The Proposed Regulations and Insurance Company Investment Activities

Designation as a 'Covered Banking Entity'

An insurance company is a "covered banking entity" if it controls or is affiliated with an insured depository institution (as defined in Section 3(c) of the Federal Deposit Insurance Act), which includes any bank, thrift, industrial loan company or other entity whose deposits are insured by the FDIC.[1] An insurance company also is a covered banking entity if it is an affiliate or subsidiary of a bank holding company (as defined in Section 8 of the International Banking Act of 1978), which includes any non-U.S. bank that has a U.S. branch, agency or commercial lending company subsidiary and the parent company of such non-U.S. bank.[2] Under the proposed regulations, except as otherwise permitted, an insurance company that is a covered banking entity is subject to the prohibitions on proprietary trading[3] and acquiring or retaining an ownership interest in, or acting as a sponsor to, a hedge fund or private equity fund.[4] It also is subject to extensive reporting and recordkeeping requirements applicable to other covered banking entities.[5]

Exemptions Applicable to Insurance Companies

The proposed regulations exempt certain proprietary trading activities by covered banking entities, two of which are directly applicable to insurance companies:

Permitted trading on behalf of customers: The proposed regulations permit proprietary trading to the extent that it is conducted on behalf of customers.[6] Insurance company investment activities for separate accounts are considered to be "on behalf of customers" if:

- the insurance company is directly engaged in the business of insurance and subject to regulation by a State[7] insurance regulator or foreign insurance regulator;
- the insurance company purchases or sells the covered financial position solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
- all profits and losses arising from the purchase or sale of a covered financial position are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by that separate account and not to the insurance company; and
- the purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws and other laws, regulations and written guidance of the State or jurisdiction in which such insurance company is domiciled.[8]

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[1] Proposed Regulations § __.2(e).

[2] *Id.*

[3] *Id.* § __.3. *See* also Proprietary Trading Restrictions Under the Proposed Regulations.

[4] Proposed Regulations § __.10. *See also* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations.

[5] *See* Proposed Regulations § __.7.

[6] *Id.* § __.6(b). *See also* Proprietary Trading Restrictions Under the Proposed Regulations.

[7] The proposed regulations define "State" as any state, territory or possession of the United States and the District of Columbia. Proposed Regulations § __.2(aa).

[8] *Id.* § __.6(b)(iii).

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This permitted activity relates to trading by regulated insurance companies for separate accounts, which the proposed regulations define as "an account established and maintained by an insurance company subject to regulation by a State insurance regulator or a foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company."[9] The exemption applies equally to U.S. and non-U.S. regulated insurance companies.

Permitted trading by a regulated insurance company: The prohibition on proprietary trading does not apply to the purchase or sale of a covered financial position by an insurance company or any affiliate of an insurance company if:

- the insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;
- the insurance company or its affiliate purchases or sells the covered financial position solely for the general account of the insurance company;
- the purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
- the appropriate federal banking agencies, after consultation with the Council and the relevant State insurance commissioners, have not jointly determined, after notice and comments, that a particular law, regulation or written guidance of the State or jurisdiction in which such insurance company is domiciled is insufficient to protect the safety and soundness of the covered banking entity or the financial stability of the United States.[10]

An insurance company general account is defined as all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State or foreign law.[11]

By permitting trading and investment activities in the separate accounts and general accounts of regulated insurance companies, the proposed regulations enable insurance companies that may otherwise be precluded by their affiliation with a depository institution or bank holding company to continue conducting ordinary insurer investment activities. These permitted activities manifest a recognition that insurance companies and their investment activities already are regulated extensively and supervised closely by state insurance regulators.

Reporting and Recordkeeping Requirements

Although proprietary trading activities by insurance companies in compliance with all applicable insurance investment laws and regulations are permitted,[12] an insurance company that is a covered banking entity nonetheless must comply with the reporting and recordkeeping requirements of the proposed regulations.[13]

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[9] *Id.* § __.2(z).

[10] *Id.* § __.6(c).

[11] *Id.* § __.3(c)(6).

[12] *See* Proprietary Trading Restrictions Under the Proposed Regulations.

[13] *See* Proposed Regulations § __.7.

If a covered banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion, the proposed regulations require that banking entity to comply with the quantitative measurement, recordkeeping and reporting requirements set forth in Appendix A of the proposed regulations.[14] Covered banking entities with less significant trading activities are not subject to the requirements of Appendix A but are required to establish a compliance program and satisfy other reporting and recordkeeping requirements.[15]

Limitations on Permitted Trading Activities

Notwithstanding the exemptions provided for certain trading activities involving insurance company general and separate accounts, the proposed regulations would impose prudential "backstops" on such activities. The proposed regulations would not permit any transaction, class of transactions or activity to the extent that it would:

- involve or result in a material conflict of interest between the covered entity and its clients, customers or counterparties;
- result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy; or
- pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.[16]

Trading in Hedge Funds and Private Equity Funds

With certain exceptions, a covered banking entity is prohibited from acquiring or retaining any ownership interest in or sponsoring a hedge fund or private equity fund (defined as "covered funds").[17] Unlike the proposed regulations with respect to proprietary trading, the proposed regulations for covered fund activities and investments, except as they relate to bank owned life insurance (BOLI), do not contain exemptions directly applicable to covered banking entities that are regulated insurance companies.

BOLI: The prohibition on acquiring or retaining any ownership interest in or sponsoring a covered fund does not apply to the acquisition or retention by a covered banking entity of any ownership interest in or acting as sponsor to BOLI.[18] BOLI is defined as a separate account that is used solely for the purpose of allowing a covered banking entity to purchase an insurance policy for which the covered banking entity is the beneficiary.[19] BOLI policies are purchased by banking entities to cover key employees and help them reduce their employee benefit costs. The exemption is available only if the covered banking entity that purchases the insurance policy does not control the investment decisions regarding the underlying assets

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[14] *Id.* § __.7(a).

[15] *Id.* §§ __.7(b) & (c).

[16] *Id.* § __.8.

[17] *Id.* § __.10. *See* Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations for a description and discussion of the prohibition on covered fund activities and investments, as well as the exceptions to the prohibition.

[18] Proposed Regulations § __.14(a).

[19] *Id.* § __.14(a)(1).

or holdings of the separate account. In addition, the exemption requires the entity to hold its ownership interest in the separate account in compliance with applicable supervisory guidance regarding BOLI.[20] The exemption allows insurance companies to offer separate account BOLI products to bank clients, even though such accounts, like the traditional hedge funds and private equity funds, would be investment companies but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

[20] *Id.*