Superintendent").

The Proposed Amendments also clarify that submission of a detailed plan of operations as part of Item 5, which previously was couched in discretionary terms but typically required in practice, is now mandatory. This item now also requires the submission of five-year financial projections relating to the insurer. Additionally, if within five years of the date of acquisition of control the insurer enters into any reinsurance treaty or agreement with, or any transaction for the investment with, lending to, purchase of assets from,

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[4] New York Insurance Law Section 1506 prohibits any person, other than an authorized insurer, from acquiring "control" of any New York domestic insurer unless the person gives notice to the domestic insurer and receives the Superintendent's prior approval. "Control" is defined as "the possession direct or indirect of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract (except a commercial contract for goods or non-management services) or otherwise" and "is presumed to exist if any person directly or indirectly owns, controls or holds with the power to vote 10% or more of the voting securities of any other person."

[5] "Note B" in Item 2 ("Note B"), which lists the types of entities and persons associated with the applicant for which the various items called for in the Application must be provided, is amended to include an express reference to limited partnerships, limited liability partnerships and limited liability companies as well as general partners of limited partnerships or limited liability partnerships and managers, managing members or similar persons of limited liability companies. Note B is referenced in Items 2, 3, 5, 6 and 9 of the Application. As the DFS indicates in the Impact Statement, it has historically taken the view that these entities were covered by the term "or similar entity".

or encumbering its assets to or for the benefit of, the applicant or any person controlling, controlled by or under common control with the applicant, then the insurer must submit new five-year projections. If the Superintendent determines that the new projections show that the insurer will not have adequate capital, then the insurer must obtain additional capital in an amount and of a quality sufficient to remedy the deficiency as determined by the Superintendent. It bears noting that the latter requirement falls explicitly on the insurer rather than any person controlling the insurer.

With respect to the acquisition of a life insurer, the Proposed Amendments give the Superintendent explicit authority to require, as a condition to approval of the acquisition, the creation and funding of a "trust account" in an amount and for a duration determined in the discretion of the DFS. To impose such a condition, the Superintendent must first determine that, absent such action, the acquisition is likely to be hazardous or prejudicial to the insurer's policyholders or shareholders. Any required trust account must "substantially conform[]" to the requirements of a New York credit for reinsurance trust account (commonly known as a "Regulation 114 trust").[6] In making such determination, the DFS may consider, among other factors, whether the applicant or any person controlling, controlled by or under common control with the applicant (i) is registered or required to be registered with the SEC pursuant to the Investment Advisers Act of 1940, or would be required to so register if it had $150 million or more in assets under management;[7] (ii) is an investment company as defined in the Investment Company Act of 1940, but without giving effect to the Section 3(c)(1) and 3(c)(7) exclusions from the definition;[8] (iii) is an entity formed within the previous 36 months; (iv) is primarily engaged in investment management activities; or (v) holds for investment purposes a portfolio where non-publicly registered securities or holdings represent 50% or more of its assets.

Another item in the Application (Item 9) titled "Materials to be Filed as Exhibits" is revised to require submission of all "materials used to solicit investors" and, with respect to persons identified in Note B, to expressly require the submission of "any operating agreement, management agreement, partnership or

[6] The Impact Statement notes that, although the Proposed Amendments reference the establishment of a trust only in connection with an acquisition of a life insurer, the Superintendent has the discretion to condition an acquisition, in appropriate circumstances as needed, on the fulfillment of additional requirements, including the use of a trust or other financial backstop where a non-life insurer is being acquired.

[7] The Proposed Amendments also refer to entities "registered or required to register" with the SEC pursuant to two provisions that do not themselves require registration but rather (i) in the case of Rule 204(b)-1, requires reporting on Form PF by an investment adviser to private funds to the extent private fund assets under management at the end of its most recent fiscal year were at least $150 million, and (ii) in the case of Form PF, is the reporting form for investment advisers to private funds and certain commodity pool operators and commodity trading advisors.

[8] The Proposed Amendments refer to Section 3(c)(3) rather than 3(c)(7) but we believe that a reference to Section 3(c)(7) was intended as the text references "companies … where all owners are qualified purchasers as defined in [Section 2(a)(51) of the Investment Company Act]".

limited partnership agreement, or any other contract or agreement, pursuant to which any [such person] controls or purports to control the applicant."

