Developing Your NAIC Corporate Governance Annual Disclosure (“CGAD”)

Note: This is the second in a series of Client Alerts for insurance companies as they begin preparing for the NAIC’s extensive new corporate governance disclosure requirements. The first Client Alert can be accessed at Pearl Meyer & Partners’ website at http://www.pearlmeyer.com/naiccorporategovernanceannualdisclosure.

Overview

In 2012, the National Association of Insurance Commissioners (“NAIC”) kicked-off an ambitious process to require extensive disclosure of regulated insurance companies’ corporate governance practices. The NAIC approved the Model Act and Regulations at its Summer 2014 National Meeting in Louisville, Kentucky. The Model Act and Regulations were disseminated to state insurance departments and regulators in late 2014 for review and adoption at the state level. The NAIC expects covered companies to make their first filing by June 1, 2016.

PM&P Observation: While the CGAD requirements are not prescriptive, the content of the Model Regulation does little to hide the NAIC’s views on corporate governance, which are clearly influenced by public company standards. Considering the volume and content of required disclosure, early preparation is vital, particularly for companies which have not previously articulated some of the policies or procedures for which the CGAD requires discussion. Companies may also consider implementing changes to their governance frameworks in 2015 so that the first CGAD filing in 2016 reflects governance and oversight best practices.

Our first Client Alert served to provide notification and drive awareness of the coming disclosure requirements, the timeline for compliance and who is required to comply. This and subsequent Client Alerts to be published throughout 2015 will cover each of the disclosure requirements in greater detail and provide our observations and recommendations. Disclosure required under the CGAD is organized into four main sections:

1. Corporate Governance Framework
2. Policies & Practices of the Board and its Committees
4. Risk Management Processes

This Client Alert focuses on required disclosure under the Corporate Governance Framework (Section 1) and Policies & Practices of the Board and its Committees (Section 2) as there is significant overlap in describing and disclosing the policies and structure of the Board and its Committees, and how those entities are governed.
**What is Required Under Section 1: Corporate Governance Framework?**

The Corporate Governance Framework section requires description of the company’s governance framework and structure including consideration of:

1. The Board and Committees responsible for overseeing the insurer, the level at which that oversight occurs and the rationale for Board size and structure; and
2. Duties of the Board and the various Committees and how each is governed, including a discussion of the role of the Chief Executive Officer and Chairman of the Board.

Presumably, oversight of most insurers occurs at the parent level and thus, the CGAD should be prepared from the perspective of the parent Board and its Committees. However, oversight of an insurer operating within a large diversified conglomerate may occur at the management level of the parent company. In these cases, the CGAD should be prepared from the perspective of parent level management.

Oversight and governance in most insurers occurs in a semi-distributive structure where some broader responsibilities and duties (e.g., strategy review/development, CEO evaluation and hiring/firing, M&A decision-making, etc.) remain with the full Board while other responsibilities are handled with the Committee. In addition to the Audit Committee, which is required by the NAIC, corporate governance best practices suggest that most companies should have a Compensation Committee, responsible for administering executive pay programs and approving pay levels for the CEO and other senior executives, as well as a Nominating and Governance Committee, responsible for ensuring effective and appropriate Board composition, governance and oversight. Other Committees that a Board might utilize or convene are typically based on facts and circumstances of the particular insurer.

Board Committees should have a charter that clearly outlines the role and responsibilities of the Committee and its members, how Board members are appointed to the Committee, qualifications required to serve on the Committee and the governance structure of the Committee (i.e., how the chair is selected and the chair’s primary responsibilities, minimum committee size and meeting frequency and how Committee performance will be evaluated). Each Committee should have a chair responsible for setting meeting agendas and working with management to ensure that Committee members are receiving the support necessary for the Committee to discharge its oversight responsibilities. The charter should be reviewed at least annually to ensure it continues to meet the needs of the insurer.

