CALIFORNIA DEPARTMENT OF INSURANCE
LEGAL DIVISION
Office of the Commissioner
Adam M. Cole, Bar No. 145344
Bryant W. Henley, Bar No. 200507
James W. Holmes, Bar No. 085369
George Teekell, Bar No. 211850
45 Fremont Street, 23rd Floor
San Francisco, CA 94105
Telephone: 415-538-4500
Facsimile: 415-904-5889

Attorneys for California Department of Insurance

BEFORE THE CALIFORNIA

OFFICE OF ADMINISTRATIVE LAW

In the Matter of the Review of the Petition for Determination Re: California Department of Insurance Communications to Insurers Dated February 10, 2010 and March 4, 2010	File No. CTU2010-0329-02 **RESPONSE OF THE CALIFORNIA DEPARTMENT OF INSURANCE TO PETITION FOR DETERMINATION**

Table of Contents

Table of Authorities

CASES

CALIFORNIA STATUTES

OTHER STATUTES

REGULATIONS

OTHER AUTHORITIES

I. Introduction

The Insurance Commissioner of California must ensure that assets in insurance companies' portfolios are financially sound. Financial soundness is a bulwark for policyholders, ensuring that insurance companies will be able to pay their customers' claims. In recognition of this critical function, California law gives the Commissioner broad discretion to act quickly and flexibly to safeguard insurer assets and the interests of policyholders.

For example, the Commissioner may take prompt action against all insurers that report inadequate levels of "risk based capital." (Ins. Code §§ 739 to 739.12.) The Commissioner may similarly take prompt action against all insurers that have inadequate required deposits. (*Id.* §§ 939 to 956.) The Commissioner may take immediate action through cease and desist orders against all insurers that are in financially hazardous condition. (*Id.* § 1069.2.)

Noticeably absent from these provisions is a requirement that the Commissioner undertake a rulemaking proceeding before taking action to secure insurers' portfolios. Rulemaking serves an essential purpose where it applies. But the Legislature understood that not all agency action must be accompanied by rulemaking. Such a requirement would hamper critical consumer protection functions where speed and flexibility are called for. Courts recognize that Administrative Procedure Act rulemaking is not required when it would "effectively eviscerate" a statute calling for streamlined agency action. (See, e.g., *Alta Bates Hospital v. Lackner* (1981) 118 Cal.App.3d 614, 621.) Moreover, not all agency action is a "rule" or "regulation." An agency's own analysis and research of a problem, its request for information, and its use of the bully pulpit to encourage behavior – these are not "regulations."

In this case, the Commissioner did just what the law directs. He took action to safeguard insurers' portfolios from risk arising out of investments in companies doing business with the Iranian nuclear, defense, and energy sectors. Iran's pursuit of nuclear weapons, its support of international terrorism, and its despotic rule not only render ***it*** unstable politically and economically, but put at risk ***any company*** that does business with the Iranian nuclear, defense, and energy sectors. As a leading expert, Roger W. Robinson, Jr., explains:

> [P]ublicly traded companies that do business in U.S.-sanctioned countries, such as Iran, are exposed to "global security risk," even if such activities are legal and commercial in nature. Such risks can be material and impact adversely on share value and corporate reputation. Among the risks to which companies doing business in terrorist-sponsoring states are exposed include: new U.S., U.N., or other official sanctions that affect a company's operations; sanctions violations; negative publicity; law suits by victim's rights and other groups; and opposition-oriented shareholder activism, including divestment campaigns.[1]

The Commissioner retained Mr. Robinson to assist in determining whether the portfolios of any insurers are subject to financial risk from investments in companies doing business with the Iranian nuclear, defense, and energy sectors.

With assistance from Mr. Robinson and other experts, the Commissioner evaluated thousands of investments on a security-by-security basis. After months of study, the Commissioner issued a list of 51 companies that are doing business with the Iranian nuclear, defense, and energy sectors, and are subject to financial risk as a result of those dealings (the "List").

The Commissioner requested that all insurers doing business in California indicate whether they will voluntarily agree not to invest in companies on the List in the future. The Commissioner prepared a form for insurers to fill out and return indicating their willingness (or not) to forgo investing in these companies in the future.

The Commissioner also directed insurers to submit financial statements identifying their Iran-related holdings. He directed that they use a special column, labeled "Nonadmitted Assets," to list investments in companies on the List. The Commissioner advised that effective March 31, 2010, he would treat those investments as "non-admitted." Insurers may continue to hold those investments in their portfolios, but for purposes of California financial statements, the assets will not count toward the insurers' surplus. Insurers are not required to divest those holdings.

All but a handful of the 1,300 insurers admitted to do business in California responded to

---

[1] Testimony of Roger W. Robinson, Jr. before Joint Subcommittee Hearing: Subcommittee on Domestic and International Monetary Policy, Trade and Technology (FSC) and the Subcommittee on Terrorism, Nonproliferation and Trade (HCFA) (Apr. 18, 2007) (available at foreignaffairs.house.gov/110/rob041807.htm).

the Commissioner's request for a response to his request about future investments. More than 1,000 insurers returned the Commissioner's form or sent their own version of a letter indicating that they do not intend to make future investments in companies on the List. Although not required to do so, some insurers voluntarily divested from companies on the List. The Commissioner has not entered orders against any insurers in connection with Iran investment matters.

No individual insurer has challenged the Commissioner's actions addressing financial soundness of Iran-related investments. But five trade associations of insurance companies – the American Council of Life Insurers, the American Insurance Association, the Association of California Insurance Companies, the Association of California Life and Health Insurance Companies, and the Personal Insurance Federation of California – petition OAL to declare the Commissioner's actions impermissible "underground regulations."

As we show below, none of the actions challenged by the trade associations is an underground regulation.

