RISK RETENTION GROUP (E) TASK FORCE

Risk Retention Group (E) Task Force Dec. 5, 2009 Minutes – W:\Dec09\TF\Risk Retention_Group_E_ TF\12-risk.doc
Letter from Robert H. Myers, Jr. (NRRA) to Scott Richardson (SC) dated Aug. 11, 2009, regarding Application of Risk Retention Group Standards to State Actions (Attachment One)

Draft: 12/11/09

Risk Retention Group (E) Task Force
San Francisco, CA
December 5, 2009

The Risk Retention Group (E) Task Force met in San Francisco, CA, Dec. 5, 2009. The following Task Force members participated: Scott H. Richardson, Chair, represented by Leslie Jones (SC); Jim L. Ridling represented by David Parsons (AL); Christina Urias represented by Steve Ferguson (AZ); Steve Poizner represented by Jill Jacobi and Louis Quan (CA); Gennet Purcell represented by Sean O'Donnell (DC); Karen Weldin-Stewart represented by Elliott Jacobson and Steve Kinion (DE); J.P. Schmidt represented by George Sumner (HI); Sharon P. Clark represented by David Hurt (KY); Glenn Wilson represented by Jaki Gardner (MN); Scott J. Kipper represented by Brett Barratt (NV); James J. Wrynn represented by Robert Easton (NY); Joel Ario represented by Dave DelBiondo (PA); Kent Michie represented by Neal Gooch (UT); and Paulette Thabault represented by Dave Provost (VT).

1. Discuss *Annual Financial Reporting Model Regulation* (#205) and Corporate Governance Standards

Ms. Jones said the Task Force had previously discussed some of the models impacting the Part A: Laws and Regulations accreditation standards that had been revised since the Task Force's initial Part A deliberations, particularly model #205. Certain requirements in the model related to audit committees and audit committee member independence conflict with guidelines in the corporate governance standards adopted by the Property and Casualty Insurance (C) Committee. To resolve one of the conflicts, it was suggested that the auditors could be specifically excluded from the definition of a "material service provider" in the corporate governance standards. Ms. Jacobi said that was not a good solution because auditors certainly fit the definition of a typical material service provider. Skip Myers (National Risk Retention Association) noted that when the Risk Retention (C) Working Group developed the corporate governance standards, it was very deliberate in considering appropriate guidelines for risk retention groups (RRGs) related to audit committees and independence. The Task Force agreed that the states may comply with either model #205 or the corporate governance standards to fulfill the Part A requirements related to audit committees and audit committee member independence.

2. Discuss Vermont's Letter Regarding the Previously Adopted Part A Standards

Ms. Jones said that a letter (See 2009 Proceedings 3rd Quarter, Attachment Two of the Risk Retention Group (E) Task Force Minutes) from Peter Raymond (VT), requested clarification on several of the Part A: Laws and Regulations standards that had previously been adopted by the Task Force. Mr. Provost discussed the first item in the letter regarding whether RRGs would be required to file RBC. Julie Glaszczak (NAIC) said that, based on the Part A Summary Memo, RRGs are not required to file RBC; however, in order for the states to use the analysis tool developed by the Capital Adequacy (E) Task Force, the RBC report would need to be filed. Ms. Jones said the reason why the Part A Summary Memo does not require filing of RBC is because, at that time, the Task Force had asked the Capital Adequacy (E) Task Force to consider developing a new RBC formula specific to RRGs. In lieu of developing a new formula, the Capital Adequacy (E) Task Force developed the analysis tool. Mr. O'Donnell said he was not comfortable with requiring RRGs to file RBC because it is not necessarily meaningful, considering the basis of accounting used by many RRGs. He noted that there should be some sort of appropriate measure of capital adequacy for RRGs. Ms. Jones suggested that, as an interim solution, RRGs be required to file RBC, but that a subgroup be formed to develop a regulatory tool to assess capital adequacy; this regulatory tool could be an expansion of the sensitivity test developed by the Capital Adequacy (E) Task Force. It was noted that the Part A standards are not effective until Jan. 1, 2011, so RRGs would not have to file RBC until Dec. 31, 2011. Ms. Gardner moved and Mr. Ferguson seconded a motion to require RRGs to file RBC as part of the Capital and Surplus Part A standards and form a subgroup to develop a regulatory tool to assess capital adequacy. The motion passed, with Delaware voting against the motion. Arizona was appointed chair of the subgroup, with Delaware, the District of Columbia, New York, South Carolina and Vermont as members of the subgroup.

