# Insurance Industry Guide for Capital Markets

A Practical Guidance® Practice Note by
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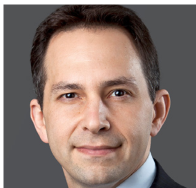

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This guide covers all related information that a securities practitioner needs when working with an insurance company. It provides an overview of the industry and covers applicable securities laws and regulations, securities offering process, disclosure and corporate governance obligations, stock exchange requirements, commercial and regulatory trends, and practical tips for counsel.

## Overview of the Insurance Industry

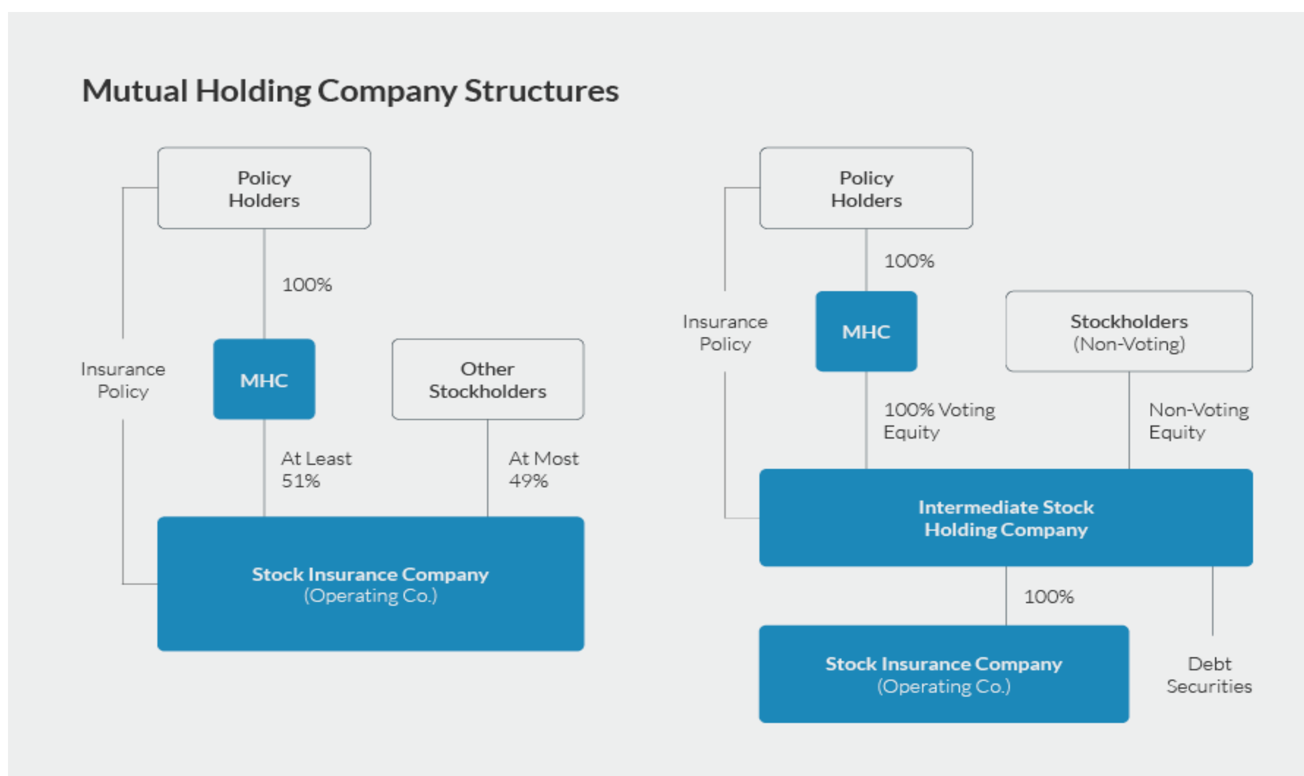
The insurance industry provides financial protection against a range of risks or perils in exchange for a premium payment. By selecting risks through the underwriting process and pooling such risks from different sources, the insurance company business model aims to collect more in premiums than is ultimately needed to pay out in loss claims. But even if loss claims exceed premiums collected in any year, an insurance company can still be profitable by generating investment income on the premiums collected until they are paid out in loss claims. So, the profitability of an insurance company rests on both its ability to underwrite risk and to manage investment assets.

The industry generally consists of companies providing protection against property and casualty risks, life and annuity risks, and health risks. The industry is further divided among primary insurance companies, who issue contracts of insurance directly to insureds (whether individuals or business entities), and reinsurance companies, who enter into reinsurance contracts with primary insurers to assume risks written by the primary insurer. Reinsurers effectively provide insurance to primary insurance companies.

Insurance and reinsurance are regulated businesses, subject primarily to the laws of the jurisdiction of the company's domicile. Their activities are also regulated, through licensing and other requirements, by the laws of the jurisdictions where they conduct business. In the United States, insurance is primarily regulated at the state, not the federal, level. Since the financial crisis and the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (111 P.L. 203, 124 Stat. 1376) (Dodd-Frank Act), certain federal oversight has been imposed for the larger systemically important companies. In Europe, among European Union (EU) countries, insurance is regulated primarily by the EU Commission as well as by home country financial regulators.

Insurance companies may take a number of different legal forms. The most common form is a stock corporation, which is typically set up as a wholly owned subsidiary of a non-insurance corporate holding company. These holding companies are the entities most frequently engaged in capital-raising activities on behalf of their subsidiary operating insurance companies. The other common form of insurance entity is a mutual company. Many of the largest companies in the United States (including life insurance companies such as Northwestern Mutual, New York Life, and Mass Mutual and property-casualty companies such as Nationwide and State Farm) are mutual companies whose equity owners are the policyholders. A mutual company would not be able to issue equity securities directly as a means to raise capital. To raise surplus capital for statutory accounting purposes, a mutual company may issue a surplus note, which is a long-term, deeply subordinated debt instrument. The defining characteristic of a surplus note is that no payment of principal or interest may be made without the prior approval of the domicile insurance regulator.

Other corporate forms exist in the insurance industry. Mutual holding companies (MHCs) are holding companies (not operating companies) of stock insurance companies, and the owners of such mutual holding companies are the policy holders of the stock insurance companies. MHCs are generally required to own at least 51% of the stock insurance company. This format allows the downstream stock insurance subsidiary of the MHC to raise voting equity capital. In a typical structure (such as shown in the following diagram on the right), an intermediate stock holding company on top of the operating insurance company (i.e., the parent of the operating company and subsidiary of the MHC) will issue debt securities and non-voting equity securities to raise capital. Many prominent U.S. insurance companies have chosen this form, including Pacific Life, Liberty Mutual, Ohio National, Western & Southern, CUNA Mutual, and Securian Financial.




Another organizational form unique to the insurance industry is known as a reciprocal exchange. In a reciprocal exchange, each policyholder is an owner and risk taker. Policyholders share in the profits and they also are subject to assessments for losses. Reciprocal exchanges are managed by a designated attorney-in-fact which is typically a non-insurance company acting as a managing agent. Prominent reciprocal exchanges in the United States include Farmers and USAA. Other examples include PURE, the New York writer of auto policies, and Erie Indemnity, whose attorney-in-fact is a publicly traded company. For surplus capital, reciprocals rely upon retained earnings and policyholder assessments. They have the ability to borrow and, like mutual insurance companies, they also can issue surplus notes.

# Applicable Securities Laws and Regulations

The same federal and state statutes and regulations that govern securities offerings by issuers in other industries apply to insurance companies. These may be summarized as follows:

## Securities Act

The principal federal statute regulating securities offerings is the Securities Act of 1933, as amended (73 P.L. 22, 48 Stat. 74, 73 Cong. Ch. 38) (Securities Act). See U.S. Securities Laws. The Securities Act requires each offer and sale of securities in the United States to be registered with the Securities and Exchange Commission (SEC) unless an exemption from registration is available. The primary objectives of the Securities Act are to protect investors and prevent fraud in connection with the offer and sale of securities. To accomplish these goals, the Securities Act requires (unless an exemption is available) that investors be provided with a prospectus prior to purchasing any securities being offered. The prospectus, which is part of the registration statement filed with the SEC, will contain extensive information about the issuer and the securities being offered so that investors are able to make a fully informed decision as to whether or not to invest in the securities. Regulation SK promulgated under the Securities Act contains extensive and detailed rules as to what information must be included in the prospectus, but the Securities Act's overriding principal regarding disclosure is that:

- The prospectus should contain all information that a reasonable person would consider material in making an investment decision.
- The prospectus must not contain an untrue statement or omission of a material fact.

In reviewing the registration statement, the SEC's focus is solely on the quality and accuracy of the disclosure and not upon the merits of the securities being offered. Secondly, in furtherance of its goals, Section 11 (15 U.S.C. § 77k) of the Securities Act imposes statutory liability against the issuer, its directors, the officers who sign the registration statement, and the underwriters involved in the securities offering if the registration statement contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements included therein not misleading. In the case of the issuer, Section 11 liability is strict. In addition, Section 12(a)(2) (15 U.S.C. § 77l) of the Securities Act provides that any person who offers or sells a security by means of any oral or written communication that contains a similar material misstatement or omission is liable to the purchaser for damages. For further information, see Liability under the Federal Securities Laws for Securities Offerings.

Not all offerings of securities must be registered with the SEC. Section 4 (15 U.S.C. § 77d) of the Securities Act sets forth a list of transactions that are exempt from its registration requirements, including "transactions by an issuer not involving any public offering." This is referred to as the private placement exemption (Section 4(a)(2)). There is a substantial body of case law, SEC Staff interpretations, and securities law practice dealing with the private placement exemption. The availability of the exemption depends upon an analysis of the particular facts of the offering, including, but not limited to, the:

- Number and sophistication of the investors
- Relationship between the issuer and the investors
- Solicitation efforts of the issuer

In order to provide issuers with certainty regarding a Section 4(a)(2) exemption, the SEC adopted Regulation D which provides a safe harbor exemption for two types of securities offerings, provided certain conditions are satisfied:

- Rule 504 (17 C.F.R. § 230.504) exempting securities offerings up to $10 million in any 12 month period by issuers that are not subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (73 P.L. 291, 48 Stat. 881, 73 Cong. Ch. 404) (Exchange Act)
- Rule 506 (17 C.F.R. § 230.506) (the most widely used exemption) exempting securities offerings of an unlimited dollar amount to an unlimited number of "accredited investors" and up to 35 non-accredited investors

Another common type of unregistered offering used by issuers, including insurance companies (especially in the case of debt securities), is a Section 4(a)(2) private placement by the issuer to a financial intermediary followed by a resale of the securities by the intermediary to qualified institutional buyers (or QIBs) pursuant to Rule 144A (17 C.F.R. § 230.144a) of the Securities Act or in offshore transactions pursuant to Regulation S (17 C.F.R. § § 230.901- 905), or both methods combined. For further information on private offerings, see Private Placement Process, Top 10 Practice Tips: Private Placements, Equity Offerings Comparison Charts, Regulation D Offerings, and Rule 144A Transactions, and Regulation S Transactions.

U.S. or Canadian insurance companies may also avail themselves of the exemption for securities offerings up to $75 million provided under Regulation A (17 C.F.R. §§ 230.251 – 263), which was adopted by the SEC in June 2015 pursuant to the mandates of the JOBS Act (discussed below) and amended in 2019 and 2021. See Regulation A-Plus Limited Public Offerings under Securities Act Section 3(b)(2) and "Regulation A-plus" Tier 1 and Tier 2 Offerings Summary Chart.

The philosophy behind these exemptions is that accredited investors or QIBs have the sophistication and means to fend for themselves and therefore, there is less of a need for the protections that the registration process provides investors. In the case of smaller offerings, it is a matter of balancing the goal of protecting public investors versus the goal of fostering capital formation by reducing the time and cost of securities offerings by exempting the offerings from the registration process, with the scales tipping in favor of the latter for offerings of smaller size.