The Impact Statement notes that the DFS modeled certain of the Proposed Amendments on the 2009 "Final Statement of Policy on Qualifications for Failed Bank Acquisitions" of the Federal Deposit Insurance Corporation (the "FDIC Statement"), which provides guidance to private capital investors interested in acquiring or investing in banking institutions that acquire failed insured depository institutions. For example, the DFS considers the requirement of a financial backstop, in the form of a trust account, in the Proposed Amendments to be "similar" to the FDIC Statement's requirement that the resulting depository institution must maintain a ratio of Tier 1 common equity to total assets of at least 10% for a period of three years from the time of acquisition, after which the depository institution must maintain a level of capital adequacy not lower than "well capitalized" during the remaining period of ownership by the investors. Conversely, the DFS found it unnecessary to establish a provision similar to the FDIC Statement's prohibition on an insured depository institution acquired by an investor from extending credit to the investor or its affiliates, citing the sufficiency of the prior approval requirements under existing insurance laws with respect to such transactions.

The Proposed Amendments are subject to a 45-day comment period commencing May 14, 2014, the date of publication of the notice, until June 28, 2014.

Observations

- Although the Proposed Amendments and the Impact Statement focus largely on "private equity firms . . . and other investors with a similar investment horizon", the increased disclosure requirements in the Proposed Amendments would technically apply to all applicants seeking approval to acquire control of a New York insurance company. This would necessarily include applicants that seek to make direct or indirect minority investments in New York insurance companies as long as such investments constitute an acquisition of "control" under the New York Insurance Law.[9]
- Conversely, although the trust account requirement could potentially apply to all applicants seeking to acquire life insurers (and, as the DFS notes in the Impact Statement, may be imposed on applicants proposing to acquire non-life insurers as well), the enumerated factors (referenced above) that the Superintendent *may* consider in determining whether to impose the requirement (as well as the 2013 Approvals) clearly evidence a focus on private capital investors acquiring life insurers.
- The new disclosure requirements under Item 5 and Item 9 of the Application could be viewed as encompassing the submission of fund documentation beyond that related to the investing vehicles, which private capital firms regard as very sensitive. The DFS, however, typically treats information contained in an Application as confidential and exempt from disclosure under New York's freedom of information laws.[10]

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[9] See Note 4 above.

[10] See New York Insurance Law Sec. 1504(c).

- The Proposed Amendments' requirement that the plans described in Item 5 (including any plans the applicant may have for the next five years to declare any dividends or "change the insurer's investment portfolio") may not be modified or amended without the prior written approval of the Superintendent introduces a formal post-acquisition "maintenance" requirement that historically has been left to informal discussion between applicant and regulator. Further, neither the Proposed Amendments nor the Impact Statement provide guidance as to the level of modification that will trigger the approval requirement. For example, will a modest change to the insurer's portfolio require prior approval? Is the declaration of a dividend not originally contemplated in the Application within five years of the acquisition subject to approval requirements beyond those expressly provided in the statutes governing dividends (*e.g.*, New York Insurance Law Sec. 4207)?

- The Proposed Amendments are also unclear as to who must establish the trust account in instances where multiple investors are involved.[11] If the DFS were to require the implementation of a trust account by a minority investor as part of the approval process, that investor would effectively be required to backstop the operations of an insurer that it may not actually control or of which it does not own all of the equity and related economic benefits. Private capital firms may be unwilling, or unable due to duties to investors or otherwise, to agree to establish a trust account in such circumstances. Although the DFS would presumably take an applicant's pro forma ownership interest into account in determining whether to impose a trust account requirement, the Proposed Amendments and the Impact Statement do not address such situations.

- The potential requirement to implement a trust account for any transaction is subject to a determination by the Superintendent that, without it, the transaction is "likely to be hazardous or prejudicial to the insurer's policyholders or shareholders." This standard is one of the enumerated factors under the New York Insurance Law (Sec. 1506(b)) the Superintendent must already consider in determining whether to approve the acquisition. Although, on its face, this would appear to be a relatively high standard, it is not clear how it would be interpreted by the DFS in the context of determining the extent to which a trust fund is required (and the amount thereof). A similar requirement was imposed in connection with the 2013 Approvals, which suggests the potential for regular imposition, rather than in exceptional cases only. In those transactions, the trust account was required to be maintained for at least seven years, with the potential to have a corresponding impact on investment returns.

- Lastly, we note that the National Association of Insurance Commissioners, as well as states other than New York, are also studying the issue of private equity investments in life insurers, and the NAIC is in the early stages of developing a series of best practices and new procedures with respect thereto.

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[11] The proposed revisions to Item 5 state that the trust account would need to be established by "the applicant or any holding company within the insurer's holding company system".

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