Board leadership has been a hot-button topic for several years now. Current best practices suggest that there should be a mechanism to ensure effective representation of the independent Board members. This can be accomplished through a non-employee Board chair or an independent lead Director when the Board chair is an employee (e.g., Chairman & CEO).

The oversight model varies for insurers which are part of a larger corporation. For some subsidiary insurers, oversight may be provided by members of the senior management team of the parent company without an actual insurer Board structure. Other subsidiary insurers may have a Board to whom the insurer CEO reports, with the Board comprised of members of senior management and/or Board members of the parent company.

More recently, subsidiary insurer Board practices are evolving to a more structured governance model, with a Board comprised of both senior management of the parent company and outside Board members, either appointed by the parent company’s Board or senior management team. Boards structured in this manner will typically also have the more formal Committee structure described above. Regardless of the oversight model used for subsidiary insurers, transparent disclosure of the model that is in place and how the chosen model provides effective oversight of the insurer is required as part of the disclosure of the Corporate Governance Framework.
PM&P Observation: The NAIC’s Model Regulation provides wide latitude for compliance. For example, the Model Regulation allows companies to submit attachments and example documents that are used in the governance process. PM&P interprets this as an authorization for companies to submit existing corporate governance policy and Committee charts to comply with the requirement to describe Board policies and duties of the various Board Committees, rather than needing to follow a common prescriptive disclosure format.

Although some constituencies unequivocally advocate for splitting the Board chair and CEO role, insurers shouldn’t rely on typical market practices or corporate governance “experts” in making the decision about whether the roles should be separate or combined. However, PM&P believes that all insurers should have an independent lead Director when the chairman and CEO roles are combined or when the chair is affiliated (i.e., a former CEO of the company). The concept of independent Board leadership is geared toward ensuring sufficient checks and balances between management and the Board and there are multiple ways to strike an appropriate balance.

Increasingly, insurers who are part of larger corporations are adopting more formal governance structures, underscored by independent Board members and full-fledged Board Committees.

What is Required Under Section 2: Policies & Practices of the Board and its Committees?

Section 2 covers many of the same governance concepts from Section 1 but at a much greater level of detail. Specifically, the Model Regulation mandates disclosure of policies and practices of the Board (or most senior governing entity) and its significant Committees and requires discussion of:

1. How the qualifications, expertise and experience of each Board member meets the needs of the insurer;
2. How Board and Committee independence is maintained;
3. The number of meetings the Board and each Committee held during the year and Director attendance;
4. How the insurer identifies, nominates and elects Board members, including:
   a. Whether a Nominating Committee is in place
   b. If term and/or age limits have been adopted
   c. Functioning of the election and re-election process
   d. How Board diversity is considered and whether a diversity policy is in place; and
5. Board and Committee evaluation processes including Board improvement/Board training activities.

CGAD requirements under Section 2 closely track the disclosure required of publicly-traded companies in proxy statements sent to investors and filed with the Securities & Exchange Commission. As such, insurers can reference the disclosure practices of public companies to understand various approaches.
How the Qualifications, Expertise and Experience of each Board Member Meets the Needs of the Insurer

Disclosure of qualifications, expertise and experience and how these meet the needs of insurers can be addressed in three easy steps:

1. Inventory the background and experience of Board members and for each, compile several pieces of information:
   a. Demographic information (name, age, etc.);
   b. A brief biography;
   c. List of positions each Board member has held in the past 5 years; and
   d. Length of service on the Board.

2. Compile the experience, expertise and qualities the insurer looks for in populating the Board:
   a. Insurers generally look to populate the Board with candidates who are familiar with the company’s business and have desirable experience and expertise (e.g., industry, customers, regulators, government, products and services, community ties, financial, M&A, business strategy, human resources, etc.) as well as appropriate individual characteristics (e.g., integrity, independence of thought, ability to work collegially, good judgment, etc.).
   b. The list of experience and individual characteristics will be different from insurer to insurer.