In addition to the exemptions from registration for the types of transactions referred to above, the Securities Act provides exemptions from registration for certain types of securities. Some of these securities exemptions have been utilized by the insurance industry to either raise capital or to offer insurance products that have characteristics of securities.

Section 3(a)(8) (15 U.S.C. § 77c) of the Securities Act exempts "any insurance or endorsement policy or annuity contract or optional annuity contract issued by a corporation subject to the supervision of the insurance commissioner…of any State or Territory of the United States or the District of Columbia." This exemption has been interpreted to not apply to variable annuity contracts whose value is tied to performance of a designated investment portfolio. While such contracts often contain death benefit provisions and guaranteed minimum benefits, they are viewed as having more of the characteristics of securities. Fixed annuity contracts and funding agreements that provide a guaranteed fixed return, with the insurance company retaining all of the investment risk, and financial guaranty insurance policies are covered by the Section 3(a)(8) exemption.

Section 3(a)(10) exempts any security issued in exchange for any outstanding securities, claims, or property interests where the terms and conditions of such issuance and exchange "are approved, after a hearing upon the fairness of such terms and conditions…by any court…or by any State or Territorial…insurance commission." This exemption has been relied upon in demutualization transactions where policyholders of mutual insurers are issued common shares in exchange for their ownership interest in the mutual company. Under state insurance laws, the demutualization process typically requires regulatory approval by the domicile state insurance regulator following a public hearing on the merits of the transaction. For further information on Section 3 exemptions, see Section 3 Exemptions from Securities Act Registration Checklist.

## Exchange Act

While the Securities Act is primarily focused on regulating the offer and sale of securities by issuers and their affiliates, the primary focus of the Exchange Act is the regulation of subsequent trading in those securities in secondary market transactions. The Exchange Act applies to any company that (1) makes a public offering of securities pursuant to a registration statement filed with the SEC under the Securities Act, (2) lists its securities on a U.S. national securities exchange (including the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq), or (3) has at least $10 million in assets and a class of equity securities held by at least 2,000 shareholders or 500 shareholders who are not accredited investors (and, in the case non-U.S. companies, at least 300 of the shareholders are residents of the United States). The Exchange Act requires such companies to register their securities under the Exchange Act and to file periodic reports with the SEC (including, in the case of U.S. companies, annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K), which contain information similar to that required in a registration statement under the Securities Act. These reports provide the investing public with current public disclosure of companies whose securities are trading in the secondary markets so that they may make informed investment decisions. The Exchange Act also regulates the mechanics of securities transactions in the secondary market, the solicitation of proxies, tender offers, as well as the activities of underwriters, broker-dealers, and certain other market participants. For further information on Exchange Act requirements, see Periodic and Current Reporting Resource Kit, Registration Requirements under Section 12 of the Exchange Act, NYSE and Nasdaq Listing Requirements Compliance, and Broker-Dealer Federal Regulation Compliance.

## JOBS Act

In April 2012, Congress enacted the Jumpstart Our Business Startups Act (112 P.L. 106, 126 Stat. 306) (the JOBS Act) in order to help small businesses raise funds in the public capital markets by reducing certain regulatory requirements. The JOBS Act created a new category

of issuer called an emerging growth company (EGC) (principally, issuers with less than $1.07 billion of revenues) that receives various accommodations designed to facilitate the initial public offering (IPO) process. The JOBS Act also provides ongoing relief for EGCs from certain reporting obligations under the Exchange Act. For further information on the JOBS Act and EGCs, see Emerging Growth Company Guide for Capital Markets, Top 10 Practice Tips: Emerging Growth Companies, and JOBS Act and Foreign Private Issuers Checklist.

## Sarbanes-Oxley Act and Dodd-Frank Act

Companies that complete a securities offering that is registered with the SEC under the Securities Act or otherwise become subject to the reporting obligations of the Exchange Act also need to comply with the provisions of the Sarbanes-Oxley Act of 2002 (107 P.L. 204, 116 Stat. 745) (the Sarbanes-Oxley Act) and the Dodd-Frank Act.

Enacted in response to the Enron and WorldCom scandals in the early 2000s, the Sarbanes-Oxley Act implemented a number of significant regulations to enhance corporate responsibility and financial disclosures, and to address corporate and accounting fraud. Some of the key provisions under the Sarbanes-Oxley Act applicable to all reporting companies (including insurance and insurance holding companies) include (1) heightened standards for auditor and audit committee independence; (2) a requirement for management and, for issuers that are accelerated or large accelerated filers, the external auditor to assess and report on the adequacy of the company's internal control over financial reporting; (3) certifications by the chief executive officer (CEO) and chief financial officer (CFO) of the company in all annual and quarterly reports regarding the disclosure and financial statements in the report, disclosure controls and procedures, and internal control over financial reporting; and (4) prohibition on loans to directors and officers. The Sarbanes-Oxley Act also requires the board of directors of all U.S. public companies to establish an independent compensation committee and corporate governance committee (each with a charter addressing specific matters) and to have at least one member of the audit committee who is a financial expert. For further information on the Sarbanes-Oxley Act and its reforms, see NYSE and Nasdaq Board of Directors and Committee Governance Requirements Under Sarbanes-Oxley and Dodd-Frank — Audit Committee Standards, Improper Influence of Auditors, Internal Control over Financial Reporting, CEO-CFO Certification Preparation, Sarbanes-Oxley Section 302 Certification, Sarbanes-Oxley Section 906 Certification, SOX's Prohibitions against Loans to Directors and Officers, Incentive Compensation: Clawback Provisions, NYSE and Nasdaq Board of Directors and Committee Governance Requirements Under Sarbanes-Oxley and Dodd-Frank — NYSE and Nasdaq's Rules under Dodd-Frank and Sarbanes-Oxley, Whistleblower Protections under Dodd-Frank and Sarbanes-Oxley, and Attorney Reporting Standards under Sarbanes Oxley Act Section 307 Checklist.

The Dodd-Frank Act was adopted in response to the financial crisis that began in 2008. While the primary focus of the Act was reforming regulation of the financial services industry to promote stability in the financial markets, Title IX contained provisions relating to corporate governance and disclosure matters which impact all publicly listed companies in the United States including (1) heightened independence standards for compensation committees and their advisors, (2) enhanced disclosures regarding executive compensation, (3) the requirement for a non-binding shareholder vote on executive compensation and golden parachutes, and (4) matters relating to broker non-votes. For further information on the Dodd-Frank Act, see Dodd-Frank Wall Street Reform and Consumer Protection Act Key Provisions, Dodd-Frank Executive Compensation Rules Regulatory Implementation Status Chart, and Dodd-Frank Executive Compensation: Key Provisions Q&A.

## Trust Indenture Act

The Trust Indenture Act of 1939, as amended (76 P.L. 253, 53 Stat. 1149, 76 Cong. Ch. 411) (TIA), applies to all public offerings of debt securities, including by insurance companies. In connection with any SEC registered offering of debt securities, the TIA requires the appointment of a trustee that meets specified suitability and independence criteria and that will act on behalf and for the benefit of holders of the debt securities issued under the indenture. The TIA also requires SEC registered debt securities to be issued under an indenture that is qualified under the TIA. The TIA requires each indenture qualified under the TIA to contain certain provisions specified by the TIA. If such provisions are not included in the indenture, they are automatically deemed to be included therein and will supersede any conflicting provisions in the Indenture.

## Blue Sky and State Insurance Securities Laws

Absent an exemption, offers and sales of securities are also subject to state securities laws, commonly known as blue sky laws, although the National Securities Markets Improvement Act (NSMIA) enacted in 1996 preempts states from applying registration and qualification requirements of blue sky laws to securities offerings of covered securities. Covered securities include (1) securities listed on a national securities exchange, (2) any security of the same issuer

that is equal to or senior to any such listed security, and (3) securities offered and sold in offerings that are exempt from federal registration requirements under a specified exemption of the Securities Act, including Section 4(a)(2) thereof. The most prominent example of a category (3) covered security is a security offered in reliance on Rule 506 of Regulation D under the Securities Act described above. Although NSMIA preempts state registration and qualification requirements for the offer and sale of covered securities, states are permitted to impose notice filing, consent to service, and fee requirements. For further information, see Securities and Transaction Exemptions under Blue Sky Laws, Blue Sky Law Compliance in Securities Offerings, and Blue Sky Laws Application to Offerings after NSMIA.

Apart from the state blue sky laws, some state insurance codes impose regulatory conditions on offerings by certain insurance companies and their holding companies. For example, Section 1204 of the New York Insurance Law provides that no person or entity can sell or propose to sell to the public within the state of New York any security issued by any insurer (or holding company of an insurer) not authorized to do business in New York unless such person or entity is licensed to do so under Section 1204. New York insurance regulations (11 NYCRR § 7.2) provide exemptions for certain securities or classes of securities from the requirements of Section 1204. Practitioners should carefully review these exemptions to determine if a license is necessary in a particular transaction. The most likely exemptions include offerings of securities listed on a designated national securities market, an offering registered under the Securities Act, and an offer and sale to a bank, an insurance company, or other institutional buyer. In a 2002 interpretive letter, the New York insurance regulator clarified that an offering to a qualified institutional buyer under Rule 144A would also be exempt. See Selected Opinions of the General Counsel, OGC Opinion No. 2002-17 (Jan. 15, 2002) (http://www.dfs.ny.gov/insurance/ogco2002/rg201232.htm).

# Securities Offering Process

## Public Offerings

The process for a securities offering by an insurance company is basically no different from that followed by other types of issuers. The following is a general description of the typical process for a public offering of securities by an insurance company (or its holding company) that is not already a public company:

### *Pre-Filing Period*

- **Legal perspective.** For public offerings of securities, the period before the filing of a registration statement is called the quiet period because Section 5(c) of the Securities Act prohibits any written or oral offers of securities prior to the filing with the SEC of a registration statement relating to such offering of securities (subject to certain exceptions for companies that qualify as well-known seasoned issuers or WKSIs and "testing-the waters communications" (i.e, offers) made to potential investors that are qualified institutional buyers under Rule 144A or institutional accredited investors under Rule 501(a)). The Securities Act defines the term offer very broadly. The SEC has stated that any publicity or other activity that may help to condition the public mind or arouse public interest in the offering can constitute an offer. Accordingly, the issuer and all parties involved in the offering need to be careful not to publicly mention (whether in a press release, news article, TV interview, or otherwise) that the issuer is about to undertake an offering of securities. For further information, see IPO Process: Permitted Communications, Publicity and Communications Resource Kit, Permitted Communications Memorandum (IPO), and Communication as Offer of Securities Chart.
- **Engagement of underwriters.** Once a company determines that it wants to undertake a public offering of securities, it usually engages one or more investment banks to assist in the marketing and distribution of the securities. These investment banks will be the lead managers of the underwriting syndicate for the offering. Very often the investment banks will request the company to sign an engagement letter pursuant to which the company agrees to engage the investment banks as the underwriters for the offering on an exclusive basis and to reimburse them for their costs and expenses and indemnify them for any losses they may incur as a result of material misstatements or omissions in the registration statement or prospectus.
- **Organizational meeting.** The offering process officially begins with the kick-off organizational meeting among all the members of the working group, including representatives of the company, the underwriters, company counsel, underwriters' counsel, and the company's independent auditors. During the organizational meeting, the parties will discuss the terms of the offering, the timeline and steps of the offering process, the documentation for the offering, and the roles and responsibilities of each party.