First, the Commissioner was permitted without rulemaking to consult experts to prepare a list of companies doing business with the Iranian nuclear, defense, and energy sectors, and to determine whether those companies are subject to financial risk as a result of those dealings. These actions further the Commissioner's statutory mandate to ensure that investments in insurers' portfolios are financially sound. Neither the development of a list nor the Commissioner's assessment of financial risk presented by investment in companies on the list is a "regulation." The list and assessment were the result of a case-by-case evaluation and are not a "standard of general application." (Gov. Code § 11342.600.) Moreover, by themselves, neither the list nor the assessment of financial risk imposes any obligation or has any effect on insurers. Rather, the list and assessment memorialize the Commissioner's factual research about individual securities. The Commissioner was not required to do that research through a rulemaking proceeding. (This is Issue B in OAL's May 27, 2010 letter.)

Second, the Commissioner's request that insurers voluntarily agree not to invest in companies on the List in the future and the form he prepared for insurers to indicate their position

on future investments are not regulations. The Commissioner's request was not an "order." It was a permissible use of his bully pulpit to encourage behavior. Further, requesting information from insurers about investment activities was a lawful exercise of the Commissioner's power to "examine the business and affairs" of insurers. (Ins. Code § 730(a).) In addition, the Commissioner was permitted to prepare a form for insurers to complete as a means to respond to his request without undertaking a rulemaking proceeding. (Gov. Code § 11340.9(c) [rulemaking is not required for "[a] form prescribed by a state agency or any instructions relating to the use of the form . . ."].) Finally, although most insurers responded by completing and returning the form, some responded with their own letters, not using the form. The Commissioner did not take any action against insurers that responded in their own chosen format to his request. (This is Issue C in OAL's May 27, 2010 letter.)

Third, the Commissioner was not required to undertake a rulemaking to require insurers to file financial reports on their Iran-related holdings and to safeguard insurers' portfolios by treating investments in companies on the List as "non-admitted" on insurers' financial statements. Insurance Code Section 923 gives the Commissioner broad authority to specify the use of forms and methods of financial reporting without undertaking rulemaking. Section 923 provides: "The commissioner may make changes from time to time in the form of the statements and the number and method of filing reports ***as seem to him or her best adapted to elicit from the insurers a true exhibit of their condition***" (emphasis added). Section 923 authorizes the Commissioner to prescribe a form of reporting for Iran-related assets and to treat those assets as "non-admitted" on insurers' financial statements as the method "best adapted to elicit from the insurers a true exhibit of their condition." Given the need for swift action to address financial solvency concerns, Section 923 creates a flexible framework for the Commissioner to address financial reporting issues. Section 923 contains its own "notice" requirement providing that the Commissioner "shall notify each insurer of any changes" from industry-wide forms "which the commissioner has determined pursuant to this section to be appropriate." Requiring rulemaking before the Commissioner can specify financial reporting for Iran-related holdings would "essentially eviscerate" Section 923. (This is Issue A in OAL's May 27, 2010 letter.)

The APA does not endorse turning every agency action into a regulation. Indeed, the APA expressly admonishes that there are ***too many*** regulations. "The Legislature finds and declares as follows: (a) There has been an unprecedented growth in the number of administrative regulations in recent years. . . . (c) Substantial time and public funds have been spent in adopting regulations, the necessity for which has not been established." (Gov. Code § 11340.) "It is the intent of the Legislature that the purpose of . . . review [by OAL] shall be to ***reduce*** the number of administrative regulations." (*Id.* § 113401.1(a) [emphasis added].) As a mechanism to reduce rulemaking, the APA requires showings of "necessity" and "nonduplication," among other things, before a regulation will be accepted. (Gov. Code § 11349(a) & (f).)

The Petitioners' effort to bridle the Department with regulatory proceedings that are both unnecessary and duplicative of the Commissioner's existing authority runs counter to the goals of the APA.

II. Background

A. Data Call

In April 2009 or shortly thereafter, the Commissioner[2] commenced an effort to monitor and evaluate Iran-related investments held by insurers doing business in California. The effort began with a "data call" to insurers requesting information about Iran-related holdings in their portfolios. (See Ins. Code § 730(a) [the Commissioner may "examine the business and affairs" of an insurer whenever the Commissioner "deems [it] necessary"].) In July 2009, the Department requested that all insurers holding a certificate of authority to do business in California[3] identify companies in their investment portfolios that do business with the Iranian nuclear, defense, energy, and banking sectors. Insurers began submitting responses as early as July 2009. By December 31, 2009, virtually all of the 1,300 insurers licensed to do business in California had filed responses.

---

[2] We use the words "Commissioner" and "Department" (for "California Department of Insurance") interchangeably.

[3] We will refer to insurers holding a certificate of authority to do business in California as insurers "licensed in California" or "admitted in California." (Ins. Code § 24.)

B. The Department's Creation of a List of Companies Doing Business with the Iranian Nuclear, Defense, and Energy Sectors, and Subject to Financial Risk

The Department evaluated responses on a case-by-case basis. In addition, the Department consulted with experts in the area of Iranian investments by multinational companies. The Department consulted with:

- KLD Research and Analytics, Inc. ("KLD"). KLD is an investment research firm that provides management tools for monitoring risks related to international, environmental, social, and governance issues, including risks related to Iran. KLD is a leading authority on social and environmental research and indexes for institutional investors.
- Conflict Securities Advisory Group, Inc. ("CSAG"). CSAG is a research and consulting firm that assesses global security risk – i.e., risk from corporate ties to countries posing security threats, engaged in terrorism, or developing unconventional weapons. CSAG provides impartial risk assessment tools and services to people and organizations interested in global security-related market risk factors. CSAG has expertise analyzing and understanding countries such as Iran, which have been designated as state sponsors of terrorism by the U.S. State Department.
- RWR Advisory Group ("RWR"). RWR is a risk management and advisory firm, specializing in evaluating risk to corporate reputation and share value stemming from business ties to security-sensitive countries, such as Iran. RWR's personnel have consulted and published extensively on security-related risk in the global capital markets. The President of RWR is Roger W. Robinson, Jr.

