

A Financial System That
Creates Economic Opportunities
Asset Management and Insurance



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A Financial System That Creates Economic Opportunities

Asset Management and Insurance

Report to President Donald J. Trump

Executive Order 13772 on Core Principles
for Regulating the United States Financial System

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Acronyms and Abbreviations

Acronyms and Abbreviations	Term
'40 Act	Investment Company Act of 1940
Advisers Act	Investment Advisers Act of 1940
AUM	Assets Under Management
Banking Report	June 2017 Report published by Treasury on Banks and Credit Unions
BHC	Bank Holding Company
BICE	Best Interest Contract Exemption
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
Code	Internal Revenue Code
Compact	Interstate Insurance Product Regulation Compact
CPO	Commodity Pool Operator
CTA	Commodity Trading Advisor
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act
DOL	U.S. Department of Labor
ECP	Exempt Commercial Purchasers
ERISA	Employee Retirement Income Security Act
ETF	Exchange Traded Fund
EU	European Union
Exchange Act	Securities Exchange Act of 1934
Executive Order	Executive Order 13772 on Core Principles for Regulating the United States Financial System
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FEMA	Federal Emergency Management Agency
FIO	Federal Insurance Office
FINRA	Financial Industry Regulatory Authority
FRB	Board of Governors of the Federal Reserve System
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council

G-20	Group of 20
GAAP	Generally Accepted Accounting Principles
GAO	U.S. Government Accountability Office
GDP	Gross Domestic Product
G-SIFI	Global Systemically Important Financial Institution
G-SIB	Global Systemically Important Bank
G-SII	Global Systemically Important Insurer
HHS	U.S. Department of Health and Human Services
HUD	U.S. Department of Housing and Urban Development
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
iCBCM	Cross-Border Crisis Management Group for Insurers
ICS	Insurance Capital Standard
IFRS	International Financial Reporting Standards
IIPRC	Interstate Insurance Product Regulation Commission
IOSCO	International Organization of Securities Commissions
IRA	Individual Retirement Account or Individual Retirement Annuity
IRS	Internal Revenue Service
ISLHC	Insurance Savings and Loan Holding Company
L&H	Life and Health
LTC	Long-term Care
McCarran-Ferguson	The McCarran–Ferguson Act of 1945, 15 U.S.C. §§ 1011-1015
MMMF	Money Market Mutual Fund
NAIC	National Association of Insurance Commissioners
NARAB	National Association of Registered Agents and Brokers
NARAB II	National Association of Registered Agents and Brokers Reform Act of 2015
NAV	Net Asset Value
NBNI G-SIFI	Non-Bank, Non-Insurer Global Systemically Important Financial Institution
NFA	National Futures Association
NIPR	National Insurance Producer Registry

NRRA	Nonadmitted and Reinsurance Reform Act of 2010
OCC	Office of the Comptroller of the Currency
OLA	Orderly Liquidation Authority
OMB	Office of Management and Budget
ORSA	Own Risk and Solvency Assessment
P&C	Property and Casualty
PLMA	Producer Licensing Model Act
SEC	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
Secretary	U.S. Treasury Secretary Steven T. Mnuchin
SR Letters	Supervision and Regulation Letters
SRO	Self-regulatory Organization
SSB	Standard-setting Body
Treasury	U.S. Department of the Treasury
TRIA	Terrorism Risk Insurance Program Reauthorization Act of 2015
TRIP	Terrorism Risk Insurance Program
UDAAP	Unfair, Deceptive and Abusive Acts and Practices
U.S./EU Covered Agreement	Bilateral Agreement Between the United States of America and the European Union On Prudential Measures Regarding Insurance and Reinsurance

Executive Summary



Introduction

President Donald J. Trump established the policy of his Administration to regulate the United States financial system in a manner consistent with a set of Core Principles. These principles were set forth in Executive Order 13772 on February 3, 2017. This report is prepared by the U.S. Department of Treasury (Treasury), under the direction of Secretary Steven T. Mnuchin, in response to the Executive Order. This report, as with the prior reports and the subsequent report described below, will identify any laws, treaties, regulations, guidance, reporting and record keeping requirements, and other government policies that promote or inhibit federal regulation of the U.S. financial system in a manner consistent with the Core Principles.

The Core Principles are:

- A. Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
- B. Prevent taxpayer-funded bailouts;
- C. Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses the systemic risk and market failures, such as moral hazard and information asymmetry;
- D. Enable American companies to be competitive with foreign firms in domestic and foreign markets;
- E. Advance American interests in international financial regulatory negotiations and meetings;
- F. Make regulation efficient, effective, and appropriately tailored; and
- G. Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

Scope of This Report

The financial system encompasses a wide variety of institutions and services and, accordingly, Treasury is delivering a series of four reports related to the Executive Order covering:

- The depository system, covering banks, savings associations, and credit unions of all sizes, types and regulatory charters (the Banking Report,¹ which was publicly released on June 12, 2017);

1. U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (June 2017).

- Capital markets: debt, equity, commodities and derivatives markets, central clearing and other operational functions (the Capital Markets Report,² which was publicly released on October 6, 2017);
- The asset management and insurance industries, and retail and institutional investment products and vehicles (**this report**); and
- Nonbank financial institutions, financial technology, and financial innovation.

On April 21, 2017, President Trump issued two Presidential Memoranda to the Secretary of the Treasury (Secretary). One calls for Treasury to review the Orderly Liquidation Authority (OLA) established in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The other calls for Treasury to review the process by which the Financial Stability Oversight Council (FSOC) determines that a nonbank financial company could pose a threat to the financial stability of the United States and that such entity shall be subject to supervision by the Board of Governors of the Federal Reserve System (Federal Reserve) and enhanced prudential standards, as well as the process by which the FSOC designates financial market utilities as systemically important. While some of the issues described in this report are relevant to OLA and FSOC designations, Treasury will submit separate reports on those topics to the President.

This report covers the asset management and insurance industries. Specifically, the report examines issues related to the regulatory structure of financial entities and products in each of these sectors.

Review of the Process for This Report

For this report, Treasury leveraged the engagement process for the Banking Report, connecting with more stakeholders and focusing on asset management and insurance issues. As directed by the Executive Order, Treasury consulted with the member agencies of the FSOC. Treasury also consulted extensively with a wide range of other stakeholders, including trade groups, financial services firms, consumer and other advocacy groups, academics, legal experts, and others with relevant knowledge. Treasury also reviewed a wide range of data, research, and published material from both public and private sources.

Treasury incorporated the widest possible range of perspectives in evaluating approaches to the regulation of the U.S. financial system according to the Core Principles. For a list of organizations and individuals providing input to Treasury for the preparation of this report, see *Appendix A*.

Asset Management Industry in the United States

The U.S. asset management industry is the global leader in promoting vibrant capital markets and diverse investment and savings opportunities for investors and businesses. An asset manager manages assets on behalf of investors, businesses, and other institutions using different types of funds

2. U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets* (Oct. 2017).

and other investment structures. U.S. asset managers range in size from a few million dollars to over five trillion dollars in assets under management. In the United States alone, registered investment companies, a type of investment fund, held almost \$20 trillion of assets under management, representing the investments of more than 95 million individuals.³ Further demonstrating the strength of the U.S. asset management industry, nine of the top 10 largest global asset managers are headquartered in the United States.

Retail and institutional investors and businesses use asset managers to manage their investments. The diversity of the products and services offered by asset managers allows for investment customization based on risk appetite, investment objectives, and investment horizon. In the United States, the most popular fund structures for retail investors include mutual funds, exchange-traded funds (ETFs), and money market mutual funds. Popular investment structures for institutional investors include private equity funds, hedge funds, venture capital funds, and managed accounts. Some investors prefer active management of their funds, which can be characterized as investment managers making investments in an effort to outperform the market, while a growing share of investors prefer passive management, which seeks to generate a return that emulates an index or benchmark.

The industry has experienced robust growth in recent years, thanks to asset appreciation, strong demand from U.S. households, the aging of the U.S. population, and the rise of defined contribution retirement plans.

The Securities and Exchange Commission (SEC) is the primary regulator of the asset management industry, but other regulators, such as the Commodity Futures Trading Commission (CFTC) and state securities regulators, also have responsibilities with respect to asset management. Specific regulatory requirements depend on the product offerings and the nature of the services being provided.

Insurance Industry in the United States

The United States is the world's largest insurance market, delivering property and casualty, life, and health insurance coverage to American consumers and businesses. Policyholders — both individual and commercial — utilize diverse insurance products to safeguard themselves, their property, and their businesses against unexpected events. In 2016, U.S. direct written premiums represented a 29% world market share.⁴

The industry is stratified based on size, product offerings, ownership structure, and geographic footprint. For example, some insurers operate in a single state, while others write policies across the globe. Insurers also differ by ownership structure. While some insurers are public companies,

3. Investment Company Institute, *2017 Investment Company Fact Book*, at 6, available at: https://www.ici.org/pdf/2017_factbook.pdf ("ICI Fact Book").

4. Based on global total direct written premiums. Swiss Re Institute, *Sigma, World Insurance in 2016: the China Growth Engine Steams Ahead* (July 5, 2017), available at: http://media.swissre.com/documents/sigma3_2017_en.pdf.

others are mutually owned by their policyholders. At year-end 2016, U.S. insurers included 780 life and health insurers, 2,655 property and casualty insurers, and 1,095 health insurers.⁵

The financial health of the industry has continued to improve since the financial crisis. In 2016, the U.S. insurance industry's direct written premiums totaled \$1.3 trillion, which represent a roughly 15% increase over 2009 levels.⁶ The industry also employs more than 2.8 million people.⁷

The United States maintains a state-based system for insurance regulation. Both solvency and market conduct laws and regulations are set by state legislators and state insurance commissioners. Treasury's Federal Insurance Office (FIO), established by Dodd-Frank, serves as the central insurance authority in the federal government. While not serving a regulatory function, FIO represents the United States in international insurance forums, provides insurance policy expertise for the federal government, addresses foreign market access issues, and assists the Secretary in administering the Terrorism Risk Insurance Program. The Federal Reserve also supervises certain savings and loan holding companies that own insurance companies as well as insurance companies designated for Federal Reserve supervision by the FSOC.

Summary of Issues and Recommendations

Treasury's review of the regulatory framework for both asset management and insurance firms has identified significant opportunities for reform consistent with the Core Principles:

- Ensuring appropriate evaluation of systemic risk and solvency;
- Promoting efficient regulation and rationalizing the regulatory framework to decrease regulatory burdens and maximize product and service offerings;
- Rationalizing U.S. engagement in international forums to promote the U.S. asset management and insurance industries, and encourage firm competitiveness; and
- Enhancing consumer access to a variety of relevant products and services.

As stated above, Treasury's recommendations to the President are focused on identifying laws, regulations, and other government policies that ensure the regulation of the financial system is in accordance with the Core Principles.

A list of all of Treasury's recommendations in this report is in **Appendix B**, including the recommended action, method of implementation (Congressional and/or regulatory action), and identification of the Core Principles addressed.

Following is a summary of the themes and recommendations in the report.

5. SNL Financial; A.M. Best, *Best's Aggregates & Averages* (2016), available at: <http://www3.ambest.com/aggavg/toc/archive.aspx>.

6. SNL Financial.

7. Sean Kevelighan, Steven Weisbart, and James Lynch, *Insurance: Leading Through Disruption*, available at: [https://www.treasury.gov/initiatives/fio/Documents/\(1\)_Marketplace_Update_-_III.pdf](https://www.treasury.gov/initiatives/fio/Documents/(1)_Marketplace_Update_-_III.pdf)

Systemic Risk, Solvency, and Stress Testing

The financial crisis led to questions — both domestically and internationally — about how to address financial stability and create a regulatory framework to mitigate systemic risk. Through the passage of Dodd-Frank⁸ and efforts of the Financial Stability Board (FSB) and other international bodies, a framework emerged that assessed systemic risk posed by specific financial entities. This framework took an entity-centric and bank-centric approach to addressing systemic risk. Tools, including stress testing and risk management programs, were then implemented to address entities posing a heightened risk to the stability of the financial system. Asset management firms and insurance companies have been evaluated for systemic risk and subjected to some enhanced regulatory standards. Yet, both have legal, structural, and operational characteristics that make them different than banks.

Treasury's position is that entity-based evaluations of systemic risk are generally not the best approach for mitigating risks arising in the asset management and insurance industries. Treasury broadly supports shifting to an activities-based framework, which would identify certain business activities as having higher systemic risk characteristics. An appropriate regulatory framework would then be established by primary regulators to address elevated engagement in those activities. These recommendations are made in recognition of the fundamental differences in business and legal structures between banking, asset management, and insurance.

Treasury also rejects the need for stress testing of asset management firms. Stress testing is a regulatory tool that can be a part of systemic risk evaluation. Treasury recognizes the possibility of liquidity risk that may arise during mutual fund redemptions, but believes a strong liquidity risk management framework is a more effective approach to addressing the concern.

Finally, Treasury supports the ongoing domestic work on insurance capital and liquidity standards. To ensure an efficient and effective regulatory framework, state insurance commissioners and the Federal Reserve must collaborate with the goal of developing implementable and harmonious capital standards that minimize unnecessary regulatory burdens. Further, Treasury supports robust liquidity risk management programs for insurers, similar to Treasury's approach to the asset management industry, and will encourage the state insurance commissioners and the Federal Reserve to make progress in this area.

These recommendations are consistent with the Core Principles. They are designed to foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and solvency. Further, implementing these recommendations would help rationalize the regulatory approach to systemic risk, solvency, and stress testing in the asset management and insurance industries, thus leading to more efficient, effective, and appropriately tailored regulation.

Efficient Regulation and Government Processes

Ensuring efficient regulation and government processes is an important component of an effective financial regulatory framework. The asset management industry operates within a regulatory

8. Public Law No. 111-203.

framework that, at its core, consists of laws with origins dating to the 1930s and 1940s. Since that time, SEC regulations and guidance as well as statutory changes have tried to keep up with new market participants, products, and services. Further, market events, such as the financial crisis, have resulted in the addition of new regulatory requirements, which adds complexity for the industry.

The insurance sector has operated under state laws and regulations for over 150 years. Since the passage of McCarran-Ferguson in 1945, the federal government has repeatedly recognized the primacy of state insurance regulation. Over time, state laws have evolved; new products, like cyber and terrorism insurance, have been developed; and insurers have entered new and foreign markets.

While regulation of each of these industries is important to protect consumers and the markets, a recalibration of regulation and government processes is important from time to time to ensure an effective and efficient framework.

Treasury recommends several changes in the regulatory structure for asset management and in government processes for the insurance sector. For example, the SEC should implement regulations to standardize and simplify the approval process for ETFs. If adopted, this rule would remove the need to obtain individualized exemptive relief from the SEC for “plain vanilla” ETFs. Other recommendations include modernizing fund disclosure material through electronic delivery of shareholder material, and harmonizing and rationalizing the fund reporting requirements to eliminate overlapping and duplicative requirements.

For insurers, Treasury is committed to realigning FIO’s operations through five pillars of focus. This realignment will help promote the state-based insurance regulatory system in the United States, and make FIO’s work more effective. Treasury recommendations also include encouragement of uniform product approval processes and standards at the state level, which will expedite the speed of bringing new products to market. Further, Treasury supports the National Association of Insurance Commissioners’ work to establish uniform state laws for protecting customer data. Such state laws must be uniform and implemented expeditiously to reduce compliance costs for multistate insurers and ensure the protection of customer data.

These recommendations are consistent with the Core Principles. The implementation of these recommendations would rationalize our financial regulatory framework to make it more efficient and effective. These changes will empower Americans to make independent and informed financial decisions that will enable them to save for retirement, build individual wealth, and protect businesses and individuals from unexpected events.

International Engagement

International regulatory forums addressing financial services policy have grown in importance since the financial crisis. These forums address issues of financial stability, regulatory fragmentation, and market access. Some of these forums, such as the FSB, serve a broad mandate — financial stability. Others, such as the International Organization of Securities Commissions and the International Association of Insurance Supervisors, are specific to the asset management and insurance industries, respectively. As noted, the United States has nine of the 10 largest asset managers in the world. Further, the United States represents the world’s largest single-country insurance market by a significant margin. Because of the increased globalization of asset management and insurance,

and the ongoing international regulatory dialogue, the United States must remain engaged and speak with a strong voice at international forums to promote U.S. interests.

Treasury recommends continued U.S. engagement in international forums as international regulatory issues are debated and standards are crafted. Such engagement should enable the promotion of the U.S. asset management and insurance industries; a coordinated approach by the U.S. members of international forums; and placement of the appropriate domestic bodies in international forums to address ongoing policy formulation.

To facilitate the work in international forums, Treasury will work to increase transparency of the domestic policymaking and international standard-setting process, and ensure robust domestic stakeholder discussions to inform policy priorities.

These recommendations are consistent with the Core Principles. Their implementation would enable American companies to be competitive with foreign firms in domestic and foreign markets, and advance American interests in international financial regulatory negotiations and meetings. Further, the implementation of these recommendations would help restore public accountability in the policymaking of federal financial regulatory agencies.

Promoting Economic Growth and Informed Choices

One of the key features of the asset management industry is the vast array of choices available to investors. To date, more than 9,500 mutual funds and 1,700 ETFs operate in the United States.⁹ For individual investors, mutual funds and ETFs offer easy access to professional management and portfolio diversification. Investors can select among stock (equity) funds, bond (fixed-income) funds, and funds that invest in multiple asset classes, such as balanced funds and target date funds. Within these categories, there are even more choices. For example, an investor can select from stock funds that invest in all types of companies or stock funds that invest only in companies in a particular sector, with particular financial fundamentals, in a specific market capitalization bracket, or within a country or defined geographic region.

In addition to funds, the asset management industry provides advisory services to individual accounts, through which an investor can purchase, sell, and hold securities and money market instruments. The myriad of product choices available to investors stems from the strength and considerable competition across the U.S. asset management industry. The accessibility of asset management services and products to investors facilitates capital formation and economic growth.

As with any investment, results are not guaranteed and there is risk that investors may lose some or all of their original investment. For these reasons, investors should receive effective and informative disclosure, so they may make informed choices when investing in the capital markets. In this manner, investors can decide, based on their individual risk tolerances, between the safety of principal and the possibility of earning higher returns.

The financial regulatory framework can directly affect economic growth and how American consumers make financial choices. As Americans build wealth and plan for retirement, the regulation

9. ICI Fact Book, at 22.

of investment products and services can lead to an increase in investment-related costs or loss of investment opportunities.

Treasury supports current efforts at the Department of Labor (DOL) to reexamine the implications of the revised fiduciary rule and related exemptions adopted by the DOL in April 2016 (the Fiduciary Rule). A delay in full implementation of the Fiduciary Rule is appropriate until the relevant issues are evaluated and addressed to best serve retirement investors. Treasury supports the SEC's engagement on this topic, and encourages the DOL and SEC to work with the states to evaluate the impacts of a fiduciary rule across markets.

Treasury recognizes the increasingly important role of the life insurance industry and its products in securing retirement income. Treasury recommends strengthening consumer access and choice with respect to annuities as investments options within employer-sponsored retirement plans such as 401(k) plans. Treasury will also convene an inter-agency task force to develop policies to complement reforms at the state level relating to the regulation of long-term care insurance.

Regulation can also negatively impact growth of the U.S. economy by failing to provide incentives for investment or even penalizing certain types of investments. For example, in the persistent low interest rate environment, U.S. insurance companies have sought higher-yielding investments, including infrastructure investments. Infrastructure projects present an appealing opportunity to insurers given the benefits of higher yields and longer durations that may improve profitability and asset-liability management, particularly for life insurers. Infrastructure investment is also attractive to property and casualty insurers that historically have been among the largest investors in municipal bonds. Infrastructure is a top priority for the Trump administration, and investments by insurers can play a role in stimulating infrastructure spending.

To promote robust investment in American infrastructure, Treasury recommends a reevaluation of state insurance capital requirements and how those requirements may be better calibrated to encourage insurer infrastructure investment.

These recommendations are consistent with the Core Principles. The implementation of these recommendations would empower Americans to make informed financial choices, build wealth, and save for retirement. Further, their implementation would promote economic growth by ensuring U.S. financial firms are globally competitive and investors have access to a full range of investment options.

Asset Management



Introduction

The U.S. asset management industry is a critical component of the nation's vibrant financial system. The asset management industry plays a key role in capital formation and credit intermediation, facilitates the flow of capital from investors to corporations and governments, and enables the growth of retirement savings for millions of Americans. Through mutual funds and exchange-traded funds (ETFs), an individual can assemble a diversified portfolio of investments, providing exposure to a variety of asset classes, at a very low cost. These financial products form the cornerstone for many 401(k) plans, individual retirement accounts, and 529 college savings plans.

The asset management industry makes it possible for all Americans to participate in the capital markets. In 2016, U.S. registered investment companies owned 31% of U.S. corporate equity, 19% of U.S. and foreign corporate bonds, 13% of U.S. Treasury and government agency securities, and 23% of U.S. municipal securities.¹⁰ Notably, U.S. money market mutual funds also play a key role in cash management for businesses as well as individuals, managing 22% of U.S. nonfinancial businesses' short-term assets.¹¹

A key feature of asset management is the separation of the assets of the investment adviser from the assets being managed. Asset managers are separate legal entities from their funds. Losses or liabilities incurred by one fund are not the responsibility of other funds within the same fund complex. For non-fund assets managed by asset managers, custody rules impose a number of requirements to safeguard those assets.

Asset management encompasses a broad number of entities and participants, including:

- **Investment companies** (also known as **investment funds**) are pooled vehicles whose primary activities are investing, reinvesting, or trading in securities, such as stocks, bonds, money market instruments, and other assets. **Registered investment companies** are investment companies that have registered with the Securities and Exchange Commission (SEC) and are subject to additional regulatory oversight.
- **Mutual funds** are the most common form of registered investment company. A mutual fund offers a “redeemable security,” meaning an investor purchases and redeems shares directly with the fund at a net asset value (NAV) that is set each day based on the market value of the fund's assets.
- **Closed-end funds** typically raise capital in an initial public offering and investors purchase and sell shares of the fund on the secondary market at market prices, which may differ from the fund's NAV.
- **Exchange-traded funds (ETFs)** are a particular type of registered investment company. ETFs enter into contractual relationships with “authorized participants,” typically large broker-dealers, who are permitted to purchase and redeem fund shares directly from the ETF. All other investors purchase and sell ETF shares at market prices that may differ from the ETF's NAV.

10. ICI Fact Book, at ii.

11. *Id.* at page 13.

- **Private funds** are pooled investment vehicles not required to register as investment companies with the SEC. Generally, they are either limited in the number of investors allowed or have investor qualification requirements.¹² Hedge funds, venture capital funds, and private equity funds are types of private funds.
- A **fund complex** or **fund family** is a group of funds that are related and/or share a common investment adviser.
- **Investment advisers** are fiduciaries in the business of providing investment advice.¹³ Investment advisers manage the portfolios of investment companies and/or private funds. Some investment advisers provide investment advice to individual clients. A **registered investment adviser** is an investment adviser registered with the SEC or a state securities regulator.
- A **commodity pool operator (CPO)** is an individual or organization that operates a commodity pool and solicits funds for that commodity pool. A commodity pool is an enterprise in which funds contributed by a number of persons are combined for the purpose of trading futures or options on futures, retail off-exchange foreign exchange contracts, or swaps, or to invest in another commodity pool.¹⁴
- A **commodity trading advisor (CTA)** is an individual or organization that, for compensation or profit, advises others directly or indirectly on the value of or the advisability of trading futures contracts, options on futures, retail off-exchange foreign exchange contracts or swaps.¹⁵

Trends and Industry Outlook

In 2016, assets held by U.S. registered investment companies amounted to almost \$20 trillion and represented the investments of more than 95 million individuals.¹⁶ Gross assets held by private funds with SEC-registered investment advisers totaled \$11 trillion.¹⁷ SEC-registered investment advisers reported approximately \$70 trillion in regulatory assets under management.¹⁸ The industry has experienced robust growth in recent years, thanks to asset appreciation, strong demand from U.S. households, the aging of the U.S. population, and the rise of defined contribution retirement

12. See, e.g., 15 U.S.C. § 80a-3(c)(1) and (c)(7).

13. 15 U.S.C. § 80b-2(a)(11); see *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

14. See <https://www.nfa.futures.org/registration-membership/who-has-to-register/cpo.html>.

15. See <https://www.nfa.futures.org/registration-membership/who-has-to-register/cta.html>.

16. ICI Fact Book, at 9.

17. Division of Investment Management, U.S. Securities and Exchange Commission, *Private Funds Statistics, Fourth Calendar Quarter 2016* (July 7, 2017), available at: <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2016-q4.pdf>.

18. Amount of regulatory assets under management provided by SEC staff based on analysis of Form ADV data; amount excludes assets managed by state-registered investment advisers.

plans. Globally, investable assets in the asset management industry are expected to approach or exceed \$100 trillion by 2020.¹⁹

Figure 1: Top 20 Worldwide Asset Managers in 2016 (\$ billions)

Rank	Firm name	Primary Domicile	AUM
1	BlackRock	United States	\$5,148
2	Vanguard Group	United States	\$3,965
3	State Street Global Advisors	United States	\$2,468
4	Fidelity Investments	United States	\$2,131
5	J.P. Morgan Asset & Wealth Management	United States	\$1,771
6	BNY Mellon Investment Management	United States	\$1,648
7	PIMCO	United States	\$1,609
8	AXA Group	France	\$1,503
9	Capital Group	United States	\$1,479
10	Goldman Sachs Group	United States	\$1,379
11	Prudential Financial	United States	\$1,264
12	Amundi	France	\$1,141
13	Legal & General Group	U.K.	\$1,105
14	BNP Paribas	France	\$1,062
15	Wellington Management Group	United States	\$979
16	Northern Trust Asset Management	United States	\$942
17	TIAA	United States	\$907
18	Natixis Global Asset Management	France	\$877
19	HSBC Holdings	U.K.	\$831
20	Invesco	United States	\$813

Note: As of December 2016

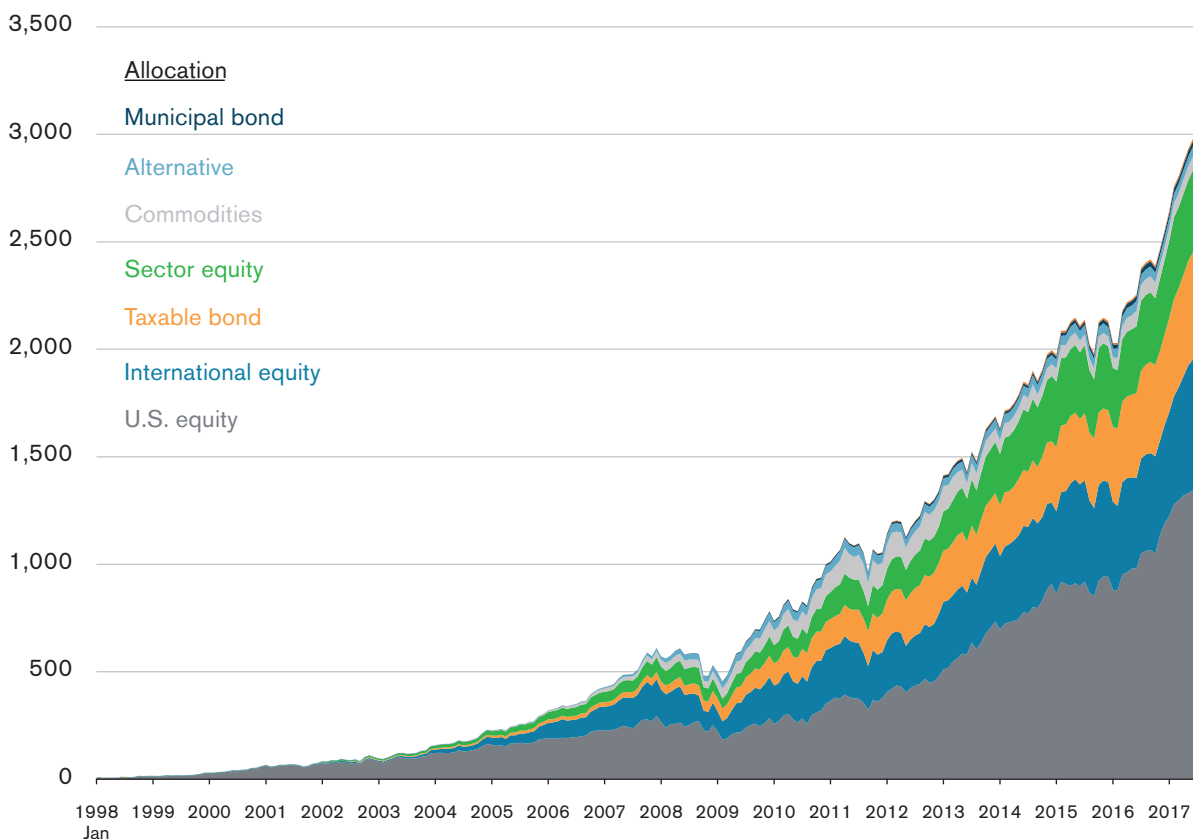
Source: Pensions & Investments, Treasury analysis

Investors are shifting from actively managed funds to passively managed funds as investors become increasingly conscious of the impact of management fees on long-term wealth creation and preservation.²⁰ Actively managed funds typically seek to outperform the market or a particular index or benchmark, whereas passively managed funds emulate an index or benchmark. In addition,

19. The Boston Consulting Group, *Global Asset Management 2017: The Innovator's Advantage* (2017), available at: http://image-src.bcg.com/Images/BCG-The-Innovators-Advantage-July-2017_tcm9-163905.pdf; see also PricewaterhouseCoopers, *Asset Management 2020: A Brave New World* (2014), available at: <https://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf>.
20. Morningstar, *U.S. Investors Favored Passive Funds over Active by a Record Margin in 2016* (Jan. 11, 2017), available at: <https://corporate.morningstar.com/US/documents/AssetFlows/AssetFlowsJan2017.pdf>.

ETFs — active and passive — are expected to continue to grow as the level of product sophistication continues to increase. Institutions have increasingly used ETFs to achieve specific asset-class or geographic exposures, and retail investors, particularly younger investors, employ ETFs as a low-cost alternative to both active and passive mutual funds.²¹ Together, the option to invest in actively or passively managed funds, or a combination of both, provides investors customization options to meet investment objectives.

Figure 2: Asset Growth in Exchange-Traded Funds: 1998-2017 (\$ billions)



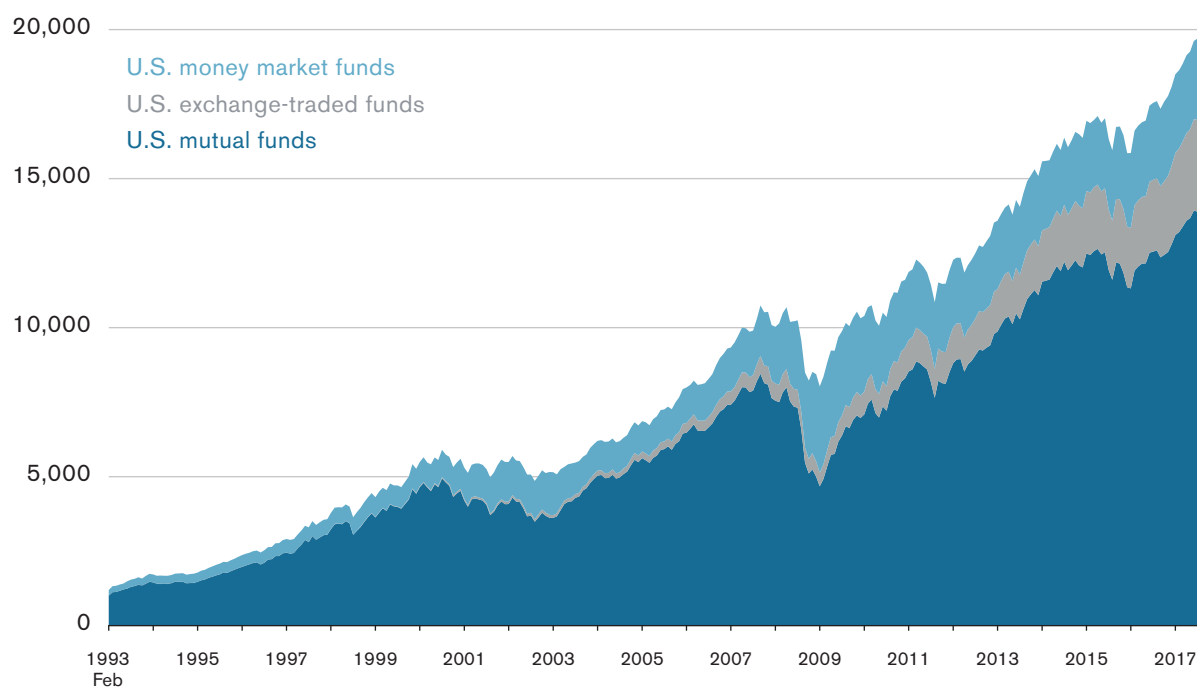
Note: Data are through July 2017

Source: Morningstar Direct

21. Greenwich Associates, *Active Strategies, Indexing and the Rise of ETFs* (Q3 2017), available at: <https://www.ishares.com/us/literature/whitepaper/2017-greenwich-global-research-report-web-en-us.pdf>; BlackRock, *ETF Pulse Survey*, available at: <https://www.ishares.com/us/about-etfs/etf-pulse> (survey conducted in Sept. 2016).

Although the largest asset managers have had continued growth in assets under management (AUM), fees charged to investors have decreased. On average, expense ratios for stock and bond funds have declined substantially over the past 20 years.²² Substantial asset flows are going to fewer asset managers and global competition for AUM has placed downward pressure on margins, with the effect of making it more difficult for smaller asset managers as well as new entrants to the market. For example, the five largest fund families increased their overall percentage of net assets to 47% in 2016, up from 36% in 2005.²³ Moreover, implementation of compliance regimes under the current regulatory framework has put continued pressure on margins, has favored the largest asset managers by disproportionately affecting smaller asset managers, and reduced the ability of asset managers to reinvest for innovation and long-term growth.

Figure 3: Asset Growth in Mutual Funds, Money Market Funds, and Exchange-Traded Funds: 1993-2017 (\$ billions)



Note: Data are through July 2017

Source: Morningstar Direct

22. Investment Company Institute, *Trends in the Expenses and Fees of Funds, 2016* (May 2017), available at: <https://www.ici.org/pdf/per23-03.pdf> (finding the average stock fund expense ratio fell from 1.04% in 1996 to 0.63% in 2016 and the average bond fund expense ratio declined from 0.84% to 0.51% during the same period).

23. ICI Fact Book, at 18.

The Regulatory Structure of the Asset Management Industry

The SEC, along with state securities regulators, constitute the primary regulators of the asset management industry in the United States. Other federal agencies, such as the Commodity Futures Trading Commission (CFTC), the Department of Labor (DOL), and the Internal Revenue Service (IRS), as well as self-regulatory organizations (SROs) such as the Financial Industry Regulatory Authority (FINRA) and the National Futures Association (NFA) also affect the asset management industry. In addition, federal, state, and local prosecutors engage in criminal enforcement of the securities laws.

Securities and Exchange Commission

The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Broadly, the SEC has jurisdiction over investment companies,²⁴ investment advisers, brokers and dealers, securities offerings in the primary and secondary markets, municipal advisors, transfer agents, and security-based swap dealers. The SEC is responsible for selectively reviewing the disclosures and reports of registered investment companies. The SEC also oversees 21 national securities exchanges, 10 credit rating agencies, and seven active registered clearing agencies, as well as FINRA. Although FINRA does not regulate mutual funds directly, it regulates the broker-dealers that sell mutual funds.²⁵ In addition, ETFs are subject to the listing standards of the relevant national securities exchange.

State Securities Regulators

State securities regulators are generally responsible for regulating investment advisers with less than \$100 million in assets under management. States may also require the licensing of certain financial professionals, including registered representatives and investment adviser representatives. States are preempted from regulating securities offerings by registered investment companies.²⁶ States also retain the authority to investigate and to bring enforcement actions against persons who engage in fraudulent behavior.

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24. A common trust fund or similar fund maintained by a bank, subject to certain conditions, is excluded from SEC jurisdiction. See 15 U.S.C. § 80a-3(c)(3) and (11). Such collective investment funds are regulated by the banking regulators. See Office of the Comptroller of the Currency, *Comptroller's Handbook, Collective Investment Funds* (May 2014), available at: <https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/collective-investment-funds/pub-ch-collective-investment.pdf>.
 25. In this capacity, FINRA administers rules on mutual fund advertising; sales practices, including the sales loads that broker-dealers may charge; the incentives provided to registered representatives; and the execution of mutual fund portfolio transactions. See <http://www.finra.org/industry/mutual-funds>.
 26. 15 U.S.C. § 77r.

Other Regulatory Agencies

Commodity Futures Trading Commission

The CFTC is an independent federal regulatory agency with exclusive jurisdiction over the markets for futures, options on futures, and swaps. The CFTC regulates any asset manager that operates as a CPO or as a CTA. The CFTC also oversees the NFA. The NFA reviews all disclosure documents from CPOs and CTAs, as well as CPO annual pool financial statements.

Internal Revenue Service

Most registered investment funds have elected to have pass-through tax treatment under subchapter M of the Internal Revenue Code, which is administered by the IRS. Subchapter M requires that the fund comply with a number of conditions, including that at least 90% of the fund's gross income be derived from investing in securities or publicly traded partnerships, and that the fund satisfy certain diversification requirements.

Department of Labor

The DOL enforces the Employee Retirement Income Security Act of 1974 (ERISA). ERISA imposes fiduciary obligations on asset managers that provide services to employee benefit plans, such as a defined benefit pension plan. In addition to fiduciary obligations, these asset managers are subject to the prohibited transaction provisions of ERISA.

Reporting and Disclosure

Investment advisers primarily are regulated under the Investment Advisers Act of 1940 (Advisers Act). Investment advisers who have more than \$100 million in assets under management or advise a registered investment company are generally required to register with the SEC.²⁷ In 2010, Dodd-Frank amended the Advisers Act, in general, to require advisers to hedge funds and other private funds to register with the SEC unless exempted by the Advisers Act from registration.²⁸

Investment advisers register with the SEC by filing a form that contains extensive information about the adviser.²⁹ The SEC uses such information to prepare for, conduct, and implement a risk-based examination program of investment advisers. This information is also aggregated by the SEC staff to obtain census data, monitor industry trends, and assess emerging risks.³⁰ Information filed by investment advisers must be updated on an annual basis, and certain information must be

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27. 15 U.S.C. § 80b-3. Certain exceptions to registration may apply, such as an investment adviser whose only clients are insurance companies or that is a foreign private adviser. *Id.*
 28. Dodd-Frank exempted from registration investment advisers that solely advise venture capital funds and investment advisers that solely advise private funds if the adviser has AUM in the United States of less than \$150 million. See Dodd-Frank §§ 407 and 408. Although not required to register with the SEC, exempt reporting advisers are subject to certain reporting obligations. 17 C.F.R. § 275.204-4.
 29. See Form ADV, 17 C.F.R. § 279.1. Form ADV is a joint form that is also used to register as an investment adviser with the state securities regulators for advisers not eligible for SEC registration.
 30. See Form ADV and Investment Advisers Rules (Aug, 25, 2016) [81 Fed. Reg. 60418 (Sept. 1, 2016)].

promptly revised if the information previously filed becomes inaccurate.³¹ This information is also publicly available on the Investment Adviser Public Disclosure website.³²

Investment companies are primarily regulated under the Investment Company Act of 1940 ('40 Act), unless exempt from registration by the '40 Act. The securities offered and sold by registered investment companies to the public must also be registered in compliance with Securities Act of 1933 (Securities Act).³³ Registered investment companies are also subject to the Securities Exchange Act of 1934 (Exchange Act). Registered investment companies are subject to extensive SEC rules adopted to implement these statutes.

To enable investors to make informed decisions, the federal securities laws and SEC regulations require a fund that is making a public offering to disclose information about its offering in a prospectus at the time of sale to the public and then provide additional information subsequently in semiannual reports to shareholders. The prospectus describes the fund's objectives, fees and expenses, performance, investment strategies, risk factors, and management. The fund's shareholder information provides current financial information, including performance, and portfolio holdings.

Leverage, Liquidity, and Custody

The '40 Act limits the ability of mutual funds to engage in leveraged transactions, such as short sales, purchases of securities on margin, and derivative transactions, unless those transactions are covered by liquid assets or offsetting transactions.³⁴ Additionally, SEC guidelines provide that mutual funds must limit their holdings of illiquid securities to 15% of net assets to meet the '40 Act requirement that a security be redeemed by its holder within seven days of receipt of a redemption request.³⁵ In October 2016, the SEC formalized this requirement into its rules.³⁶ The holder of a mutual fund is entitled to receive approximately the proportionate share of the fund's current net assets or its cash equivalent. The value of securities held by a mutual fund is defined as the market value, when market quotations are readily available, or fair value, as determined by its board of directors, if they are not. SEC rules define the net asset value (NAV) for use in computing the price of a redeemable security.³⁷ The calculation of the NAV is required for any changes in the fund's portfolio no later than the first business day following the trade date.³⁸

31. 17 C.F.R. § 275.204-1(a).

32. See www.adviserinfo.sec.gov.

33. Typically, an investment company will file a joint registration statement under the Securities Act and the '40 Act. See Form N-1A, 17 C.F.R. §§ 239.15A and 274.11A. Some investment companies may elect not to make a public offering of their securities and, in such circumstances, will register only under the '40 Act.

34. 15 U.S.C. § 80a-18; see also Securities Trading Practices of Registered Investment Companies (Apr. 18, 1979) [44 Fed. Reg. 25128 (Apr. 27, 1979)].

35. Revisions to Guidelines to Form N-1A (Mar. 12, 1992) [57 Fed. Reg. 9828 (Mar. 20, 1992)].

36. Investment Company Liquidity Risk Management Programs (Oct. 13, 2016) [81 Fed. Reg. 82142 (Nov. 18, 2016)] (adopting new Rule 22e-4(b)(iv)).

37. 17 C.F.R. § 270.2a-4.

38. *Id.*

For mutual funds, the '40 Act restricts certain transactions between a mutual fund and its investment adviser, which prevent the adviser from managing the fund for the adviser's own benefit. Finally, the '40 Act requires investment companies to safeguard custody of fund assets, including verification of the assets by an independent public accountant.³⁹ Similarly, non-fund assets managed by an SEC-registered investment adviser are also subject to custody rules and must be kept separate from the asset manager.⁴⁰ These provisions help to ensure that the assets of investors are not commingled with the assets of the investment adviser.

Historical Performance during Periods of Financial Stress

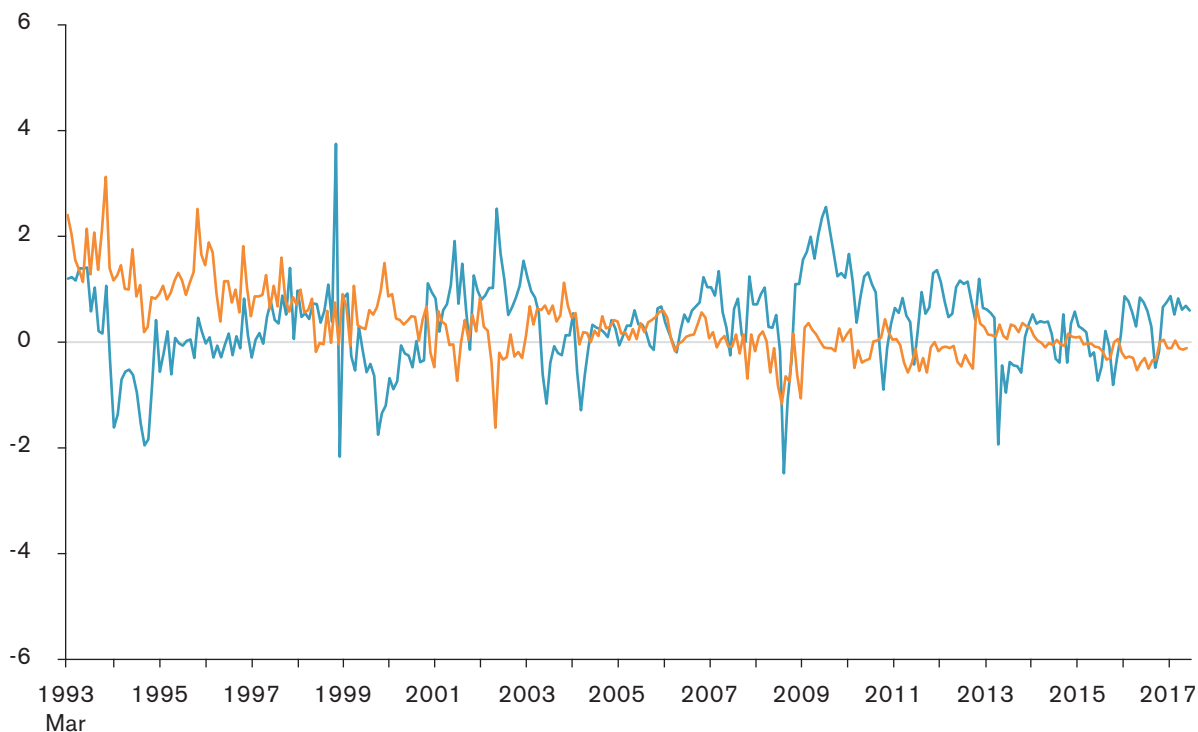
The performance of the asset management industry during periods of financial stress demonstrates that the types of industry-wide “runs” that occur in the banking industry during a systemic crisis have not materialized in the asset management industry outside of money market mutual funds. One reason for this outcome is structural; fund assets are financed with the capital of shareholders and redemptions constitute market value return of that capital from the fund itself.

Mutual funds are owned by many investors, each with their own time horizons for investing, their own risk preferences, and their own investment goals. Since the turn of the century, aggregate net flows — either total net redemptions or subscriptions — into equity and debt funds have rarely exceeded more than 1% and 2% of total assets under management on a monthly basis, respectively (see Figure 4). This trend continued through the financial crisis, when mass redemptions would have been most likely. The chart below outlines monthly net flows into or out of U.S. equity and bond funds.

39. 15 U.S.C. § 80a-17(f); 17 C.F.R. §§ 270.17f-2 and 270.17f-4.

40. 15 U.S.C. § 80b-18b; 17 C.F.R. § 275.206(4)-2.

