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NAIC

National Association of Insurance Commissioners

Agenda
Reinsurance (E) Task Force
Orlando, FL
Saturday, March 29, 2008
3:00 – 5:00 P.M.
Gaylord Palms Convention Center – Osceola C – Ballroom Level

Roll Call

New Jersey, Chair	Georgia	New York
Alabama	Illinois	North Dakota
Arizona	Iowa	South Carolina
Arkansas	Kentucky	Texas
California	Maine	Vermont
Connecticut	Massachusetts	Virginia
Delaware	Minnesota	Washington
District of Columbia	Nevada	West Virginia
Florida	New Hampshire	Wisconsin

1. Reinsurance Task Force Interim Meeting – Newark, NJ

2. Reinsurance Regulatory Modernization Framework Memorandum

3. Any Other Matters Brought Before the Task Force

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NAIC

National Association of Insurance Commissioners

TO: Reinsurance (E) Task Force Members Interested Regulators and Interested Parties

FROM: Bryan Fuller, NAIC Senior Reinsurance Manager

DATE: March 19, 2008
SUBJECT: Reinsurance (E) Task Force Activities

The Reinsurance (E) Task Force met in a regulator-to-regulator meeting in Newark, NJ on March 11-12, 2008 and discussed outstanding issues of the reinsurance regulatory modernization framework.

The purpose of this memo is to brief you on that meeting of the Reinsurance (E) Task Force and review some of the outstanding issues related to the reinsurance regulatory framework. As part of amending the reinsurance regulatory framework, U.S. insurance regulators are proposing to develop a system that would allow for a single state regulator which has been certified by the NAIC Reinsurance Supervision Review Department (RSRD) as meeting a set of standards confirming its regulatory capacity to supervise a national reinsurer. This certified reinsurance supervisor would serve as a regulator for national reinsurers. This proposal allows a national reinsurer to have one regulatory supervisor for all its domestic U.S. business.

U.S. licensed insurers providing reinsurance who do not chose to become a national reinsurer would have the option to continue to operate under the current regulatory framework.

Other aspects of this single regulatory system for national reinsurers include:

- A host state will be required to grant appropriate credit for reinsurance ceded by one of its domestic insurers to a national reinsurer authorized by a certified reinsurance supervisor.
- "Appropriate" means that the ceding insurer's domiciliary regulator (host state supervisor) retains the same authority it has under existing law to evaluate the amount of the liabilities ceded and retained, to determine whether the contract transfers risk.
- In order to be certified as a national reinsurer, a company must be domiciled and licensed as a national reinsurer under a jurisdiction certified by the RSRD.

Definition of terms

"Home state" means the "certified" state where the national reinsurer is domiciled.

"Certified reinsurance supervisor" means the insurance supervisory agency of the home state of a national reinsurer.

"Host state" means the domicile of the ceding company.

"Host state supervisor" means the ceding company's domestic regulator.

"National reinsurer" means a reinsurer that is approved by a certified reinsurance supervisor to write business across the United States while submitting to the regulatory authority of the certified reinsurance supervisor.

"Risk state" means the state where risk is insured, but may not be the home or host state.

"Risk state supervisor" means the regulator where risks are being insured, but is not the certified reinsurance supervisor or host state supervisor.

Role of Certified Reinsurance Supervisors

To promote a single point of contact, the certified reinsurance supervisor (home state supervisor) shall be responsible for examining its national reinsurers for solvency and compliance with applicable laws. Host state supervisors may request additional information concerning a national reinsurer writing business through a certified reinsurance supervisor.

Valid regulatory reasons for additional information include, but are not limited to the following:

- Material financial concerns exist with the national reinsurer. A concern is "material" if there is a substantial likelihood that a reasonable person would consider it important.

    - Premium volume, if the national reinsurer writes a material amount of its business in the host state, and another valid regulatory reason exists.

- A determination by the ceding company's domiciliary regulator to grant or deny credit for reinsurance in a particular transaction based upon a determination of whether a contract transfers risk that may differ from the determination by the certified reinsurance supervisor.

- Specific concerns with potential fraud supported by appropriate documentation.

The framework contemplates establishment of a certification mechanism so that those states that have the resources, expertise and experience to regulate reinsurance can do so as a certified reinsurance supervisor which will have exclusive jurisdiction over its national reinsurers. The framework also contemplates the creation of a consultative process to facilitate the resolution of disputes among insurance regulators regarding reinsurance issues. This consultative process shall be localized within a supervisory review board of the RSRD consisting of state insurance regulators. After consultation, the decision by the certified reinsurance supervisor with respect to the financial solvency of the reinsurer is final.

Role of Host State Supervisors.

The host state supervisor shall be granted the right to request specific analysis and/or examination procedures performed by the certified reinsurance supervisor and the right to receive completed financial analysis and examination workpapers from the certified reinsurance supervisor. Such information is protected under the NAIC's Information Sharing Agreement.

A host state supervisor shall advise the certified reinsurance supervisor whenever the host state supervisor has reasonable cause to believe an examination of a branch of a national reinsurer is necessary due to an emergency.

Home State Notification and Action.

The certified reinsurance supervisor shall be responsible for initiating enforcement actions against a national reinsurer. The certified reinsurance supervisor shall notify all host state supervisors immediately of any enforcement action, formal or informal, taken against a national reinsurer. If possible, notification by the certified reinsurance supervisor will be given in advance of the enforcement action.

What regulatory authority is retained by the ceding company's domestic regulator when ceding business to a reinsurer domiciled in a "certified" state?

The host state supervisor (ceding insurer's domiciliary regulator) retains the same authority it has under existing law to evaluate risk transfer and to evaluate the amount of liability ceded and retained by its domestic ceding insurers.

Certified State Standards Subgroup. In order to start working on the actual requirements for a state to be approved as a certified reinsurance supervisor, the Task Force formed a subgroup to work on these standards which includes California, Delaware, Florida, New Jersey, New York and Virginia.

How would extraterritorial application of state law be addressed in the framework?

Credit for reinsurance is governed only by the ceding insurance company's domiciliary state, and the laws of the ceding company's domiciliary state (host state) shall apply to the specific reinsurance contract to determine the validity of the risk transfer of that contract. A determination by the host state supervisor to grant or deny credit for reinsurance in a particular transaction cannot be challenged. Certified reinsurance supervisors, risk state supervisors and host state supervisors should consult with each other to resolve any differences between them. Any disagreement among regulatory authorities may be discussed within the supervisory review board of the RSRD, but the final regulatory decision will rest with the appropriate supervisory entity regarding credit for reinsurance allowed a ceding insurer or the financial solvency determination of a reinsurer.

Mandatory contractual clauses should be in place for both ceding insurers and reinsurers that are uniform across the country and would be established through the RSRD. Clauses that should become uniform include, but are not limited to the following:

Parties to the Agreement Clause - would stipulate that the policyholder is not ordinarily a party to the reinsurance contract, and does not have direct rights against the reinsurer.

Net Retained Lines Clause – would clarify which portion of the company's business will be subject to the agreement and states the uncollectibility of other reinsurance.

Premium Clause – would state the method of calculating premiums and the schedule of payments.

Reinsurance Intermediary Clause – would stipulate that the credit risk for the intermediary is on the reinsurer. In other words, payment from the ceding company to the broker is deemed paid to the reinsurer. However, payment to the broker from the reinsurer does not relieve the obligations of the reinsurer to the ceding company.

Service of Suit Clause – Unauthorized reinsurers and national reinsurers must designate the Insurance Commissioner as the legal agent for the process of suit.

Insolvency Clause – The required wording of the Insolvency Clause should not vary by state. Reinsurance is payable directly to the liquidator or successor without diminution regardless of the status of the ceding company.

The certified reinsurance supervisor would have sole jurisdiction over the financial solvency of the national reinsurer. The Task Force will be making amendments to the Credit for Reinsurance Model Law and Regulation in order to create a new class of reinsurer (national reinsurer). It was also felt that the current accreditation standard of "substantially similar" might not be stringent enough to ensure uniformity in regulations across the U.S.

To which companies does this proposal apply?

This proposal applies to national reinsurers who choose to become approved in a certified state to write reinsurance across the U.S. The framework would provide for a new class of "national" reinsurer licensed by a certified reinsurance supervisor. U.S. licensed insurers providing reinsurance would also have the option to continue to operate under the current regulatory framework.