The States of California, Florida, and New York have directed their public employees' pension funds to divest from holdings in companies doing business with various sectors of the Iranian economy. (See Cal. Gov. Code § 7513.7; Fla. Stats. § 215.473; Office of N.Y. State Comptroller, Nov. 14, 2007 Press Release[4].) The Department reviewed lists prepared by the

---

California Public Employees' Retirement System (CalPERS), the Florida Retirement System Trust Fund, and the New York State Comptroller of companies doing business with various sectors of the Iranian economy.[5]

Based on a company-by-company analysis, consultation with KLD, CSAG and RWR, and review of lists prepared by the California, Florida, and New York pension funds, the Department developed a list of 50 companies doing business with the Iranian nuclear, defense, and energy sectors.[6] Insurers requested that the Department make that list public. The Department did so on February 10, 2010. On April 16, 2010, the Department added one company to the list. The current list ("List") identifies 51 companies.

By way of example, following are three companies on the List with a brief description of the financial risk they face:

- Ulan-Ude Aviation Plant JSC is a Russian company that provides equipment to the Iranian military. Ulan-Ude's military support of a terrorist regime with nuclear weapons ambitions subjects Ulan-Ude to reputational and financial risk. If Iran fires a weapon at another country and parts of the weapon are found and bear the label "Ulan-Ude," the financial condition of Ulan-Ude could collapse.
- Royal Dutch Shell has worked with the Iranian regime in developing oil and gas projects in the Persian Gulf. With the increased opprobrium Iran is coming under as a result of sanctions legislation such as the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (22 U.S.C. §§ 8501 *et seq*), companies such as Royal Dutch Shell face reputational harm and financial risk for continued support of the Iranian energy sector.

---

[4] New York State Comptroller Thomas P. DiNapoli's announcement may be viewed at http://www.osc.state.ny.us/press/releases/nov07/111407.htm.

[5] See (1) www.calpers.ca.gov/eip-docs/investments/reports/iran-related-investments.pdf; (2) http://www.sbafla.com/fsb/ProtectingInvestmentsAct/tabid/402/Default.aspx; and (3) http://www.osc.state.ny.us/press/releases/june09/063009a.htm.

[6] At the request of insurers, and given the difficulty of researching the issue, the Department agreed not to include on the List companies doing business with the Iranian banking sector and multinational banks doing business in Iran.

- ZiO-Podol'sk OAO is a Russian company that manufactures power machinery for power plants, including nuclear power plants. Among the products developed by ZiO-Podol'sk are heat-recovery steam generators for a nuclear power plant in Iran. The ability of Iran to develop nuclear power is a substantial global threat. ZiO-Podol'sk's collaboration with Iran to develop nuclear power plants presents financial and reputational risk to ZiO-Podol'sk.

The Department made determinations about the financial soundness of investments in the 51 companies on a security-by-security basis, following careful research on each security, and with the assistance of experts. Based on consultation with RWR, the Department determined that companies on the List are subject to financial risk (referred to as "asymmetric risk") because of their involvement with the Iranian nuclear, defense, and energy sectors.

Several companies on the List contacted the Department stating that they do not believe they belong on it. The Department has communicated on a company-by-company basis to be sure it correctly placed each company on the List. The Department's analysis to date indicates that all 51 companies continue to do business with the Iranian nuclear, defense, and energy sectors and belong on the List.

C. The Commissioner's Request That Insurers Voluntarily Agree Not to Make Iran-Related Investments in the Future and the Form for Their Response

Given the financial risk from investments in companies on the List, the Department requested that insurers licensed to do business in California voluntarily agree not to invest in companies on the List in the future. The Department directed that insurers notify the Department by April 2, 2010 whether they agree to refrain from making future investments in companies on the List until either (a) Iran is removed from the United States State Department's list of state sponsors of terrorism or (b) the company and its affiliates cease doing business with Iran's nuclear, defense, and energy sectors and the Department removes the company from the List. The Department provided a form for insurers to fill out and send to the Department indicating whether they agree to the requested moratorium.

More than 1,250 of the 1,300 insurers licensed in California returned the form or

responded with personalized letters. More than 1,000 insurers stated that they do not intend to invest in companies on the List in the future.

D. The Department's Direction to Insurers to File Financial Statements Listing Iran-Related Investments and the Department's Treatment of Those Assets as "Non-Admitted"

To address financial hazard posed by investments in companies on the List, the Department directed insurers to submit financial statements identifying investments in companies on the List. In addition, the Department directed insurers to report such investments in "Column 2" of their Annual Statements. Insurers must file Annual Statements, in which they publicly identify all investments. Column 2 is labeled "Nonadmitted Assets." The Department advised that effective March 31, 2010, it will treat such investments as non-admitted. Insurers may continue to hold Iran-related investments in their portfolios, but for purposes of their California financial statements, the assets will not count toward the insurers' surplus.

Placement of insurers' Iran-related investments in Column 2 does not require insurers to divest from those holdings. Nonetheless, some insurers voluntarily divested from companies on the List. "Non-admission" of investments has not impaired any insurer's surplus to trigger any action by the Department.

E. The Petition

On March 29, 2010, the five trade associations filed a Petition for Determination ("Petition") asking OAL to find that the Department's actions are improper "underground regulations." The Department responded by notifying OAL that Petitioner's counsel, Bill Gausewitz, served as former Special Counsel to the Commissioner, worked on the Department's Iran investment efforts, and had a conflict of interest. The Department requested that OAL not consider the Petition in light of the conflict. (1 C.C.R. § 270(c).)

On May 27, 2010, OAL sent a letter to the Commissioner and Mr. Gausewitz advising that OAL would consider the Petition notwithstanding the conflict. OAL explained that it "does not possess the technical expertise to evaluate the underlying ethical issues raised by the Commissioner. . . . Such matters are within the purview of the State Bar and the courts." (May 27, 2010 letter at p. 2. fn. 2.) On June 29, 2010, Mr. Gausewitz's firm sent a letter to OAL

announcing that it had withdrawn. The letter stated that "the five trade associations on whose behalf the petition was filed should be regarded as the petitioners."