Mr. Provost discussed the second item in Vermont's letter, which asks whether an RRG needs to file holding company filings with just the state of domicile and/or with other states in which it is registered. Ms. Glaszczak noted that section 4A of the *Insurance Holding Company System Regulatory Act* (#440) indicates that the states should require every insurer authorized to do business in it shall file Forms B and C; however, it does exempt foreign insurers domiciled in jurisdictions that have adopted model #440. Therefore, Ms. Glaszczak explained, because all states have adopted substantially similar versions of the model, Form B and C filings only need to be filed with the state of domicile.

Vermont's letter also noted that the Task Force needed to discuss what communication should take place when a disclaimer of affiliation is granted. A disclaimer of affiliation should be filed with all states in which the RRG is registered to do business, but it was unclear whether the filing should be made by the RRG or by the domestic state. After some discussion, the Task Force agreed that the domestic state should require RRGs to file the disclaimer of affiliation as a change in business plan that would need to be filed by the RRG with the other states in which it is registered to do business. The Task Force instructed Ms. Glaszczak to draft an additional guideline to be included within the Information Sharing standard and forward this to the Financial Regulation Standards and Accreditation (F) Committee.

Mr. Provost discussed the question in Vermont's letter regarding reinsurance. The Task Force instructed Ms. Glaszczak to draft language to clarify that, under the Task Force's reinsurance guidelines, current cedants should be grandfathered in as acceptable, and the new requirements should be utilized prospectively.

Regarding the last question in Vermont's letter, Ms. Glaszczak said that a due date of June 30 for the audited financial statements would be considered substantially similar for accreditation purposes.

3. Discuss Letter Received from the National Risk Retention Association

Mr. Myers summarized his letter (Attachment One), noting various issues that RRGs have experienced in dealing with non-domestic state insurance departments. Mr. O'Donnell said that the accreditation program focuses on the domestic state's regulation of companies, not that of the non-domestic state. He noted that, while the accreditation program is not the appropriate place for this information, perhaps the *Risk Retention and Purchasing Group Handbook* (the Handbook) could be updated to provide guidance to non-domestic regulators. Ms. Jacobi said that as the law has developed over time, there have been various legal cases dealing with the federal Liability Risk Retention Act of 1986. She indicated that non-domestic states have in good faith attempted to follow this law. Ms. Jones suggested that a referral be made to the Risk Retention (C) Working Group to consider Mr. Myer's letter and whether any updates should be made to the Handbook. Mr. Myers noted that the Handbook contains only guidance and that the accreditation program is one of the only enforcement mechanisms at the NAIC. The Task Force agreed that the accreditation program is not the appropriate forum for Mr. Myers' concern and to refer the issue to the Property and Casualty Insurance (C) Committee.

Having no further business, the Risk Retention Group (E) Task Force adjourned.

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NRRA
NATIONAL RISK RETENTION ASSOCIATION

August 11, 2009

Scott Richardson, Commissioner
State of South Carolina
Chair, NAIC Risk Retention Group Task Force
2301 McGee Street, Suite 800
Kansas City, MO 64108
Attention: Julie Glaszczak [jglaszcz@naic.org]

Re: Application of Risk Retention Group Standards to State Actions

Dear Commissioner Richardson:

The purpose of this letter is to respectfully request that the NAIC amend the accreditation standards developed for the regulation of risk retention groups ("RRGs") to promote state compliance with the legal requirements of the Liability Risk Retention Act ("LRRA" or the "Act"), 15 U.S.C. § 3901, *et seq.*, and the interpretation of the Act's requirements by the NAIC Risk Retention and Purchasing Group Handbook ("Handbook"). As set forth in more detail below, numerous states violate the Act and the directives of the Handbook, and, thereby, violate federal law and frustrate the intent of Congress.

Following the issuance in 2005 of the General Accountability Office's Report on RRGs,[1] the NAIC appointed two working groups – the Risk Retention (C) Working Group and the Risk Retention (E) Task Force. Over the course of the next several years, these groups worked hard to first study the regulation of RRGs in light of the GAO's analysis and then to develop model rules and accreditation standards which would improve their regulation.

The Working Group finished its efforts first and adopted corporate governance standards. The full "C" Committee has recently agreed to examine the method by which those standards should be implemented. The Task Force engaged in a much more lengthy process and recently completed its review and proposed amendment of the Part A, B, and C accreditation standards in the context of RRGs.

Both the Working Group and Task Force were exemplary in their transparency and willingness to receive comment from and work with interested parties from the risk retention and

[1] Risk Retention Groups: Common Regulatory Standards and Greater Member Protections are Needed (GAO-05-536, August 15, 2005).

alternative risk industry. NRRA was a very active participant in all of these activities, including the NAIC quarterly meetings and interim conference calls.

While the efforts of both the Working Group and the Task Force will have the effect of enhancing the consistency of RRG regulation by the states, there has been no effort to include within the accreditation standards any requirement that the states conform to the Act. A summary of the issues follows.

