

# HOUSE BILL REPORT

## HB 3011

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### As Reported by House Committee On:

Insurance, Financial Services & Consumer Protection

**Title:** An act relating to safeguarding securities owned by insurers.

**Brief Description:** Safeguarding securities owned by insurers.

**Sponsors:** Representatives Loomis, Rodne and Kelley.

### Brief History:

#### Committee Activity:

Insurance, Financial Services & Consumer Protection: 1/29/08 [DP].

#### Brief Summary of Bill

- Allows a broker/dealer to serve as a custodian of securities bought and sold by a domestic insurer.
- Establishes terms and conditions required in a contract between an insurer and a custodian.

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### HOUSE COMMITTEE ON INSURANCE, FINANCIAL SERVICES & CONSUMER PROTECTION

**Majority Report:** Do pass. Signed by 8 members: Representatives Kirby, Chair; Kelley, Vice Chair; Roach, Ranking Minority Member; Hurst, Loomis, Santos, Simpson and Smith.

**Staff:** Jon Hedegard (786-7127).

#### Background:

The Insurance Commissioner (Commissioner) is authorized to regulate insurance in Washington. This includes oversight of financial solvency, licensing of agents and brokers, approval of insurance rate and form (contract) filings, collection of premium taxes, and responding to consumer complaints.

Washington's financial solvency system is accredited by the National Association of Insurance Commissioners (NAIC). Accredited insurance departments are reviewed every five years to

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ensure they continue to meet baseline standards. The accreditation standards require that insurance departments have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs, and that they have the necessary resources to carry out that authority. If a state is not accredited, the domestic insurers in that state may be subject to independent financial exams by every other state.

The NAIC adopted a model for safeguarding securities in 1980. The model was amended in 1981 and 2004.

Statute establishes the framework for investments by domestic insurers. The investments of a foreign or alien insurer are regulated by the state of its domicile, but must be substantially the same quality as high as those required for like domestic insurers. The provisions regarding custody of securities were enacted in 2000. The law allows a domestic insurer to hold securities, deposit securities in a clearing corporation, or deposit securities in a custodian bank. The Commissioner can order the transfer of the securities to a different custodian if the Commissioner reasonably fears that the insurer may be in financial jeopardy. The Commissioner has rule-making authority to implement the statutory framework.

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### **Summary of Bill:**

#### Definitions.

Four definitions are added: "agent;" "custodied securities;" "tangible net worth;" and "Treasury/Reserve Automated Debt Entry Securities system (TRADES)."

Three existing definitions are modified: "qualified custodian;" "clearing corporation;" and "broker."

Two existing definitions are modified: "Federal Reserve book-entry securities system;" and "participating financial institutions."

"Broker/dealer" is a broker or dealer as defined in the securities provisions of the Uniform Commercial Code that:

- is registered with, and subject to, the Securities and Exchange Commission;
- maintains membership in the Securities Investor Protection Corporation; and
- has a tangible net worth equal to or greater than \$250 million.

"Clearing corporation" is as defined in the securities provisions of the Uniform Commercial Code that is organized for the purpose of effecting transactions in securities by computerized book-entry. It may include a corporation that is organized or existing under the laws of a foreign country that is legally qualified under foreign law to effect transactions in securities by computerized book-entry. It also includes the TRADES system and treasury direct book-entry securities systems.

"Custodian" is:

- a bank, or trust company that is adequately capitalized as determined by the standards adopted by the United States banking regulators and that is regulated by either state

banking laws or is a member of the Federal Reserve System and that is legally qualified to accept custody of securities;

- a bank or trust company established and regulated under the laws of another country that is adequately capitalized as determined by the standards adopted by the international banking authorities and legally qualified to accept custody of securities; or
- a broker/dealer.

"Custodied securities" means securities held by the custodian or its agent or in a clearing corporation, including the TRADES or treasury direct systems.

#### Custodians.

The changes in definitions permits a broker/dealer to serve as a custodian of securities bought and sold by a domestic insurer.

#### Agreements with Custodians.

An insurer must have a written agreement with a custodian for the custody of its securities. The securities that are the subject of the agreement may be held by the custodian or its agent or in a clearing corporation. The agreement must be authorized by the board of directors of an insurer or of an authorized committee of the board.