The framework introduces a requirement for authorization by certified reinsurance supervisors of reinsurers established in the home state. The license granted by the certified reinsurance supervisor will enable the national reinsurer to trade throughout the whole of the U.S. The certified reinsurance supervisor will have exclusive responsibility for financial supervision of the reinsurer, whose head office is located in its jurisdiction: that means that a reinsurer already authorized by a certified reinsurance supervisor would be required to get a new license in order to become a national reinsurer.

Presentation by the New York and Florida on their reinsurance modernization proposals.

The New York State Insurance Department and the Florida Office of Insurance Regulation gave presentations on their proposals addressing reinsurance collateral. Both proposals would allow for collateral to be calibrated based on the financial strength ratings of reinsurers, along with other quantitative minimum requirements. The Reinsurance Task Force will be working closely with both New York and Florida in order to achieve a more uniform proposal that takes into account potential collateral recalibration as well as the broader issues of reinsurance regulation that form part of the framework modernization process.

DLA Piper/Swiss Re memorandum regarding constitutionality of states entering into Mutual Recognition Agreements with foreign jurisdictions.

The Task Force reviewed a memorandum commissioned by Swiss Re which included three areas of concern: (1) traditional equivalence principles would require that unequal treatment and other burdens on companies should not be imposed simply based on their nationality; (2) the RSRD's mutual recognition framework is argued in the memo to be unconstitutional because the states cannot enter into mutual recognition agreements with a foreign power; and (3) the RSRD proposal is impracticable because it will not be adopted unanimously by the states, which would practically be required in order for the proposal to work. The NAIC will be obtaining outside counsel to provide a legal opinion on the memorandum.

Future Meetings.

The goal of the Task Force is to complete and present the revised reinsurance regulatory framework by the end of 2008, and will hold a number of interim meetings to accomplish this charge. The implementation phase of regulatory modernization could then begin in 2009. Future meetings of the Task Force will deal with the port of entry concept, collateral calibration to perceived risk, implementation issues and consideration of modifications required to existing statutes and regulatory tools such as risk-based capital, accounting guidance, financial statement reporting, etc.

NAIC
National Association of Insurance Commissioners

FRAMEWORK MEMORANDUM

DATE: December 2, 2007

TO: Members of the Reinsurance (E) Task Force

FROM: Bryan Fuller, NAIC Staff

RE: Reinsurance Regulatory Modernization Proposal

The Reinsurance Task Force has acknowledged that in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the U.S. is warranted and if so, how soon such a framework can be implemented. The regulators believe that a reinsurance regulatory framework must be sufficiently flexible to accommodate the rapidly changing reinsurance environment while providing for appropriate levels of financial stability, solvency and predictability that are critical to a vigorous market and a strong and secure insurance regulatory system.

The framework will facilitate cross-border transactions and enhance competition within the U.S. market while ensuring that U.S. insurers and policyholders are adequately protected against the risk of insolvency. As part of amending the reinsurance regulatory framework, the Reinsurance Task Force is proposing to modernize the U.S. reinsurance regulatory system along the following lines:

- Mutual Recognition
    - A new NAIC entity called the Reinsurance Supervision Review Department (RSRD) would be established. Assessing regulatory effectiveness through an "outcomes-oriented" approach, the RSRD, with the approval of U.S. insurance regulators, would determine which non-U.S. jurisdictions are entitled to enter into mutual recognition agreements.
- Single State U.S. Regulator – U.S. Reinsurers
    - To avoid inappropriate extraterritorial regulation, a domestic reinsurer may access the U.S. market upon certification by its state of domicile or another appropriate U.S. regulator. Uniform minimum standards would be established for a company to qualify for certification, and for a state to qualify to be recognized as a reinsurer's single state regulator.

- Single State U.S. Regulator – Non-U.S. Reinsurers
    - A non-U.S. reinsurer from an RSRD-approved jurisdictions could be certified to access the U.S. market through one jurisdiction, referred to as the reinsurer's "port of entry." Again, the process would be governed by uniform minimum standards.

The Financial Condition (E) Committee referred a charge to the Reinsurance Task Force on the overall framework of U.S. reinsurance regulation. The "framework charge" would eventually involve direct coordination with technical experts from other working groups, and may evolve through discrete stages over time.

The Financial Condition (E) Committee charged the Reinsurance Task Force to consider the design of a revised U. S. reinsurance regulatory framework. In keeping with the original timeline of the Reinsurance Task Force charges, the framework will be presented for adoption at the 2007 NAIC Winter National Meeting. The Task Force recognizes that a number of issues require further discussion and analysis including but not limited to the following:

Outstanding Issues

- Establish appropriate collateral levels from zero to 100% on a prospective basis.
    - Runoff issues
    - Treatment of downgrades
    - Slow pay reinsurers
- How does the proposal address uniformity among the states?
    - What is the mechanism to ensure that states implement similar methodologies?
- What prevents inappropriate extraterritorial application of state law?
- Would the proposal apply to all entities and groups assuming reinsurance risk and to what extent the proposal applies to primary insurers assuming reinsurance risk?
    - Treatment of affiliated reinsurance transactions?
- What regulatory authority is retained by the ceding company's domestic regulator?
- Requirements to qualify for and maintain status as a recognized Port of Entry state and as recognized single-state regulator for U.S. reinsurers.
- Reconciliation to U.S. GAAP or Statutory Accounting guidelines.
- The potential that a reinsurer will use retrocessions as a loophole around collateral posting requirements.
- Definition of terms (e.g. "home state," "host state," and "port of entry state")
- Whether to establish or facilitate some type of security fund.

- Determination of how mutual recognition agreements should be negotiated, enforced and terminated.
- Mutual recognition parties would determine that their counterparts apply appropriate legal standards and regulatory requirement. Potential areas shall include but not be limited to:
   i. Financial condition, including capitalization, investment and reserving requirements;
   ii. Licensing, including an assessment of the quality and competence of licensee ownership and management;
   iii. Periodic analysis and examination of the financial condition and operating practices of licensees; and
   iv. Management of insurers within holding company systems.
   v. Legal environment and regulation of market practices.
      a. Ability to implement Mutual Recognition Agreements (MRA's),
      b. Schemes of Arrangement and/or involuntary transfers

DISCUSSION DRAFT ONLY

DLA PIPER

MEMORANDUM
ATTORNEY WORK PRODUCT

TO: Swiss Re America Holding Corporation

DATE: November 6, 2007

RE: Analysis of NAIC Proposal

We have been asked to evaluate the legal and policy implications of the National Association of Insurance Commissioners' *Draft Proposal to Grant Recognition of Regulatory Equivalence to Non-U.S. Insurance Supervisors.*[1] Our research and analysis indicate that in its current form, the Draft Proposal does not achieve the central purpose of "equivalence": to facilitate trade and ease regulatory burdens in situations where a foreign company is compliant with regulations substantially similar to those in the United States.[2] While representing a step in the right direction, the NAIC Proposal mandates higher burdens for certified foreign companies and leaves unbridled discretion for states to impose further burdens.[3] More importantly, however, by calling for states to establish a "mutual recognition framework" with foreign countries, the NAIC Proposal most likely violates the Constitution's Foreign Affairs doctrine because Congress has not provided the necessary consent.[4] Apart from the policy and legality flaws, the Draft Proposal is currently impractical.

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[1] Staff, NAIC, *Draft Proposal to Grant Recognition of Regulatory Equivalence to Non-U.S. Insurance Supervisors* (September 7, 2007) [hereinafter *NAIC Proposal*]. *See also*, Staff, NAIC, *Port of Entry State Criteria for Reinsures Supervised in Jurisdictions Approved by the NAIC Reinsurance Supervision Review Department and U.S. Licensed Reinsurers* [hereinafter *NAIC Port of Entry Criteria*].

[2] Some commentators refer to "equivalence" as a subset of "harmonization" (*e.g.*, Richard A. Merrill, *FDA and Mutual Recognition Agreements: Five Models of Harmonization*," 53 Food & Drug L.J. 133, 135-37 (1998) (citing "equivalence" as one of the models, but noting the inherent substantive difference in it)), but it is conceptually distinct, as discussed further below. Some trade documents also use the term "recognition," which is typically the result of a finding of equivalence.