Background and Legal Analysis

Under the LRRA, in order to do business in a non-domiciliary state, a risk retention group is only required to submit to that non-domiciliary state a filing containing the information delineated in Section 3902(d) of the LRRA.[2] The LRRA expressly preempts any other non-domiciliary state regulation unless it falls within one of the specified exceptions to preemption under Section 3902(a)(1). 15 U.S.C. § 3902(a). The exceptions to preemption relate primarily to unfair trade practices, premium taxes, registration of an agent, injunctions from a court of competent jurisdiction, and a notice on policies informing policyholders that the RRG may not be subject to all of the insurance laws of the state and is not a member of the state guaranty fund. *Id.* at § 3902(a)(1).

Despite these provisions of the LRRA, many states currently impose a variety of filing, fee, informational response and approval requirements on non-domiciliary RRGs. For instance, the California Department of Insurance requires foreign RRGs to (1) wait 60 days after delivery of its registration filing before it may commence operation in the state, (2) file a recurring annual registration renewal, (3) pay registration and renewal fees, (4) submit additional information as conditions for the Department's "approval," and (4) make changes to documents filed and

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[2] That section provides as follows:

(d) Each risk retention group shall submit –

. . . .

(2) to the insurance commissioner of each State in which it intends to do business, before it may offer insurance in such state –

(A) a copy of such plan or study (which shall include the name of the State in which it is chartered and its principal place of business); and

(B) a copy of any revisions to such plan or study as provided in paragraph (1) (B) (which shall include any change in the designation of the State in which it is chartered); and

(3) to the insurance commissioner of each State in which it is doing business, a copy of the group's annual financial statement submitted to the State in which the group is chartered as an insurance company. . . .

approved in the RRG's domiciliary state before the Department will "approve" the RRG's registration in California. For additional examples, please see the attached chart (Appendix A).[3]

These practices violate the LRRA. Two federal court decisions expressly concur with this position: *Attorney's Liability Assurance Society, Inc. v. Fitzgerald*, 175 F. Supp. 2d 619 (W.D. Mich. 2001) and *National Risk Retention Association v. Brown*, 927 F. Supp. 195 (M.D. La. 1996).

In *Fitzgerald*, the court rejected a non-domiciliary state's attempt to regulate foreign RRGs. First, the court found that the state improperly concluded that the foreign RRGs did not qualify as RRGs under the LRRA. *Fitzgerald*, 175 F. Supp. 2d at 629-34. Secondly, the court found that the LRRA preempted a regulatory fee which the non-domiciliary state attempted to assess against foreign RRGs. *Id.* at 636. Specifically, the court found:

> The LRRA's purpose would be thwarted if every state could exact a regulatory fee . . . . from non-resident risk retention groups. . . . Congress could have provided an exception for non-chartering states to collect a fee . . . ., over and above allowing collection of premium taxes. But it did not, which requires the conclusion that the regulatory fee was preempted.

Id. Thus, the court recognized the importance of limiting the regulatory powers of non-domiciliary states as Congress intended under the LRRA.

In *Brown*, a non-domiciliary state attempted to impose requirements not specified in Section 3902(d) of the LRRA as conditions for foreign RRG registration. The conditions included a required minimum capital and surplus of $5 million, posting of funds or a bond of $100,000 with the commissioner, and an annual submission of a plan of operation along with a $1,000 examination fee. The court held that the non-domiciliary state exceeded its authority over foreign RRGs:

> The burden imposed by the application process for a non resident risk-retention group is broader than is allowed by the LRRA. Section 3902(d) sets out the documents which are to be submitted to the insurance commissioner in the state in which it intends to do

[3] Appendix A summarizes those state actions which occur frequently. Other actions – such as challenges to a RRGs capitalization, informational reporting requirements, challenges regarding "financial responsibility" laws, challenges based upon the definition of a "liability" and others – occur occasionally and generally relate to specific state laws and, therefore, need to be treated on a case-by-case basis.

> business but is not chartered . . . . risk retention groups are exempted from any further requirements under Section 3902(a)(1).

Brown, 927 F. Supp. at 201. Accordingly, unless a specific regulatory power has been conferred upon a non-domiciliary state under the LRRA, Section 3902 prohibits the non-domiciliary state from directly or indirectly regulating the RRG.

NAIC Handbook

The NAIC recognizes that non-domiciliary states cannot utilize the registration process to regulate RRGs beyond the scope that the LRRA permits. Section II, 2.(a), of the NAIC's Risk Retention and Purchasing Group Handbook (rev. 1999) states:

> Section 3902(a)(1)(D) of the LRRA provides that any state may require that a RRG doing business in the state register with and designate the insurance commissioner of each state in which it does business as the group's agent for the purpose of receiving service of legal documents or process. Registration is intended to provide states with an orderly mechanism to identify RRGs operating within their borders. *Registration is not intended to provide non-chartering states with any regulatory powers over RRGs other than that provided in the LRRA.*
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> (emphasis added).

