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Client Alert

Private Equity

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For more information, contact:

Bernhardt Nadell
+1 212 556 2252
bnadell@kslaw.com

Conrad C Axelrod
+1 212 556 2314
caxelrod@kslaw.com

Gary Ho
+1 212 556 2174
gho@kslaw.com

Candice Zheng
+1 212 556 2337
czheung@kslaw.com

Delarin Yemi-Sofumade
+1 404 572 2521
dyemi-sofumade@kslaw.com

King & Spalding
New York
1185 Avenue of the Americas
34th Floor
New York, New York 10036
Tel. +1 212 556 2100

NAIC's Focus on Investment Management Agreements (IMAs) involving Private Equity-Owned Insurers

As private equity investors continue to increase their presence in the insurance industry with acquisitions of insurers and reinsurance of blocks of insurance contracts through insurer portfolio companies and segregated cells, the National Association of Insurance Commissioners ("NAIC") remains focused on developing tools and action plans to address various risks posed by ownership or investment in insurers and blocks of business by private equity companies. In 2023, the NAIC Risk-Focused Surveillance (E) Working Group ("RFSWG") developed proposed revisions to the NAIC's Financial Analysis Handbook and the Financial Condition Examiners Handbook (collectively, the "FA Handbooks") that provide additional guidance to state insurance regulators to assist them with their review of Form D filings (Prior Notice of Certain Inter-affiliate Transactions) relating to inter-affiliate investment management agreements (IMAs) and service contracts. Further, in late 2023, the NAIC formed the Affiliated Investment Management Agreement Drafting Group ("IMA Drafting Group"), which met in September 2023 to discuss existing guidance in NAIC handbooks related to investment advisors and IMAs and the need for enhancements to the existing guidance to more directly address regulatory review and monitoring of investment advisory services provided by an affiliate. The drafting process relating to this workstream remains ongoing, and the IMA Drafting Group aims to present proposed revisions to the RFSWG for its consideration in 2024.

BACKGROUND

The NAIC previously indicated that it is concerned with the (i) lack of transparency and adequate regulatory disclosure concerning private equity-controlled holding company structures, (ii) some private equity owners' focus on short-term results, which are not fully aligned with the long-term nature of life insurance products, and (iii) complexity risk and illiquidity risk associated with increasing investments in privately structured securities. At the NAIC Summer National Meeting in July 2022, for example, the Macroprudential Working Group ("MWG"), the Financial Stability (E) Task Force ("FSTF") and the Financial Condition (E) Committee adopted a "final" plan to address concerns with private equity ownership of insurers, which included making referrals to NAIC subgroups like the RFSWG.

During meetings in 2021 and 2022, the MWG prepared a list of areas of concern relating to private equity ownership of insurers referred to as the "*List of Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers"* (the "13 Private Equity Considerations"). Despite the widespread, well-founded perception that these concerns are peculiar to private equity ownership, the MWG actually developed its list with an activities-based framework, recognizing that any insurers, including but not limited to private equity-owned insurers, could be affected by the types of activities discussed in the 13 Private Equity Considerations. These 13 Private Equity Considerations listed the following as areas of scrutiny by regulators: (1) Holding company structures, (2) Ownership and control, (3) Investment management agreements, (4) Owners of insurers with short-term focus and/or unwillingness to support a troubled insurer, (5) Operational, governance, and market conduct practices, (6) Definition of private equity, (7) Identifying related part-originated investments (including structured securities), (8) Identifying underlying affiliated/related party reinvestments and/or collateral in structured securities, (9) Asset manager affiliates and disclaimers of affiliation, (10) Privately structured securities, (11) Reliance on rating agencies, (12) Pension transfer business supported by complex investments, and (13) Offshore/complex reinsurance.

Since the development of the 13 Private Equity Considerations in December 2021, the NAIC has made some progress addressing some of these considerations, but the work remains ongoing.

INVESTMENT MANAGEMENT AGREEMENTS (IMAS)

During various meetings in 2021 and 2022, the MWG discussed various concerns regarding IMAs between an insurer and an affiliated investment manager, both of which may be owned or controlled by the same private equity company. These concerns include the following:

1. whether the IMAs are negotiated on an arm's length basis between the insurer and the affiliated investment manager and reflect "market" or customary terms including with respect to amount and types of investment management fees assessed on the insurer,
2. the difficulty and cost (e.g., termination fee) associated with terminating an IMA by the insurer,
3. the degree of discretion or control of the investment manager over the investment guidelines, allocation, and decisions of the insurer through contractual or other arrangements (e.g., excessive control or discretion given over the investment strategy and its implementation),
4. the potential conflict-of-interest that may arise from the fact that (i) the investment manager and the insurer are controlled by the same private equity firm and may have directors or officers that serve in multiple roles across affiliated entities and may personally benefit from the positive performance of one or both of these entities, or (ii) the investment manager allocates insurer assets to investment products (including private equity funds) that are also controlled by, and ultimately benefit, the private equity firm that owns a stake in the insurer,

5. investment management fees paid to a parent company of an insurer may effectively act as a form of unauthorized dividend and effectively reduce the insurer's overall investment returns, and
6. potential unwillingness of private equity owners to inject capital into a troubled insurer.