Figure 4: Equity and Bond Mutual Fund Net Flow Rates: 1993-2017 (percent)



U.S.-registered bond mutual fund net flow rate (taxable and municipal)

U.S.-registered equity mutual fund net flow rate (international equity, sector equity, U.S. equity)

Note: Data are through July 2017

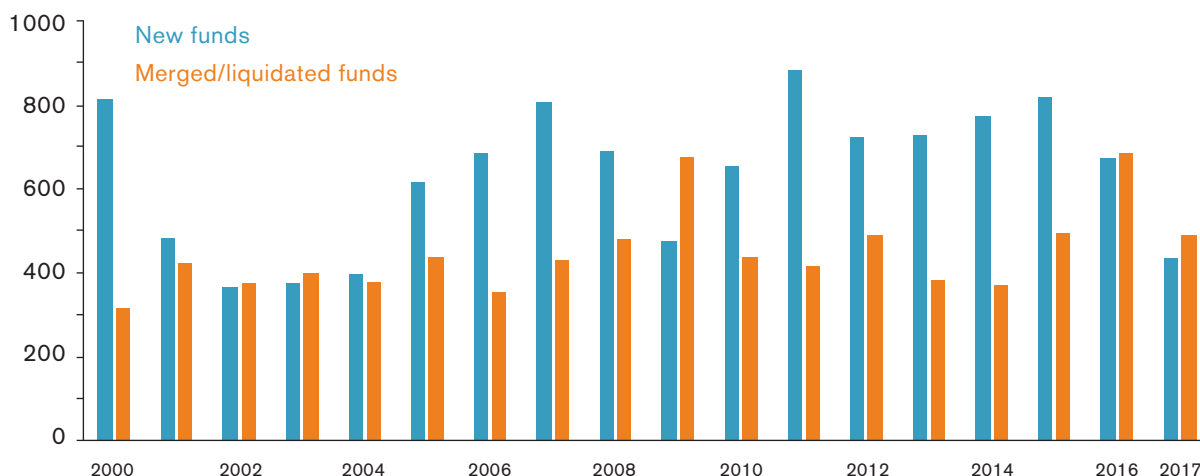
Source: Morningstar Direct

History of Fund Activity and Closures

One feature that distinguishes the asset management industry is the ease by which funds are formed and terminated, without any disruption to the financial markets. Fund sponsors routinely create new funds to meet investor demand, and they merge or liquidate funds that do not attract sufficient investor interest. In 2016, 676 mutual funds and ETFs opened, while 688 funds merged or were liquidated (see Figure 5).⁴¹ This occurred without a material impact on the industry or the financial markets.

41. Morningstar Direct.

Figure 5: Number of New and Merged/Liquidated Open-Ended Mutual Funds and Exchange-traded Funds 2000-2017 (through Oct. 5, 2017)



Source: Morningstar Direct

Disruptive Market Events and Asset Management

When disruptive events occur in the asset management industry, significant redemptions at individual funds or fund complexes have not led to material market dislocations or longer term systemic consequences to the economy. An example of this dynamic was on display following the unexpected departure of key personnel from PIMCO in September 2014 (see Figure 6).⁴² Specifically, the PIMCO Total Return Fund, directly managed by Bill Gross, experienced fund outflows of \$120 billion.⁴³ The roughly \$60 billion in net redemptions during September and October 2014 alone were the largest amount of money ever withdrawn from a fund during a two month period.⁴⁴ Despite these outsized redemption levels, the fund's returns were above the average return of core bond funds.⁴⁵ More importantly, investors were able to redeem investments made at PIMCO and transfer business to other investment managers in an orderly manner without any material impact to PIMCO, the other investment managers, or the financial markets more broadly.

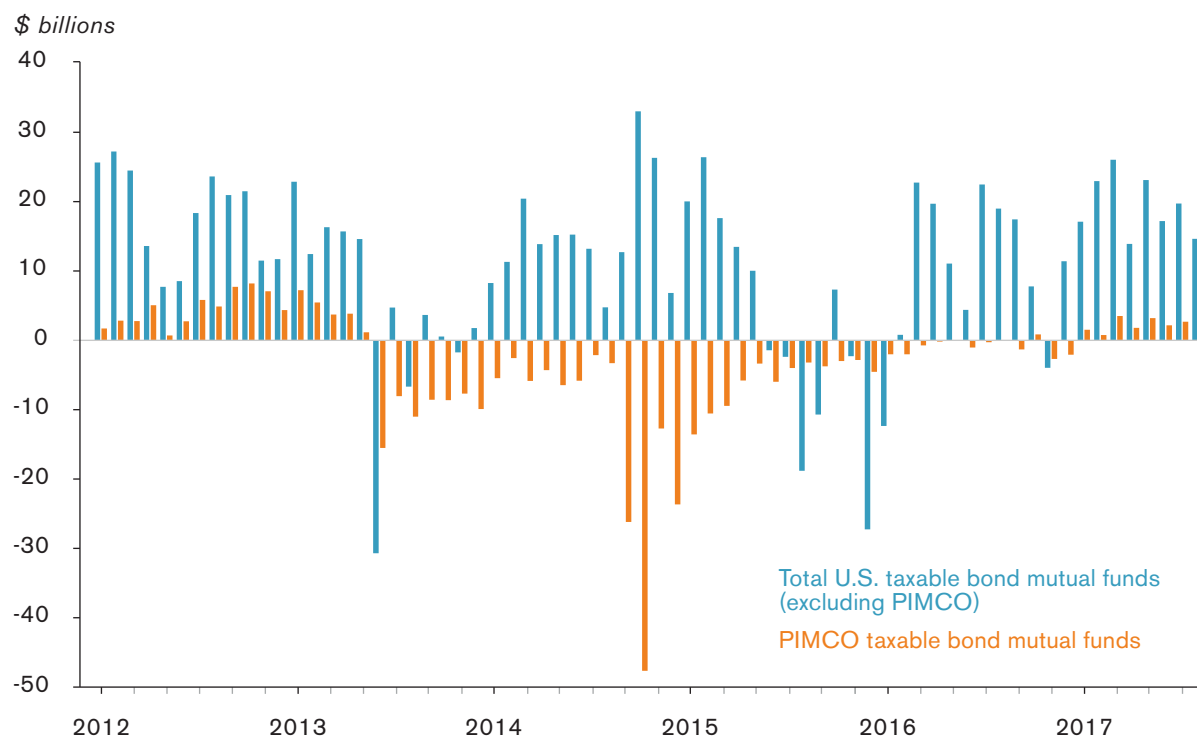
42. In 2014, PIMCO lost both of its co-chief investment officers, Bill Gross and Mohammed El-Erian.

43. Stephen Foley and Alistair Gray, *Pimco Fund Outperforms Bill Gross a Year After 'Bond King' Left*, *The Financial Times* (Sept. 23, 2015).

44. Morningstar, *PIMCO Recap: Flows, Ratings, and Firm-Level Views, Weighing in on PIMCO Six Weeks After Bill Gross' Sudden Departure* (Nov. 10, 2014), available at: <http://morningstardirect.morningstar.com/client-comm/MorningstarPIMCORecapFlowsRatingsFirmLevelViews.pdf>.

45. Morningstar, *PIMCO Update June 2015* (June 4, 2015), at 7, available at: http://corporate.morningstar.com/US/documents/ResearchPapers/COMBINED_PIMCO_June2015%20_FINAL.pdf.

Figure 6: PIMCO Taxable Bond Mutual Fund Monthly Net Flows and Total U.S. Taxable Bond Mutual Fund Monthly Net Flows (excluding PIMCO)



Note: Data are through July 2017

Source: Morningstar Direct

Rising Costs and Regulatory Burden

Although total AUM continues to rise across the asset management industry, so do costs. The costs of asset management are expected to soar by 2022. The reasons for rising costs are diverse, with commercial cost pressures increasing as firms expand distribution networks and costs rise for product development, technology, and data management. However, one of the most important drivers of these rising costs is the cost of complying with an increased regulatory burden since the financial crisis. For example, in a recent study of global asset managers, banks, and brokers, participants highlighted perceptions that regulations are increasing costs and that compliance spending at a typical firm is expected to double over the next five years. Respondents reported that while they spend 4% of total revenue on compliance, they expect those costs to rise to up to 10% of total revenue by 2022.⁴⁶ Many of these costs are passed along to individual retail investors in the form of expenses higher than they would be if compliance costs had been the same.

46. Duff & Phelps, *Global Regulatory Outlook 2017*, at 4, available at: <https://www.duffandphelps.com/assets/pdfs/publications/compliance-and-regulatory-consulting/2017-global-regulatory-outlook-viewpoint.pdf>.

The pace of regulatory expansion, reach, and complexity of regulation affecting funds in the asset management industry has been significant over the past nine years. Additional rules and regulations such as the SEC money market mutual fund rule reforms, enhanced fund reporting, liquidity rulemaking, the DOL fiduciary rule, new SRO rules, and requirements related to Dodd-Frank and other compliance regimes, have resulted in a median increase in compliance costs of an estimated 20% over the past five years.⁴⁷ Other regulators, such as the CFTC, have added regulatory burdens on the asset management industry, as has compliance with the reporting of cost basis of mutual fund shares under new IRS rules. Moreover, the global nature of the largest asset management firms also creates the need to comply with foreign laws and regulations. These regulatory compliance costs come in the form of legal expenses, preparation of new policies and procedures, creation of internal controls, technology expenditures, increased use of third-party service providers, rising vendor charges, increased oversight costs, and higher overall requirements for staffing and training. Moreover, these costs do not capture the opportunity costs associated with these efforts, including diversion of resources from efforts to boost portfolio return, risk management, and improved customer service.⁴⁸

The directive outlined in Executive Order 13772 provided Treasury the opportunity to initiate a much-needed review of the regulation impacting the asset management industry. Appropriately tailoring regulation, rationalizing the existing regulatory framework, and reducing redundancy would go far to foster the goals of efficient allocation of capital, strong job creation, and lasting economic growth.

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47. Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Secretary Steven T. Mnuchin (Apr. 25, 2017) (based on a survey of 42 member firms accounting for 46% of registered fund assets).
48. See, e.g., KPMG International, *The Costs of Compliance, 2013 KPMG/AIMA/MFA Global Hedge Fund Survey*, available at: <https://home.kpmg.com/content/dam/kpmg/pdf/2014/07/Cost-of-Compliance.pdf>.

Asset Management: Findings and Recommendations



Systemic Risk and Stress Testing

Systemic Risk and the Asset Management Industry

In the wake of the financial crisis, federal regulators and the Financial Stability Oversight Council (FSOC) have evaluated systemic risk as it pertains to the asset management industry. The Office of Financial Research also published a report in September 2013 titled *Asset Management and Financial Stability*.⁴⁹ Particular focus was placed on mutual funds and other pooled investment vehicles. The FSOC conducted a review of the asset management industry, which led to a focus on asset management products and activities rather than entity-specific evaluation for Federal Reserve supervision and enhanced prudential standards.⁵⁰

FSOC's evaluation of systemic risks over the past several years shows fundamental differences between asset managers and prudentially regulated institutions such as banks. Asset management is an agency-based business model, as opposed to the principal-based business model of banks. This means that asset managers manage on behalf of clients (whether a mutual fund, other pooled investment vehicle, or individual account), but they do not generally own the investments themselves.⁵¹ Furthermore, asset managers are legally separated from the funds — the assets and liabilities of the manager are distinct from assets and liabilities of the funds. The bank business model directly subjects the bank to the risks and obligations of its assets and liabilities.

To the extent that systemic risks arise from the asset management industry, prudential regulation of asset management is unlikely to be the most effective regulatory approach for mitigating these risks. Generally, asset managers and investment funds, in contrast to banks, are not highly leveraged and do not engage in maturity and liquidity transformation to the same degree that banks do through the use of bank deposits and other forms of credit. Any decline in the value of a fund's assets results in a corresponding reduction in the investor's investment, whereas a bank's obligation to its depositors and creditors remains the same even if the bank suffers losses on its asset exposures.

Existing SEC Regulation

Mutual funds are already subject to long-established regulations that reduce the risks that individual funds present to the broader financial system. Moreover, since the financial crisis, the SEC has promulgated a number of new rules designed to further address risks in this sector.

Registered investment companies have long been subject to a number of requirements under the '40 Act and SEC rules and guidance implementing the '40 Act that help to mitigate the risks of a potential "run" on the fund, including:

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49. Office of Financial Research, *Asset Management and Financial Stability* (Sept. 2013), available at: https://www.financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.
 50. Financial Stability Oversight Council, *Update on Review of Asset Management Products and Activities* (Apr. 18, 2016), available at: <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf>.
 51. An exception to this statement would be the seeding of a new fund by an asset manager, which generally constitutes a de minimis investment.

- **Leverage Limitations:** Mutual funds are statutorily prohibited from taking on borrowings that exceed one-third of the portfolio’s assets (i.e., a mutual fund must have \$3 of assets for every \$1 dollar of debt, or a 300% asset coverage requirement).⁵²
- **Diversification of Portfolio Holdings:** A diversified mutual fund or closed-end fund is required to invest more than 75% of its total assets in cash and cash items, government securities,⁵³ securities of other registered investment companies, and other securities that are limited to not more than 5% of any one issuer.⁵⁴ All mutual funds and closed-end funds are required by federal tax law to meet certain diversification requirements to be eligible for pass-through tax treatment. With respect to half of the fund’s assets, the fund may hold no more than 5% in the securities of any one issuer.⁵⁵ With respect to the other half of the fund’s assets, the limit is 25%. As a result, the minimum diversification of a mutual fund is 25% of its assets in each of two issuers, and 5% of its assets in each of 10 additional issuers.
- **Custody of Assets:** Mutual funds are required to maintain strict custody of fund assets separate from the assets of the fund manager. This requirement is designed to safeguard fund assets from theft or misappropriation. Nearly all mutual funds use bank custodians for domestic securities, and the custody agreements are constructed to be robust and thorough.⁵⁶
- **Liquidity:** At least 85% of a mutual fund’s portfolio must be invested in “liquid securities,” which are defined as assets that can be disposed of within seven days at a price approximating market value.⁵⁷
- **Daily Valuation of Fund Assets:** Mutual funds must value their portfolio holdings on a daily basis, based on market values readily available. There are certain provisions for obtaining fair value if no current market price is available for a particular price or if the market price is unavailable.⁵⁸

Since 2014, the SEC has adopted numerous additional rules impacting the asset management industry, which provide additional transparency and mitigate potential systemic risks, including:

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52. 15 U.S.C. § 80a-18. Closed-end funds are also subject to a 300% asset coverage requirement, but are not subject to the limitation of only borrowing from a bank.
 53. Government securities include any security issued or guaranteed as to principal or interest by the United States or by a person controlled or supervised by and acting as an instrumentality of the U.S. government. See 15 U.S.C. § 80a-2(a)(16). Securities issued by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are government securities as long as they satisfy such criteria.
 54. 15 U.S.C. § 80a-5(b).
 55. 26 U.S.C. §§ 851-855 (Subchapter M of the Internal Revenue Code).
 56. 15 U.S.C. § 80a-17(f); 17 C.F.R. 270.17f-1 (broker-dealer custody); 17 C.F.R. § 270.17f-2 (self-custody); 17 C.F.R. § 270.17f-4 (securities depositories); 17 C.F.R. § 270.17f-5 (foreign banks); 17 C.F.R. § 270.17f-6 (futures commission merchants); and 17 C.F.R. § 270.17f-7 (foreign securities depositories).
 57. Revisions of Guidelines to Form N-1A (Mar. 12, 1992) [57 Fed. Reg. 9828 (Mar. 20, 1992)].
 58. See 15 U.S.C. § 80a-2; 17 C.F.R. §§ 270.2a-4 and 270.22c-1.

- Enhancing portfolio reporting by mutual funds, including derivatives disclosure;⁵⁹
- Requiring implementation of liquidity risk management programs by mutual funds;⁶⁰
- Moving institutional prime money market funds to a floating NAV and permitting the imposition of liquidity fees and redemption gates for money market mutual funds;⁶¹
- Providing additional tools to allow funds to effectively pass on costs stemming from investor purchase and redemption activity;⁶²
- Improving disclosures provided by registered investment advisers;⁶³ and
- Shortening the securities transaction settlement cycle from three days to two days.⁶⁴

Recommendations

Treasury’s position is that entity-based systemic risk evaluations of asset managers or their funds are generally not the best approach for mitigating risks arising from asset management. Rather than focus on entity-based evaluations, primary federal regulators should focus on potential systemic risks arising from asset management products and activities, and on implementing regulations that strengthen the asset management industry as a whole. Treasury recommends that while the FSOC maintains primary responsibility for identifying, evaluating, and addressing systemic risks in the U.S. financial system, the FSOC look to the SEC to address systemic risks through regulation within and across the asset management industry in the United States.

Stress Testing and the Asset Management Industry

The promulgation of a statutory requirement for stress testing of large investment advisers and mutual funds came about, in part, because of the success of the initial supervisory stress test exercise led by the Federal Reserve for the largest bank holding companies in the midst of the financial crisis.⁶⁵ Dodd-Frank requires certain nonbank financial companies to conduct annual stress tests.⁶⁶ Stress testing is required for registered investment companies and registered investment advisers having more than \$10 billion in consolidated assets. According to information provided by the Investment Company Institute, more than 400 funds had \$10 billion in assets or more as of July 31, 2017.

Under Dodd-Frank, each federal primary financial regulatory agency, in coordination with the Federal Reserve and the Federal Insurance Office (FIO), as appropriate, must “issue consistent

59. Investment Company Reporting Modernization (Oct. 13, 2016) [81 Fed. Reg. 81870 (Nov. 18, 2016)].

60. Investment Company Liquidity Risk Management Programs (Oct. 13, 2016) [81 Fed. Reg. 82142 (Nov. 18, 2016)].

61. Money Market Fund Reform; Amendments to Form PF (July 23, 2014) [79 Fed. Reg. 47736 (Aug. 14, 2014)].

62. Investment Company Swing Pricing (Oct. 13, 2016) [81 Fed. Reg. 82084 (Nov. 18, 2016)].

63. Form ADV and Investment Advisers Act Rules (Aug. 25, 2016) [81 Fed. Reg. 60418 (Sep. 1, 2016)].

64. Securities Transaction Settlement Cycle (Mar. 22, 2017) [82 Fed. Reg. 15564 (Mar. 29, 2017)].

65. Governor Daniel K. Tarullo, *Stress Testing after Five Years* (June 25, 2014), available at: <https://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm>.

66. See Dodd-Frank § 165(i)(2) (codified at 12 U.S.C. § 5365).

and comparable regulations” to implement the stress tests.⁶⁷ As with bank stress testing, the methodologies established by the SEC are required to include three sets of conditions: (1) baseline, (2) adverse, and (3) severely adverse scenarios. Results are required to be reported to both the SEC and the Federal Reserve, and the company is required to publish a summary of the results. In 2014, the then-SEC Chair indicated that the SEC staff was evaluating how to tailor stress testing for the asset management industry.⁶⁸ To date, however, no stress testing rule has been proposed by the SEC.

Prudential stress testing for asset management raises significant implementation challenges. The challenge in applying prudential stress-testing to asset managers was recognized by the SEC’s chief economist in 2016, when he expressed a number of concerns with these statutory stress-testing requirements, including how to engage in such testing when fluctuations in asset values are passed through to fund investors by design.⁶⁹

Where appropriate, the SEC has imposed regulations on mutual funds to address potential risks that funds might face as a result of stressed market conditions, including revised rules for money market mutual funds and new liquidity risk management requirements for other mutual funds.⁷⁰

Recommendations

While Treasury endorses the principle of appropriate risk management in the asset management industry, it does not support prudential stress testing of investment advisers and investment companies as required by Dodd-Frank. Treasury supports legislative action to amend Dodd-Frank to eliminate the stress testing requirement for investment advisers and investment companies.

In the alternative, Treasury supports the view that the stress testing provisions of Rule 2a-7 for money market mutual funds and Rule 22e-4 on liquidity risk management programs, discussed in the next section, satisfy the spirit of Dodd-Frank’s stress testing requirements.

Efficient Regulation and Government Processes

Liquidity Risk Management

Liquidity can be defined as the ability by a financial market participant to quickly liquidate assets as needed and without a significant impact on price to meet immediate, short-term financial obligations with cash. Since the financial crisis, regulators have correctly focused on liquidity risk in global financial markets. This concern stems from deep scars left by the liquidity crunch during the financial crisis, in which stressed market conditions led rapidly to liquidity crises at various market participants as concerned counterparties and investors withdrew credit and funding, which

67. 12 U.S.C. § 5365(i)(2)(C).

68. Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 11, 2014), available at: <https://www.sec.gov/news/speech/2014-spch121114mjw>.

69. Rob Tricchinelli, *SEC Vexed by Asset Manager Stress Test Rule*, Bloomberg BNA (Feb. 8, 2016), available at: <https://www.bna.com/sec-vexed-asset-n57982067065/>.

70. 17 C.F.R. § 270.2a-7(g)(8) (money market funds); 17 C.F.R. § 270.22e-4(b)(1)(i)(B) (liquidity risk management programs).

precipitated further liquidity-driven asset sales, or “fire sales.” An example of how stressed liquidity conditions can present risks is the failure of Bear Stearns in 2008, which stemmed in part from the rapid withdrawal of credit lines and funding by the firm’s creditors and counterparties as the firm experienced losses due to its exposure to subprime mortgages.

Policymakers and regulators responded to such concerns, particularly the risk that firms do not have enough capital and liquid resources to survive stressed markets, through a number of regulations promulgated since the crisis — for example, bank capital and liquidity rules addressed in Treasury’s Banking Report. For asset management, policymakers have focused on how to address the risks of rapid investor redemptions and their potential impact on fund investors and market conditions. For example, the 2015 closure of the Third Avenue Focused Credit Fund highlighted how a fund might inadequately manage its liquidity risk, with implications for investors who might be unable to redeem their shares in the fund, and market conditions that are potentially impacted by a fund’s asset sales to meet its redemption requests.

Regulations for Liquidity Risk

The regulatory framework for liquidity risk management of registered investment companies has been established through SEC guidance and the requirements of the ’40 Act, as well as more recent liquidity rules, such as the Rule 22e-4 under the ’40 Act.⁷¹ Private funds, such as hedge funds, private equity funds, and venture capital funds, typically have specific contractual provisions governing an investor’s ability to take all or part of an investment out of the fund.

The ’40 Act requires mutual funds generally to redeem shares at their proportionate share of a fund’s NAV within seven days of tender.⁷² Thus, asset managers have a responsibility to manage the liquidity of the fund’s investment portfolios in a manner consistent with their redemption obligations. Many investors expect to receive redemption proceeds sooner as some mutual funds represent in their prospectuses that they will pay redemption proceeds in fewer than seven days. In recognition of the redemption obligation, the SEC has long-standing guidelines containing a liquidity standard that generally limits a mutual fund’s aggregate holdings of “illiquid assets” to no more than 15% of the fund’s net assets.⁷³ In October 2016, the SEC adopted Rule 22e-4, which formalized the 15% limitation on illiquid investments and requires notification to the SEC if the level of illiquid investment assets exceeds 15% of its net assets.⁷⁴

Under the 15% guidelines, a portfolio security or other asset is considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment.⁷⁵ The 15% guidelines have generally caused funds

71. Investment Company Liquidity Risk Management Programs (Oct. 13, 2016) [81 Fed. Reg. 82142 (Nov. 18, 2016)] (“SEC Liquidity Release”).

72. See 15 U.S.C. §§ 80a-2(a)(32) and 80a-22(e).

73. Revisions of Guidelines to Form N-1A (Mar. 12, 1992) [57 Fed. Reg. 9828 (Mar. 20, 1992)] (“Form N-1A Guidelines Release”); Statement Regarding “Restricted Securities” (Oct. 21, 1969) [35 Fed. Reg. 19989 (Dec. 31, 1970)].

74. See SEC Liquidity Release. The liquidity risk management program rules become effective on December 1, 2018 for all funds except funds that would qualify as smaller entities, whose compliance date is June 1, 2019.

75. Form N-1A Guidelines Release.

to limit their exposures to particular types of securities that cannot be sold within seven days and that the SEC and staff have indicated may be illiquid, depending on the facts and circumstances. To the extent that a fund's holdings of illiquid securities exceeds 15%, the guidelines have been interpreted as preventing the fund from acquiring any additional illiquid assets.⁷⁶

Fund managers frequently base their portfolio decisions on evaluation of asset types and certain information about the assets, such as issuer type, issuer domicile, duration, credit quality, and currency. This approach is appropriate because instruments with similar characteristics are often highly comparable and substitutable from a liquidity perspective. In addition, fund managers use their judgment in evaluating asset liquidity. Even within an asset class, such as fixed-income, the liquidity of issues can differ considerably depending on factors such as credit quality and industry. Internal policies and procedures require a certain amount of flexibility to account for market and issuer-specific dynamics.

In addition to making important changes to codify and strengthen the 15% limit on illiquid investments, Rule 22e-4 requires all mutual funds (except for money market mutual funds) and certain ETFs to adopt a liquidity risk management program. Funds would be required to monitor the liquidity risk of their portfolio and determine a minimum percentage of their assets that must be invested in highly liquid investments. Under the rule, mutual funds must use a specific, uniform scheme for classifying, reviewing, and reporting the liquidity of each portfolio holding on a monthly basis and providing aggregated information to the public on a quarterly basis. Each fund is required to classify each of its portfolio investments into one of four defined liquidity categories, known as "buckets." These buckets are intended to take into account relevant market-, trading-, and investment-specific considerations, including, among other things, market depth and whether sales of an investment would significantly change the market value of the investment.⁷⁷

The rule has resulted in funds assessing the adequacy of their liquidity management practices. However, concerns have arisen regarding the rule's approach to measuring liquidity risk, and the costs involved in implementing the rule. The rule mandates an overly prescriptive asset classification or bucketing methodology despite the fluid, and sometimes subjective, nature of liquidity. This uniform bucketing requirement may not help funds improve their current liquidity risk management programs. As a result, funds may continue to use their current methodologies for classifying the liquidity of their investments alongside the costly mandated bucketing methodology.

Recommendations

Treasury supports robust liquidity risk management programs and believes they are imperative to effective fund management and the health of the financial markets. For this reason, Treasury supports the 15% limitation on illiquid assets. However, Treasury rejects any highly prescriptive regulatory approach to liquidity risk management, such as the bucketing requirement. Instead, Treasury supports the SEC adopting a principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements. Consistent with these recommendations,

76. Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (Sept. 22, 2015) [80 Fed. Reg. 62274, 62284 n. 92 (Oct. 15, 2015)].

77. SEC Liquidity Release.

the SEC should take appropriate action to postpone the currently scheduled December 2018 implementation of Rule 22e-4's bucketing requirement.

Swing Pricing

“Swing pricing” is the process of adjusting the NAV of fund shares to effectively pass on the costs from purchase or redemption activity to the investors associated with that activity. Mutual funds calculate a daily NAV, typically as of 4 p.m. Eastern Time, which is the price at which an investor can purchase or redeem fund shares. SEC rules require that an investor request to purchase or redeem mutual fund shares be at a price based on the next NAV calculated after the receipt of the request.⁷⁸

Some have expressed concerns that investor redemptions could dilute the interests of non-redeeming shareholders, particularly in times of stressed liquidity conditions.⁷⁹ In this scenario, changes in portfolio holdings to satisfy redemptions can occur several business days after the redemption request. If these activities and their associated costs are not reflected in the NAV at redemption, the costs of providing liquidity to the first redeeming investors could be borne by remaining investors in the fund. In other words, the transaction costs may be lower for earlier redeeming investors than for later, creating a “first-mover advantage.” This concern has risen due to the significant growth in assets managed by funds with less-liquid investments, such as fixed-income funds, emerging market debt funds, open-end funds with alternative strategies, and emerging market equity funds.

It has been suggested that swing pricing could protect existing investors from dilution associated with such purchase-and-redemption activity and may be a useful tool to manage liquidity risks. Pooled investment vehicles in certain foreign jurisdictions, including France, Hong Kong, Ireland, Italy, Mexico, the Netherlands, Singapore, and the United Kingdom, currently use various forms of swing pricing to mitigate shareholder dilution associated with other shareholders' capital activity.⁸⁰

In October 2016, the SEC finalized a rule that would permit mutual funds to use swing pricing on a voluntary basis.⁸¹ The SEC also adopted amendments to require certain disclosures by funds using swing pricing. The rule changes become effective in November 2018.

Although Treasury recognizes the theoretical possibility of a first-mover advantage, empirical evidence demonstrating the inadequacy of existing liquidity management practices for mutual

78. 17 C.F.R. § 270.22c-1.

79. Financial Stability Board, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (Jan. 12, 2017), at 11-12, available at: <http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf>.

80. International Organization of Securities Commissions, *Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 Survey to Members* (Dec. 2015), at 4, available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf>.

81. Investment Company Swing Pricing (Oct. 13, 2016) [81 Fed. Reg. 82084 (Nov. 18, 2016)]. Closed-end funds, unit investment trusts, ETFs, and money market mutual funds are not permitted to use swing pricing.

funds and other registered investment companies is unsubstantiated.⁸² Treasury observes that, given current distribution practices of U.S. mutual funds, there may be practical difficulties with implementing swing pricing. Unlike foreign jurisdictions, most U.S. funds are sold through intermediaries, including broker-dealers, insurance companies, and retirement plan record-keepers, which aggregate and net purchases and redemptions in a particular fund. Purchase-and-redemption information from these distribution channels may not be known until well after NAV is determined.

Treasury encourages further analysis of whether, and to what extent, swing pricing is implemented by funds. Particular concern should be focused on investor protection and whether funds are appropriately setting the amount of the swing as justified by relevant trading costs.

Derivatives

Derivatives are essential financial tools that enable portfolio managers of investment companies to manage and hedge risk, enhance portfolio liquidity, gain or reduce exposure to certain asset classes, manage or equitize cash, and reduce transaction costs. While derivatives can be used for speculative activities, funds often use derivatives to mitigate their risks.

Regulation of Derivatives

The SEC's regulation of derivatives stems from a 1979 general statement of policy regarding the '40 Act's treatment of senior securities.⁸³ The use of senior securities by funds is subject to certain prohibitions and limits on leverage (or asset coverage).⁸⁴ While the SEC found that derivatives transactions may be considered senior securities and therefore subject to the '40 Act limitations, the SEC staff has also allowed funds to engage in derivatives activities over the years through "no-action" letters as long as they met certain other key conditions.⁸⁵ This approach has been developed through a patchwork of more than 30 no-action letters issued by the SEC staff, which apply the 1979 statement of principles to various types of derivatives and other transactions on an instrument-by-instrument basis.⁸⁶

82. See, e.g., Sheheryar Malik and Peter Linder, *IMF Working Paper On Swing Pricing and Systemic Risk Mitigation* (July 2017), at footnote 6, available at: <http://www.imf.org/en/Publications/WP/Issues/2017/07/18/On-Swing-Pricing-and-Systemic-Risk-Mitigation-44957>.

83. Securities Trading Practices of Registered Investment Companies (Apr. 18, 1979) [44 Fed. Reg. 25128 (Apr. 27, 1979)].

84. The '40 Act limits the ability of funds to obtain leverage or incur obligations to persons other than the fund's common shareholders through the issuance of senior securities, defined, in part, as bonds, debentures, notes, or similar obligations or instruments constituting a security and evidencing indebtedness. The '40 Act prohibits a mutual fund from issuing or selling any senior security, other than a borrowing from a bank, and subject to a requirement to maintain 300% asset coverage.

85. Division of Investment Management, U.S. Securities and Exchange Commission, *Registered Investment Company Use of Senior Securities – Select Bibliography* (last modified June 17, 2016), available at: <https://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm>.

86. Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015) [80 Fed. Reg. 80884, 80887 (Dec. 28, 2015)].

In December 2015, the SEC proposed new derivatives rules to modernize and refresh the regulation of funds' derivatives activities.⁸⁷ The proposed rule would permit mutual funds, ETFs, and closed-end funds to enter into derivatives transactions, notwithstanding the '40 Act's restrictions on the issuance of senior securities, provided the funds comply with the conditions in the proposed rule. The proposed rule would impose the following conditions:

- Comply with one of two portfolio limitations, either the exposure-based portfolio limit or the risk-based portfolio limit, each of which is designed to limit the fund's leverage obtained through derivatives;
- Segregate an amount of qualifying coverage assets (limited to cash and cash equivalents) for derivatives, so funds could meet their obligations in a stress scenario; and
- For funds that engage in more than a limited amount of derivatives transactions or use certain complex derivatives transactions, establish a formalized derivatives risk management program.

While the proposed rule's comprehensive approach to the regulation of funds' derivatives activities is an improvement from the current piecemeal approach, the proposal has several key concerns.

First, portfolio limits could unnecessarily restrict funds from using derivatives, even for hedging or other risk mitigating purposes. Limiting the risk management and liquidity tools available to fund managers would result in less efficient asset management, higher transaction costs, and lower returns. The result could be the closure of certain funds, or forced changes to investment strategies that would disrupt current business practices and reduce investor choice.

Second, the proposed rule's use of gross notional amount as a measure for derivatives exposure is problematic. The proposed rule's exposure-based portfolio limit would require a fund to limit its aggregate exposure to 150% of the fund's net assets calculated based on the aggregate gross notional amount of the fund's derivatives transactions. However, a high gross notional exposure of a fund's portfolio is not necessarily correlated with leverage or risk levels. A recent study conducted by economists at the SEC's Division of Economic and Risk Analysis noted that similar notional amounts of derivatives across different underlying asset classes generally do not represent similar units of risk.⁸⁸ High gross notional amounts could lead to a fund being more risky, less risky, or equally risky compared with a fund that has no derivatives exposure. Using the gross notional amount as a measure for derivatives exposure risks does not take into account the beneficial effects of using derivatives in portfolio management. Absent a clearly defined connection between gross notional amounts of derivatives and leverage, and evidence that derivatives used for leverage create unacceptable levels of risk, the SEC's proposed rule is problematic.

Third, while it is important for funds to manage the risks of their derivatives obligations, the rule's limiting of qualifying coverage assets to cash and cash equivalents could require funds to hold more of those assets than they would otherwise, potentially reducing investment returns and causing tracking errors for funds that follow indexes.

87. Id.

88. Daniel Deli et al., *Use of Derivatives by Registered Investment Companies* (Dec. 2015), available at: <https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf>.

In October 2016, the SEC also adopted new reporting requirements for registered investment companies that would support its effort to modernize derivatives regulations.⁸⁹ Pursuant to Form N-PORT, almost all funds would report information about their monthly portfolio holdings to the SEC in a structured data format, including extensive information on derivatives investments. Funds would be required to disclose certain characteristics and terms of their investments in derivatives to enable a better understanding of the profit-and-loss profile of such investments and the exposures created by such investments. The compliance date for the enhanced fund reporting is June 1, 2018.

Recommendations

While Treasury supports the SEC's goal of modernizing the regulation of derivatives for funds, Treasury has concerns with certain aspects of the proposed rule. Treasury recommends the SEC consider a derivatives rule that would include a derivatives risk management program and an asset segregation requirement, but reconsider what, if any, portfolio limits should be part of the rule. Any portfolio limits, if adopted, should be based on significantly more risk-adjusted measures of a fund's derivatives than the current proposal. The SEC should also reconsider the scope of assets that would be considered qualifying coverage assets for purposes of the asset segregation requirement. Treasury further recommends that the SEC examine the derivatives data that will be reported by funds starting next year and publish analysis based on empirical data regarding their use of derivatives.

Exchange Traded Funds

Since the introduction of ETFs in 1993, investor interest has continued to grow.⁹⁰ Although early ETFs tracked only broad-based U.S. equity indexes, ETFs are now available to investors in many asset classes.⁹¹ The large variety of ETFs enables an investor to easily hold a diversified investment portfolio, customized to the investor's risk tolerance. Many ETFs have lower expense ratios and may be more tax efficient than traditional mutual funds, features that can be attractive to investors.

Given their growing market share and expanding diversity of products offerings, ETFs broaden the array of choices available to investors. Unlike mutual funds, ETFs trade like stocks on a stock exchange, and the price of the ETF changes throughout the day. The purchase and sale of individual ETF shares in the market are similar to the purchase and sale of single stocks, and the market price of the shares varies during the trading day due to various factors, including the underlying prices of the ETF's assets and the demand for the ETF. ETFs can be actively or passively managed. ETFs do not issue or redeem their shares at a NAV; instead, they issue and redeem large blocks of shares called creation units, with authorized participants, while other investors pay the ETF market price.

89. Investment Company Reporting Modernization (Oct. 13, 2016) [81 Fed. Reg. 81870 (Nov. 18, 2016)].

90. This discussion focuses on ETFs that are registered investment companies. Other exchange traded products involve pooled investment vehicles that are not registered under the '40 Act, because they invest in precious metals, futures, or derivative contracts, or other assets not constituting securities. In addition, financial institutions may issue exchange-traded notes, which are senior debt instruments whose returns are based on reference assets, but are not pooled investment vehicles. See Request for Comment on Exchange-Traded Products (June 12, 2015) [80 Fed. Reg. 34729 (June 17, 2015)] ("ETF Request for Comment").

91. ICI Fact Book, at 59.

ETF sponsors enter into contractual relationships with financial institutions known as authorized participants. Only authorized participants may purchase and redeem shares directly from the ETF, and they do so only in creation units, which generally hold 25,000 to 200,000 ETF shares. To purchase a creation unit, an authorized participant deposits a basket of securities and other assets (a “purchase basket”) with the ETF. The authorized participant receives the creation unit in return for the purchase basket, and can hold or split up the creation unit and sell the ETF shares in the secondary market. To redeem, the authorized participant acquires a large block of the ETF shares on the secondary market and delivers the shares to the ETF. In return, the ETF typically provides a basket of certain securities and other assets (a “redemption basket”) to the authorized participant. The makeup of purchase and redemption baskets is identified daily by the ETF, generally reflects the ETF’s portfolio holdings, and equals the aggregate NAV of the ETF shares comprising a creation unit.

Arbitrage plays an important role in the purchase and redemption of ETFs. An ETF’s market price fluctuates during the trading day, so the intraday market price might not equal the fund’s NAV at the end of the day. Thus, authorized participants have economic incentives to reduce the difference between the intraday market price and the NAV, because they can trade directly with the ETF at the NAV as well as on the market. As a result, the market value of the ETF moves back in line with the ETF’s NAV per share, so other investors are able to buy ETF shares at a price closer to the ETF’s NAV per share.

The ETF arbitrage mechanism depends in part on the transparency of the ETF’s portfolio and the liquidity of the underlying securities. Transparency of the ETF portfolio facilitates the arbitrage mechanism by assisting authorized participants in deciding whether to purchase or redeem creation units based on the relative values of ETF shares in the secondary market and the securities comprising the ETF portfolio. The liquidity of securities comprising an ETF’s portfolio facilitates the arbitrage mechanism because arbitrageurs must be readily able to purchase and sell the securities comprising the purchase and redemption baskets.

Regulation of ETFs

For an ETF to begin trading on a national exchange, the ETF must first file an application with the SEC to obtain an exemptive relief order, which exempts the ETF from certain provisions of the ’40 Act and other SEC rules. As of the end of 2016, the total number of ETFs in the marketplace had grown to more than 1,700,⁹² and exemptive relief orders apply to each ETF.

The exemptive relief process can involve significant time and expense in addition to the expense of creating a new ETF, including registering the fund as an investment company and registering the offering of its securities under the Securities Act. Depending on the particular ETF, some exemptive relief orders have unique provisions and require additional scrutiny. To the extent that an ETF requires a change in exchange listing standards, a separate rule change process is required and handled by the SEC’s Division of Trading and Markets in addition to the exemptive relief order

92. *Id.*

process managed by the SEC's Division of Investment Management.⁹³ These divisions within the SEC, which administer different underlying statutes, can apply different criteria and requirements in obtaining approvals, which can also change over time.

The SEC proposed a rule in 2008 to streamline this unpredictable, lengthy, and expensive ETF approval process. The 2008 rule would have generally codified the exemptive relief orders previously issued by the SEC and would have permitted new ETFs to operate without obtaining exemptive relief orders under specified conditions.⁹⁴ The rule would have limited actively managed ETFs to those that provide portfolio transparency to market participants, thereby promoting an effective arbitrage mechanism and reducing significant premiums and discounts in secondary market transactions. Under the proposed rule, actively managed ETFs would have been permitted to continue to seek exemptive order relief through applications to the SEC.⁹⁵ This proposal was never finalized by the SEC.

The proposed rule would have permitted ETFs to operate without exemptive relief orders from the following provisions of the '40 Act:

- **Issuance of “redeemable securities”:** The rule would provide exemptive relief from Sections 2(a)(32) and 5(a)(1) of the '40 Act,⁹⁶ allowing ETFs to register as open-end investment companies despite limiting redemptions solely to creation units while excluding individual ETF shares.
- **Trading of ETF shares at negotiated prices:** The rule would provide exemptive relief from Section 22(d) of the '40 Act⁹⁷ and Rule 22c-1⁹⁸ thereunder. This would allow ETF shares to be purchased and sold at market prices in secondary market transactions and not at a price listed in a prospectus or based on the NAV.
- **In-kind transactions between ETFs and affiliates:** The rule would provide exemptive relief from Section 17(a)(1) and Section 17(a)(2) of the '40 Act,⁹⁹ allowing certain affiliated entities of an ETF (including but not limited to entities that own more than 5% of its voting securities) the ability to purchase and redeem creation units through in-kind transactions.

93. 17 C.F.R. § 240.19b-4. Certain ETFs are eligible for under generic listing standards previously approved for an exchange. In such situations, only a notice is required to be filed with the SEC within five business days after commencement of trading. See ETF Request for Comment, 80 Fed. Reg. at 34737-38.

94. Exchange-Traded Funds (Mar. 11, 2008) [73 Fed. Reg. 14618 (Mar. 18, 2008)].

95. At the same time, the SEC proposed Rule 12d1-4, which codified much of the anti-pyramiding exemptive relief generally obtained by ETFs, but eliminated many of the conditions imposed in previously issued exemptive orders and would have allowed investment companies to invest in ETFs in excess of the current limits imposed by the '40 Act. *Id.*

96. 15 U.S.C. §§ 80a-2(a)(32) and 80a-5(a)(1).

97. 15 U.S.C. § 80a-22(d).

98. 17 C.F.R. § 270.22c-1.

99. 15 U.S.C. § 80a-17(a)(1) and (a)(2).

- **Additional time for delivering redemption proceeds:** The rule would provide exemptive relief from Section 22(e) of the '40 Act,¹⁰⁰ allowing an ETF that includes foreign securities in its redemption basket for a period not exceeding 12 days, upon the tender of a creation unit for redemption.

ETFs relying on the proposed rule would have been required to adhere to the following conditions, which were designed to be consistent with the '40 Act and preserve investor protections:

- **Transparency of index and portfolio holdings:** The ETF would either need to disclose on its website the identities and weightings of the component securities and other assets held by that ETF, or have a stated investment objective of obtaining investment returns that correspond to the returns of a securities index. The ETF's disclosures must be accessible by the public and free of charge. Intraday changes to portfolio holdings or advance notice of portfolio trades would not be required.
- **Listing of ETF shares on a national securities exchange and dissemination of the intraday value of purchase and redemption baskets:** The ETF shares would need to be approved for listing and trading on a national securities exchange, which discloses at regular intervals and during the trading day the intraday value of the securities comprising the purchase and redemption baskets, calculated on a per-share basis.
- **Marketing of ETF shares:** ETFs under this rule would be required to identify themselves in any sales literature as ETFs and explain that they neither sell nor redeem individual ETF shares. ETFs would also need to disclose the prior business day's NAV and the closing market price of ETF shares in secondary market transactions, as well as other data.

Recommendations

Treasury recommends that the SEC move forward with a “plain vanilla” ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders, subject to conditions the SEC determines appropriate and in the public interest. To this end, the SEC should either re-propose or propose a new rule on ETFs for public comment.

Adopting a plain vanilla ETF rule would not only reduce cost and delay for new entrants, it would also enable ETF sponsors to avoid the potential for costly updates to existing exemptive relief orders when introducing new products, and help reduce uneven treatment between ETFs. Likewise, a plain vanilla ETF rule would enable the SEC staff to focus efforts on more novel and more difficult ETF exemptive relief applications and timely responses to these requests.

Additionally, to streamline the ETF process and reduce inefficiency, the SEC should consider establishing a single process for ETF and related approvals rather than allowing SEC divisions to set multiple and sometimes conflicting requirements.

Business Continuity and Transition Planning

Business continuity planning plays an important role in allowing investment companies and investment advisers to operate during times of disruption. These plans outline how investment advisers

100. 15 U.S.C. § 80a-22(e).

would minimize investor impact in the event of a major disruption. For example, such plans may designate alternate work sites in case of a natural disaster or other disturbance. Disruptive events can include natural disasters, cyberattacks, acts of terrorism, technology failures, and departures or unavailability of key employees. Business continuity planning helps to ensure that critical functions and activities can continue to operate in adverse conditions; it can also mitigate negative effects and facilitate a return to normal operations.

As the SEC staff has observed, fund complexes and their service providers have developed and continually improved their business continuity plans for decades.¹⁰¹ These efforts have been tested in recent times, during the terrorist attacks on September 11, 2001, natural disasters such as Hurricane Katrina in 2005 and Hurricane Sandy in 2012, and the economic disruptions of the financial crisis, which included the rapid and unexpected exit of major market participants.

According to the SEC, investment advisers, both during routine times as well as during non-routine disruptions, generally transition client accounts without a significant impact to themselves, their clients, or the financial markets.¹⁰² This can be attributed to the agency relationship of advisers managing the assets on behalf of their clients and the custody and asset segregation requirements of the '40 Act and the Advisers Act and the SEC rules thereunder.¹⁰³ As a result, transitioning accounts from one adviser to another is largely a streamlined process that may not even involve the legal transfer or sale of assets.¹⁰⁴

Business continuity plans have long been required under investment advisers' general fiduciary obligations to investors.¹⁰⁵ The SEC in 2003 adopted Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the '40 Act to require investment advisers and investment companies to maintain business continuity plans as part of their compliance policies and procedures.¹⁰⁶ These rules require investment advisers and funds to adopt and implement written compliance policies and procedures, including business continuity plans to the extent they are relevant. As principles-based rules, they provide investment advisers and investment companies with flexibility to implement a business continuity plan appropriate for that particular entity. Since then, the SEC staff has provided continued guidance on business continuity planning. The SEC staff has examined fund complexes and their critical service providers' business continuity plans and capabilities following disruptive events, and published their findings and guidance in 2016.¹⁰⁷ The SEC examination

101. Division of Investment Management, U.S. Securities and Exchange Commission, *IM Guidance Update 2016-04, Business Continuity Planning for Registered Investment Companies* (June 2016), available at: <https://www.sec.gov/investment/im-guidance-2016-04.pdf>.