F. Issues to Be Addressed

OAL's May 27 letter identifies three specific alleged underground regulations which OAL will consider:

A. A statement in a letter dated February 10, 2010, which states: "Accordingly, effective March 31, 2010, the Department will treat all investments by insurers holding a certificate of authority to transact insurance in California in companies on the List and affiliates owned 50% or more by companies on the List as non-admitted on the insurer's financial statements. For all financial statements filed with the Department for periods ending on or after March 31, 2010, each insurer must report all of its investment holdings on the List as not admitted assets." The February 10, 2010, letter is attached hereto as Exhibit A.

B. A determination in the Department's letter of February 10, 2010, that companies on the List referenced in A, above, are "subject to financial risk as a result of doing business with the Iranian oil and natural gas, nuclear, and defense sectors."

C. A document titled "Response Form" that requires insurers to agree or not to agree by March 12, 2010, that they will refrain from investing in companies on the List or affiliates owned 50% or more by companies on the List until either (a) Iran is removed from the United States State Department's list of state sponsors of terrorism or (b) the company and its affiliates cease to do business with Iran's oil and natural gas, nuclear, and defense sectors and is removed from the List. The Response form is attached hereto as Exhibit B.

We address each of these issues below, though in a different order reflecting the chronological sequence of actions taken.

III. OAL Issue B: The Commissioner Was Not Required to Use Rulemaking to Create a List of Companies Subject to Financial Risk Based on Iran-Related Activities

A. The Commissioner's Creation of a List of Companies Subject to Financial Risk Was Not a Regulation

The APA defines "regulation" as:

> "Regulation" means every rule, regulation, order, or standard of general application or the amendment, supplement, or revision of any rule, regulation, order, or standard adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to

govern its procedure. [Gov. Code § 11342.600.]

As the Supreme Court elaborated in *Tidewater Marine Western, Inc. v. Bradshaw* (1996) 14 Cal.4th 557:

> A regulation subject to the APA thus has two principal identifying characteristics. First, the agency must intend its rule to apply generally, rather than in a specific case. The rule need not, however, apply universally; a rule applies generally so long as it declares how a certain class of cases will be decided. Second, a rule must "implement, interpret, or make specific the law enforced or administered by [the agency], or . . . govern [the agency's] procedure." (*Id.* at p. 571 [citations omitted].)

For five reasons, the Department's identification of companies subject to Iran-related financial risk is not a regulation.

First, the List is not a "rule, regulation, order, or standard of general application." Rather, it is a memorialization of research conducted by the Department. The Commissioner's duty to safeguard insurer portfolios by making determinations about investment soundness, quality, liquidity and diversification (see, e.g., Ins. Code §§ 717(b), 706.5, 1196(a) & 1215.5(f)(6)) and his authority to disseminate accurate information to insurers and the public (*id.* § 12921.3(d)) require the Commissioner to perform research and do studies from time to time. A study and assessment of risks are not a regulation, because they are not, in the language of the APA, a "guideline, criterion, bulletin, manual, instruction, order, standard of general application, or other rule . . . ." (Gov. Code § 11340.5(a)). In the language of *Tidewater*, they do not "declare[] how a certain class of cases will be decided." They are, instead, a compilation of information – a summary of the Commissioner's research findings. The Commissioner was not required to use rulemaking to undertake his study, prepare the List, and make an assessment of companies on it.

Second, the List reflects a case-by-case analysis of specific companies' activities, not a "standard of general application." The Department reviewed the characteristics of specific companies, based on consultation with experts and the Department's own research. The Department made a company-by-company assessment of geopolitical risk each company faces. No single criterion or methodology applies uniformly to each company on the List. The Department continues to examine the circumstances of individual companies, and may remove a

company if, based on relevant sources of information, the Department finds that the company no longer maintains a level of contact with Iran presenting financial risk. This process bears no relation to a "standard of general application." (See, e.g., *Tidewater, supra,* 14 Cal.4th at p. 571 [interpretations that arise in the course of case-specific adjudication are not regulations].)

Third, in and of themselves, the List and assessment of risk have no effect on insurers. They set neither a "performance standard" that specifies an objective with achievement criteria (Gov. Code § 11342.570) nor a "prescriptive standard" that "specifies the sole means of compliance" (*id.* § 11342.590). They set no standards at all. They require no compliance. They impose no obligations. They require insurers to do nothing. They are, instead, a summary of the Commissioner's research findings.

Fourth, the List is an exercise of the Commissioner's power to "disseminate" information to the public.

> The commissioner may in person or through employees of the division meet with persons, organizations and associations interested in insurance for the purpose of securing cooperation in the enforcement of the insurance laws of this State and may ***disseminate information concerning the insurance laws of this State for the assistance and information of the public.*** (Ins. Code § 12921.5 (emphasis added].)

The Commissioner is not required to undertake a rulemaking to disseminate information.

Fifth, companies on the List are not subject to the Department's oversight. The List therefore does not "regulate" those businesses at all.

B. The Commissioner's Development of a List of Companies Subject to Financial Risk Was Not a "Quasi-Legislative" Act

The purpose of the APA is to make the rulemaking process applicable to the exercise of any "quasi-legislative" power. (Gov. Code § 11346(a).) As the Court explained in *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 10, quasi-legislative rules represent "an authentic form of substantive law-making." At its core, an agency using its quasi-legislative power is "truly 'making law'" and its rules "have the dignity of statutes." (*Ibid.*) The APA also applies to "interpretive" regulations. (See *Tidewater, supra,* 14 Cal.4th at pp. 574-575

["policy that an agency intends to apply generally . . . and that predicts how the agency will decide future cases is essentially legislative in nature . . ."].)