- **Due diligence.** Commencing with the organizational meeting, the underwriters, their counsel, and the issuer's counsel will immediately begin the due diligence process which entails (1) reviewing all material documents applicable to the issuer and its subsidiaries, including, among others, material contracts, debt agreements, charters and other organizational documents, board minutes, licenses, and documents related to litigation, and (2) holding due diligence sessions with the issuer's management team and independent auditors. Since insurance companies are regulated entities, due diligence will also involve a session with the issuer's compliance officers and regulatory counsel and reviewing documentation which is particularly relevant to the regulation of insurance companies such as insurance licenses, permits and approvals, regulatory filings, and material correspondence with insurance regulators. For further information on the due diligence process, see Top 10 Practice Tips: Underwriters' Counsel Due Diligence for Securities Offerings and Due Diligence for Securities Offerings Resource Kit.
- **Drafting registration statement and other offering documents.** The issuer, the underwriters, and their respective counsel will also immediately begin drafting the registration statement, including the prospectus. Issuer's counsel, with assistance from the issuer, is primarily responsible for drafting the registration statement. The drafting process will involve numerous in-person and telephonic drafting sessions, each of which can last many hours, with significant time spent in particular on drafting and refining the first few pages of the prospectus which summarizes the business of the issuer and the terms of the offering (often referred to as the summary box). The parties will also begin drafting and negotiating the underwriting agreement (for which underwriters' counsel has the primary drafting responsibility) as well as the legal opinions and 10b-5 negative assurance letter to be delivered to the underwriters by counsel for the issuer and the underwriters. In addition to the standard representations and warranties, the underwriting agreement for insurance companies will most likely include representations and warranties addressing matters particular to insurance companies, including that (1) the insurance company is in compliance with all applicable insurance laws and regulations in all material respects, (2) the offering does not conflict with any insurance laws and regulations, (3) all filings, notices, registrations, and approvals that need to be made with or obtained from insurance regulators have been made and obtained, and (4) the insurance company has recorded adequate reserves for its insurance obligations in a consistent manner throughout the period presented in the prospectus and in accordance with generally accepted accounting principles (GAAP) and has not recently changed its policies with respect to recording reserves. In addition to customary closing conditions, the underwriting agreement for an insurance company issuer will often include a requirement to deliver to the underwriters an opinion from the issuer's regulatory counsel addressing matters such as (1) the insurance company having all necessary licenses and approvals from insurance regulators to operate its business, (2) the offering not conflicting with any insurance laws or regulations, (3) the insurance company having obtained or made all necessary approvals, notices, or filings that must be obtained from or made with insurance regulators in connection with the offering, and (4) the disclosure in the Regulatory section of the prospectus being a fair and accurate summary of the insurance laws and regulations discussed therein. Underwriters' counsel will also be working with the issuer's auditors in the preparation of the auditors' comfort letter to the underwriters. In the comfort letter, the auditors make certain representations as to their independence and types of reviews they have performed with respect to the issuer's financial statements and provide a description of the other procedures they have conducted in order to provide assurance, or comfort, to the underwriters that financial information in the prospectus either ties to or is derived from either the issuer's financial statements or the books and records of the issuer. If the offered securities will be listed on an exchange, such as the NYSE or Nasdaq, the issuer's counsel prepares the listing application. If debt securities are being offered, the parties will have to negotiate the terms of the securities and the covenant package as well as draft an indenture. For further information on documents in a securities offering generally, see Initial Public Offerings Resource Kit, and Follow-On Offerings Resource Kit.
- **Filing the registration statement.** Once finalized, the company files the registration statement with the SEC and the listing application with the applicable exchange. As of July 2017, the SEC allows companies to file a confidential draft registration statement for IPO filings (and offerings within one year of a company's IPO). A company that files a confidential draft registration statement must file the registration statement publicly (including all previously confidential submissions) at least 15 days before the road show, or if there is no road show, 15 days before effectiveness.
- The entire pre-filing process described above will generally take anywhere from six to eight weeks (and

possibly longer) depending upon the focus of the parties and the complexity of the deal, including the issuer's business, corporate and ownership structure, and the terms of the securities.

### *Waiting Period*

- **Legal perspective.** The period between the public filing of the registration statement and the point in time at which the SEC declares the registration statement effective is often referred to as "the waiting period." During the waiting period, offers for the registered securities may be made orally or by means of the preliminary prospectus included in the registration statement or other written communication (referred to as a free writing prospectus) satisfying the requirements of the Securities Act. However, until the SEC declares the registration statement effective, the Securities Act prohibits any sales of the securities subject to the registration statement.
- **SEC review.** The SEC will normally inform the issuer within seven to 10 days after the registration statement has been filed as to whether or not the registration statement will be reviewed. If the SEC elects to review the registration statement, the SEC will normally send a comment letter to the issuer within 30 days of the initial filing date containing questions and requests for additional or supplemental information. The back and forth process of responding to the SEC's comments by filing amendments to the registration statement along with a response letter, including subsequent rounds of SEC comments and issuer amendments and response letters, can take anywhere from one to four weeks depending upon the number and nature of the SEC's comments. In connection with IPOs, most companies opt to undergo the SEC review process on a confidential basis by filing the registration statement and all amendments thereto with the SEC confidentially instead of filing them publicly via the SEC's EDGAR portal. Filing the registration statement confidentially does not commence the waiting period and no offers for the securities may be made (subject to the exceptions mentioned above); however filing confidentially allows a company to address the SEC's comments outside of public scrutiny (at least initially). When the SEC's comments have been addressed and the registration statement is complete, the Company can then decide to file with registration statement publicly via EDGAR and commence the offering and roadshow described below. It is also possible that at such time the equity capital markets may have soured or entered a period of high volatility and the Company may decide that it is not the right time to launch the IPO. In this situation, filing confidentially allows the Company to withdraw its registration statement and terminate the offering process without the public embarrassment of having to pull the deal. Following the public filing of the registration statement, the SEC will also publish on the EDGAR portal all of the documents that were previously filed confidentially, including the initial registration statement, all of the SEC's comment letters, the Company's response letters and the related amendments to the registration statement. For further information on the SEC review process, see SEC Review Process and SEC Comment Letter Responses.
- **Finalizing other documents.** During the waiting period, counsel for the issuer and the underwriters will continue to work on finalizing the other offering documentation, including the underwriting agreement, the comfort letter, opinions of counsel, and negative assurance letters to be delivered at closing. Issuer's counsel will also continue to work on getting the listing application approved and filing all necessary exhibits to the registration statement with the SEC. For examples of closing lists in various contexts, see Closing Memorandum (IPO), Closing Checklist (Follow-on Public Equity Offering; Non-Shelf), Closing Memorandum (Non-Shelf Registered Debt Offerings), Closing Checklist (Rule 144A and/or Regulation S Debt Offering).
- **Roadshow.** When the issuer and the underwriters are comfortable that all material comments from the SEC have been cleared, the underwriters and certain members of the issuer's management team will commence the road show during which they will distribute the preliminary prospectus and make in-person, live-streamed, and video-recorded presentations to investors. The road show can last anywhere from one to two days in the case of a seasoned public issuer or one and a half to two weeks for an issuer's initial public offering of securities. During the road show, the underwriters begin obtaining indications of interest from potential investors, enabling them to gage the level of investors' interest and determine the appropriate public offering price. At the end of the road show and assuming the SEC has no further comments to the registration statement, the issuer and the underwriters will request the SEC to declare the registration statement effective at a specified time and date. For further information, see Road Show Preparation.

### *Post-Effective Period*

- **Legal perspective.** Once the SEC has declared the registration statement effective, sales of securities subject to the registration statement may be made, provided that the confirmation of the sale is preceded

by the filing with the SEC of the final prospectus meeting the requirement of the Securities Act.

- **Pricing.** After the SEC declares the registration statement effective, the issuer and the underwriters will negotiate and agree on the final pricing terms and size of the offering based on the indications of interest that the underwriters have received from investors during the road show, and then sign the underwriting agreement. At this point, the auditors will also deliver their comfort letter to the underwriters. The final pricing terms of the offering will be inserted into the final prospectus which then will be filed with the SEC within two business days of pricing and sent to investors to confirm sales. For considerations relating to pricing, see IPO Changes on Pricing Day.
- **Settlement.** The settlement of the offering will normally occur on the second or third business day after the date of pricing (known as T+2 or T+3). In September 2017, the SEC adopted rules that require securities trades to settle regularly within two trading days of the date of sale, but allow for a longer settlement period as long as the contracting parties have agreed to the longer settlement period at the time of the trade. At the closing, once the opinions of counsel, negative assurance letters, bring-down comfort letter, and other closing document are delivered to the underwriters, the underwriter will wire the purchase price to the issuer, and the issuer will issue the securities to the underwriters. The underwriters in turn will distribute the securities to the investors. For information on disclosure of an alternative settlement cycle, see Alternative Settlement Cycle Disclosure.

### *Shelf Registration Process*

The Securities Act allows for issuers that satisfy certain criteria to avail themselves of a more stream-lined shelf registration process whereby the issuer registers an amount of one or more classes of equity and/or debt securities on what is known as a shelf registration statement. A shelf registration statement permits the issuer to offer and sell the registered securities from time to time on a delayed or continuous basis. The advantage of the shelf registration statement is that once it is declared effective by the SEC, issuers can access the capital markets quickly and efficiently by offering and selling registered securities from time to time as needed without having to wait for any further SEC review. The other advantage of the shelf registration statement is that the information that is required to be included in the registration statement and the prospectus may be incorporated by reference from the periodic reports that the issuer files with the SEC under the Exchange Act. As a result, the disclosure in the shelf registration statement is automatically and continuously updated every time the issuer files its periodic reports under the Exchange Act. Once the shelf registration statement is effective, securities offerings can be conducted in a matter of weeks and sometimes as short as a few days depending upon how long it takes the underwriters and counsel to complete their due diligence and negotiate the terms of the securities and any applicable offering documents. To be eligible to use a shelf registration statement, the issuer must satisfy certain criteria specified by the applicable form, including, but not limited to, that the issuer has been subject to reporting requirements of the Exchange Act for at least 12 months and has timely filed all of the necessary periodic reports under the Exchange Act during the 12-month period immediately prior to filing the registration statement. Upon filing, a shelf registration statement is still subject to review by the SEC as discussed above, but the chances of being reviewed are less than in connection with an IPO. Furthermore, for issuers that qualify as WKSIs, the shelf registration statement goes effective automatically upon filing without any SEC review. For further information, see Shelf Registration.

## Private Placements

The private placement of securities can be a much shorter process than a registered public offering of securities. The primary reason for this is that there is no SEC review. In addition, the prescriptive disclosure requirements of Regulations S-K and S-X do not technically apply, as discussed below. Regulation D specifies the types of information that must be provided to investors that are non-accredited investors and Rule 144A has limited information requirements. However, for offers and sales made to accredited investors under Regulation D or for private placements made pursuant to Section 4(a)(2) there is no requirement as to the specific information that must be provided to investors and instead issuers are guided only by the general anti-fraud provisions of the federal securities laws. Nonetheless, in order to avoid any liability in private placements under these anti-fraud provisions, many issuers will provide investors with an offering memorandum that contains the type of information that would be included in a prospectus in a registered offering.

In unregistered offerings, such as Rule 144A/Regulation S offerings, where a financial intermediary acts as the initial purchaser and may have liability as an underwriter or as a participant in the offer and sale of securities, the process, while shorter and not involving any SEC review, can be very similar to a registered offering of securities. The initial purchasers, their counsel, and issuer's counsel will conduct due diligence essentially the same way they would

for a registered offering. The disclosure in the offering memorandum or circular will often closely follow the disclosure requirements under Regulation S-K and include financial statements that would be required by Regulation S-X. The parties will negotiate and sign a purchase agreement which largely resembles an underwriting agreement in a registered offering. Counsel for the issuer and the initial purchasers will deliver opinions and negative assurance letters, and the auditors will deliver a comfort letter to the initial purchasers, just as they would deliver such documents to underwriters in a registered offering. While private placements are shorter than registered securities offerings, the time period can vary drastically. Where the issuer is already a public reporting company and the offering memorandum will incorporate the issuer's Exchange Act reports by reference and the terms of the securities are straight forward, the entire process can range from one to three weeks. But for a first-time issuer where the offering memorandum must be drafted from scratch and the terms of the securities or covenant package is complicated, the process can range from six to eight weeks or possibly longer. For further information, see Private Placement Process, Private Placements Resource Kit, Rule 144A / Regulation S Offerings Resource Kit, and Offering Memorandum Drafting for Rule 144A / Regulation S Offerings.