102. Adviser Business Continuity and Transition Plans (June 28, 2016) [81 Fed. Reg. 43530, 43535 (July 5, 2016)] ("Business Continuity Proposing Release").

103. See 15 U.S.C. § 80a-17(f); 15 U.S.C. § 80b-18b.

104. Business Continuity Proposing Release, 81 Fed. Reg. at 43535.

105. See Compliance Programs of Investment Companies and Investment Advisers (Dec. 17, 2003) [68 Fed. Reg. 74714, 74716 (Dec. 24, 2003)] ("Compliance Rules Release").

106. *Id.*

107. Division of Investment Management, U.S. Securities and Exchange Commission, *Guidance Update - Business Continuity Planning for Registered Investment Companies* (June 2016), available at: www.sec.gov/investment/im-guidance-2016-04.pdf.

staff published observations after reviewing investment advisers' business continuity plans in the aftermath of Hurricane Sandy in August 2013.¹⁰⁸ Also in August 2013, the CFTC staff, SEC staff, and FINRA published best practices and lessons learned from Hurricane Sandy in relation to business continuity plans.¹⁰⁹

In June 2016, the SEC proposed a new Rule 206(4)-4 under the Advisers Act that would require registered investment advisers to adopt and implement written business continuity and transition plans “reasonably designed to address operational and other risks related to a significant disruption in the investment adviser’s operations.”¹¹⁰ The rule has not been finalized. The proposed rule would require policies and procedures concerning: (1) business continuity after a significant business disruption, and (2) business transition in the event the investment adviser is unable to continue providing investment advisory services to clients.¹¹¹ The proposed rule contains a number of prescriptive requirements for the content of business continuity and transition plans.¹¹²

In proposing the rule, the SEC cited concerns that business continuity planning was inconsistent among investment advisers and, in some instances, not sufficiently robust. The costs of compliance with the proposed rule could be significant. The SEC estimated that each registered investment adviser would initially spend between \$11,000 and \$1.3 million to upgrade systems and comply with other provisions of the proposed rule, and approximately 25% of those amounts for maintenance each subsequent year. These costs would not only be borne by the 12,000 investment advisers currently in operation, but also ultimately their clients, as the costs are likely to be passed on by the advisers.

Recommendations

Treasury strongly endorses the principle of effective and robust business continuity planning by investment advisers and investment companies. With the existing principles-based rule already in place, there is no compelling need for additional rulemaking in this area. Treasury recommends that the current SEC proposal be withdrawn.

Treasury further recommends that the SEC and its staff continue to work with investment companies, investment advisers, and other relevant parties to recommend improvements to their business continuity plans, to the extent that such plans are determined not to be sufficiently robust, and to address new issues as they arise.

108. Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *National Exam Program Risk Alert* (Aug. 27, 2013), available at: <https://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf>.

109. CFTC Division of Swap Dealers and Intermediary Oversight, SEC National Examination Program, and FINRA, *Joint Observations of Business Continuity Planning* (Aug. 2013), available at: <https://www.sec.gov/about/offices/ocie/jointobservations-bcps08072013.pdf>.

110. Business Continuity Proposing Release, 81 Fed. Reg. at 43530.

111. *Id.* at 43537.

112. *Id.* at 43534-35.

Money Market Mutual Fund Reform

A money market mutual fund (MMMF) is a type of open-end investment company that seeks to maintain a stable NAV of \$1 per share.¹¹³ MMMFs invest in short duration, low risk securities such as U.S Treasuries and high quality commercial paper to provide investors with liquidity and higher returns than can otherwise be found in other cash equivalent investments. The combination of principal stability, liquidity, and competitive yields has made MMMFs popular with retail and institutional investors as a cash management vehicle.

MMMFs were first established in the early 1970s as a solution to the Federal Reserve's then-Regulation Q, which at the time prohibited bank demand deposits from paying interest and capped the rate of interest on other types of bank accounts at 5.25%.¹¹⁴ MMMFs are typically used by investors seeking short-term, liquid, and cash-like investments with the potential for some incremental yield relative to cash held at a bank.

During the fall of 2008, many MMMFs experienced large-scale redemptions and other money market funds saw reduced liquidity for the securities of otherwise credit-worthy issuers.¹¹⁵ Due to illiquidity concerns across the market, some MMMFs were not able to satisfy investor redemption requests. In September 2008, the Reserve Primary Fund's exposure to Lehman Brothers led the fund to "break the buck," or fall below the value of \$1 per share.

The federal government subsequently intervened in the money market, specifically through the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. The facility was introduced to help MMMFs that held asset-backed commercial paper (ABCP) meet investors' demands for redemptions, and to foster liquidity in the ABCP market and money market mutual funds more generally.

In addition, in September 2008, Treasury established a Temporary Guarantee Program for Money Market Funds to guarantee the share price of any publicly offered eligible MMMF that applied to and paid a fee for participation in the program.¹¹⁶ The program was designed to address temporary dislocations in the credit markets. President Bush approved Treasury's use of the assets of the Exchange Stabilization Fund to guarantee payments under the program.¹¹⁷

In 2010, the SEC undertook a series of reforms to Rule 2a-7, which governs MMMFs. The reforms included: (1) daily and weekly liquidity minimums of 10% and 30% of total assets respectively, (2) general liquidity requirements, which require portfolio managers to determine

113. See <https://www.federalreserve.gov/regreform/reform-glossary.htm> (money-market mutual fund).

114. Investment Company Institute, *Report of the Money Market Working Group* (Mar. 17, 2009), at 21, available at: https://ici.org/pdf/ppr_09_mmwg.pdf.

115. Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission, *Responses to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (Nov. 30, 2012), at 7, available at: <https://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf> (noting that prime money market fund assets fell by 24%, or \$498 billion, during the period September 2, 2008 to October 7, 2008).

116. See U.S. Department of the Treasury, *Press Release* (Sept. 29, 2008), available at: <https://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx>.

117. *Id.* Section 131 of the Emergency Economic Stabilization Act of 2008, Public Law No. 110-343 (codified at 12 U.S.C. § 5236), subsequently limited the establishment of any future guaranty program for MMMFs.

whether they have additional liquidity needs beyond the rule's minimum requirements to meet reasonably foreseeable shareholder redemptions, (3) portfolio maturity limits of weighted average maturity of 60 days or less, and weighted average life of 120 days or less, (4) stress testing requirements, requiring funds to determine how they would perform in stressed market conditions, (5) portfolio holdings disclosure requirements for the funds to file a report with the SEC on a monthly basis, and (6) new Rule 22e-3, which permits fund boards to suspend redemptions and payment of redemption proceeds.¹¹⁸

In 2014, the SEC, following the issuance of proposed recommendations by the FSOC, undertook additional reforms, the pillar of which requires “prime” (non-government) institutional MMMFs to float the NAV of their shares instead of letting the funds maintain the stable \$1 NAV per share. In addition, boards of directors were given discretion to lower “gates” on redemptions, or charge fees of up to 2% if market stress causes a fund's weekly liquid assets to fall below 30%. Retail and government MMMFs were exempted from the rule.¹¹⁹ The compliance date for the floating NAV requirement and liquidity fees and gates was October 14, 2016.

By October 31, 2016, prime and tax-exempt MMMFs experienced a decrease in assets of \$1 trillion since the beginning of the year, and government MMMFs saw an increase in assets of \$968 billion during the same period.¹²⁰

Dual SEC and CFTC Registration

In 2012, the CFTC adopted rules that required certain investment companies and investment advisers to register with the CFTC as commodity pool operators (CPOs), even if already required to register with the SEC.¹²¹ Commodity pools are collective investment vehicles designed to trade in commodity interests, including futures, options on futures, retail foreign exchange transactions, and swaps.

Registered Investment Companies

Prior to the 2012 CFTC amendments, investment companies registered with the SEC, and their principals or employees, were effectively exempt from the CFTC's definition of CPOs. The 2012 amendments, however, narrowed the universe of SEC-registered investment companies and their advisers that could be exempt from the CPO definition to funds whose commodity transactions (other than for bona fide hedging purposes) do not require aggregate initial margin and premiums in excess of 5% of their portfolio's liquidation value, and where the aggregate net notional value of commodity transactions does not exceed 100%.¹²² Under the 2012 amendments, SEC-registered investment companies must also refrain from marketing themselves as vehicles for trading in the

118. Money Market Fund Reform (Feb. 23, 2010) [75 Fed. Reg. 10060 (Mar. 4, 2010)].

119. Money Market Fund Reform; Amendments to Form PF (July 23, 2014) [79 Fed. Reg. 47736 (Aug. 14, 2014)].

120. Division of Investment Management, U.S. Securities and Exchange Commission, *Money Market Fund Statistics* (Aug. 18, 2017), at 4, available at: <https://www.sec.gov/divisions/investment/mmf-statistics/mmf-statistics-2017-7.pdf>.

121. Commodity Pool Operators and Compliance Trading Advisors: Compliance Obligations (Feb. 8, 2012) [77 Fed. Reg. 11252 (Feb. 24, 2012)] (“CPO/CTA Compliance Obligations”).

122. 17 C.F.R. § 4.5

commodity futures, commodity options, or swaps markets to qualify for exemption from the CPO definition.

The CFTC took action in this area in response to a petition filed by the National Futures Association (NFA). The CFTC said one reason for promulgating the amendments was that certain SEC-registered investment companies were offering “de facto” commodity pools while claiming an exemption under the Commodity Exchange Act (CEA).¹²³ In its petition to the CFTC, the NFA expressed concern that three SEC-registered investment companies were being marketed to retail customers as commodity futures investments, but were not subject to CFTC and NFA regulation.¹²⁴ In response to public comment that many SEC-registered funds would be swept into the CPO definition under the amendments, the CFTC stated that its oversight of these investment companies was necessary despite the fact that they were already registered with the SEC.¹²⁵

According to the Investment Company Institute, as of early 2016, 101 advisers to SEC-registered investment companies were required to dually register with the CFTC after the amendments and be subject to separate reporting and regulatory obligations imposed by the CFTC and NFA. Even though the CFTC presented the de facto commodity pool issue as one of the principal reasons for its 2012 amendments, the CFTC’s expanded jurisdiction now captures many funds that do not resemble, or compete with, traditional commodity pools.¹²⁶ These funds must comply with the separate regulatory regime administered by the CFTC and NFA, including obligations for disclosure, shareholder reports, financial statements, recordkeeping, and periodic reports under the CEA. Although the CFTC provided limited relief to investment companies subject to dual registration and regulation by the SEC and CFTC, funds and their advisers must still demonstrate compliance with the conditions of such exemptions.¹²⁷

Recommendations

Treasury recommends amending the CFTC rules so an investment company registered with the SEC and its adviser are exempt from dual registration and regulation by the CFTC as a CPO. To address concerns of de facto commodity pools operating without sufficient oversight, the CFTC and the SEC should work together to identify a single regulator for these entities, with the goal that oversight of these entities will either remain with the SEC or be transferred to the CFTC

123. CPO/CTA Compliance Obligations, at 11254.

124. Letter from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David Stawick, Office of the Secretariat, CFTC (Aug. 18, 2010), available at: <https://www.nfa.futures.org/news/newsPetition.asp?ArticleID=3630>.

125. CPO/CTA Compliance Obligations, 77 Fed. Reg. at 11254.

126. The ICI indicated that the 101 investment advisers served approximately 500 funds that were no longer eligible for the CPO exclusion.

127. Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators (Aug. 12, 2013) [78 Fed. Reg. 52,308 (Aug. 22, 2013)]. For example, for relief under certain exemptions, the CFTC can make its own independent assessment as to whether disclosures from a registered investment company satisfy its obligations under the federal securities laws as well as any informal SEC staff guidance. See 17 U.S.C. § 4.12(c). In 2017, the CFTC updated its recordkeeping requirements under the CEA, including amendments that would provide better alignment of CFTC provisions with SEC provisions, but the separate CFTC regulatory structure remains for dually registered entities. See Recordkeeping (May 23, 2017) [82 Fed. Reg. 24479 (May 30, 2017)].

and NFA. Treasury further recommends that the CFTC and the SEC cooperate to share information provided by their respective regulated entities so disclosures made to one agency can address the information needs of the other agency to monitor the markets for securities and derivatives transactions.¹²⁸

Advisers to Private Funds

Advisers to private funds are now generally subject to SEC oversight, after Title IV of Dodd-Frank eliminated the applicable exemption from registration under the '40 Act for such advisers.¹²⁹ After the 2012 amendments, certain advisers to private funds are also required to register with the CFTC as CPOs. Specifically, if private funds are offered to investors who are “qualified eligible persons” or accredited investors under the SEC’s Regulation D, both the funds and their advisers must register with the CFTC as CPOs.¹³⁰ As a result, certain advisers to private funds are required to register with the SEC as an investment adviser and also register with the CFTC as CPOs.

By comparison, the regulatory treatment of investment advisers that could potentially be categorized as commodity trading advisors (CTAs) is less onerous, and includes provisions designed to prevent dual registration requirements with not only the SEC, but also with the CFTC as CTAs. Dodd-Frank contained provisions stating that SEC-registered investment advisers are not required to register with the CFTC as CTAs if they are not advising commodity pools engaged primarily in trading commodity interests. Conversely, a CFTC-registered CTA is not required to register with the SEC as an investment adviser, unless its predominant business is giving securities-related advice.¹³¹ Dodd-Frank did not include similar provisions designed to prevent dual registration requirements for CPOs.

Under the 2012 CFTC rule, many private fund advisers are required to dually register with the SEC as investment advisers and the CFTC as CPOs. In the 2012 rulemaking, the CFTC rejected commenter suggestions to provide a limited exemption from the CPO registration requirement for SEC-registered investment advisers that are not primarily engaged in trading commodity interests, finding that dual registration was “not irreconcilable” with Dodd-Frank.¹³² The CFTC provided no analysis of why SEC regulation of investment advisers was inadequate and merely responded that “regulation is necessary to ensure a well-functioning market and to provide investor protection.”¹³³

Thus, absent the availability of a different exemption such as the de minimis exemption, advisers to private funds are subject to dual registration with the SEC as investment advisers and the CFTC as CPOs, and must comply with the separate regulatory regime under the CFTC and NFA.

128. This recommendation also applies with respect to private fund advisers.

129. See Dodd-Frank § 403.

130. CPO/CTA Compliance Obligations, 77 Fed. Reg. at 11264. The CFTC retained a de minimis exemption for entities with less than 5% exposure to commodity interests. *Id.* at 11261.

131. Dodd-Frank §§ 403 and 749.

132. CPO/CTA Compliance Obligations, 77 Fed. Reg. at 11261-62.

133. *Id.* at 11262.

Recommendations

Treasury recommends amendments to the CFTC rules that would exempt private funds and their advisers from registration as CPOs if the advisers are subject to regulatory oversight by the SEC. Treasury also recommends that the CFTC review and determine what, if any, exemptions should be made available for SEC-exempt reporting advisers.

Modernizing the Delivery of Registered Fund Disclosures

The Securities Act, the Exchange Act, and the '40 Act impose an extensive set of disclosure requirements on registered investment companies so that investors can make informed investment decisions.¹³⁴ For example, when purchasing shares of a mutual fund, an investor must be provided with a prospectus that contains information about the fund's objectives, fees and expenses, performance, investment strategies, risk factors, performance, and management.¹³⁵ Mutual funds, ETFs, and closed-end funds are required to send a semiannual report to investors, which contains updated financial information, a list of the fund's portfolio securities, and other information.¹³⁶ The regulatory default is to provide these disclosures in paper by mail unless consent has been obtained for electronic delivery. Unfortunately, paper disclosures are often discarded by fund shareholders.¹³⁷ Delivering these disclosures in paper comes at a significant expense, which are paid out of fund assets.

Promoting transparency in financial markets and providing appropriate disclosure is a fundamental part of investor protection. Transparency of fund information remains critical to a dynamic asset management industry and investor trust and well-being. However, regulatory requirements must adapt appropriately to advances in technology and increased access to the Internet across the United States. As shown in Figure 7, 84% of U.S. adults have access to the Internet,¹³⁸ and 92% of all mutual fund-owning households have access.¹³⁹

134. See, e.g., 15 U.S.C. §§ 77e(b), 78m(a), 78o(d), and 80a-29.

135. See, e.g., Form N-1A, 17 C.F.R. §§ 239.15A and 274.11A.

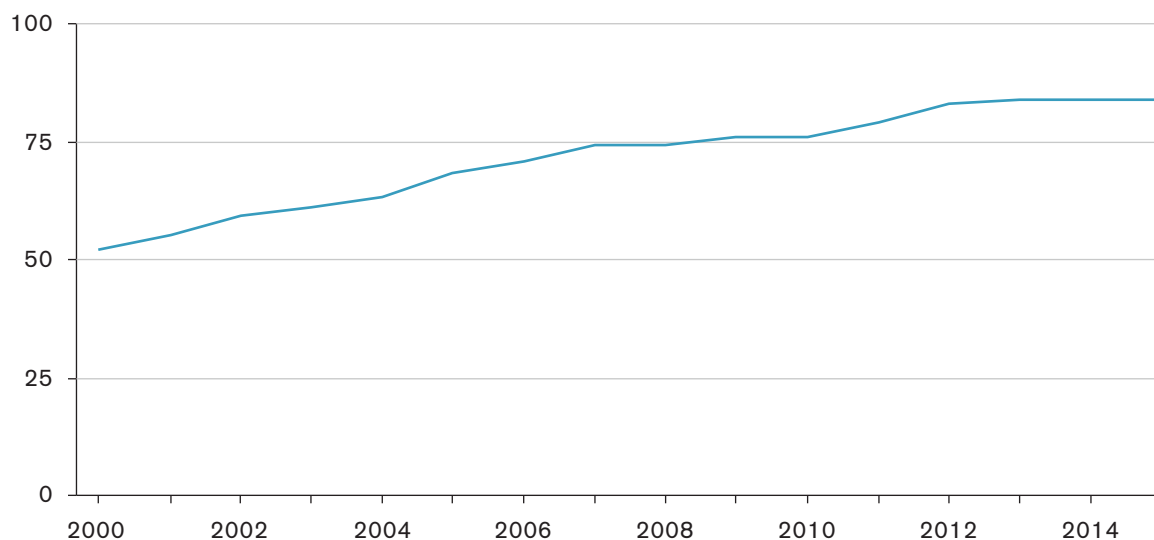
136. 17 C.F.R. §§ 270.30e-1 and 270.30e-2.

137. Office of Investor Education and Advocacy, U.S. Securities and Exchange Commission, *Mandatory Disclosure Documents Telephone Survey* (July 30, 2008), at 78, available at: https://www.sec.gov/pdf/disclosure_docs.pdf (finding that 50% never, very rarely, or rarely read fund shareholder reports).

138. Andrew Perrin and Maeve Duggan, Pew Research Center, *Americans' Internet Access: 2000-2015* (June 26, 2015), available at: <http://www.pewinternet.org/2015/06/26/americans-internet-access-2000-2015/>.

139. ICI Fact Book, at 129.

Figure 7: American Adults Who Use the Internet: 2000-2015 (percent)



Source: Pew Research Center surveys

In 2009, the SEC amended its rules to provide mutual funds with a new option for satisfying prospectus delivery obligations.¹⁴⁰ Under the rule, a fund could give key information to investors in a summary prospectus and post the complete statutory prospectus, the statement of additional information, and the two most recent shareholder reports on a website.¹⁴¹ Funds that elect to use a summary prospectus must send the statutory prospectus to the investor upon request. According to SEC staff, the vast majority of funds now use a summary prospectus.

In May 2015, the SEC proposed Rule 30e-3 under the '40 Act that would permit a mutual fund to transmit shareholder reports through a website.¹⁴² A fund relying on the proposed rule would be required to comply with certain conditions, including making the shareholder report and other information publicly accessible and free of charge on a website, providing notice to shareholders of the availability of the shareholder report online, and allowing shareholders to request paper copies by mail. The website materials must be presented in a format convenient for reading online and printing on paper and permit a person to retain an electronic version. Most notably, the proposed rule would permit the use of implied consent to delivery by website in the absence of further instruction from the shareholder. The rule has not been finalized by the SEC.

140. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies (Jan. 13, 2009) [74 Fed. Reg. 4546 (Jan. 26, 2009)].

141. 17 C.F.R. § 230.498.

142. Investment Company Reporting Modernization (May 20, 2015) [80 Fed. Reg. 33590 (June 12, 2015)].

The delivery of fund reports and other materials by electronic means, such as a website, would enable significant cost savings. Electronic delivery could also enable a greater level of detail and information to reach investors through an online platform that would likely enhance the user experience and provide greater educational value for investors. For fund shareholder reports alone, such a change could save investors up to \$2 billion over the next 10 years while reducing significant environmental waste.¹⁴³

Recommendations

Treasury recommends that the SEC finalize its proposed rule to modernize its shareholder report disclosure requirements and permit the use of implied consent for electronic disclosures. The SEC should explore other areas for which the delivery of information to investors through an electronic medium using implied consent is appropriate and consistent with investor protection. As part of this effort, Treasury encourages consideration of innovative uses of new technology to enhance the delivery of information to fund investors.

Notwithstanding the benefits of electronic delivery, Treasury recognizes that not all persons have access to the Internet. In addition, some investors will prefer to receive their disclosures in paper rather than electronically. Consistent with the Core Principles, Treasury strongly believes that investors should retain the choice to continue receiving paper disclosures.

Asset Management Reporting and Disclosure Requirements

Ensuring the prudent, efficient, and effective collection of data by financial regulators is critical to their role of overseeing the financial markets. The asset management industry is subject to a significant number of reporting obligations, which provide regulatory and public transparency into their activities.

Reporting obligations are imposed both at the asset manager level and the fund level. These obligations come from a variety of sources, including the securities laws, the derivatives laws, and SRO rules.

Investment advisers must report certain information on Form ADV to register with either the SEC or the states, and once registered, must update the form annually.¹⁴⁴ In 2016, the SEC adopted amendments to Form ADV, which included enhanced disclosure requirements on separately managed accounts advised by asset managers.¹⁴⁵ Investment advisers to private funds also need to provide information on Form PF.¹⁴⁶ Form PF contains specific disclosure requirements for large hedge fund advisers, large liquidity fund advisers, and large private equity advisers. If the registered investment adviser is also a publicly traded company, the adviser will have additional reporting

143. ICI Viewpoints, *The SEC's Online-Delivery Gift to Fund Shareholders* (Apr. 4, 2016), available at: https://www.ici.org/viewpoints/view_16_sec_shareholder_gift.

144. 15 U.S.C. § 80b-3(c); 17 C.F.R. § 275.204-1.

145. Form ADV and Investment Adviser Act Rules (Aug. 25, 2016) [81 Fed. Reg. 60418 (Sept. 1, 2016)].

146. 17 C.F.R. § 275.204(b)-1.

obligations under the federal securities laws to file audited financial statements and other information with the SEC.¹⁴⁷

Registered investment companies are subject to many ongoing disclosure requirements. Mutual funds, which are engaged in a continuous offering, must update their prospectuses and registration statements on an annual basis.¹⁴⁸ Funds other than MMMFs are required to report portfolio holdings on a quarterly basis.¹⁴⁹ The portfolio holdings data will be significantly enhanced by recently adopted Form N-PORT, which will require reporting on a monthly basis once it becomes effective.¹⁵⁰ In addition, funds will be required to report aggregate purchase and sales of fund shares on Form N-PORT.¹⁵¹ As part of its rulemaking to modernize fund reporting, the SEC introduced an annual requirement to provide census-like information on a new form, Form N-CEN. Registered investment companies are required to report their proxy voting record through Form N-PX on an annual basis.¹⁵²

The SEC requires MMMFs to disclose information pursuant to a specially tailored reporting regime.¹⁵³ The SEC requires MMMFs to report their portfolio holdings monthly and to publicly disclose monthly holdings on the fund's website.¹⁵⁴ MMMFs also have a requirement to report to the SEC within one business day after the occurrence of a material event, such as a default, insolvency of a portfolio security, or imposition of liquidity fees.¹⁵⁵

Asset managers and investment companies are subject to reporting obligations that generally apply to any market participant. Funds must report significant stakes in public companies by filing Schedule 13D or 13G.¹⁵⁶ Asset managers, registered investment companies, and private funds may also be required to file Form 13H under the large trader reporting rules.¹⁵⁷ Asset managers who exercise investment discretion over at least \$100 million in equity securities traded on national securities exchanges must report positions quarterly on Schedule 13F.¹⁵⁸

Asset managers who are commodity pool operators or commodity trading advisers have additional reporting obligations. CPOs and CTAs register with the CFTC through the National Futures Association, an SRO.¹⁵⁹ Although Form PF is a joint form for investment advisers to private funds,

147. See 15 U.S.C. §§ 78(m) and 78o(d) and rules thereunder.

148. 15 U.S.C. § 77j(a)(3).

149. Registered investment companies are required to disclose publicly their schedule of investments on Form N-Q after the first and third quarters of their fiscal year and on Form N-CSR after the second and fourth quarters of their fiscal year.

150. Investment Company Reporting Modernization (Oct. 13, 2016) [81 Fed. Reg. 81870 (Dec. 18, 2016)].

151. *Id.*

152. 17 C.F.R. § 270.30b1-4.

153. Money Market Fund Reform (Feb. 23, 2010) [75 Fed. Reg. 10060 (Mar. 4, 2010)].

154. 17 C.F.R. §§ 270.30b1-7 and 270.2a-7(h)(10).

155. 17 C.F.R. § 270.30b1-8.

156. 17 C.F.R. § 240.13d-1.

157. See Large Trader Reporting (July 27, 2011) [76 Fed. Reg. 46960 (Aug. 3, 2011)].

158. 17 C.F.R. § 240.13f-1.

159. See <https://www.nfa.futures.org/registration-membership/who-has-to-register/index.html>.

CPOs, and CTAs, asset managers have asserted that under some circumstances they must still make reports on Forms CPO-PQR, CTA-PR, PQR, and PR. To the extent that the asset manager is filing SEC reports on the same pooled investment vehicle, there may be some duplication. The SEC, CFTC, and NFA have undertaken efforts to harmonize reporting obligations, but in outreach meetings with Treasury, asset managers indicated that differences remained in reporting with respect to definitional terms, methodologies, and timing.

Duplicative reporting requirements can add considerable burden and costs to funds that are passed on to investors. Reporting requirements can be particularly challenging to the extent that an asset manager serves as investment adviser to mutual funds, ETFs, private funds, and separately managed accounts. With new reporting requirements, asset managers and funds are working toward meeting reporting deadlines, but are faced with time-consuming operational complexities of integrating and developing new systems to pull information from different sources, coordinating with third party service providers, and testing to ensure that information is accurate.

Among the more troubling aspects of reporting are multiple types of required reporting formats that essentially request the same information, but in a slightly different manner or based on different timing, for example, when some reports are based on calendar year while others use fiscal year. The cumulative effect of these duplicative and onerous regulatory requirements serves to artificially inflate costs, which are passed on to the individual investor. Cost of reporting requirements also serve as barriers to entry for new competitors, thereby depriving investors of more choices.

Recommendations

Treasury strongly endorses the principle of transparency and investor protection as it pertains to the asset management industry and financial markets more broadly. Thorough reporting of fund holdings and other key financial data is essential to a well-functioning financial system.

However, given the immense data reporting requirements added over the past few years, the SEC, the CFTC, SROs, and other regulators should work together to rationalize and harmonize the reporting regimes. Where possible, duplicative forms should be combined and any unnecessary or inconsistent data collection should be eliminated. Treasury recommends that regulators continue to update reporting requirements to utilize structured data where appropriate.

Information Security

Information security and protection is of paramount importance in an increasingly digital global financial system. The collection of data by federal agencies and regulators into a single system or data repository administered by one or multiple entities can raise serious information security concerns if not adequately protected. A security breach could expose firms or funds in the asset management industry to predatory trading practices or the replication of proprietary fund investment strategies, among other concerns. A security breach also has the potential to result in material loss of value for shareholders and individual investors in affected funds.

A Government Accountability Office (GAO) report released in July 2017 noted that the SEC “improved the security controls over its key financial systems and information” from a previous GAO audit but had not fully implemented prior GAO recommendations focused on protecting fund information and the systems and networks in which that data is administered. Furthermore, GAO uncovered additional data security control deficiencies impacting the “confidentiality, integrity, and availability of its information systems.”¹⁶⁰

Cybersecurity intrusions to non-public information maintained by federal financial regulators have already occurred. In September 2017, the SEC announced that a software vulnerability in the test filing component of its EDGAR system was exploited and resulted in access to non-public information, which may have provided the basis for illicit gains through trading.¹⁶¹

Treasury recommends that all regulatory agencies that collect any form of data from registered firms in the asset management industry redouble efforts to ensure the information security measures are meeting and exceeding standards set by Congress and the recommendations of other federal oversight bodies such as the GAO.

The Volcker Rule

Section 619 of Dodd-Frank is commonly referred to as the Volcker Rule. Five federal regulatory agencies are responsible for implementing the rule: the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), SEC, and CFTC. Treasury has a statutory role to coordinate the rulemaking. The Volcker Rule was discussed in detail in Treasury’s June 2017 Report published by Treasury on Banks and Credit Unions (Banking Report).

In the Banking Report, Treasury recommended substantial amendment to the Volcker Rule. Treasury recommended that the proprietary trading restrictions of the Volcker Rule not apply to banking entities with greater than \$10 billion in assets unless they exceed a threshold amount of trading assets and liabilities. Treasury also identified ways of reducing the complexity of the rule to decrease regulatory burden, such as simplifying the definition of proprietary trading and allowing banking entities to more easily hedge their risks and conduct market-making activities. Treasury

160. U.S. Government Accountability Office, *Information Security: SEC Improved Control of Financial Systems but Needs to Take Additional Actions* (July 2017).

161. Chairman Jay Clayton, *Statement on Cybersecurity* (Sept. 20, 2017), available at: <https://www.sec.gov/news/public-statement/statement-clayton-2017-09-20>.

also recommended changes to the compliance program requirements to decrease regulatory burden, and increased coordination among the five responsible regulatory agencies.

Some provisions of the Volcker Rule have a particular impact on the asset management industry. In the Banking Report, Treasury recommended modifying the covered fund provisions of the rule to decrease regulatory burden, including by refining the definition of “covered fund” and extending the seeding period exemption from one year to three years. Treasury further recommended that banking entities other than depository institutions and their holding companies should be permitted to share a name with funds they sponsor, provided that the separate identity of the fund is clearly disclosed to investors. Finally, the Volcker Rule’s application on affiliates and subsidiaries of “banking entities” is predicated on the Bank Holding Company Act’s definition of “control”, which may not be appropriate for certain funds.

Since the publication of Treasury’s Banking Report, the FSOC has considered potential improvements to the Volcker Rule;¹⁶² the three federal banking regulators announced that they would not take action under the Volcker Rule for certain foreign funds for one year;¹⁶³ the Federal Reserve issued new guidance on the procedures banking entities can follow to request extensions of the one-year seeding period for covered funds;¹⁶⁴ and the OCC issued a request for public comment on potential changes to the Volcker Rule.¹⁶⁵

Recommendations

Treasury recommends regulators take further action to reduce the burden of the Volcker Rule on asset managers and investors. The relevant agencies should continue to refrain from enforcing the Volcker Rule’s proprietary trading restrictions against foreign private funds that are not “covered funds” under the rule until a permanent solution to the identified challenges is implemented. The agencies should also forbear on enforcement of the restriction on funds sharing names with banking entities, consistent with the recommendation in Treasury’s Banking Report under Executive Order 13772. Treasury also recommends that Congress revise the definition of “banking entity” to encompass only insured depository institutions, their holding companies, foreign banking organizations, and affiliates and subsidiaries of such entities, defined as those in which there is 25% or more voting equity or voting power on the investment committee.¹⁶⁶

162. U.S. Department of the Treasury, *Press Release* (July 28, 2017), available at: <https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/7-28-17%20FSOC%20readout.pdf>.

163. *Joint Press Release* (July 21, 2017), available at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170721a.htm>.

164. Division of Supervision and Regulation, Board of Governors of the Federal Reserve System, *Procedures for a Banking Entity to Request an Extension of the One-Year Seeding Period for a Covered Fund* (July 24, 2017), available at: <https://www.federalreserve.gov/supervisionreg/srletters/sr1705.htm>.

165. Proprietary Trading and Certain Interests in and Relationships with Covered Funds (Volcker Rule); Request for Public Input (Aug. 1, 2017) [82 Fed. Reg. 36692 (Aug. 7, 2017)].

166. See 12 U.S.C. § 1841(a)(2)(A).

International Engagement

The United States features the most vibrant capital markets in the world. Fourteen of the 20 largest global asset managers, in terms of assets under management, are based in the United States, and the world's 20 largest mutual funds are managed by U.S. asset managers. Market-based intermediation through asset management entities enhances the efficiency, and contributes to the overall resilience, of the domestic and international financial systems. Because these successful U.S. businesses are multinational companies, appropriate regulatory cooperation across jurisdictions is vital to promote a global level playing field for these firms. The U.S. regulators and private sector participants are actively engaged in bilateral and multilateral forums to promote consistent regulatory standards across borders.

Figure 8: Top 50 Worldwide Mutual Funds, Money Market Funds, and Exchange-Traded Funds

Rank	Name	Domicile	Total Net Assets (\$ millions)
1	Vanguard Total Stock Market Index Fund	United States	596,476
2	Vanguard S&P 500 ETF Index Fund	United States	338,259
3	Vanguard Total International Stock Index Fund	United States	295,121
4	SPDR S&P 500 ETF	United States	242,542
5	Vanguard Institutional Index Fund	United States	229,582
6	Vanguard Total Bond Market Index Fund	United States	185,539
7	American Funds The Growth Fund of America	United States	167,278
8	American Funds EuroPacific Growth Fund	United States	149,890
9	JPMorgan U.S. Government Money Market Fund	United States	142,072
10	Vanguard Total Bond Market II Index Fund	United States	133,884
11	Fidelity Government Cash Reserves	United States	130,878
12	Fidelity 500 Index Fund	United States	122,893
13	iShares Core S&P 500 ETF	United States	121,908
14	Fidelity Contrafund Fund	United States	116,093
15	American Funds American Balanced Fund	United States	115,903
16	American Funds The Income Fund of America	United States	107,503
17	American Funds Capital Income Builder	United States	106,279
18	Vanguard Wellington Fund	United States	101,663
19	Vanguard Prime Money Market Fund	United States	96,140
20	Fidelity Investments Money Market Funds Government Portfolio	United States	95,018
21	American Funds Washington Mutual Investors Fund	United States	93,681
22	JPMorgan Liquidity Funds - U.S. Dollar Liquidity Fund	Luxembourg	93,625
23	American Funds Capital World Growth and Income Fund	United States	93,100
24	Vanguard Developed Markets Index Fund	United States	92,798

Figure 8: Top 50 Worldwide Mutual Funds, Money Market Funds, and Exchange-Traded Funds *continued*

Rank	Name	Domicile	Total Net Assets (\$ millions)
25	PIMCO Income Fund	United States	92,007
26	American Funds Fundamental Investors	United States	89,502
27	Vanguard Total International Bond Index Fund	United States	88,550
28	American Funds Investment Company of America	United States	88,381
29	Vanguard Mid Cap Index Fund	United States	87,954
30	Fidelity Government Money Market Fund	United States	85,294
31	Goldman Sachs Financial Square Government Fund	United States	85,007
32	Franklin Income Fund	United States	83,129
33	Vanguard Emerging Markets Stock Index Fund	United States	81,755
34	Metropolitan West Total Return Bond Fund	United States	79,765
35	BlackRock Liquidity Funds FedFund	United States	79,259
36	iShares MSCI EAFE ETF	United States	78,691
37	Vanguard Small Cap Index Fund	United States	77,622
38	Vanguard Federal Money Market Fund	United States	76,194
39	PIMCO Total Return Fund	United States	73,295
40	American Funds New Perspective Fund	United States	71,360
41	AustralianSuper Balanced	Australia	67,931
42	Dreyfus Government Cash Management Fund	United States	67,290
43	Dodge & Cox Stock Fund	United States	67,181
44	Vanguard Growth Index Fund	United States	66,398
45	Federated Government Obligations Fund	United States	66,249
46	Vanguard REIT Index Fund	United States	64,623
47	Dodge & Cox International Stock Fund	United States	64,392
48	Vanguard Short Term Investment Grade Fund	United States	62,089
49	Wells Fargo Government Money Market Fund	United States	60,768
50	Amundi Cash Corporate	France	59,612

Source: Morningstar Direct
 Note: Assets as of 7/2017

Multilateral standard setting framework

The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulators and is recognized as the international standard-setter for the securities sector. IOSCO develops and promotes adherence to internationally recognized

standards for securities regulation. Its members are 215 securities regulators, including the SEC and the CFTC, from 115 jurisdictions.¹⁶⁷

IOSCO works closely with the Financial Stability Board (FSB) on the international regulatory reform agenda. The FSB was established in 2009 as the successor to the Financial Stability Forum, with a broadened mandate to promote financial stability.¹⁶⁸ The FSB membership consists of 70 representatives from 25 jurisdictions and 10 international organizations and standard-setting bodies (SSBs).¹⁶⁹ Treasury, the Federal Reserve, and the SEC are the U.S. members of the FSB.¹⁷⁰ The CFTC is not a member, but participates in select FSB activities. It is important to note, in the context of multilateral standard setting, that entities such as IOSCO and FSB have no legal authority or jurisdiction over the United States.

The FSB's objective is to enhance cooperation at the international level regarding the work of national financial authorities and international SSBs to develop and promote the implementation of effective regulatory, supervisory, and other financial-sector policies. In collaboration with other international financial institutions, the FSB works to identify and propose measures for vulnerabilities affecting financial systems in the interest of global financial stability.¹⁷¹

Because the objectives of the FSB are broadly worded, the FSB has wide parameters in which to operate. In some cases, the FSB has gone beyond its core mission of enhancing global financial stability into areas where the connection has been more tenuous. For example, the FSB has had extensive work streams on measures to address firm-level misconduct risk, monitor compensation structures, and evaluate governance frameworks that appear more supervisory in nature than related to financial stability. A second example is the FSB's efforts to work on climate-related financial disclosures, on which the FSB convened a task force of private individuals to develop voluntary disclosure standards. Treasury strongly believes that the FSB's objectives should be focused on its mission of enhancing global financial stability.

One of the Core Principles is to advance American interests in international financial regulatory negotiations and meetings. To this end, U.S. engagement in the FSB and international financial regulatory SSBs remains important to promote financial stability, level the playing field for U.S. financial institutions, and prevent unnecessary and overly burdensome regulatory standard-setting that could stifle financial innovation. While the FSB has a wide mandate to evaluate whether various vulnerabilities could create global financial stability risk and should be addressed through regulatory action, Treasury's position is that the FSB's activities should be limited to its purpose of monitoring and enhancing global financial stability. Wherever possible, financial stability risk assessments and standards should be tailored to industry sectors and undertaken by the appropriate

167. See https://www.iosco.org/about/?subsection=about_iosco.

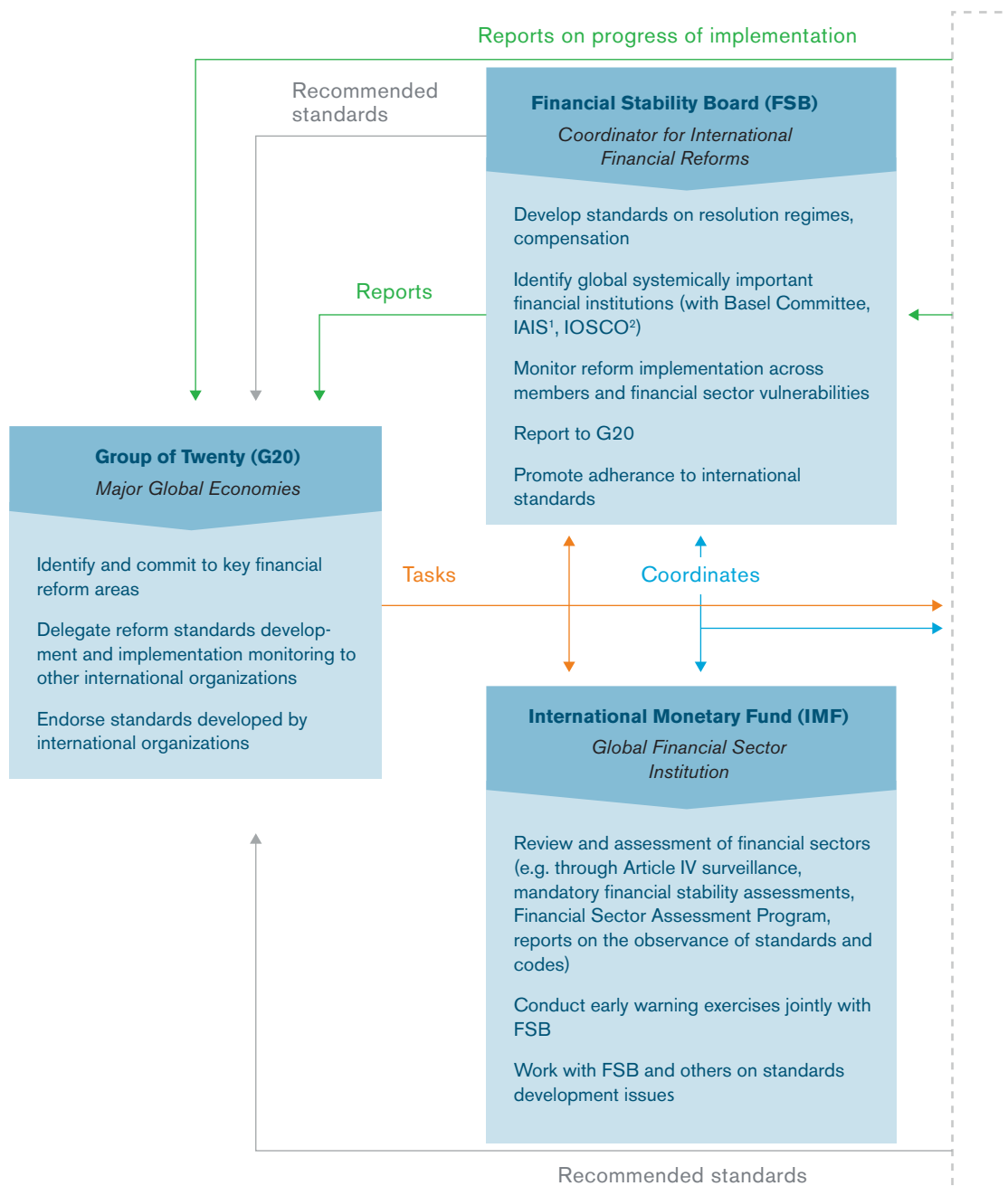
168. See <http://www.fsb.org/about/#history>.

169. Financial Stability Board, *3rd Annual Report* (July 25, 2016), available at: <http://www.fsb.org/wp-content/uploads/FSB-3rd-Annual-Report.pdf>.

170. Americans may also participate in the plenary based of their roles in other capacities. For example, the president of the Federal Reserve Bank of New York currently serves as chairman of the Committee on the Global Financial System and participates in the FSB plenary in that capacity.

171. See *Charter of the Financial Stability Board* (June 2012), available at: <http://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf>.

Figure 9: Selected International Bodies Comprising the International Financial Architecture



1 International Association of Insurance Supervisors

2 International Organization of Securities Commissions

Source: GAO (2014), Treasury analysis, based on international organization websites and U.S. federal agencies

Figure 9: Selected International Bodies Comprising the International Financial Architecture *continued*

Standard-setting bodies (SSBs)



standard-setter with the necessary technical supervisory expertise (e.g., IOSCO for asset management and the International Association of Insurance Supervisors (IAIS) for insurance).

Multilateral work on asset management

Global systemically important financial institutions (G-SIFIs) are defined by the FSB as financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. The FSB's initial attention on too-big-to-fail institutions was the catalyst to establish a framework focused on financial institutions, known as the entity-based approach. As the FSB developed this framework, the need for a differentiated approach to diverse sectors within the financial system became clear. This was particularly true in the areas of insurance and asset management.

In 2014 and 2015, the FSB undertook two rounds of consultations on proposed methodologies for identifying nonbank, non-insurer global systemically important financial institutions (NBNI G-SIFIs). These methodologies proposed to evaluate the global footprint of asset management firms, broker-dealers, and finance companies. The FSB's 2014 consultation on asset management asked for public feedback on a number of methods for identifying NBNI G-SIFIs that were generally based on size of assets under management.¹⁷² There was considerable push back to this approach, as it would have, in effect, singled out U.S. mutual funds as the only funds that would be subject to further review for NBNI G-SIFI designation, and did not adequately take into account the underlying risks of the funds or their fund managers.

In March 2015, the FSB issued a second consultative document that suggested a revised methodology for identifying NBNI G-SIFIs that also used size as the initial screening method for funds.¹⁷³ The consultation suggested two options for funds: (1) \$100 billion in net assets under management, or (2) \$200 billion in gross assets under management unless it could be demonstrated that the fund is not a dominant player in its markets. Asset managers would be subject to consideration if they held \$100 billion on their balance sheets or had \$1 trillion of assets under management. As with the 2014 consultation, the initial screening criteria would have effectively centered on large U.S. mutual funds and U.S. asset managers as candidates for G-SIFI designation.

Subsequently, the FSB and IOSCO concluded that working on activities, rather than specific entities, would be a more appropriate way to monitor and address any systemic risk in the asset management sector. The FSB's initial NBNI G-SIFI methodologies for the asset management industry were never finalized or approved. More recently, in January 2017, the FSB acknowledged

172. Financial Stability Board and IOSCO, *Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Jan. 8, 2014), available at: http://www.fsb.org/wp-content/uploads/r_140108.pdf.

173. Financial Stability Board and IOSCO, *2nd Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Mar. 4, 2015), available at: <http://www.fsb.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf>.

that asset managers and investment funds pose very different structural issues from banks and insurance companies because asset managers act as agents who are appointed by investors in accordance with pre-defined investment strategies.¹⁷⁴

Instead of an entities-based approach, the FSB, in consultation with IOSCO, set out 14 policy recommendations to address the structural vulnerabilities from asset management activities that could potentially present financial stability risks.¹⁷⁵ The FSB identified four structural vulnerabilities associated with asset management activities posing potential financial stability risks: (1) liquidity mismatch between fund investments and redemption terms for open-end funds, (2) leverage within investment funds, (3) operational risk and challenges at asset managers in stressed conditions, and (4) securities lending activities of asset managers and funds. The FSB viewed liquidity mismatch and leverage as the key vulnerabilities on which to focus.