INDUSTRY CONCERNS REGARDING IMAS

Support for Additional Scrutiny of IMAs

Following the public release of the 13 Private Equity Considerations in December 2021, several industry leaders and interested parties submitted comment letters to the FSTF and the MWG, as well as attended subsequent NAIC National Meetings, to express their views on the matter. For example, Risk & Regulatory Consulting ("RRC"), a national professional services firm that provides insurance regulatory services to clients and state insurance regulators, in its January 3, 2022, comment letter, recognized the significant growth in the reliance by insurers on investment managers outside of the insurance legal entities, who are unaffiliated, affiliated through a holding company, or formerly affiliated through a prior owner. RRC expressed concerns that there may be inadequate protections for the insurer – and therefore the policyholders – against various conflicts of interest wherein investment managers engage in practices that are not in the best interest of the insurer such as engaging in inappropriate or excessive trading and cross trading with the investment manager's other clients.

During the NAIC Spring National Meeting in April 2022, RRC continued to support an approach where state insurance regulators perform a thorough review of inter-affiliate IMAs to ensure they are fair and reasonable to the insurer, and during such review, consider whether (1) the IMAs included detailed and reasonable investment guidelines, (2) there is sufficient expertise at the insurer and on the insurer's board of directors to properly assess the performance and compliance of the investment manager, and (3) the investment manager is registered as an investment adviser under the Investment Advisers Act of 1940 and recognizes the standard of care as a fiduciary.

Countervailing Arguments raised by Interested Parties

On the other hand, the American Investment Council ("AIC"), while applauding the NAIC's efforts generally, made various countervailing arguments against additional scrutiny and oversight of investment management arrangements in its January 18, 2022, comment letter to the FSTF. Specifically, the AIC argued that insurers seek out investments that have higher risks in search of higher rates of returns because private equity funds have outperformed traditional asset classes – like publicly traded stocks and public mutual funds – for the past forty (40) plus years, and that this outperformance inures to the benefit of policy holders.

In its July 21, 2022, referral letter to the RFSWG, the MWG noted additional comments from the AIC including arguments that fees paid to investment managers should be considered on a "net" basis, that is, on the basis of total return (i.e., after fees are taken into account), versus being considered in isolation. Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities, and net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks. Because insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis, the AIC argued that there has been consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength for insurers.

Furthermore, the AIC argued that further oversight of IMAs by state insurance regulators is unnecessary given that consistent with applicable state investment laws and regulations, investments in private equity funds make up a relatively small portion of insurers' balance sheets, and that insurance regulators already have existing robust regulatory tools

available to protect insurers, especially where private equity firms may have conflicts of interest in the context of their insurance-related activities. These tools include the imposition of capital requirements, subjecting insurers to ongoing examinations, requiring solely independent directors to review and approve of these arrangements to ensure fairness, and review of certain inter-affiliate transactions by regulators pursuant to Form D filings by insurers.

The AIC also noted that the terms of an inter-affiliate IMA should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm's length basis, and investments sourced and allocated by alternative asset managers on behalf of insurers should not, absent other factors, be viewed as presenting potential conflicts of interest, especially where insurers hold full control over asset allocation of its investment portfolio and the duration or maturity of such assets.

Last, the AIC indicated that insurers often have the right to terminate their IMAs by providing prior written notice (e.g., upon 30 days' notice). Furthermore, asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer's general account assets (e.g., dedicating or re-assigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such and based on their experience, the desire for external asset managers to seek contractual protections (subject to arm's length negotiations) should an insurer decide to terminate the arrangement earlier than originally anticipated by the parties is entirely appropriate.

NAIC'S CURRENT WORKSTREAMS REGARDING OVERSIGHT OF IMAS

Proposed Revisions to FA Handbooks

The NAIC has developed a number of workstreams to address their IMA concerns. For example, the RFSWG drafted proposed revisions to the FA Handbooks during various working sessions between July 2022 and August 2023 to update specific guidance surrounding inter-affiliate transactions and service arrangements, including IMAs. The RFSWG recognized that state insurance regulators, as part of their review of Form D filings, should analyze the operational risk and the risk of financial loss that could result from inadequate or failed internal processes, personnel and systems of insurers, as well as unforeseen external events.

General Review of Inter-affiliate Arrangements

Currently, the FA Handbooks advise state insurance department analysts with concerns regarding the economic substance of an inter-affiliate IMA or service contract to:

- obtain and review supporting contracts;
- determine whether the actual amounts paid are in agreement with the supporting contracts;
- request justification from the insurer for amounts in excess of the actual costs of providing the service (e.g., any arrangement based on a cost-plus formula or percent of premiums formula);
- contact vendors or review vendor pricing schedules for those services being performed by/for an affiliate and that are also provided by unrelated third-party vendors (e.g., data processing, actuarial, investment management) in order to determine the reasonableness of the intercompany transfer pricing level;
- evaluate whether any portion of such fees in substance are dividends that should be evaluated in the context of dividend regulations; and
- determine if agreements received appropriate regulatory approval in conformity with regulatory requirements.