# Disclosure Obligations

## Regulation S-K and S-X

The SEC has adopted various forms of registration statements to be used in connection with the securities offering. The applicable form will depend on, among other things, whether the issuer is a U.S. issuer or a foreign private issuer (FPI, as further discussed below) and on the public reporting history of the issuer under the Exchange Act. Each form of registration statement will set forth the types of information that must be included in the registration statement and refer the registrant to the detailed disclosure requirements set forth in Regulation S-K (17 C.F.R. § 229.10 - § 229.1208), except for a registration statement on Form 20-F for FPIs which has the detailed disclosure requirements set forth therein. The types of information that must be included or incorporated by reference in a registration statement and the related prospectus include, but are not limited to, descriptions of the following items:

- The issuer's business, including its properties and facilities, products and service offerings, future prospects, and material customers and suppliers
- The industry in which the company operates and the competitive and regulatory environment
- Risk factors related to the company's business and industry
- A discussion of management's analysis of the company's financial condition and results of operation (MD&A)
- Material contracts and related party transactions
- Material obligations, contingencies, and litigation of the issuer and its subsidiaries
- Biographies of the issuer's officers and directors, a description of the committees of the board, corporate governance policies, and executive compensation programs
- The terms or the rights, powers, and limitations of the securities being offered
- The planned use of proceeds from the offering
- The tax treatment of the securities
- The underwriting arrangements and the plan of distribution

For further information, see Registration Statement and Preliminary Prospectus Preparations for an IPO.

The forms of registration statement will also refer the issuer to Regulation S-X (17 C.F.R. § 210.1-01 - § 210.12-29) which specifies the form and content of, and requirements for, financial statements that must be included in registration statements and prospectuses. These financial statements include the historical financial statements of the issuer and may also include the historical financial statements of any significant acquisition that has recently occurred or that is probable, as well as pro forma financial statements reflecting on a pro forma basis any material acquisition or disposition that has recently occurred or that is probable. For further information, see Financial Statements and Reporting Resource Kit.

While the specific disclosure requirements of Regulations S-K and S-X do not apply to offerings exempt from registration, they provide counsel with a useful reference point in determining what disclosure the SEC considers relevant or important to disclose to investors. Any exempt offering would be subject to the anti-fraud rules of the federal securities laws, including Section 10(b) (15 U.S.C. § 78j) under the Exchange Act and Section 17 under the Securities Act.

The disclosure and financial statement requirements prescribed by the applicable form of registration statement and Regulations S-K and S-X apply to public offerings by

insurance companies just as they do for public offerings by issuers in other industries. The following is a discussion of disclosure requirements and issues that are particular to insurance companies.

## GAAP vs. SAS Financials

Mutual companies cannot issue equity securities given their corporate form, but they can issue debt securities, including, for example, surplus notes which count as surplus for statutory accounting purposes. An obvious problem for mutual companies is complying with Regulation S-X requirements to present historical financial information in accordance with U.S. GAAP. All U.S. domiciled insurance companies are required to prepare financial statements in accordance with statutory accounting standards (SAS) promulgated by the National Association of Insurance Commissioners (NAIC). SAS differs from GAAP in a number of important respects and focuses more upon the liquidation value of the business as opposed to its going concern value. For example, SAS does not have a concept of deferred acquisition costs (DAC), the asset booked by life and other insurance companies at the time a policy is issued, which represents the expense of commissions paid to agents and brokers at the time a policy is issued. Under GAAP, these costs are deferred and amortized as an expense over the expected duration of the policy. Under SAS, these costs are not deferred but are expensed in full up front. SAS also has a concept of admitted and non-admitted assets. The latter may not be included in a company's computation of statutory surplus or risk-based capital. A non-admitted asset would include for example an investment amount that did not meet investment law restrictions under state law and receivables more than 90 days past due. Under GAAP, such assets would be booked at either their fair market value or amortized cost.

In the case of stock insurance companies, they would prepare and file periodically with state insurance regulators SAS financial statements. They would also prepare GAAP financials for SEC reporting purposes. Many mutual companies, however, do not prepare GAAP financials. The SEC has provided some accommodation to mutual insurers in Section 7.02 (17 C.F.R. § 210.7-02) of Regulation S-X, which provides that financial statements for mutual life insurance companies and their wholly owned stock insurance company subsidiaries may be presented in accordance with SAS.

With respect to an offering of surplus notes (many of which are conducted without registration under Rule 144A and Regulation S), the issuing insurance company would typically use SAS financial statements in its offering document. This would be the case for both issuing mutual insurance companies and stock insurance companies. SAS financials could have relevance even for a stock company that prepares GAAP financials because the SAS financials would be the frame of reference for an insurance regulator in approving any payments on the surplus notes or in regulating any dividends paid by the insurance operating company to its parent holding company. The offering memorandum would include a discussion of the material differences between GAAP and SAS in the presentation of the financial statements.

## Additional Insurance Information

Sections 7.03 (17 C.F.R. § 210.7-03) and 7.04 (17 C.F.R. § 210.7-04) of Regulation S-X also prescribe specific line items to be covered in insurance company financial statements. Section 7.05 (17 C.F.R. § 210.7-05) mandates certain schedules for insurance companies relating to summary of investments, supplemental insurance information regarding among other items, DAC, loss reserves, and reinsurance. In addition, for property-casualty insurance companies, an additional schedule of information on DAC, reserves, non-investment income, paid claims, and premiums written is required.

Certain specific information is also required to be disclosed by insurance companies under Regulation S-K. Securities Act Industry Guide 6 and Exchange Act Guide 4 require disclosures concerning unpaid claims and claim adjustment expenses of property-casualty insurance underwriters. The disclosure must provide an analysis of changes in reserves for claims and claim adjustment expenses over the latest three one-year periods and also a table showing loss reserve development over the past ten years. This is commonly referred to as a loss triangle table. In many instances, as for example in the IPO of newly-formed Bermuda property-casualty reinsurers, there is not ten years of loss development history and in fact there may be less than three years of historical financial statements. In such cases, shorter periods for loss development are presented, or in some cases not at all where it would not be deemed material.

## Dividend Restrictions

One of the most critical disclosure issues in any insurance company securities offering relates to restrictions on dividend capacity and capital requirements, either of which may restrict the ability to make payments on the security. With the exception of offerings made directly by mutual companies, most insurance company securities offerings are made by non-insurance holding companies or subsidiaries. For a typical stock insurance company in the United States, the holding company is not subject

to regulation as an insurer. It can raise debt capital and contribute the proceeds to the insurance company as statutory surplus. If the insurance company were to issue the debt directly, it would be required to book a liability on its existing statutory balance sheet which would negate any additions to surplus. But for this typical structure to work, the holding company needs to be able to rely upon the insurance company subsidiary to make dividend payments to the holding company for liquidity and as a source of funds to pay security holders. Similarly, shareholders and other creditors of the holding company are relying on those same dividend payments.

Under the insurance laws of most states, an insurance company may only pay a dividend to its parent in the amount of its earned surplus in the prior year. Earned surplus is a statutory accounting term equivalent to retained earnings under GAAP. In addition, under most state insurance laws an insurance company cannot pay a dividend which would exceed the lesser of (1) 10% of statutory surplus as of its most recent statutory financial statement and (2) the prior year's net gains from operations, if the insurer is a life insurer, or net income, if the insurer is not a life insurer. See Section 5.B. of the NAIC Model Insurance Holding Company System Regulatory Act (2015). In the case of insurance companies domiciled in the EU, the Solvency II capital requirements (further discussed in "Regulatory Trends" below) would apply in connection with any dividend payment.

Counsel in any securities offering for an insurance holding company will need to focus on these rules as part of the due diligence process. As part of the risk factor disclosure and MD&A sections, there would typically be a discussion of the applicable rules and also a quantification of the actual dividend capacity of the operating insurance companies. Of course, if the issuer had other restrictions, such as that contained in any bank covenant, these would also be discussed in the offering document.

## SEC Staff Focus

Practitioners can expect that in the SEC staff's review of insurance company registration statements and annual reports, the SEC staff will request that companies disclose the nature of dividend restrictions on insurance company subsidiaries and the amount of retained earnings or net income restricted or unrestricted for payment of dividends. Rule 4-08(e) (17 C.F.R. § 210.4-08) of Regulation S-X requires additional disclosure in the financial footnotes of the nature of the restrictions and the amount of restricted net assets when restricted net assets exceed 25% of consolidated net assets.

Moreover, the SEC staff has emphasized the importance of disclosing minimum capital requirements for all jurisdictions with significant operations, including those of non-U.S.-domiciled subsidiaries and foreign insurance operations.

In this connection, the SEC staff has commented that under FASB Account Standards Codifications (ASC) it is not sufficient to state only that total adjusted capital is in excess of the risk-based capital requirements for all insurance entities. SEC comments have required companies to disclose the amount of statutory capital and surplus necessary to satisfy state and, if applicable, foreign regulatory requirements if it is significant in relation to actual statutory capital and surplus. In the event that statutory capital and surplus are not significant, companies must explain why in the notes to their financial statements. The SEC staff has also commented that statutory capital and surplus disclosures must be audited.

## Reserve Liability Disclosures

Another important disclosure issue for insurers is the discussion of reserve liabilities. Insurance involves the promise to pay in the future upon the occurrence of a future fortuitous event. Typically, this promise to pay in the future is in an amount that is a multiple of the premium received in any year. The amount of reserve liabilities to be booked by an insurer and the timing thereof is a complicated actuarial exercise and depends heavily on the nature of the risk and the type of coverage. Insurance companies make assumptions and judgments, and it is not an exact science. For property-casualty insurers, the reserve liabilities booked include a concept known as incurred but not reported losses (IBNR). A Florida hurricane could result in an insurance company booking a reserve liability for anticipated losses even if it has yet to receive an actual claim by a policyholder. Over time, as actual claims are submitted and paid, the insurer may decide it is appropriate to increase reserves or to reduce (or release) reserves.

In the context of reviewing MD&A disclosure, counsel needs to understand that the insurer's reserve practices can significantly impact net income from period to period as well as the company's solvency.

## Intangible Assets of Insurance Companies

Another issue for insurance company MD&A disclosure relates to intangible assets and the risk of the potential write down as an expense. One such intangible asset unique to insurance companies is deferred acquisition costs or DAC. Acquisition costs represent the commissions paid to agents and brokers at the time a policy is written. Under SAS, acquisition costs are expensed in full when paid. Under GAAP, the acquisition costs are deferred

and amortized over the expected life of the policy. So, for a typical life insurance policy, the acquisition costs can exceed the amount of the first-year premium. Under SAS, this means the company has a net loss with respect to such policy, negatively impacting surplus, in that first year; whereas under GAAP, the same company is able to amortize the expense over the life of the policy resulting in a much less negative impact on the profitability of such policy in that first year. Under GAAP, a DAC is capitalized as an asset. The disclosure issue for counsel to consider is the consequence of a policy lapse in this period of deferral, which lapse would require an "acceleration" of DAC and its full expensing. Companies can mitigate this risk by including surrender charges in their policies which require the policy holder to pay an additional fee when the policy lapses early due to the failure by the policyholder to pay the premium, as well as other techniques.