In July 2017, IOSCO proposed to reaffirm and enhance the guidance set out in the 2013 Liquidity Report as proposed in a new consultation on liquidity risk management for funds.¹⁷⁶ IOSCO has been asked to complete its work on the liquidity recommendations by the end of 2017 and on leverage measures by the end of 2018.

Around the same time, the FSB issued another assessment covering shadow banking, including asset management, and announced that it would continue to hold open the option to focus on any residual entity-based source of systemic risk.¹⁷⁷ Specifically, the FSB recommended that all member authorities establish a systematic process for ensuring that any entities or activities that could pose material financial stability risks are brought within the regulatory perimeter. The FSB reiterated that it and IOSCO “will re-visit the proposed [NBNI G-SIFI] methodologies after IOSCO completes its work to operationalize the FSB recommendations to address asset management structural vulnerabilities, with a focus on any residual entity-based sources of systemic risk from distress or disorderly failure that cannot be effectively addressed by market-wide activities-based policies.”¹⁷⁸

174. Financial Stability Board, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (Jan. 12, 2017), at 8, available at: <http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf> (“FSB Policy Recommendations”). The limited historical evidence of systemic risks arising from investment funds cited by the FSB includes few examples – the 1998 collapse of leveraged hedge fund Long-Term Capital Management (LTCM) and issues with money market mutual funds (MMMFs) during the 2008 financial crisis. LTCM occurred during a period during which private funds and their investment advisers were generally exempt from SEC registration and reporting requirements; that situation has been rectified and the SEC and Office of Financial Research now receive extensive data on private funds. MMMFs are distinctly different in operation than other types of funds, and the SEC’s recent structural reforms of MMMFs significantly addressed the risks they could pose.

175. *Id.*

176. International Organization of Securities Commissions, *Consultation on CIS Liquidity Risk Management Recommendations* (July 2017), available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD573.pdf>. The consultation period ended in September 2017.

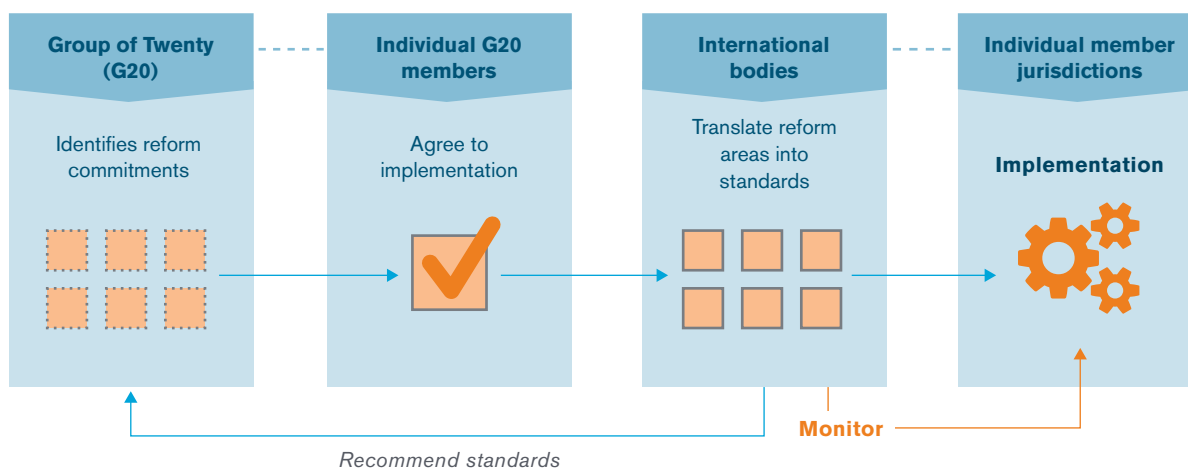
177. Financial Stability Board, *Assessment of Shadow Banking Activities, Risks and the Adequacy of Post-Crisis Policy Tools to Address Financial Stability Concerns* (July 3, 2017), available at: <http://www.fsb.org/wp-content/uploads/P300617-1.pdf>.

178. *Id.* at 18.

Improving transparency and accountability

While international standards are not binding on the United States and must be separately implemented by domestic regulators, FSB members and stakeholders can benefit from increased transparency and accountability in the international standard setting process. Although the FSB has published consultative drafts of some proposed policy documents, these consultations are not subject to requirements comparable to the Administrative Procedure Act. Also, FSB consultative drafts and other policy papers generally do not disclose whether the responsible party for drafting such papers is from the FSB secretariat or from an FSB member agency.

Figure 10: The G-20 Initiated Financial Reform Process



Source: GAO (2014), based on international organization website information

Additionally, the FSB’s meetings with industry are generally invitation-only during public consultation periods, and without public records of its discussions. Commenters on FSB policy recommendations can request confidential treatment, which further restricts the ability of the public to benefit from responses of commenters. Thus, the public may not have full insight as to the analysis and data that FSB is considering. There is also no FSB requirement to conduct pre-implementation economic analysis.¹⁷⁹ Unlike in the United States, where agencies conducting a rulemaking must examine all relevant data provided by interested persons after the notice and comment period has ended and articulate a basis for their actions, the FSB is not required to do so.

179. Treasury supports the FSB’s efforts to evaluate the effects of financial regulatory reforms. See Financial Stability Board, *Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms* (July 3, 2017), available at: <http://www.fsb.org/wp-content/uploads/P030717-4.pdf>.

Use of “Shadow Banking”

FSB reports and other reports often use the term “shadow banking” to describe credit intermediation involving entities and activities (fully or partly) outside of the regular banking system. Notwithstanding the inclusion of a footnote disclaimer¹⁸⁰ that appear in select FSB documents, Treasury prefers to transition to a different term, “market based finance.” Applying the term “shadow banking” to registered investment companies is particularly inappropriate as the word “shadow” could be interpreted as implying insufficient regulatory oversight, or disclosure. Registered investment companies, as described in this report, are regulated by the SEC and provide extensive public and regulatory transparency of fund portfolio holdings on a quarterly, monthly and, in some cases, daily basis.

Recommendations

Treasury strongly supports continued U.S. participation in international SSBs such as the FSB and IOSCO to promote U.S. interests. Moreover, Treasury believes that the U.S. should play a leading role in those SSBs, particularly with respect to financial market supervision and asset management where our firms and markets are the largest in the world. U.S. agencies that have seats on the FSB, IOSCO, or other international SSBs, as well as staff members from U.S. regulators assigned to work with these entities, should more effectively coordinate their representation on behalf of the United States.

Treasury recommends further improvements to the FSB and SSB processes to better promote transparency, accountability, and appropriate representation with respect to policymaking. We encourage the FSB to expand its practice of posting summaries of the comments raised in the consultation process and changes made to address such comments.¹⁸¹

Treasury recommends that U.S. representatives to FSB and IOSCO review the particular processes used by each international SSB and work to ensure that they utilize a collaborative process that includes, where appropriate, economic analysis and subject-matter expertise at the relevant SSB. Processes for international SSBs should be thorough, fair, and provide appropriate opportunity for public input and discussion. Those processes should include clear definition of issues to be addressed, rigorous examination of evidence, and reasoned analysis and explanations.

Treasury recommends that the FSB transition away from using the term “shadow banking” in its monitoring of credit intermediation outside of the regular banking sector.

180. The standard footnote, as used in the FSB’s 2016 Shadow Banking Monitoring Report states that: “The FSB defines shadow banking as ‘credit intermediation involving entities and activities (fully or partly) outside of the regular banking system.’ Some authorities and market participants prefer to use other terms such as ‘market-based finance’ instead of ‘shadow banking.’ The use of the term ‘shadow banking’ is not intended to cast a pejorative tone on this system of credit intermediation. However, the FSB uses the term ‘shadow banking’ as this is the most commonly employed and, in particular, has been used in earlier G20 communications.” Treasury notes that some FSB documents, such as press releases, do not contain the full disclaimer.

181. See, e.g., Financial Stability Board, *Guidance on Central Counterparty Resolution and Resolution Planning: Overview of Responses to the Public Consultation* (July 24, 2017), available at: <http://www.fsb.org/wp-content/uploads/P250717-3.pdf>. References to specific comment letters in the summaries could further improve transparency.

Finally, and more specific to the work on asset management and insurance, the U.S. members of the FSB should work to revise the G-SIFI framework so it appropriately takes into account the differentiated ways that sectors are structured and manage risks. Reliance on the technical supervisory expertise at the SSBs is important to this tailoring effort.

Economic Growth and Informed Choices

The asset management industry plays an important role in facilitating the flow of resources from investors into the capital markets. A significant amount of such resources is provided by retirement savings. Having a broad array of choices permits retirement investors to select investments that match their particular risk tolerances. Robust capital markets can promote economic growth, including job creation, infrastructure development, and increased standards of living. Regulatory burdens that impede capital formation or reduce investment choices can lessen the efficiency of the market in allocating capital and potentially lower economic growth.

Standards of Conduct for Financial Professionals

The standards of conduct applicable to financial professionals derive from numerous sources – principally, the SEC, the Department of Labor (DOL), state securities and insurance regulators, and self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA). As a practical matter, different standards of conduct apply to financial professionals depending upon the customers that they are servicing, the types of services being provided, and the products being offered.

ERISA and the DOL Fiduciary Rule

The Employee Retirement Income Security Act of 1974 (ERISA) imposes fiduciary obligations on a person who engages in specified activities with respect to an employee benefit plan or its assets, including rendering investment advice for a fee or other compensation. Title I of ERISA imposes an affirmative prudence and loyalty obligation on fiduciaries to an employee benefit plan and also prohibits fiduciaries from engaging in prohibited transactions involving conflicts of interest with respect to the plan. Title II of ERISA, which was codified in the Internal Revenue Code (Code), imposes excise taxes on fiduciaries and other disqualified persons who engage in prohibited transactions involving conflicts of interest with respect to a plan or IRA. Pursuant to Reorganization Plan No. 4 of 1978, the DOL has regulatory and interpretive authority with respect to the Code's prohibited transaction rules, including the definition of fiduciary, and can issue administrative exemptions from the prohibited transaction rules and excise taxes.

ERISA broadly provides that a person is a fiduciary to the extent “he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or property” of the plan or IRA.¹⁸² Under the prior regulatory definition of fiduciary adopted in 1975, a person was deemed to be a fiduciary to a plan or IRA with respect to any particular instance of advice only if he or she satisfied a five-part test. Fiduciary status attached to a person who (1) rendered investment advice

182. ERISA § 3(21)(A) and Code § 4975(e)(3).

(2) on a regular basis, (3) pursuant to a mutual understanding that the advice (4) would serve as a primary basis for investment decisions and (5) would be individualized. Under this definition, fiduciary status frequently did not attach to investment advice provided to employee benefit plans or IRA owners.¹⁸³

In April 2016, the DOL amended its definition of fiduciary and adopted several related administrative exemptions from the prohibited transaction provisions in ERISA and the Code (collectively, the Fiduciary Rule). The new definition of fiduciary expanded the scope of persons defined to be fiduciaries, for purposes of (1) the fiduciary prudence and loyalty obligation provisions of ERISA that apply to plans, (2) the prohibited transaction rules of ERISA that apply to plans, and (3) the prohibited transaction rules of the Code that apply to plans and IRAs.¹⁸⁴ In adopting the Fiduciary Rule, the DOL emphasized changes in the U.S. retirement savings landscape since the enactment of ERISA, particularly the shift from employer sponsored defined benefit pension plans to participant-directed defined contribution plans, such as 401(k) plans. The DOL also noted the widespread growth of assets in IRAs, identifying that individuals are increasingly responsible for managing their own retirement savings. In this context, the DOL expressed concerns that financial professionals often operate within compensation structures that do not align with their customers' interest and that create incentives and other conflicts of interest to steer customers into particular products that are more costly or complex than similar available products.¹⁸⁵

Under the Fiduciary Rule, certain types of fees and compensation, such as commissions, 12b-1 fees,¹⁸⁶ and revenue sharing payments, received by financial professionals covered by the new definition of fiduciary may be considered “prohibited transactions” under ERISA and the Code. These compensation arrangements are commonly used by financial professionals who provide services, including advice, to IRAs and IRA owners. To permit fiduciaries to receive these types of otherwise prohibited compensation, sell only a limited range of products, and not be subject to an obligation to provide ongoing advice, the DOL adopted new administrative exemptions, most notably the Best Interest Contract Exemption (BICE).¹⁸⁷ The BICE requires, among other conditions, adherence to certain impartial conduct standards, including providing advice in the retirement investor's best interest, charging no more than reasonable compensation, and avoiding misleading statements. The BICE also imposes certain disclosure obligations and, for IRAs, requires a written contract that acknowledges fiduciary status and prohibits the inclusion of provisions that would limit or disclaim liability or waive rights to participate in a class action or similar type of legal

183. For example, broker-dealers might be outside the definition of fiduciary if they provided advice on a one-time basis or if their customer agreed that the advice would not be the primary basis for investment decisions.

184. Definition of the Term “Fiduciary”; Conflict of Interest Rule-Retirement Investment Advice (Apr. 1, 2016) [81 Fed. Reg. 20945 (Apr. 8, 2016)].

185. 81 Fed. Reg. at 20949-20951 (summarizing the DOL's analysis of harm caused by conflicts of interest).

186. Refers to payments made pursuant to a plan adopted under '40 Act Rule 12b-1.

187. Best Interest Contract Exemption (Apr. 1, 2016) [81 Fed. Reg. 21002 (April 8, 2016)].

proceeding.¹⁸⁸ Compliance with certain conditions of the BICE, including the requirement to enter into a written contract, is not required for advice to place plan assets or IRA assets in an investment vehicle where only “level fees” are charged, such as an asset-based fee.

Securities and Insurance Laws

Financial professionals, including those advising on securities investments in IRA accounts, have been long subject to rules under federal and state securities laws that impose standards of conduct designed to protect retail investors. Although investment advisers and broker-dealers frequently offer the same or substantially similar services when providing personalized investment advice for securities transactions, they have been regulated through two different federal statutes that take different approaches to investor protection.

Investment advisers are fiduciaries under either the Investment Advisers Act of 1940 (the Advisers Act) or state securities laws.^{189,190} This designation does not, however, necessarily result in fiduciary status under ERISA. Broker-dealers are regulated under the Securities Exchange Act of 1934 and generally subject to the suitability standard under rules of FINRA as well as other FINRA requirements, and are subject to FINRA inspections and enforcement.¹⁹¹ Similarly, under most state insurance laws and regulations, insurance agents must comply with suitability standards when recommending annuity products to consumers.¹⁹²

There has been considerable discussion over the years as to whether broker-dealers and investment advisers should be subject to the same standard of conduct. As the SEC has noted,¹⁹³ studies have

188. This condition would prevent financial institutions relying on the BICE from including arbitration limitations in the written contract. However, on August 30, 2017, the DOL formally announced that it will not pursue a claim against any fiduciary based on failure to satisfy the BICE if the sole reason for the failure is inclusion of an arbitration limitation. See U.S. Department of Labor, *Field Assistance Bulletin No. 2017-03, Enforcement Policy on Arbitration Limitations in the Best Interest Contract Exemption and Principal Transactions Exemptions* (Aug. 30, 2017), available at: <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2017-03>. The Treasury and IRS have confirmed that a similar enforcement policy applies to IRAs under the Code. U.S. Internal Revenue Service, *Non-Applicability of Excise Taxes Under Section 4975 to Conform with DOL Temporary Enforcement Policy on Fiduciary Duty Rule, Announcement 2017-4*, available at: <https://www.irs.gov/pub/lirs-drop/a-17-04.pdf>.

189. As a fiduciary, an adviser’s duty includes an obligation to act in the best interest of its clients, including duties of loyalty and care, and to avoid or mitigate any conflicts of interest with clients. See Staff of U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers* (Jan. 2011), available at: <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

190. In 1996, the National Securities Markets Improvement Act allocated oversight of investment advisers between the SEC and state securities regulators, with the SEC responsible for investment advisers with \$25 million or more in assets under management or who advise a registered investment company. Dodd-Frank subsequently raised this threshold to \$100 million.

191. Under the suitability standard, a broker-dealer must have reasonable grounds for believing that the investment is suitable for the customer based upon information about the customer and the customer’s individual needs and circumstances. FINRA Rule 2111, available at: http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

192. See National Association of Insurance Commissioners, *Suitability in Annuity Transactions Model Regulation*, available at: <http://www.naic.org/store/free/MDL-275.pdf>.

193. See, e.g., Duties of Brokers, Dealers, and Investment Advisers (Mar. 1, 2013) [78 Fed. Reg. 14848, 14849 (March 7, 2013)].

found that retail customers are often not aware of a financial professional's status as a broker-dealer or investment adviser or the different regulatory approaches for these entities and the different duties that flow from them.¹⁹⁴ Section 913(g) of Dodd-Frank provided the SEC with discretionary authority to adopt rules that require the standard of conduct for broker-dealers, when providing personalized investment advice to a retail customer, to be no less stringent than for investment advisers. However, Section 913(g) also clarified that if the SEC adopted a uniform standard, a broker-dealer's receipt of commission-based compensation or sale of a limited range of products would not be considered a violation as applied to a broker or dealer, and that the uniform standard would not require a broker or dealer to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.¹⁹⁵

Status of the Fiduciary Rule

On February 3, 2017, President Trump issued a memorandum (the Presidential Memorandum) directing the DOL to re-examine the Fiduciary Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice.¹⁹⁶ Specifically, the President directed that the DOL consider (1) whether the anticipated applicability of the final rule has harmed or is likely to harm investors due to a reduction of Americans' access to certain retirement savings offerings, retirement product structures, retirement savings information, or related financial advice; (2) whether the anticipated applicability of the final rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees; and (3) whether the final rule is likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services. The President directed that if the DOL makes an affirmative determination as to any of the above three considerations, or the DOL concludes for any other reason, after appropriate review, that the Fiduciary Rule, prohibited transaction exemptions (PTEs), or both are inconsistent with the priority of the Administration "to empower Americans to make their own financial decisions, to facilitate their ability to save for retirement and build the individual wealth necessary to afford typical lifetime expenses, such as buying a home and paying for college, and to withstand unexpected financial emergencies,"¹⁹⁷ then the DOL shall publish for notice and comment a proposed rule rescinding or revising the Fiduciary Rule, as appropriate and as consistent with law.

Subsequently, the DOL extended the applicability date of the new fiduciary definition and the impartial conduct standards from April 10 to June 9, 2017 and set January 1, 2018 as the

194. See, e.g., Angela A. Hung, et al, RAND Institute for Civil Justice, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (2008), available at: https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf. The same report also found, based on a survey, that retail customers were generally satisfied with their financial professional, be it a representative of a broker-dealer or an investment adviser.

195. It should be noted that since 1975, IRA advisers, including registered investment advisers, broker dealers, and insurance agents, who met the conditions of the 1975 DOL rule were subject to uniform standards under the prohibited transaction provisions of the Code.

196. Memorandum from President Trump for the Secretary of Labor on Fiduciary Duty Rule (Feb. 3, 2017) [82 Fed. Reg. 9675 (February 7, 2017)].

197. *Id.* at section I(b).

compliance date for all remaining provisions of the Fiduciary Rule.¹⁹⁸ The DOL later proposed to extend the compliance date for the full Fiduciary Rule to July 1, 2019.¹⁹⁹ The DOL released a request for information seeking public comments on the Fiduciary Rule, with comments due on September 15, 2017.²⁰⁰

In June 2017, SEC Chairman Jay Clayton issued a statement requesting comments on the standard of care under the federal securities laws that should apply to investment advisers and broker-dealers serving retail investors, including retirement investors.²⁰¹ Chairman Clayton's statement noted Secretary of Labor Alexander Acosta's prior statement that the two agencies should engage constructively with each other in this area.²⁰²

Treasury's Stakeholder Engagement and Perspective

Treasury supports the current efforts at the DOL to re-examine the implications of the Fiduciary Rule. Treasury believes it is appropriate to delay full implementation of the Fiduciary Rule until the relevant issues, including costs of the rule and exemptions, are evaluated and addressed to best serve investors, and believes that such assessment and resolution of standard of conduct issues should include participation by the SEC and other regulators.

A review of the DOL rulemaking record demonstrates stakeholders' serious concerns that the Fiduciary Rule will have unintended consequences and is likely to (1) harm investors due to a reduction of Americans' access to certain retirement savings offerings, retirement product structures, retirement savings information, or related financial advice; (2) result in dislocations or disruptions within the retirement services industry that may adversely affect investors and retirees; and (3) cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services. As part of the process for preparing this report, Treasury has heard similar and other specific stakeholder concerns that the Fiduciary Rule may (1) raise incremental costs for financial service providers that will be passed on to retirement investors; (2) create an uneven playing field in the market for certain financial products, strategies, and business

198. Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Advice; Best Interest Contract Exemption (Prohibited Transaction Exemptions 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016-02); Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128 (Apr. 3, 2017) [82 Fed. Reg. 16902 (Apr. 7, 2017)] (to be codified at 29 C.F.R. Part 2510).

199. Extension of Transition Period and Delay of Applicability Dates; Best Interest Contract Exemption (PTE 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (PTE 2016-02); Prohibited Transaction Exemption 84-24 for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, and Investment Company Principal Underwriters (PTE 84-24) (Aug. 28, 2017) [82 Fed. Reg. 41365 (Aug. 31, 2017)].

200. Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions (June 29, 2017) [82 Fed. Reg. 31278 (July 6, 2017)].

201. Chairman Jay Clayton, *Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers* (June 1, 2017), available at: <https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31>.

202. See Secretary Alexander Acosta, *Deregulators Must Follow the Law, So Regulators Will Too*, Wall Street Journal (May 23, 2017), at A19.

models over others that could influence recommendations based on ease of compliance rather than the investor's best interest; (3) result in higher fees for IRA investors; and (4) create different compliance requirements based on the tax treatment of different accounts, which could create unintended imbalances in the market between those accounts.

In the ever changing investment advice landscape, some stakeholders also noted that industry has been working to improve investment advice but may need more time to implement changes, including the adoption of new products and solutions, and the implementation of new technologies that can deliver low-cost advice and education. Finally, other stakeholders contend that the Fiduciary Rule should be implemented without changes to prevent exposing consumers to losses that will compound over time. Treasury encourages DOL to consider these stakeholder comments along with the many other public comments it receives as it continues to evaluate the Fiduciary Rule.

Treasury believes that conflicts of interest should be addressed in a manner that preserves, to the extent possible, access to a wide range of asset classes, investment products, business models, distribution channels, and other relevant features of financial services that benefit American workers and their families – those that may already have significant investment assets, those just starting to save, those who may already have a high level of financial sophistication, and those just beginning to learn or who choose to rely on others for investment advice. Accordingly, Treasury believes that conflicts of interest should be addressed in a manner that does not disrupt the free functioning of the markets and access to financial services.

Notwithstanding the similar tax treatment accorded to 401(k) plans and IRAs, Treasury has heard suggestions that it is not clear that, as a matter of public policy, the DOL should be the regulator of financial professionals for IRAs or that the ERISA fiduciary standards that apply to plans should also be applied to IRAs through the BICE.²⁰³ Moreover, the DOL's Fiduciary Rule by statutory design regulates only IRAs and not other retail accounts, creating the possibility that many financial professionals will elect to adopt different practices for accounts that are nearly identical except that some are eligible for favorable tax rules and others are not. This aspect of the Fiduciary Rule creates potential marketplace imbalances and opportunities for unnecessary duplication due to different rule sets seeking to address the same concerns, although there were and continue to be inconsistencies among other regulators.

Financial professionals involved in securities are already extensively regulated and examined by the SEC and state securities regulators and, in the case of broker-dealers, by FINRA. Since 2015, SEC staff has placed a special priority on examining investment advisers and broker-dealers on

203. See, e.g., Statement of Bradford P. Campbell before the House Committee on Education and the Workforce, Hearing on "Regulatory Barriers Facing Workers and Families Saving for Retirement" (May 18, 2017), available at: https://edworkforce.house.gov/uploadedfiles/testimony_campbell.pdf.

matters of importance for investors saving for retirement.²⁰⁴ Treasury believes that the SEC has the ability to address investor protection concerns through a variety of means, such as requiring, directly or indirectly through FINRA, appropriate supervisory and compliance programs by retirement service providers and regulation of marketing and disclosure materials used by them. The SEC also oversees FINRA and is authorized by law to cooperate with the states to effectuate greater uniformity in securities matters.²⁰⁵ The SEC's jurisdiction extends to financial professionals for both IRAs and other investment accounts, and state insurance regulators, where granted the necessary authority from state legislatures, can apply the same rules for annuities held both within and outside of IRAs. Within the federal regulatory framework, Treasury believes that the SEC and DOL should work together to address standards of conduct for financial professionals who provide investment advice to IRA and non-IRA accounts.

Treasury also recommends that the DOL and the SEC engage with state insurance regulators regarding the impact of standards of care on the annuities market. Because annuities are the only financial services product that can provide a guaranteed lifetime income stream, and because longevity risk (the risk of outliving one's assets) has become a key retirement concern, annuities are an important contributor to the Core Principle of empowering Americans to save for retirement. Given the size and scale of the annuities market,²⁰⁶ federal regulators should coordinate with the states in order to achieve consistent standards of conduct across product lines.²⁰⁷

In summary, Treasury encourages the SEC, the DOL, and the states to work together to implement a regulatory framework appropriately tailored to both preserve investor choice and protect retirement investors in an efficient and effective manner.

204. Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *Retirement-Targeted Industry Reviews and Examinations Initiative (June 22, 2015)*, available at: <https://www.sec.gov/about/offices/ocie/retirement-targeted-industry-reviews-and-examinations-initiative.pdf>; see also U.S. Securities and Exchange Commission, *Press Release 2017-7* (Jan. 12, 2017), available at: <https://www.sec.gov/news/pressrelease/2017-7.html> (announcing that senior investors and retirement investments continue to be on the SEC exam priority list for 2017).

205. See 15 U.S.C. 77s(d).

206. Individual annuity sales in 2016 totaled \$222.1 billion. LIMRA Secure Retirement Institute, *Individual Annuities* (2016, 4th Quarter).

207. The NAIC is considering incorporation of a best interest standard into its model regulation on annuity suitability. See NAIC Annuity Suitability (A) Working Group, *Meeting Summary Report* (Aug. 6, 2017), available at: http://www.naic.org/meetings1708/cmt_e_a_2017_summer_nm_materials.pdf?1503696953048.

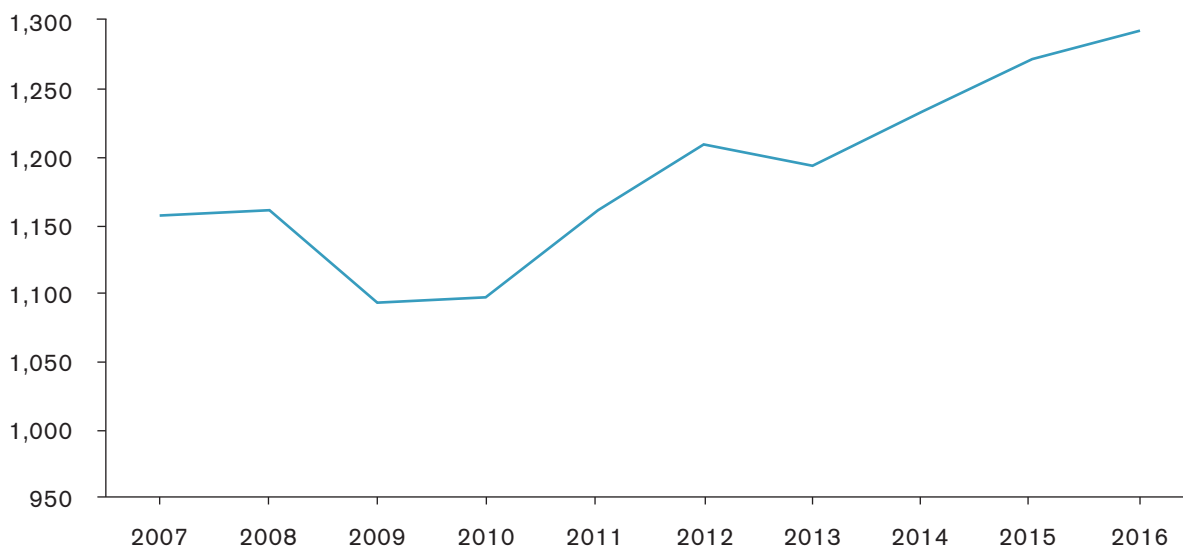
Insurance



Introduction

The U.S. insurance industry is the largest, most competitive, and most diverse in the world. The industry provides important retirement planning tools for individuals, and its products allow both commercial and individual policyholders to obtain protection for a range of risks. Relying on the financial security provided by this risk transfer, policyholders are able to direct resources that they otherwise would have to reserve for such uncertainties to productive economic activity, such as capital investment.

Figure 11: Total Direct Written Premiums for L&H and P&C Insurance Sectors (\$ billions)



Source: SNL Financial

At year-end 2016, the U.S. insurance industry included 2,655 property and casualty (P&C) insurers, 780 life and health (L&H) insurers, and 1,095 health insurers,²⁰⁸ which generated 29% of global total direct written premiums.²⁰⁹ In 2016, the U.S. insurance industry's direct written premiums totaled \$1.3 trillion, as shown in Figure 11.²¹⁰ The industry employs more than 2.8

208. SNL Financial; A.M. Best, *Best's Aggregates & Averages* (2016), available at: <http://www3.ambest.com/aggavg/toc/archive.aspx>.

209. Swiss Re Institute Sigma, *World Insurance in 2016: the China Growth Engine Steams Ahead* (2017), available at http://media.swissre.com/documents/sigma3_2017_en.pdf.

210. SNL Financial. Life and health insurers' premiums generally consist of those generated from sales of annuities and life insurance; property and casualty insurers' premiums generally consist of those generated from sales of auto, home, and commercial property and liability insurance. Figures exclude results from insurers that are licensed to write only health insurance.

million people.²¹¹ Further, with total assets exceeding \$8.5 trillion, insurers are major participants in the economy through their investments, and play a notable role with respect to infrastructure investment.²¹² For example, holdings of U.S. insurers currently account for more than 10% of the \$3.8 trillion municipal bond market. Local, regional, and national insurers and reinsurers participate in the diverse U.S. insurance market. Recognizing its vitality, non-U.S. insurers also increasingly participate in the U.S. market (for example, through primary insurance operations and reinsurance). Similarly, U.S. insurers increasingly recognize opportunities for growth overseas, both in established and developing economies.

The primary insurance marketplace can be categorized in several different ways, one of which is by line of business. Typically the insurance lines of business are categorized as follows²¹³:

- **Property and Casualty (P&C) insurance.** Property and casualty insurers offer protection to policyholders for financial loss associated with damage to physical property and loss from legal liability. This includes automotive, home, and commercial property and liability insurance. Figure 12 shows the top 10 largest U.S. P&C insurance groups ranked by total personal and commercial lines' direct written premiums, including their market share, for 2016.
- **Life and Health (L&H) insurance.** Life insurers offer life insurance and annuities, and some may also be licensed to issue insurance coverage for losses associated with accidents or disability. L&H insurers offer their products to both individuals and groups. Figure 13 shows the top 10 largest U.S. L&H insurance (life insurance and annuities only) groups ranked by direct written premiums, including their market share, for 2016.

Like the banking sector, the primary insurance marketplace can be categorized by size and type of organization. The insurance industry includes insurers licensed in only one state, licensed in all 50 states, and licensed throughout the United States and around the globe. Insurers can also be categorized by whether they are organized as a stock or mutual insurance company, whether they own a depository institution, whether they are evaluated by FSOC for supervision by the Federal Reserve, or whether they are identified by the Financial Stability Board (FSB) as a global systemically important insurer (G-SII).

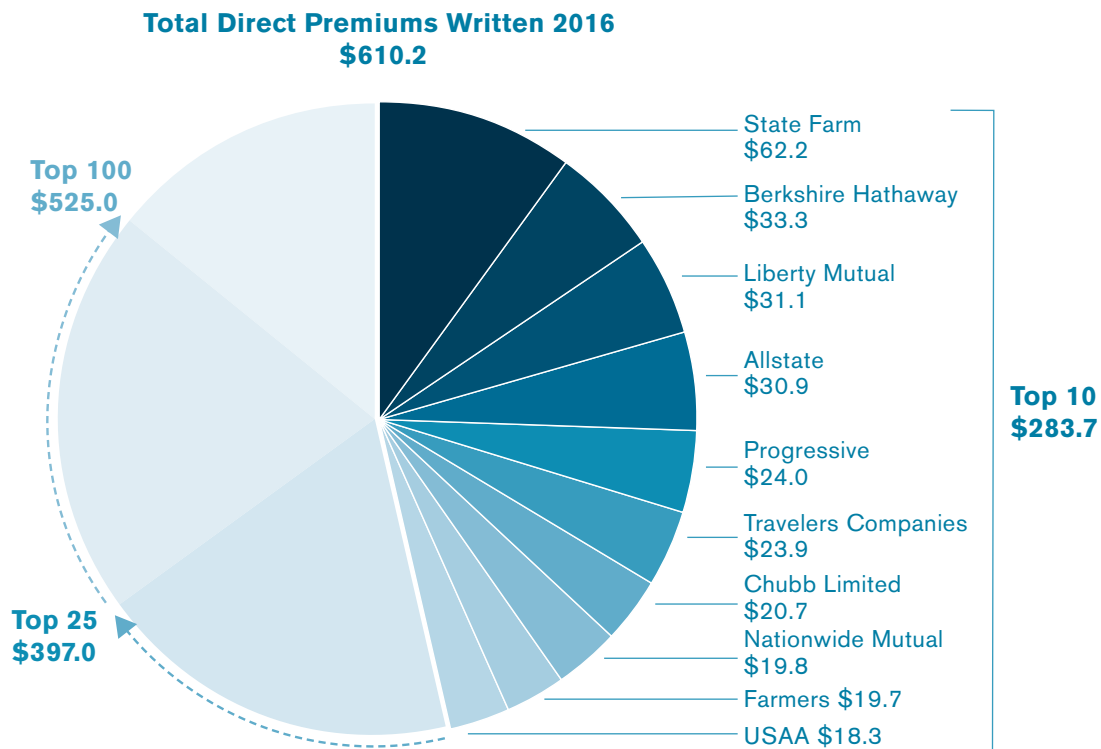
The insurance marketplace can also be categorized as “admitted” or “nonadmitted.” Carriers in the admitted market (sometimes referred to as “standard” insurers) qualify by filing an application with the insurance department of each jurisdiction where they conduct business, receiving approval, and complying with each state’s insurance laws and regulations, including requirements for filing and approval of policy forms and rates.

211. Sean Kevelighan, Steven Weisbart, and James Lynch, *Insurance: Leading Through Disruption*, available at: [https://www.treasury.gov/initiatives/fio/Documents/\(1\)_Marketplace_Update_-_III.pdf](https://www.treasury.gov/initiatives/fio/Documents/(1)_Marketplace_Update_-_III.pdf)

212. SNL Financial. Includes L&H and P&C U.S. legal entity insurers.

213. In addition to the P&C and L&H sectors described below, a third U.S. insurance sector is health insurance. The health insurance sector includes companies licensed solely as health insurers or Health Maintenance Organizations, and also generally includes government programs such as Medicare and Medicaid. A detailed analysis of the health sector is not included in this report.

Figure 12: U.S. Combined Lines Direct Premiums Written by P&C Insurance Groups (\$ billions)



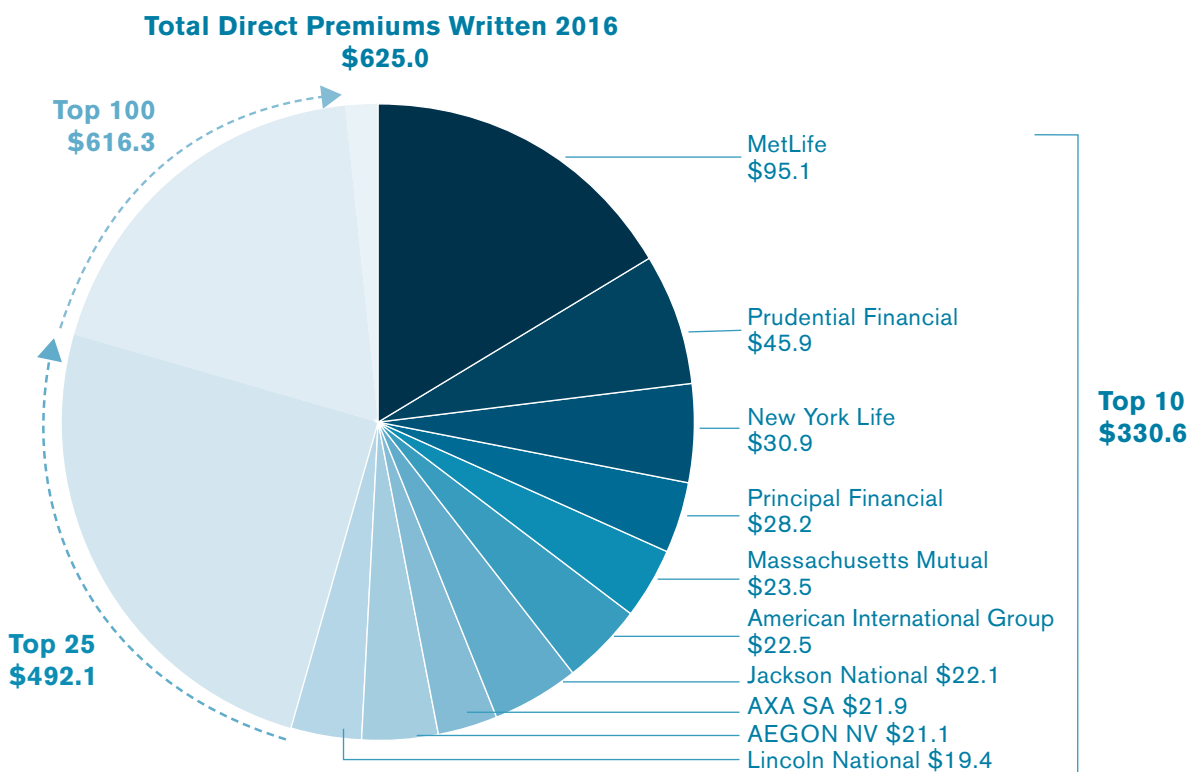
Source: SNL Financial (includes all lines of business)

Carriers in the nonadmitted market (sometimes referred to as “surplus lines” insurers) are less strictly regulated than carriers in the admitted market, and are exempt from form and rate requirements. The purpose of surplus lines is to permit access to products that are not otherwise available through admitted lines. There are approximately 200 insurers approved or eligible to sell surplus lines coverage in the United States.²¹⁴ In 2016, premiums in the surplus lines market totaled more than \$25 billion.²¹⁵ As shown in Figure 14, excess and surplus lines premiums grew steadily between 2011 and 2015 with increasing market share; in 2016, excess and surplus lines premiums flattened, leading to a slight decrease in market share.

214. Government Accountability Office, *Property and Casualty Insurance Effects of the Nonadmitted and Reinsurance Reform Act of 2010* (Jan. 2014), at 1, available at: <http://www.gao.gov/assets/670/660245.pdf>.

215. See Business Insurance, *Excess and Surplus Lines Premiums Up in 2016*, available at: <http://www.businessinsurance.com/article/20170124/NEWS06/912311565/Excess-and-surplus-lines-premiums-up-in-2016-stamping-offices>.

Figure 13: U.S. Direct Premiums Written by L&H Insurance Groups (\$ billions)



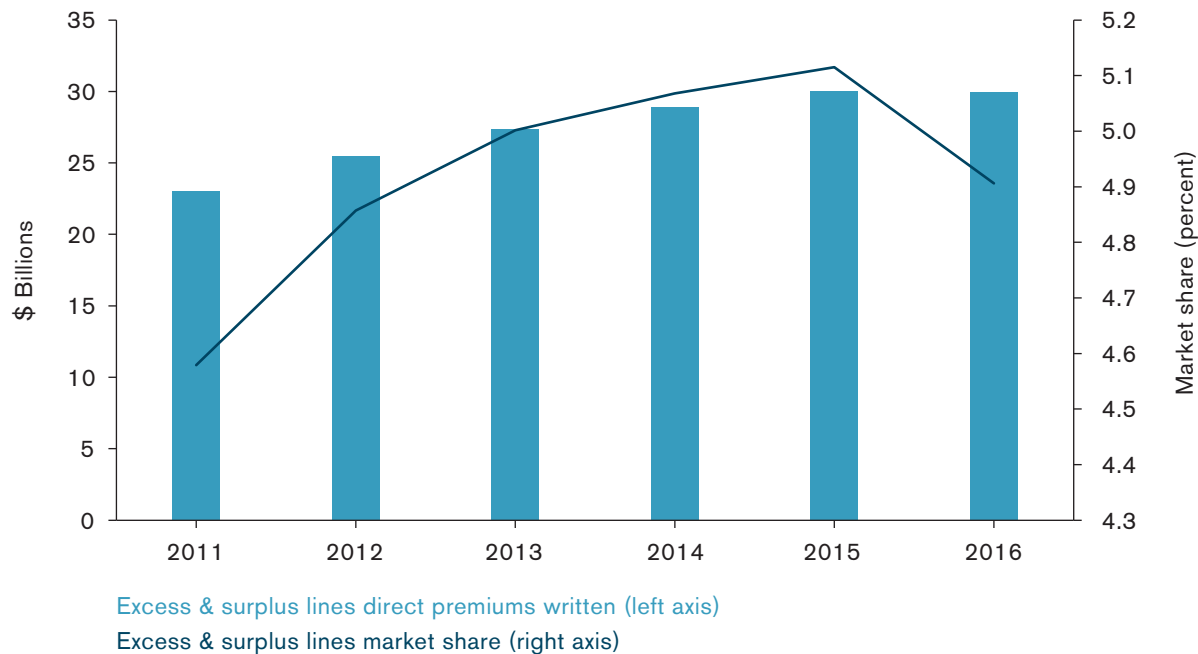
Source: SNL Financial (includes all lines of business)

Risks typically written in the surplus lines market include: (1) nonstandard risks (e.g., those with unusual underwriting requirements), (2) unique risks that admitted carriers do not offer, and (3) capacity risks for which an insured seeks a higher level of coverage than admitted insurers are willing to provide.²¹⁶ For example, surplus lines insurers may write policies to cover a research laboratory working on an unproven drug, a special sporting event, or liabilities arising from environmental impairment.²¹⁷

216. Government Accountability Office, *Property and Casualty Insurance Effects of the Nonadmitted and Reinsurance Reform Act of 2010* (Jan. 2014), at 9 (text box), available at: <http://www.gao.gov/assets/670/660245.pdf>.

217. *Id.* at 7.

Figure 14: U.S. Excess & Surplus Lines Direct Premiums Written and Market Share



Source: SNL Financial

Reinsurers, i.e., insurance companies that specialize in assuming risks from other insurance companies, are also critical to a well-functioning insurance marketplace. U.S. insurers depend on reinsurers — domiciled in the United States and abroad — to support the issuance of new policies, minimize loss fluctuations, and limit or diversify risk.²¹⁸ In 2017, global reinsurer capital was approximately \$605 billion, including \$86 billion of capital markets reinsurance, both of which are record levels.²¹⁹ Globally, in 2016, the top 50 reinsurers had gross written premiums of \$225.3 billion.²²⁰

218. Reinsurance is a contract of indemnity between commercial parties — an insurer (i.e., the “cedent” or “ceding insurer”) and one or more reinsurers (i.e., “assuming insurers”) — by which, in exchange for a premium, a specified portion of the risks under one or more insurance policies written by the cedent are transferred (ceded) to the reinsurers.

219. Aon Benfield, *Reinsurance Market Outlook June and July 2017 Update*, at 2.

220. See www3.ambest.com/bestweek/DisplayBinary.aspx?TY=P&record_code=265357&URatingId=2666445.

Figure 15: Composition of Investment Portfolio for P&C Insurance Sector

	2012	2013	2014	2015	2016
Bonds	65.4%	62.5%	61.5%	62.1%	61.3%
Preferred Stocks	0.9%	0.8%	1.0%	0.9%	0.7%
Common Stocks	18.3%	21.4%	21.5%	21.1%	21.8%
Mortgage Loans	0.4%	0.5%	0.7%	0.8%	0.9%
Real Estate	0.7%	0.7%	0.7%	0.8%	0.8%
Contract Loans	0.0%	0.0%	0.0%	0.0%	0.0%
Derivatives	0.0%	0.0%	0.0%	0.0%	0.0%
Cash & Short Term Investments	6.0%	5.6%	5.9%	5.8%	5.8%
Other Investments	8.3%	8.4%	8.7%	8.5%	8.6%
Total Cash & Invested Assets	100%	100%	100%	100%	100%

Source: SNL Financial

Figure 16: Composition of General Account Investment Portfolio for the L&H Insurance Sector*

	2012	2013	2014	2015	2016
Bonds	74.7%	74.7%	73.9%	73.8%	73.5%
Preferred Stocks	0.2%	0.2%	0.3%	0.3%	0.2%
Common Stocks	2.1%	2.1%	2.1%	2.0%	2.2%
Mortgage Loans	9.9%	10.1%	10.3%	10.9%	11.2%
Real Estate	0.6%	0.6%	0.6%	0.6%	0.6%
Contract Loans	3.7%	3.7%	3.6%	3.4%	3.3%
Derivatives	1.2%	1.1%	1.6%	1.5%	1.6%
Cash & Short Term Investments	3.1%	2.7%	2.8%	2.8%	2.6%
Other Investments	4.4%	4.7%	4.9%	4.7%	4.7%
Total Cash & Invested Assets	100%	100%	100%	100%	100%
Share of Total General Account Assets	94.9%	94.7%	94.7%	94.7%	94.5%
General Account Assets / Total Assets	63.6%	61.2%	61.3%	61.8%	62.3%
Separate Account Assets / Total Assets	36.4%	38.8%	38.7%	38.2%	37.7%

* L&H insurers maintain a General Account and Separate Accounts. Separate Accounts, as the name implies, are held apart from the general investment account of an insurer and hold and invest proceeds from the sales of products for which policyholders retain the investment risks.

