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So What Do We Do Now?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter, "Dodd-Frank") was signed into law on Wednesday July 21, 2010. It is sizeable, complicated, controversial legislation with material impact to commercial enterprises. In the wake of the recent U.S. financial crises, the Act blends immediate change with more than 50 studies to be undertaken. Throughout its 2,300 pages, Dodd-Frank trumpets financial industry safety and soundness. It purports two bases for reform: 1) government intervention, oversight and restrictions that are intended to identify and lessen risk in the overall financial system; and 2) consumer protections to protect market participants.

We thought it helpful in light of this momentous legislation to highlight salient points in Dodd-Frank relevant to the risk management and insurance spheres. This paper does not purport to be an exhaustive discussion on the extremely broad changes made, constitutional issues raised, nor the multi-varied expenses and exposures that Dodd-Frank will inevitably present to individuals and businesses. With this paper, we seek to introduce and highlight certain risk management and insurance issues for your consideration.

In the coming months we will be updating our Dodd-Frank report to address additional issues that may affect your businesses, highlight new exposures and suggest insurance considerations that may assist with your risk management.

Here Come the Feds

Dodd-Frank establishes certain agencies and offices in an attempt to consolidate, supervise and unify various aspects of insurance:

- Casting off a broad net over "non bank-financial companies", Dodd-Frank may newly subject many large U.S. insurance companies to "oversight" by the Federal Reserve.
- Title V of Dodd-Frank is entitled the "Federal Insurance Office Act of 2010" and establishes an authority to monitor all aspects of the insurance industry, to gather relevant information on and from the insurance industry, and to report to Congress regularly on the state of affairs within the industry. If the Federal Insurance Office believes an entity poses significant systemic risk, it may recommend additional supervision by the Federal Reserve. Additionally, the Act calls for a study on how to modernize and improve insurance regulation.
- Through "Subtitle B," the Non-admitted and Reinsurance Reform Act of 2010, Dodd-Frank strives for uniformity in surplus lines insurance premium taxes by calling on the states to enter into an interstate compact within the next 12 months.
- The Director of the Federal Insurance Office is empowered to determine whether a state's insurance measures are inconsistent with international

agreements relating to insurance. If state measures are found to be less favorable to a foreign insurer than a domestic one, then they may be unenforceable.

Increased federal involvement in insurance matters has not caused an immediate hardening of the insurance market, nor sweeping changes to standard insurance forms. On the positive side, centralization and uniformity may bring clarity and consistency to otherwise complicated issues, such as premium tax collection. On the other hand, introducing uniformity to a marketplace accustomed to local supervision could have deleterious effects, decreasing competition and stifling creativity.

Fact-finding missions by a Federal Insurance Office will undoubtedly bring extra work for insurers in 2011, but we do not anticipate that the costs involved with such compliance will be a catalyst for rate hikes. Without significant insurance losses or market events, continued abundant capacity and competition is likely to keep rates suppressed. Though certain market sectors, such as real estate and financial institutions, bear bruises from the credit crisis, there are no immediate signs of market tumult as a result of Dodd-Frank.

Dodd-Frank's more immediate impact for 2011 is in the realm of directors and officers liability. A discussion on these points follows.

Codifying Lessons Learned

Dodd-Frank attempts to codify reactions to lessons from Enron, the Dot-Com Boom-Bust, and the Credit Crisis in three basic areas: executive compensation, disclosure, and whistle-blowing. Generally:

- Shareholders are granted the right to "Say on Pay" vote, i.e. non-binding votes with respect to executive compensation. These votes may take place at a minimum of once every three years, but shareholders can vote to determine a more regular say on pay assessment.
- Companies listing on national exchanges must have claw-back provisions or a recoupment policy concerning director compensation premised on inaccurate financial statements.
- Compensation committees of listed companies must be independent and must consider factors affecting independence if they select third-party compensation advisors.
- Issuers are required to disclose the relationship between executive compensation paid and the financial performance of the issuer and must also disclose internal pay ratio of median total compensation to the CEO (or similar position if CEO is not used by the entity).
- Whistleblowers are incented by awards from 10% to 30% of recovered funds for recoveries of more than \$1 million. Whistleblowers are protected from discrimination or retaliation for their activities.