[3] *Id.* at 4 (requirement that foreign re-insurers post 100% collateral (or more as the "host" state regulator may require) as alternative for licensing in U.S.); 5 and 6 (right of host states to "supplement" foreign regulations); 8 (right of host states to impose "appropriate conditions" on a license to a certified foreign company); and 10 (lengthy "disclosure" requirements imposed on foreign re-insurers).

[4] U.S. Const., art. II, § 2; *American Ins. Ass'n v. Garamendi,* 539 U.S. 396, 449 (2003).

This is a reasoned opinion. It provides an overview of the federal government authority with respect to mutual recognition agreements and then analyzes the Constitutional vulnerabilities and other concerns regarding the NAIC Proposal. Because the NAIC Proposal is just that – a proposal – there is no dispositive federal or state statute, regulation or published case law on the subject addressed in this letter. Accordingly, our opinion is based upon analysis of certain facts in the light of applicable insurance and common laws in effect at all times material. In particular, our opinion is based upon the laws of the United States of America. We also have examined, relied upon and based our opinion on the documents specified and information described above, and such other records, documents and information as we have deemed necessary and relevant, and upon such matters of law as we have deemed necessary for the purpose of providing this opinion. Our engagement has been limited to specific matters as to which we have been consulted.

I. BACKGROUND

A. International Insurance Trade

As the global marketplace becomes more interconnected, so too do the rules under which international trade is governed. In the past 10-15 years, countries have begun to recognize the benefits of reducing trade barriers and establishing new means to lower regulatory hurdles while preserving consumer protection and market competition.[5] West Virginia Insurance Commissioner Jane Kline recently outlined the benefits of streamlining international insurance rules as follows:

> For the sake of international financial stability, the insurance sector can benefit from streamlined regulation. We can, at a much lower cost than at any time in the history of civilization, spread risks around the world and improve financial stability, and this can be facilitated by regulatory consistency and cooperation.[6]

Commissioner Kline also recited the NAIC's goals with respect to streamlining, including "common accounting and financial standards for insurance companies all over the world."[7]

Reinsurance is a particular area of interest in the international regulatory context. Commissioner Kline characterizes the situation, and NAIC's agenda on the reinsurance front this way:

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[5] Benedict Kingsbury, Nico Krisch and Richard Stewart, *The Emergence of Global Administrative Law,* 68 Law & Contemp. Probs. 15 (Summer/Autumn 2005) (discussing the "embryonic" field of global administrative law, including various transnational administrative bodies).

[6] Jane Kline, *Developing the International Regulatory Climate*, *Progres*, the Geneva Association Information Newsletter, No. 45, June 2007.

[7] *Id.*

> Reinsurance remains one of the areas where there are still wide differences between the U.S. and Europe. Many differences turn on the issue of 'collateral calibration,' which some might see as a euphemism for collateral controversy. Calibration, in this case, simply means that U.S. insurance regulators think some adjustments in the U.S. collateral requirements should be considered. The final outcome will follow considerable study and vetting. The NAIC is addressing differences through two initiatives which just came out in the Spring. First, the Reinsurance Evaluation Office proposal from the NAIC's Reinsurance Task Force would establish an organization to evaluate reinsurance entities on financial strength, operating integrity, business operations, claims-paying history, and management quality, and then would assign a rating to each entity. Second, the NAIC is examining whether or not a comprehensive retooling of the reinsurance sector is needed. If we don't change the regulation of these entities we need to prepare for the growth of new risk transfer techniques, like 'cat bonds,' to augment traditional reinsurance.[8]

The U.S. federal government also has expressed concern that unnecessary regulation remains a significant obstacle. Earlier this year, Treasury Secretary Henry Paulson remarked: "The addition of new regulators over many years, and the tendency of these regulators to adapt to the changing market by expanding, as opposed to focusing on, the broader objective of regulatory efficiency, is a trend that we should examine."[9]

Europeans acknowledge the harm from over-regulation as well. Alastair Evans, the Head of Lloyd's of London's International Relations / Business Development Unit, provided this articulation of why over-regulation in the insurance industry is a problem:

> First and foremost, it generates needless compliance costs for the industry. These costs cannot be endlessly internalized by firms: they must find their way back to policyholders in the form of higher premiums. Where the regulatory rule-book is long and detailed, it needs numerous, knowledgeable regulators to apply and enforce the rules: often the financing of these regulatory authorities falls back on the industry itself, generating further costs. It goes without saying that, to the extent that any firm diverts internal resources to needless tasks linked to over-regulation, it diverts them away from more market facing activities. Over-regulation can also be at variance with other supervisory trends, such as increasingly favoured principles-based approaches and the growing emphasis placed by the regulators on the obligation of senior management to properly assess, mitigate and monitor their firms' own risks.[10]

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[8] *Id.*

[9] Quoted in *Paulson Promises Quick Changes in Wall Street Regulation*, Int'l Herald Trib., March 14, 2007.

[10] Alistair Evans, *The Risk of Over-Regulation of the Insurance Industry: 'The Child of Crisis,'" Progres*, the Geneva Association Information Newsletter, No. 45, June 2007.

Prominent members of the international financial services community – including representatives of both the public and private sectors, as well as academia – have stressed the need for a harmonized system of reinsurance regulation founded, in part, upon mutual recognition. The Group of Thirty ("G30")[11] has studied the reinsurance industry, its regulatory regime and the issues addressed in this memorandum intently.[12] G30 sees a major challenge to the reinsurance industry being "the willingness/ability of regulators to implement consolidated supervision of major groups across jurisdictions, within an international framework based on cooperation and mutual recognition."[13] G30 concluded that the world needs "a better articulated and more consistent approach to the regulation of reinsurance business."[14] The Group suggested that regulators "pursue a more harmonized and standardized oversight framework, based on mutual recognition, an enhanced role of the International Association of Insurance Supervisors (IAIS), and a supervisory code of conduct for offshore locations of insurance and reinsurance business."[15]

In response to such concerns, both the NAIC and the IAIS have become more involved in cross-border issues, such as mutual cooperation among regulators. During the NAIC's Joint Meeting of the Executive Committee/Plenary on Sunday, March 5, 2006, the following charge to the NAIC's Reinsurance Task Force (RTF) was adopted:

> The Reinsurance (E) Task Force is directed to develop alternatives to the current reinsurance regulatory framework, including the use of collateral[16] within the U.S. and abroad. Consider approaches that account for a reinsurer's financial strength regardless of domicile, i.e., state or country. Identify and consider variations in state law and regulation relative to reinsurance contracts, financial reporting, etc. As part of its deliberations, the Task Force should consult with international regulators in addition to all other interested parties. The Task Force shall present the proposal to the membership by the December 2006 national meeting.[17]

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[11] G30 is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. Established in 1978, it aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers. Paul A. Volcker is Chairman of its Trustees. *See* http://www.group30.org/about.htm.
[12] *See generally, Group of Thirty, Reinsurance and International Financial Markets* (2006), at http://www.group30.org/pubs/pub_1320.htm.
[13] *Id.* at 3.
[14] *Id.* at 7.
[15] *Id.*
[16] In the U.S., the reinsurance obligations of unauthorized (and mostly non-U.S.) reinsurers must be one hundred percent (100%) collateralized in order for the ceding (that is, the reinsured) company to take balance sheet and income credit statement. NAIC, *U.S. Reinsurance Collateral White Paper* 1 (Dec. 6, 2005).
[17] *NAIC Port of Entry Criteria, supra* note 1, at 1, quoting the language adopted during the Joint Meeting of the Executive Committee/Plenary on March 5, 2006.