3. Match the background and experience of Board members to the company’s Board requirements:
   a. Board member expertise can be discussed in the context of company requirements in narrative form as part of each individual Director’s biography or can be more simply disclosed in the form of a chart with Directors on the vertical axis and Board expertise requirements on the horizontal axis with check marks where a Director satisfies the criteria.

How Board and Committee Independence is Maintained

Based on current NAIC requirements, insurers are aware of Board and Committee independence standards. Insurers may consider codifying those standards as part of the Board’s and Committees’ charters, describing the tests for independence that will be conducted. Board minutes should also indicate that Board member independence is assessed and verified periodically, likely on an annual basis. It is in an insurer’s best interest to disclose the facts and circumstances of any relationships (business, familial, etc.) that could be perceived as jeopardizing Board member independence and note how independence is protected for each disclosed relationship. Insurers should also ensure that key Board Committees are populated by independent Board members.

Independence of the entire Board can also be assessed. Independent members of the Board and Committees, in exercising their independence, should regularly meet in executive session without the presence of management to discuss sensitive topics. Boards and Committees should also have the option to engage outside advisors (legal, compensation, search, etc.) who report directly to the Board with professional fees for this outside expertise paid for by the insurer. Independent Board leadership, in the form of a non-executive Board chair or a lead independent Director when the Board chair is an employee, further ensures that the Board can demonstrate a sufficient level of independence from management.
The Number of Meetings the Board and Each Committee Held During the Year and Director Attendance

Disclosure of Board and Committee meeting frequency and member attendance is a straightforward aspect of the CGAD. Insurers simply need to disclose the number of times the Board and each Committee met during the past year and then quantify Director attendance based on Board and Committee assignments. The record of meeting attendance should be included and verifiable in meeting minutes. SEC disclosure requirements mandate that public companies disclose whether any Director attended fewer than 75% of the meetings based on the number of meetings held by the Board and the Committee(s) to which that Director was assigned. This SEC standard of disclosure on Director attendance should be sufficient for purposes of the CGAD’s requirements.

**PM&P Observation:** Each year following the initial CGAD filing, insurers are required to update those areas/policies/practices that have changed from the prior year. For aspects of an insurer’s corporate governance structure that have not changed, insurers are permitted to say there was no change, and they are not required to make a new CGAD filing. However, as the number of Board and Committee meetings changes from year to year and as Director meeting attendance may vary, insurers will need to update the aspect of the CGAD that discusses meeting frequency and Board attendance.

How the Insurer Identifies, Nominates and Elects Board Members

Companies are required to disclose and discuss four separate items related to Board member election:

1. Whether a Nominating Committee is in place;
2. If term limits have been adopted;
3. Functioning of the election and re-election process; and
4. How Board diversity is considered and whether a diversity policy is in place.

In today’s environment, almost all public companies maintain a Nominating Committee, responsible for identifying and recruiting potential Board candidates and it is often combined with the Governance Committee, creating a single group responsible for Board member recruitment and enforcing the company’s governance standards. Current governance standards suggest that companies should maintain a Nominating Committee and the CGAD simply requires insurers to disclose whether one exists.

Term limits remain a minority practice in the US. Many companies, however, maintain mandatory retirement provisions, requiring Directors to submit their resignation once achieving a certain age. The Board then maintains the discretion whether to accept the resignation or not. The majority of publicly-traded companies maintain a mandatory retirement age of 75.

**PM&P Observation:** Some argue that Director independence from management is compromised the longer a Director serves on the Board. Outside the US this belief is typically enforced through the use of term limits which limit the number of years that a Director can serve. Term limits and mandatory retirement ages are intended to ensure refreshment of Board member perspective and encourage desired Board turnover. Although the US has been slow to adopt the term limit concept, the issue is increasingly on the radar screen of large institutional investors and proxy advisors and will gain increasing attention in the coming years.