The Commissioner's creation of a list of companies subject to financial risk because of their associations with Iran does not fall within the spectrum of quasi-legislative action. The list and assessment do not bear the characteristics of law-making which define quasi-legislative acts. Further, the list and assessment do not even achieve the status of an "interpretive regulation" because they are neither a statement of policy nor a mechanism that "predicts how the agency will decide future cases." Under even the broadest interpretation of a "quasi-legislative" action described in *Tidewater*, the list and assessment of risk do not meet the test.

IV. OAL Issue C: The Commissioner Was Not Required to Use Rulemaking to Prepare a Form for Insurers to Respond to His Request for a Moratorium on Iran-Related Investments

A. The Form Is an Exercise of the Commissioner's Examination Power, Which Does Not Require Rulemaking

The Commissioner has broad authority to examine and obtain information from insurers. "[W]henever he or she deems necessary," the Commissioner may "examine the business and affairs" of an insurer. (Ins. Code § 730(a) & (b).) The examination process is broad. The Commissioner may examine "any company as often as the commissioner in his or her discretion deems appropriate." (*Id.* § 730(b).) Examinations may be of "any person, or the business of any person, insofar as the examination or investigation is, in the discretion of the commissioner, necessary or material to the examination of the company." (*Id.* § 730(c).) The Commissioner's examination power applies to all insurers transacting business in California (*id.* §§ 729(a) & 730(b)), ensures "free access to all the books and papers of the company," and covers "all its affairs" so the Commissioner may ascertain "its condition and ability to fulfill its obligations" and whether "it has complied with all laws applicable to its insurance transactions" (*id.* § 733). As necessary, the Commissioner's power of examination includes the power to issue subpoenas, administer oaths and examine persons under oath "as to any matter pertinent to the examination." (*Id.* § 734.) The Commissioner may even conduct examinations "at the expense of the insurer, organization or person examined." (*Id.* § 736.)

The scope of an examination is extremely broad. Examinations can include almost every sort of inquiry.

> "Examine" or "examination" as used in Code Section 730 includes an examination or review ***of any nature, scope or frequency*** by the Department of a licensed insurer, regardless of the location of the review or examination. (10 C.C.R. § 2303.2(j) [emphasis added].)

Significantly, the examination sections of the Insurance Code do not include any provision for rulemaking, unlike many other sections of the Code.

Here, the Department engaged in an examination to ascertain the financial condition of insurers. Investments in Iran-related businesses are subject to asymmetric financial risk. While insurers may, under certain circumstances, invest in Iran-related businesses, the Department must monitor those investments to ensure the safety of insurers' portfolios.

Although the Commissioner would have been within his right to conduct an on-site examination of each insurer or even issue subpoenas and solicit testimony under oath to determine whether insurers intended to invest in certain Iran-related businesses and bill each insurer for the cost of this effort, the Department chose a much less obtrusive approach. The Department elected instead to issue a survey of all insurers, requiring each company to "assist the [Department] and aid in the examination" by notifying the Department of the insurer's plans with regard to particular investments in the future. The answers to the survey provided the Department with information so that the Department could determine which insurers were likely to possess investments with risks tied to Iran. This information, in turn, enables the Department to allocate its limited resources to direct its focus to only those companies with a stated intention to continue to invest in such assets.

The Department's response form is not an underground regulation. The Department's examination did not have the essential character of a regulation, which is to establish rules applicable to future conduct or cases. Instead, the examination was a gathering of information.

Indeed, had the Department adopted a regulation to conduct its examination, the regulation would have been improper because it would duplicate the examination statutes and regulation. (See Gov. Code § 11349(f) [a regulation may not "serve the same purpose as a state

or federal statute or another regulation"].)

In sum, the Commissioner's preparation of a response form for insurers was authorized by the Commissioner's statutory examination authority, is not a "rule, regulation, order or standard of general application," and does not require rulemaking.

B. The Form is Not "Quasi-Legislative" Action

As with the List, the form created by the Commissioner for insurers to indicate whether they agree to an investment moratorium is not quasi-legislative action. (See, *supra*, Section III.B.) Not only does the form not bear the characteristics of "law-making," its use does not constitute a "standard" or "rule." Nor does the form achieve the status of an "interpretive regulation" since it is neither a statement of policy nor a mechanism that "predicts how the agency will decide future cases." Under even the broadest interpretation of a "quasi-legislative" action described in *Tidewater*, the Commissioner's form does not meet the test.

C. Creation of Forms Is Exempted from APA Rulemaking

The requirements of the APA do not apply to:

> A form prescribed by a state agency or any instructions relating to the use of the form, but this provision is not a limitation on any requirement that a regulation be adopted pursuant to this chapter when one is needed to implement the law under which the form is issued. [Gov. Code § 11340.9(c).]

The form exemption applies here. The Commissioner created the form as a means to gather information regarding insurers' plans for Iran-related investments. The Commissioner was permitted to gather that information as an exercise of his examination authority (see *supra* Section IV.A) and his use of the bully pulpit. Accordingly, the Commissioner was permitted to prepare a form to record the results of that effort. Because the form only gathered information as authorized by the examination statute, it was not an instance of using a form to substitute for a regulation as described in the second clause of Government Code Section 11340.9(c).

V. OAL Issue A: The Commissioner's Directive to Insurers to File Financial Statements Identifying Iran-Related Investments and the Department's Treatment of Iran-Related Assets as "Non-Admitted" Are Not Underground Regulations

A. Insurance Code Section 923, on Which the Commissioner Based His Actions, Does Not Require Rulemaking

1. Section 923 and Its Legislative History

Insurance Code Section 923 provides:

> The commissioner shall require every insurer which is required to file an annual or quarterly statement to use the statement blanks and instructions thereto for the appropriate year ***adopted by the National Association of Insurance Commissioners***. The statements shall be completed in conformity with the Accounting Practices and Procedures Manual adopted by the National Association of Insurance Commissioners, to the extent that the practices and procedures contained in the manual do not conflict with any other provision of this code. ***The commissioner may make changes from time to time in the form of the statements and the number and method of filing reports as seem to him or her best adapted to elicit from the insurers a true exhibit of their condition.*** The commissioner ***shall notify*** each insurer of any changes from the National Association of Insurance Commissioners' statement blanks ***which the commissioner has determined*** pursuant to this section to be appropriate. [Emphasis added.]

