

FEDERATION OF REGULATORY COUNSEL, INC.

NEW NAIC STANDARDS FOR AUDIT COMMITTEE INDEPENDENCE

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A majority of states have adopted the Model Audit Rule either by statute or rule. ¹ Although some provisions of the Rule are already in effect in certain states, the independence requirements for insurance company audit committees generally take effect on January 1, 2010.²

BACKGROUND: THE INDEPENDENCE REQUIREMENTS OF SOX. The Sarbanes-Oxley Act ("SOX") adopted in 2002 expanded the responsibilities of audit committees of publicly-traded companies, including publicly-traded insurance companies and insurance holding companies. In brief, SOX:

- Makes audit committees directly responsible for the appointment, compensation, and oversight of the work by that company (including resolution of disagreements between management and the auditor regarding financial reporting);
- Requires each audit committee to establish procedures for handling complaints, including anonymous submissions by employees, regarding accounting, internal accounting controls, or auditing matters;
- Authorizes each audit committee to engage independent counsel and other advisers, as it determines necessary to carry out its duties;
- Requires appropriate funding of the audit committee to perform its functions, including funding to retain auditors, the audit committee's independent counsel, and other advisers; and
- Requires each member of the audit committee to be "independent."

As discussed below, the SEC has provided further guidance regarding the "independence" standard.

THE NAIC MODEL AUDIT RULE. In June 2006, after many months of debate, the NAIC gave final approval to the current version of the Model Audit Rule. The Rule extends a modified version of the audit committee independence requirement of SOX to almost all insurers.

Exemptions. The Model Audit Rule's requirements for audit committees do *not* apply to:

- An insurer that is a SOX Compliant Entity (whether required to be compliant with, or voluntarily compliant with, identified provisions of SOX)³;
- A direct or indirect wholly-owned subsidiary of a SOX Compliant Entity; or
- A foreign or alien insurer.

But insurers that are subject to the audit committee provisions should be familiar with requirements related to the duties, and in particular, the composition of the audit committee.

Audit Committee Basics.

Appointment of the Committee. The audit committee must be appointed by the board of directors for the purpose of overseeing the accounting and financial reporting processes, and the audit of financial statements, of an insurer or group of insurers within the same insurance holding company.⁴ If an audit committee is not

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designated by the insurer, the insurer's entire board of directors is deemed to be the audit committee.

Board Members Only. Every member of an insurer's audit committee must be a member of the board of directors.

Special Rule for Insurers in a Holding Company System. The Model Audit Rule allows companies within an insurance holding company structure to streamline compliance with the audit committee requirements by electing to designate the audit committee of a company that controls a group of insurers as the audit committee for the controlled insurers. If such an election is made, then members of the audit committee may be members of the board of the controlling entity. Please note that a company making this election must notify its regulators.

The Independence Requirement. As previously noted, SOX requires that the audit committee of all Listed Companies be "independent." The Model Audit Rule for the first time formally extends an independence requirement to all but the smallest insurance companies.⁵

Size Matters. In applying the independence requirement to insurers, the NAIC recognizes that 100% independence, required by SOX, could be difficult for many smaller insurers to achieve. As a result, the percentage of the audit committee that must be independent depends on the size of the insurer.

Insurers with more than \$500 million in direct written and assumed premiums must have an audit committee comprised of at least 75% independent directors. Insurers with direct written and assumed premiums between \$300 million and \$500 million must have 50% or more of the members of the audit committee be independent. There are no independence requirements for companies with less than \$300 million in premium. The NAIC's "Implementation Guide" for the Model Audit Rule provides additional detail about when and how to measure premium volume and how to address situations when a company moves from one "category" to another.⁶

Who is "Independent"? Many insurers, including those who are not subject to SOX and companies of all sizes, have already moved to name to the audit committee directors whom they believe to be "independent." But as the requirements of the Model Audit Rule take effect, it is important for companies to be familiar with the criteria established in the Model Audit Rule.

In order to be considered independent for purposes of service on the audit committee, the Model Audit Rule provides that the person:

- May not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, accept any consulting, advisory or other compensatory fee from the entity; or
- Be an affiliated person of the entity or of any subsidiary of the entity.⁷

These parameters establish who will not be considered independent for purposes of satisfying the requirements of the Rule and are consistent with corresponding provisions of SOX and the additional guidance regarding determining "independence" adopted by the SEC. *See* SEC Rule 10A-3, *Standards Relating to Listed Company Audit Committees*, adopted by SEC Release No. 33-8820 on April 9, 2003.

Specifically, both the Model Audit Rule and SEC Rule 10A-3 exclude from being considered as independent persons who have either of the following two relationships:

- **Affiliated Persons:** any person who directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the insurer; and

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- **Compensated Persons:** any person who, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee of the insurer, accepts any consulting, advisory or other compensatory fee from the insurer or any parent or subsidiary of the insurer.