The Handbook further elaborates upon the limitations of the non-domiciliary state's authority and the role of the chartering or "lead" state in Section A.1.(a)(i):

> A chartering state should recognize that, due to the preemption of many state laws with respect to RRGs, non-chartering states depend on the domestic state to perform background checks on directors, officers and key management personnel of a RRG to ensure the competency, character and integrity of the insurer's management. As the lead regulator, the chartering state can help satisfy the legitimate concerns of non-chartering states with respect to the directors, officers and management of a RRG by conducting these background checks. Such action by the chartering state eliminates the need for redundant regulatory functions and is consistent with both the letter and intent of the LRRA.

Section A.1.(a)(ii) again emphasizes the same theme:

> Due to the preemption of many state laws with respect to RRGs, non-chartering states rely on the accuracy and completeness of the chartering state's review of a RRGs application. [See (i) above.] Requests for information outside of that required by the LRRA can be challenged by a RRG. [See (iii) below.] . . . . It is in the interest of both regulators and RRGs to avoid utilizing scarce resources for overlapping regulation.

The Handbook also prohibits the assessment of fees:

> The relevant portion of the LRRA for purposes of determining whether states can charge registration and other fees provides as follows: "any State may require [a risk retention group] to pay, on a nondiscriminatory basis, applicable premium and other taxes which are levied on admitted insurers and surplus lines insurers..." 3902(a)(1)(B). This language used in the LRRA does not specifically mention or authorize non domiciliary state to charge "fees."
>
> Handbook, Section II.A.4.

This same section of the Handbook notes the Brown decision and advises:

> The court in the recent case of NRRA v. Brown found that the LRRA does not authorize a non-domiciliary state to charge fees. The court in that case held that non-domiciliary states could not *assess annual, application or policy form review fees* against a risk retention group domiciled in another state. Given the language in the LRRA and this most recent case, States are urged to have counsel review their state law assessment provisions to determine their permissibility under the LRRA.
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> *Id.* (emphasis in original).

As set forth in Appendix A, numerous states consistently ignore the NAIC Handbook and the requirements of federal law.

Impact on Consumers and RRGs

The financial impact of state regulatory practices on RRGs has been substantial. According to a recent survey by *The Risk Retention Reporter*, an industry journal, for an RRG operating in all states, the annual cost for registration fees is approximately $9,300, and the cost is $8,500 for annual renewal, filing, and/or other fees. "Impact on Risk Retention Groups of State Encroachment of Liability Risk Retention Act Preemptions," *The Risk Retention Reporter*, Jan. 2009, at 8. Moreover, states that impose approval and requirements beyond the scope of the LRRA force RRGs to incur significant compliance and legal costs to satisfy individual state regulators' demands.

The results of the *Risk Retention Reporter*'s survey, which received responses from captive managers representing 118 RRGs, demonstrate that state regulatory violations of the LRRA are prevalent. Sixty-one percent of survey respondents reported that states had "overreached" by attempting to directly or indirectly regulate the operation of a foreign RRG. The responses indicated that 39 states engage in some form of overreaching.

Conclusion

State regulatory practices in violation of the LRRA not only impose significant financial burden on RRGs but also stymie Congress' intent to encourage the formation of RRGs to provide affordable liability coverage. NRRA respectfully requests that the NAIC review states' compliance with the LRRA and the Handbook and add to the accreditation standards provisions that will encourage states to conform to the law.

Thank you in advance for your consideration of this request.

Sincerely yours,

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APPENDIX

SUMMARY OF STATE VIOLATIONS OF THE LRRA

Initial Registration Requirements

- The majority of states charge an initial registration fee
- Four states charge an initial registration fee equal to or greater than $1000 (Alaska, California, Louisiana, and South Carolina)
- Several states require "review" or "approval" process spanning a few months to a few years before registration is effective (including California, Florida, North Carolina, New Jersey and Texas)

Annual Registration

- Over a dozen states require an annual "renewal fee," ranging from $100-$1,000, often in addition to an annual statement or "maintenance" filing fee, ranging from $50-$300
- Several states require filing state-specific renewal form (including Alabama, California, Massachusetts, Mississippi, North Dakota, and Ohio)

Other Fees/Requirements

- Many states require medical malpractice RRGs to file claims reports either quarterly or annually (including Illinois, Montana, and Washington)
- Several states require other fees, e.g., fraud program fees, desk audit fees, renewal certificate of authority fees

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