

2012 Special Committee on Financial Institutions and Insurance

SECURITIES COMMISSIONER AND AGENCY FEE FUNDS AND REVENUE

Conclusions and Recommendations

The Special Committee makes no recommendation on this topic.

Proposed Legislation: None.

BACKGROUND

The charge to the Special Committee on Financial Institutions and Insurance was to study, review, and report on three assigned topics (two are combined into one report topic): the Securities Commissioner and agency fee funds and revenue, and the regulation of insurance holding companies.

On the subject of the Securities Commissioner and agency fee funds and revenue, the Committee was directed to review the impact of 2012 SB 349 on the Office of the Securities Commissioner, including its function and the role of the agency, amount of fee revenue currently collected by the Securities Commissioner, the impact of receipts currently transferred by the agency to the State General Fund (SGF) pursuant to existing law, and the allocation of funds, otherwise intended for transfer to the State General Fund, to support economic development and “corporate formation.”

The topic was requested by the Senate Financial Institutions and Insurance Committee and was assigned by the Legislative Coordinating Council for study and review.

COMMITTEE ACTIVITIES

In October, the Committee received an overview of its charges and proposed legislation from Committee staff. The Committee also

received a comparative review of financial services agencies’ fee funds and informal comments from the Office of the Securities Commissioner.

Topic Overview: 2012 SB 349. Committee staff provided a review of SB 349, explaining the bill would have amended the Kansas Uniform Securities Act and a statutory provision governing employment under the Office of the Securities Commissioner to describe the purposes and intentions of the Act, amend existing special revenue fund requirements, establish two new fee funds, and authorize the Commissioner to appoint certain staff in the unclassified service. Among provisions highlighted, the bill would have:

- Enacted new law to clarify that, for the purposes of administrative proceedings of the Office of the Securities Commissioner, the term “agency head” means the Securities Commissioner, the Executive Director (Office of the Securities Commissioner), or person appointed by the Commissioner.
- Created a statement of intent and purpose to the Kansas Uniform Securities Act (a preamble), stating “[t]his act is intended to preserve the integrity and efficiency of the capital formation process and to ensure fairness and full disclosure in securities markets so that investors will have confidence to invest and pursue the

financial benefits that are possible through financing the development and growth of businesses and organizations in our Kansas economy that are based on capitalism.”

Among amendments to the Act, the bill would have:

- Permitted the Administrator to require the filing of a notice as a condition of any exemption (*e.g.*, broker-dealer, agent, and investment adviser registration). The Administrator would have been allowed to require a notice filing fee, not to exceed \$300 annually, for an exemption.
- Deleted provisions that had allowed for a carry forward in the Securities Act Fee Fund of \$50,000 on the first day of each fiscal year. The bill instead would have allowed the Administrator to make or authorize transfers from the Securities Act Fee Fund to one or more special revenue funds under the Administrator’s authority or to a special revenue fund of other executive branch agencies with responsibilities reasonably related to investment of capital, creation of jobs or other programs within the state for which the benefits of securities regulation and preservation of the integrity of the capital formation process can be realized as determined by the Administrator in consultation with heads of other such agencies. At the end of each fiscal year, the Administrator or designee would have been required to ensure that an unencumbered fund balance of at least \$250,000 is retained in the Securities Act Fee Fund to carry forward for use in the following fiscal year, in accordance with appropriations acts for administration and enforcement of the Act.
 - Under the current law, in addition to the \$50,000 carry forward balance, all amounts transferred from the Securities Act Fee Fund to the SGF are to be used for the purposes of reimbursement for accounting, auditing, budgeting, legal, payroll,

personnel, purchasing services and other governmental services performed on behalf of the agency by other state agencies that receive SGF appropriations.

- Broadened the investor education programming outlined in statute to encompass initiatives that inform the public about personal financial literacy and investments. Under the current law, the public programming focuses on investing in securities, with particular emphasis on the prevention and detection of securities fraud. The bill also would have deleted certain requirements for the Investor Education Fund, specifying the Fund must be administered for the purposes of investor education (as described above) or for the following purposes, at the discretion of the Administrator:
 - Education of applicants for registration under this act and registrants or their representatives including official hospitality;
 - Training of the Administrator’s staff; or
 - Grants to public or private schools or universities in Kansas for education in personal or business finance and related subjects.

