

MODEL AUDIT RULE ("MAR") FAQs

General Questions

1. Can the independent accounting firm that audits an insurer also prepare its federal tax returns?

Answer: Yes. Section 7(H) allows the independent CPA who performs the audit to engage in other non-audit services, including tax services, if the engagement is approved in advance by the audit committee. Audit committee pre-approval is waived with respect to non-audit services if the insurer is a SOX Compliant Entity or a direct or indirect wholly owned subsidiary of a SOX Compliant Entity and:

- (1) the aggregate amount of such non-audit services is no more than 5% of the total amount of fees paid to the independent auditor during the fiscal year,
- (2) the services were not recognized by the insurer at the time of the engagement to be non-audit services, and
- (3) the services are promptly brought to the attention of the audit committee and approved prior to completion of the audit. See Section 7(I).

2. The boards of mutual companies are often composed exclusively of policyholders. Will the policyholder board member no longer be considered independent if serving on the audit committee?

Answer: No. Section 14(C) states that in order to be considered independent for purposes of the composition of the audit committee, a member may not other than in his or her capacity as a member of the audit committee, board of directors or any other board committee, accept any consulting, advisory or other compensatory fee from the entity or be an affiliated person of that entity or any subsidiary thereof. This definition would appear to allow mutual policyholders to be considered independent unless they are also accepting some other fee besides their board fee for their services.

3. Would board members receiving stock as part of their compensation be considered independent within the requirements for audit committees?

Answer: Yes. As discussed in the previous question, as long as the compensation they are earning relates to their services on the board of audit committee, they should be considered independent.

4. What are the penalties associated with violations of the MAR?

Answer: Section 15 lists conduct by the insurer in connection with the preparation of the required reports and documents that could lead to regulatory sanctions. The drafting note leaves the discretion to states to determine which types of penalties would be administered.

5. Under the MAR, how many members of the audit committee must be financial professionals?

Answer: None. That requirement appeared in an earlier draft but has been removed in the final version.

6. Is an audit committee required for every insurer or only those companies with over \$500,000,000 in direct premium?

Answer: Every insurer is required to have an audit committee but only those insurers writing over \$100,000,000 of direct written and assumed premiums are required to meet any independence standards.

7. Can an entire board serve as an audit committee?

Answer: Yes. The entire board can serve as the audit committee provided that it meets any applicable independence requirements.

8. Does the MAR apply to reinsurance companies?

Answer: The MAR applies to insurers which are defined to mean a licensed or authorized insurer as defined under state law. It is likely that this definition would include reinsurers. Also, the independence requirements are based on direct written and *assumed* premiums, and any reinsurer that is assuming premiums in excess of \$100,000,000 would also have to meet the independence requirements for the audit committee.

9. Will management's report of internal control over financial reporting be kept confidential?

Answer: Yes. Section 16(E)(2) states that management's report on internal controls and any documentation provided in support thereof during the course of a financial condition examination shall be kept confidential by the state insurance department.

10. If the parent company audit committee is used as the insurance company audit committee, will the audit committee board members have to be board members of the subsidiary insurer?

Answer: No. The definition of audit committee in Section 3(C) allows the audit committee of an entity that controls an insurer to be deemed to the audit committee of the controlled insurers solely for the purposes of complying with the MAR.

11. Will a company doing business with insurers that are not subject to the MAR see a difference in its operations with the insurer?

Answer: [WSB?]

12. If a board member is an officer or partner or holds a similar high-level position with a company that does business with the insurer, does that relationship compromise the board member's independence?

Answer: Most likely. The MAR does not specifically address this question but does reference the SEC's Final Rule 33-8220, *Standards Relating to Listed Company Audit Committees*, adopted April 9, 2003. In this document, the SEC states that executives doing business with the company on whose board they sit are not considered independent. We would expect that state departments of insurance would interpret the MAR independence requirements similarly.

13. If a person is doing business with the holding company but not the insurer, would that change their independence?

Answer: Most likely. The SEC Final Rule casts a broad net over compensation and includes payments made either directly or indirectly to the person or their company. We would expect state departments of insurance to interpret the independence requirements similarly to the SEC.

Questions Regarding Alternative Risk Arrangements

1. Does the MAR apply to risk retention groups and captives?

Answer: The MAR applies to any entity that meets the definition of insurer. We think this definition would likely encapsulate captive insurers but would not reach risk retention groups. However, the final answer will depend on how states modify the MAR to expand or contract its reach.

2. Some state laws require that a state resident sit on a board of directors or that state residents make up a certain percentage of directors. How will these board members be treated for independence purposes if they or their companies do business with the insurer?

Answer: The MAR is not crystal clear on this question. Assuming that the company meets the threshold for audit committee independence, it is likely that these required residents would not be treated as independent directors. However, Section 14(C) does state that "if law requires board participation by otherwise non-independent members, that law shall prevail and members may participate in the audit committee and be designated as independent for audit committee purposes unless they are an officer or employee of the insurer or one of its affiliates." This would seem to imply that the residents could be treated as independent members of the audit committee. However, we are unsure how states will interpret this language or whether they will still require a minimum number of independent directors regardless of residency.