Insurers are required to describe how Directors are elected and re-elected to the Board. Specific practices in this area vary based on state requirements as well as the specific legal structure of the
insurer, but the process that is used to identify candidates for consideration to election or appointment to the Board should be described in detail as well as how Board candidates are actually elected or appointed. In addition, the insurer’s process for re-electing current Board members whose terms are expiring also needs to be included in the disclosure.

Board diversity has received greater attention over the last several years and companies increasingly consider diversity in Director candidate search activities. The CGAD seeks disclosure as to how the insurer includes diversity as part of its Board candidate search criteria and whether a formal policy exists.

**PM&P Observation:** While many companies consider and look for diversity in the qualities and experience of desirable Board candidates, most companies do not maintain formal policies or positions on Director recruitment and demographic diversity. Board member search processes typically begin with a set of criteria from which a roster of potential Board candidates who fit those criteria is developed. While diversity may be one of several criteria considered in this process, in our experience, Boards want to ensure a broad set of experiences, expertise, skill sets and perspectives for their membership, and Boards will consider potential candidates using more of a holistic approach.

**Board and Committee Evaluation Processes Including Board Improvement/Training Activities**

Boards will be required to disclose their processes for evaluating the performance of the entire Board as well as the performance of the Board’s Committees, in accordance with the company’s corporate governance guidelines. Typically, full Board and Committee evaluations take place annually, with the rigor and structure of these reviews varying based on the individual needs of the Board.

Less formal processes may incorporate a discussion by the Board or Committee of its performance in the prior year and identify opportunities for improved performance in the coming year. More rigorous processes may incorporate the use of written feedback tools with a combination of criteria on which each Board or Committee member rates the Board or Committee’s performance and more open-ended questions for which each member can offer input to enhance performance in the new year. Feedback gathered from these instruments is then consolidated and reviewed, first by the Chair and/or lead Director and then discussed with the entire Board or Committee.

Responsibilities and activities around Board education and development will also need to be disclosed. Board education efforts, which may be assigned to a Governance Committee with support from management, may include new Director on-boarding or orientation activities as well as continuing education in the areas of technical knowledge, industry and broader market trends, regulatory changes impacting corporate governance, recommended best practices and the like. These educational activities are sometimes delivered to the entire Board as part of regularly-occurring meetings or Directors may also attend educational conferences conducted by associations or universities.

**PM&P Observation:** A regular and rigorous Board and Committee review process can serve to enhance the overall effectiveness of the Board in fulfilling its fiduciary responsibilities for the organization. The degree of formalization of this process should be customized to fit the organization’s and the Board’s culture and regular communication style as well as take into consideration the dynamics of the personalities on the Board. In our experience, these review processes tend to be somewhat informal, but a properly structured process will ensure that any corporate governance issues are uncovered early and a resolution can be openly and quickly resolved thus maximizing the effectiveness of the Board and its processes.
Important Notice: Pearl Meyer & Partners has provided this analysis based solely on its knowledge and experience as compensation consultants. In providing this guidance, Pearl Meyer & Partners is not acting as your lawyer and makes no representations or warranties respecting the legal, tax or accounting implications or effectiveness of this advice. You should consult with your legal counsel and tax advisor to determine the effectiveness and/or potential legal impact of this advice. In addition, this Client Alert is not intended or written to be used, and cannot be used by you or any other person, for the purpose of (1) avoiding any penalties that may be imposed by the Internal Revenue Code, or (2) promoting, marketing or recommending to another party any transaction or other matter addressed herein, and the taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.

About Pearl Meyer & Partners

For more than 25 years, Pearl Meyer & Partners (www.pearlmeyer.com) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges for multinational companies ranging from the Fortune 500 to not-for-profits as well as emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop global programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. Pearl Meyer & Partners maintains U.S. offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose, as well as an office in London.
NEW YORK
570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
Clifford House
15 Clifford Street
London W1S 4JY
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

SAN JOSE
2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com

www.pearlmeyer.com