Another intangible unique to the insurance industry is value of business acquired (VOBA). This is analogous to goodwill and would be booked at the time of the acquisition of a book of business (i.e., a portfolio of insurance policies) or an operating insurer. VOBA is established as the actuarially determined present value of future gross profits of the business acquired and is amortized in proportion to future premium revenues or the expected future profits, depending upon the type of business acquired. As with DAC, many assumptions go into the calculation of VOBA, including with respect to interest rates, policy terminations, and claims payments. These assumptions are reexamined periodically (at least annually) and could result in write downs of VOBA, thereby impacting profitability and solvency. For an issuer with relatively material amounts of VOBA on its balance sheet, counsel needs to consider the risk of such a write down and the adequacy of the disclosure of the Risk Factors and MD&A sections of the offering document.

In reviewing insurance company registration statements, the SEC staff has focused comments on enhancing disclosure concerning: the methodology and key assumptions used for determining whether any intangible assets have been impaired; the sensitivity of assumptions used to determine fair value; and a description of actual or potential facts or events which could lead to an impairment charge. If any impairment testing has been conducted, the issuer may need to disclose the results of such testing, and if no testing has been conducted, the reasons why.

## Risk Factors

In the Risk Factor section of the prospectus or offering memorandum, there are generally three categories of risk factors: (1) risks related to the business of issuer, (2) risks related to the industry in which the issuer operates, and (3) risks related to the securities being offered. Within the first two categories of risks factors, there are risks that are applicable to most if not all issuers and the industry itself (e.g., the loss of key personnel could harm the business and the insurance industry is highly regulated) as well as risks that are specific to the issuer due to the particular facts and circumstances facing the issuer. A good risk factor section addresses all of these risks. A frequent comment by the SEC to the Risk Factor section of the prospectus is to revise or delete bland or generic risk factors that could apply to any issuer. Therefore, even with respect to risks that are applicable to most if not all issuers, counsel should tailor the risk factor to the particular facts and circumstances of the issuer.

In order to properly draft the Risk Factor section, counsel must have a thorough understanding of all of the risks the issuer faces. Such understanding can only be achieved through a thorough and complete due diligence process. In order to be properly prepared to conduct due diligence (i.e., to ask insightful questions and address the pertinent matters in diligence sessions), counsel must be fully versed on the latest issues and developments in the industry. If you are acting as counsel to the issuer or the underwriters in a securities offering by an insurance company and are not familiar with the particular issuer or industry, prior to attending the first diligence session (or, ideally, the organizational meeting) you should review three to five recent annual reports or prospectuses of the more prominent players in the issuer's sector in order to obtain a good understanding of these hot-button issues and developments. For additional information on risk factors in general, see Top 10 Practice Tips: Risk Factors and Risk Factor Drafting for a Registration Statement.

The following is a list of some of the more common risk factors that are specific or unique to issuers in the insurance industry, many of which are related to some of the disclosure issues that are particular to insurance companies discussed above:

- **The insurance industry is highly regulated.** This risk factor has many facets and counsel needs to work with the issuer and its regulatory counsel to ensure that all of the nuances of this risk are covered and tailored to the specific risks of the issuer, including:
  - Compliance with numerous regulations can be time consuming and costly and thus negatively impacts profitability.
  - Failure to comply can subject the issuer to fines, penalties, loss of license as well as reputational damage.

- Numerous regulations can impair an issuer's growth strategy in terms of both organic growth through expansion into new territories and growth through acquisitions.
- Often regulators must approve rate increases or new product offerings before they can be implemented by insurance companies and any rejection or delay in the approval process can negatively impact growth in revenues and profitability.
- New regulations (both currently known and unknown) can further increase operating costs, impair the issuer's growth strategy, and otherwise negatively impact the issuer.
  - Counsel needs to make sure any material pending legislation and its potential impact on the issuer is disclosed. Due to the drastic changes in health care laws (both recent and anticipated), this aspect of regulatory risks is particularly relevant to health insurance companies.
- Deregulation (which is an important theme of the Trump administration) can potentially be harmful to an issuer if it reduces barriers to entry and increases competition.

- **Loss reserves are estimates and may be inadequate to cover the insurance company's actual liability for losses, causing its results of operations to be adversely affected.** This is one of the principal risks faced by all insurance companies. In drafting this risk factor, counsel should work closely with the issuer's CFO and accounting department, as well as the issuer's outside auditors, to ensure accuracy. The disclosure in this risk factor should complement the discussion of this topic in the MD&A and should describe all variables that must be considered in making loss reserves determinations and the difficulties and uncertainties in making such determinations. The following language is taken from a risk factor in the IPO prospectus of Heritage Insurance Holdings, Inc., a property and casualty (P&C) insurance company:

  "Factors that affect unpaid losses and loss adjustment expenses include the estimates made on a claim-by-claim basis known as "case reserves" coupled with bulk estimates known as "incurred but not yet reported" (or "IBNR"). Periodic estimates by management of the ultimate costs required to resolve all claims are based on our analysis of historical data and estimations of the impact of numerous factors such as (i) per claim information; (ii) industry and company historical loss experience and development patterns; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages and changes in political attitudes; and (iv) trends in general economic conditions, including the effects of inflation. Management revises its estimates based on the results of its analysis. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate resolution of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors.

  Because of the inherent uncertainties in the reserving process, we cannot be certain that our reserves will be adequate to cover our actual losses and loss adjustment expenses. If our reserves for unpaid losses and loss adjustment expenses are less than actual losses and loss adjustment expenses, we will be required to increase our reserves with a corresponding reduction in our net income in the period in which the deficiency is identified. Future loss experience substantially in excess of our reserves for unpaid losses and loss adjustment expenses could substantially harm our results of operations and financial condition."

  While this risk is generic to all insurers, counsel should be careful to describe any facts or circumstances that are particular to the issuer that make reserving judgments especially difficult for its management. For example, Heritage Insurance Holdings addressed the particular difficulty it faced in estimating reserves due to its limited operating history:

  "We maintain reserves to cover our estimated ultimate liabilities for losses and loss adjustment expenses, also referred to as loss reserves. As a new company, we have a limited operating history and a limited loss history which may negatively impact our ability to accurately establish loss reserves. Our current loss reserves are based primarily on industry historical data and statistical projections of what we believe the resolution and administration of claims will cost based on facts and circumstances then known to us. As a new company, our claims experience and our experience with the risks related to certain claims is inherently limited, and we must rely heavily on industry historical data, which may not be indicative of future periods. As a result, our projections and our estimates may be inaccurate, which in turn may cause our actual losses to exceed our loss reserves. If our actual losses exceed our loss reserves, our financial results, our ability to expand our business and to compete in the property and casualty insurance industry may be negatively affected."

The risk factor should also discuss (1) any recent changes in the issuer's reserving process, including its policies and procedures, both quantitatively and qualitatively, and the reasons for such changes, and (2) any significant deficiencies in the reserving process that that issuer had experienced in the past and the dollar impact it had on subsequent periods (which makes the risk real and concrete to readers and tells them this is not simply a theoretical risk).

- **Risk factors addressing the inherent uncertainty in estimating the extent of future liabilities that the insurance company is agreeing to cover and establishing premiums at a rate that will be low enough to be competitive yet high enough to cover those liabilities and also generate a profit.** All insurance companies have one or more risk factors touching upon this theme. Counsel should work with the issuer's management and finance, actuarial, and sales teams to draft this risk factor. Some examples of this risk factor include:
  - Our success depends on our ability to accurately price the risks we underwrite.
  - The inherent uncertainty of models and our reliance on such models as a tool to evaluate risk may have an adverse effect on our financial results.
  - The effects of emerging claim and coverage issues on our business are uncertain and negative developments in this area could have an adverse effect on our business.
  - The failure of the risk mitigation strategies we utilize could have a material adverse effect on our financial condition or results of operations.
  - ◦ Lack of effectiveness of exclusions and other loss limitation methods in the insurance policies we assume or write could have a material adverse effect on our financial condition or our results of operations.
- **Risk factor addressing the fact that the issuer's insurance company subsidiary is subject to minimum capital and surplus requirements.** This risk factor addresses the issue discussed above under the subheading Dividend Restrictions. An insurance company's failure to meet minimum statutory capital and surplus requirements can subject the insurance company to regulatory action, including
  - A prohibition on the insurance company subsidiary from paying dividends up to the holding company parent (the issuer), which in turn impacts the issuer's liquidity and ability to pay its own creditors and pay dividends to its shareholders
  - Increased regulatory review and supervision
  - A prohibition or limit on the insurance company from writing additional policies until such requirements are satisfied
  - Potentially a loss of license

  Counsel should work with the issuer's regulatory counsel to ensure the accuracy of this disclosure. This risk factor should address the different factors that could negatively impact the ability of the insurance company to meet these requirements, particularly those that may be beyond the control of the issuer, and any failure of the insurance company to meet these requirements in the past (to demonstrate to the reader that this risk is not theoretical). The SEC will also require the issuer to disclosure what the insurance company's actual capital and surplus amounts and ratios currently are.

- **Risk factors related to reinsurance.** In order to limit their potential exposure to insured risks, many insurance companies purchase reinsurance from third party reinsurers. By using reinsurance, an insurance company is able to write more policies and generate a larger premium volume than would have been possible at its then current level of capital. However, reinsurance does not discharge the insurance company's obligations under the insurance policies it writes; it merely provides the insurance company with a contractual right to seek reimbursement on certain claims. The insurance company remains liable to its policyholders even if it is unable to collect the amount it is owed under its reinsurance contracts. As a result, insurance companies are subject to credit risk with respect to their reinsurers. Counsel should be sure to disclose:
  - The overall amount of reinsurance the insurance company has
  - A break-down of the amount reinsurance from each reinsurer
  - The credit ratings of each reinsurer

  Counsel also needs to examine the terms of the reinsurance contacts because very often a reinsurer will not agree to cover all insured losses. There may be circumstances in which the insurance company must pay the policy holder for the amount of the insured loss, but is unable to get reimbursed from the reinsurer under the reinsurance contract. If that is the case, then counsel will need to adequately disclose such discrepancy. Another related risk to address is the ability of the insurance company to renew or obtain reinsurance in the future. Currently, due to oversupply in the market, obtaining reinsurance is relatively cheap and a very

cost efficient means of obtaining capital to grow one's business. However, market conditions may change and there is no assurance that an insurance company will be able to obtain an adequate amount of reinsurance at favorable pricing and other terms in the future if at all.