Source: SNL Financial

In some cases, the federal government is also a direct participant in the insurance marketplace. For instance, the Federal Crop Insurance Corporation provides reinsurance to commercial writers of crop insurance; Treasury, through the Terrorism Risk Insurance Program (TRIP), provides a backstop for insured commercial P&C losses resulting from a “certified act of terrorism;” and the Federal Emergency Management Agency, through the National Flood Insurance Program, offers residential and commercial flood insurance.

State governments also participate in the insurance marketplace. To ensure their residents have access to necessary insurance products, some states serve as insurers of last resort for individuals who cannot obtain insurance in the voluntary market. Florida, for instance, has created a P&C insurer that provides homeowners insurance to coastal homeowners who would otherwise be unable to purchase such insurance.²²¹ Such residual market coverage is typically offered in most states for workers’ compensation, personal automobile liability, and property insurance.

The insurance industry as a whole is an important participant in U.S. capital markets. The U.S. insurance industry held approximately \$5.5 trillion in cash and invested assets at the end of 2016.²²² In addition, insurers held \$3.8 trillion in the bond market and \$432 billion in the stock market at year-end 2016.²²³ Figures 15 and 16 show asset allocations for the P&C and L&H sectors, respectively, for the last five years. Infrastructure investments are particularly attractive to life insurers due to their long durations and stable cash flows.

Trends and Industry Outlook

The U.S. insurance industry is in sound financial condition, with L&H sector capital and surplus reaching a record \$380.7 billion at year-end 2016, a 3.7% increase over the prior year, while the P&C sector reported year-end 2016 policyholder surplus of \$712.3 billion, up 3.6% from 2015 and also a record high.²²⁴ During the period from 2010 through 2016, the surplus bases of the L&H and P&C sectors experienced annual average growth rates of 3.9% and 4.7% respectively. This solid capital base allows insurers to invest in the capital markets and in their own growth with confidence that they can absorb unexpected adverse developments in the general economy and in the insurance markets they serve.

Despite its strong balance sheet, the industry has faced headwinds, which have dampened its operating performance in recent years. The L&H sector’s earnings peaked at \$42.3 billion in 2013, followed by three years of lower earnings in a fairly close range. The “low for long” interest rate environment has been a significant drag on the investment income of both sectors, although this negative impact is more pronounced for L&H insurers. Other factors affecting L&H operating results include slow sales growth (less than 2% annually²²⁵) and strained underwriting performance.

221. Citizens Property Insurance Corporation, *Who We Are*, available at: <https://www.citizensfla.com/who-we-are>.

222. National Association of Insurance Commissioners, *Capital Markets Special Report*, available at: http://naic.org/capital_markets_archive/160606.htm.

223. *SNL Financial*. Common stock investments total does not include affiliated investments.

224. Unless otherwise noted, the source for all data in the “Trends and Outlook” section is SNL Financial.

225. McKinsey & Company, *Rethinking US Life Insurance Distribution* (May 2016), at 5, available at: <http://www.mckinsey.com/industries/financial-services/our-insights/rethinking-us-life-insurance-distribution>.

After three consecutive years of underwriting profit, the P&C sector recorded an underwriting loss in 2016 and its net income fell to \$44.4 billion, a 24% drop from 2015 and 38% lower than peak net income of \$71.6 billion in 2013. In the commercial lines segment, profit margins are under pressure from the effects of soft prices, lack of organic growth, and competition from alternative sources of capital such as hedge funds, foreign investors, and the capital markets.²²⁶ The auto insurance segment is facing sharp increases in the frequency and severity of claims, as auto insurance losses and expenses have exceeded premiums for 10 consecutive years.²²⁷

Going forward, in addition to low interest rates, both sectors will be challenged by rapidly changing technology, shifts in consumer expectations and preferences, cybersecurity risks, and regulatory uncertainty. Some of the keys to success for the industry and individual companies include the ability to execute strategic decisions quickly and effectively, understand and harness technology, and maintain pricing discipline and superior risk management during periods of stress and volatility.

The Regulatory Structure of the Insurance Industry

The Primacy of State Regulation

The 50 states, the District of Columbia, and the five U.S. territories are the primary regulators of the business of insurance in the United States. For over 150 years, the U.S. state-based insurance regulatory system has promoted the primary objective of protecting policyholders.

State legislatures enact insurance laws, which are implemented and enforced by state regulators primarily through adoption of rules and regulations governing the conduct of insurers and the rights of consumers. Insurance regulators operate within the state executive branches, either as stand-alone offices or as divisions of larger departments. Most insurance commissioners are either appointed by the governor for a set term or serve at the pleasure of the governor; however, in 11 states, the commissioner is elected by popular vote.²²⁸

Broadly speaking, state regulation is divided into prudential regulation (frequently referred to as “solvency” regulation) and marketplace regulation. Prudential regulation consists of oversight of an insurer’s financial condition and its ability to satisfy policyholder claims. State statutes require insurers to meet minimum capital standards and financial reporting requirements, and regulate financial aspects of an insurer’s operations such as establishing reserves for payment of future claims, selecting and managing investments, obtaining reinsurance, conducting risk management, and engaging in transactions with affiliates. The state where an insurer is incorporated is primarily responsible for its financial oversight as well as for sanctioning or taking other remedial actions if an insurer operates in an unsafe and unsound manner.

226. PriceWaterhouseCoopers, *Top Insurance Industry Issues in 2017 (2017)*, at 17, available at: <https://www.pwc.com/us/en/insurance/publications/assets/pwc-2017-insurance-top-issues.pdf>.

227. Insurance Information Institute, *Personal Automobile Insurance: More Accidents, Larger Claims Drive Costs Higher* (October 2016), at 4, available at: http://www.iii.org/sites/default/files/docs/pdf/auto_rates_wp_092716-62.pdf.

228. National Association of Insurance Commissioners, *State Commissioners Elected/Appointed*, available at: http://www.naic.org/documents/members_state_commissioners_elected_appointed.pdf.

Marketplace regulation governs an insurer's business conduct, such as the pricing of premiums, advertising, minimum standards governing the terms of insurance policies, payment of claims, and licensing of insurance agents and brokers, together with general issues of consumer protection and access to insurance. Each state where an insurer operates regulates the insurer's market conduct in that state. Accordingly, although many insurers operate on a multistate or national basis, each state regulates its own insurance markets, and this regulation may not be uniform from state to state.

Reinsurers are regulated by the states through direct regulation of licensed reinsurers and their reinsurance transactions. State insurance regulators directly regulate reinsurers domiciled in their state, as well as U.S. reinsurers that are licensed in their state but domiciled elsewhere. Reinsurers and primary insurers are subject to the same set of solvency laws and regulations. State insurance regulators also indirectly regulate reinsurance transactions through the credit for reinsurance regulations, which, among other things, require insurers to meet certain prescribed financial statement account criteria.

Under the McCarran-Ferguson Act passed by Congress in 1945,²²⁹ state laws governing the business of insurance are not invalidated, impaired, or superseded by any federal law unless the federal law specifically relates to the business of insurance.²³⁰ McCarran-Ferguson states that “the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several states.”²³¹

State regulation of the insurance industry is coordinated through the National Association of Insurance Commissioners (NAIC), a voluntary organization whose membership consists of the chief insurance regulatory officials of the 50 states, the District of Columbia, and five U.S. territories.²³² The NAIC was originally formed in 1871, and reorganized in 1999 as a nonprofit corporation. The NAIC describes itself as “the U.S. standard-setting and regulatory support organization” through which “state insurance regulators establish standards and best practices, conduct peer review and coordinate their regulatory oversight.”²³³ The NAIC also provides centralized support services and programs to assist states in exercising certain statutory responsibilities.²³⁴

Although the NAIC is not itself a regulator or government authority, it plays a central role in state insurance regulation and policy through its development of model laws and regulations for

229. The McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015.

230. *Id.* at § 1012(b).

231. In limited circumstances, Congress has determined that national or international interests require legislation that mandates uniformity of state insurance laws or regulations, while keeping regulation at the state level. For example, the Nonadmitted and Reinsurance Reform Act of 2010 sets uniform standards for surplus lines insurers and reinsurers while also providing that the laws of an insurer or reinsurer's state of domicile control.

232. National Association of Insurance Commissioners, *About the NAIC*, available at: http://naic.org/index_about.htm.

233. National Association of Insurance Commissioners, *2016 Annual Report: Inspiring Innovation* (Apr. 8, 2017).

234. For example, the NAIC developed and maintains the Interstate Insurance Product Regulation Commission, a centralized life insurance product approval process for participating states; the National Insurance Producer Registry, a national electronic database of licensed insurance agents; and the System for Electronic Rate and Form Filing, an electronic form and rate filing system for insurance products.

consideration by the states,²³⁵ helping state regulators conduct peer review, and coordinating regulatory oversight of the insurance sector. The NAIC also provides regulatory, actuarial, legal, and technical resources and expertise to state insurance departments.

The Financial Regulation Standards and Accreditation Program of the NAIC is an important component of prudential oversight by state insurance regulators.²³⁶ Accreditation is a certification given to a state insurance department once it has demonstrated that it has met and continues to meet an assortment of legal, financial, and organizational standards as determined by a committee of its peers. A state becomes accredited by adopting specified NAIC model laws and regulations in the form adopted by the NAIC or in a substantially similar manner.²³⁷ All 50 states, the District of Columbia, and Puerto Rico are accredited as of July 2017.²³⁸

Federal Government Involvement in the Business of Insurance

Although the states have been and remain the primary regulators of the insurance industry, the federal government has long had a significant impact on insurers and the business of insurance. This role can take several forms, but some of the more significant impacts include:

- Prudential regulation, including the Federal Reserve’s regulation of FSOC-designated insurers and savings and loan holding companies that own insurance companies;
- Monitoring and reporting on the insurance industry, and developing federal policy on prudential aspects of international insurance matters through the Federal Insurance Office (FIO), including the negotiation of “covered agreements;”
- The regulation of financial products or markets which include, but are not limited to, insurance, such as the SEC’s regulation of securities and the CFTC’s regulation of derivatives;
- Taxation of insurers and their products through the IRS under Treasury’s supervision; and
- Federal insurance programs, including the Federal Emergency Management Agency’s administration of the National Flood Insurance Program and Treasury’s administration of the Terrorism Risk Insurance Program.

The next section provides a brief overview of some of the key federal entities that have a role in regulating the business of insurance.

235. Model laws and regulations become effective only if and when they are officially enacted or promulgated by a state. Actual laws and regulations may vary, sometimes significantly, from NAIC models.

236. National Association of Insurance Commissioners, *Accreditation* (Jan. 6, 2017), available at: http://www.naic.org/cipr_topics/topic_accreditation.htm. See also National Association of Insurance Commissioners, *Financial Regulation Standards and Accreditation Program* (August 2017), available at: http://www.naic.org/documents/cmte_f_frsa_pamphlet.pdf.

237. National Association of Insurance Commissioners, *New or Revised Financial Solvency Regulation-Related Model Laws and Regulations Status Regarding Consideration for Accreditation as of August 10, 2017*, available at: http://www.naic.org/documents/committees_f_related_model_law_stat_accred.pdf.

238. National Association of Insurance Commissioners, *Financial Regulation Standards and Accreditation Program – Accredited U.S. Jurisdictions*, available at: http://www.naic.org/cmte_f_accredited_states.htm.

Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC) was established by Dodd-Frank²³⁹ and is charged with three purposes. Generally, those are to: (1) identify risks to the financial stability of the United States, (2) promote market discipline, and (3) respond to threats to the financial stability of the United States.²⁴⁰ The FSOC consists of 10 voting members — including an independent member with insurance expertise — and five nonvoting members — including a state insurance commissioner and the FIO Director.²⁴¹

Section 113 of Dodd-Frank authorizes the FSOC to designate a nonbank financial company for supervision by the Federal Reserve and enhanced prudential standards if the FSOC determines that the company’s material financial distress — or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities — could pose a threat to U.S. financial stability.²⁴² A “nonbank financial company” is defined to include insurance companies.²⁴³

The FSOC also has the authority to examine specific activities of potential systemic importance.²⁴⁴ Section 120 of Dodd-Frank permits the FSOC to provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity.²⁴⁵ To issue such a recommendation, the FSOC must determine that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity could create or increase the risk of significant liquidity, credit, or other problems spreading among, for example, U.S. financial markets.²⁴⁶

Federal Insurance Office

Title V of Dodd-Frank established the Federal Insurance Office in Treasury.²⁴⁷ Title V vested FIO with authority to monitor all aspects of the insurance sector except health insurance, monitor the extent to which traditionally underserved communities and consumers have access to affordable insurance products, represent the United States on prudential aspects of international insurance matters, including at the International Association of Insurance Supervisors, assist the Secretary in negotiating covered agreements, consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance, and perform such other

239. 12 U.S.C. § 5321.

240. 12 U.S.C. § 5322. Specifically, the FSOC is charged: (1) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (2) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure; and (3) to respond to emerging threats to the stability of the U.S. financial system.

241. 12 U.S.C. § 5321. The Secretary serves as the Chairperson of the FSOC.

242. 12 U.S.C. § 5323(a).

243. 12 U.S.C. § 5311(a)(4).

244. 12 U.S.C. § 5330(a).

245. *Id.*

246. *Id.*

247. 31 U.S.C. § 313(a).

related duties and authorities as may be assigned to FIO by the Secretary.²⁴⁸ FIO also assists the Secretary in administering TRIP.²⁴⁹

Federal Regulators and Agencies Involved in Insurance

Board of Governors of the Federal Reserve System

The Federal Reserve serves a central role in the financial system overseeing monetary policy through the Federal Open Market Committee as well as operating, through the Federal Reserve Banks, key components of the payment, clearing, and settlement system. Its mission also includes maintaining the stability of the financial system. The Federal Reserve also regulates bank holding companies, savings and loan holding companies, state-chartered member banks and, in certain instances, nonbank financial companies.

The Federal Reserve regulates nonbank financial companies with significant insurance activities that have been designated by the FSOC pursuant to Section 113 of Dodd-Frank.²⁵⁰ For these insurers, the Federal Reserve is required by Section 165 of Dodd-Frank to establish enhanced prudential standards, including more stringent risk-based capital requirements and stress tests.²⁵¹ Title III of Dodd-Frank also transferred to the Federal Reserve the supervisory functions related to savings and loan holding companies and their non-depository subsidiaries that were performed by the Office of Thrift Supervision until July 2011.²⁵² The Federal Reserve acts as the group-wide supervisor for these firms, some of which are primarily engaged in the business of insurance.²⁵³

Securities and Exchange Commission

The mission of the Securities and Exchange Commission (SEC) is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Broadly, the SEC has jurisdiction over brokers and dealers, securities offerings in the primary and secondary markets, investment companies, investment advisers, credit rating agencies, and security-based swap dealers. Some insurance products are subject to registration with the SEC under the Securities Act²⁵⁴ and

248. 31 U.S.C. § 313(c). In addition, Dodd-Frank assigns specific duties to the Director of FIO. Pursuant to Title I, the Director serves as a nonvoting member of the FSOC. Under Title II, the affirmative approval of the Director, along with a vote of two-thirds of the members of the Federal Reserve then serving, is required before the Secretary may make a determination on whether to seek the appointment of the Federal Deposit Insurance Corporation as receiver of an insurance company.

249. For purposes of this report, TRIP refers to the program, as it is administered through regulations found in 31 C.F.R. Part 50.

250. 12 U.S.C. § 5323(a).

251. 12 U.S.C. § 5365.

252. 12 U.S.C. § 5412.

253. *Id.*

254. 15 U.S.C. § 77a et seq. Section 3(a)(8) of the Securities Act exempts any insurance policy or annuity contract issued by a corporation subject to the supervision of a state insurance commissioner. However, courts and the SEC have determined that certain insurance products are not within the scope of Section 3(a)(8). See, e.g., Definition of "Annuity Contract or Optional Annuity Contract," Securities Act Release No. 6558 (Nov. 21, 1984), [49 Fed. Reg. 46750 (Nov. 28, 1984)]; *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

to other federal securities laws. Also, the separate accounts underlying variable life insurance policies and annuity contracts are generally regulated as investment companies under the Investment Company Act of 1940 ('40 Act).²⁵⁵

Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) works to maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising state-chartered banks that are not members of the Federal Reserve System for safety and soundness and consumer protection, working to make large and complex financial institutions resolvable, and acting as the receiver of failed banks.²⁵⁶ The FDIC has in place rules and regulations that govern the actions of FDIC-insured institutions, including rules and regulations regarding capital adequacy for supervised institutions.²⁵⁷ Pursuant to Title II of Dodd-Frank, the FDIC may also be appointed receiver of insurance companies that are determined to pose a significant risk to the nation's financial stability if the Secretary, in consultation with the President, makes certain determinations following the recommendation of the Federal Reserve and the Director of the Federal Insurance Office.

Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks and federal savings associations, as well as federal branches and agencies of foreign banks. The purpose of the OCC is to ensure that supervised institutions operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations. In coordination with other U.S. banking regulators and international standard setters, the OCC identifies and develops policies to address emerging risks to bank capital. Title III of Dodd-Frank abolished the Office of Thrift Supervision and transferred the supervision and regulation of federally chartered savings associations, including those affiliated with insurers, to the OCC.²⁵⁸

Consumer Financial Protection Bureau

In limited circumstances, the Consumer Financial Protection Bureau (CFPB) can regulate insurers or their activities. Created by Title X of Dodd-Frank, the CFPB has authority, which was previously divided among seven agencies, over 18 enumerated federal consumer financial laws. It regulates the offering and provision of consumer financial products and services under federal

255. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64.

256. Banking Act of 1933, Public Law 73-66, 48 Stat. 162.

257. See 12 C.F.R. Part 324.

258. 12 U.S.C. § 5412.

consumer financial laws, develops consumer financial education initiatives, and researches and monitors the market for financial services.²⁵⁹

U.S. Department of Housing and Urban Development

The mission of the Department of Housing and Urban Development (HUD) is to create strong, sustainable, inclusive communities and quality affordable homes for all. To that end, the Federal Housing Administration (FHA) within HUD provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single family and multifamily homes (including manufactured homes) and hospitals. It is the largest insurer of mortgages in the world, insuring over 38 million properties since its inception in 1934.²⁶⁰ Among other things, HUD is vested with the authority to engage in formal adjudications of housing discrimination claims pursuant to the Fair Housing Act.

U.S. Department of Health and Human Services

The Department of Health and Human Services (HHS) administers the Medicaid and Medicare programs, which together pay approximately two-thirds of the costs of long-term care in the United States.²⁶¹ HHS has also adopted and enforces the “Standards for Privacy of Individually Identifiable Health Information,” also known as the HIPAA Privacy Rule,²⁶² which established a set of national standards for the protection of certain health information required under the Health Insurance Portability and Accountability Act of 1996.

Commodity Futures Trading Commission

The Commodity Futures Trading Commission (CFTC) was established in 1974 as an independent federal regulatory agency with exclusive jurisdiction over the markets for commodity futures and options on futures. The CFTC’s jurisdiction also extends to many other types of derivative contracts, including futures contracts on energy products, metals, financial assets and indexes, interest rates, and other financial, commercial, or economic contingencies. In 2010, Dodd-Frank amended the Commodity Exchange Act — governing futures markets and the CFTC’s authorities — to, among other things, expand the CFTC’s jurisdiction to include swaps, or derivative contracts that are based not on underlying assets or commodities, but on the exchange of financial instruments. Derivatives are used extensively by insurers (typically larger insurers), generally for hedging commercial risk. Accordingly, CFTC regulations can significantly affect insurers’ ability to efficiently hedge and manage their business risks in financial markets.

259. 12 U.S.C. §§ 5491 and 5493. The CFPB has, with regard to federal consumer financial laws, supervisory and enforcement authority over: (1) banks, thrifts, and credit unions with assets over \$10 billion, as well as their affiliates; (2) all nonbank residential mortgage originators, brokers, and servicers; (3) all payday lenders; (4) all non-bank private student lenders; (5) larger participants in markets for other consumer financial products or services as determined by CFPB rulemaking; and (6) other firms where the CFPB has reasonable cause to determine their conduct poses risks to consumers related to the offering or provision of consumer financial products or services. 12 U.S.C. §§ 5514 and 5515.

260. See U.S. Department of Housing and Urban Development, *The Federal Housing Administration (FHA)*, available at: https://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/fhahistory.

261. Peter Gallanis, et al., *State of the Long-Term Care Insurance Industry: NOLHGA Presentation to the NAIC* (Mar. 30, 2017), available at: http://www.naic.org/documents/cmte_e_mlwg_related_state_of_ltc_industry.pdf.

262. 45 C.F.R. § 160; 45 C.F.R. § 164 Subparts A and E.

Internal Revenue Service

Section 7801 of the Internal Revenue Code (Code) provides the Secretary with full authority to administer and enforce internal revenue laws. The Code affords certain life insurance and annuity products favorable tax treatment that makes those products more attractive to some consumers. Examples include tax-free death benefits under life insurance policies and tax-deferred growth of cash values within life insurance and annuities. The Internal Revenue Service also administers provisions of the Code that are unique to taxation of L&H and P&C insurers.

The following chart provides examples of involvement in insurance by the entities described above as well as other federal regulators and agencies.

Other Federal Regulators and Agencies Involved in Insurance

Agency	Examples of Involvement
Board of Governors of the Federal Reserve System (Federal Reserve)	The Federal Reserve regulates nonbank financial companies with significant insurance activities that have been designated by the FSOC pursuant to Section 113 of Dodd-Frank. The Federal Reserve also has a supervisory role with respect to savings and loan holding companies (SLHCs), including insurer-owned savings and loan holding companies, and their non-depository subsidiaries. The Federal Reserve acts as the group-wide supervisor for these firms, some of which are primarily engaged in the business of insurance.
Commodity Futures Trading Commission (CFTC)	Dodd-Frank amended the Commodity Exchange Act – governing futures markets and the CFTC’s authorities – to, among other things, expand the CFTC’s jurisdiction to include swaps, or derivative contracts that are based not upon underlying assets or commodities but upon the exchange of financial instruments. Derivatives are used extensively by insurers (typically larger insurers) generally for hedging commercial risk.
Consumer Financial Protection Bureau (CFPB)	In limited circumstances, the CFPB can regulate insurers or their activities. Created by Title X of Dodd-Frank, the CFPB regulates the offering and provision of consumer financial products and services under federal consumer financial laws, develops consumer financial education initiatives, and researches and monitors the market for financial services.
Export-Import Bank of the United States	Wholly-owned federal government corporation that provides financing for export operations where private financing is unavailable; support includes export credit insurance that insures accounts receivable against commercial or political risk. ¹
Federal Aviation Administration	Issues insurance for air operations that the President decides are necessary in the interest of air commerce or national security or to carry out the foreign policy of the United States; subject to indemnities from the agency or department sponsoring the flights. ²
Federal Communications Commission	Regulates the telemarketing of insurance products under the Telephone Consumer Protection Act (including its Do Not Call Registry). ³
Federal Crop Insurance Corporation in the U.S. Department of Agriculture	Administers the Federal Crop Insurance Program, under which the federal government reinsures commercial writers of crop insurance. ⁴
Federal Deposit Insurance Corporation (FDIC)	The FDIC may be appointed receiver of systemically important insurance companies that are determined to pose a significant risk to the nation’s financial stability if the Secretary, in consultation with the President, makes certain determinations following the recommendation of the Federal Reserve and the Director of the Federal Insurance Office.
Federal Emergency Management Agency in the U.S. Department of Homeland Security	Administers the National Flood Insurance Program. ⁵

Other Federal Regulators and Agencies Involved in Insurance *continued*

Agency	Examples of Involvement
Federal Housing Finance Agency in the U.S. Department of Housing and Urban Development	Establishes requirements for the issuers of private mortgage insurance. ⁶
Federal Maritime Administration	Can issue marine war risk insurance on an emergency, stand-by basis which becomes effective simultaneously with the automatic termination of ocean marine commercial war risk insurance policies; sets insurance requirements for vessels or technology financed by the Federal Ship Financing Program. ⁷
Federal Trade Commission	Has jurisdiction over deceptive insurance advertising practices when not regulated by state law. ⁸
Internal Revenue Service (IRS)	Section 7801 of the Internal Revenue Code (Code), provides the Secretary with full authority to administer and enforce internal revenue laws. The Code affords certain life insurance and annuity products favorable tax treatment that makes those products more attractive to some consumers. Examples include tax-free death benefits under life insurance policies and tax-deferred growth of cash values within life insurance and annuities. The IRS also administers provisions of the Code that are unique to taxation of L&H and P&C insurers.
Nuclear Regulatory Commission	Sets regulations for insurance requirements for nuclear reactors and other facilities pursuant to the Price-Anderson Act. ⁹
Office of the Comptroller of the Currency (OCC)	The OCC identifies and develops policies to address emerging risks to bank capital. Title III of Dodd-Frank abolished the Office of Thrift Supervision and transferred the supervision and regulation of federally chartered savings associations, including those owned by insurers, to the OCC.
Office of Finance and Insurance Industries in the U.S. Department of Commerce	Deploys policy, promotion, and analysis work to expand U.S. financial services exports, attract investment to the United States, and facilitate the growth and development of new and inclusive segments of finance, including in the area of insurance.
Overseas Private Investment Corporation	Government corporation providing political risk insurance to support investment by U.S. businesses in emerging markets. ¹⁰
Securities and Exchange Commission (SEC)	Unless otherwise exempted, insurance products constitute securities and are subject to registration with the SEC under the Securities Act and to other federal securities laws. The separate accounts underlying variable life insurance policies and annuity contracts are generally regulated as investment companies under the '40 Act.
United States Trade Representative	Authorized jointly with Treasury to enter into covered agreements with foreign governments respecting insurance. ¹¹

Other Federal Regulators and Agencies Involved in Insurance *continued*

Agency	Examples of Involvement
U.S. Department of Health and Human Services (HHS)	HHS administers the Medicaid and Medicare programs, which together pay approximately two-thirds of the costs of long-term care in the United States. HHS has also adopted and enforces the “Standards for Privacy of Individually Identifiable Health Information,” also known as the HIPAA Rule, which established a set of national standards for the protection of certain health information required under the Health Insurance Portability and Accountability Act of 1996.
U.S. Department of Homeland Security	Sets insurance requirements under the SAFETY Act, under which companies licensed to provide anti-terrorism products and services are released from liability in excess of insurance limits. ¹²
U.S. Department of Housing and Urban Development (HUD)	The Federal Housing Administration (FHA) within HUD provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single family and multifamily homes (including manufactured homes) and hospitals.
U.S. Department of Labor	Administers major disability compensation programs for coal miners, longshoremen and harbor workers, energy employees, and federal workers; regulates compliance with the Employee Retirement Income Security Act (ERISA).

1. Fixing America’s Surface Transportation Act, Pub. L. 114-94, 129 Stat. 1312 (2015).
2. 49 U.S.C. § 44301, et seq.
3. 47 U.S.C. § 227; 47 CFR 64.1200.
4. Federal Crop Insurance Act (7 U.S.C. § 1505 Management of Corporation); Code of Federal Regulations (CFR), Title 7- Agriculture, Subtitle B-Regulations of the Department of Agriculture, Chapter IV - Federal Crop Insurance Corporation (general administrative regulations of the FCIC) codified in 7 CFR 400; regulations pertaining to private sector plans of insurance submissions are published in Subpart V, 7 CFR 400.700-722.
5. 42 U.S.C. Chapter 50.
6. Housing and Economic Recovery Act of 2008, Pub. L. 110-289 (2008).
7. 46 U.S.C. Chapter 539 (Pub. L. 109-304) (war risk insurance provisions); 46 CFR Part 308 (implementing regulations).
8. Federal Trade Commission v. Travelers Health Association, 363 US 293 (1960); McCarran-Ferguson Act, 15 U.S.C §1012(b).
9. 42 U.S.C. § 2210.
10. Foreign Assistance Act of 1961 (as amended), 22 U.S.C. 2191.
11. Dodd-Frank, Title V (Pub. L. 111-203, 124 Stat. 1376).
12. Homeland Security Act of 2002, Public Law 107-296.

Source: Treasury internal analysis

The Financial Crisis, Insurers, and Dodd-Frank

The financial crisis was precipitated by ill-designed public policies, inadequate oversight, and numerous events, including a decline in housing prices, an increase in mortgage delinquencies, and deterioration in the value of mortgage-backed securities. As the crisis spread throughout the financial system, some of the largest financial institutions suffered significant losses. Like other parts of the financial sector, the insurance industry was affected in several ways, including by the extension of extraordinary government assistance to American International Group, or AIG. The crisis also contributed to the failure of financial guaranty insurers, and caused a number of insurers to seek federal emergency liquidity assistance, including for the purpose of stabilizing capital levels for variable annuity products. This prompted policymakers to develop reforms at the domestic and international level to remedy weaknesses in the financial system that were exposed during the crisis.

Net income for both the L&H and P&C sectors fell dramatically from pre-crisis levels in 2008, but this decline was mainly due to realized capital losses on insurers' investment portfolios rather than underwriting activities. As a result, asset values dropped and capital and surplus accounts were negatively impacted by losses. However, solvency concerns and failures in the industry were relatively limited. From 1980 to 2010, there were 291 failures of life insurance companies in the United States, but the peak period for failures was from 1989 to 1994 (when a total of 152 life insurers failed), not during the financial crisis.²⁶³ P&C insurer failures followed a similar pattern, with overly competitive pricing and increases in reserves cited as possible causes.²⁶⁴ In 2008 and 2009, there were 18 life insurance company receiverships and nine liquidations,²⁶⁵ while the P&C sector experienced 19 receiverships and 11 liquidations.²⁶⁶ By the end of 2009, capital and surplus levels for both sectors of the U.S. insurance industry had recovered to pre-crisis levels, while financial leverage was slightly lower than pre-crisis, where it has remained through 2016. Figure 17 presents selected financial data for the L&H and P&C sectors, showing their financial performance and condition in the years around, and following, the financial crisis.

263. Stephen Robb, Society of Actuaries, *Comparative Failure Experience in the U.S. and Canadian Life Insurance and Banking Industries from 1980 to 2010* (Mar. 2013), available at: <https://www.soa.org/research-reports/2013/research-2013-comparative-failure-experience/>.

264. David F. Bradford, editor, *The Economics of Property-Casualty Insurance* (1998), available at: <http://www.nber.org/chapters/c6941.pdf>. A 1990 report issued by the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigations entitled *Failed Promises: Insurance Company Insolvencies* found that the then current system of solvency regulation was inadequate due to the insurance industry's rapid expansion, underpricing, inadequate oversight, inadequate loss reserves, poor reinsurance transactions, and fraud (U.S. House of Representatives, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, *Failed Promises: Insurance Company Insolvencies*, 101st Cong., 2nd Sess., Committee Print 101-P (Washington: GPO 1990)).

265. In a receivership, a court-appointed receiver has custodial responsibility for the property of an insurer, including tangible and intangible assets and rights in cases where the insurer cannot meet its financial obligations. In a liquidation, the insolvent insurer's operations are concluded, and its assets are distributed among policyholders, creditors, and shareholders, according to the hierarchy of claims established by state law.

266. Government Accountability Office, *Impact of and Regulatory Response to the 2007-2009 Financial Crisis* (June 2013), at 17, available at: <https://www.gao.gov/assets/660/655612.pdf>.

Figure 17: Selected Financial Data - U.S. Insurance Industry

L&H Insurance Sector (\$ billions)

	2006	2007	2008	2009	2010
Premiums, Consideration, & Deposits	565.93	597.01	608.19	493.01	561.96
Net Investment Income	161.53	168.04	162.19	156.62	164.14
Net Income	37.01	31.63	(52.31)	21.53	28.05
Total Assets	3,005.42	3,086.62	3,178.98	3,230.48	3,356.50
Policyholders' Surplus	253.10	266.94	251.77	290.69	306.43
Leverage	11.87	11.56	12.63	11.11	10.95

Source: SNL Financial

P&C Insurance Sector (\$ billions)

	2006	2007	2008	2009	2010
Net Premiums Written	448.91	446.94	440.35	423.08	426.22
Net Investment Income	53.14	56.50	53.13	48.40	48.10
Net Income	66.45	63.62	3.71	32.20	37.22
Total Assets	1,452.52	1,506.30	1,447.81	1,491.67	1,548.38
Policyholders' Surplus	497.08	529.13	461.76	517.97	561.78
Leverage	2.92	2.85	3.14	2.88	2.76

Source: SNL Financial

In response to the crisis, Congress passed Dodd-Frank in 2010. Dodd-Frank is enormous in its scale, reach, and complexity. Given its scale, it is difficult to summarize the totality of Dodd-Frank. Key characteristics of Dodd-Frank with significant implications for the insurance industry include:

- **Mitigation of Systemic Risk:** Title I of Dodd-Frank established the FSOC for the oversight of systemic risks. Among other responsibilities and authorities, the FSOC can designate nonbank financial companies for Federal Reserve supervision, and can designate financial market utilities as systemically important. Dodd-Frank also requires the Federal Reserve to adopt enhanced prudential standards for U.S. bank holding companies having total assets of at least \$50 billion, along with certain foreign banking organizations and designated nonbank financial companies.

- **Resolution Planning:** Title II of Dodd-Frank established a non-bankruptcy mechanism for resolving financial companies, including insurance companies, whose failure and resolution under otherwise applicable federal or state law would have serious adverse effects on U.S. financial stability. To do so in the case of an eligible insurance company, the affirmative approval of the FIO Director, along with a vote of two-thirds of the members of the Federal Reserve then serving, is required before the Secretary may make a determination on whether to seek the appointment of the FDIC as receiver of such insurance company. In most cases, however, Dodd-Frank allows state resolution mechanisms to operate so long as state insurance regulators act within 60 days. If state insurance regulators fail to act, Title II allows the FDIC to resolve the affected insurance company under applicable state law.
- **Elimination of the Office of Thrift Supervision:** Title III of Dodd-Frank eliminated the Office of Thrift Supervision and transferred its duties to the OCC, the Federal Reserve, and the FDIC.²⁶⁷ Among other things, this transfer of powers and duties made the Federal Reserve the group-wide supervisor for insurance parent companies with insured depository institutions.²⁶⁸
- **Creation of the Federal Insurance Office:** Title V of Dodd-Frank established FIO in Treasury.
- **Derivatives:** Title VII of Dodd-Frank created a new structure for regulating over-the-counter derivatives, which are used by insurers and their affiliates to hedge their investments and other business risks.
- **Securities Act Exemption:** Section 989J of Dodd-Frank (the “Harkin Amendment”) directs the SEC to treat certain life insurance and annuity products as exempt securities under the Securities Act, subject to specified conditions.

267. 12 U.S.C. § 5412.

268. *Id.*

Insurance: Findings and Recommendations



Systemic Risk and Solvency

Systemic Risk and the Insurance Industry

The financial crisis exposed gaps in the regulation of the insurance industry, including a lack of regulatory oversight of non-insurance activities undertaken by insurance companies. For example, AIG Financial Products Corporation and AIG Securities Lending Corporation — two non-insurance affiliates of AIG — led to the near-failure of AIG, which threatened the financial stability of the United States.

Section 113 of Dodd-Frank authorizes the FSOC to designate a nonbank financial company to be subject to supervision by the Federal Reserve and enhanced prudential standards if the company's material financial distress — or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities — could pose a threat to U.S. financial stability.²⁶⁹ Three of the four companies initially designated by the FSOC under Section 113 were insurers. AIG and Prudential Financial were designated by the FSOC in 2013; MetLife was designated in 2014.²⁷⁰ In March 2016, a federal court order rescinded the FSOC designation of MetLife, which has been appealed by the the FSOC and remains pending. In September 2017, the FSOC announced that it rescinded the designation of AIG.²⁷¹

As noted earlier, Dodd-Frank also authorizes the FSOC to examine activities of potential systemic importance. The FSOC has previously issued proposed recommendations under its Section 120 authority with respect to the regulation of money market mutual funds,²⁷² but has not used this authority to address risks in the insurance industry.

Many stakeholders have argued that entity-based systemic risk evaluations of individual insurers may not be the best approach for mitigating risks arising from the insurance industry. These commenters state that such evaluations may not take into account the fundamental differences between insurers' business models and those of depository institutions. Finally, stakeholders noted that entity-based systemic risk evaluations are targeted toward only a limited number of firms and therefore may not be best for mitigating systemic risk, particularly in cases where activities or practices are undertaken by a significant number of industry participants.

Recommendations

Treasury's position is that entity-based systemic risk evaluations of insurance companies generally are not the best approach for mitigating risks arising from the insurance industry. Rather than focus on entity-based systemic risk evaluations, insurance regulators should focus on potential risks arising from insurance products and activities, and on implementing regulations that strengthen the insurance industry as a whole. Also, while the FSOC maintains primary responsibility for

269. 12 U.S.C. § 5323(a) (1).

270. See U.S. Department of the Treasury, *Financial Stability Oversight Council*, available at: <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

271. *Id.*

272. Notice Seeking Comment on Asset Management Products and Activities (Dec. 18, 2014), [79 Fed. Reg. 77488 (Dec. 24, 2014)].

identifying, evaluating, and addressing systemic risks in the U.S. financial system, the states are the primary regulators of the insurance industry in the United States, and insurance regulation at the federal level should be conducted in coordination with the states.

International Association of Insurance Supervisors

In many ways, the international response to the financial crisis mirrored that of the United States. In April 2009, the Group of 20 (G-20) established the Financial Stability Board (FSB) to monitor and make recommendations about the global financial system. A key initiative of the FSB is the identification of systemically important financial institutions (SIFIs), which are defined as financial institutions whose distress or disorderly failure, because of their size, complexity, and systemic interconnectedness, would cause significant disruption to economic activity and the wider financial system. Among other things, the International Association of Insurance Supervisors (IAIS) is charged by the FSB with recommending insurers that should be identified as SIFIs (i.e., global systemically important insurers, or G-SIIs).

In 2013, the IAIS developed an assessment methodology to inform its recommendation to the FSB of insurers that may be eligible for identification as G-SIIs. In July 2013, the FSB — in consultation with the IAIS and national authorities — identified an initial list of nine G-SIIs. An annual process for potential identification was subsequently conducted, with nine G-SIIs being identified in each year.

In November 2016, the FSB announced its G-SII list, and in 2017 the IAIS announced its intention to explore an activities-based approach to address systemic risk as a possible complement to the G-SII entity-based assessment approach.²⁷³ Unlike an entity-based approach, which focuses on the extent to which any single insurance company poses a threat to the broader financial system, an activities-based approach examines risk across insurers to assess vulnerabilities that may be relevant to financial stability.²⁷⁴

In January 2017, the IAIS established the Systemic Risk Assessment Task Force with responsibility to assess and measure systemically risky activities through an activities-based approach and improve cross-sectoral consistency in systemic risk measurement. The work plan of the task force involves publication of an initial consultation paper in 2017, followed by a second, more detailed, consultation paper in late 2018. These consultations would each seek stakeholder input on the development of an activities-based assessment.

Recommendations

Treasury recommends that FIO and the other U.S. members of the IAIS support the IAIS' work on the activities-based approach. Such an approach is a more appropriate method of assessing potential systemic risk in the global insurance market. The U.S. members of the IAIS should advocate for the development of an activities-based framework that is proportionate and appropriately

273. International Association of Insurance Supervisors, *Systemic Risk and Insurance, Presentation at Annual Global Seminar* (June 29, 2017), available at: <https://www.iaisweb.org/file/67325/2-alberto-corinti-170611-sratf-presentation-to-stakeholders>.

274. *Id.*

tailored to the U.S. insurance market. In recognition of the activities-based approach, the IAIS should reassess its existing G-SII policy measures, including how to improve the IAIS' 2014 guidance on liquidity management and planning.²⁷⁵

Treasury also recommends that FIO and the other U.S. members of the IAIS take steps to improve the IAIS G-SII assessment methodology and consider how to increase transparency with respect to the assessment methodology's development. U.S. members of the IAIS should advocate that the IAIS enhance its work on cross-sectoral consistency with other financial sectors — such as through work with the Basel Committee on Banking Supervision — which will allow the IAIS to better assess the potential global systemic risk of insurers.

Preserving Solvency: Capital Initiatives

Insurers assume risk from policyholders that may give rise to future payment obligations, which makes capital a particularly important consideration for insurer solvency.²⁷⁶ For long duration business lines (e.g., life insurance) insurers are exposed to potentially significant levels of interest rate risk because the markets for assets to back these obligations are limited to investments that may mature before the maturation of the obligations they offset. Therefore, capital serves as a safety net in cases where actual payments exceed reserves. Similarly, short duration business lines (e.g., property insurance) rely on capital to serve as a buffer for unexpected, often catastrophe-related, losses that may exceed reserves.

Insurance regulation in the United States includes the supervision of both the nature and extent of an insurer's capital. As insurance markets become more global, supervisors in the United States and elsewhere are increasingly aware of the need to understand the financial viability of insurers that are based elsewhere but operate in their markets. One way to enhance understanding among supervisors in different jurisdictions may be through a commonly understood, quantitative capital standard that would be applied at the group level. With respect to insurance, a “group” refers to two or more insurance legal entities that coexist as part of a corporate family by virtue of ownership or affiliation.

While some foreign jurisdictions currently have a group capital requirement that is applicable to insurers, no such standard exists in the United States. The current state-based solvency regulation framework in the United States applies capital requirements only at the insurance legal-entity level. State and federal authorities have recently taken steps toward the development of insurance group capital frameworks.

There are currently three distinct organizations working on development of group-wide capital initiatives that could be applicable to U.S. insurers: (1) the NAIC and state insurance regulators, (2) the Federal Reserve, and (3) the IAIS.²⁷⁷

275. See <https://www.iaisweb.org/page/supervisory-material/financial-stability-and-macroprudential-policy-and-surveillance//file/47800/liquidity-guidance-final>.

276. Reserves for claims and future payment obligations are treated as liabilities by insurers.

277. The group capital standard in development at the IAIS includes involvement by U.S. members of the IAIS.

State Regulator Capital Initiatives

At the state level, insurance regulators impose minimum capital requirements on a legal entity basis but have not, to date, developed a capital assessment for insurance groups. In late 2015, state insurance regulators, through the NAIC, expressed the intention to construct a U.S. group capital calculation using a risk-based capital aggregation approach. The states' approach would use existing regulatory capital calculations for all entities within the holding company structure, rather than developing replacement or additional standards.²⁷⁸

Federal Reserve Capital Initiatives

In June 2016, the Federal Reserve published an advance notice of proposed rulemaking on Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities.²⁷⁹ The advance notice invites comment on two approaches to group capital requirements for these institutions: (1) a “building block approach” that uses existing legal entity capital requirements as the basis for measuring insurance depository institution holding companies (e.g., savings and loans holding companies, or SLHCs) and (2) a “consolidated approach” for insurance companies designated by the FSOC.

The proposed building block approach would sum capital resources and sum capital requirements across different legal entities in the group to arrive at one group-level amount for each. Capital requirements would generally be the sum of the capital requirements at each regulated insurance or depository institution's subsidiary, based on the regulatory capital rules of each respective subsidiary's lead insurance or banking regulator.²⁸⁰ The Federal Reserve's proposed building block approach is conceptually similar to the aggregation approach being considered by the NAIC and state regulators.

The proposed consolidated approach would categorize all consolidated assets and insurance liabilities into risk segments tailored to account for the liability structure and other unique features of the insurance group. It would then apply risk factors to the amounts in each risk segment. The approach would be based on U.S. generally accepted accounting principles (GAAP), with appropriate adjustments for regulatory purposes. The consolidated approach would also allow for supervisory stress testing.

Recommendations

The group capital initiatives by the NAIC, the states, and the Federal Reserve should be harmonized, to the extent possible, to mitigate duplicative and unnecessary regulatory burdens for U.S.

278. For example, this approach would use risk-based capital for U.S. legal entity insurers, jurisdiction-appropriate calculations for non-U.S. legal entities, and Basel Committee on Banking Supervision requirements for banking entities. For legal entities without existing capital requirements (i.e., non-regulated financial services entities), a standard would need to be adopted. For multi-national insurers, this approach may need to address how to aggregate jurisdictional requirements of multiple countries that differ in design and calibration.

279. Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (June 9, 2016), [81 Fed. Reg. 38631 (June 14, 2016)].

280. Additionally, adjustments may be needed to address other exposures, e.g., to harmonize permitted accounting practices that vary across states.

insurers. The Secretary will direct FIO to consult with the state insurance regulators, the NAIC, and the Federal Reserve on their respective group capital initiatives to produce the best outcomes for U.S. insurers, U.S. policyholders, and the U.S. insurance market. The Secretary will also direct FIO to coordinate this work. FIO will then advocate for the U.S. approach to group capital in international forums.

IAIS Capital Initiatives

The work of the state regulators, the NAIC, and the Federal Reserve being conducted will influence the United States' position with respect to group capital initiatives in development at the IAIS. The IAIS Insurance Capital Standard (ICS) is being developed as part of the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame).²⁸¹ ComFrame aspires to provide a more uniform approach to group capital through a risk-based group capital standard that is understood by supervisors across jurisdictions. The ICS has several foundational building blocks: (1) a valuation basis for assets and liabilities, (2) a capital requirement that considers all relevant and material risks and is calibrated at a sufficient level, and (3) criteria to determine qualifying capital resources that are available to meet that capital requirement.²⁸² The ICS is also intended to replace the Basic Capital Requirement as the foundation for the Higher Loss-Absorbency Requirement.²⁸³ The Higher Loss-Absorbency Requirement is subject to further review and improvement, and is scheduled to be implemented beginning in 2022, once revised, and apply to any G-SIIs identified in 2020.

While adoption of the ICS by the IAIS is not scheduled until late 2019, the work product in development highlights potential issues that suggest the remaining work will be complex and challenging. First, the IAIS needs to determine the way forward once the ICS development process is complete. In an effort to do so, the IAIS recently called for more options in Version 1.0 with respect to valuation methodologies and capital resources to be tested than had originally been envisioned.

281. The IAIS defines an Internationally Active Insurance Group (IAIG) as a large, internationally active group that includes at least one insurance activity where: (1) premiums are written in not fewer than three jurisdictions (including the home jurisdiction), and gross premiums written outside the home jurisdiction are not less than 10% of the group's total gross written premiums, and (2) based on a rolling three-year average, total assets are not less than \$50 billion, or gross written premiums are not less than \$10 billion. See IAIS, *Common Framework for the Supervision of Internationally Active Insurance Groups, Revised DRAFT*, at 2 (Sept. 2014), available at: <https://www.iaisweb.org/page/supervisory-material/common-framework//file/58726/revised-comframe-draft-2014>.