The terms of the agreement must comply with the following:

- Insurer certificates must be held separate from the securities certificates of the custodian and all of its customers.
- Securities held indirectly by the custodian and securities in a clearing corporation must be separately identified on the custodian's official records as being owned by the insurer.
- Registered custodied securities must be registered in the name of the company, the custodian, a clearing corporation, or a nominee.
- Custodied securities are subject to the instructions of the insurer and may be withdrawn upon the demand of the insurer, except custodied securities used to meet the deposit requirements.
- The custodian is required to send the insurer a confirmation of all transfers of custodied securities to or from the account of the insurer.
- The custodian is required to provide the insurance company with monthly reports of various holdings of custodied securities.
- The custodian's trust committee's annual reports of its review of the insurer trust accounts must be provided to the insurer.
- The custodian and its agents are required to send to the insurance company all reports that they receive from a clearing corporation on their respective systems of internal accounting control and reports prepared by outside auditors on the custodians or its agents internal accounting control of custodied securities that the insurer may reasonably request.

During the course of the custodian's regular business hours, the custodian's records relating to the custodied securities may be examined by:

- an officer or employee of the insurer;
- an independent accountant selected by the insurer; and

- a representative of an appropriate regulatory body.

#### Records.

The custodian must maintain records relating to custodied securities sufficient to enable the insurer to report in the insurer's annual statement and that is required in an audit of the financial statements of the insurer.

#### Insurance of Custodied Securities.

A bank or trust company must maintain insurance in an adequate amount to cover the bank's or trust company's duties and activities as custodian for the insurer's assets. A broker/dealer must maintain insurance for custodied securities to ensure coverage in an amount equal to or greater than the market value of the custodied securities. The Commissioner may determine whether the type of insurance is appropriate and whether the amount of coverage is adequate.

#### Loss of Custodied Securities.

The custodian must indemnify the insurance company for any loss of custodied securities caused by the negligence or dishonesty of the custodian's officers or employees or agents, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction.

If the custodian is obligated to indemnify the insurer, the custodian must promptly replace the value of the securities and any loss of rights or privileges resulting from the loss of securities. The custodian is not liable for a failure to take an action by acts which are beyond its reasonable control.

In the event that the custodian accesses a clearing corporation through an agent, the agent is subject to the same liability for loss of custodied securities as the custodian.

#### Notification to the Office of the Insurance Commissioner.

The custodian must provide written notification to the Commissioner if the custodial agreement with the insurer has been terminated or if 100 percent of the account assets in a custody account are withdrawn. The notification must be provided to the Commissioner within three business days.

#### Rules.

The Commissioner may adopt rules governing the deposit of securities by insurers with clearing corporations, including establishing standards for national banks, state banks, trust companies, and brokers/dealers to qualify as custodians for insurance company securities.

A change is made to account for the current options for book-entry systems used by the U.S. Treasury.

A number of language changes are made related to the changes in definitions.

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**Appropriation:** None.

**Fiscal Note:** Not requested.

**Effective Date:** The bill takes effect 90 days after adjournment of session in which bill is passed.

**Staff Summary of Public Testimony:**

(In support) The bill allows for a more modern way to treat custodied securities. It allows certain qualified brokers to be custodians. It also creates important new safeguards. The bill is based on the NAIC model and will make Washington uniform with the way other states treat the regulation of insurer's securities. The bill is very technical but it is a very simple concept. The state adopted the NAIC model in 2000. The NAIC amended their model in 2004. This accounts for the changes in the NAIC model. The bill allows a broker to be a custodian. The securities industry worked with the Office of the Insurance Commissioner (OIC) to craft safeguards and to fit the model language into the existing state regulatory framework. The securities industry supports the new safeguards that will protect insurers and their policyholders. The bill is a good enhancement to the existing law. The original securities model developed out of a criminal matter. The OIC supports this revision of the existing law. It provides important new protections.

(Opposed) None.

**Persons Testifying:** Representative Loomis, prime sponsor; Bill Stauffacher, Securities, Industries and Financial Market Association; Mel Sorensen, Property Casualty Insurance Association; and Mary Clogston, Office of the Insurance Commissioner.

**Persons Signed In To Testify But Not Testifying:** None.