- **Risks relating to an insurance company's investment portfolio.** An important component of an insurance company's profitability is the returns it receives on its investment portfolio, including interest income, dividends, and capital gains. The growth and stability of an insurance company's investment portfolio is also critical to cover the insurance company's current and future obligations under the insurance policies that it writes. As a result, counsel must review the issuer's investment policies and work with the issuer's management, finance team, and outside auditors to assess the nature and concentration of the investments in the insurance company's investment portfolio, in order to understand and adequately describe the related risks. The following is a list of the headings and subheadings from the Risk Factors section of MetLife Inc.'s 2016 annual report related to its investment portfolio:
  - *If Difficult Conditions in the Global Capital Markets and the Economy Generally Persist, They May Materially Adversely Affect Our Business and Results of Operations*

    Our business and results of operations are materially affected by conditions in the global capital markets and the economy generally. Stressed conditions, volatility and disruptions in financial asset classes or various markets, including global capital markets, can have an adverse effect on us, in part because we have a large investment portfolio and our insurance liabilities are sensitive to changing market factors…
  - *Adverse Global Capital and Credit Market Conditions May Significantly Affect Our Ability to Meet Liquidity Needs, Our Access to Capital and Our Cost of Capital*
  - *We Are Exposed to Significant Global Financial and Capital Markets Risks Which May Adversely Affect Our Results of Operations, Financial Condition and Liquidity, and May Cause Our Net Investment Income to Vary from Period to Period*
    - Interest Rate Risk …
    - Credit Spreads …
    - Equity Risk …
    - Real Estate Risk …
    - Obligor-Related Risks …
    - Foreign Currency Exchange Rate Risks …
    - Derivatives Risk …

## MD&A and Business

For a discussion of the key points that counsel should consider when preparing the business and MD&A sections for an issuer in the insurance industry, see the discussion above in the introductory section of this section. In addition, counsel should be familiar with the operating and financial metrics that management, analysts, and investors use to evaluate the performance of companies in the insurance industry. The most common metrics are loss ratio, operating expense ratio, and combined ratio (expressed as either a net premium earned or on a gross premium basis or both). A well-drafted prospectus or offering memorandum will have a clear explanation of what these ratios are, how they are calculated, and how they are used by management. Furthermore, while these ratios are commonly used in the industry, each issuer or a particular subsector within the industry may have slight nuances in their calculation that counsel should be aware of to make sure those nuances are disclosed to the reader. The following disclosure taken from the MD&A section of National General Holdings Corp.'s 2016 annual report on Form 10-K is a good example of an explanation of these ratios and their use:

> "*Net loss ratio*. The net loss ratio is a measure of the underwriting profitability of an insurance company's business. Expressed as a percentage, this is the ratio of loss and LAE incurred to net earned premiums.
>
> *Net operating expense*. These expenses consist of the sum of general and administrative expense and acquisition costs and other underwriting expenses less ceding commission income and service and fee income.
>
> *Net operating expense ratio (non-GAAP)*. The net operating expense ratio (non-GAAP) is one component of an insurance company's operational efficiency in administering its business. Expressed as a percentage, this is the ratio of net operating expense to net earned premium.
>
> *Net combined ratio (non-GAAP)*. The net combined ratio (non-GAAP) is a measure of an insurance company's overall underwriting profit. This is the sum of the net loss and net operating expense ratio (non-GAAP). If the net combined ratio (non-GAAP) is at or above 100 percent, an insurance company cannot be profitable without investment income, and may not be profitable if investment income is insufficient. …

> We evaluate our operations by monitoring key measures of growth and profitability, including net loss ratio, net combined ratio (non-GAAP) and operating leverage. We target a net combined ratio (non-GAAP) between 90% and 95% while seeking to maintain optimal operating leverage in our insurance subsidiaries commensurate with our A.M. Best rating objectives. To achieve our targeted net combined ratio (non-GAAP) we continually seek ways to reduce our operating costs and lower our expense ratio. For the year ended December 31, 2016, our operating leverage (the ratio of net earned premium to average total stockholders' equity) was 1.7x, which was within our planned target operating leverage of between 1.5x and 2.0x."

For a discussion of rules relating to inclusion of non-GAAP measures in SEC filings, see SEC Regulation of Non-GAAP Financial Measures.

Finally, the Business section of the prospectus or offering memorandum for insurance companies should include a Regulatory subsection which gives an overview of the regulatory regime impacting the issuer and its industry, including a discussion of the applicable regulatory authorities at the federal and state level and any self-regulatory organizations, the relevant laws and regulations, and any trends in the regulatory environment. Counsel for the issuer should work with the issuer's compliance personnel and regulatory counsel in drafting this section. Most often, the underwriters will request an opinion from the issuer's regulatory counsel that the disclosure in the Regulatory section is a fair and accurate summary of the laws, rules, and regulators discussed therein.

### Other Prospectus Disclosure

The remaining disclosure points in a registration statement or prospectus will generally follow those which apply to non-insurance issuers. These points would include sections on management, executive compensation, related party transactions, descriptions of the securities offered, tax, and ERISA considerations.

Because of the importance of investment returns to the business, offering documents often separate out from the MD&A a section on investments. This section would provide historical information (past two to three years) on asset categories within the investment portfolio, amortized costs and fair market values, realized and unrealized gains, ratings, and industry breakdowns. Information on impairment losses for other-than-temporary declines in fair market value would also be discussed. Since the financial crisis in 2008, enhanced disclosure would typically be provided regarding investments in mortgage loans and mortgage backed securities.

In addition, every prospectus and registration statement for an insurance company or insurance holding company would include a Regulation section. For U.S. companies, this would describe the U.S. insurance regulations applicable to the issuer and for non-U.S. issuers and multi-nationals, the principal non-U.S. regulations affecting the business. For U.S. companies, the regulation section would describe in general terms the breadth of the fifty-state regulatory system. It would also describe the state insurance holding company regulations, the laws relating to guarantee associations and assessments thereunder, and the National Association of Insurance Commissioners (NAIC) and its role in establishing uniform financial tests and risk-based capital standards. It would also discuss any pending regulatory proposals or developments. In this connection, emerging federal regulations since the adoption of Dodd-Frank would be addressed.

## Underwriting Agreements

The underwriting arrangements for an offering by an insurance company or insurance holding company would generally not be different from those for other types of issuers. A U.S. public offering of debt or equity securities by an insurance holding company is typically conducted through a syndicate of underwriters led by one or more lead underwriters. The underwriting agreement between the issuer and the underwriters provides for the several (not joint) commitments of each underwriter to purchase its allocation of the securities offered. The underwriters purchase the securities from the issuer at a discount to the public offering price, which is the price that the underwriters sell the securities to the investors in the offering. The amount of underwriting discount is not specific to the insurance industry, but rather to the type and size of the offering. The underwriting discount in an IPO would typically be 7% of gross offering proceeds. For an offering of investment grade debt securities, the underwriting discount is generally in the range of 0.5% to 1.0%, and for follow-on offerings (i.e., not an IPO) of common stock is generally in the range of 3.0% to 3.5%.

In addition to the basic purchase and sale commitment, the underwriting agreement contains issuer representations and warranties, covenants, conditions (including specifying legal opinions, comfort letters, and other closing deliverables), and indemnification provisions. For a form of general underwriting agreement, see Underwriting Agreement (Primary Offering).

In a 144A underwritten offering, there is a purchase agreement with the underwriters, who are referred to as initial purchasers. The purchase agreement contains most of the same provisions as an underwriting agreement, except those relating to registration with the SEC. For a form of purchase agreement, see Purchase Agreement (Rule 144A and/or Regulation S Debt Offering).

In a private placement transaction under Section 4(a)(2) of the Securities Act, there is no underwriting agreement. Instead, the investors enter into a purchase agreement directly with the issuer. If an investment bank is acting as a placement agent in the transaction, it will often enter into a placement agency agreement.

Most of the provisions in any underwriting agreement or purchase agreement prepared by an investment bank's counsel are standard, and negotiation of terms is limited with most of the negotiation focused on the issuer's representations and warranties.

As discussed above in "Securities Offering Process," the underwriting agreement or the purchase agreement for a securities offering by an insurance company will include representations and warranties, as well as opinions of counsel, that are specific to insurance matters. The following are examples of typical insurance representation and warranties for an insurance holding company:

- Each subsidiary of the Company that is required to be organized and licensed as an insurance company (collectively, the Insurance Subsidiaries) is duly licensed as required in its jurisdiction of organization and is duly licensed or authorized as required in each jurisdiction outside its jurisdiction of organization where it is required to be so licensed or authorized to conduct its business as described in the Registration Statement, the Pricing Prospectus, and the Prospectus, except where the failure to be so licensed or authorized, individually or in the aggregate, would not reasonably be expected to result in a Material Adverse Effect.
- The Insurance Subsidiaries have made all required filings (including statutory annual and quarterly statements and statutory balance sheets and income statements included therein) under applicable insurance statutes in each jurisdiction where such filings are required, except for such filings the failure of which to make would not, individually or in the aggregate, reasonably be expected to result in a Material Adverse Effect.
- Each of the Insurance Subsidiaries has all other necessary authorizations, approvals, orders, consents, certificates, permits, registrations, and qualifications (Authorizations), of and from all insurance regulatory authorities necessary to conduct their respective existing business as described in the Registration Statement, the Pricing Prospectus, and the Prospectus, except where the failure to have such Authorizations, individually or in the aggregate, would not reasonably be expected to result in a Material Adverse Effect.
- No Insurance Subsidiary has received any notification from any insurance regulatory authority to the effect that any additional Authorizations are needed to be obtained by any Insurance Subsidiary in any case where it would reasonably be expected that the failure to obtain such additional Authorizations or the limiting of the writing of such business would result in a Material Adverse Effect.
- Except as set forth in the Registration Statement, the Pricing Prospectus, and the Prospectus, no insurance regulatory authority having jurisdiction over any Insurance Subsidiary has issued any order or decree impairing, restricting or prohibiting (A) the payment of dividends by any Insurance Subsidiary to its parent, other than those restrictions applicable to insurance or reinsurance companies under such jurisdiction generally, or (B) the continuation of the business of the Company or any of the Insurance Subsidiaries in all material respects as presently conducted, in each case except where such orders or decrees would not, individually or in the aggregate, reasonably be expected to result in a Material Adverse Effect.
- Neither the Company nor any of its Insurance Subsidiaries has received any written notice from any of the other parties to any material reinsurance treaties, contracts, agreements, or arrangements to which the Company or any Insurance Subsidiary is a party that such other party intends not to perform its obligations thereunder, except to the extent that such nonperformance would not have a Material Adverse Effect.

If the initial draft of the representations and warranties are not qualified by the Material Adverse Effect qualifier, counsel for the issuer should be sure to request its inclusion and such a request will generally not meet much resistance from the underwriters and their counsel.

The following are examples of typical opinions that may be requested of the issuer's regulatory counsel on behalf of an insurance holding company which is the parent of a P&C insurance company subsidiary and a subsidiary that is a licensed managing general agent (MGA):

- P&C Insurance Subsidiary has received all necessary authorizations, approvals, orders, consents, certificates, permits, registrations, and qualifications and has made

all declarations and filings with the [Applicable State Insurance Regulator] necessary to conduct its business operations as described in the Disclosure Package and the Prospectus, and all of the foregoing are in full force and effect.

- MGA Subsidiary has received all necessary authorizations, approvals, orders, consents, certificates, permits, registrations, and qualifications and has made all declarations and filings with the [Applicable State Insurance Regulator] necessary to conduct its business operations as described in the Disclosure Package and the Prospectus, and all of the foregoing are in full force and effect.
- The execution and delivery by Holdings of, and the performance by Holdings of its obligations under (including the issue and sale of the Shares), and the consummation of any other of the transactions contemplated by, the Underwriting Agreement do not and will not violate any Applicable Insurance Law (defined below) applicable to Holdings or any of its subsidiaries; no consent, approval, authorization or order of, or qualification or filing with, any governmental body, agency or court under Applicable Insurance Law is required for the performance by Holdings of its obligations under the Underwriting Agreement or in connection with the transactions contemplated thereby. "Applicable Insurance Law" means the insurance laws of the State of [ ] and the rules and regulations adopted thereunder.
- The Statements included in the Disclosure Package and the Prospectus under the headings "Risk Factors—Risks Related to Regulation of our Insurance Operations" and "Business—Government Regulation" fairly summarize the matters therein described.

# Continuous Disclosure and Corporate Governance

For an insurance company or insurance holding company that has registered securities under the Securities Act, listed securities on a national securities exchange, or is otherwise subject to Exchange Act reporting requirements as described in "Applicable Securities Laws and Regulations," the same continuous disclosure requirements that apply to other types of issuers will apply. For domestic companies (as well as any foreign company that does not qualify as an FPI), these continuous disclosure requirements include the obligation to file the following reports electronically with the SEC under the Exchange Act:

- Annual report on Form 10-K within 60, 75, or 90 days after the end of the company's fiscal year depending upon whether the company is a large accelerated filer, accelerated filer, or a non-accelerated filer
- Quarterly reports on Form 10-Q within 40 days (for large accelerated and accelerated filers) or 45 days (non-accelerated filers) following end of the company's fiscal quarter
- Current reports on Form 8-K upon the happening of material events relating to the company (which for most events must be filed within 4 business days of the occurrence)
- Proxy Statements on Schedule 14A, preliminary copies of which must be filed 10 days prior to the time definitive copies are sent to securities holders (unless the proxy statement relates to an annual meeting at which only specified matters will be addressed) and definitive copies filed no later than the date sent to shareholders

A foreign private issuer, or FPI, includes any foreign issuer (other than a foreign government) unless both of the following conditions are satisfied: (1) more than 50% of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States, and (2) any of the following is true: (A) the majority of the executive officers or directors are U.S. citizens or residents, (B) more than 50% of the assets of the issuer are located in the United States; or (C) the business of the issuer is administered principally in the United States.

