

INSURING THE FINANCIAL INDUSTRY IN A POST-REFORM WORLD

The 2300 pages of the Dodd-Frank Wall Street Reform and Consumer Protection Act are likely to impact every aspect of finance in America once all the rules and regulations supporting the legislation are finally completed. However, only insurance will be affected by nearly every major change in the Act.

This widespread connection between insurance and finance is the result of the expansive and encompassing nature of insurance itself. Every bank, every mortgage broker and even hedge funds need insurance to operate. So while insurance is barely mentioned in the Act, anyone working in finance will need to recognize that the far-reaching changes instituted by the Act¹ will have a direct impact on the way financial institutions are insured in this country.

We believe that the insuring of financial institutions will be most directly altered by the following seven consequences of the legislation.

1. **INVESTMENT ADVICE** The potential imposition of the fiduciary standard on providers of investment advice
2. **CONSUMER FINANCIAL PROTECTION AGENCY** The creation of a new agency focused on the protection of the average financial consumer
3. **PRE-EMPTION** Potential strengthening of state powers to assert financial regulation
4. **NEW REGULATORY AUTHORITY / FINANCIAL STABILITY COUNCIL** The granting of broad new powers of oversight to the newly instituted Financial Stability Council



5. **HEDGE FUNDS** Registration of previously unregulated private funds
6. **VOLCKER RULE** The limitation of proprietary trading by federally insured depository institutions
7. **MORTGAGE ORIGINATION & SECURITIZATION** New rules on credit minimums and retention of securitized asset pools

Three broader reforms embedded in the Act will impact all of corporate America. These provisions are related to whistle-blowing, executive pay and proxy voting and are addressed separately in **Executive Risks Alert Issue 50**, "Executive Risks and the Wall Street Reform and Consumer Protection Act."

1. INVESTMENT ADVICE

Securities firms dodged a serious bullet in the form of “fiduciary duty.” Earlier versions of the Reform Bill included imposing a fiduciary standard on measuring the appropriateness of the investments a firm sold. (Currently brokers are only held to the test of whether an investment is suitable; the fiduciary test would require that salespersons confirm that the investment is in the best interests of the customer.) If brokers are treated as fiduciaries, they will need to take major steps to change the way their sales forces determine the appropriateness of the investments they sell. Compliance manuals will need to be rewritten and compliance managers will be forced to oversee the extensive training and enforcement programs that would accompany any new regulations resulting from the heightened standard. A true fiduciary test will also mean that there will undoubtedly be more litigation by investors claiming that their salesperson has failed to meet the stricter standard.

FIDUCIARY DUTY: The obligation to act in the best interest of another party. A fiduciary obligation exists whenever one person places special trust and confidence in another person and relies upon that person, the fiduciary, to exercise his expertise in acting for the client; and the fiduciary knowingly accepts that trust and confidence and undertakes to act on behalf of the client by exercising his own discretion and expertise.

Brokers and their insurers argued that securities salespeople should not be held to the same standard as professional money managers, while consumer advocates responded that the fiduciary standard is needed because investors are confused by the various titles used by financial advisers. (Among the 68 studies commissioned by the Act are reviews of advisers’ accreditation, mutual fund advertising and financial literacy among investors.) Although the bill fails to impose the fiduciary standard, § 913 does require that the SEC undertake a six-month study of “the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers” and others.

INSURANCE IMPACT

While the standard remains unchanged for the time being, insurers will be watching carefully. If the SEC concludes their study and determines that stockbrokers should be held to the stringent fiduciary standard, expect the cost for Error & Omission lines of insurance to climb accordingly.

2. CONSUMER AGENCY

Title X of the Dodd-Frank Act creates the Bureau of Consumer Financial Protection. Although the new watchdog sits within the Federal Reserve, it is intended to operate independently. The unit will have rulemaking and some enforcement power over banks and non-banks that offer consumer financial products or services, such as credit cards, mortgages and other loans. The idea for the Bureau grew out of criticism that bank regulators failed to properly exercise their consumer-protection authority during the housing boom. The new Bureau will assume much of that oversight. (The new Financial Stability Oversight Council will be given authority to overrule the Bureau if it determines that the Bureau’s rules threaten the safety, soundness or stability of the U.S. financial system. The New Director of the Bureau will sit on the Council.)