Under the bill, the Administrator would have been permitted to make or authorize transfers from the Securities Act Fee Fund to the Investor Education Fund when necessary to replenish the Investor Education Fund for operations, up to an aggregate maximum of \$500,000 in any fiscal year. The aggregate maximum could be exceeded with the approval of the State Finance Council.

- Established the Securities Litigation Fund. This new fund would be used for the purpose of enforcing provisions of the Act through administrative hearings and

actions in state and federal courts to resolve alleged violations of the Act, or a rule or regulation or order issued under the Act. The Administrator would be permitted to make or authorize transfers from the Securities Act Fee Fund to replenish the Securities Litigation Fund for operations (up to aggregate maximum of \$500,000 in any fiscal year). As with the Investor Education Fund, the aggregate maximum amount could be exceeded, with State Finance Council approval.

- Established the Securities Restitution Fund, a Fund to be used for the purpose of receiving and disbursing restitution payments in connection with settlements of enforcement cases and other legal proceedings under the Act. The Administrator would be permitted to authorize restitution to be paid to Kansas residents who have been awarded damages in connection with alleged or adjudicated violations of the Act. The Administrator would be permitted to make or authorize transfers from the Securities Act Fee Fund to replenish the Securities Restitution Fund for operations (up to aggregate maximum of \$500,000 in any fiscal year). As with the Investor Education Fund and the Securities Litigation Fund, the aggregate maximum amount could be exceeded, with State Finance Council approval. The Administrator, by rules and regulations or order, would be required to specify definitions, forms, procedures, and limitations for the payment of restitution awards from the Securities Restitution Fund.
- Authorized the Commissioner to appoint other staff in the unclassified service. Under the current law, the Commissioner may appoint only directors in the unclassified service.

2012 Legislation and Committee Testimony.

The Committee analyst also highlighted similar legislation introduced during the 2012 Session: HB 2770 (provisions identical to SB 349) and HB

2770 (similar provisions; exceptions, maximum transfers increased to \$750,000 and transfer to other state agencies capped at \$3.0 million per fiscal year).

Proponents of the bill appearing at the Senate Committee hearing on SB 349 included the Securities Commissioner and the agency's General Counsel. Representatives of EverFi (financial literacy programming provisions) and the Kansas County & District Attorneys Association (creation of a litigation fund) submitted written testimony in support of specified components of the bill.

Fiscal Information. The fiscal note prepared by the Division of the Budget stated the Office of the Securities Commissioner indicated the bill would decrease SGF revenues by \$10.49 million in FY 2012 and by \$10.74 million in FY 2013. The fiscal note highlighted the decreases in SGF revenues and the potential effect on the November 4, 2011, Consensus Revenue Estimate for FY 2013 and the fiscal effect on state revenues for FY 2014 – FY 2017; those revenue estimates (negative) would be:

- FY 2014: (\$10.8 million);
- FY 2015: (\$11.0 million);
- FY 2016: (\$11.2 million); and
- FY 2017: (\$11.4 million).

The Office of the Securities Commissioner did not provide expenditures or transfer estimates on how it planned to make distributions from the Securities Act Fee Fund that would have been authorized by the bill. The fiscal note estimates that if the Commissioner makes the maximum transfer amounts authorized in the bill, then the Investor Education Fund, Securities Litigation Fund, and Securities Restitution Fund would each receive \$500,000 in FY 2012 and each future fiscal year; other state agencies in the Executive Branch would receive transfers that total \$8.79 million in FY 2012 and \$9.2 million in FY 2013. The fee revenue associated with collecting fees for notice filings for an exemption from the registration requirements (a provision in the bill) was determined to be negligible. The fiscal note

also commented on the potential savings associated with the agency's use of existing staff to hire an attorney to conduct its own administrative hearings. As the agency has very few hearings each year, the cost savings were estimated to be negligible.

Agency Overview and Funding Sources.