Underwriters will likely re-visit applications and policy wording to identify any necessary adjustments in light of mandates by Dodd-Frank, particularly because the

duties imposed on corporate management broaden potential exposure. Stakeholder action as a result of failed compliance with the Act's mandates is a legitimate concern. It is therefore imperative that companies ensure processes and procedures to ensure compliance and thoroughly review their insurance forms.

Key provisions in the D&O policy that should be reviewed include:

- Warranty statements in the application
- Conduct exclusion triggering events
- Severability
- Definition of Loss and punitive damage treatment
- Definition of Claim – informal investigation triggers and mercurial regulatory turf wars impact on coverage and limits
- Breadth of Insureds that may claim limits under the policy

Executive liability is organic, evolving with the legal landscape. It is axiomatic that complicated legislation invites courtroom battles, and indeed, challenges have begun. For example, Dodd-Frank confirmed the SEC's authority to issue and improve rules concerning proxy access. As a result of consequent new rules, shareholders owning more than 3 percent of outstanding shares for three years will be entitled to include their nominees in proxy materials. This makes it easier for shareholders to run dissident slates of directors for board membership. The U.S. Chamber of Commerce and the Business Roundtable have challenged the rules in court, arguing that they unfairly advantage special interests. A stay of the rule has been granted and the result is uncertainty over the fate of proxy access. Companies should monitor developments and litigation such as this to ensure that their compliance and risk management strategy reflects the current landscape.

Changes to Securities Law and SEC Authority

Dodd-Frank prods the Securities and Exchange Commission to expedite its enforcement process and broadens its authority in several ways:

- The Commission must institute an action within 180 days upon written Wells Notice.
- Civil penalties may be sought in cease and desist proceedings.
- Subpoenas in federal SEC enforcement actions may be served on a nationwide basis.
- Recklessness is established as a sufficient standard for proving aiding and abetting liability under the Securities Act, the Securities Exchange Act, and the Investment Advisors Act. The legislation stops short of extending aiding and abetting liability for private actions, but calls for a study of the impact of such a change to the law.
- The extraterritorial application of securities anti-fraud provisions is clarified to include conduct within the United States that constitutes significant steps in furtherance of the violation, even if the conduct occurs outside the United States and only with foreign investors, or where the conduct occurring outside the United States has a foreseeable substantial effect within the United States.

- The SEC is called upon to study the impact of extending extraterritoriality to private rights of action.

Changes to SEC Authority are notable. Most immediately, Dodd-Frank's SEC provisions sound on a financial note. The ability for national subpoenas will undoubtedly increase defense costs as local witness barriers are removed. On the other hand, since it can now seek penalties in cease and desist proceedings, it is possible that the SEC may seek more enforcement through administrative proceedings, which could prove less costly for certain defendants.

The potential changes in processes and protocols of regulators could have a material effect on a D&O policy; care should be given to morph policy terms to continue coverage presently enjoyed, and to expand coverage to address new exposures created by Congress (or delegated to bureaucrats to create). Particular care should be given to Claims triggers and the worldwide coverage provisions.

Careful Considerations for a Market "On Hold"

Viewpoints on the impact of Dodd-Frank to corporate governance are mixed. Some view Dodd-Frank as a positive step toward rooting out or preventing corporate malfeasance, thereby decreasing the possibility of stakeholder dissatisfaction and litigation. Others believe that increased protocols merely prove a catalyst for the plaintiff bar and increased activism and shareholder litigation. On a broad level, it appears that previous deference to corporate self-determination is yielding to increasing corporate governance directives and second-guessing.

The passage of Dodd-Frank does not immediately alter the present selectively soft insurance market. But as Dodd-Frank's mandates and studies are implemented, the path ahead is unclear. As always, the most prudent risk strategy is to understand fully your policy's terms and conditions and to carefully evaluate your limits adequacy. Integro's brokers are pleased to work with you to examine your risk proactively in light of developments such as Dodd-Frank and we welcome the opportunity to discuss its implications with you further.

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About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs of complex institutional risks. Integro has offices across North America, as well as in Bermuda and London. Its headquarter office is located at 1 State Street Plaza, 9th Floor, New York, NY 10004. 1-877-688-8701. www.integrogroup.com.
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