REACH OF THE NEW BUREAU OF CONSUMER FINANCIAL PROTECTION

- Mortgages
- Real Estate
- Credit Cards
- Debit Cards
- Consumer Loans
- Payday Loans
- Credit Reporting Agencies
- Debt Collection
- Stored-Value Cards
- Investment Advisory

The Bureau will write and enforce its own regulations (as well as enforcing existing federal provisions) pertaining to consumer financial products. However, the Bureau will not have purview over community banks. In fact, any institution with assets less than \$10 billion is exempt from the reach of the Bureau. This anomaly is the result of the political horse trading that surrounded the bill. The impact of the new Bureau and its

potentially burdensome oversight will only be felt by larger depository institutions and small check-cashing firms. The logic of this dichotomy is hard to comprehend. If a bank grows past the \$10 billion mark or the merger of two banks results in a firm that exceeds the limit, then it will find itself suddenly forced to comply with a whole new set of regulations.

Despite vigorous lobbying by the Obama administration, auto dealers are also exempt.

INSURANCE IMPACT

While it is too early to tell how tough an overseer the new Bureau will prove to be, there is no doubt that it will add additional costs and administrative burdens to the larger banks. It is important to note that the Bureau does not have direct authority over insurance companies. State-regulated entities, like insurance companies, are specifically beyond the reach of the new agency. More rules, more uncertainty about their enforcement and an additional supervisor all equate to more regulatory risks and a higher probability of increased litigation. Carriers will likely be cautious until they understand whether the new watchdog's bark is worse than its bite.

3. PRE-EMPTION

The Dodd-Frank Bill will allow states to impose their own stricter consumer protection laws on national banks. National banks would be entitled to seek exemption from state laws on a case-by-case, state-by-state basis if application "would have a discriminatory effect on national banks."² The Bill explicitly invokes the standard established by the Supreme Court in the **Barnett Bank** case.

BARNETT BANK OF MARION COUNTY V. NELSON 517 U.S. 25, 41 (1996)

Congress intended to avoid "the possibility of inadvertent federal intrusion [into state regulation of insurance] - say, through enactment of a federal statute that describes an affected activity in broad, general terms, of which the insurance business happens to constitute one part."

Pre-emption is a uniquely American legal concept. In its most direct form it declares that a state may not pass a law inconsistent with a federal law. The conflict between federal and state regulation dates back to the founding of our country. The McCarran-Ferguson Act of 1945 established that silence (in terms of insurance regulation) on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several states."

The Dodd-Frank Bill reads in relevant part:

"(b) PREEMPTION STANDARD.— (1) IN GENERAL.—State consumer financial laws are preempted, only if— (A) application of a State consumer financial law would have a discriminatory effect on national banks, in comparison with the effect of the law on a bank chartered by that State; (B) in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in Barnett Bank of Marion County, N. A. v. Nelson"

INSURANCE IMPACT

Pre-emption becomes important in the context of insurance because national banks need a clear understanding if they are to be held to state standards or national standards, particularly as they relate to consumer regulations. The Dodd-Frank Bill means that national banks must comply with all national and state regulations (as long as state regulations don't discriminate against them). This means that that the standard established in Barnett is still employed, but it also means that states can enforce the new federal consumer laws, even when the federal government fails to do so.

More consumer regulation and oversight by state **and** federal regulators can only mean tougher times ahead for national banks and their insurance providers.

4. NEW REGULATORY AUTHORITY/ FINANCIAL STABILITY COUNCIL

Financial Stability and **Liquidation Authority** are the headings for the first two titles of the newly signed Dodd-Frank Bill. Wall Street's collapse in 2008 brought to light the glaring shortfalls in financial regulation. At the time of the Bear Stearns and Lehman failures, neither the U.S. Treasury nor the Federal Reserve had authority under the law to force financial institutions into bankruptcy despite any systemic risk that their firms might engender. The Administration has repeatedly stated that one of the main objectives of the Act was to avoid a repeat of the bailouts that occurred over the last two years. At the signing ceremony for the bill, President Obama avowed, *"Finally, because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes. There will be no more taxpayer-funded bailouts. Period."*

MEMBERS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

- Secretary of Treasury
- Fed Chairman
- Comptroller
- Director of the Bureau of Consumer Financial Protection
- SEC Chairman
- FDIC Chairman
- CFTC Chairman
- Director of Federal Housing Finance Agency
- Chairman of the National Credit Union Administration
- Insurance Representative appointed by President
- *And five non-voting members:*
 - Director of the Office of Financial Research
 - Director of the Federal Insurance Office
 - A State Insurance Commissioner
 - A State Banking Supervisor
 - A State Securities Commissioner