Committee analyst provided information on the regulatory role of the Office of the Securities Commissioner and the funding for the Office. The agency is funded entirely by industry fees and fines and settlements, which are deposited into two fee funds:

- *The Securities Act Fee Fund.* This Fund is financed by fees received from agents of broker-dealers, investment advisers, investment companies (mutual fund issuers) and other issuers of securities offering investment capital in Kansas. State law requires 90 percent of the fees (rates set in statute) received by the Commissioner be credited to the Securities Act Fee Fund and 10 percent to the SGF, up to a yearly maximum of \$100,000. On the last day of the state fiscal year, the Director of Accounts and Reports transfers all unencumbered funds in excess of \$50,000 into the SGF to provide reimbursement of services provided to the agency by the Department of Education.
- *The Investor Education Fee Fund.* This Fund is financed by civil penalties received from settlements of enforcement cases. State law requires 90 percent of fees received by the Commissioner be credited to the Investor Education Fee

Fund and 10 percent of the fees be credited to the SGF, up to a yearly maximum of \$100,000. There is no requirement to transfer funds from the Fund to the SGF (unlike the Securities Act Fee Fund). Revenue from the Investor Education Fee Fund fluctuates from year to year depending on fines and settlements available for collection.

The Committee reviewed FY 2007 through FY 2011 revenues, expenditures, and transfers from the two funds. The analyst also provided a comparative chart of revenues, expenditures, transfers, balances, and performance measures for the State's financial services agencies.

Agency Comment. Representatives for the Office of the Securities Commissioner appeared before the Committee to answer questions regarding the legislation and agency operations. An agency representative indicated, at the current time, the Commissioner does not support SB 349 nor are plans being considered to continue pursuit of this legislation, or similar bills, for the 2013 Session.

Committee discussion included states' oversight of financial services, organization of regulatory agencies, or both; the revenue mix from domestic and out-of-state entities; appointments to the unclassified service; and the effect on agency operations from year-end transfers.

CONCLUSIONS AND RECOMMENDATIONS

Following discussion, the Committee concluded that it would make no recommendation on the assigned topic.

2012 Special Committee on Financial Institutions and Insurance

REGULATION OF INSURANCE HOLDING COMPANIES

Conclusions and Recommendations

On the topic of insurance holding company regulation, the Special Committee recommends the introduction of a bill to be drafted as a prefile with collaboration from the Kansas Insurance Department, industry representatives, and Committee staff. The bill, using 2012 HB 2077 (as further amended by Senate Committee) for its base, is to be composed of relevant insurance holding company provisions and conceptual amendments presented during the Special Committee's review. If the bill is not approved by the Legislative Coordinating Council, it should be introduced and heard concurrently in each respective chamber's appropriate committees by February 1, 2013.

Proposed Legislation: One bill.

BACKGROUND

The charge to the Special Committee on Financial Institutions and Insurance was to study, review, and report on three assigned topics (two are combined into one report topic): the Securities Commissioner and agency fee funds and revenue; and the regulation of insurance holding companies.

On the subject of the regulation of insurance holding companies, the Committee was directed to study the modernization of the laws governing insurance holding companies in Kansas, including the adoption of uniform standards consistent with the National Association of Insurance Commissioners (NAIC) model act; and review streamlining state regulation, the role of the supervisory college and future oversight of the Kansas Insurance Department, anticipated costs for the state regulator and insurers, and the issues non-adoption of the model law create for accreditation and domestic insurance companies subject to other states' laws.

The topics were requested by the House Insurance Committee and were assigned by the

Legislative Coordinating Council for study and review.

COMMITTEE ACTIVITIES

In October, the Committee received an overview of its charges and proposed legislation from Committee staff. The Committee received testimony from representatives of the Kansas Insurance Department and insurance companies and association representatives.

Topic Overview. The staff analyst provided a summary on recent insurance holding company legislation, including consideration of 2012 HB 2508. The bill was requested by the Kansas Insurance Department to "ensure that holding company operations outside of the domestic insurance industry do not pose a hazard to the sound operation of the domestic company, and ultimately to protect Kansas insurance consumers from such hazards." The House Committee on Insurance heard the proposed legislation in February 2012 and, after much discussion, later voted to request an interim study in lieu of working the bill. The Senate Committee on

Financial Institutions and Insurance held an informational hearing on insurance holding companies in March 2012 and later agreed to delete the contents of HB 2077, as amended by the Senate Committee (2011 Session), and to insert provisions that would create and amend the Insurance Holding Company Act (HB 2508) and provisions pertaining to the combination sale of life insurance coverage with certain health care riders (HB 2373, as amended by the House Committee). The Senate Committee also inserted amendments to HB 2508, as introduced, to delete certain references to “affiliates” and to decrease a penalty amount.