In crafting Section 923, the Legislature understood that financial statements do not constitute static and unalterable reports that may only be changed through a full-fledged rulemaking process. Since 1872, the Commissioner has had discretion to specify the form of insurers' annual statements. Political Code Section 615, the predecessor of today's Section 923, provided:

> The Insurance Commissioner must cause to be prepared, and furnish to each person and to each of the companies incorporated in this State, and to the attorneys of each of the companies incorporated or chartered by other States or foreign governments, printed forms of the statements herein required; and he may make such changes from time to time in the form of the same as seem to him best adapted to elicit from the companies a true exhibit of their condition in respect of the several points hereinbefore enumerated. [Political Code of 1872, § 615.]

The language vesting discretion in the Commissioner to determine the form of annual statements has remained essentially intact each time the statute has been revised: The

Commissioner "may make such changes from time to time in the form of such statements . . . as seem to him . . . best adapted to elicit from the [insurers] a true exhibit of their condition. (Stats. 1907, ch. 119, § 615, p. 159; Stats. 1935, ch. 145, § 615, p .145; Stats. 1992, ch. 614, § 3, p. 2731; Stats. 2004, ch. 599, § 2, p. 4729.) In fact, the only significant change was to broaden the statute (in 1907) by eliminating the original qualifying reference to "in respect of the several points hereinbefore enumerated." From early in its history, the language was understood to "give[] the Insurance Commissioner very broad powers in determining the form that such statements . . . shall take." (Opinion of the Attorney General, No. 4841 (1923).)

However, in the most recent revision, the scope of the Commissioner's Section 923 power – still expressed in the unqualified 1907 language – was expanded to include the form of insurers' quarterly statements, as well as their annual statements. The Legislature intended both that the Commissioner should continue to make whichever changes to the forms of the statements seem to him or her best adapted to elicit from insurers a true exhibit of their condition *and* that he or she should receive those documents more frequently and without delay. According to an Assembly Insurance Committee analysis, the change was necessary to protect the public: "Under current law it is possible, and not uncommon, for an insurance company operating in a financially hazardous manner to fail to file or to delay filing of, financial documents. Enacting this bill will improve the ability of both [the Department] and [the National Association of Insurance Commissioners] to identify financially risky insurance companies, and to protect the public from unnecessary exposure to risk." (Assem. Insurance Com., Analysis of Assem. Bill No.1728 (2003-2004 Reg. Sess.), as amended June 17, 2004, p. 3)

In providing that financial statements must conform to the "statement blanks and instructions . . . for the appropriate year adopted by the National Association of Insurance Commissioners" ("NAIC"), the Legislature was aware of the need for evolution and alteration of financial statements from time to time. Not only did the Legislature recognize the need for the Commissioner to make changes to bring financial statements into "conformity" with the NAIC's Accounting Practices and Procedures Manual, but the Legislature also vested in the Commissioner *additional* discretion to make other changes to the financial statements "from time

to time" in order to "elicit a . . . true exhibit of [the insurers'] condition" and in the manner "as seem to [the Commissioner] best adapted" to reflect the financial condition of insurers. (Ins. Code § 923.)

Cognizant of the importance of providing insurers with advance warning of changes to financial reporting requirements, the Legislature created a specific notification process to inform insurers of "any changes from the National Association of Insurance Commissioner's statement blanks which the Commissioner has determined pursuant to this section to be appropriate." (*Id.*) As the Legislature recognized and in view of the Department's need for an evolving financial statement reporting process that can quickly adapt to the complexities of the financial market, the requirements of the Administrative Procedure Act do not work here.

2. Rulemaking Is Inconsistent with Section 923

The APA establishes a formal process for state agencies to adopt regulations. The agency must give public notice of proposed regulatory action. (Gov. Code §§ 11346.4, 11346.5.) The agency must prepare and issue a complete text of the proposed regulation with a statement of the reasons for it. (*Id.* § 11346.2(a) & (b).) The agency must give interested members of the public at least 45 days to comment on the proposed regulation. (*Id.* §§ 11346.4(a) & 11346.8.) The agency must respond to each comment in writing. (*Id.* §§ 11346.8(a) & 11346.9.) At the close of this process, the agency must deliver the rulemaking file to OAL, which has 30 working days to review the file and approve or disapprove it. (*Id.* § 11349.3(a).) When one factors in the time necessary to draft text, summarize and digest comments, and deliberate internally, the fastest an agency possibly can start and finish a rulemaking is three months. It is a rare rulemaking that is completed so quickly.[7]

---

[7] "Emergency" rulemaking is not an option for financial statement oversight. The standards for justification of emergency rulemaking are high. (See Gov. Code § 11346.1(b)(2) [expediency, convenience, best interest, general public need or speculation are not adequate to justify an "emergency" for rulemaking purposes]; 1 C.C.R. § 50(a)(5)(B)(1) & (2) [facts describing emergency must demonstrate by substantial evidence that emergency rulemaking is necessary to avoid "serious harm to the public peace, health safety or general welfare" and that adoption of an emergency regulation will alleviate that harm].) Changes to financial statements, while related to the welfare of the public, will not necessarily and always rise to the level of averting "serious harm." Indeed, one purpose of revising financial statement reports is to address changed circumstances *before* they cause harm.

Requiring rulemaking as a precondition to reporting changes would be inconsistent with Section 923 for at least three reasons.

First, as noted in the preceding section, Section 923 prescribes specific procedures for notifying insurers of changed reporting requirements. Those requirements differ from what the APA would dictate. Moreover, the phrase, "any changes from the [NAIC] statement blanks which the Commissioner has determined pursuant to this section to be appropriate" reflects that at the point when insurers are notified, the Commissioner *already will have made* the decision to change the reporting requirements. The statutory language thus indicates that APA-type notice and comment are not to be used in the specific arena of insurance accounting and reporting directives.