Title I and II of the Act delegate broad powers to the newly created Financial Stability Council. First among them is the

authority to require that systemically important non-bank financial firms be regulated by the Fed or FDIC. This is a clear attempt to avoid the lapses that allowed giant financial firms like AIG to avoid federal regulation. The Act sets up a liquidation procedure to be run by the FDIC. The Treasury would supply funds necessary to cover the up-front costs of winding down failed firms. However, as part of the liquidation process, the government would be required to put a "repayment plan" in place. After liquidation, regulators would be authorized to recoup any losses incurred by assessing fees on financial firms with more than \$50 billion in assets. So when can the new Council take control of a company that is in default or in danger of default? When the failure of the company would have "serious adverse effects on financial stability in the United States."³ Critics of the new law are asking: By the time the Council agrees that a large systemically important company is in danger of default, won't the damage already be done? The new law does not appear to enable regulators to take proactive steps of splitting financial institutions that *could* endanger the financial system. Firms that are "too big to fail" must fail or be close to failure before the Council can act.

The Council is also mandated to recommend to the Fed stricter capital, leverage and other rules for large, complex financial firms that are judged to threaten the financial system.

INSURANCE IMPACT

Until the rules and regulations are written in support of Title I & II of the Act, it is too early to tell if there will be any serious impact to insurance markets from this portion of the Act. The existence of the Council and stricter rules for capital and leverage do not, in themselves, reduce the types of risk that financial institutions are able to insure. Can we envision scenarios where directors claim their firm was unfairly forced into receivership by the Council? Could this be a D&O defense? Might there be insurance products created that enhance capital ratios? We can only speculate. The only obvious insurance

benefit to be garnered from this much publicized and much debated portion of the Act, at present, is that a safer system means fewer failures and less litigation surrounding the industry in general.

5. HEDGE FUNDS

Hedge fund managers that take the time to read the new Dodd-Frank Bill may be lulled into thinking that only Title IV “Regulation of Advisers to Hedge Funds and Others” deals directly with them. That would be a mistake. Many provisions throughout the bill deal, directly or indirectly, with the management of investment funds. Fund managers need to be alert to the **many provisions that may have a significant impact** on their businesses and may alter their risk management in the near future. Perhaps the most powerful weapon in the government’s arsenal in the fight against systemic risk is the oversight authority granted the newly created Financial Stability Council. The Council now has oversight of nonbank financial companies. The Act defines “nonbank financial companies” as those companies “predominantly engaged in financial activities.” Hedge funds meet that requirement.

§ 416. GAO STUDY ON SELF-REGULATORY ORGANIZATION FOR PRIVATE FUNDS.

The Comptroller General of the United States shall—

1. conduct a study of the feasibility of forming a self-regulatory organization to oversee private funds; and
2. submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the results of such study, not later than 1 year after the date of enactment of this Act.

If the Council determines that a hedge fund may be in material financial distress and that that distress could pose a threat to the financial stability of the United States, the Council is authorized to require the fund to register with, and be supervised by, the Federal Reserve Board of Governors and be subject to “prudential standards.” If the Council determines that a fund presents a “grave threat” to financial stability, the Council has broad powers to limit a fund’s continuing operation and may force it to sell assets. In fact, the **Council may force a fund into bankruptcy** nominating the FDIC to act as receiver.

If a hedge fund has been forced by the Council to report to the Federal Reserve, it (along with large banks) will be assessed fees to help support the Office of Financial Research, which in turn,

funds the Council. The scale of the assessment is determined by the Council based on a variety of factors. When other institutions supervised by the Federal Reserve fail, the cost of that failure may also be assessed to hedge funds supervised by the Fed. A fund that is subjected to Fed supervision could, potentially, be **liable for substantial fees** in the form of these assessments.

Hedge fund managers and private equity advisers with more than \$150 million in assets will now be **required to register** with the SEC under the Investment Advisers Act of 1940. Registration subjects funds to periodic inspections by SEC examiners. Registered funds also must hire a chief compliance officer and set up policies to avoid conflicts of interest. They will also be required to report information about their trades and portfolios that is “necessary for the purpose of assessing systemic risk posed by a private fund.” The data, kept confidential, may be shared with the Financial Stability Oversight Council.

Additionally, funds that utilize non-securities-based swaps (e.g., interest rate swaps) will be subject to registration with the CFTC under the Commodity Exchange Act unless exempt under certain provisions.

INSURANCE IMPACT

The potential for increased investigations by regulatory entities has increased substantially. Such investigations can consume inordinate amounts of time and result in substantial costs to the subject firm. Private equity and hedge funds will want to be sure that they are prepared and that their E&O policies provide adequate protection against the rising tide of regulatory oversight.