HB 2077 (as further amended by Senate Committee, 2012). The resulting HB 2077, among other provisions, would have established the Insurance Holding Company Act and amended the Insurance Code to modify existing provisions governing insurance holding companies. The analyst briefly summarized provisions of the bill as follows. Under the new Act (New Section 1), the Insurance Commissioner would be granted the power to participate in a supervisory college for any domestic insurance company (insurer) that is part of an insurance holding company system with international operations. Pertinent highlights contained in the bill (sections noted) include:

- The supervisory college oversight and powers assigned to the Commissioner (New Section 1);
- The added definition for “enterprise risk” contained in KSA 40-3302 (Section 3);
- The added requirements related to statements filed with the Commissioner and public hearings contained in KSA 40-3304 (Section 4);
- The amendments to the required information to be filed with registration statements under KSA 40-3305 (Section 5);
- The addition of a standard to the regulation of material transactions by registered insurers with their affiliates contained in KSA 40-3306 (Section 6);

- The clarification concerning examination, information requests, and subpoena power included in KSA 40-3307 (Section 7); and
- The specifications concerning confidential information and disclosure provisions under KSA 40-3308 (Section 8).

The fiscal note for HB 2508 (a fiscal note was not available for the Senate Substitute bill) was provided by the analyst and Committee discussion followed about the status of the contents of HB 2373 (excluded from insurance conference reports), types of carriers subject to requirements of the Insurance Holding Company Act, and Senate Committee amendments.

Regulation of Insurance Holding Companies. Representatives of the Kansas Insurance Department provided an overview of insurance holding companies and regulation in Kansas and commented on the substantive provisions in the proposed insurance holding company legislation.

A Department representative noted Kansas has been regulating insurance holding companies since 1974; insurance holding company law was enacted in 1974 based on an NAIC model act. The 2012 legislation also is based on an NAIC model act. The purpose of regulation is to ensure the domestic insurer is able to pay policyholders’ claims. An insurance holding company is:

- A company (called a parent company) that owns other companies’ outstanding stock and consists of two or more business entities including at least one insurer;
- A company could hold non-insurance companies or subsidiaries such as retailers, manufacturing, railroads, and other types of businesses;
- Subsidiaries under the ownership or common control of a parent are referred to as affiliates; and
- Collectively, the parent and subsidiaries are referred to as a holding company system.

The conferee addressed the concept of “windows” and “walls” – regulators have “windows” to scrutinize group activity and assess its potential impact on the ability of the insurer to pay its claims and “walls” to protect the capital of the insurer by requiring the insurance commissioner’s approval of material related-party transactions. Examples of “windows” and “walls” were discussed in the context of current law and the proposed legislation and include:

- Windows represent access to information (KSA 40-3305) and examination authority (KSA 40-3307).
- Walls represent requirements for prior approval to acquire an insurer (KSA 40-3304) and prior approval of certain material transactions (KSA 40-3306).

The representative noted the recent financial crisis involving AIG, which resulted in insurance regulators re-evaluating their holding company system regulatory framework. Given the complexity of many holding company systems, the need was demonstrated to maintain the regulatory “walls” in place and to enhance the “windows” of the system. The representative indicated the Department would like to re-introduce the 2012 legislation (using HB 2077 as the base), with the following changes: broadening the confidentiality under Section 8 for documents filed pursuant to KSA 40-3304 as well as delaying the initial compliance date and creating a premium volume-based exemption from the new enterprise risk report requirement under Section 5. Under this proposed change, insurers with total direct and assumed annual premiums of less than \$300 million would be exempted from submitting an enterprise risk report.