The reporting obligations for FPIs are less burdensome than those for domestic issuers. An FPI is required to file its annual report on Form 20-F within four months after its fiscal year end. In contrast to the quarterly reports on Form 10-Q and current reports on Form 8-K, FPIs file periodic reports on Form 6-Ks that contain information material to an investment decision in the securities of the registrant. Form 6-Ks must contain press releases, securityholder reports, and other information that:

- The FPI discloses under the laws of its home country
- Is required to be submitted to the stock exchange on which the FPI's securities are traded and that has been made public by such exchange
- The FPI distributes or is required to distribute to its securityholders
- Is material with respect to the issuer and its subsidiaries concerning matters specified in the form (e.g., changes in business or changes in management)

There is no precise filing deadline for Form 6-Ks. The form states that they must be filed with the SEC promptly after the information is made public by the FPI under applicable home county laws or securities exchange rules. Unlike domestic companies, FPIs are also not required to file with U.S. GAAP financial statements (as they can use International Financial Reporting Standards as issued by the International Accounting Standards Board or other accounting principles with a U.S. GAAP reconciliation). FPIs are also exempt from the Exchange Act's requirements with respect to proxy solicitations and the prohibitions on selective disclosure under Regulation FD (though in practice many FPIs voluntarily comply with Regulation FD).For more information on FPIs, see Foreign Private Issuer Guide for Capital Markets.

In addition to the Exchange Act reporting requirements, an FPI whose securities are listed on the NYSE or Nasdaq are subject to the NYSE and Nasdaq regulations regarding the disclosure (to the public and the relevant exchange) of material information that would reasonably be expected to affect the value of the FPI's securities or influence investors' decisions. Companies satisfy these requirements by issuing press releases and filing their Exchange Act reports. Although the Exchange Act does not require FPIs to file or make publicly available quarterly financial information as it does for domestic companies on Form 10-Q, the NYSE and Nasdaq currently require listed FPIs to disclose on Form 6-K an interim balance sheet as of the end of the FPI's second quarter and interim income statement for the six-month period. These interim financial statements are due not more than six months after the end of the company's second fiscal quarter. Even though it is not required, most publicly-traded FPIs file quarterly reports on Form 6-K due to market expectations, whether or not their securities are listed on an exchange. For FPIs with effective shelf registration statements, they must file a post-effective amendment or incorporate by reference interim financial statements for the first six months of their fiscal year no later than nine months after the end of their fiscal year.

For companies that are not reporting companies but have issued securities eligible for resale under Rule 144A, that rule requires issuers to make available the following information if requested by an investor prior to the time of sale: (1) a very brief and reasonably current description of the business of the company and its products and services offered; and (2) the company's most recent balance sheet and profit and loss and retained earnings statements and similar financial statements for such part of the two preceding fiscal years as the company has been in operation.

Due to market practice, most offerings under Rule 144A as well as private placements under Section 4(a)(2) include contractual undertakings by the issuer to provide more specific information including annual audited financial statements, quarterly financial statements, and notification of any material corporate events.

Like all public companies, insurance companies need to also monitor new rulemaking and guidance issued by the SEC, NYSE, and Nasdaq on matters that are increasingly areas of focus for investors such as Environmental, Social and Governance (ESG), including new mandates or enhanced disclosure requirements related to climate change, sustainability, board diversity and inclusion, human capital and other key areas as they evolve. For example, in early 2021, the Commissioner of the SEC directed the SEC staff to increase its attention on the ways in which public companies implement the SEC's 2010 Guidance Regarding Disclosure Related to Climate Change, which provides direction to companies regarding the SEC rules that may require disclosure about climate change, despite the fact that climate change is not explicitly referenced in the existing rules. The SEC's disclosure requirements are largely principles-based and may require different information from different companies, including climate change-related information. Another example is the new rules adopted by Nasdaq (with phase-in implementation commencing in August 2023) which require listed companies to have, or to explain why they do not have, at least two diverse directors, including (1) at least one director who self-identifies as female (regardless of gender designation at birth) and (2) at least one director who self-identifies as either an "Underrepresented Minority," as defined in the Nasdaq rule, or as LGBTQ+. Foreign issuers (including FPIs) and smaller reporting companies may satisfy the board-composition requirement by having two directors who self-identify as female.

# Stock Exchange Requirements

The listing standards and corporate governance requirements for listed companies under the NYSE and Nasdaq, including Sarbanes-Oxley provisions applicable to reporting companies, apply with equal force to insurance company issuers. These corporate governance standards include, but are not limited to, the following:

- **Majority independence.** A majority of the board must be independent (not required for FPIs).
- **Audit committee.** All members must be independent and financially literate (required for FPIs). One member

must have accounting or related financial management expertise, and the committee must have a charter with specified provisions (not required for FPIs).

- **Nominating / corporate governance committee.** All members must be independent and the committee must have a charter with specified provisions (not required for FPIs).
- **Compensation committee.** All members must be independent and the committee must have a charter with specified provisions (not required for FPIs).
- **Shareholder approval.** Certain corporation transactions require prior shareholder approval, including (i) equity compensation plans for executive officers, (ii) issuances of common stock in excess of 1% of the number of shares or voting power outstanding to a director, officer or substantial security holder, and (iii) certain issuances of common stock equal to or greater than 20% of the number of shares or voting power outstanding (not required of FPIs).
- **Corporate governance guidelines.** Under NYSE rules, the board must adopt guidelines addressing specified matters including director qualification standards, director responsibilities, director access to management and independent advisors, director orientation and continuing education, management succession, and annual performance of the boards (not required for FPIs).
- **Code of business conduct and ethics.** The board must adopt a code addressing specified matters, including conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with laws, and encouraging the reporting of illegal or unethical behavior (not required for FPIs).
- **CEO certification.** The CEO must certify annually to NYSE regarding compliance with NYSE corporate governance listing standards.

FPIs are required to disclose in their annual reports on Form 20-F any significant way in which their corporate governance practices differ from those followed by domestic companies under stock exchange listing standards. For additional information on listing standards, see NYSE and Nasdaq Board of Directors and Committee Governance Requirements Under Sarbanes-Oxley and Dodd-Frank, 20% Rule and Other NYSE and Nasdaq Shareholder Approval Requirements, Nasdaq Corporate Governance Listing Requirements Table, and NYSE Corporate Governance Listing Requirements Table.

# Other Key Laws and Regulations

In addition to the federal securities laws referred to under "Applicable Securities Laws and Regulations," securities lawyers working with insurance company issuers need to be familiar with the regulatory framework that applies to insurance companies and the business of insurance. These regulations do not apply directly to the securities offering itself but are highly relevant to conducting due diligence and drafting disclosures to enhance an investor's understanding of the risks associated with an investment in securities issued by an insurance company.

In the United States, insurance is regulated at the state level. Each state has adopted an insurance code as well as an insurance holding company act. The state insurance codes address:

- Licensing and regulating insurance companies and others involved in the insurance industry
- Monitoring and preserving the financial solvency of insurance companies
- Regulating and standardizing insurance policies and products
- Controlling market conduct and preventing unfair trade practices
- Regulating other aspects of the insurance industry

The insurance holding company laws address affiliate transactions, including the payment of dividends from an insurance company to its parent company. These state insurance laws are enforced and administered by state insurance commissioners who are empowered with significant discretion in applying the insurance laws and regulations.

It is important for securities practitioners to understand that the state insurance law system is designed for the primary protection of policyholders and not shareholders, creditors, or other securityholders.

To promote uniformity among state insurance regulations, the National Association of Insurance Commissioners (NAIC) was formed. The NAIC develops model statutes and regulations, including with respect to accounting standards, investments, disclosure, and corporate governance. Since 1990, the NAIC has maintained an accreditation program to promote effective insurance company financial solvency regulation across the states. NAIC accreditation allows non-

domestic states to rely on an insurance company's domestic regulator to fulfill a baseline level of effective financial regulatory oversight.

This leads to efficiencies both for the non-domestic regulators and for insurance companies that are licensed and operating in multiple states. Currently, all 50 states, the District of Columbia, and Puerto Rico are NAIC-accredited jurisdictions. The accreditation standards are designed to determine whether a state insurance department has adequate statutory and administrative authority to regulate an insurance company's corporate and financial affairs.

The adoption of accreditation standards is one of the most important ways in which the NAIC promotes regulatory uniformity among the states. NAIC model laws and regulations are only effective in a state if they are enacted into law by that state's legislature and promulgated by its insurance commissioner. However, whenever the NAIC designates a particular requirement as an accreditation standard, states have a powerful incentive to put it into effect—or risk losing their NAIC accreditation.

# Regulatory Trends

The insurance industry is both highly regulated and global. Any practitioner representing insurance companies in securities offerings needs to be cognizant of regulatory matters and trends impacting the client's business and financial condition.

Perhaps the most significant ongoing regulatory trend in the insurance industry today is the emergence of new global capital standards. Since the financial crisis erupted in 2008, the NAIC has focused its attention on developing standards for so-called group supervision of insurance companies. The primary focus of insurance regulation has historically been on the solvency of the operating insurance company itself. The rescue of AIG by the U.S. government laid bare the financial risk that non-insurance affiliates of insurance companies can create for otherwise solvent and healthy insurance companies. At the same time, the insurance industry is a global industry and the United States and other developed countries have acknowledged the need to develop uniform capital standards to avert future global financial crises. The G-20, the Financial Stability Board, and the International Association of Insurance Supervisors are the chief international organizations developing global standards for internationally active insurance groups.

Meanwhile at the beginning of 2016, the EU put into effect new capital standards known as Solvency II and identified certain countries as having equivalent regulatory regimes entitling companies domiciled therein to avoid duplicative regulation. Thus far, the United States is not among the jurisdictions so designated, although in January 2017 a so-called covered agreement was reached among EU and U.S. regulators addressing group supervision, reinsurance, and the sharing of information among insurance regulators. This covered agreement should enhance regulatory certainty for insurers and reinsurers operating in both the U.S. and the EU.

One of the consequences of the Dodd Frank Act was to vest in a new Federal Insurance Office (FIO) within the Treasury Department, the authority to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters. The FIO was empowered to negotiate arrangements (called covered agreements) with one or more foreign authorities that achieve a level of protection for U.S. insurance or reinsurance consumers substantially equivalent to the level of protection achieved under the U.S. state insurance regulatory system. The FIO was also given the authority to determine whether such covered agreements will preempt state insurance regulation.

The new covered agreement with the EU:

- Eliminates the requirement that EU reinsurers post collateral as a condition for a U.S. ceding insurer (i.e., the transferor of risk to the reinsurer) to take statutory financial statement credit for reinsurance, provided that the reinsurer satisfies certain minimum financial tests and other requirements
- Prohibits national regulators in the EU from imposing local presence requirements on U.S. reinsurers as a condition of doing business in EU member states
- Confirms the mutual agreement of the United States and the EU that insurers operating in each other's markets will only be subject to worldwide prudential insurance group oversight by the supervisors in their home jurisdiction, although individual regulators will still be able to regulate operations within their jurisdictions

Full implementation of the agreement will take place over a period of five years as individual states adopt implementing legislation.

In the life insurance industry, one of the more significant regulatory developments relates to the use of captive insurance companies to help finance regulatory reserve requirements for certain types of life insurance products. Since 2000, the life industry has been subject to significant regulatory reserve requirements for certain products like level premium term life insurance, which provide for a fixed annual premium amount for a period of 10 or more years.