282. IAIS, *Consultation on Risk-based Global Insurance Capital Standard (ICS) Version 1.0 Public Consultation Document*, available at: <https://www.iaisweb.org/page/consultations/closed-consultations/risk-based-global-insurance-capital-standard--second-consultation//file/61557/2016-risk-based-global-insurance-capital-standard-ics-consultation-document>. The IAIS began field testing the ICS in 2013, with the process evolving through annual iterations to include testing of these three components.

283. International Association of Insurance Supervisors, *Basic Capital Requirement for G-SIIs* (Oct. 23, 2014); International Association of Insurance Supervisors, *Higher Loss Absorbency Requirement for Globally Systemic Important Issuers-(G-SIIs)*, (Oct. 5, 2015), available at: <https://www.iaisweb.org/page/supervisory-material/financial-stability-and-macroprudential-policy-and-surveillance>.
<https://www.iaisweb.org/page/supervisory-material/financial-stability-and-macroprudential-policy-and-surveillance>.

Another key issue is comparability. Comparability involves the valuation of assets and liabilities, which can affect the consistency of outcomes across jurisdictions. The valuation method preferred by the majority of members is a market-adjusted valuation, similar to that used in the European Union's Solvency II insurance regulatory regime, which makes certain adjustments to attempt to mitigate the volatility and inconsistency of a pure market-based valuation. Nevertheless, concerns persist among some industry stakeholders as to whether the market adjustments currently being tested by the IAIS sufficiently reduce the potential adverse non-economic volatility impacts or whether they sufficiently reflect the manner in which insurers manage risks.

With respect to valuation, the IAIS is also considering financial reporting that uses GAAP, with jurisdictionally specific adjustments to increase comparability. This approach has the advantage of basing the ICS valuation on amounts that have been determined and presented based on published guidance by accounting standard setters, and have been subjected to independent audit. The adoption of a financial reporting-based approach also needs to consider the differences between GAAP developed by the Financial Accounting Standards Board (FASB), which is used in the United States, and International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB), which is used by many other countries.

Recommendations

It is critical that the U.S. members of the IAIS present a consistent, unified approach to ICS development. Such standards should recognize the diverse approaches to solvency regulation taken by various jurisdictions around the globe. A core goal should be to ensure that the ICS initiative accommodates the U.S. insurance business model and the existing state-based regulatory system. Such standards should also be developed in a manner that recognizes the variety of supervisory approaches to valuation and accounting requirements, and definitions of what constitutes capital.

The IAIS should reexamine its current timeline to deliver ICS Version 2.0 in 2019. Treasury recommends that the IAIS postpone ICS Version 2.0 until a later date to allow further consultation with IAIS members and stakeholders on the development of an ICS that is implementable in all major insurance markets. Additionally, the valuation methodology of the ICS will be affected by the ongoing work of the IASB and the FASB. A delay in implementation of the ICS would enable the IAIS to incorporate these potential accounting changes within the ICS, which could result in an improved global capital standard.

Preserving Solvency: Liquidity Initiatives

Understanding liquidity risk is a critical component of insurance solvency regulation and oversight. Generally, liquidity can be defined as the ability of a financial market participant to quickly liquidate assets, without substantial price concessions, to meet immediate, short-term financial obligations. Potential cash outflows in a stress environment can cause liquidity issues, and may lead to asset sales at distressed prices. Such a scenario not only has solvency-related implications for an individual insurer, but potentially for broader financial markets as well. Significantly tighter access to credit, for example, would have a significant impact on the ability to secure short-term debt financing among other spillover effects.

PriceWaterhouseCoopers has outlined several core aspects of liquidity which, in Treasury's view, provides a structured approach to any evaluation of liquidity that may be undertaken by policymakers.²⁸⁴

State Regulator Liquidity Initiatives

In August 2017, the NAIC launched its Macro-Prudential Initiative, which will consider, among other things, liquidity needs of large life insurers.²⁸⁵ Particularly, the NAIC's Financial Stability Task Force created a new Liquidity Assessment Subgroup.²⁸⁶ In its proposal to create the subgroup, the Financial Stability Task Force explained that state regulators currently have little substantive data on insurers' liquidity risk, do not require liquidity stress testing, and thus have no common measure to assess insurers' level of liquidity risk. This raised concerns regarding how larger insurers would perform under liquidity stress, and how such an event might impact the broader financial markets.²⁸⁷ The new subgroup is charged with constructing a liquidity stress framework based on a review of existing data related to liquidity risk, as well as gaps in that data that do not fully address regulatory needs.²⁸⁸

Federal Reserve Liquidity Initiatives

Pursuant to Section 165 of Dodd-Frank, in June 2016 the Federal Reserve issued a Proposed Rule on Enhanced Prudential Standards for Systemically Important Insurance Companies that seeks to mitigate liquidity risks at systemically important insurance companies, and account for differences between bank holding companies and systemically important insurance companies.²⁸⁹ The proposal would require a systemically important insurance company designated by the FSOC to implement a number of provisions to manage its liquidity risk, and includes requirements to: (1) meet key internal control requirements with respect to liquidity risk management, (2) generate comprehensive cash-flow projections, (3) establish and monitor liquidity risk tolerance, and (4) maintain a contingency funding plan to manage liquidity stress events when normal sources of funding may not be available.²⁹⁰ The proposed rule also would introduce liquidity stress-testing requirements and would require the company to maintain liquid assets that are sufficient to meet

284. PriceWaterhouseCoopers LLP, *Global Financial Markets Liquidity Study* (Aug. 2015), available at: <http://www.pwc.se/sv/pdf-reports/global-financial-markets-liquidity-study.pdf>.

285. National Association of Insurance Commissioners, *Financial Stability (EX) Task Force: Meeting Summary Report* (August 6, 2017), available at: http://www.naic.org/meetings1708/cmte_ex_financial_stability_tf_2017_summer_nm_summary.pdf.

286. *Id.*

287. National Association of Insurance Commissioners, *FSTF Proposal for Liquidity Assessment Subgroup* (August 6, 2017), available at: http://naic.org/meetings1708/cmte_ex_financial_stability_tf_2017_summer_nm_materials_3.pdf.

288. *Id.*

289. Enhanced Prudential Standards for Systemically Important Insurance Companies (June 9, 2016), [81 Fed. Reg. 38610 (June 14, 2016)]. Among other things, Section 165 requires that enhanced prudential standards include liquidity requirements.

290. *Id.*

net cash outflows for 90 days over the range of liquidity stress scenarios used in internal stress testing.²⁹¹

IAIS Liquidity Initiatives

In 2014, the IAIS set forth guidance to group-wide supervisors on the direction of liquidity management planning for G-SIIs.²⁹² The principles defined by the IAIS as part of an effective liquidity management plan include: (1) development of a policy statement on the near- and long-term risk tolerance, (2) explanation of the corporate governance structure that will oversee the liquidity management, (3) a method for analyzing an insurer's liquidity risk through various time horizons and scenarios, and (4) annual reporting by G-SIIs to their group-wide supervisor.²⁹³ The guidance, which is meant to complement existing liquidity arrangements, outlines the key supervisory features that would be expected of a G-SII.²⁹⁴ In a 2016 report, *Systemic Risk from Insurance Product Features*, the IAIS studied the extent to which certain product features could pose substantial liquidity risk.²⁹⁵ The IAIS also noted that the updated methodology for the assessment of G-SIIs²⁹⁶ was revised to more appropriately account for certain liquidity features in insurance products. Moving forward, the IAIS Systemic Risk Assessment Task Force is expected to perform an activities-based assessment of liquidity risk in the global insurance sector.

Recommendations

Treasury supports robust liquidity risk management programs for insurers and encourages state insurance regulators, the NAIC, and the Federal Reserve to continue their work on addressing potential liquidity risk in the insurance sector. The Secretary will direct FIO to monitor developments in liquidity management and liquidity stress testing, and to encourage state insurance regulators, the NAIC, and the Federal Reserve to continue to make progress on domestic liquidity risk initiatives. The Secretary will also direct FIO to advocate for improvements to the existing IAIS standards regarding liquidity management and planning.

Efficient Regulation and Government Processes

Role of State and Federal Regulation

The state-based insurance regulatory system has a 150-year record of protecting the rights of policyholders and regulating insurers. For the most part, the system has been effective. This is due, in

291. Id.

292. International Association of Insurance Supervisors, *Guidance on Liquidity Management and Planning* (October 22, 2014), available at: <https://www.iaisweb.org/file/47800/liquidity-guidance-final>.

293. Id.

294. Id.

295. International Association of Insurance Supervisors, *Systemic Risk from Insurance Product Features* (June 16, 2016) available at: <http://www.iaisweb.org/file/61174/systemic-risk-from-insurance-product-features>.

296. Id.

part, to the knowledge and experience of state legislators and regulators who are well-positioned to tailor regulation to the activities of their stakeholders and respond to their citizens' unique needs.

Treasury endorses the state-based regulatory model for the U.S. insurance industry and recommends narrowing the scope of federal involvement as detailed throughout this section. Treasury also recognizes the importance of the federal government's involvement in the administration of key insurance programs that provide stability, certainty, and opportunity to Americans and their businesses. There are, however, areas for improvement of these programs, which are detailed below.

Despite the strengths of the state-based insurance regulatory system, stakeholders voiced concerns that the system exhibits a degree of inefficiency by virtue of inconsistent laws and regulations among the states. This section recommends that states and the NAIC take targeted action to make regulation efficient, effective, and appropriately tailored, as contemplated by the Core Principles.

Stakeholders also expressed that lawmakers, regulators, and policymakers have missed opportunities to collaborate at both the federal and state levels. Such collaboration would advance American interests abroad, make regulation more efficient, and foster economic growth. Treasury therefore recommends enhanced collaboration, both between the state and federal governments, and within the federal government.

Finally, Treasury recognizes that the increasingly international dimension of the insurance business mandates a federal presence that advances American interests in international negotiations and meetings. Treasury recommends robust engagement in international standard-setting bodies to ensure that the U.S. insurance stakeholders and the federal government are well-represented and that those representatives more effectively coordinate their positions and policies prior to major international meetings.

The Revised Role of the Federal Insurance Office

Among other things, FIO was established to address the lack of insurance industry expertise in the federal government, assist in the administration of certain government insurance programs and activities, and provide a U.S. federal government perspective in an increasingly globalized industry. To better align FIO with its statutory framework and to ensure consistency with the long-established U.S. policy of state-based insurance regulation, Treasury has crafted five pillars that will guide FIO's mission:

- Promote the U.S. state-based insurance regulatory system and advocate for the U.S. insurance sector in international forums and negotiations, and in foreign markets.
- Provide insurance policy expertise and advice to the federal government, state insurance regulators, and industry through the publication of comprehensive research and analysis, consultation on emerging issues, and evaluation of federal insurance programs.
- Provide coordinated and collaborative leadership on insurance issues that engage the federal government and state insurance regulators, including through enhanced coordination between the federal government and state insurance regulators.
- Protect the U.S. financial system and economy by advising the Secretary and the FSOC on insurance-related matters that may pose a threat to U.S. financial stability.

- Protect America's financial security by promoting access to insurance products and administering the Terrorism Risk Insurance Program.

These five pillars are being established to advance the Core Principles of Executive Order 13772. First, they will enable U.S. insurance companies to be more competitive in foreign markets, where U.S. firms actively participate and, in some cases, see opportunity for continued expansion. Second, they will advance U.S. interests in various international forums by ensuring appropriate and coordinated advocacy for the U.S. state-based insurance regulatory system, the U.S. insurance sector, and U.S. policyholders, which will enable the United States to be more effective in developing insurance policy. Finally, the pillars are intended to ensure that regulation is efficient, effective, and appropriately tailored by enhancing the collaboration between state and federal agencies and improving consultation with state insurance regulators, while providing expertise for research and analysis. Additional examples of FIO's revised role can be found throughout the insurance section of this report.

Recommendations

To ensure FIO is accountable to these core pillars, Treasury is committed to FIO's increased transparency and stakeholder engagement, and will implement mechanisms to achieve these objectives. For example, Treasury is committed to making its international negotiating posture and actions more accessible to various stakeholders through both public and private forums. Additionally, Treasury and FIO are committed to more regular and consistent engagement with state insurance regulators and stakeholders on developing issues of importance to the insurance industry, state regulators, and U.S. policyholders.

The Federal Reserve's Regulation of Insurer Savings and Loan Holding Companies

Business groups primarily engaged in the business of insurance that own insured depository institutions may be subject to supervision by the Federal Reserve. Pursuant to Regulation Q, the Federal Reserve acts as the group-wide supervisor for savings and loan holding companies (SLHCs) in cases where: (1) an insurance underwriting company is the ultimate parent company of a SLHC affiliate, or (2) a SLHC holds 25% or more of its total consolidated assets in insurance underwriting subsidiaries.²⁹⁷ In these cases, SLHCs may be referred to as insurance SLHCs, or ISLHCs.

Federal Reserve supervision includes an evaluation of the impact of material subsidiaries and business units on the consolidated and banking entities.²⁹⁸ The Federal Reserve's supervisory regime

297. 12 C.F.R. § 217.2. Most ISLHCs are organized as mutual insurance companies that are structured in a manner such that the parent company is an operating insurance company, not a holding company without other business operations.

298. Federal Reserve reviews include discovery reviews, targeted reviews, and enhanced continuous monitoring reviews; annual rating of an institution, reviews of corporate governance, enterprise risk management, compliance, and internal audit; requirements for capital and liquidity; and reviews of investments and investment risk management.

includes substantial recordkeeping and reporting requirements.²⁹⁹ For example: Federal Reserve Forms Y-6 and Y-11 require substantial financial reporting, Form FR Y-8 requires that affiliated transactions be reported to the Federal Reserve, and enterprise risk management and corporate governance practices are reported to the Federal Reserve pursuant to Form F and SR Letters. These compliance requirements impose significant costs on ISLHCs.

Federal Reserve supervision also includes continuous examination of the financial condition of ISLHCs through a number of discovery and targeted reviews. These examinations also generate significant costs. ISLHCs must pay an annual assessment for Federal Reserve supervision and examinations.³⁰⁰

State insurance regulators impose the same or similar recordkeeping, reporting, and examination requirements.³⁰¹ Like the Federal Reserve, state insurance regulators require extensive annual financial reports,³⁰² require reports on affiliated transactions,³⁰³ evaluate risk management and corporate governance,³⁰⁴ apply risk-based capital requirements,³⁰⁵ conduct annual financial condition analyses, and conduct periodic financial condition examinations that can last years.³⁰⁶ Such examinations must be conducted at least once every five years. State insurance regulators are reimbursed by insurers for costs associated with their examinations.

299. Section 5000 (BHC Inspection Program) includes references to records that an ISLHC must provide access to in an examination. See <https://www.federalreserve.gov/boarddocs/supmanual/bhc/5000p1.pdf>. Federal Reserve supervision of ISLHCs is guided by its Supervision Manuals and Supervision and Regulation Letters (SR Letters). See <https://www.federalreserve.gov/publications/supmanual.htm> (supervisory manual); <https://www.federalreserve.gov/supervisionreg/srletters/srletters.htm> (SR Letters).

300. This assessment is based on total consolidated assets. For example, one stakeholder represented to Treasury that its most recent annual Federal Reserve assessment cost \$5.3 million, compared to the \$1.5 million cost of its most recent full scope financial condition examination conducted by state insurance regulators.

301. The relative consistency of states' work product is maintained through the NAIC's Financial Regulation Standards and Accreditation Program; currently, all 50 states are accredited under this program.

302. See, e.g., National Association of Insurance Commissioners, *Form B and Annual Statements; Annual and Quarterly Statement Blanks, 2016 Edition*, NAIC, 2017, and *Annual and Quarterly Statement Instructions, 2016 Edition*, NAIC, 2017.

303. See, e.g., National Association of Insurance Commissioners, *Annual Statements; Annual and Quarterly Statement Blanks, 2016 Edition*, NAIC, 2017, and *Annual and Quarterly Statement Instructions, 2016 Edition*, NAIC, 2017.

304. See, e.g., National Association of Insurance Commissioners, *ORSA and Form F: NAIC, Risk Management and Own Risk Solvency Assessment Model Act*, available at: <http://www.naic.org/store/free/MDL-505.pdf>; NAIC Insurance Holding Company System Model Regulation with Reporting Forms and Instructions, available at: www.naic.org/store/free/MDL-450.pdf.

305. National Association of Insurance Commissioners, *Financial Analysis Handbook* (2016), available at: www.naic.org/prod_serv/FAH-ZU-16-02.pdf.

306. State insurance regulator supervision is primarily guided by the NAIC's *Financial Condition Examiner's Handbook*, and its *Financial Analysis Handbook 2016 Edition*. State insurance regulators also apply corrective measures (in the case of a breach of various levels of capital requirements); require enterprise risk reporting, conduct and/or participate in supervisory colleges (for large multi-state groups); require annual independent audits of financial statements, audit committees, and internal audit functions; and have in place regulatory requirements for approval of material intercompany transactions and extraordinary dividends.

The duplicative supervision of ISLHCs at the state and federal levels is costly and inefficient. The duplicative supervisory, recordkeeping, and reporting requirements of ISLHCs by the Federal Reserve and state insurance regulators may also contribute to an unlevel playing field for these insurers as compared to insurers that do not own insured depository institutions.

Recommendations

To reduce duplicative and inefficient oversight, Treasury recommends that the Federal Reserve leverage information procured from ISLHCs by state regulators and the NAIC, including information regarding an ISLHC's ultimate parent company. The Federal Reserve should also harmonize its financial reporting and recordkeeping requirements with corresponding state regulatory requirements. To this end, Treasury recommends that the Federal Reserve, state insurance regulators, and NAIC establish formal procedures and take steps that will better coordinate the supervision and examinations of insurers regulated by both state insurance regulators and the Federal Reserve.

Treasury also recommends that the Federal Reserve reassess whether its ISLHC examinations are appropriately tailored and proportionate to the unique business model of each ISLHC, and the size, organizational structure, and potential risks posed by each ISLHC.

The Consumer Financial Protection Bureau

Title X of Dodd-Frank expressly excludes the “business of insurance” from the list of financial products and services within the CFPB’s jurisdiction.³⁰⁷ Dodd-Frank also prohibits the CFPB from exercising enforcement authority over “a person regulated by a State insurance regulator.”³⁰⁸ A “person” is defined to be “any person that is engaged in the business of insurance and subject to regulation by any State insurance regulator, but only to the extent that such person acts in such capacity.”³⁰⁹

There are, however, a limited number of exceptions where the CFPB may exercise its authority over the business of insurance and persons regulated by state insurance regulators:

- If an insurer offers a financial product or service to the extent that the insurer is engaged in the offering or provision of a consumer financial product or service³¹⁰ (e.g., debt protection contracts that are administered by insurers on behalf of a bank³¹¹);

307. 12 U.S.C. § 5481(15)(C). The “business of insurance” is defined by Dodd-Frank as “the writing of insurance or the reinsuring of risk by an insurer, including all acts necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons.” 12 U.S.C. §5481(3).

308. 12 U.S.C. § 5517(f)(1).

309. 12 U.S.C. §5481(22). A “person” is defined to include both individuals and entities.

310. 12 U.S.C. § 5517(f)(2).

311. James C. Sivon and Adam D. Maarec, *The CFPB and the Business of Insurance: An Analysis of the Scope of the CFPB's Authority Over Insurance Sales*, 68 Consumer Fin. L.Q. Rep 190, 192.

- To supervise and enforce violations of federal consumer laws³¹² (e.g., violations of the Real Estate Settlement Procedures Act that relate to insurers³¹³);
- If persons knowingly or recklessly provide substantial assistance in an Unfair, Deceptive, or Abusive Acts and Practices (UDAAP) violation³¹⁴ (i.e., if an insurer knowingly or recklessly supports a covered person or service provider in violation of the UDAAP provisions of Dodd-Frank³¹⁵); or
- To request information from a person regulated by a state insurance regulator in connection with the CFPB’s rulemaking, investigative, subpoena, or hearing powers.³¹⁶

Despite the general exclusions, these statutory exceptions create considerable uncertainty concerning what the CFPB can examine or regulate. Insurers are concerned that, if the CFPB interprets the exceptions broadly, it could potentially regulate insurers or the business of insurance in a manner more expansive than the statutory exceptions intend. Such regulatory actions could also be duplicative of actions undertaken by state insurance regulators.

Recommendations

Treasury recommends that Congress clarify the “business of insurance” exception to ensure that the CFPB does not engage in the oversight of activities already monitored by state insurance regulators.

The U.S. Department of Housing and Urban Development

Congress enacted Title VIII of the Civil Rights Act of 1968 — commonly known as the Fair Housing Act (FHA) — to “provide, within constitutional limitations, for fair housing throughout the United States.”³¹⁷ To accomplish this, the FHA made it unlawful to “refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, or national origin.”³¹⁸ The FHA also makes it unlawful “[t]o discriminate against any person in the terms, conditions, or privileges of sale or rental of a dwelling, or in the provision of services or facilities in connection therewith,” (i.e., disparate treatment) because of those same protected characteristics.³¹⁹ HUD is vested with the authority to engage in formal adjudications of housing discrimination claims, as

312. 12 U.S.C. §§ 5517(f)(2), 5514(e), 5515(d), 5516(e); 5517(n). See also 12 U.S.C. § 5481 (12).

313. James C. Sivon and Adam D. Maarec, *The CFPB and the Business of Insurance: An Analysis of the Scope of the CFPB’s Authority Over Insurance Sales*, 68 Consumer Fin. L.Q. Rep 190, 192.

314. 12 U.S.C. § 5536(a)(3). This authority may be applied to insurers only to the extent that the company provides non-insurance services to a covered person or service provider.

315. 12 U.S.C. §§ 5531, 5536.

316. 12 U.S.C. § 5517(n)(2).

317. 12 U.S.C. § 3604(a).

318. 12 U.S.C. § 3604(b).

319. *Id.* Twenty years later, Congress amended the FHA to also include sex, familial status, and handicap as protected characteristics.

well as the authority to issue rules — following a notice and comment period — to effectuate the goals of the FHA.³²⁰

In 2011, HUD proposed a rule that would also impose a duty to avoid practices that are neutral by legal and regulatory definitions but with discriminatory effects (i.e., disparate impact).³²¹ This, among other things, would require entities covered by the rule to assess whether adverse fair housing consequences result from any business practice, even if such practices have no explicit discriminatory features.

HUD has expressed its intention to apply the disparate impact rule to the insurance industry.³²² If this application leads to collection and evaluation of data on protected classes under insurance policies, this could be challenging as state insurance regulations ordinarily prohibit the consideration of protected characteristics in the evaluation and pooling of risk,³²³ and such data collection is expressly prohibited by insurance laws of at least one state.³²⁴ To the extent that otherwise non-discriminatory underwriting practices result in disparate outcomes, the rule could also impose unnecessary burdens on insurers and force them to alter practices in a manner that may not be actuarially sound.³²⁵

Recommendations

Treasury recommends that HUD reconsider its use of the disparate impact rule. In particular, HUD should consider whether the disparate impact rule, as applied, is consistent with McCarran-Ferguson and existing state law. HUD should also reconsider whether such a rule would have a disruptive effect on the availability of homeowners insurance and whether the rule is reconcilable with actuarially sound principles.

320. 12 U.S.C. § 3612.

321. 24 C.F.R. § 100.500.

322. See, e.g., Implementation of the Fair Housing Act's Discriminatory Effects Standard; Final Rule (Feb. 8, 2013) [78 Fed. Reg. 11459 (Feb. 15, 2013) at 11475], available at: <https://portal.hud.gov/hudportal/documents/huddoc?id=discriminatoryeffectrule.pdf>.

323. See, e.g., 215 Ill. Comp. Stat. 5/424(3); Alaska Stat. § 21.36.090; Ky.Rev.Stat. Ann. § 304.12-085; Mass Gen. Laws Ann. ch. 175 § 4C; Me.Rev.Stat. tit. 24-A, § 2303(1)(G); Okla. Stat. Ann. tit. 36, § 985; S.C.Code Ann. § 38-75-1210(B)(1); Tenn.Code Ann. § 56-5-303(a)(2)(d); Tex. Ins.Code Ann. § 544.002.

324. Md. Code Ann. Ins. § 27-501(c)(1). See also, *American Insurance Association v. U.S. Department of Housing and Urban Development*, 74 F. Supp. 3d 30 at 46 (D.D.C. 2014). In *Property Casualty Insurers Association of America v. Donovan*, the U.S. District Court for the Northern District of Illinois held that HUD had failed to give adequate consideration to the arguments that the rule, as applied to insurers, (1) violates the McCarran-Ferguson Act, (2) violates the “filed rate” doctrine, and (3) is inconsistent with the “fundamental nature of insurance.” The case was remanded to HUD for consideration of those issues. *Property Casualty Insurers Association of America v. Donovan*, 66 F. Supp. 3d 1018 (N.D. Ill. 2014). On October 5, 2016, after reconsideration of the insurance industry comments in accordance with the court’s decision in *Donovan*, HUD determined that categorical exemptions or safe harbors for insurance practices are unworkable and inconsistent with the broad fair housing objectives and obligations embodied in the Act. [81. Fed. Reg. 69012-02 (Oct. 5, 2016)].

325. See *American Insurance Association v. U.S. Department of Housing and Urban Development*, 74 F. Supp. 3d 30 at 46 (D.D.C. 2014).

The Securities and Exchange Commission

Because variable annuities are non-exempt securities, they generally must be registered with the SEC³²⁶ and sold with a prospectus, i.e., a disclosure document containing detailed information about the product, its features, and associated risks. A variable annuity prospectus can range from 100 to 300 pages in length and contains dense legal, actuarial, and regulatory language not readily understood by retail investors. In addition, securities laws require preparation and delivery of an annual prospectus update³²⁷ that repeats much of the information contained in the original prospectus, without a roadmap to help investors identify the relevant changes.

For almost a decade, the insurance industry has advocated for: (1) a user-friendly summary prospectus that explains key information about the annuity contract, and (2) a streamlined annual update document that is available online at any time, for both new investors and investors who already own annuity contracts.³²⁸ Even though it adopted a summary prospectus for mutual funds in 2009,³²⁹ the SEC has yet to act with respect to variable annuities.

In its report to Congress on objectives for fiscal year 2018, the SEC's Office of the Investor Advocate characterized the variable annuity summary prospectus initiative as a promising idea that appears noncontroversial but has languished behind other rulemaking priorities.³³⁰ In addition, in May 2015 the SEC proposed Rule 30e-3, which would allow mutual funds to provide statutorily required shareholder reports on the Internet.³³¹ In the variable annuity context, this proposal would lower costs while improving the effectiveness of disclosure by allowing variable annuity contract owners to access and search the voluminous information they currently receive in paper form for each investment fund underlying their contracts.³³²

In addition to securities regulation, the SEC directs accounting and auditing practices and policies for publicly held companies in the United States. To develop financial accounting and reporting standards, the SEC Office of the Chief Accountant works with the independent FASB, which sets financial accounting and reporting standards for public and private companies and nonprofit organizations that follow GAAP.³³³ The SEC and FASB also take into account standards set by the

326. See SEC Form N-4, available at: <https://www.sec.gov/about/forms/formn-4.pdf>.

327. 17 C.F.R. § 230.485(b).

328. See, e.g., Letter from the Committee of Annuity Insurers to the Honorable Walter J. Clayton III (July 11, 2017), available at: https://www.annuity-insurers.org/wp-content/uploads/2017/07/EV_Chairman-Clayton-Letter-on-behalf-of-the-Committee-of-Annuity-Insurers.pdf ("Clayton Letter").

329. Enhanced Disclosure and New Prospectus Delivery Option For Registered Open-End Management Investment Companies (Jan. 13, 2009) [74 Fed. Reg. 4545 (Jan. 26, 2009)], available at: <http://www.sec.gov/rules/final/2009/33-8998.pdf>.

330. Office of the Investor Advocate, *Report on Objectives Fiscal Year 2018*, at 1, available at: <https://www.sec.gov/files/sec-office-investor-advocate-report-on-objectives-fy2018.pdf>.

331. See *supra* at 49.

332. In an informal survey conducted in 2015, several members of the Committee of Annuity Insurers indicated that they send approximately one billion pages per year to contract owners to meet their statutory obligation to deliver annual and semi-annual fund reports. Letter from the Committee of Annuity Insurers to the Honorable Mary Jo White (July 22, 2016), at 4, available at: <https://www.sec.gov/comments/s7-08-15/s70815-612.pdf>.

333. See Office of the Chief Accountant, About the Office, Securities Exchange Commission, available at: <https://www.sec.gov/page/oca-section-landing>.

IASB, which develops IFRS and has the mission of developing a single set of globally accepted accounting standards.³³⁴

Some insurers have expressed concern that the SEC may accept FASB and IFRS standards without sufficiently taking their unique business models into account.³³⁵

Recommendations

Treasury believes that a variable annuity summary prospectus and streamlined annual update would offer substantial benefits to consumers and insurers. Moreover, allowing online access to annual prospectus updates and annual and semiannual underlying fund reports would both lower expenses and improve the quality of disclosure by making it readily accessible and searchable. Accordingly, Treasury recommends that the SEC prioritize annuity-related disclosure reform by proposing a rule permitting a variable annuity summary prospectus and a streamlined prospectus update, while continuing to provide appropriate disclosure to investors. The SEC should also move forward with finalization of Rule 30e-3. Finally, the SEC should take steps to improve the efficiency and effectiveness of the regulation of insurance products under its jurisdiction.³³⁶

To develop accounting standards that appropriately reflect insurers' unique business models, Treasury also encourages the SEC to enhance its engagement with the insurance sector, including state insurance regulators and the NAIC. Specifically, the SEC should engage with insurance regulators and stakeholders to assess how FASB and IFRS standards could affect the insurance industry.

Terrorism Risk Insurance Program

Data Collection

Treasury, through FIO, is required to collect information annually concerning the effectiveness of the Terrorism Risk Insurance Program ("TRIP" or "Program"). This information, in turn, forms the

334. In addition to GAAP, all insurers utilize an accounting standard known as Statutory Accounting Principles (SAP) that utilizes the GAAP framework, but is tailored to permit regulators to analyze the unique nature of the business of insurance. Developed by the NAIC, SAP focuses on the balance sheet, rather than the income statement, and emphasizes insurer liquidity. See National Association of Insurance Commissioners, *Statutory Accounting Principles* (last updated July 11, 2017), available at: http://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm.

335. See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP (Dec. 21, 2007) [73 Fed. Reg. 985 (Jan. 4, 2008)]. For example, in 2007, the SEC issued a final rule in which it accepted financial statements prepared according to IFRS that are included in SEC filings from foreign private securities issuers.

336. For example, life insurers are increasingly offering annuity contracts that are not exempt securities but also are not eligible for registration on Form N-4, which is specifically tailored to variable annuities. To offer their products, these insurers must use registration forms designed for equity or debt offerings by public companies. Waiver of disclosure requirements that are irrelevant to regulated insurance product offerings would reduce regulatory costs and improve consumer disclosure. See Clayton Letter.

basis for annual reports that Treasury is required to submit to Congress concerning the Program.³³⁷ Treasury collects this information from a number of sources, including insurance rating bureaus and directly from participating insurers. Much (although not all) of the data collected by Treasury for its analyses is on a state or national level. Even at this level of detail, the data collected by Treasury to fulfill its statutory mandate requires substantial effort on the part of reporting insurers. For example, Treasury calculates that insurance groups that write on a nationwide basis could be required to report more than 8,000 individual data elements, some of which must be generated by reference to even more detailed information.

In 2016, state insurance regulators also began collecting data on terrorism risk insurance. Although much of the information sought by the states is similar in nature to that collected by FIO, the state data calls have sought information — from individual insurance companies and in some cases on a policy- and zip-code-level basis — which is more granular than the data requested by Treasury.

By comparison, because of the request for various kinds of information at a policy level, the state data call could generate a reporting obligation into the millions of individual data elements for individual insurance companies that write large numbers of TRIP-eligible lines policies on a nationwide basis. Although individual responding insurers that issue smaller numbers of TRIP-eligible lines policies will be subject to a lesser burden, the data call burden on insurance groups writing terrorism risk insurance subject to the Program can be significant.

Throughout Treasury's engagement, stakeholders routinely commented that these data calls serve the same or similar purposes, and that the multiple data calls, on different bases, create an undue burden on portions of the insurance industry.

Recommendations

The Secretary will direct FIO to coordinate with state insurance regulators and the NAIC to attempt to eliminate or reduce the inconsistencies between the existing data calls concerning terrorism risk insurance. Assuming this can be done, state insurance regulators and FIO should also explore the possibility of conducting a single data call that can serve the needs of both federal and state authorities while reducing unnecessary compliance costs on industry.

337. Terrorism Risk Insurance Act of 2002 §§ 104(h)(1), (2), 108(h); 15 U.S.C. § 6701 note ("TRIA"). Because the provisions of TRIA, as amended (including the Terrorism Risk Insurance Program Reauthorization Act of 2015, Public Law No. 114-1, 129 Stat. 3), appear in a note of the United States Code, references to the provisions of TRIA or the 2015 Reauthorization Act are identified by the sections of the law (e.g., TRIA § 102(1) (definition of an "act of terrorism"). See also Federal Insurance Office, U.S. Department of the Treasury, *Report on the Overall Effectiveness of the Terrorism Risk Insurance Program* (June 2016), available at: https://www.treasury.gov/initiatives/fio/reports-and-notice/ Documents/2016_TRIP_Effectiveness_%20Report_FINAL.pdf; see also Federal Insurance Office, U.S. Department of the Treasury, *Study of Small Insurer Competitiveness in the Terrorism Risk Insurance Marketplace* (June 2017), available at: [https://www.treasury.gov/initiatives/fio/reports-and-notice/ Documents/Study_of_Small_Insurer_Competitiveness_in_the_Terrorism_Risk_Insurance_Marketplace_\(June_2017\).pdf](https://www.treasury.gov/initiatives/fio/reports-and-notice/ Documents/Study_of_Small_Insurer_Competitiveness_in_the_Terrorism_Risk_Insurance_Marketplace_(June_2017).pdf).

Certifying an “Act of Terrorism”

Section 107 of the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIP Reauthorization Act)³³⁸ required Treasury to issue a report concerning the process by which an act of terrorism is certified by the Secretary (Certification Process)³³⁹ for purposes of the Program, and also to promulgate final rules concerning the Certification Process. Treasury’s report concerning the Certification Process was issued in October 2015.³⁴⁰ In April 2016, Treasury issued a proposed rule and received a number of comments suggesting changes. In December 2016, Treasury made certain changes to the proposed rule, and issued an interim final rule — subject to a further opportunity for comment — concerning the Certification Process.³⁴¹

The Certification Process set forth in the interim final rule requires Treasury to notify the public when the process commences, and provide updates as the process continues. The interim final rule does not obligate Treasury to commence a Certification Process at any specific time after an event has occurred, given that uncertainties regarding the circumstances of the event or the extent of insured losses, for example, may not permit Treasury to commence a Certification Process at a specifically designated time. Stakeholders have stated that this approach does not provide them with sufficient certainty when they are required to handle claims arising out of a particular event. This uncertainty is generated in part because an insured that failed to purchase terrorism coverage may be subject to an exclusion triggered only in the event the Secretary certifies an event as an act of terrorism.

The Treasury rules concerning the Certification Process provide for a transparent process that will notify the public if a particular event is being evaluated as to whether it is an act of terrorism under the TRIP Reauthorization Act. Such information will permit policyholders and insurers to assess their rights and responsibilities in light of the Program in a timely fashion. Treasury would only evaluate an event for certification as an “act of terrorism” under TRIA, however, if the event had some reasonable likelihood of resulting in insured losses in excess of the certification threshold.

Recommendations

The Secretary will direct FIO to be proactive in applying this Certification Process in connection with any event that has some reasonable likelihood of resulting in more than \$5 million in insured losses under TRIA, to provide transparency to the public as to whether the event is under consideration by the Secretary for purposes of the Program. State regulators, policyholders, and insurers are likewise encouraged to inform Treasury whenever they believe an “act of terrorism” under TRIA

338. Pub. L. 114-1, 129 Stat. 3.

339. See TRIP Reauthorization Act § 107.

340. U.S. Department of the Treasury, *The Process for Certifying an “Act of Terrorism” under the Terrorism Risk Insurance Act of 2002* (Oct. 2015), available at: <https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2015%20Report%20on%20the%20Certification%20Process%20under%20the%20Terrorism%20-%20Production%20Version.pdf>.

341. See TRIP Certification [81 Fed. Reg. 88592 (Dec. 7, 2016)] (“Certification”) (as codified at 31 C.F.R. § 50.60-50.63); Terrorism Risk Insurance Program [81 Fed. Reg. 93756 (Dec. 21, 2016)].

has taken place, for which they have some reason to believe total insured losses are or will be in excess of \$5 million.³⁴²

The Advisory Committee on Risk-Sharing Mechanisms

The Advisory Committee on Risk-Sharing Mechanisms (ACRSM) is a federal advisory committee established by the TRIP Reauthorization Act. ACRSM is statutorily required to provide advice, recommendations, and encouragement with respect to the creation and development of non-governmental risk-sharing mechanisms to protect against losses arising from acts of terrorism.³⁴³ The ACRSM is comprised of nine members who are representatives of insurers, reinsurers, and capital market participants.³⁴⁴ The ACRSM is now investigating the potential for increasing private participation in the terrorism risk insurance market. To facilitate its exploration of these topics, the ACRSM created five subcommittees (Direct Insurance, Reinsurance, Capital Markets, Exploration of Catastrophic Risks in Other Markets, and Consumer Interests).

Recommendations

In recognition of the importance of the Program and the upcoming consideration of any further reauthorization, the Secretary encourages the ACRSM to continue its efforts and develop recommendations for FIO. In particular, the work of the ACRSM should focus on how to increase private market participation in the terrorism insurance marketplace, with the goal of providing enhanced taxpayer protection in a way that does not result in market dislocations for the consumers and providers of terrorism risk insurance. FIO should also evaluate potential ways to increase private market participation in the terrorism insurance marketplace. Increased private market participation will protect, and help promote, the security and financial and economic strength of the United States.

Insurer Data Security

To protect the integrity of, and confidence in, the insurance marketplace, it is important to protect the personal identifiable information (PII), private health information (PHI), and financial information of policyholders and other third parties stored on insurers' systems. The protection of information systems is also crucial for the integrity and resilience of insurers' operations. As the 2015 data breaches at health insurers Anthem, Inc. and Premera Blue Cross illustrate,³⁴⁵ insurers are attractive targets for cyber criminals and other hackers. The U.S. insurance industry has great diversity, ranging from large companies with global presences to local insurers that operate in only a single county. Although large insurers generally have sophisticated cybersecurity systems and

342. See TRIP, Certification, 81 Fed. Reg. at 88595 (Dec. 7, 2016)] (“[N]othing in TRIA or Treasury’s proposed rules prohibits a stakeholder from contacting Treasury to bring to its attention an event that the stakeholder believes might be subject to certification under TRIA, or other information relevant to that event.”).

343. TRIP Reauthorization Act § 110.

344. 15 U.S.C. § 6701, note.

345. Anthem, Inc., *Statement Regarding Cyber Attack against Anthem* (Feb. 5, 2015), available at: <https://www.anthem.com/health-insurance/about-us/pressreleasedetails/W/2015/1813/statement-regarding-cyber-attack-against-anthem>; Premera Blue Cross, *About the Cyberattack* (Mar. 2015), available at: <https://www.premera.com/wa/visitor/about-the-cyberattack>.

practices, the same is not necessarily true for smaller insurers.³⁴⁶ Regardless of size, it is critical that all insurers protect policyholder and third party information.

Cybersecurity and data security are national policy issues that require coordination among federal and state public sector entities and partnership between the public and private sectors. Officials and regulators at both federal and state levels of government are working with insurers to improve the cybersecurity of the insurance industry, and are focused on increasing insurer cybersecurity while decreasing the burdens imposed by the proliferation of non-uniform data security and data breach notification laws and regulations.

Most states have had insurance-specific data protection laws on the books for many years.³⁴⁷ In recent years, the NAIC has moved to improve protection of PII and PHI possessed by insurers. In addition to data *security* requirements, every state except for Alabama and South Dakota has enacted data breach *notification* requirements through “legislation requiring private or governmental entities to notify individuals of security breaches of information involving personally identifiable information.”³⁴⁸

In October 2017, after a year and a half of development, the NAIC adopted an Insurance Data Security Model Law.³⁴⁹ Subject to certain exceptions, the NAIC Insurance Data Security Model Law is intended to apply to insurers, agents, and other licensees. The model law addresses: (1) the implementation of information security programs, (2) investigation of cybersecurity events, including risk assessment and risk management, as well as oversight of third-party service providers, and (3) notification to state insurance regulators about cybersecurity events, including but not limited to providing relevant state insurance commissioners with a description of how the information was exposed, lost, stolen, or breached; how the event was discovered; the period during which the information system was compromised; the total number of consumers affected in the state; and the efforts being undertaken to remediate the situation. The Insurance Data Security Model Law does not, however, require data breach notification to consumers,³⁵⁰ nor would it displace existing state laws regarding data privacy or data breach notification.

346. Fitch Ratings noted that smaller insurers would have to “allocate significant new resources and bear significant costs to meet the requirements” in the NAIC’s *Insurance Data Security Model Law*. See Fitch Ratings, *Press Release: NAIC Rules May Boost U.S. Insurers’ Cyber Risk Management* (Aug. 16, 2017), available at: <https://www.fitchratings.com/site/pr/1027897>.

347. Between 1980 and 2002, the NAIC released three model laws and regulations regarding data privacy and information security: (1) the *Insurance Information and Privacy Protection Model Act*; (2) the *Privacy of Consumer Financial and Health Information Model Regulation*; and (3) the *Standards for Safeguarding Consumer Information Model Regulation*. Not all states have adopted laws that are the same or substantially similar to each of these models.

348. National Conference of State Legislatures, *Security Breach Notification Laws* (last updated Apr. 12, 2017), available at: <http://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx>.

349. See NAIC, *NAIC Passes Insurance Data Security Model Law* (Oct. 24, 2017), available at: http://www.naic.org/Releases/2017_docs/naic_passes_data_security_model_law.htm; NAIC, *Data Security Model Law v6 clean* (Aug. 7, 2017), available at: http://www.naic.org/documents/cmte_ex_cswg_final_model_law_v6_clean.pdf.

350. The Insurance Data Security Model Law requires notification to consumers only if there already is an applicable state data breach notification law.

New York State has moved forward to address data security. On March 1, 2017, the New York Department of Financial Services (NYDFS) implemented a new cybersecurity regulation for entities under its jurisdiction, *Cybersecurity Requirements for Financial Services Companies*.³⁵¹ The regulation requires banks, insurance companies, and other financial services institutions regulated by the NYDFS “to establish and maintain a cybersecurity program designed to protect consumers’ private data and ensure the safety and soundness of New York’s financial services industry.”³⁵² The regulation is the first of its kind at the state level and is similar in many respects to the Insurance Data Security Model Law.

The Insurance Data Security Model Law will not necessarily result in nationally uniform insurance laws regarding data breach notification and data security. The model law does not address consumer notification, and the degree of discretion and flexibility afforded to states in adopting and implementing NAIC model laws may undercut uniformity with regard to data security. Even though the Insurance Data Security Model Law has been adopted by the NAIC, as with all model laws, it still needs to be enacted by states to enter into force. Such enactment may take some states several years, and even then, uniform adoption is not guaranteed. Further, the Insurance Data Security Model Law will supplement, not replace, other state laws regarding privacy and consumer data, including insurer-specific laws consistent with existing NAIC model laws and regulations. Because these laws are neither uniform nor specific to insurers, complying with this patchwork of breach notification laws poses regulatory challenges and inefficiencies for insurers that operate in multiple states.

Recommendations

Treasury supports the state-based system of insurance regulation and recognizes that many aspects of the business of insurance are local in nature and do not lend themselves to uniform national approaches. However, data security, data breach notifications, and more broadly, cybersecurity are also issues of national concern. U.S. insurers should be subject to the same requirements for cybersecurity and protection of PII and PHI regardless of where they are domiciled and operate, and U.S. policyholders should be able to expect the same level of protection of their personal data regardless of where they live.

Treasury recommends prompt adoption of the NAIC Insurance Data Security Model Law by the states. Treasury further recommends that if adoption and implementation of the Insurance Data Security Model Law by the states do not result in uniform data security regulations within five years, Congress pass a law setting forth requirements for insurer data security, but leaving supervision and enforcement with state insurance regulators.

Treasury also recommends that state legislators, state regulators, and the NAIC work to expeditiously pass uniform legislation regarding data breach notification for insurers, and encourages the NAIC to make any such model law an accreditation standard. If adoption and implementation

351. New York State Department of Financial Services, *Cybersecurity Requirements for Financial Services Companies* (Feb. 13, 2017), 23 NYCRR Part 500.

352. New York State, *Press Release: Governor Cuomo Announces First-In-The-Nation Cybersecurity Regulation protecting Consumers and Financial Institutions from Cyber-Attacks to Take Effect March 1* (Feb. 16, 2017), available at: <http://www.dfs.ny.gov/about/press/pr1702161.htm>.

of data breach notification efforts by the states do not result in uniform requirements within five years, Treasury encourages Congress to pass a law setting forth requirements for data breach notification specific to insurers. Such legislation should leave supervision and enforcement with state insurance regulators.

Insurer Cyber Threats

Treasury serves as the federal interface for matters involving cyber threats and cybersecurity for institutions within the financial services sector, including insurers.³⁵³ The Secretary also chairs the Financial and Banking Information Infrastructure Committee (FBIIC), a coordinating body of financial regulatory agencies — including a representative of state insurance regulators — tasked with improving the reliability and security of the financial-sector infrastructure. The FBIIC regularly collaborates with the Financial Services Sector Coordinating Council (FSSCC), a private-sector body that works with Treasury toward the shared goal of maintaining a robust and resilient financial services sector.

Treasury also works with the insurance industry and state and federal insurance regulators to improve insurance-sector cybersecurity through improved information sharing, effective supervision by relevant regulators, and increased coordination between the public and private sectors. For example, in August 2017, together with the FSSCC, Treasury led a public-private tabletop exercise with participants from the insurance industry, state regulators, the NAIC, and law enforcement community. Employing a simulated cyber incident, this tabletop exercise was designed to identify key challenges for effective public-private response and coordination. Treasury also works closely with the Financial Services Information Sharing and Analysis Center (FS-ISAC), a cyber and physical threat intelligence analysis and sharing resource for the financial services sector, including insurers.