The IAIS recently developed a non-obligatory framework for a Multilateral Memorandum of Understanding (MMoU) which seeks to establish "broader contacts and cooperation among insurance supervisory authorities in the fulfillment of their supervisory functions."[18] IAIS is currently encouraging members to accede to the framework, which they deem to be a "necessary and adequate reaction to the increasing globalization of the insurance business and integration of capital markets."[19]

B. The NAIC's Proposal

The NAIC Proposal would allow for a single state regulator of authorized reinsurers. Under this system, a U.S. licensed reinsurer, or a "certified" foreign reinsurer,[20] would be able to choose a particular state as its "home" state regulator, allowing it to automatically assume reinsurance in every other U.S. "host" state.[21] Foreign reinsurers would become certified if deemed equivalent under minimum guidelines to be established by an NAIC Reinsurance Supervision Review Department (RSRD).[22] Functional equivalence would:

> take into account 'whether and to what extent the "host regulator" should rely or "recognize" the prudential supervision of the "home regulator," and whether and to what extent the "host regulator" should supplement "home regulation" with additional "host rules" in order to maintain its "appropriate levels of protection."[23]

This proposal "would also require the establishment of a mutual recognition network," and would assess "the nature of the reciprocal recognition that would be required."[24] Unilateral recognition, however, is also listed as an option.[25]

Once certified, however, foreign reinsurers would not be treated the same as U.S. reinsurers:

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[18] Axel Oster (Chair of IAIS Working Group) and Arup Chatterjee (IAIS Secretariat), *IAIS Multilateral Memorandum of Understanding*, *Progres*, the Geneva Association Information Newsletter, No. 45, June 2007.

[19] *Id.* It is worth noting here that agreements to share information are distinct from agreements to afford market access. The former does not affect commerce, while the later does.

[20] In unique U.S. reinsurance regulatory parlance, a reinsurer domiciled in a U.S. state other than that of the subject regulator is referred to as "foreign," while a reinsurer domiciled in a country other than the U.S.A. is referred to as "alien." *See, e.g.*, NAIC, Credit for Reinsurance Model Law; *see also*, NAIC, Credit for Reinsurance Model Regulation. For ease of reference, the term "foreign" is used throughout this memorandum to refer to non-U.S. domiciled reinsurers.

[21] *NAIC Proposal*, *supra* note 1, at 3, ¶ 3.

[22] *Id.*

[23] *Id.*, at 4-5, ¶ 7.

[24] *Id.*, at 3, ¶ 5.

[25] *Id.*, at 7.

- *First*, the level of collateral required to be posted by certified reinsurers would depend upon an assigned class rating (1-5, from most to least strong) and other indices of financial strength determined by the RSRD.[26] Under this class system, foreign reinsurers that are not licensed in the U.S. would be required to post collateral of not less than sixty percent (60%) of their assumed U.S. obligations, while licensed U.S. reinsurers would not be required to post collateral unless they were assigned Class 5.[27] The collateral required for "assumed" (that is, reinsured) liabilities could, under NAIC's plan, exceed 100% of the gross liabilities insured, "based upon the risk of adverse loss development";[28]

- *Second*, state regulators may "supplement" the foreign regulatory regime by requiring the foreign reinsurer to comply with U.S. laws as "necessary to ensure the achievement of the fundamental purposes of regulation";[29] and

- *Third*, a foreign reinsurer would be required to "disclose" various information, including: (1) that it is regulated in part by foreign laws that differ from U.S. laws; (2) that the remedies against the foreign reinsurer may vary from those against comparable U.S. reinsurers; (3) any "special risks" associated with alien insurers (such as tax, currency and time differences); and (4) differences in the regulatory regime (*e.g.*, accounting standards).[30]

The below examination of equivalence, and its various manifestations in current U.S. law, reveals that the Draft Proposal is inconsistent with the goals of regulatory streamlining.

II. THE DRAFT PROPOSAL IS CONTRARY TO TRADITIONAL EQUIVALENCE PRINCIPLES

There is a clear trend in international regulations away from imposing unequal treatment and other burdens on companies simply based on nationality. The World Trade Organization (WTO) agreements instruct countries to lower barriers to trade, including differing regulations, which often operate as trade barriers. Industry groups such as the TransAtlantic Business Dialogue stress the resolution of regulatory differences.[31] The goal of lower barriers is to reduce costs and thus facilitate trade and lower prices. The means for enacting these goals, however, are left open.

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[26] *Id.*, at 4. *See also, NAIC Port of Entry Criteria, supra* note 1, at 2.
[27] *NAIC Port of Entry Criteria, supra* note 1, at 8.
[28] *Id.*; *NAIC Proposal, supra* note 1, at 4, ¶ 6.
[29] *NAIC Proposal, supra* note 1, at 6.
[30] *Id.* at 10.
[31] TransAtlantic Business Dialogue, *Report and Recommendations to the 2007 EU-US Summit Leaders* (April 2007).

The United States has pursued trade agreements and "executive" agreements with many of its trading partners. For example, the General Agreement on Trade in Services (GATS) encourages the practice of "recognition," which should, "[w]herever appropriate," "be based on multilaterally agreed criteria."[32] The Technical Barriers to Trade agreement (TBT) also encourages members "to be willing to enter into negotiations for the conclusion of agreements for the mutual recognition of results of each other's conformity assessment procedures."[33] Such recognition can be achieved through a mutual recognition agreement (MRA) or unilaterally, and can either entail equivalence, or not – as detailed further below.

The following analysis of some of the models for implementing equivalence at the federal level confirms that, by increasing the regulatory burden on foreign reinsurers, the NAIC Proposal runs contrary to the purpose of equivalence as it has been practiced in the U.S. and Europe.

A. *Mutual Recognition Agreements*

There are four general types of international agreements under U.S. law:

1. Treaties which must be ratified by two-thirds of the Senate;

2. Executive-legislative agreements that, due to statutes or customs are, after negotiation by the executive branch, the subject of legislation that must be passed by both houses of Congress and a simple majority, then presented to the President for signature;

3. Presidential agreements under the President's constitutional powers, such as his powers as Commander-in-Chief, without need for Congress to enact legislation (controversial; seldom-used); and

4. Executive branch agreements that are negotiated and entered into under an agency's statutory authority, without need for legislative approval.

MRAs falls into the last category – it is an executive branch agreement that is negotiated and entered into under the President's (or authorized representative's) Constitutional power to conduct diplomatic affairs. MRAs do not require Senate approval. In order to implement an MRA, agencies must have the implicit or explicit statutory authority to do so.[34]

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[32] GATS, Art. VII, 5.
[33] TTB, Art. 6.3.
[34] *See* Restatement (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES, §302 comment a. *See also* Linda Horton, *Mutual Recognition Agreements and Harmonization*, 29 Seton Hall L. Rev. 692, 712 (1998).

MRAs are the most common vehicle for enacting the principle of equivalence.[35] They allow nations to accept one another's conformity assessment tests, certifications and/or regulations either because they are deemed to be equivalent, or because they meet the criteria set forth in the MRA. An MRA is formed when two or more countries pledge to accept each other's standards, either as equivalent to their own, or by agreeing to accept each other's testing for their respective standards.[36] Thus, not all MRAs necessarily involve equivalence, though most are based on equivalence since true harmonization is difficult to achieve.[37]

MRAs create conditions under which participating parties commit to the principle that if a product or service can be sold lawfully in one jurisdiction, it can be sold lawfully in another participating jurisdiction. Regulators expect MRAs:

> to provide benefits in the form of 1) increased regulatory efficiency and effectiveness through 'leveraging' of scarce resources; 2) long-term regulatory cooperation and convergence; and 3) the development of more transparent and internationally compatible regulatory practices in different countries.[38]

These benefits are the primary goals of MRAs.

We now consider the relative authority of different governmental branches to enter into binding MRAs.

i. *Authority*

The President, with the authorization or approval of Congress, is vested with the power to make international agreements dealing with any matter that falls within the powers of Congress or of the President under the Constitution.[39] The Trade Agreements Act of 1979 was revised to specifically provide the United State Trade Representative (USTR) with "responsibility for coordinating United States discussions and negotiations with foreign countries for the purpose of establishing mutual recognition arrangements with respect to standards-related activity."[40]

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[35] The term "mutual recognition agreements" was first used in the E.U. by private conformity assessment bodies from different member countries which certified products and processes, and was only later adopted by states entering into bilateral agreements. Kalypso Nicolaidis and Gregory Shaffer, *Transnational Mutual Recognition Regimes: Governance Without Global Government*, 68 Law & Contemp. Probs. 263, 265 (2005).
[36] Alexander Donahue, *Equivalence: Not Quite Close Enough for the International Harmonization of Environmental Standards*, 30 Envtl. L. 363 (2000).
[37] *TACD Briefing Paper on Mutual Recognition Agreements*, TransAtlantic Consumer Dialogue, March, 2001, at 5.
[38] *Id.* at 14.
[39] U.S. Const., Art. II, § 2; Restatement, *supra* note 34, §302(2).
[40] 19 U.S.C. § 2541. The FDCA also provides that the FDA must:

> not later than 180 days after November 21, 1997, make public a plan that establishes a framework for achieving mutual recognition of good manufacturing practices inspection.