In *Paleski* v. *State Dep't. of Health Services* (2006) 144 Cal.App.4th 713, 727-31, the court held that the existence of specific statutory provisions for notifying licensees of agency requirements meant that APA procedures did not apply. The court held that the APA did not apply to drug authorization criteria developed by the Department of Health because the governing statute prescribed different notice requirements. "The necessary effect of this subdivision is to exempt the criteria from the APA. It would make little sense to require that the criteria be published only in the provider manuals, which are of limited availability, if the broader notice requirements of the APA had to be met." (*Id.* at p. 729.) The court explained that the specific provisions of the statute prevailed over the more general provisions of the APA. (*Ibid.*)

More fundamentally, Section 923 and the Department's insolvency statutes (see, e.g., Ins. Code § 706.5) are intrinsically incompatible with emergency rulemaking because those sections make the agency's action dependent *only* on the Commissioner's discretion. For the Commissioner to act under Section 923, all that is required is that a change to financial reporting "*seem*" to him "best adapted to elicit from the insurers a true exhibit of their condition."

By way of analogy, the Commissioner may order an insurer to stop writing new business "whenever, *in his judgment*" the investments of the insurer are not sufficiently liquid, unless certain other specified conditions are met. (Ins. Code § 706.5 [emphasis added].) The court in *Alta Bates* explained of similar language: "Inherent in this language is the inescapable conclusion that the Legislature intended the level of factual proof to be lower than that normally intended to apply to administrative decisions contemplated by the [APA]." (*Alta Bates, supra*, 118 Cal.App.3d at p. 622.)

Emergency rulemaking under the APA imposes numerous procedural hurdles on an agency. That is precisely what Section 923 seeks to prevent.

Second, requiring rulemaking would be inconsistent with the timing for filing reports, which the Commissioner may change with prior notice to insurers. The Department receives reports of financial information on a quarterly, as well as annual, basis. (See, e.g., Ins. Code §§ 920 & 923.) Despite the fact that any regulation adopted via APA rulemaking would require at least three months to complete, financial statement information requires real-time analysis and review. If APA rulemaking were required before the Department could revise a quarterly financial statement filing (i.e., every three months), the APA would turn the financial statement process on its head. The Department could never implement a reporting change that would become effective for the next quarterly statement. Section 923 does not contemplate this result.

Accounting procedures implemented under statutory authorization are not considered regulations subject to the APA. In *Pacific Gas & Electric Co. v. Dept. of Water Resources* (2003) 112 Cal.App.4th 477, 503-07, the court held that that a formula developed by the Department of Water Resources to determine the amount utilities had to reimburse for power contracts was not a regulation subject to the APA, despite the general applicability of the formula to a regulated class involving dozens of long-term contracts, because the formula was a "cost-accounting exercise" performed pursuant to statutory authority. The court canvassed leading cases finding certain agency actions to be exempt from the APA. In particular, the court relied on *City of San Joaquin v. Bd. of Equalization* (1970) 9 Cal.App.3d 365, 375, which held that an inter-agency sales tax allocation process was not a regulation because the process was "merely a statistical accounting technique." (*PG&E, supra,* 112 Cal.App.4th at. p. 505.) *PG&E* also observed that not all generally applicable agency actions are "quasi-legislative." (*Id* at pp. 502-503.)

As with the challenged actions in *PG&E* and *San Joaquin*, the Commissioner's directive for Iran-related financial reporting under Section 923 involves an accounting method, the purpose of which is to ascertain the extent of insurers' Iran-related investments and the impact of those investments on insurers' surplus. The accounting method in this case has much less impact on licensees than the procedures in *PG&E* and *San Joaquin.* In those cases, the "accounting exercise" actually determined how much money the affected parties paid or received, while the Department's requirement does not have such an effect.

Third, reading the APA to require rulemaking under Section 923 would conflict with well settled principles of statutory construction. Words must be construed in context, keeping in mind the nature and purpose of the statute, and the various parts of a statutory enactment must be harmonized by considering the particular clause in the context of the statutory framework as a whole. (*People v. Black* (1982) 32 Cal.3d 1, 5.) Courts endeavor to construe statutes in a manner that comports most closely with the Legislature's intent, to promote the statute's general purpose and avoid a construction that would lead to absurd consequences. (*Smith v. Superior Court* (2006) 39 Cal.4th 77, 83.) "An interpretation that renders statutory language a nullity is obviously to be avoided." (*Williams v. Superior Court* (1993) 5 Cal.4th 337, 357.) Implied exemption from the requirements of the APA logically and necessarily applies to financial statement reporting. Indeed, courts have recognized the need for implied exemption in contexts that are similar to those at issue here.

3. A Requirement of Rulemaking Would "Effectively Eviscerate" Section 923

Courts refuse to treat statutorily authorized agency action as a "regulation" if doing so would "effectively eviscerate" the agency's enabling statute. In *Alta Bates Hospital v. Lackner* (1981) 118 Cal.App.3d 614, hospitals challenged a directive of the Director of the Department of Health to reduce Medi-Cal reimbursements paid to hospitals for outpatient services by 10%. (Alta Bates, *supra*, 118 Cal.App.3d at p. 616.) The hospitals contended that the challenged directive constituted a "regulation" within the meaning of the Government Code that had not been adopted in accordance with the APA. (*Id.* at pp. 619-620.) The Court of Appeal, reversing the trial court's finding that the APA applied, focused on the language of the statute as well as the practical effect that the APA would have on the Director's power to address a fiscal emergency.

The Court noted that the Legislature gave the Director "wide discretion over Medi-Cal eligibility." (*Alta Bates*, supra, 118 Cal.App.3d at p. 620.) The relevant statute required the Director to reduce payments "at any time during the fiscal year" when the total amounts actually paid in a fiscal year exceeded the amounts scheduled to be paid. (*Ibid.*) Notably, the statute also contained a provision requiring the Director to "consult with representatives of concerned

provider groups" before reducing reimbursements to hospitals. (*Id.* at p. 620.) Although the statutes implemented by the Director did not contain an express exemption from the APA, the Court recognized the incongruity of the APA's procedures when applied to the Director's discretion to undertake prompt action to address a fiscal emergency.