6. VOLCKER RULE

Beyond registration and oversight the new Financial Reform Act impacts hedge funds in many important, but less obvious ways. The extent of some of these changes will not be

truly understood until the associated rules are drafted by the respective agencies. The following list outlines some of the key, and perhaps unexpected, provisions that will affect hedge funds and private investment advisers.

Volcker Rule – At first glance § 619 of the Act appears to prohibit banks from making investments in hedge funds and private equity funds. This is not the case. Buried under the ‘Permitted Activities’ section is the ‘De Minimis Investment’ provision that allows banks to invest up to 3% of their tier 1 capital in hedge funds but no more than 3% of any given fund. Few banks have ever invested more than 3% of their tier 1 capital in such funds so the impact on most banks should be minor.⁴ Smaller hedge funds with bank investors may well be affected by the 3% ‘total ownership’ limitation.⁵

VOLCKER RULE BY 2022?

Banks Given Up To 12 Years to Comply

Rules curbing banks investments in their own funds will take effect between 15 months to two years, according to the Dodd-Frank Act. Banks will have two years to comply, with the potential for three one-year extensions after that. They could seek another five years for “illiquid” funds such as private equity or real estate, potentially giving banks until 2022 to fully implement the Volcker rule.

ACCREDITED INVESTOR AND QUALIFIED CLIENT

STANDARD The Act directs the SEC to adjust the “accredited investor” standard under Regulation D under the Securities Act so that the individual net worth requirement (currently \$1,000,000) excludes the value of a primary residence and is adjusted periodically by SEC rule. In addition, there will be regular reviews to adjust the standard.

SHORT-SALE REFORM The Act includes a monthly disclosure requirement for short positions and prohibits “a manipulative short sale of any security” (although it fails to define the term).

WHISTLEBLOWER INCENTIVES Whistleblowers who voluntarily provide original information may be awarded up to 10-30% of monetary sanctions imposed against the offending entity at the SEC’s discretion.⁶

STANDARDS FOR BROKERS AND DEALERS The SEC will be studying the standard of care to be exercised by investment advisers.

ENHANCEMENT OF SEC ENFORCEMENT POWERS

The Act enhances the SEC’s enforcement powers:

- The SEC will now be permitted to prosecute for aiding and abetting of securities violations. The standard of intent may be satisfied by recklessness.
- The SEC will have authority to impose civil penalties in administrative cease-and-desist proceedings and obtain penalties for aiding and abetting cases under the Advisers Act.
- The Act grants the SEC extraterritorial jurisdiction over violations of the antifraud provisions of the relevant securities regulations.
- Control person liability under Section 20(a) of the Exchange Act will apply in SEC enforcement actions, not only in private actions.

FORMER DIRECTOR & OFFICER

LIABILITY The SEC may bring an action for breach of fiduciary duty against former directors, officers or investment advisers, or principal underwriters of an investment company who served at the time of the alleged misconduct, in addition to persons or entities currently serving in those capacities.

ADVISER SAFEGUARDS OF CLIENT

ASSETS This might well be called the “Madoff Rule.” The Act amends the Advisers Act by providing that an investment adviser registered under the 1940 Act shall take steps to safeguard client assets over which the adviser has custody, including verification of such assets by an independent accountant.

STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS

The SEC will conduct a study that will review the need for enhanced examination and enforcement resources for regulation of investment advisers including more frequent examinations.

REGULATIONS OF MUNICIPAL SECURITIES Under the Act, municipal advisers are required to register with the SEC, and the Act imposes a fiduciary duty on those advisers with respect to municipal entities they advise.

RESTRICTIONS ON MANDATORY PRE-DISPUTE ARBITRATION AND WAIVER CLAUSES The SEC may now establish rules prohibiting the use of agreements that require investment adviser customers to arbitrate any future dispute arising under federal securities laws. The Act also invalidates any contractual provision requiring persons to waive compliance with any rules propagated by FINRA.

OFFICE OF THE INVESTOR ADVOCATE The Act establishes the SEC's Office of the Investor Advocate to assist retail investors in resolving significant problems.

IMPACT

Of the Dodd-Frank provisions impacting hedge funds, perhaps the most critical, from an insurance perspective, are those related to the Volcker Rule. These rules will likely spawn new companies and reconfigurations of investment advisers as banks decide whether to spin off their proprietary trading vehicles, reduce trading limits or close their proprietary businesses altogether. The other provisions cited above will take time to institute but will undoubtedly mean more time spent on compliance at hedge funds, particularly with increased scrutiny from the SEC and incentivized whistleblowers. There is no question that, when the final rules are written, hedge funds, their advisers and their directors and officers will have substantially more liability than under the current regulatory regime.