21 U.S.C. § 383(c)(4).

Congress may also grant the executive branch the authority to enter into mutual recognition agreements. One prominent example is the first major MRA between the U.S. and Europe, which involved regulatory activity governed by the Food and Drug Administration (FDA). The FDA's authority for participating in this MRA is found in the Federal Food, Drug, and Cosmetic Act (FDCA):

> (b) Agreements with foreign countries
>
> ...the [HHS] Secretary may enter into agreements with foreign countries to facilitate commerce in devices between the United States and such countries... In such agreements, the Secretary shall encourage the mutual recognition of –
>
> > (1) good manufacturing practice regulations..., and
> >
> > (2) other regulations and testing protocols as the Secretary determines to be appropriate.[41]

The FDCA specifically requires the FDA to:

> support the Office of the United States Trade Representative, in consultation with the Secretary of Commerce, in efforts to move the acceptance of mutual recognition agreements relating to the regulation of drugs, biological products, devices, foods, food additives, and color additives, and the regulation of good manufacturing practices, between the European Union and the United States.[42]

Occasionally, Congress has also authorized some official or agency other than the President to make international agreements, but only with his consent.[43]

ii. *How MRAs and Equivalence Work*

MRAs that provide for recognition of test results, *etc.*, and thereby provide conformity with the importing country's regulations (in other words, non-equivalence), generally establish a designating authority (DA) responsible for certifying competent conformity assessment bodies (CAB). The National Institute for Standards and Technology (NIST), for example, is the U.S. DA under portions of the current MRAs.[44] The NIST, in its role as the DA, lists the CABs which can test products and issue its decision.[45]

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[41] 21 U.S.C. § 383.
[42] 21 U.S.C. § 383(c)(2).
[43] Restatement, *supra* note 34, §303, Reporter Note 10.
[44] *See, e.g.,* E.U./U.S. MRA. *See also* http://ts.nist.gov/Standards/Global/faq.cfm.
[45] *See, e.g.*, Agreement on Mutual Recognition Between the European Community and the United States America, Dec. 1, 1998, Hein's No. KAV 5464, arts. 2 and 7 ("E.U./U.S. MRA").

In an equivalence scenario, if the product is approved, the CAB essentially substitutes compliance with a foreign regulation for compliance with the corresponding domestic regulation.[46] Under an equivalence model, "each country agrees that despite some differences, the other country's securities regulation regime is 'close enough.'"[47] Such a decision, then, allows for recognition of a foreign regulatory regime as being "close enough" to the U.S. regulatory regime to promote the goals of the U.S. regime, such as consumer protection. "If there is indeed equivalence," another commentator writes, "it would not add to the quality of regulatory protection to insist on compliance with local rules; it would simply create an unnecessary hurdle to services being offered to those investors."[48]

MRAs tend to be sector-specific. The E.U./U.S. MRA, for example, contains provisions for telecommunications, electromagnetic compatibility, electrical safety, recreational craft, medical devices, and pharmaceutical good manufacturing practices (GMP).[49] The first five sectors fall into the category of conformity assessments, performed by the exporting party's CAB, while the sixth sector, on GMPs:

> involves the mutual recognition of GMP inspection reports generated by the other party's regulatory agencies. Once the parties have determined that each other's regulatory systems are equivalent, they will be able to accept each other's GMP inspection reports.[50]

Other MRAs, whether based on equivalence or conformity assessment, are specific to just one sector, such as telecommunications.[51]

The E.U. and U.S. have also considered "MRA-plus" type agreements, whereby core regulations and standards applicable to a specific product group would be analyzed to determine to what extent they could be considered to be functionally equivalent.[52] This would essentially allow equivalence determinations for standards at the international level. The MRA between the U.S. and E.U. on marine equipment is one such attempt.[53]

The decision to allow a foreign regulation can be made by one country's CAB (unilaterally) or the decision can be made at the same time that the corresponding country allows

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[46] Sidney A. Shapiro, *International Trade Agreements, Regulatory Protection, and Public Accountability*, 54 Admin. L. Rev. 435, 453 (2002).
[47] Tzung-bor Wei, *The Equivalence Approach to Securities Regulation*, 27 Nw. J. Int'l L. & Bus. 255, 280 (2007) (noting that in the context of the U.S.-Canada Multi-Jurisdictional Disclosure System, the "SEC acknowledges persistent differences between U.S. and Canadian disclosure requirements, but nevertheless judges the two to be functionally substitutable").
[48] *Id.* at 258.
[49] E.U./U.S. MRA., §§ 2-7.
[50] *TACD Briefing Paper on Mutual Recognition Agreements*, *supra* note 37, at 6.
[51] *See* APEC Tel MRA and the CITEL MRA.
[52] *TACD Briefing Paper on Mutual Recognition Agreements*, *supra* note 37, at 6.
[53] *Agreement on Mutual Recognition Between the European Community and the United States America on Marine Equipment*, Feb. 27, 2004.

some aspect of regulation as equivalent to its own (bilateral).[54] The Technical Barriers to Trade Agreement recognizes the possibility of unilateral recognition, and encourages bilateral recognition where possible: "Members shall ensure, whenever possible, that results of conformity assessment in other Members are accepted, even when those procedures differ from their own...."[55]

Equivalence decisions may (or may not) be subject to the notice-and-comment rulemaking requirements of the Administrative Procedure Act (APA). A provision in the implementing legislation for the World Trade Organization requires notice-and-comment on FDA findings that a country's seafood inspection system is equivalent.[56] In the absence of a provision addressing this issue, there are arguments for and against a notice-and-comment requirement.[57]

B. *Examples of Unilateral Recognition Models*[58]

An agency of the U.S. government can also unilaterally certify a foreign regulatory system through an MRA or other type of less formal agreement, typically provided by an agency's authorizing legislation or a specific grant of authority.

A report from one organization that analyzes international regulations, the International Organization of Securities Commission, compares mutual and unilateral recognition as follows:

> Under a unilateral recognition system, a jurisdiction generally will not apply local requirements to a foreign intermediary if the home regulatory regime to which that intermediary is subject meets certain investor criteria. Unilateral recognition does not require reciprocity on the part of the foreign regulator with respect to intermediaries from the local country conducting business in the foreign jurisdiction.
>
> A mutual recognition system is similar to a unilateral recognition system in that the 'access' jurisdiction recognizes the adequacy of a foreign intermediary's 'home' regulation (and thus permits the foreign intermediary to operate within its borders without complying with local regulations), but it requires reciprocity for its own intermediaries from the home regulator. Under this type of system, each

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[54] Sidney A. Shapiro, *International Trade Agreements, Regulatory Protection, and Public Accountability*, 54 Admin. L. Rev. 435, 454 (2002).
[55] TBT, Art. 6.1.
[56] Uruguay Round Agreements Act, 19 USC 2578a (1994).
[57] *See, e.g.*, Horton at 714-715 (citing the arguments and distinguishing situations where it is more likely).
[58] Some commentators refer to *de facto* "unilateral recognition," *see, e.g.*, Amir Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 Va. J. Int'l L. 583 (2001) (international securities markets hold so much power over national securities regulators that they effectively engage in "unilateral recognition"), but the term is not used in that sense in this memo.

jurisdiction recognizes that the other's regulatory regime provides the necessary investor and market protections.[59]

The Commodity Futures Trading Commission (CFTC) recently adopted an equivalence method by allowing for acceptance of regulations concerning foreign futures commission merchants and commodities trading advisors.[60] The new CFTC rules allow a foreign intermediary to operate in the U.S. if the intermediary complies with comparable requirements imposed by its own foreign regulator.[61] The foreign regulator makes the application to the CFTC, which then conducts a comparative regulatory examination to determine if the local regulation is "equivalent" to the CFTC regulations imposed on U.S. firms. If approved, the foreign intermediary files an application with the National Futures Association, the body to which the CFTC has delegated the authority to verify the fitness of, and representations made by, firms applying for such relief and to confirm the availability of that relief. The CFTC has granted exemptions of this nature for futures commission merchants designated by regulatory authorities in Australia, Singapore, Canada, the United Kingdom, France, Japan, Spain, New Zealand, Germany and Brazil.