RFSWG's current proposed revisions to the FA Handbooks suggest that state insurance regulators consider taking the following actions in connection with its review of a Form D filing:

- when reviewing supporting contracts for economic substance, compare them against Form D filings previously submitted to the state insurance department (if applicable);
- consider whether additional examination procedures should be recommended to verify or validate information regarding transactions and services with affiliates, including whether the expense allocations continue to be fair and reasonable;
- compare cash flows relating to any prior agreements (if similar in services/scope, and whether those were with affiliates or non-affiliates) to the forecasted cash flows relating to the proposed transaction or amendment; the comparison should consider not just the fees/expenses, but also the impact on cash flows relating to the services provided (e.g., reduced claims cost, etc.);
- consider the insurer's aggregate exposure to all agreements with affiliates, current and trending, absolute dollars and relative to base (e.g., capital and surplus, total expenses, etc.) and whether the terms and amounts meet the "fair and reasonable" standard;
- determine if one or more agreements with affiliates trigger or increase concerns regarding related party risks or create financial solvency concerns;
- evaluate whether expenses incurred and payment received are allocated to the insurer in conformity with prescribed insurance accounting practices consistently applied;
- determine whether books, accounts and records of each party are maintained clearly and accurately to disclose the nature and details of the transactions including such information as is necessary to support the reasonableness of charges or fees to the respective parties; and
- evaluate whether the transaction complies with the state's requirements regarding the insurer's ownership of data and records that are held by an affiliate, and control of premium or other funds belonging to the insurer that are collected or held by an affiliate.

Investment Management Costs

The FA Handbooks already acknowledge that the cost for inter-affiliate services is a common area for abuse when parent companies desire to withdraw funds from the insurer but do not want to, or are not permitted to, obtain a shareholder dividend from the insurer. Specifically, the FA Handbooks currently advise state insurance regulators to:

- understand why the parties were motivated to enter into such contracts and particularly, the benefit to the insurer;
- verify all regulatory approvals were received and that the transactions recorded in the Annual Financial Statement reflect the transactions as approved; and
- request and use fee estimates for services provided by an affiliate where a market already exists to evaluate these transactions to determine if an arm's length transaction exists and to identify any discrepancies in reporting across the various information sources.

The RFSWG's current proposed revisions suggest that external resources like an investment expert should be consulted to assist in the review of complex IMAs with affiliates, and state insurance analysts should be alert to possible abuses

regarding the transfer of assets between property/casualty and life/health affiliates merely to impact their RBC calculation.

Development of Further Guidance

During its August 14, 2023, Summer National meeting, the RFSWG encouraged interested parties to participate in the IMA Drafting Group which will develop further guidance to address NAIC's concerns with respect to affiliated IMAs. During such meeting, RRC stated that the NAIC should provide further guidance regarding the following:

- whether investment guidelines are sufficiently detailed to guide the investment managers' activities and to allow the insurer to assess compliance and performance;
- whether the termination provisions are appropriate;
- whether investment managers could engage sub-advisers and if the insurer has control over such engagements and which party has the responsibility to pay management fees to sub-advisers; and
- whether there are adequate reporting requirements that allow the insurer to monitor the investment manager and meet its reporting and regulatory needs.

As noted above, the IMA Drafting Group hopes to present proposed revisions for the RFSWG's consideration in early 2024.

Ownership and Control via IMAs

As noted above, the MWG recognizes that a party may exercise a controlling influence over an insurer through contractual arrangements, including IMA provisions that impose onerous or costly IMA termination provisions. These arrangements may also grant the investment manager excessive control or discretion over the investment strategy and its implementation of the insurer. The MWG has also noted that asset-management services may need to be distinguished from ownership when assessing and considering controls and conflicts.

RRC acknowledged that all IMAs grant some level of authority to the investment manager but noted that it is important to ensure that there are appropriate restrictions and limitations imposed on the discretion granted through the agreement. One potential solution for insurers to provide effective oversight and avoid granting control of the insurer through the agreement could be for the IMAs to provide sufficient guidance on the types of investments acceptable to the insurer (e.g., investment guidelines).

Further, the Group Solvency Issues (E) Working Group (GSIWG) formed a drafting group to develop a set of best practices for regulatory review of these arrangements. After these best practices are developed, the drafting group will consider whether any such practices should be proposed for inclusion in NAIC handbooks or if any other action should be considered. The MWG noted that more updates regarding this workstream will come during its Spring National Meeting in March 2024.

CONCLUSION

As noted above, tasks and actions relating to the oversight of IMAs by the NAIC and state insurance regulators remain ongoing. We will continue to monitor further developments at the NAIC with respect to this matter and the other Private Equity Considerations.

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