Defining the supervisory college, its role, and other Insurance Holding Company Act provisions. Another Department representative spoke to the definition and role envisioned for the “supervisory college” – a forum for cooperation and information sharing among regulators within an international insurance holding company system. Participating regulators could include state, federal, and international regulators. The conferee reviewed the authority the Kansas Insurance Commissioner would have related to supervisory colleges and provided an example of a

supervisory college environment and discussion agenda. Additionally, supervisors have found that a range of communication channels are required for effective functioning of the colleges; these include physical meetings, video or audio conferences, secure online tools, e-mail infrastructure, and official letters. Supervisory colleges, the conferee continued, are typically held once yearly and are designed to share appropriate information with respect to the principal risks and risk management practices of the group. Information shared at supervisory colleges is confidential. Usually, the host state where an insurance company is located would provide coordination of supervisory college meetings. In discussion with the Committee, the representative emphasized the supervisory college does not delegate any authority of the Kansas Insurance Commissioner. The supervisory college functions as an information-gathering entity and holds no authority.

The Department representatives responded to Committee questions and provided additional information about the regulation of insurance holding companies, the proposed legislation, and NAIC accreditation standards. Responses included:

- *Capital requirements and material transactions.* In Kansas, a statutory provision sets minimum capital requirements for an insurance company; a risk-based capital (RBC) guideline exists which mandates action by the Department should a life, health, or accident insurer’s RBC fall below 200 percent.
 - For a non-life insurance company, the Department will review any agreement that would impact 3 percent or more of an insurer’s admitted assets of 25 percent of capital and surplus; for a life insurance company, the threshold is 3 percent of an insurer’s admitted assets. Should these thresholds be unmet, prior approval by the Department is not required for specific material transactions.
 - The Insurance Holding Company Act does not allow the Department to

require capitalization changes of the in-state, operating company until the RBC falls beneath the statutory minimum requirements. The Act provides “windows” to request additional information from the holding company.

- *Acquisitions and mergers.* An acquiring party may be required to maintain or restore the capital of the insurer to the level required by law within 60 days after change of control. The Department has the responsibility to invoke certain requirements to ensure capital solvency; the Department controls the acquisition approval. Additionally, the Department reviews and validates five years of financial statements for companies requesting acquisition approval to ensure financial soundness of the acquiring party.
- *Accreditation and Anticipated Costs.* The proposed insurance holding company legislation presents no additional costs to the Department outside of its existing budget. The next NAIC accreditation review is scheduled for 2016, which is the deadline for implementing the Model Holding Company System Act. It is possible that Kansas’ accreditation could be jeopardized without implementation of the Kansas Insurance Holding Company Act.

A Department representative also noted that there was no opposition from consumers and industry representatives and collaboration within the industry and Department continued to adjust possible future legislation.

Industry response to amendments to insurance holding company regulation in Kansas. A representative of the National Association of Mutual Insurance Companies (NAMIC) testified in support of the amendments to the Insurance Holding Company Act, noting his support for retaining state-based insurance regulation and the amendment exempting small companies from the enterprise risk report. A

representative for the Security Benefit Life Insurance Company spoke in support of introducing legislation, including proposed amendments to the 2012 legislation, during the 2013 Session. The legislation, the representative noted, is necessary to ensure the Department maintains its NAIC accreditation; without such legislation, an insurer would be required to undergo multiple, duplicative financial condition examinations in each state in which the parent company holds domiciled companies. Additionally, the representative noted, the amendments will prevent highly confidential financial documents from being disclosed and inappropriately available to competitors. A representative of the American Council of Life Insurers indicated the proposed legislation enhances the Insurance Commissioner’s ability to monitor and protect the financial strength of Kansas insurers while strengthening and preserving state-based regulation.

Additional written support of the proposed legislation, including the amendments presented to the Special Committee, was provided by representatives of the American Insurance Association, the Kansas Association of Property and Casualty Insurance Companies, and Polsinelli Shughart, PC.

CONCLUSIONS AND RECOMMENDATIONS

On the topic of insurance holding company regulation, the Special Committee recommends the introduction of a bill to be drafted as a prefile with collaboration from the Kansas Insurance Department, industry representatives, and Committee staff. The bill, using 2012 HB 2077 (as further amended by Senate Committee) for its base, is to be composed of relevant insurance holding company provisions and conceptual amendments presented during the Special Committee’s review. If the bill is not approved by the Legislative Coordinating Council, it should be introduced and heard concurrently in each respective chamber’s appropriate committees by February 1, 2013.