Another entity utilizing the unilateral equivalence determination mechanism is the U.S. Board of Governors for the Federal Reserve System. The Federal Reserve employs this recognition in connection with its determination of whether a foreign bank is subject to

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[59] Technical Committee of the International Organization of Securities Commissions, *Regulation of Remote Cross-Border Financial Intermediaries,* (February, 2004), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOpd182.pdf.

[60] Part 30 of the CFTC Regulations, 17 C.F.R. pt 30, App. A.

[61] The CFTC's authority for this regulation comes from §§ 4(a) and 4(b) of the Commodity Exchange Act. Section 4(a) of the Act (7 U.S.C. § 6(a)) provides, in it relevant part:

> *Unless exempted by the Commission* ... it shall be unlawful for any person to offer to enter into, to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States, its territories or possessions, for the purpose of soliciting or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery ... *unless (1) such transaction is conducted on or subject to the rules of a board of trade which has been designated or registered by the Commission as a contract market or derivatives transaction execution facility.*

Section 4(b) (7 U.S.C. § 4(b)) provides:

> The Commission may adopt rules and regulations proscribing fraud and requiring minimum financial standards, the disclosure of risk, the filing of reports, the keeping of books and records, the safeguarding of customers' funds, and registration with the Commission by any person located in the United States, its territories or possessions, who engages in the offer or sale of any contract of sale of a commodity for future delivery that is made or to be made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions. Such rules and regulations may impose different requirements for such persons depending upon the particular foreign board of trade, exchange, or market involved.

"comprehensive consolidated supervision" by a bank supervisor in that entity's home jurisdiction.[62]

The structure and scope of authorizing legislation may limit the ability of an agency to determine that a foreign legal system is a "functionally equivalent" substitute for compliance with U.S. laws. If for example, the Secretary of Treasury were to be broadly charged with ensuring that the reinsurance industry is regulated in a manner that adequately protects insurers, such authorization could potentially accommodate equivalency agreements. If, on the other hand, the Secretary is charged with certifying on a case-by-case basis that individual reinsurers meet specifically delineated standards, there may be administrative legal obstacles affecting the ability of the agency to "outsource" its administrative functions to a foreign government.

C. *Pros / Cons*

Advantages of equivalence include:

- *Efficiency.* Fewer regulatory requirements translate to greater efficiency and lower costs for the companies involved.
- *Practicability.* Harmonization and other methods that change substantive U.S. law require legislation and/or rulemaking for implementation.
- *Flexibility.* If regulators know that the systems need not be identical, they can be more accommodating to differences in the systems.
- *Innovation.* One European regulator has noted, for example, that a "healthy recognition by both sides that there can be more than one way to achieve a common objective," encourages "managed competition."[63]

Some analysts believe that MRAs with equivalence could be disadvantageous as well, resulting in either less substantial consumer protections or a lack of reciprocal recognition of U.S. regulations in the same area.[64]

D. *Examples of Areas of Regulation Where Equivalence Sought*

1. U.S.

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[62] 12 CFR 211.24(c)(1)(ii)(2006).
[63] Statement of Alexander Schaub, Dir. Gen., Internal Mkt. of the European Comm'n, H. Comm. on Fin. Servs. Hearing on E.U.-U.S. Financial Markets Regulatory Dialogue, 108th Cong. (2004).
[64] *See, e.g.*, Shapiro, *supra* note 54, at 10 (citing concerns over lack of obligation to seek public input, shifting location of regulatory decisions to foreign countries, among other reasons).

U.S. regulatory authorities use the concept of equivalence in many areas. With respect to securities regulation, for example, U.S. regulators are working on recognition of several aspects of foreign regulations:

- Accounting standards. U.S. and European regulators are working together to harmonize accounting standards. The Securities and Exchange Commission (SEC) issued a "roadmap" that could permit European companies to use European accounting standards in the United States. Similarly, the European Community declared that it will allow U.S. companies to use U.S. accounting standards in Europe if they are deemed equivalent to European accounting standards.[65]

- Auditing. Under Sarbanes-Oxley, accounting firms must register with the Public Company Accounting Oversight Board if they prepare audit reports on financial statements filed in the United States. The Board issued rules in 2004 to allow foreign accounting firms to ask that the Board rely on foreign inspections instead of being subject to Board investigations. The Board examines the quality of the foreign system and then decides how much reliance to place on the foreign supervisory system. The Board does not reveal the list of countries for which it is willing to rely on foreign inspections.[66]

- Disclosure. The SEC and Canadian securities administrators entered into an agreement to allow companies in the United States and Canada to use disclosure statements filed in their home jurisdictions, and to defer to the home country's review process.[67]

As noted above, through the E.U./U.S. MRA, and authorizing legislation, U.S. regulators also allow equivalence in many other areas, such as food and drug regulation. Particular areas of food and drug regulation include:

- Inspection/Certification. The Food and Drug Administration (FDA) maintains a system that relies upon foreign government safety certification as a prerequisite for international shipments. The U.S. Department of Agriculture (USDA) procedures allow certain foreign governments to inspect and certify overseas meat processing facilities as a prerequisite for international shipment. In this context, the USDA acts unilaterally, in consultation with other interested agencies, such as U.S. Customs and Border Protection; and

- Research Evaluation. The FDA entered into an *ad hoc* agreement with Britain and Canada to jointly evaluate the results of a Canadian study on the effects of saccharin.[68]

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[65] Wei, *supra* note 47, at 271.
[66] *Id.*
[67] *Id.*
[68] Merrill, Richard, *FDA and Mutual Recognition Agreements*, 53 Food and Drug L.J. 133 (1998).

2. Europe

The E.U. Financial Conglomerates Directive is another example of equivalence. Initiated in 2002 and effective in 2005, the Directive provides "prudential supervision" at the conglomerate level.[69] Supplementary supervision is imposed on the parent company unless the third-country's supervision is deemed to be equivalent to European supervision. For the purposes of the Directive, Switzerland is a non-European country because it is not part of the European Economic Area.

A July 2004 report issuing general guidance on the Directive concluded that the U.S. regulatory system was broadly equivalent across the banking, securities and *insurance* markets.[70] E.U. regulators nonetheless must make individual decisions on equivalence themselves.

E. *Application to NAIC Proposal*

The NAIC Proposal does not treat domestic and foreign reinsurers the same. As noted above, foreign reinsurers will face:

1) A higher collateral requirement in nearly all cases;

2) Great uncertainty with respect to how states may "supplement" the regulations applicable to them; and

3) Onerous and unfavorable disclosure requirements.

This disparate treatment is inconsistent with the purpose of equivalence. Until and unless the proposal allows foreign reinsurers to operate on a level playing field, the proposal cannot accurately be called an equivalence system.

III. THE NAIC PROPOSAL IS CONSTITUTIONALLY SUSPECT

Apart from the problematic policy substance of the NAIC Proposal, the Proposal is arguably open to preemption and constitutional challenge. As currently drafted, the proposal presents a factual context akin to those where, because of actual or potential interference with foreign affairs, the Supreme Court has consistently admonished the states to refrain from entering. Several aspects of the Proposal are especially suspect: first, it either does, or in administration would, conflict with the Trade Agreements Act; second, it is not authorized by

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[69] Wei, *supra* note 47, at 271.

[70] General Guidance from the European Financial Conglomerates Committee to E.U. Supervisors (July 6, 2004), available at http://ec.europa.eu/inernal_market/financial-conglomerates/docs/guidance-usa-final-060704_en.pdf.

McCarran-Ferguson[71] or any other Congressional enactment authorizing the states to burden foreign commerce; and third, the Foreign Affairs and Foreign Commerce aspects of modern constitutional jurisprudence greatly suggest that state action even potentially conflicting with federal interests would be more likely to be subject to successful preemptive challenge.