The Model Audit Rule stops there. It does not provide additional guidance, explanation or examples regarding determining independence. However, a drafting note in the Model Audit Rule states that in determining "independence," the commissioner will consider the guidance provided by the SEC to companies listed on one of the stock exchanges.⁸

SEC GUIDANCE

"Affiliated Persons"

SEC Rule 10A-3 provides additional guidance as to who is an Affiliated Person, and accordingly, is not independent for purposes of audit committee membership. Under SEC Rule 10A-3 each of the following are Affiliated Persons:

- Any person who is an executive officer of the insurer;
- Any person who is the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the insurer, if a stock company; however, being the owner of one or more insurance policies issued by the insurer, whether a mutual or a stock company, is not a prohibited affiliation;
- Any person who is an executive officer of a subsidiary or parent of the insurer;
- Any person who is a director of a subsidiary or parent of the insurer and who also is an employee of the subsidiary or parent of the insurer; and
- Any general partner or managing member of a parent or subsidiary of the insurer.

"Compensated Persons"

SEC Rule 10A-3 also provides additional guidance as to who is a Compensated Person, and accordingly, is not to be considered independent for purposes of audit committee membership. Under SEC Rule 10A-3, the following rules determine whether an individual is a Compensated Person:

- **Direct Acceptance Rule:** Any person who accepts any fee that is compensatory for providing any service or property to the insurer or any subsidiary thereof;
- **Family Member Rule:** Any director who has a spouse, a minor child or stepchild or a child or stepchild sharing a home with the director who accepts a fee that is compensatory for providing any service or property to the insurer or any subsidiary thereof; and
- **Entity Rule:** Any director who is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position in an entity that accepts any fee that is compensatory for providing accounting, consulting, legal, investment banking or financial advisory services to the insurer or any subsidiary thereof.

There is no *de minimis* exception to any of the above rules. Acceptance of "any" compensatory fee -- regardless of amount -- apparently results in a person being a Compensated Person, and accordingly not independent.

Exceptions from Being Compensated Persons. SEC Rule 10A-3 provides exceptions for certain compensation that will *not* result in a person being considered a Compensated Person. These exceptions include:

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- Acceptance of fixed amounts of compensation under a retirement plan, including deferred compensation, for prior service;
- Being compensated by an entity that does not provide accounting, consulting, legal, investment banking or financial advisory services (the "Prohibited Services") to the insurer or a parent or subsidiary; and
- Being a limited partner, non-managing member or occupying similar positions who, in each case, have no active role in providing to the entity any of the Prohibited Services.

We emphasize the second exception listed above: a person is a Compensated Person under the Entity Rule only if the entity performs specific services -- accounting, consulting, legal, investment banking or financial advisory -- that the SEC believes are problematic. Persons are not considered Compensated Persons under the Entity Rule if the entity is performing, for example, "other commercial relationships."

The Buck Stops with the Board. Notwithstanding this guidance from the SEC and the basic rules established by the Model Audit Rule, insurers and their boards should heed the SEC caution that independence must be ultimately determined based on a consideration of all relevant facts and circumstances that there is no relationship which, in the opinion of the board, would interfere with the exercise of independent judgement. SEC Rule 10A-3 specifically includes this cautionary note. Before appointing individuals to the Audit Committee, the board should consider all relevant facts and circumstances and determine that there is no relationship which, in the opinion of the board, would interfere with the exercise of independent judgement in carrying out the responsibilities as a member of the audit committee.

Insurers may also want to confer with their domiciliary regulator regarding the independence standard. As discussed above, the reference to SEC Rule 10A-3 is included in a drafting note. Some states may not incorporate this reference to SEC Rule 10A-3 into their version of the Model Audit Rule. Similarly, some regulators may have other standards that they may consider or impose on insurers domiciled in their states.

CONCLUSION

SEC Rule 10A-3 also cautions about the importance of audit committees in corporate America in providing consumers, such as purchasers of insurance, and regulators, such as insurance departments, with accurate and reliable financial information to make informed decisions. As seen from recent events, confidence in the reliability of corporate financial information is fundamental to the liquidity and vibrancy of our economy and markets. In this era of increased scrutiny and the potential for more oversight by regulators, boards should exercise caution in making any factual determinations required to determine "independence" for purpose of audit committee members.

Endnotes

1. The new version of the Rule also contains other important changes, including requirements related to auditor independence and internal control over financial reporting; these changes are noted briefly below, but not analyzed here.
2. General resources about Model Audit Rule, including the results of a May 2009 survey of state adoption, are available on the NAIC website at www.naic.org/committees_e_naic_aicpa_wg.htm.
3. To be a "SOX Compliant Entity" for purposes of the Model Audit Rule, an entity must comply with the preapproval requirements of Section 201; the audit committee independence requirements of Section 301; and the internal control over financial reporting requirements of Section 404. *See* Section 3.M of the Model Audit

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Rule.

4. *See* Model Audit Rule, Section 3.C.
5. Some state insurance regulators have required, or "strongly encouraged," insurers to have independent directors on their audit committees.
6. The Implementation Guide was adopted by the NAIC in 2009 and is an "informational appendix" - Appendix G - to the NAIC Accounting Practices & Procedures Manual.
7. An exception is made where the law requires board participation by otherwise non-independent members. And there is a "transition period" for members of the audit committee who cease to be independent during their service on the audit committee. Model Audit Rule, Sections 14.C and 14.D.
8. *See* Drafting Note to Section 14.D of the Model Audit Rule.