Known as Regulation XXX, these reserve requirements are viewed by actuaries in the industry as redundant (i.e., highly unlikely to ever be called upon to meet contractual obligations to policyholders). Nevertheless, these redundant reserves need to be booked on a company's statutory balance sheet and so need to be financed in some manner and supported by real assets in some manner. More than a decade ago, companies developed techniques to finance these reserves through reinsurance to a captive subsidiary (i.e., a wholly-owned subsidiary of an insurer whose sole purpose is to provide reinsurance for its parent) that would raise capital either through the issuance of securities or through bank facilities or reinsurance. Regulators in New York and at the NAIC began to question these techniques and following several years of study, in 2015 regulatory guidance known as AG48 was adopted which had the effect of requiring more assets to be funded at the captive level to support the liabilities. At the same time, the NAIC adopted new principle based reserving standards which changes the reserve requirements for life insurance products in a way which reduces the so-called redundancy.

These regulatory trends have had the recent effect of reducing the number of structured financing transactions taking place in the industry as companies assess the impact of the regulatory trends and consider capital raising techniques that meet the regulatory standards as well as risk/return expectations of capital market participants.

# Commercial Trends

An overriding commercial trend impacting the insurance industry (both life and property-casualty) since the financial crisis has been the prolonged period of chronically low interest rates. Insurance companies depend heavily on investment returns earned on the premiums that they receive from policyholders pending the payment of any claims. The low interest rate environment has reduced investment returns and thereby dampened returns on equity for insurers. At the same time, in the property-casualty sector, in the past decade there have been fewer catastrophic events and the pricing of premiums has been soft. This has changed in recent years with the occurrence of severe wildfires, tropical storms, hurricanes, and tornados. Finally, there has been an influx of capital to the industry from both traditional and non-traditional sources (as further discussed below with respect to insurance-linked securities). This has resulted in the industry being relatively over-capitalized and made it difficult to achieve attractive returns on equity capital.

These trends have led to some consolidation in the industry, particularly among reinsurance companies, and has also reduced the number of securities offerings by insurance companies, particularly of equity securities. Many insurance companies have responded by issuing contingent capital facilities, which provide equity capital at a time when the insurer most needs it, usually when it has experienced unexpectedly high insurance claims. These offerings have taken a variety of different structural forms, but at their core they provide for the issuance of equity securities, whether voting or non-voting, at the occurrence of a defined event. In some transactions, the capital is raised by an off-balance sheet trust or vehicle that holds collateral to support the securities. When the triggering event happens, the collateral is used to acquire newly issued equity securities of the insurance company. As a result, the insurance company does not add to its already overcapitalized balance sheet until such time as it actually needs the capital.

Over the last decade, one of the more significant trends in the property-casualty sector has been the growth in alternative risk transfer techniques and the convergence of insurance risk markets with capital markets. The trend started with the low probability/high severity risks from catastrophic events like earthquakes and hurricanes. With catastrophe bonds, which are principal at-risk notes issued by offshore special purpose insurers with a term of typically three to five years, insurers and reinsurers are able to raise risk capital outside the traditional avenues of the global reinsurance markets or through the issuance of debt or equity securities. Institutional investors have been attracted to these catastrophe bonds because while principal is at risk, the risk is remote (usually with probabilities of loss around 2 to 3%) and importantly uncorrelated to other market risks such as interest rates and other macroeconomic trends. In addition, the return that investors receive on catastrophe bonds is higher than many other investment options. Other types of insurance-linked securities (ILS) have emerged covering such insurance risks as motor third party liability insurance, health insurance, financial institution operational risk, and extreme mortality (or pandemic) risk. A number of dedicated fund managers have raised capital from pension funds, endowments, and other institutional investors to invest specifically in insurance-linked securities. Such funds currently exceed more than $106 billion assets under management. The amount of catastrophe bonds outstanding exceeds $35 billion. Alternative risk markets have matured into a staple for large segments of the insurance market and are likely to only grow in importance for the industry.

For the practitioner, insurance-linked securities are generally structured to be off-balance sheet and so the disclosure is very different from other types of securities offerings. The ILS market is generally a 144A market, although there is an active private placement (Section 4(a)(2)) market for smaller transactions.

# Practice Tips

When working with insurance or reinsurance companies on securities offerings, you should pay particular attention to the following:

- All of the U.S. securities laws and related regulations apply to public offerings of insurance companies just as they do to public offerings of any other type of issuer. There are no short cuts. The same holds true for transactions which are exempt from registration, including 144A offerings, Regulation S offerings, and private placements under Section 4(a)(2). The conditions of each of these exemptions need to be met with equal force as with other types of issuers. In addition, there will be specific additional disclosure requirements for insurance companies, such as the disclosure on loss reserve developments required under Guide 6 of Regulation S-K.
- With respect to non-U.S. insurance companies that meet the definition of FPI, the same accommodations regarding compliance with the federal securities laws would apply as they would to other types of FPIs. It is important, however, to pay attention to the Investment Company Act of 1940, as amended (40 Act), and the rules thereunder. Insurance companies are fundamentally investment companies as most of their assets are investment securities. U.S. companies enjoy an exemption under Section 3(c)(3) (15 U.S.C. § 80a-3(c)(3)) of the 40 Act. For non-U.S. companies, there is an exemption under Rule 3a-6 (17 C.F.R. § 270.3a-6) for foreign insurance companies that meet the conditions of the rule. These conditions include the requirement that the issuer be engaged "primarily and predominantly" in the business of writing insurance contracts and be regulated as an insurance company in its home country. These conditions need to be carefully considered. The consequence of violating them could be to render voidable any securities offering, even where the Securities Act and Exchange Act have been carefully complied with.
- Because insurance is a highly-regulated business, any securities practitioner must understand the regulatory framework in which a company operates in order to conduct due diligence properly and craft effective disclosure, including risk factors. As discussed above, it is often the case that in a registered public offering or an underwritten 144A offering, the underwriters will request a legal opinion on the company's licensing status under applicable insurance law, compliance with insurance law, and the accuracy of the regulatory disclosure in the offering document. Such opinions may be given by in-house counsel who is closest to these issues. It may also be given by outside counsel in some circumstances if issuers retain insurance regulatory counsel to address these issues. You should make arrangements to cover these basic legal diligence issues early in the offering process.
- Know the basics of SAS accounting and the differences with GAAP. For insurance company securities offerings, it is important for the securities practitioner to have a good working relationship with the company's auditors. You cannot be expected to know all the accounting rules, but you need to be conversant enough to discuss issues with the auditors and with the company. Know what a combined ratio, a loss ratio, and an expense ratio are. Understand the basics of booking for reserve liabilities and IBNR losses and the role of both internal and external actuaries in reviewing these numbers. Consider how these numbers change over time. Accounting for insurance companies relies upon many assumptions regarding future interest rates and behavior of customers (e.g., policy lapse rates, mortality, and morbidity). Changes to these assumptions can result in material swings in financial statement line items from period to period. In some cases, companies have been required to restate historical financial statements as the basis of certain assumptions change. Effective legal diligence and disclosures around accounting assumptions is often critical for insurance companies.
- Liquidity and capital resource disclosure for an insurance company can be key and will be tied to regulations relating to dividends to holding companies and capital requirements. Counsel needs to have a thorough understanding of the relevant rules and their application to the issuer in order to draft proper disclosure and in certain instances to assure compliance with financing covenants and other contractual obligations.
- As a regulated entity, an insurance company may require certain regulatory approvals to successfully complete a securities offering. A demutualization is an extreme example of an insurance company securities offering which is a heavily regulated process. For mutual companies that issue surplus notes, the issuance itself will likely require regulatory approval. In the realm of certain types of contingent capital facilities, there may

be a need to obtain regulatory relief to clarify that a certain statutory accounting result is achieved. Whether some type of regulatory approval or consent is needed should be discussed early in the process. Also, in some instances, no regulatory approval is needed but a company will feel that, for the sake of maintaining a positive relationship with its primary regulator, a discussion with the regulator is warranted. Again, this should be flagged early in the process. A related point is determining whether the company is commercially domiciled in a state outside its home jurisdiction. California and Texas, for example, apply many of their regulations to companies domiciled in other states by virtue of the company doing a significant amount of business in those states.

- Pay attention to the ratings of the insurance company and to issues that may impact changes to such a rating. Like banks, insurance companies rely on the trust and confidence of their customers to remain viable. In many instances, a rating from AM Best or other nationally recognized rating agency is a prerequisite to compete. A downgrade can be devastating. This will be relevant to identifying disclosure issues and crafting risk factors.


**Stephen G. Rooney, Partner and Co-Head of Global Insurance Industry Group, Mayer Brown LLP**


Stephen G. Rooney is Co-leader of Mayer Brown's Global Insurance Industry Group. He practices in the areas of securities offerings, structured finance and mergers and acquisitions. Over the past 25 years, he has represented issuers and underwriters in connection with domestic and international offerings of equity, debt and hybrid securities, and he has extensive experience in negotiating and structuring M&A within the insurance and financial services industries. Stephen also counsels domestic and international clients on corporate governance matters and director fiduciary duties.

Stephen has served as transaction counsel in a variety of insurance-linked securities offerings and other structured financings, including numerous catastrophe bond offerings; the first securitization of life insurance regulatory reserves; the first securitization of private equity investment portfolios; and the first securitization of insurance policy loans. He has advised on more than 100 insurance-linked securities offerings and reinsurance side-car formations in the last five years alone.

Stephen was named a "Dealmaker of the Year" for 2014 by *The American Lawyer* for his role as transaction counsel in the first-of-its-kind catastrophe bond offering sponsored by New York's Metropolitan Transportation Authority (MTA). He has also been consistently recognized as a leading insurance industry transaction lawyer in *Chambers USA and Who›s Who Legal: Insurance and Reinsurance*.


**John P. Berkery, Partner, Mayer Brown LLP**


John P. Berkery is a partner in Mayer Brown's Corporate & Securities practice. He represents underwriters, issuers and selling stockholders in a wide range of capital markets transactions, including registered public offerings (IPOs, follow-on offerings, continuous offering programs), private placements (including Rule 144A/Reg S offerings and PIPE (private investment in public equity) transactions), leveraged buyouts, restructurings and liability management transactions (exchange offers, tender offers and consent solicitations). He is experienced in a broad spectrum of securities products, ranging from high-yield to investment-grade debt securities and from simple common equity to complicated convertible debt and other hybrid and equity-linked securities. His practice also includes assisting clients with their on going reporting obligations, corporate governance requirements and other compliance issues arising under the Securities Exchange Act of 1934, the NYSE and NASDAQ, as well as general corporate law matters.


**David S. Bakst, Partner, Mayer Brown LLP**


David S. Bakst is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice focusing on capital markets. His practice focuses on a wide variety of public and private securities offerings ranging from large New York Stock Exchange and NASDAQ listed IPOs and multibillion-dollar debt offerings to smaller private offerings. With more than 20 years of capital markets experience, particularly focusing on securities offerings involving non-US issuers, David has led securities offerings for a number of the most prominent issuers in Europe, Asia, Australia, and Latin America. He advises clients from a broad range of industries, including life sciences, financial services, energy, telecommunications, and technology. David regularly advises leading investment banking firms on domestic and international capital markets offerings, and also advises companies regarding Securities Act and Exchange Act compliance, NYSE and NASDAQ compliance, corporate governance, and Sarbanes-Oxley Act matters.

For three consecutive years David has been ranked as "highly regarded" by the *IFLR1000* guide for Capital Markets: Debt, Capital Markets: Equity, and M&A in the United States. David has also been recommended by *The Legal 500 US* in the Capital Markets: Debt, Equity and Global Offerings categories, as well as in the Healthcare: Life Sciences category. The guide notes, «David Bakst is an experienced capital markets specialist with significant expertise in a variety of global markets.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