Federal courts recognize three types of federal preemption: "Express" preemption refers to situations where Congress, in enacting a federal statute, has explicitly stated its intent to preempt state law in a particular area. "Implied" (or "field") preemption refers to situations where the intent of Congress to supersede state law may be inferred, *e.g.*, because "[t]he scheme of federal regulation may be so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it."[72] Finally, "conflict" preemption refers to situations "where Congress has not completely displaced state regulation in a specific area, [but] state law is nullified to the extent that it actually conflicts with federal law."[73] Conflict preemption arises where the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[74]

States are sovereign governments within our federalist system, with their own regulatory regimes, subordinate only to superior federal power under the Supremacy Clause.[75] With respect to the NAIC Proposal, federal trade power specifically, and foreign affairs power generally serve as superior sources of power and thus serve to prevent states from entering the type of agreements with foreign sovereigns that the Draft Proposal anticipates.

A. *Federal Trade Power Preempts the NAIC Proposal*

While there is currently no "pervasive" scheme of federal regulation of insurers,[76] the NAIC proposal presents a number of conflicts with the federal government's conduct of foreign trade. The USTR negotiates treaties and agreements around the world. In executing this authority, its leverage often depends upon its ability to address subject matter comprehensively and exclusively. This is particularly true with respect to USTR's long history of asserting jurisdiction over the area of financial services, including reinsurance services. The GATS, as discussed above, is one area in which USTR has addressed insurance policy as a trade matter in the past. If the NAIC and/or states enter separate agreements in the area of insurance, it is

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[71] McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq.* (empowering states with regulatory authority in the area of insurance).
[72] *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).
[73] *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 153 (1982).
[74] *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).
[75] The Supremacy Clause states: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof ... shall be the supreme Law of the Land ... any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const., art. VI, cl. 2.
[76] Congress has, however, enacted a substantial amount of insurance law. *See, e.g.*, Risk Retention Act of 1982, 15 U.S.C. §§ 3901-03, 3905, 3906, 42 U.S.C. §§ 9671-75; Urban Property Protection and Reinsurance Act, 12 U.S.C. §§ 1749bbb *et seq.*; North American Free Trade Agreement (NAFTA), pt. V, ch. 14, annex 1404.4 (Aug. 12, 1992). The Employee Income Retirement Security Act of 1974 (ERISA), 29 U.S.C. § 1001, 1144(a), preempts state law.

directly antagonistic to the USTR's larger authority to negotiate on an exclusive basis in this area.

The likelihood of conflict preemption is even greater in light of the Trade Agreements Act of 1979 which direct the USTR to "coordinate" federal government negotiations regarding MRAs with respect to "standards-related activity." That statute provides, in part:

> The Trade Representative has responsibility for coordinating United States discussions and negotiations with foreign countries for the purpose of establishing mutual recognition agreements with respect to standards-related activities. In carrying out this responsibility, the Trade Representative shall inform and consult with any Federal Agency having expertise in the matters under discussion and negotiation.[77]

The phrase "standards-related activity," by reasoned application, includes financial and other standards for qualifying reinsurers to do business in the United States.

Recent experience teaches that, at a minimum, USTR would need to consult with the Department of Treasury on international economic policy decisions affecting reinsurance, and this consultation would make evident the extent to which the structure of particular equivalency agreements were in tension – and hence again preempted – by U.S. international economic undertakings. During negotiation of the WTO Financial Services Agreement (FSA) and, more recently, the Free Trade Agreement with Korea, USTR and Treasury officially shared responsibility for reinsurance issues. Again, because the NAIC proposal affords no opportunity for USTR and Treasury to participate in the negotiations for an MRA concerning reinsurance, it frustrates the objectives of the Trade Agreements Act of 1979. Implied conflict preemption by reason of frustration of purpose has already been discussed, *supra.*

Beyond the current conflict with the TAA, Congress has recognized the need to regulate in the arena of international insurance and reinsurance business.[78] Most recently, for example, Congress extended the protection of U.S. bankruptcy law to aid the international administration of insurance company receiverships through Chapter 15 of the U.S. Bankruptcy Code.[79]Congress also is currently considering legislation for an optional federal charter[80] ("op-fed") – which could lead to another direct conflict. This chartering legislation would repeal McCarran-Ferguson and assert a new dual federal regulatory authority for insurance laws. If the legislation establishes a federal regulatory program for reinsurers, the legislation – depending on its final terms – could enhance the argument that the Draft Proposal conflicts with the objectives of the federal

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[77] 19 USC § 2541 (1994), amended by Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4809 (1994).
[78] *See* discussion *supra* Sec. II.A.(i).
[79] 11 U.S.C. 1506.
[80] The National Insurance Act of 2007 (S. 40; H.R. 3200), introduced in May by Sens. John Sununu (R-NH) and Tim Johnson (D-SD) in the Senate, and in July by Reps. Melissa Bean (D-IL) and Ed Royce (R-CA) in the House, would provide a comprehensive system for federal regulation and supervision of national insurers and national agencies.

legislation and, as such, is preempted. The Treasury Department recently testified in favor of this legislation.[81]

As currently drafted, the op-fed legislation envisions that the Department of Treasury would be the appropriate agency to take the lead in recognizing the insurance regulations of foreign governmental entities. In such a situation, Treasury, along with USTR, would properly certify a foreign regulator either unilaterally or through an MRA. The NAIC Proposal as presented runs directly counter to these initiatives by virtue of its lack of provision for a sufficient federal role.

B. *States Lack the Authority to Enter Agreements with Foreign Sovereigns*

The Constitution specifically provides that "[n]o State shall enter any Treaty, Alliance, or Confederation,"[82] and further provides that "[n]o State shall, without the Consent of Congress, ... enter into any Agreement or Compact ... with a foreign Power."[83] In other words, states may enter into "agreements" or "compacts" with foreign governments only with the consent of Congress. The Proposal, however, purports to give the NAIC and states the power to enact an agreement with foreign sovereigns without any statutory authority or other indication of consent by Congress.

McCarran-Ferguson does not provide this consent.[84] The Supreme Court, in *American Ins. Ass'n v. Garamendi,* recently held that McCarran-Ferguson was "directed to implied preemption by *domestic* commerce legislation" and therefore "cannot sensibly be construed to address preemption by executive conduct in *foreign affairs*."[85] Thus, that McCarran-Ferguson leaves insurance regulation generally to the states *vis a vis* domestic or interstate commerce does not in any way indicate implicit consent for states to enter into agreements with foreign sovereigns. *Garamendi* confirms that the McCarran-Ferguson cannot be used as a sword to allow states to enter into negotiations with foreign governmental entities.

C. *The Foreign Affairs Doctrine Prohibits States from Effectuating the NAIC Proposal*

While the Supreme Court in recent cases has refrained from finding categorical field preemption of the states under the Foreign Affairs and Foreign Commerce clauses, it has relied upon both to readily find conflict preemption whenever state and federal regulatory approaches

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[81] *See, e.g.,* Statement of Randy Quarles, Undersecretary of the Treasury, Senate Banking Committee hearing on insurance regulation, July 18, 2006 (strongly endorsing federal insurance regulation; citing detrimental effects that state regulation has on foreign insurance capital).
[82] U.S. Const., art. I, § 10, cl. 1. The distinctions among these terms are lost to history.
[83] U.S. Const., art. I, § 10, cl. 3 (also known as the "Compact Clause").
[84] McCarran-Ferguson provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance ... unless such Act specifically relates to the business of insurance ...." 15 U.S.C. 1012(b). Of course, McCarran-Ferguson cannot overcome powers or limitations imposed by the Constitution.
[85] *American Ins. Ass'n. v. Garamendi,* 539 U.S. at 428 (emphasis added).

have differed. This jurisprudence casts serious doubt on the constitutionality of the Proposal. The Foreign Affairs doctrine vests exclusive power over foreign policy with the federal government. The Supreme Court has made clear that "[p]ower over external affairs is not shared by the States; it is vested in the national government exclusively."[86] States cannot negotiate treaties or bilateral trade agreements with foreign governments, as the U.S. Constitution confers treaty-making power and responsibility for conducting foreign affairs on the President and Executive Branch.[87]

Similarly, the Foreign Commerce clause vests Congress with the power to "regulate Commerce with foreign nations."[88] In *Japan Line, Ltd. v. County of Los Angeles,* the Supreme Court struck down a local property tax on certain ship containers engaged in foreign commerce.[89] The *Japan Line* Court cites the importance of this provision:

> 'In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power'.... The need for federal uniformity is no less paramount in ascertaining the negative implications of Congress' power to 'regulate Commerce with foreign nations' under the Commerce Clause.[90]

The Court also referenced the "Framers' overriding concern that 'the Federal Government must speak with one voice when regulating commercial relations with foreign governments.'"[91] The NAIC Proposal, if enacted, would regulate commercial relations with foreign governments, and prevent the federal government from speaking with one voice in the area of insurance regulation internationally.