Recommendations

Treasury recommends that steps be taken to improve information sharing within the insurance industry. Insurance industry cyber security is enhanced when insurers share information with each other about threats and best practices, and collaborate with the public sector on cybersecurity issues. Treasury and state insurance regulators should continue to promote insurer participation in the FS-ISAC and similar entities, particularly among the thousands of small and regional firms that operate within the United States that may not yet be engaged with such national information sharing efforts. In addition, the Secretary will direct FIO to establish a working group charged with assessing cybersecurity challenges for the insurance sector and issuing recommendations to insurance sector participants and relevant regulators, with particular attention paid to small and regional insurers.

353. Presidential Policy Directive 21: Critical Infrastructure Security and Resilience.

Challenges in the Cyber Insurance Market

As cyber risks have increased over the last two decades, the insurance industry has responded with a variety of insurance products. These products — loosely referred to as “cyber insurance” — cover risks arising “from the use of electronic data and its transmission, including technology tools such as the Internet and telecommunications networks,” as well as “physical damage that can be caused by cyber attacks, fraud committed by misuse of data, any liability arising from data storage, and the availability, integrity, and confidentiality of electronic information.”³⁵⁴ By providing a risk transfer mechanism, cyber insurance contributes to the financial resilience of policyholders that suffer a cybersecurity incident or attack. This is especially important given that the average cost of a data breach is \$3.62 million.³⁵⁵ Cyber insurance policies may also provide access to pre- and post-breach resources to help policyholders reduce their vulnerability to, or recover from, such events.

The cyber insurance market reached an estimated \$3 to \$4 billion in gross premiums in 2016, with the large majority of the demand historically (and presently) based in the United States.³⁵⁶ In comparison, the cyber insurance market was estimated to be approximately \$2.75 billion in 2015 and \$2 billion in 2014.³⁵⁷ Currently, approximately 100 insurers offer cyber insurance products.³⁵⁸ The market for cyber insurance is relatively concentrated, however, with the top 15 insurers comprising more than 80% of the market in 2016.³⁵⁹

Two related obstacles to the continued growth of the cyber insurance market are: (1) a lack of relevant data regarding evolving cyber risks, and (2) the threat of accumulation risk. At the center of these challenges is the difficulty in collecting and analyzing data regarding cyber risks. Industry representatives acknowledge that “the availability of data on cyber risk is scarce” and “even if historical data are available, the fast changing environment might render this data

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354. CRO Forum, *Cyber Resilience: The Cyber Risk Challenge and the Role of Insurance* (Dec. 2014), at 5, available at: <http://www.thecroforum.org/cyber-resilience-cyber-risk-challenge-role-insurance/>. Cyber losses arising out of a certified act of terrorism may be covered under the Terrorism Risk Insurance Program (Program) [81 Fed. Reg. 95312 (Dec. 27, 2016)]. However, cyber losses can arise in a variety of ways and cause impacts that would not satisfy the requirements of the Program.
355. Ponemon Institute Study, *Cost of Data Breach Study 2017* (June 13, 2017), available at: <https://www.ponemon.org/library/2017-cost-of-data-breach-study-united-states>.
356. Standard & Poor's, *Looking Before They Leap: U.S. Insurers Dip Their Toes In The Cyber-Risk Pool* (June 2015), available at: <https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1403078&SctArtId=320678>.
357. U.S. Department of the Treasury, Federal Insurance Office, *Annual Report on the Insurance Industry* (Sept. 2015), available at: https://www.treasury.gov/initiatives/fio/reports-and-notice/2015%20FIO%20Annual%20Report_Final.pdf; U.S. Department of the Treasury, Federal Insurance Office, *Annual Report on the Insurance Industry* (Sept. 2016), available at: https://www.treasury.gov/initiatives/fio/reports-and-notice/2016_Annual_Report.pdf.
358. NAIC, *Report on the Cybersecurity Insurance Coverage Supplement* (Aug. 6, 2017), available at: http://www.naic.org/documents/cmt_e_ex_cybersecurity_tf_rpt_cyber_ins_coverage_suppliment.pdf.
359. Insurance Journal, *Cyber Insurance Premium Volume Grew 35% to \$1.3 Billion in 2016* (June 23, 2017), available at: <http://www.insurancejournal.com/news/national/2017/06/23/455508.htm>.

useless.”³⁶⁰ Thus, insurers may lack “the necessary inputs for creating a reliable cyber model” that would mirror the advanced modeling done for other types of catastrophic risk, such as hurricanes.³⁶¹ Without the data to better assess exposure of individual policyholders to cyber losses, insurers have difficulty appropriately understanding accumulation risk (i.e., the risk that a single cybersecurity incident causes losses to multiple policyholders across multiple lines of insurance). For example, insurers have difficulty analyzing the risk of multiple policyholders using the same software, hardware, or third-party service providers.³⁶² An attack that targets such commonly used products or services could cause enormous losses, both insured and uninsured.³⁶³

To assess the need for more and better data regarding cyber risk and associated losses, the Department of Homeland Security formed a Cyber Incident and Analysis Working Group, made up of chief information security officers and chief security officers from various critical infrastructure sectors, insurers, and cybersecurity professionals. This working group focused on the feasibility of a cyber incident database, publishing several white papers on the topic.³⁶⁴ While neither the insurance industry nor any other private sector actor has developed the database proposed by the working group, the industry is working to improve data collection and the modeling of cyber risks. For example, individual insurers rely on proprietary collections of claims and other data, and catastrophe risk modelers are creating new tools for insurers.³⁶⁵

Product Approval and Speed to Market

The state-based insurance product approval process varies from state to state, as do compliance standards for insurers. Some states require products to be approved before they are offered (i.e., prior approval); others allow introduction to the market without approval so long as specified standards are met (i.e., use and file); and still others reserve the option to review a product after its introduction (i.e., file and use). Both the duration of review and the substantive standards for approval can vary based on different rules and regulations, the opinions of individual examiners, and state insurance department resource constraints.

360. Geneva Association, *Ten Key Questions on Cyber Risk and Cyber Risk Insurance* (Nov. 2016), available at: <https://www.genevaassociation.org/research-topics/cyber-and-innovation/ten-key-questions-cyber-risk-and-cyber-risk-insurance>.

361. AIR, *Issue Brief: Insuring Cyber Risks* (July 2017), available at: www.air-worldwide.com/publications/white-papers/documents/insuring-cyber-risk.

362. AIG, *Cyber Today: Outlook, Underwriting Challenges, and Recommendations* (presentation, Federal Advisory Committee on Insurance, Washington, D.C., Aug. 17, 2017).

363. Cyence and Lloyd's, *Counting the Cost: Cyber Exposure Decoded* (2017), available at: <https://www.lloyds.com/news-and-insight/risk-insight/library/technology/countingthecost>.

364. Department of Homeland Security, *Cybersecurity Insurance* (last published June 30, 2016), available at: <https://www.dhs.gov/cybersecurity-insurance>.

365. Insurance Journal, *New Modeling Product from AIR Worldwide Analyzes Client Cyber Risk* (Apr. 24, 2017), available at: <http://www.insurancejournal.com/news/national/2017/04/24/448698.htm>; Insurance Journal, *RMS Expands Range of 'Cyber-Physical' Models for Property Insurers* (Apr. 6, 2017), available at: <http://www.insurancejournal.com/news/international/2017/04/06/447172.htm>.

Such variability can be problematic for the many insurers that conduct business on a regional or other multistate basis, including numerous large carriers operating in multiple markets nationwide. For these companies, lack of uniformity in key aspects of regulation can create significant burdens and undermine efficient and effective regulation. In particular, inconsistent standards with respect to speed-to-market in the product approval process can harm product innovation and the competitiveness of insurance products compared to other financial products, while also increasing costs and reducing consumer choice.

The Interstate Insurance Product Regulation Commission (IIPRC)

The states and the NAIC and have long recognized concerns over lack of uniformity in product approvals and taken steps to improve the process. In July 2003, the NAIC adopted the Interstate Insurance Product Regulation Compact (Compact), which created the Interstate Insurance Product Regulation Commission (IIPRC).³⁶⁶ The IIPRC develops uniform product standards for specified life insurance, annuity, disability income, and long-term care products.³⁶⁷ If a product is filed for approval with the IIPRC, its uniform product approval standards supersede the standards of any compacting state unless the insurer submits a product directly to a compacting state's insurance regulator (and not the IIPRC) for approval.

Despite the IIPRC's accomplishments, the nationwide uniformity and efficiency of the product approval process remain a work in progress.³⁶⁸ California, Florida, and New York, which collectively represented 20.5% of nationwide premium in 2015, have not joined the Compact. Insurance company representatives have called attention to a common pattern: a new product obtains approval in a majority of states through the IIPRC or direct filings within several months, but approval in the remaining states, including some states with large populations, can take additional months or even years. In some cases, a product is never approved by all states. In addition, even when products are approved, inconsistent or conflicting state laws, regulations, and regulatory practices create state-by-state variations, resulting in significant additional costs for insurers with respect to product administration and marketing.

Recommendations

To increase consumer choice and decrease costs for both insurers and, by extension, consumers, Treasury encourages the NAIC to bring in states that have not yet joined the Compact. Treasury also encourages the IIPRC to continue its efforts to complete the development of standards for

366. Upon the adoption of the Compact by a state, the state is allowed to join the IIPRC. The IIPRC came into existence in May 2006 upon meeting the threshold requirement of 26 states or 40% of premium volume nationwide.

367. The IIPRC currently has 45 members (44 states and Puerto Rico) representing about 70% of nationwide premium volume. In 2016, the 226 insurers registered with the IIPRC submitted 1,059 products for review, of which 976 were approved with an average approval time of 30 days. For statistical information regarding participation in the Compact and product approvals, see the IIPRC's website, available at: <http://www.insurancecompact.org/>.

368. Treasury recognizes that improving the speed-to-market of financial products presents challenges for regulators, given the pace of market changes and product innovation. Treasury further recognizes the productive efforts of the NAIC, including establishment of the IIPRC and the continuing work of the Speed to Market Working Group under the Innovation and Technology Task Force.

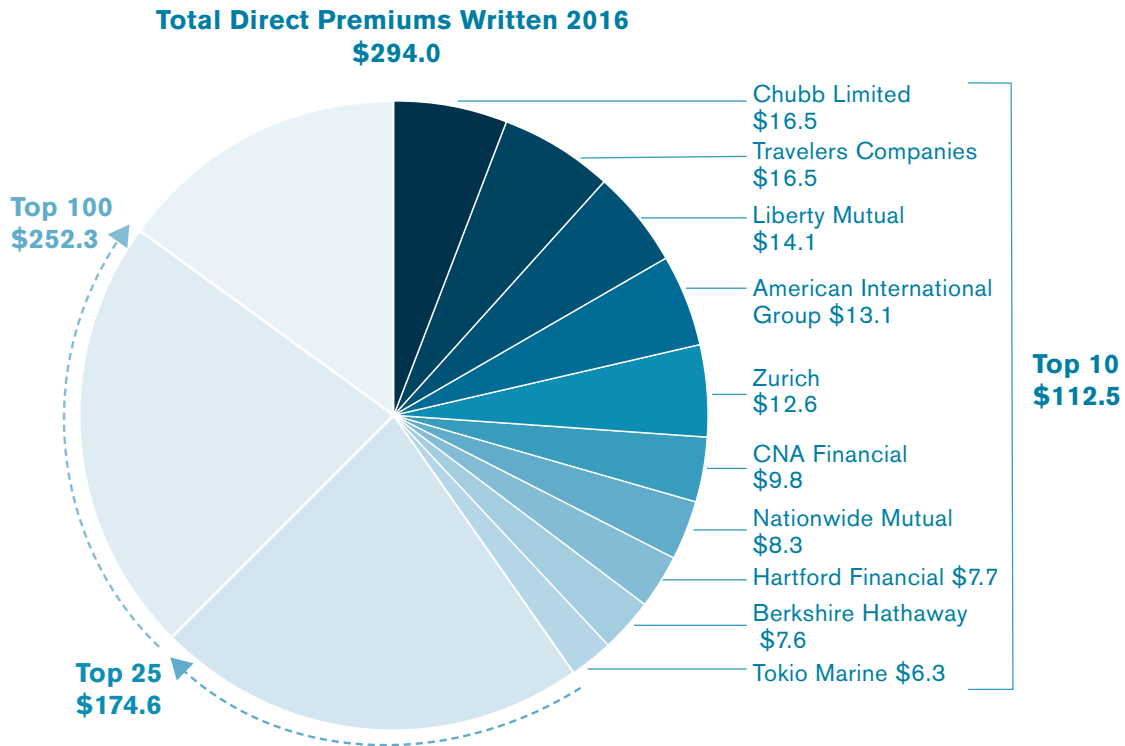
all product lines within its authority. Finally, Treasury recommends that the states take steps to mitigate inconsistent or conflicting state laws, regulations, and practices applicable to approval of insurance products.

Commercial Lines Regulation

Commercial insurance (i.e., insurance coverage for business) is a subset of P&C insurance that had over \$294 billion in direct written premiums in 2016 (see Figure 18). Commercial insurance is an important component to economic growth because it allows businesses to transfer some of the risks associated with doing business. To cover the risk involved in the many different kinds of businesses, commercial lines insurers sell over 20 major insurance coverages and dozens of specialty products.³⁶⁹ The unique nature of commercial operations makes standardized policy forms impractical, which creates demand for custom (i.e., manuscript) policies to address insurance needs.

369. Insurance Information Institute, *Commercial Insurance—Introduction*, available at: <http://www.iii.org/publications/commercial-insurance/introduction>.

Figure 18: U.S. Commercial Lines Direct Premiums Written by P&C Insurance Groups (\$ billions)



Source: SNL Financial (includes all lines of business)

Insurance sold to sophisticated commercial policyholders is, for several reasons, generally subject to less regulatory scrutiny than policies sold to individuals and families. Commercial policyholders often have insurance subject-matter expertise and bargaining power that individual consumers lack. Commercial policyholders are also better able to self-insure against risk of loss associated with coverage disputes or insurer insolvency.

The rate, form, and policy form filing requirements, particularly for commercial lines, present potential opportunities for state insurance regulation to become more efficient, effective, and appropriately tailored. Stakeholders noted that admitted insurers in commercial lines often face inconsistent and lengthy product approval periods that limit their ability to meet policyholder needs. Insurers that attempt to file products nationwide can be subject to significant transaction costs, which can be passed on to consumers. Additionally, certain stakeholders noted that this filing process can be a barrier to the development of new and innovative products.

Policymakers at the state and federal levels have enacted legislation that may be beneficial for state insurance regulators and the NAIC to consider as they look to improve the uniformity and efficiency of commercial lines regulation. To date, most solutions involve exempting policyholders or insurers from some of the regulatory hurdles in cases where potential commercial buyers meet specified criteria relating to premium paid, the buyer's size, or the nature of the risk being insured.

For instance, in 2010, Congress passed the Non-Admitted and Reinsurance Reform Act of 2010 (NRRA),³⁷⁰ which applies to nonadmitted insurers. "Nonadmitted" insurers function to permit access to products that would not ordinarily be available through the admitted market.³⁷¹ Risks typically written in the nonadmitted market include: (1) nonstandard risk (e.g., those with unusual underwriting requirements), (2) unique risks that admitted carriers do not offer, and (3) capacity risks for which an insured seeks a higher level of coverage than admitted insurers are willing to provide.

Subject to two conditions, the NRRA exempts brokers who are looking to place commercial risk from completing a due diligence search³⁷² in the admitted market prior to placing risk in the non-admitted market.³⁷³ In many cases, this is advantageous to exempt commercial purchasers (ECPs) because the non-admitted market can be more cost effective for specialized risk than the admitted market. Insurance products are also specialized to meet commercial purchaser needs and are not subject to a potentially lengthy state regulatory approval process.

Similarly, New York's "Free Trade Zone" exempts insurers from some filing requirements for eligible risks when the insurer has a special license to do so. The Free Trade Zone divides risks into two classes, one based on the level of annual premium, or Class 1, and the other based on the nature of the risks (specifically, risks that are of an unusual nature, present a high loss hazard, or are difficult to place) or Class 2.³⁷⁴ These filing exemptions allow some insurers to respond quickly to requests for coverage, and to tailor the policy language to the particular needs of buyers.

In 2015, the NAIC's Commercial Lines Working Group also issued recommendations to streamline the regulation of commercial insurance products by: (1) revising its definition of ECP to achieve greater uniformity, (2) allowing the use of manuscript policies without prior approval, (3) establishing conditions for exempting multistate risks from form and rate filing requirements, and (4) encouraging states to review existing authority to improve the efficiency and effectiveness

370. 15 U.S.C. § 8206.

371. For additional discussion of admitted and nonadmitted insurers, see *supra* at 74-75.

372. State due diligence requirements typically call for brokers to establish that a statutorily determined number of admitted insurers (usually two or three) declined to underwrite the risk before the broker may attempt to place the coverage with nonadmitted insurers.

373. Generally, exempt commercial purchasers are defined by the NRRA as any person purchasing commercial insurance that: (1) retains a qualified risk manager to negotiate insurance coverage; (2) has paid aggregate insurance premiums in excess of \$100,000 in the immediately preceding 12 months; and (3) either (a) possesses a net worth in excess of \$20,000,000; (b) employs more than 500 full-time or full-time equivalent employees or is a member of an affiliated group employing more than 1,000 employees; (c) is a not-for-profit organization or public entity generating annual budgeted expenditures of at least \$30,000,000; or (d) is a municipality with a population in excess of 50,000 persons. 15 U.S.C. § 8206.

374. New York State Insurance Department, Special Risk Insurance (11 NYCRR 16).

of rate and form review for commercial lines.³⁷⁵ If implemented, such recommendations would also streamline the ability of admitted insurers to meet buyer needs. To date, the NAIC has not formally acted on any of these recommendations, and stakeholders expressed that momentum to deregulate commercial lines appears to have stalled.

Recommendations

Treasury encourages state legislators, state regulators, the NAIC, and insurance stakeholders to work together on proposals for more efficient regulation of commercial lines products. If implemented in a manner that is appropriately tailored and with sufficient consumer safeguards, commercial lines deregulation can decrease costs for insurers, encourage innovation, and mitigate uncertainties created by inconsistent and conflicting state laws, regulations, and practices. To promote competition and meet market demands in a timely fashion, states should consider the ECP definition under the NRRA, New York's Free Trade Zone, and the 2015 NAIC Commercial Lines Working Group recommendations.

Producer Licensing and Appointments

State laws require insurance agents and brokers (collectively, “producers”) to be licensed in every jurisdiction where they conduct business. According to the NAIC, more than 2.2 million individuals and over 230,000 business entities, many of which are small businesses, were licensed as producers in 2016.³⁷⁶

Due to the increasingly interstate nature of the business of insurance, producers are often required to obtain licenses in more than one state. Individually licensed producers collectively hold more than 6.2 million separate insurance licenses, while licensed business entities hold approximately 520,000 separate insurance licenses.³⁷⁷ Nearly 15,000 business entities are licensed to operate in more than five jurisdictions and approximately 232,000 individual producers are licensed in five or more jurisdictions. However, a lack of reciprocity between the states and multiple layers of licensing requirements make obtaining and maintaining producer licenses a costly and time-consuming practice. Many states impose additional conditions on non-resident producers and choose not to recognize licensing determinations made by the insurance regulators in the producer's home state. For instance, some states require nonresidents to obtain an individual insurance license, obtain a license for the applicant's agency, and register as a foreign corporation with the secretary of state.

Licensing compliance costs have a disproportionate competitive effect on small and mid-sized businesses with smaller economies of scale. One industry association noted that approximately 60% of its members have at least one person on staff whose duties are dedicated to obtaining and maintaining the appropriate licenses for the agency and its personnel, and that agencies must devote significant resources to licensing compliance.

375. NAIC Commercial Lines (EX) Working Group, *Recommendations* (June 29, 2015), available at: http://www.naic.org/documents/cmte_c_170608_clwg_final_rec.pdf.

376. NAIC, 2016 Insurance Department, *Resources Capital Report* (June 2017), available at: http://www.naic.org/prod_serv/STA-BB-16-01.pdf.

377. *Id.*

National Association of Registered Agents and Brokers

To address licensing inefficiencies and related issues — and with the strong support of the industry and its regulators — on January 12, 2015, the President signed into law the National Association of Registered Agents and Brokers Reform Act of 2015 (NARAB II).³⁷⁸

The purpose of NARAB II is to establish a one-stop licensing compliance mechanism for insurance producers operating outside their home states, while preserving the longstanding authority of states to oversee insurance producers. To do so, NARAB II establishes a 13-member Board of Directors to govern and supervise all activities of the association. Members of the Board of Directors — consisting of eight state insurance commissioners and five industry members with demonstrated expertise in producer licensing — are appointed by the President, with the advice and consent of the Senate.³⁷⁹ In 2016, representatives for 10 of the 13 NARAB Board of Director positions were nominated, but not confirmed. Without a board to establish, govern, and supervise its activities, the Association is still not operational.³⁸⁰

The proper implementation of NARAB II should spur economic growth by helping to facilitate insurance transactions across state lines. NARAB II will reduce the redundancies that every agent licensed in multiple states must currently navigate, and provide consumers with additional options.

Recommendations

Treasury will take steps to expeditiously recommend nominees to President Trump who can be sent to the Senate for confirmation. To do so, the Secretary will direct FIO to solicit nominee recommendations and work with stakeholders on the Association's establishment. To ensure sufficient regulatory expertise, Treasury also recommends that the appointment process proceed in a manner to maintain a quorum composed of a majority of state insurance regulators.

Producer Appointments

In a majority of states, some insurance producers cannot act on behalf of an insurance company unless the producer is appointed by the insurer as its agent.³⁸¹ A producer acts as an agent of an insurer when the producer is compensated for selling, soliciting, or negotiating any product of the insurer. In order for producers to be appointed in a particular state, insurers must typically submit a notice of appointment to that state's department of insurance and pay a fee.

378. 15 U.S.C. § 6751 et seq. See also 2016 Federal Insurance Office, *Annual Report*. NARAB II reestablished the National Association of Registered Agents and Brokers (the Association), which was originally authorized by the Gramm-Leach-Bliley Act in 1999 [Pub L, No. 106–102, 113 Stat. 1338], but never established.

379. The Association may not receive, accept, or borrow any amounts from the federal government to pay for, or reimburse it for the costs of establishing or operating the association (15 U.S.C. § 6763).

380. National Association of Professional Surplus Lines Offices, Ltd., *NAPSLO Questions and Answers: Implementation of National Association of Registered Agents and Brokers (NARAB)*, available at: https://www.napslo.org/wcm/Legislative_Advocacy__PAC/NARAB_Implementation/wcm/Legislative_Advocacy__PAC/NARAB_Implementation.aspx?hkey=4929bb49-1a7b-4a55-bb73-2493d731026f.

381. See NAIC, *Producer Licensing Model Law and State Adoption Chart*, available at: <http://www.naic.org/store/free/MDL-218.pdf> ("Adoption Chart").

State regulators have taken steps to promote uniformity in agent appointments, such as establishing the National Insurance Producer Registry (NIPR, an affiliate of the NAIC), a public-private partnership that hosts a website permitting agents, agencies, and insurers to apply for licenses and make appointments. All 50 states, the District of Columbia, and the U.S. Virgin Islands, Guam, and Puerto Rico now use the NIPR.³⁸² At least 40 states have also adopted the NAIC Producer Licensing Model Act (PLMA) in whole or part, which has provided additional uniformity for the producer licensing process, including appointments as insurer agents.³⁸³

Despite these advancements, inconsistencies with respect to producer appointments remain problematic. The producer appointment portion of the PLMA is optional, and states that have adopted the language interpret it in a number of ways.³⁸⁴ For instance, some states interpret the PLMA to mean that appointments may be filed either within 15 days from execution of the agency contract or within 15 days after the insurer receives the initial submission of business from the producer, while others conclude that the appointment must occur at the earlier of the two times.

In addition, insurance regulators are likely to have most or all of a producer's information (e.g., which insurers have appointed the producer) on hand or readily accessible through other means. Although specific requirements vary by state, in most cases, the producer appointment requirement is in addition to requirements for: (1) corporate licenses for the business, (2) individual agent licenses, (3) agency licenses, (4) agency affiliation requirements, (5) insurer licenses, and (6) insurer appointments, which are required by insurers and compel agents and agencies to be appointed by the insurer to sell the insurer's products.

Recommendations

Treasury encourages state regulators and the NAIC to assess how to increase the efficiency and uniformity of the producer appointment process. This assessment should focus on reducing inefficiencies and unnecessary compliance burdens. For instance, Treasury encourages all states to adopt the PLMA and encourages regulators to interpret appointment provisions of the PLMA consistently. Treasury also encourages state legislators, state regulators, and the NAIC to consider whether the information received from the appointment reporting process is already procured or available by other requirements imposed on producers and/or insurers and, if not, whether such information can be obtained through other, more efficient means.

382. See NAIC and CIPR, *National Insurance Producer Registry (NIPR)*, available at: http://www.naic.org/cipr_topics/topic_nipr.htm.

383. Adoption Chart.

384. *Id.*

Regulatory Structure and Issues of Duplication, Overlap, and Fragmentation

Federal Interagency Coordination

While the business of insurance is primarily regulated at the state level, numerous federal agencies or authorities are involved in insurance with varying roles and responsibilities. An internal Treasury analysis indicates that more than 20 federal agencies or authorities are involved in varying degrees with insurance or the insurance industry.³⁸⁵ In some cases, the federal government itself is a participant in the insurance sector, either as a consumer or provider of insurance through a specific program.

Furthermore, insurance markets and activities have evolved in scope and complexity, thereby requiring some federal agencies to set forth rules specifically addressing the business of insurance. The advent of insurance-linked securities, the sale of variable life insurance and annuities, and the use of derivatives by insurers are examples of areas where federal regulation directly impacts the business of insurance. At times, federal agencies have not adequately considered the unique business model of insurers when promulgating rules and regulations, such as instances where prudential rules do not appropriately reflect the differences between banks and insurers.

The convergence of insurance with other financial sector products, along with the increasingly global nature of markets and economies, suggests that the business of insurance will continue to have implications at the federal level. It is important that the federal government develop an effective and harmonized approach to engagement with the insurance sector that adequately reflects the nature and existing regulatory regime of the business.

Recommendations

In addition to the specific recommendations of coordination detailed throughout this report, Treasury recommends that federal agencies and entities establish formal mechanisms to promote coordination and communication across the federal government with respect to insurance-related issues. Federal agencies and entities should also establish policies and procedures that take into account the similarities and differences of insurers and other types of businesses within the financial sector, such as banks and mutual funds.

Rather than conferring with federal agencies regarding insurance-related issues on an informal, ad hoc basis, FIO should establish a more structured and rationalized approach to its engagement with federal agencies and entities on insurance-related issues. Also, to promote coordination of the federal government's authority with respect to insurance, FIO should consult with and advise federal agencies and entities conducting rulemaking or policy action that relates to insurance.

State and Federal Coordination

As discussed, certain insurance activities, products, and issues are within the scope of both federal and state regulators. In exercising their respective authorities, state and federal regulators may take positions that create tension, conflict, or duplication between state and federal requirements. Throughout the stakeholder engagement process, stakeholders suggested that there could be

385. See, e.g., "Other Federal Regulators and Agencies Involved in Insurance," *supra* at 88-90.

improved communication and coordination between state and federal regulators on subjects where they share jurisdiction.

Additionally, several of the leading insurance regulatory and public policy issues facing the insurance market may be appropriate for various levels of involvement by both state and the federal governments. For example, cybersecurity and data protection, the use of big data in insurance underwriting, rapid advances in innovative technology, and investments in infrastructure are all issues on which state and federal governments should engage.

Recommendations

As the primary regulators of insurance, states should be consulted and afforded the opportunity to provide input when the business of insurance is implicated at the federal level. In furtherance of this objective, FIO should lead coordination efforts among federal and state agencies to improve communication and develop policy with respect to insurance-related issues. Such engagement will help to mitigate overlapping or duplicative mandates and promote coordination on issues of mutual concern to the insurance sector.

International Engagement

Multilateral Standard Setting Framework

The Financial Stability Board

The Financial Stability Board (FSB) was established in 2009 after the G-20 London Summit as the G-20's financial regulatory reform implementation organization.³⁸⁶ The FSB is established to coordinate at the international level regarding the work of national financial authorities and international standard-setting bodies (including the IAIS), and to develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies. In collaboration with other international financial institutions, the FSB intends to address vulnerabilities affecting financial systems in the interest of global financial stability.³⁸⁷

The FSB's membership consists of 70 representatives from 25 jurisdictions and 10 international organizations and standard-setting bodies.³⁸⁸ Treasury, the Federal Reserve, and the SEC are the U.S. members of the FSB.³⁸⁹ It is important to note, in the context of multilateral standard setting, that entities such as the FSB have no legal authority or jurisdiction over the United States.

The International Association of Insurance Supervisors

Established in 1994, the IAIS is the international standard-setting body responsible for developing and assisting in the implementation of principles, standards, and other supporting material for the supervision of the insurance sector.³⁹⁰ The IAIS's objectives are: to promote effective and globally consistent supervision of the insurance industry, to develop and maintain fair, safe, and stable insurance markets, and to contribute to global financial stability.³⁹¹ IAIS members include insurance supervisors and regulators from more than 200 jurisdictions in approximately 140 countries.³⁹²

In addition to FIO, the other U.S.-based members of the IAIS are the 56 state and territory insurance regulators who represent the individual sovereign jurisdictions within the United States, the NAIC, and the Federal Reserve.³⁹³ Collectively, this group is informally known as "Team U.S.A." The IAIS does not have regulatory power or legal authority, and any standards agreed upon at the IAIS are not binding and must be adopted voluntarily by each member jurisdiction.

386. See <http://www.fsb.org/about/history>; see also *supra* at 57-59.

387. See FSB, *Charter*, available at: <http://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf>.

388. Financial Stability Board, *3rd Annual Report* (July 25, 2016), available at: <http://www.fsb.org/wp-content/uploads/FSB-3rd-Annual-Report.pdf>.

389. U.S. authorities may also participate in the FSB plenary based on their roles in other capacities. For example, the President of the Federal Reserve Bank of New York currently serves as Chairman of the Committee on the Global Financial System and participates in the FSB plenary in that capacity.

390. See <https://www.iaisweb.org>.

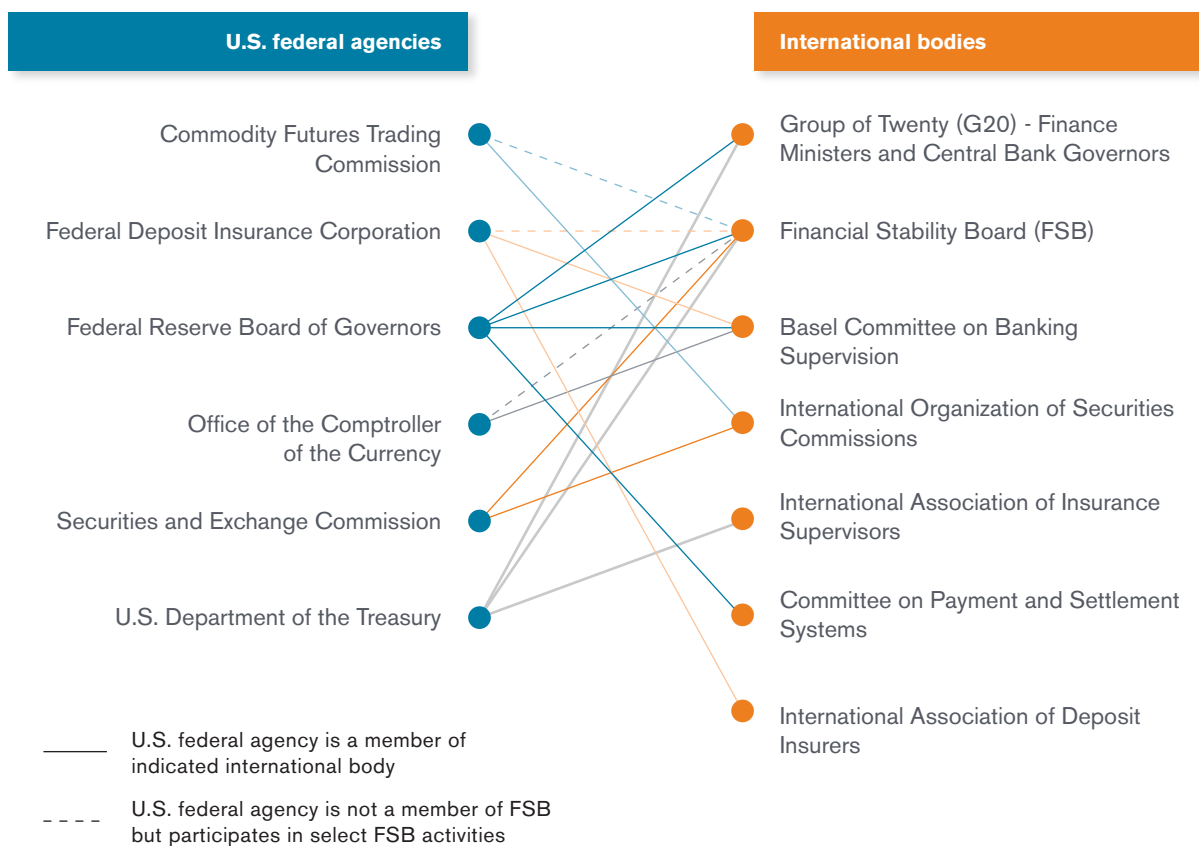
391. *Id.*

392. *Id.*

393. FIO became a full member of the IAIS in 2012 and the Federal Reserve became a full member in 2014.

Any international standards are not effective in the United States unless implemented through the relevant state and/or federal legislative process.

Figure 19: U.S. Federal Agencies Membership in Selected International Bodies



Source: GAO, based on international organization and U.S. federal agency information

Multilateral Work on Insurance

The Financial Stability Board

As noted above, a key initiative of the FSB is the identification of SIFIs, and the IAIS is charged by the FSB with recommending insurers for potential SIFI identification. In 2013, the IAIS developed an assessment methodology to inform a recommendation to the FSB of insurers that may be eligible for identification as a G-SIFI.³⁹⁴ In July 2013, the FSB — in consultation with the IAIS

394. FSB, *Global Systemically Important Insurers and the Policy Measures That Will Apply to Them* (July 18, 2013), available at: http://www.fsb.org/wp-content/uploads/r_130718.pdf?page_moved=1.

and national authorities — identified an initial list of nine insurers that are G-SIIs.³⁹⁵ An annual identification process was subsequently conducted, with nine insurers identified as G-SIIs, which will be subject to a set of G-SIIs policy measures developed by IAIS consistent with FSB’s general G-SIFI framework.³⁹⁶

The FSB is also the standard-setting body for resolution issues for G-SIIs, having promulgated the Key Attributes for Effective Resolution Regimes for Financial Institutions. The FSB’s Cross-Border Crisis Management Group for Insurers (iCBCM) assists and supports regulatory authorities in the development and implementation of resolution-related policy measures. Specifically, the iCBCM assists the Resolution Steering Group in developing and maintaining implementation guidance for resolution regimes for systemically important insurers; monitoring the progress of Crisis Management Groups (CMGs) for each G-SII and the negotiation of cross-border cooperation agreements among CMG members; and the development of guidance on resolution strategies and recovery and resolution plans for G-SIIs.

Throughout Treasury’s engagement with insurance stakeholders, representatives argued that there was an absence of U.S. insurance expertise at the FSB,³⁹⁷ which impairs both the FSB and the U.S. insurance industry. First, stakeholders expressed that the FSB is unable to fully appreciate the U.S. insurance industry, its regulatory regime, and the U.S. insurer resolution process. Second, insurance stakeholders expressed concern that they do not have adequate representation at the FSB, which is important to ensure that any FSB actions sufficiently consider the insurance business model. Further, stakeholders expressed that the FSB’s efforts on insurance-related issues, such as the identification of G-SIIs, is too heavily influenced by the central banks and prudential regulators that have a disproportionate representation at the FSB.

Recommendations

U.S. engagement in the FSB and international financial regulatory standard-setting bodies, such as the IAIS, remains important to promote financial stability, level the playing field for U.S. financial institutions, and prevent unnecessary and overly burdensome regulatory standard-setting that could stifle financial innovation. While the FSB has a wide mandate to evaluate whether various vulnerabilities could create global financial stability risk and should be addressed through regulatory action, Treasury strongly believes that the FSB’s activities should be limited to its purpose of monitoring and enhancing global financial stability. Wherever possible, financial stability risk assessments and standards should be tailored to industry sectors and undertaken by the appropriate standard setter with the necessary technical supervisory expertise, including, for insurance-related matters, the IAIS. Moreover, U.S. members of the FSB should work to revise the G-SIFI framework so it appropriately takes into account the differentiated ways sectors are structured and manage risks. Reliance on the technical supervisory expertise at the standard-setting bodies, such as the IAIS, is important to this tailoring effort.

395. *Id.*

396. IAIS, *Global Systemically Important Insurers; Updated Assessment Methodology*, available at: <https://www.iaisweb.org/file/611179/updated-g-sii-assessment-methodology-16-june-2016>

397. See FSB, *Members of the Financial Stability Board*, available at: <http://www.fsb.org/about/organisation-and-governance/members-of-the-financial-stability-board/>.

Treasury is also concerned that the FSB's efforts remain overly influenced by prudential regulatory perspectives and may, in certain instances, insufficiently take into account the differences between the banking and insurance industries and their different regulatory regimes. Accordingly, Treasury believes that the FSB should better utilize the expertise of the IAIS on insurance-related issues where appropriate. To ensure that insurance stakeholders' concerns are fully appreciated, Treasury will also advocate for increased transparency and stakeholder engagement at the FSB, as well as for standards and principles consistent with the state-based U.S. insurance regulatory system.

The International Association of Insurance Supervisors

There are four key IAIS bodies: (1) the General Meeting, (2) the Executive Committee, (3) the Financial Stability and Technical Committee, and (4) the Implementation Committee. Much of the IAIS's standard-setting work is headed by the Financial Stability and Technical Committee, which reports directly to the Executive Committee. In 2016, the IAIS established the Financial Stability and Technical Committee by merging the Financial Stability Committee and Technical Committee.³⁹⁸

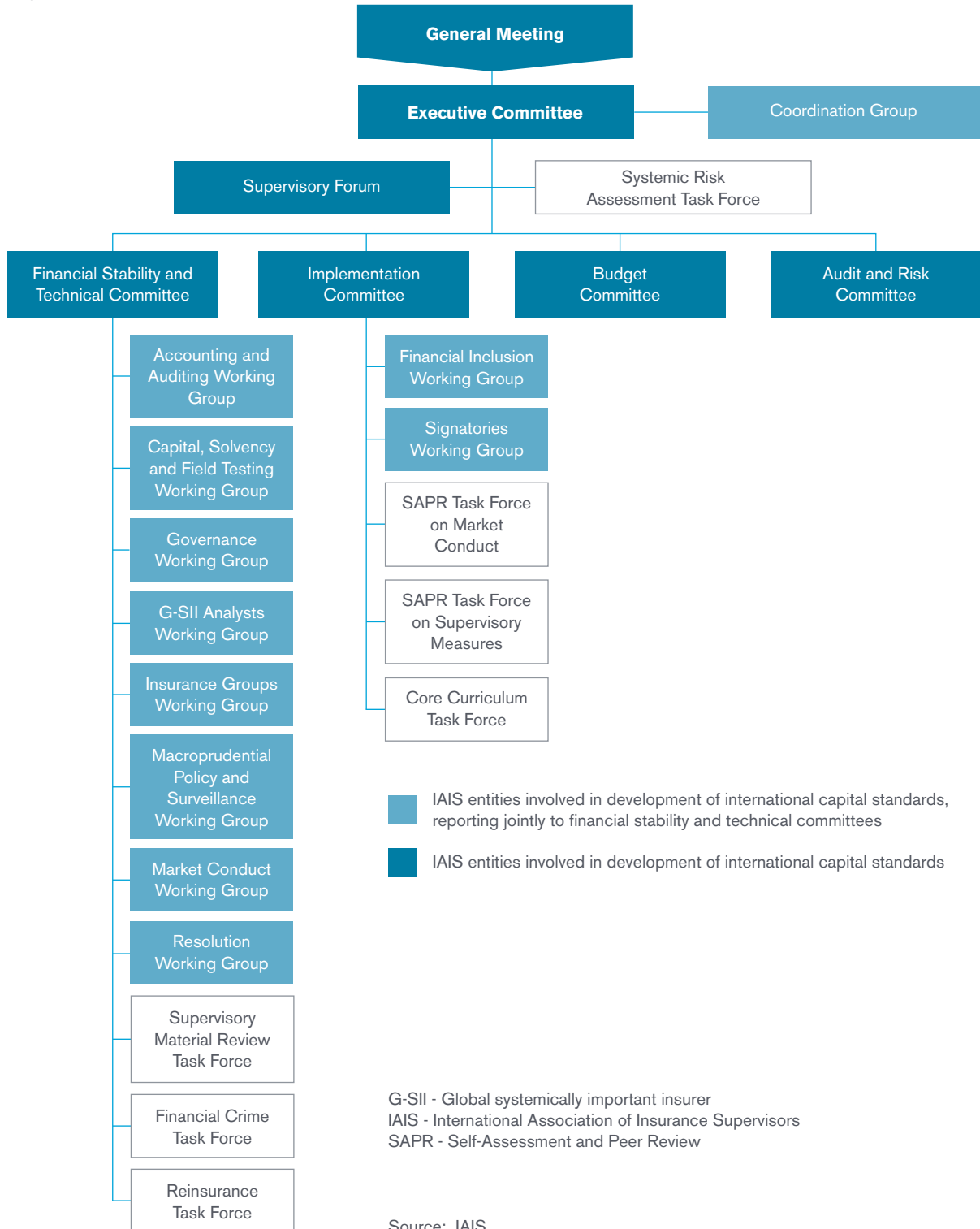
Reporting to the IAIS committees are multiple working groups and task forces that focus on a range of prudential regulation and supervision topics, including financial stability and market conduct. For example, the Capital Solvency and Field Testing Working Group and the Insurance Groups Working Group — both of which report to the Financial Stability and Technical Committee — are charged with developing the ICS and supervisory materials related to group supervision, respectively.

Recommendations

To the extent that the IAIS considers any future organizational changes to its existing structure, Treasury recommends that these changes be done in a manner that ensures appropriate and geographically balanced representation and committee leadership among the IAIS members.

398. See IAIS, *January Newsletter*, available at: <https://www.iaisweb.org/page/news/newsletter-archive/file/58705/iais-newsletter-january-2016>.

Figure 20: International Association of Insurance Supervisors Organizational Structure (updated March 2017)



Transparency

In 2014, the IAIS adopted reforms to improve its financial independence, efficiency, and transparency by eliminating a prior IAIS policy under which stakeholders paid an annual fee to attend IAIS meetings as “observers.”³⁹⁹ The new policy, which went into effect in January 2015, eliminates the distinction between stakeholders that pay fees and those that do not.⁴⁰⁰ The IAIS has also recently developed a Stakeholder Engagement Plan and published a plan summary emphasizing the IAIS’ new engagement opportunities and commitments.⁴⁰¹ The IAIS has also begun posting summaries of the stakeholder comments raised in the consultation process.

Although the elimination of stakeholder fees mitigated disparate treatment of stakeholders, this policy change also had the effect of further restricting the ability of industry and consumer stakeholders to provide significant feedback at the IAIS. In particular, stakeholders have commented that the process is not sufficiently transparent during the early stages of the standard development process. Instead, stakeholders are generally able to participate only after policies are, in effect, developed, and any such engagement takes the form of a consultation rather than collaborative discussion. Treasury believes that the IAIS, IAIS members, and stakeholders can benefit from increased transparency and accountability in the international standard-setting process.

Recommendations

Although the IAIS has taken initial steps to improve stakeholder transparency, Treasury recommends that the IAIS take additional action to further increase transparency and stakeholder input into IAIS decision-making. Treasury will continue to encourage U.S. members of the IAIS to collectively advocate for increased transparency and collaboration during the international standard development process. Specifically, Treasury will advocate for increased utilization of stakeholder workshops and informational sessions — both in person and by teleconference — to further involve stakeholders.

Role of the Federal Insurance Office

Although international standards are not self-executing, numerous federal agencies participate in standard development processes at international financial standard-setting bodies (SSBs). Among other things, this is done to enable that: (1) U.S. interests are well-represented in international standard-setting bodies, (2) the federal government is able to consider potential competitive impacts on the U.S. and global economies, and (3) standards contemplated by SSBs are consistent with this Administration’s policies and objectives.

However, as discussed above, the insurance sector is unique among the financial services industry because it is primarily regulated at the state level. Thus, when the IAIS was founded in 1994, there

399. Federal Insurance Office, *Annual Report, 2016*, at 69, available at: https://www.treasury.gov/initiatives/fio/reports-and-notice/2016_Annual_Report.pdf.

400. *Id.*

401. IAIS, *[Draft] Stakeholder Engagement Plan for Stakeholder Feedback* (November 23, 2016), at 3, available at: <https://www.iaisweb.org/page/consultations/closed-consultations/draft-stakeholder-engagement-plan>; IAIS, *Brief Overview of IAIS Stakeholder Engagement Plan* (March 20, 2017), available at: <https://www.iaisweb.org/page/about-the-iais/policies-and-procedures/file/65583/brief-overview-of-comprehensive-stakeholder-engagement-plan>.

was no federal agency with insurance expertise to ensure that U.S. interests were represented.⁴⁰² Stakeholders noted to Treasury that the absence of a federal voice was concerning because there was often inconsistency among state insurance commissioners, frequent changes in state commissioner leadership at the IAIS, and Constitutional impediments on the ability of state insurance commissioners to speak on behalf of the United States.

Among other reasons, Congress established FIO to lead coordination efforts among U.S. IAIS members to: (1) enable the federal government to express its position on insurance-related matters in international forums, (2) enable the federal government to coordinate and develop policies that are consistent across the financial services sector, and (3) provide a stable and consistent voice from the United States in support of the U.S. industry and its regulators at the international level.

Stakeholders have expressed to Treasury that a unified federal voice promoting the state-based regulatory system and the interests of the U.S. insurance sector is essential to enable the United States to enhance its influence at the IAIS and within other international standard-setting forums. Stakeholders have also expressed that FIO has historically not done enough to ensure that, when possible, there is one coordinated message from “Team U.S.A.”

Recommendations

Treasury strongly supports continued U.S. participation in international SSBs such as the IAIS to promote U.S. interests. Treasury has redefined FIO’s mission at the IAIS to, among other things: (1) advocate for the U.S. state-based insurance regulatory system, U.S. consumers, the U.S. insurance sector, and growth in the broader U.S. economy, (2) coordinate the views of Team U.S.A., and (3) promote greater transparency and stakeholder engagement in international standard-setting forums. To assist in the furtherance of its core mission and to promote U.S. economic interests, Treasury believes FIO should have a permanent, voting membership on the IAIS Executive Committee.