The Court acknowledged that, pragmatically, if the Director were required to follow the APA, the procedural mechanics would "effectively eviscerate" the Director's ability to make the necessary fiscal determinations and projections which call for action when the cost of the Medi-Cal program exceeded available funds. (*Alta Bates*, *supra*, 118 Cal.App.3d at p. 621.) The Court noted that, "[a]side from the delays which [the APA] procedure would entail, it is apparent that since the Legislature did not spell out that the [APA] should be followed, the legislative body recognized that the director is apt to be uniquely in possession of the only factual data pertaining to the problem." (*Id.* at p. 622.) The Court went on to recognize the importance of the statute's requirement that the Director consult with representatives of concerned provider groups before reducing reimbursement to those providers. (*Ibid.*) Finally, noting that the APA was "a general law containing general provisions applicable . . . to the promulgation of regulations by administrative agencies," the Court applied "well-established principles of statutory construction" to exempt the specific provision relating to the narrow subject of the Director's duties from the general requirements of the APA. (*Id.* at pp. 622-623.)

Similarly, in *Paleski, supra,* 144 Cal.App.4th, at pp. 727-731, the court explained that a factor in determining whether an agency action is a regulation is whether the APA process would impair the operation of the agency's enabling statute. The court held that the Department of Health's drug authorization criteria were not regulations for the reasons described above (see Section V.A.2) and because requiring APA rulemaking would delay the rapid response needed "when a drug is being abused or raises cost problems" (*id.* at p. 729), in contravention of the requirements of the agency's enabling statute.

Consistent with these authorities, the California Attorney General issued an opinion that an agency's changes to Medi-Cal drug price schedules did not require rulemaking, in part because applying the APA would run counter to the agency's statute. (Attorney General Opinion

No. 83-909, "Adjustment of Drug Product Prices Pursuant to Welfare & Institutions Code § 14105.7," 67 Att. Gen'l Ops. 50 (1984).) "It would be unreasonable to suggest that the complex and time-consuming APA review process should apply to the frequent updating of prescription drug prices . . . ." (*Id.* at p. 54.) Thus, treating this process as an exception was needed to "effectuate the obvious intent of the legislature." (*Ibid.*) The opinion reached this conclusion despite recognizing that the price change process "would thus constitute a 'regulation' in the broad sense . . ." because under the *Alta Bates* rationale "the provisions of [the law] do not lend themselves to the APA review procedure." (*Ibid.*)

Like the Medi-Cal provisions in *Alta Bates*, Insurance Code Section 923 gives the Department of Insurance broad discretion. If the general provisions of the APA were interpreted to trump the specific requirements of Section 923, the result would be to "effectively eviscerate" the Department's ability to modify financial statements in the manner the Legislature intended. As in *Alta Bates*, the specific provisions of Section 923 must be treated as controlling over the general provisions of the APA.

Moreover, Section 923 expressly requires the Commissioner to "notify each insurer of any changes" in the financial statement reporting requirements. The additional notice and opportunity for comment procedures provided in the APA are superfluous when superimposed over the financial statement procedures developed by the Legislature in Section 923. The APA's requirements -- including the minimum 45-days' notice, the receipt and summary of public comments, and delays relating to such requirements -- directly conflict with the less restrictive notice requirements of Section 923.

If the Department were required to promulgate a regulation before it could capture data relating to new financial risks to licensees under its regulatory review, financial statement analysis would become rudimentary and porous. If, for example, financial statement reporting criteria for credit default swap transactions, mortgage-backed securities, and investments in businesses such as Enron Corporation, WorldCom or Lehman Brothers could not occur without a regulation, the data collected in financial statements would become yesterday's news. Such a process would defeat the legislative goals of authorizing the Department to develop and augment

financial reporting requirements and the review of those reports in real-time with notice to reporting entities.

Here, the Commissioner has determined that companies engaged in specific business dealings in Iran undertake real and potentially volatile financial risk that could threaten investors. The Commissioner's ability to monitor the solvency of insurers conducting business in California includes the ability to remove risky investments from the "admitted asset" column of financial statements. By authorizing the Commissioner to make changes to financial statements "from time to time" to ensure a financial report that will "elicit from the insurers a true exhibit of their condition," the Legislature exempted the Commissioner's financial reporting requirements from APA rulemaking.

B. The Commissioner's Notification on Financial Statement Reporting Involves a Form and Is Not Subject to the APA

The Commissioner's notification about financial statement reporting involves a form and is exempt from APA rulemaking. (Gov. Code § 11340.9(c).) The Commissioner modified reporting forms for financial statements so that insurers may identify any investments in companies identified by the Department as conducting Iran-related business. The APA is inapplicable to the development of this form. The APA expressly permits the use of forms without rulemaking so long as those forms are not required in order to implement the law under which the form is issued. (*Id.*) As explained above, no regulations are required in order to implement the Commissioner's financial statement reporting form.

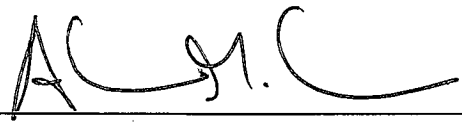
The Commissioner has authority to make changes to the form and method of financial statement reports "from time to time" and in the manner "as seem to him or her best adapted to elicit from the insurers a true exhibit of their condition." (Ins. Code § 923.) A regulation is not required "pursuant to this chapter . . . to implement the law under which the form is issued" because the statute expressly gives that power to the Commissioner.

VI. Conclusion

For the foregoing reasons, none of the actions challenged by Petitioners is a regulation. The requirements of APA rulemaking do not apply.

Dated: July 26, 2010

CALIFORNIA DEPARTMENT OF INSURANCE

By 

Adam M. Cole