The constitutional intrusiveness of the NAIC proposal is revealed by its sweep. The Proposal is not limited to states simply recognizing foreign insurance regulatory regimes as equivalent to their own. Instead it imposes reciprocal recognition by foreign governments of the states' own regulatory programs.[92] The reciprocal nature of the NAIC proposal arguably crosses the line from legitimate state regulatory action to foreign trade diplomacy. In addition, the NAIC Proposal states that

> in order for a jurisdiction to be effective in providing equivalent regulatory outcomes, U.S. insurance regulators need to be able to ... ask the home regulator

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[86] *United States v. Pink*, 315 U.S. 203, 233 (1942).
[87] U.S. Const., art. II, § 2; *United States v. Curtiss-Wright Export Corp.*, 299 U.S. 304, 319 (1936). Of course, action by the Legislative Branch (*i.e.*, Senate ratification or some form of bicameral legislation) is also required to make treaties and other agreements negotiated by the Executive Branch with foreign governments effective.
[88] U.S. Const., art. I, § 8, cl. 3.
[89] 441 U.S. 434, 448-449 (1979).
[90] *Japan Line, Ltd.*, at 448-449 (citing *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933) and U.S. Const., art. I, § 8, cl. 3).
[91] *Id.* at 449 (citing, *inter alia,* The Federalist No. 42, pp. 279-283).
[92] *NAIC Proposal, supra* note 1, at 5.

to: (i) supervise or investigate activities conducted in the home jurisdiction; and (ii) take enforcement action in the home jurisdiction.[93]

Any agreement in which a state binds foreign regulators to conduct investigations or commence enforcement actions could be challenged as an intrusion into the foreign affairs domain of the federal government.

Finally, a component of the Proposal would even seem to require additional federal law. Principles 4 and 5 of the proposal concern the enforceability of U.S. regulations and court judgments by regulators (No. 4) and by insurers and policyholders (No. 5).[94] In order to achieve these principles, the NAIC Proposal would require foreign reinsurers to agree to be bound by a Hague Convention on Choice of Court Agreements ("Convention")[95] that recently became available for ratification in the U.S.[96] The Convention is designed to ensure the recognition and enforcement of court-made judgments entered in civil disputes between parties to commercial contracts who have chosen one or more courts of a State for the resolution of their contractual disputes. It specifically and expressly encompasses proceedings and judgments involving insurance and reinsurance agreements.[97] The Convention thus will complement the benefits and protections accorded to arbitral awards and judgments entered in insurance and reinsurance disputes pursuant to various other federal treaties and statutes already in force.[98] The laudable purposes aside, forcing foreign reinsurers to be bound by this Convention demonstrates yet another intrusion of states into foreign affairs.

A recent state discussion with a foreign governmental entity reflects the inherent limitations of this activity. Earlier this year, California Governor Arnold Schwarzenegger signed a *non-binding* Memorandum of Understanding ("MOU") with the Premier of the Australian State of Victoria to establish a partnership to fight climate change.[99] This MOU sets forth several areas of collaboration between the two states, but also contains two important limitations: (1) that both states "acknowledge that this MOU is not intended to create any legally binding rights or obligations, and will not be enforceable in any court of law in Australia or in the United States of America;" and (2) that implementation is "subject to any changes in policy that they may

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[93] *Id.* at 7-8.
[94] *Id.* at 8-9.
[95] Twentieth Session of The Hague Conference on Private International Law, Special Commission on Jurisdiction, Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, available at http://www.hcch.net/index_en.php?act=conventions.text&cid=98.
[96] The Convention is a treaty that is subject to approval by the President "with the advice and consent of the Senate" pursuant to art. II, § 2, cl. 2 of the U.S. Constitution.
[97] *Id.* Art. 17.
[98] Namely, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 9 U.S.C. §§ 201-208 (the "New York Convention"), the Foreign Sovereign Immunities Act ("FSIA"), 28 U.S.C. § 1602 *et seq.*, and the Inter-American Convention on International Commercial Arbitration, 9 U.S.C. §§ 301-307.
[99] Press Release, Office of the Governor of California, Governor Schwarzenegger Collaborates with Premier Steve Bracks and the Australian State of Victoria to Fight Climate Change (May 4, 2007).

adopt."[100] These limitations may have been aimed at inoculating the MOU from criticism that California is usurping the role of the federal government by engaging in the conduct of foreign policy. The California/Victoria MOU thus underscores the concern that an MRA between states and a foreign regulator which gave effect to law in the United States would likely be vulnerable to a constitutional challenge.[101]

IV. THE NAIC PROPOSAL IS IMPRACTICABLE

In at least one prior case, the private sector, under the authority of the North American Free Trade Agreement,[102] led an effort to coordinate an agreement to recognize foreign regulations. Representatives of Canadian, American and Mexican engineers signed an MRA in 1995 which had been negotiated by three national organizations from the respective countries. Such organizations, however, could not bind the entities on behalf of whom they negotiated. Thus, in order to cover all of North America, it had to be ratified by 12 Canadian provinces, 56 American jurisdictions, and 32 Mexican states. Only Texas approved it, however, because the National Council of Examiners for Engineering and Surveying (NCEES) withdrew its support for the agreement due to what it perceived to be a lack of emphasis on exams.[103] As such, the opportunity to challenge the power of the national organizations to negotiate the MRA thus never ripened.

This failed MRA underscores several points. First, it confirms that the consent of Congress – as provided by NAFTA – was necessary to undertake this negotiation. Second, it demonstrates that national organizations lack the power to bind state regulators in an MRA without their approval. It also highlights the fact that mutual recognition negotiations in the area of state regulation carry the risk that, despite agreement among signatories, states can still refuse to adopt the NAIC's proposal or another recognition measure. This MRA shows the impracticability of obtaining 50-state approval for an MRA. The amount of time required for each state to adopt an MRA poses a very substantial drawback to the Draft Proposal. Perhaps the most successful execution of nationwide state adoption of an agreement in the insurance area is the Interstate Insurance Product Regulation Compact – and that required more than 5 years for 30 states to adopt.[104]

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[100] Memorandum of Understanding between The State of Victoria and The State of California for collaboration on climate change action, signed May 4, 2007.

[101] In addition to the constitutional infirmities, the NAIC Proposal also raises the possibility of a violation of the non-discrimination requirement of GATS (Art. VII), but that analysis is not the subject of this opinion.

[102] North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993).

[103] James McIlroy, *Commonality of Standards – Implications for Sovereignty – A Canadian Perspective*, 24 Can.-U.S. L.J. 245, 248 (1998).

[104] National Association of Insurance Commissioners' Model Regulation Service, Interstate Insurance Product Regulation Compact, April 2007, at 692-19 – 692-21.

V. CONCLUSION / RECOMMENDATION

The current version of the Draft Proposal suffers from several serious shortcomings, because it:

- *Deviates from the central purpose of equivalence by imposing additional burdens on foreign reinsurers, creating substantial uncertainties, and permitting significant variations among states;*
- *Likely violates several provisions of the Constitution; and*
- *Is impractical due to requirement of adoption by 50 states.*

As such, the proposal would almost certainly encounter numerous challenges before it could ever be enacted.

It might be possible to preserve some of the main features of the NAIC Proposal and develop it into a more workable system. For example, the single state regulation model can be utilized if it features a federal oversight function which would provide a single point for uniformity of reinsurance regulations. Under such a system, the Secretary of Treasury could establish certification criteria in conjunction with state regulators, and carry out the certification process. Treasury could also enter into MRAs, which states likely lack the power to do. The NAIC and states again could advise Treasury and USTR in MRA negotiations.

Barring this federal government role, however, state regulators will not be able to achieve an effective system of recognizing equivalent foreign regulatory systems under the current NAIC Proposal.