Improved Coordination and Transparency

Since the time when FIO and the Federal Reserve became members of the IAIS, federal and state entities have coordinated efforts and attempted to harmonize policy on prudential aspects of international insurance matters.⁴⁰³ FIO regularly convenes U.S. stakeholder sessions at Treasury and interested stakeholders regularly meet with FIO, state insurance regulators, the NAIC, and the Federal Reserve. However, Team U.S.A. has not achieved a unified and consistent policy position at the IAIS and other international forums. This is due, in part, to the autonomy, unique perspective, and different mandate of each individual U.S. member of the IAIS.⁴⁰⁴ One consistent concern noted by stakeholders is that the inability of Team U.S.A. to collaborate and speak with a unified voice at the IAIS detracts from the collective influence of the U.S. members. This view was also

402. The NAIC and insurance regulators of each of the 50 states, five territories, and the District of Columbia were members of the IAIS prior to FIO’s establishment.

403. For instance, Team U.S.A. members regularly hold ad-hoc and scheduled calls and meetings.

404. Each member of Team U.S.A. has different perspectives and priorities. For example, and as a general matter, state insurance regulators and the NAIC focus on policyholder protection, the Federal Reserve focuses on safety and soundness, and FIO develops federal policy on prudential aspects of international insurance matters.

included in a 2015 Government Accountability Office (GAO) report.⁴⁰⁵ Stakeholders noted that it would be beneficial to the U.S. insurance sector to have increased transparency and stakeholder input in the development of policy positions by Team USA.

Recommendations

U.S. representatives at the IAIS should advance policy positions that best represent the interests of the U.S. insurance sector, U.S. consumers, the state-based U.S. insurance regulatory system, and the U.S. economy. Treasury recognizes that each member of Team U.S.A. has a different mandate. Nevertheless, Treasury believes that the U.S. members of the IAIS will be best-positioned to advance American interests if Team U.S.A. coordinates its efforts and harmonizes its policy positions at the IAIS.

In furtherance of this objective, Treasury recommends that an enhanced interagency process between the U.S. members of the IAIS be established to ensure stronger and more efficient coordination on international prudential insurance matters. Treasury endorses the 2015 GAO report recommendation that Team U.S.A. develop best practices to implement and sustain interagency collaborative efforts, and the Secretary will direct FIO to coordinate with the other U.S. members of the IAIS to formally define and implement this strengthened collaborative process.

To increase transparency, the Secretary will also direct FIO to conduct quarterly coordination meetings for stakeholders to engage with Team U.S.A. members on issues arising at the IAIS. Additionally, the Secretary will direct FIO to consider establishing an advisory committee or other mechanism, such as issuing formal requests for information, to provide increased stakeholder input to members of Team U.S.A.

Advancing American Competitiveness Abroad

Access to Foreign Markets by U.S. Insurers

Emerging markets present significant opportunities for the insurance industry and foreign jurisdictions to develop an insurance marketplace that protects policyholders, encourages investment, and encourages expansion. The economic growth rate in certain emerging markets significantly outpaces the rest of the world.⁴⁰⁶ With respect to insurance, the economic growth rate of emerging markets outpaces the overall average, due in part to the fact that emerging markets have low insurance penetration and density relative to more developed economies.

Some emerging markets have seen rapid expansion in recent years. For example, premiums in emerging Asian economies grew by 17% in 2016, compared to 3% premium growth in the U.S. over the same time. The Chinese market largely drove this growth as life premiums grew by 29%.⁴⁰⁷

405. GAO, *International Insurance Capital Standards, Collaboration among U.S. Stakeholders Has Improved but Could Be Enhanced*, at 36-43, available at: <http://www.gao.gov/assets/680/671043.pdf>.

406. For example, in 2016, India remained the fastest growing major economy with real GDP growth of 7%. Likewise, China, the world's second largest economy, experienced real GDP growth of 6.7%. By contrast, real GDP growth for the global economy was 2.5%. See Swiss Re Institute, *sigma* No 3/2017, at 3, available at: http://institute.swissre.com/research/overview/sigma/3_2017.html. ("Sigma No 3/2017").

407. See *Sigma* No 3/2017 at 9.

In other emerging markets, the insurance penetration remains relatively low. In India, for example, insurers write only 1.5% of the world's total insurance premiums,⁴⁰⁸ notwithstanding the country's large population and other economic factors that make the Indian insurance marketplace ripe for significant growth.

Despite these opportunities, certain jurisdictions have imposed measures that prevent host jurisdictions from achieving greater insurance penetration and realizing the associated benefits including better risk management and possibly higher economic growth rates, which could be reached through a more open approach to foreign insurers and investment. The nature of the restrictions varies in scope, application, and line of business. For example, some jurisdictions place caps on foreign direct investment, thereby keeping domestic joint-venture partners in a controlling position. Others restrict the transfer of data and impose local server requirements. Still others restrict the manner in which insurers may purchase reinsurance from non-domestic reinsurers, which undermines the fundamental insurance principle of global risk diversification, increases the vulnerability of financial stability consequences, and inhibits domestic competition.

These measures also restrict the ability of non-domestic insurers, reinsurers, and intermediaries — including those domiciled in the United States — from competing on a level playing field. Regardless of purpose, the result of such measures by certain countries is to provide a strategic advantage and market position to their domestic insurers, to the detriment of U.S. companies. By contrast, few barriers to entry exist for insurers and reinsurers seeking to do business in the United States. This has helped make the United States the world's largest insurance market with 29% of the global market share. Certain market access restrictions may also be inconsistent with certain IAIS Insurance Core Principles.

Recommendations

The Secretary will direct FIO and the Undersecretary for International Affairs to enhance engagement in multilateral and bilateral dialogues on issues concerning the insurance sector's international market access. These dialogues should work to prevent market access restrictions in other jurisdictions, as well as evaluate potential measures that could be taken to protect the competitiveness of U.S. companies in global markets. Such dialogues should also promote access to insurance products and services in jurisdictions where market penetration is low. Treasury will coordinate with other federal agencies and entities that are engaged in multilateral and bilateral dialogues on market access issues affecting the insurance industry.

In addition, Treasury recommends that members of Team U.S.A. encourage the IAIS to analyze whether certain market access restrictions such as forced domestic retention of reinsurance risk and foreign direct investment are consistent with the goals of the IAIS Insurance Core Principles.

Covered Agreements

Title V of Dodd-Frank authorizes the Secretary and the United States Trade Representative jointly to negotiate a covered agreement on behalf of the United States. A covered agreement is an

408. PWC, *India Insurance Perspective* (July 24, 2017), available at: <http://www.pwc.in/assets/pdfs/publications/2017/india-insurance-perspective.pdf>.

international agreement regarding prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance and reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation.⁴⁰⁹

In January 2017, the United States and the European Union (EU) announced their agreement on final legal text of a covered agreement formally titled *Bilateral Agreement Between the United States of America and the European Union On Prudential Measures Regarding Insurance and Reinsurance* (U.S.-EU Covered Agreement). The U.S.-EU Covered Agreement addresses three areas of insurance and reinsurance prudential measures: (1) group supervision, (2) reinsurance supervision, including collateral and local presence requirements, and (3) exchange of information between supervisory authorities.

The U.S.-EU Covered Agreement promotes U.S. interests by allowing U.S. insurers with EU operations to avoid burdensome worldwide group capital, governance, and reporting requirements under the EU’s “Solvency II” prudential regulatory system for insurers, as well as EU local presence and collateral requirements for U.S. reinsurers. Of most interest for the EU, the Agreement builds on NAIC initiatives underway at the state level and commits the United States to eliminating state-based reinsurance collateral requirements as applied to premiums ceded to EU reinsurers that meet the consumer protection standards specified in the Agreement. Collateral elimination for EU reinsurers will apply prospectively only, on a national basis, and according to the timeline established in the Agreement.

On September 22, 2017, the U.S.-EU Covered Agreement was signed by the Secretary and the U.S. Trade Representative on behalf of the United States, and the Estonian and EU Ambassadors to the United States on behalf of the EU. The Secretary noted that “by providing regulatory clarity and reducing regulatory burdens, the Agreement enables American companies to be more competitive in the EU, enhances opportunities for U.S. insurers and reinsurers at home and abroad, and furthers the administration’s goal of sustained economic growth.”⁴¹⁰

In conjunction with signing the Agreement, the United States released a Policy Statement⁴¹¹ that provides additional clarity for the domestic insurance sector on certain terms of the Agreement, and addresses how the United States intends to implement the Agreement. The Policy Statement emphasizes that the Agreement “affirms the U.S. system of insurance regulation, including the role of state insurance regulators as the primary supervisors of the business of insurance” in the United States and explains that the U.S.-EU Covered Agreement supports the principles specified in the Core Principles Executive Order.⁴¹² The Policy Statement also recognizes the key implementation

409. 31 U.S.C. § 313(r)(2).

410. Treasury, *USTR Sign Covered Agreement on Prudential Insurance and Reinsurance Measures with the European Union* (Sept. 22, 2017), available at: <https://www.treasury.gov/press-center/press-releases/Pages/sm0164.aspx>.

411. Treasury, *Statement of the United States on the Covered Agreement with the European Union* (Sept. 22, 2017), available at: https://www.treasury.gov/initiatives/fio/reports-and-notice/Document/US_Covered_Agreement_Policy_Statement_Issued_September_2017.pdf.

412. *Id.*

role that state insurance regulators will play in meeting U.S. obligations under the Agreement, including revising relevant laws concerning credit for reinsurance.⁴¹³

Given the benefits associated with the U.S.-EU Covered Agreement, additional covered agreements may be mutually beneficial to the United States and other foreign jurisdictions. For example, should the United Kingdom (U.K.) withdraw from the EU, the United States should consider whether it would be mutually beneficial for the United States and the U.K. to enter into negotiations on prudential insurance and reinsurance matters, similar to those addressed by the U.S.-EU Covered Agreement. The U.K. is the fourth largest global insurance market by life and nonlife direct written premium and companies domiciled there — including the Lloyd's market — are important sources of insurance and reinsurance capacity in the United States.⁴¹⁴

Recommendations

Treasury believes that appropriate transparency and regular, substantive engagement with stakeholders is necessary for the proper implementation of the U.S.-EU Covered Agreement. Accordingly, the Secretary will direct FIO to continue to improve its coordination with state insurance regulators, the NAIC, and other stakeholders as the provisions of the U.S.-EU Covered Agreement are implemented in the respective jurisdictions. Treasury will also coordinate and consult with the Office of the United States Trade Representative, Congress, state insurance commissioners, and other industry stakeholders as it explores entering into covered agreement negotiations with other foreign jurisdictions.

Economic Growth and Informed Choices

Insurer Investment in Infrastructure

Due to a persistent low interest rate environment over the past 10 years, the net yield on invested assets achieved by insurers has steadily declined. As a result, insurers have increasingly sought out higher-yielding alternatives, one of which is infrastructure investment. Infrastructure investments are a key priority of the Trump Administration,⁴¹⁵ and may be funded publicly, privately, or through public-private partnerships. In the United States, the main funding vehicle for infrastructure projects historically has been through the municipal bond market. More recently, private equity investment in infrastructure projects has increased as well.

Insurers find equity investments in public/private partnerships especially appealing. This is particularly true for life insurers, which benefit from not only potentially higher yields

413. Id.

414. Insurance Information Institute, *Insurance Fact Book 2017, Premiums, World Life and Nonlife Insurance in 2016*, available at: <https://www.iii.org/publications/insurance-fact-book-2017/world-insurance-markets/premiums> (sub. req.). Industry stakeholders have expressed concerns about the effect of the U.K.'s withdrawal from EU, in view of the recently finalized covered agreement with the EU.

415. See The White House, *President Trump is Working to Rebuild our Nation's Infrastructure* (Feb. 28, 2017), available at: <https://www.whitehouse.gov/the-press-office/2017/02/28/president-trump-working-rebuild-our-nations-infrastructure>.

and returns, but more importantly, long-duration assets that better match cash flows on long-duration insurance liabilities. Infrastructure investment is also attractive to property and casualty insurers that historically have been among the largest investors in municipal bonds.

Nevertheless, current state requirements regarding the amount and type of capital insurers must hold do not reflect the special features of infrastructure investments and, in some cases, may actually penalize insurers to the point that such investments are not economically viable. As such, more calibrated regulatory treatment of infrastructure investments, particularly as regards capital requirements, may allow insurers to consider committing more funds to this investment class. State insurance regulators, through the NAIC, are taking preliminary steps to explore revising Risk-Based Capital standards to permit increased insurer investment in infrastructure projects.⁴¹⁶

Recommendations

Treasury recommends that state insurance regulators and the NAIC evaluate potential steps to encourage the development of more calibrated regulatory treatment of high-quality infrastructure investments. Specifically, and in a manner that safeguards financial stability, state regulators and the NAIC should consider revising Risk-Based Capital charges to reflect the stable cash flows of high-quality infrastructure investments as compared to general equity investments with more volatile returns.

Retirement Security

The Promotion of Lifetime Retirement Income

The life insurance industry and its products play an important role in providing a secure retirement for millions of Americans. The retiree population (i.e., individuals age 65 and older) continues to expand rapidly, mainly due to the aging of the estimated 76 million members of the Baby Boom generation.⁴¹⁷ However, even as the need for retirement income is growing, research indicates that about half of working-age households are at risk of being unable to maintain their standard of living in retirement.⁴¹⁸ A primary reason for Americans' lack of readiness for retirement is "longevity risk," or the risk of outliving assets accumulated during the retiree's working years.⁴¹⁹

416. NAIC, Valuation of Securities (E) Task Force Special Session: Infrastructure Investment (Agenda) (August 28, 2016), http://www.naic.org/meetings1608/committees_e_vos_ssi_2016_summer_nm_agenda.pdf.

417. Insured Retirement Institute, *Boomer Expectations for Retirement 2017*, at 3, available at: https://www.myirionline.org/docs/default-source/research/iri_boomers-expectations-for-retirement-2017.pdf.

418. Alicia H. Munnell, Wenliang Hou, and Geoffrey T. Sanzenbacher, *Do Householders Have a Good Sense of Their Retirement Preparedness?*, Center for Retirement Research (Feb. 2017), Number 17-4, available at: http://crr.bc.edu/wp-content/uploads/2017/02/IB_17-4.pdf.

419. Today, for a couple age 65, there is an 85 percent chance one will live to age 85, and a 67 percent chance one will reach age 90; also, for one in four couples, one will reach age 95. Insured Retirement Institute, State of the Insured Retirement Industry: 2016 Review & 2017 Outlook, at 25, available at: <https://www.myirionline.org/docs/default-source/research/iri-state-of-the-insured-retirement-industry---2016-review-and-2017-outlook.pdf?sfvrsn=2>.

Although 401(k) plans and other defined contribution plans are important retirement savings vehicles, they differ from traditional pension plans in that 401(k) plans are designed and used primarily for asset accumulation rather than as a source of guaranteed income. In addition, only about two-thirds of private sector workers have access to any type of employer-sponsored retirement plan,⁴²⁰ and even workers enrolled in a 401(k) plan have limited access to sources of guaranteed lifetime income under the plan. Apart from Social Security and pensions, annuities⁴²¹ are the only retirement savings products offering a guaranteed income stream that cannot be outlived. This feature alone can make annuities a valuable component of a retirement savings portfolio. Despite the benefits that annuities can provide, they are not widely offered in defined contribution plans.

Employers cite concerns over legal liability under the Employee Retirement Income Security Act of 1974 (ERISA) as the principal deterrent to offering an in-plan annuity option.⁴²² In 2008, the Department of Labor (DOL) adopted a “safe harbor” rule providing that plan sponsors selecting an annuity provider could satisfy the fiduciary standard of ERISA by meeting specified conditions, including “appropriately” considering information “sufficient” to assess the annuity provider’s ability to make all future payments under the annuity contract.⁴²³ Because these terms are not defined, and because the safe harbor rule requires plan fiduciaries to reach conclusions about the solvency of the annuity provider years or decades into the future, many employers and their professional advisors are not comfortable relying on the safe harbor.

In 2014, the DOL published information indicating that it was developing amendments to the safe harbor rule to provide plan sponsors with more certainty that they have discharged their obligation when selecting an annuity provider.⁴²⁴ To date, however, the DOL has not issued any proposals to replace or amend the safe harbor.⁴²⁵

The prudence of a fiduciary decision under ERISA is based on the particular facts and circumstances, making it difficult to establish bright-line tests for conduct deemed to satisfy

420. Bipartisan Policy Center, *Securing Our Financial Future: Report of the Commission on Retirement Security and Personal Savings* (June 2016), at 20, available at: <https://bipartisanpolicy.org/wp-content/uploads/2016/06/BPC-Retirement-Security-Report.pdf>.

421. In an annuity contract, in exchange for a premium, a life insurer agrees to make scheduled payments for the lifetimes of one or more persons, or for a specified number of years. Annuities are available in a number of different forms. In the simplest form, known as a single premium immediate annuity, an individual pays one upfront premium and the insurer begins to make regular payments not later than one year from the issuance of the contract. In a deferred annuity, the insurer guarantees a fixed income starting at a future date in exchange for a single premium or a series of premiums beginning at the date of purchase. Deferred annuities with guaranteed payments that do not begin until an advanced age (such as 85) are generally referred to as longevity annuities.

422. See Government Accountability Office, *DOL Could Take Steps to Improve Retirement Income Options for Plan Participants* (August 2016), at 26-32, available at: <http://www.gao.gov/assets/680/678924.pdf>.

423. 29 C.F.R. § 2550.404a-4.

424. Introduction to the Regulatory Agenda of Federal Regulatory and Deregulatory Actions [79 Fed. Reg. 895, 1024 (Jan. 7, 2014)].

425. On July 13, 2015, the DOL issued guidance on the selection and monitoring of annuity providers for benefit distributions from defined contribution plans. This guidance did not address any issues relating to selecting and monitoring providers of in-plan investment options. See DOL, *Field Assistance Bulletin No. 2015-02* (July 13, 2015), available at: <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2015-02>.

the fiduciary standard. While Treasury acknowledges this challenge, it also believes that the sponsors of many employer retirement plans, particularly for small to mid-size employers, may not possess the financial sophistication or have access to affordable advice for evaluating the ability of a life insurer to make all future payments under an annuity contract that may last for decades.

Recommendations

To encourage the availability of in-plan annuity options and promote broader consumer choice, Treasury recommends that the Department of Labor and Treasury develop proposals on how to establish or certify one or more expert, independent fiduciary entities to assess the long-term financial strength of annuity providers. These assessments, which could be in the form of ratings or other specific metrics, could assist ERISA-governed plan sponsors in complying with their fiduciary duty obligations in selecting annuity providers for plans and enable fiduciaries to rely on such assessments as a safe harbor. This independent fiduciary function would not otherwise affect the fiduciaries' ERISA responsibilities to evaluate all other aspects of the annuity purchase decision.

Long-Term Care Insurance

Long-term care (LTC) refers to the means of meeting the health or personal care needs of individuals who are unable to care for themselves without assistance. The federal Medicare and Medicaid programs combined pay for almost two thirds of LTC expenditures,⁴²⁶ which are projected to increase significantly due to the expanding senior population and increased life expectancy.⁴²⁷

Since the 1970s, private insurers have offered LTC insurance to protect against the risk of needing long-term care at older ages. Sales of LTC insurance peaked in the early 2000s but have since experienced a steep decline based primarily on the business decisions of numerous insurers to exit the market. In response, state insurance regulators and the NAIC are actively reviewing a range of LTC insurance issues and potential policy changes to stabilize and potentially regrow the private market. For example, in April 2017 the NAIC established a Long Term Care Insurance Task Force and released a list of 10 federal public policy changes that could help to increase private long-term care financing options for middle-income Americans.⁴²⁸ These changes included allowing participants in employer-sponsored retirement plans to make penalty-free withdrawals to purchase LTC insurance, creating LTC savings accounts similar to Health Savings Accounts, and establishing more generous federal tax incentives for LTC insurance.

426. In 2015, U.S. spending on long-term care was funded primarily by Medicare and Medicaid (63%), with a 20% contribution from direct out-of-pocket spending and three percent from private LTC insurance. See Peter Gallanis, et al., *State of the Long-Term Care Insurance Industry: NOLHGA Presentation to the NAIC* (presentation, NAIC, March 30, 2017), available at: http://www.naic.org/documents/cmte_e_mlwg_related_state_of_ltc_industry.pdf.

427. An estimated 12 million Americans currently need LTC, a number projected to reach 27 million by 2050. See Bipartisan Policy Center, *Initial Recommendations to Improve the Financing of Long-Term Care* (Feb. 2016), available at: <https://cdn.bipartisanpolicy.org/wp-content/uploads/2016/12/BPC-Health-Long-Term-Care-Financing-Recommendations.pdf>.

428. NAIC Long Term Care (B) Subgroup, *Long Term Care Federal Policy Options to Present to Congress* (Apr. 3, 2017), available at: http://www.naic.org/documents/government_relations_ltc_fed_policy_opt.pdf.

Recommendations

Given the growing social need for LTC and the resulting strain on public resources, state and federal officials should collaborate on addressing the challenges of financing LTC. In addition to the existing state efforts to address problems in the LTC insurance market, the challenges in financing LTC require a coordinated response from the federal government because they are of national interest. Accordingly, Treasury will convene an inter-agency task force, including representatives of the Department of Health and Human Services, Treasury, the IRS, and the Office of Management and Budget, to develop policies to complement reforms at the state level relating to the regulation of long-term care insurance. The task force's work should be coordinated with the ongoing work of state insurance regulators and the NAIC.

Appendix A

Participants in the Executive Order Engagement Process



Participants in the Executive Order Engagement Process

Academics

Adi Sunderam, Harvard Business School

John Taylor, Stanford University Hoover Institution

Anat Admati, Stanford Graduate School of Business

Lawrence White, New York University Stern School of Business

Arnold Kling, Independent Scholar

Mark Willis, New York University Furman Center

Arthur Wilmarth, Jr., George Washington University Law School

Richard Herring, University of Pennsylvania, The Wharton School

David Skeel, University of Pennsylvania Law School

Roberta Romano, Yale Law School

Jay Rosengard, Harvard Kennedy School

Robin Greenwood, Harvard Business School

John Cochrane, Stanford University Hoover Institution

Sanjai Bhagat, University of Colorado Leeds School of Business

Consumer Advocates

AARP

Coalition for Investor Choice

Americans for Financial Reform

Consumer Federation of America

Regulators and Government Related Entities

Consumer Financial Protection Bureau

Financial Industry Regulatory Authority

Federal Deposit Insurance Corporation

National Association of Insurance Commissioners

Federal Reserve Board

North American Securities Administrators Association

Appendix A • Participants in the Executive Order Engagement Process

Office of the Comptroller of the
Currency

U.S. Securities and Exchange
Commission

U.S. Commodity Futures Trading
Commission

Industry and Trade Groups

Ace Group (Chubb)

The Cypress Group

Aegon N.V. (Transamerica)

Dodge and Cox

Aflac Inc.

Federated Investors Inc.

American International Group, Inc.

Fidelity Investments

Allianz SE

Financial Services Roundtable

Allstate Corporation

Franklin Templeton Investments

Alvarez and Marsal, LLC

Foley & Lardner LLP

American Council of Life Insurers

GEICO Corporation

American Insurance Association

Government Finance Officers
Association

American Investment Council

The Guardian Life Insurance
Company of America

Aon plc

Association for Financial
Professionals

Independent Insurance Agents and
Brokers of America, Inc.

AXA S.A.

Insured Retirement Institute

BlackRock

Invesco

Capital Group

Jackson National Life Insurance
Company

Cincinnati Financial Corporation

JP Morgan Asset Management

Council of Insurance Agents and
Brokers

Legg Mason

Appendix A • Participants in the Executive Order Engagement Process

Liberty Mutual Group, Inc.	Oliver Wyman Group
Lincoln Financial Bancorp, Inc.	Pacific Life Insurance Company
Lloyd's	PIMCO
Managed Funds Association	The Principal Financial Group
Manulife Financial Corporation (John Hancock)	Progressive Corporation
Marsh and McLennan Companies, Inc.	Prudential Financial, Inc.
Massachusetts Mutual Life Insurance Company	Property Casualty Insurers Association of America
Mesirow Financial	Reinsurance Association of America
MetLife, Inc.	RGA Reinsurance Company
National Association of Mutual Insurance Companies	State Farm Mutual Automobile Insurance Company
National Conference of Insurance Guaranty Funds	State Street Global Advisors
National Organization of Life & Health Insurance Guaranty Associations	Sonecon LLC.
Nationwide Mutual Insurance Company	Swiss Re Ltd.
Natixis	T. Rowe Price
Neuberger Berman	The Hartford Financial Services Group, Inc.
New York Life Insurance Company	Teachers Insurance and Annuity Association of America
Nomura Securities	Transatlantic Reinsurance Company
Northwestern Mutual Life Insurance Company	Travelers Companies, Inc.
Odyssey Re Holdings Corporation	United States Automobile Association
	Vanguard
	Waddell and Reed

Appendix A • Participants in the Executive Order Engagement Process

Wellington Management	Investment Advisers Association
XL Group Ltd.	Investment Company Institute
Zurich Insurance Company Ltd.	Securities Industry and Financial Markets Association
Institutional Limited Partners Association	Sullivan and Cromwell

Think Tanks

American Enterprise Institute	Competitive Enterprise Institute
Aspen Institute	Heritage Foundation
Better Markets	Hoover Institution
Bipartisan Policy Center	Mercatus Center at George Washington University
Brookings Institution	New America
CATO Institute	Pew Charitable Trust
Center for American Progress	R Street Institute
Committee on Capital Markets Regulation	Urban Institute

Appendix B

Regulatory and Legislative Recommendations



Regulatory and Legislative Recommendations

Asset Management

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Systemic Risk and Stress Testing

Treasury's position is that entity-based systemic risk evaluations of asset managers or their funds are generally not the best approach for mitigating risks arising from asset management. Instead, primary federal regulators should focus on potential risks arising from asset management products and activities, and on implementing regulations that strengthen the asset management industry as a whole.		SEC	C, D, F
The FSOC should maintain primary responsibility for identifying, evaluating, and addressing systemic risks in the U.S. financial system, and the SEC should remain the primary federal regulator of the asset management industry in the United States.		FSOC, SEC	F, G
Treasury supports legislative action to amend Dodd-Frank to eliminate the stress testing requirement for investment advisers and investment companies.	Congress		F

Liquidity Risk Management

Treasury supports the 15% limitation on illiquid assets.		SEC	A,C,F
Treasury supports the SEC adopting a principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements. The SEC should take appropriate action to postpone the currently scheduled December 2018 implementation of Rule 22e-4's bucketing requirement.		SEC	A, C, F

Derivatives

The SEC should consider a derivatives rule that would include a derivatives risk management program and an asset segregation requirement, but reconsider what, if any, portfolio limits should be part of the rule. The SEC should also reconsider the scope of assets that would be considered qualifying coverage assets for purposes of the asset segregation requirement.		SEC	A, C, F
The SEC should examine the derivatives data that will be reported by funds starting next year and publish analysis based on empirical data regarding their use of derivatives.		SEC	C

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Exchange Traded Funds

The SEC should move forward with a “plain-vanilla” ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders, subject to conditions the SEC determines appropriate and in the public interest. To this end, the SEC should either re-propose or propose a new rule on ETFs for public comment.		SEC	A, C, F
The SEC should consider establishing a single process for ETF and related approvals rather than allowing SEC divisions to set multiple and sometimes conflicting requirements.		SEC	A, F

Business Continuity and Transition Planning

The current SEC proposal on business continuity and transition planning should be withdrawn. With the existing principles-based rule already in place, there is no compelling need for additional rulemaking in this area.		SEC	F, G
The SEC and its staff should continue to work with investment companies, investment advisers, and other relevant parties to recommend improvements to business continuity plans, to the extent that such plans are determined not to be sufficiently robust, and to address new issues as they arise.		SEC	C, F, G

Dual CFTC and SEC Registration

The CFTC should amend its rules so that an investment company registered with the SEC and its adviser are exempt from dual registration and regulation by the CFTC as a CPO. To address concerns of de facto commodity pools operating without sufficient oversight, the CFTC and the SEC should work together to identify a single regulator for these entities, with the goal that oversight of these entities will either remain with the SEC or be transferred to the CFTC and NFA.		CFTC, SEC	A, C, F, G
The CFTC and the SEC should cooperate to share information provided by their respective regulated entities so that disclosures made to one agency can address the information needs of the other agency to monitor the markets for securities and derivatives transactions.		CFTC, SEC	G
The CFTC should amend its rules to exempt private funds and their advisers from registration as CPOs if the advisers are subject to regulatory oversight by the SEC. Treasury also recommends that the CFTC review and determine what, if any, exemptions should be made available for SEC exempt reporting advisers.		CFTC	A, C, F, G

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Modernizing the Delivery of Fund Disclosures

The SEC should finalize its proposed rule to modernize its shareholder report disclosure requirements and permit the use of implied consent for electronic disclosures.		SEC	A, F
The SEC should explore other areas for which the delivery information to investors through an electronic medium using implied consent is appropriate and consistent with investor protection; however, investors should retain the choice to continue to receive paper disclosures.		SEC	A, F, G

Asset Management Reporting and Disclosure Requirements

The SEC, the CFTC, SROs, and other regulators should work together to rationalize and harmonize the reporting regimes. Where possible, duplicative forms should be combined and any unnecessary or inconsistent data collection should be eliminated. Treasury recommends that regulators continue to update reporting requirements to utilize structured data where appropriate.		SEC, CFTC, SROs, States	F, G
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Volcker Rule

Regulators should take further action to reduce the burden of the Volcker Rule on asset managers and investors. The relevant agencies should continue to refrain from enforcing the Volcker Rule's proprietary trading restrictions against foreign private funds that are not "covered funds" under the rule until a permanent solution to the identified challenges is implemented.		FRB, FDIC, OCC, SEC, CFTC	D, F
The agencies should also forbear on enforcement of the restriction on funds sharing names with banking entities, consistent with Treasury's Banking Report.		FRB, FDIC, OCC, SEC, CFTC	A, D, F
Congress should revise the definition of "banking entity" to encompass only insured depository institutions, their holding companies, foreign banking organizations, and affiliates and subsidiaries of such entities that are at least 25% owned or otherwise controlled by such entities.	Congress		D, F

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

International Engagement

The United States should play a leading role in international standard-setting bodies such as the FSB and IOSCO, particularly with respect to financial market supervision and asset management where U.S. firms and markets are the largest in the world.		FRB, SEC, CFTC	E
Treasury recommends further improvements to the FSB and SSB processes to better promote transparency, accountability, and appropriate representation with respect to policymaking.		FRB, SEC, CFTC	E
Treasury recommends that U.S. representatives to FSB and IOSCO review the particular processes used by each international standard-setting body and work to ensure that they utilize a collaborative process that includes, where appropriate, economic analysis and subject matter expertise at the relevant standard setting body.		FRB, SEC, CFTC	E
Treasury recommends that the FSB transition away from using the term “shadow banking” to describe registered investment companies and their investment advisers.		FRB, SEC	E
The U.S. members of the FSB should work to revise the G-SIFI framework so that it appropriately takes into account the differentiated ways that sectors are structured and manage risks.		FRB, SEC	E

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Economic Growth and Informed Choices

Treasury supports the current efforts at the DOL to re-examine the implications of the Fiduciary Rule. Treasury believes it is appropriate to delay full implementation of the Fiduciary Rule until the relevant issues, including costs of the rule and exemptions, are evaluated and addressed to best serve investors, and believes that such assessment and resolution of standard of conduct issues should include participation by the SEC and other regulators.		DOL, SEC	A, C, F
Treasury believes that conflicts of interest should be addressed in a manner that preserves, to the extent possible, access to a wide range of asset classes, investment products, business models, distribution channels, and other relevant features of financial services that benefit American workers and their families.		DOL, SEC	A, F
Within the federal regulatory framework, Treasury believes that the SEC and DOL should work together to address standards of conduct for financial professionals who provide investment advice to IRA and non-IRA accounts.		DOL, SEC	A, G
Treasury recommends that the DOL and the SEC engage with state insurance regulators regarding the impact of the standards of care on the annuities market.		DOL, SEC, NAIC, States	A, G
Treasury encourages the SEC, the DOL, and the states to work together to implement a regulatory framework appropriately tailored to both preserve investor choice and protect retirement investors in an efficient and effective manner.		DOL, SEC	C

Insurance

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Systemic Risk and the Insurance Industry

Treasury's position is that entity-based systemic risk evaluations of insurance companies are generally not the best approach for mitigating risks arising from insurance. Instead, insurance regulators should focus on potential risks arising from insurance products and activities, and on implementing regulations that strengthen the insurance industry as a whole. Insurance regulation at the federal level should be conducted in coordination with the states.		FRB, States	B, D, F, G
FIO and the other U.S. members of the IAIS should support the IAIS' work on the activities-based approach because it a more appropriate method of assessing potential systemic risk in the global insurance market. The U.S. members of the IAIS should advocate for the development of an activities-based framework that is proportionate and appropriately tailored to the U.S. insurance market. The IAIS should reassess its existing G-SII policy measures, including how to improve the IAIS' 2014 guidance on liquidity management and planning. FIO and the other U.S. members of the IAIS should also take steps to improve the IAIS G-SII assessment methodology and consider how to increase transparency with respect to the assessment methodology's development. U.S. members of the IAIS should advocate that the IAIS enhance its work on cross-sectoral consistency with other financial sectors – such as through work with the Basel Committee on Banking Supervision.		Treasury, FRB, States	B, D, E, F, G

Preserving Solvency: Capital Initiatives

The group capital initiatives by the NAIC, the states, and the Federal Reserve should be harmonized, to the extent possible, to mitigate duplicative and unnecessary regulatory burdens for U.S. insurers. The Secretary will direct FIO to consult with the state insurance regulators, the NAIC, and the Federal Reserve on their respective group capital initiatives to produce the best outcomes for U.S. insurers, U.S. policyholders, and the U.S. insurance market. The Secretary will direct FIO to coordinate this work. FIO will then advocate for the U.S. approach to group capital in international forums.		FRB, States, Treasury	D, E, F
The ICS should recognize the diverse approaches to solvency regulation taken by various jurisdictions around the globe. A core goal should be to ensure that the ICS initiative accommodates the U.S. insurance business model and the existing state-based regulatory system. Such standards should also be developed in a manner that recognizes the variety of supervisory approaches to valuation and accounting requirements, and definitions of what constitutes capital. The IAIS should reexamine its current timeline to deliver ICS Version 2.0 in 2019. The IAIS should postpone ICS Version 2.0 until a later date to allow further consultation with IAIS members and stakeholders on the development of an ICS that is implementable in all major insurance markets.		FRB, States, Treasury	D,E

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Preserving Solvency: Liquidity Initiatives

Treasury encourages state insurance regulators, the NAIC, and the Federal Reserve to continue their work on addressing potential liquidity risk in the insurance sector. The Secretary will direct FIO to monitor developments in liquidity management and liquidity stress testing, and to encourage state insurance regulators, the NAIC, and the Federal Reserve to make progress on domestic liquidity risk initiatives. The Secretary will also direct FIO to advocate for improvements to the existing international standards regarding liquidity management and planning.		FRB, States	B, D, E F
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Role of State and Federal Regulation

Treasury is committed to FIO's increased transparency and stakeholder engagement, and will implement mechanisms to achieve these objectives. Treasury and FIO are also committed to more regular and consistent engagement with state insurance regulators and stakeholders on developing issues of importance to the insurance industry, state regulators, and U.S. policyholders.		Treasury	F, G
The Federal Reserve should leverage information procured from ISLHCs by state regulators and the NAIC, including information regarding an ISLHC's ultimate parent company. The Federal Reserve should also harmonize its financial reporting and recordkeeping requirements with corresponding state regulatory requirements. The Federal Reserve, state insurance regulators, and the NAIC should establish formal procedures to better coordinate the supervision and examinations of insurers regulated by both state insurance regulators and the Federal Reserve. The Federal Reserve should reassess whether its ISLHC examinations are appropriately tailored and proportionate to the unique business model of each ISLHC, and the size, organizational structure, and potential risks posed by each ISLHC.		FRB	F, G
Congress should clarify the "business of insurance" exception to ensure that the CFPB does not engage in the oversight of activities already monitored by state insurance regulators.	Congress	CFPB	F, G
HUD should reconsider its use of the disparate impact rule. In particular, HUD should consider whether the disparate impact rule, as applied, is consistent with McCarran-Ferguson and existing state law. HUD should also reconsider whether such a rule would have a disruptive effect on the availability of homeowners insurance and whether the rule is reconcilable with actuarially sound principles.		HUD	F, G
The SEC should prioritize annuity-related disclosure reform by proposing a rule permitting a variable annuity summary prospectus and a streamlined prospectus update, while continuing to provide appropriate disclosure to investors. The SEC should also move forward with finalization of Rule 30e-3, and take steps to improve the efficiency and effectiveness of the regulation of insurance products under its jurisdiction. The SEC should enhance its engagement with the insurance sector, including state insurance regulators and the NAIC, to assess how FASB and IFRS standards could affect the insurance industry.		SEC	A, F

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Terrorism Risk Insurance Program

The Secretary will direct FIO to coordinate with state insurance regulators and the NAIC to attempt to eliminate or reduce the inconsistencies between existing data calls concerning terrorism risk insurance. State insurance regulators and FIO should also explore the possibility of conducting a single data call that can serve the needs of both federal and state authorities while reducing unnecessary compliance costs on industry.		Treasury, States	F, G
The Secretary will direct FIO to be proactive in applying the Certification Process in connection with any event that has some reasonable likelihood of resulting in more than \$5 million in insured losses under TRIA. State regulators, policyholders, and insurers are likewise encouraged to inform Treasury whenever they believe an “act of terrorism” under TRIA has taken place, for which they have some reason to believe total insured losses are or will be in excess of \$5 million.		Treasury, States	F, G
The Secretary encourages the ACRSM to continue its efforts and develop recommendations for FIO. The work of the ACRSM should focus on how to increase private market participation in the terrorism insurance marketplace. FIO should also evaluate potential ways to increase private market participation in the terrorism insurance marketplace.		Treasury	F, G

Insurer Data Security

The states should promptly adopt the NAIC Insurance Data Security Model Law. If adoption and implementation of the Insurance Data Security Model Law by the states do not result in uniform data security regulations within five years, Congress should pass a law setting forth requirements for insurer data security, but leaving supervision and enforcement with state insurance regulators. State legislators, regulators, and the NAIC should also work to expeditiously pass uniform legislation regarding data breach notification for insurers, and the NAIC is encouraged to make any such model law an accreditation standard. If adoption and implementation of data breach notification efforts by the states do not result in uniform requirements within five years, Congress should pass a law setting forth requirements for data breach notification specific to insurers. Such legislation should leave supervision and enforcement with state insurance regulators.	Congress	States	F, G
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Insurer Cyber Threats

Steps should be taken to improve information sharing within the insurance industry. Treasury and state insurance regulators should continue to promote insurer participation in the FS-ISAC and similar entities, particularly among the thousands of small and regional firms that operate within the United States that may not yet be engaged with such national information sharing efforts. The Secretary will direct FIO to establish a working group charged with assessing cybersecurity challenges for the insurance sector and issuing recommendations to insurance sector participants and relevant regulators, with particular attention paid to small and regional insurers.		Treasury	F, G
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Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Product Approval and Speed to Market

Treasury encourages the NAIC to bring in states that have not yet joined the Compact. Treasury also encourages the IIPRC to continue its efforts to complete the development of standards for all product lines within its authority. States should take steps to mitigate inconsistent or conflicting state laws, regulations, and practices applicable to approval of insurance products.		States	D, F, G
Treasury encourages state legislators, state regulators, the NAIC, and insurance stakeholders to work together on proposals for more efficient regulation of commercial lines products. To promote competition and meet market demands in a timely fashion, states should consider the ECP definition under the NRRRA, New York's Free Trade Zone, and the 2015 NAIC Commercial Lines Working Group recommendations.		States	D, F, G,

Producer Licensing and Appointments

Treasury will take steps to expeditiously recommend nominees for the Board of Directors of NARAB II to President Trump who can be sent to the Senate for confirmation. To do so, the Secretary will direct FIO to solicit nominee recommendations and work with stakeholders on the establishment of the Association. The appointment process should proceed in a manner to maintain a quorum composed of a majority of state insurance regulators.		Treasury	A, D, F
Treasury encourages state regulators and the NAIC to assess how to increase the efficiency and uniformity of the producer appointment process. Treasury also encourages all states to adopt the PLMA and encourages regulators to interpret appointment provisions of the PLMA consistently. State legislators, regulators, and the NAIC should consider whether the information received from the appointment reporting process is already procured or available by other requirements imposed on producers and/or insurers and, if not, whether such information can be obtained through other, more efficient means.		States	D, F, G

Regulatory Structure and Issues of Duplication, Overlap, and Fragmentation

Federal agencies and entities should establish formal mechanisms to promote coordination and communication across the federal government with respect to insurance-related issues. Federal agencies and entities should also establish policies and procedures that take into account the similarities and differences of insurers and others types of businesses in the financial sector, such as banks and mutual funds. FIO should establish a more structured and rationalized approach to its engagement with federal agencies and entities on insurance-related issues. Also, FIO should consult with and advise federal agencies and entities conducting rulemaking or policy action that relates to insurance.		All (e.g. FRB, CFTC, SEC, FEMA)	C, F, G
States should be consulted and afforded the opportunity to provide input when the business of insurance is implicated at the federal level. FIO should lead coordination efforts among federal and state agencies to improve communication and develop policy with respect to insurance-related issues.		All (e.g. DHS, FBIIC)	F, G

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Multilateral Work on Insurance

<p>The FSB's activities should be limited to its purpose of monitoring and enhancing global financial stability. Wherever possible, financial stability risk assessments and standards should be tailored to industry sectors and undertaken by the appropriate standard setter with the necessary technical supervisory expertise, including, for insurance-related matters, the IAIS. Moreover, U.S. members of the FSB should work to revise the G-SIFI framework so that it appropriately takes into account the differentiated ways that sectors are structured and manage risks. The FSB should better utilize the expertise of the IAIS on insurance-related issues where appropriate. Treasury will also advocate for increased transparency and stakeholder engagement at the FSB, as well as for standards and principles consistent with the state-based U.S. insurance regulatory system.</p>		Treasury	D, E
<p>Any future organizational changes to the IAIS' existing structure should be done in a manner that ensures appropriate and geographically balanced representation and committee leadership among the IAIS members.</p>		FRB, States, Treasury	D, E
<p>The IAIS should take additional action to further increase transparency and stakeholder input into IAIS decision-making. Treasury will continue to encourage U.S. members of the IAIS to collectively advocate for increased transparency and collaboration during the international standard development process. Treasury will advocate for increased utilization of stakeholder workshops and informational sessions – both in person and by teleconference – to further involve stakeholders.</p>		Treasury, FRB, States	D, E
<p>Treasury has redefined FIO's mission at the IAIS to, among other things: (1) advocate for the U.S. state-based insurance regulatory system, U.S. consumers, the U.S. insurance sector, and growth in the broader U.S. economy, (2) coordinate the views of Team U.S.A., and (3) promote greater transparency and stakeholder engagement in international standard-setting forums. FIO should have a permanent, voting membership on the IAIS Executive Committee.</p>		Treasury	D, E
<p>U.S. representatives at the IAIS should advance policy positions that best represent the interests of the U.S. insurance sector, U.S. consumers, the state-based U.S. insurance regulatory system, and the U.S. economy. An enhanced inter-agency coordination process between the U.S. members of the IAIS should be established to ensure stronger and more efficient coordination on international prudential insurance matters. The Secretary will direct FIO to coordinate with the other U.S. members of the IAIS to formally define and implement this strengthened collaborative process. The Secretary will also direct FIO to conduct quarterly coordination meetings for stakeholders to engage with Team U.S.A. members on issues arising at the IAIS. Additionally, the Secretary will direct FIO to consider establishing an advisory committee or other mechanism, such as issuing formal requests for information, to provide increased stakeholder input to members of Team U.S.A.</p>		Treasury, FRB, States.	D, E

Recommendation	Policy Responsibility		Core Principle
	Congress	Regulator	

Advancing American Competiveness Abroad

<p>The Secretary will direct FIO and the Undersecretary for International Affairs to enhance engagement in multilateral and bilateral dialogues on issues concerning the insurance sector's international market access. Treasury will coordinate with other federal agencies and entities that are engaged in multilateral and bilateral dialogues on market access issues affecting the insurance industry. Members of Team U.S.A. should encourage the IAIS to analyze whether certain market access restrictions are consistent with the goals of the IAIS Insurance Core Principles.</p>		Treasury	D, E
<p>The Secretary will direct FIO to continue to improve its coordination with state insurance regulators, the NAIC, and other stakeholders as the provisions of the U.S.-EU Covered Agreement are implemented in the respective jurisdictions. Treasury will also coordinate and consult with the Office of the United States Trade Representative, Congress, state insurance commissioners, and other industry stakeholders as it explores entering into covered agreement negotiations with other foreign jurisdictions.</p>		Treasury USTR	D, E

Insurer Investment in Infrastructure

<p>State insurance regulators and the NAIC should evaluate potential steps to encourage the development of more calibrated regulatory treatment of high-quality infrastructure investments. Specifically, and in a manner that safeguards financial stability, state regulators and the NAIC should consider revising Risk-Based Capital charges to reflect the stable cash flows of high-quality infrastructure investments as compared to general equity investments with more volatile returns.</p>		States	F
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Retirement Security

<p>The Department of Labor and Treasury should develop proposals on how to establish or certify one or more expert, independent fiduciary entities to assess the long-term financial strength of annuity providers. These assessments, which could be in the form of ratings or other specific metrics, could assist ERISA-governed plan sponsors in complying with their fiduciary duty obligations in selecting annuity providers for plans and enable fiduciaries to rely on such assessments as a safe harbor.</p>		DOL, Treasury	A, F, G
<p>Treasury will convene an inter-agency task force, including representatives of the Department of Health and Human Services, Treasury, the IRS, and the Office of Management and Budget, to develop policies to complement reforms at the state level relating to the regulation of long-term care insurance. The task force's work should be coordinated with the ongoing work of state insurance regulators and the NAIC.</p>		Treasury, HHS, IRS, OMB, etc.	A, C, G