7. MORTGAGE ORIGINATION

Subprime mortgages were clearly one of the exacerbating causes of the financial crisis that ultimately led to the recent financial reforms and the adoption of the Dodd-Frank Act. While there was great controversy about such topics as derivatives and the registration of hedge funds, the one area where there was general agreement during the crisis was that mortgage loans, underwriting and securitization needed tighter regulation. The new section of the Dodd-Frank Act labeled the Mortgage Reform and Anti-Predatory Lending Act establishes national minimum underwriting standards for home mortgages. Lenders are required for the first time to ensure and document that a borrower is able to repay a home loan by verifying the borrower's income, credit history and job status. While such basic underwriting principles are rarely dictated by regulators, it

has become necessary in the mortgage business because the majority of home loans originated in the last decade have been securitized and the original lender has avoided the risk associated with the loan by packaging the loan for securitization. Banks originating mortgages merely kept a fee and none of the risk associated with the loan. In addition, the Act bans payments to brokers for steering borrowers to high-priced loans and restricts such questionable products as negative amortization loans.

§ 129C. MINIMUM STANDARDS FOR RESIDENTIAL MORTGAGE LOANS

(a) ABILITY TO REPAY.—

(I) **IN GENERAL.**—In accordance with regulations prescribed by the Board, no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.

Banks will receive increased scrutiny of their lending practices and the combination of the "Anti-Predatory" section of the Act and the establishment of the Consumer Finance Protection Agency will mean that government regulators will take a more active role in stopping mortgage practices that exceed the bounds of prudent banking.

Securitization – Perhaps more powerful than the threat of government oversight are the Act's new retention rules. Banks and other mortgage originators will be required to keep 5% of the mortgage pools that they plan to securitize. While the Act does provide that certain high-quality mortgages would be exempt from the retention requirement, the change will still mean that banks will need to

be wary of creating entire portfolios of toxic loans with the thought of laying the risk off on the market. Regulators will be establishing alternative risk-retention arrangements for the commercial mortgage-backed securities market.

All in all, new mortgage origination rules and mortgage securitization rules are on their way. Lenders that fail to comply will find themselves facing new enforcement agencies with new powers and consumers with broader rights of recourse. The winners are likely to include borrowers, and of course, consumer plaintiff attorneys.

INSURANCE IMPACT

While most of the Act's impact won't be known until the complete rules are written, Congress made clear its intention to alter the manner in which mortgages are underwritten in this country. One overarching objective of the Mortgage Reform provisions is the protection of borrowers. The rules supporting this portion of the Act and the creation of the Consumer Financial Protection Agency will mean that lenders will need to take significant measures to ensure compliance with the rules or risk stern consequences from regulators and the ensuing class action and derivative lawsuits.

FINAL THOUGHTS

The Dodd-Frank Act clearly sets the stage for dramatic changes in financial regulation and those changes will invariably impact the way carriers and brokers write insurance coverage for the financial services industry. However, many of those changes will only come to fruition with drafting of the hundreds of pending rules supporting the various regulations and completion of the myriad studies authorized by the Act. There can be little doubt that the push for consumer protection inherent in the Act and the new oversight authority will mean more potential litigation and regulatory intervention.

Currently, the market for executive lines for financial institutions has stabilized in response to the calming of the market in the aftermath of the financial crisis. It is natural to conclude that drastic regulatory transformation and uncertainty may lead to increased exposures and claim activity. Such claim activity typically results in higher insurance costs. However, we at Willis believe that downward market forces will counter this upward price pressure in the near-term. The hope is that, once the consequences of the Dodd-Frank Act have filtered through the financial system, the changes produced will result in less systemic risk and less opportunity for consumer complaints, which should mean lower insurance rates sometime in the future.

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The observations, comments and suggestions we have made in this publication are advisory and are not intended nor should they be taken as legal or financial advice. Please contact your own legal or financial adviser for an analysis of your specific facts and circumstances.

¹ The creation of the Federal Insurance Office in Title V of the Act is a rather perfunctory acknowledgement of insurance's critical role in American finance, doing little more than recognizing the need for a more coordinated approach to regulation of the insurance industry.

² § 5136C(b)(1)(A)

³ § 203(b)(2)

⁴ Goldman Sachs and Morgan Stanley have announced that they will be spinning off investment vehicles in an attempt to comply with § 619.

⁵ The 3% limitation on total ownership appears to grant larger funds a distinct advantage in future fundraising as they may solicit larger investments from banks in absolute terms.

⁶ In August 2010 the SEC awarded \$1 million to the couple that reported the insider trading scheme at Pequot Capital.