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PERSONAL INSURANCE FEDERATION

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 24th Floor
San Francisco, California 94105

INITIAL STATEMENT OF REASONS

TITLE 10, CALIFORNIA CODE OF REGULATIONS
CHAPTER 5, SUBCHAPTER 3
ARTICLE 3.3 – ANNUAL FINANCIAL REPORTING REGULATIONS

May 29, 2009

INTRODUCTION

These proposed regulations are intended to improve the California Department of Insurance's ("CDI") surveillance of the financial condition of insurers by requiring (1) an annual audit by independent certified public accountants ("CPA") of the financial statements that report the financial position and the results of operations of insurers; (2) Communication of Internal Control Related Matters Noted in an Audit; (3) Management's Report of Internal Control Over Financial Reporting.

A majority of the provisions in these proposed regulations are current requirements contained in the National Association of Insurance Commissioner's Annual Statement Instructions.

Background

In the mid-1970's, the National Association of Insurance Commissioners ("NAIC") considered whether all companies should be required to have an annual audit conducted by a CPA as an addition to the examination process. In 1979, the NAIC appointed a task force whose charge was to consider whether the audits should be mandated and to develop a NAIC model audit rule ("NAIC Model"). The initial NAIC Model was adopted in December of 1979, and in December of 1990, the NAIC Model was amended and made a part of the NAIC's Annual Statement Instructions. The NAIC Annual Statement Instructions specify the financial reporting requirements that insurers are required to follow when preparing their financial statements.

The NAIC Model was amended again in 1998 and 2003. In 2006, after consideration of the Sarbanes-Oxley Act of 2002, the NAIC amended the NAIC Model to include provisions regarding auditor independence, corporate governance, and internal control over financial reporting. In order to provide affected parties the opportunity to comment on the new version of the NAIC Model, it was determined that each of the states should implement the provisions of the NAIC Model as statutes and/or regulations that will go into effect on January 1, 2010. In expectation of this, the NAIC will remove the provisions of the NAIC Model from the NAIC Annual Statement Instructions effective January 1, 2010.

Significance of the NAIC Model

The provisions of the NAIC Model will become an accreditation standard effective January 1, 2010. This means that the CDI must adopt these regulations by January 1, 2010 in order to maintain its status as an accredited state.¹ If the CDI does not maintain its accredited status, other states will not be able to rely on California's Reports of Examination for California's domestic insurers. Consequently, other states may have to perform their own financial examinations of California domestic insurers. This would result in inefficiencies for the regulators and greater costs to the insurers and ultimately to policyholders who would have such costs passed onto them in the form of higher premiums.

Comparison Between the NAIC Annual Statement Instructions and the NAIC Model

The NAIC Model contains some substantive requirements that are not in the current NAIC Annual Statement Instructions.

NAIC Survey of Regulators' Adoption of the NAIC Model

The NAIC conducted a survey of insurance regulators and found that sixteen states will adopt the provisions of the NAIC Model as a statute, twenty-eight states will adopt the provisions as regulations, and seven states will use a combination of statutes and regulations (the District of Columbia is included in these totals).

As of November 2008, seven states have completed the process of adopting the provisions of the NAIC Model as either statutes or regulations. Thirteen states reported they will complete the process by the end of 2008. Thirty-one states reported they will complete the process in 2009.

California's Version of the NAIC Model: Annual Financial Reporting Regulations

These proposed regulations, the Annual Financial Reporting Regulations, are modeled after the NAIC Model and contain all of the substantive provisions of the NAIC Model and follow the NAIC Model text as closely as possible. However, the CDI did make some non-substantive changes in grammar and format and also tailored the NAIC Model for California law.

In addition, some minor revisions to California Insurance Code ("CIC") section 900.2 will be required (related to the number of days' notice that insurers must provide if they request an extension of the filing date) in order to be consistent with the provisions of the NAIC Model.

The Annual Financial Reporting Regulations are necessary to carry out the purpose set forth in CIC 900.2 and the NAIC Model: to improve a state's surveillance of the financial condition of insurers by requiring an annual audit by independent CPAs of the financial statements that report the financial position and the results of operations of insurers.

¹ See the NAIC's "Financial Regulation Standards and Accreditation Program" (December 2008)

SPECIFIC PURPOSE AND REASONABLE NECESSITY OF PROPOSED REGULATIONS

The specific purpose of each adoption and the rationale for the determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed are set forth below.

SECTION 2309.1: AUTHORITY

In conformity with the NAIC Model, Section 2309.1 provides the express statutory authority for the promulgation of these regulations. This provision is necessary to establish the authority for these regulations, and it is reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections, 923 and 930, et seq.

SECTION 2309.2: PURPOSE AND SCOPE

In conformity with the NAIC Model, Section 2309.2 provides that the purpose of these regulations is to improve a state's surveillance of the financial condition of insurers by requiring (1) an annual audit by independent CPAs of the financial statements that report the financial position and the results of operations; (2) Communication on Internal Control Matters Noted in the Audit; (3) Management's Report of Internal Control Over Financial Reporting.

This section provides that all insurers are subject to these regulations unless an insurer has direct written premiums in California of less than \$1,000,000 in any calendar year and fewer than 1,000 policyholders at the end of the calendar year. However, the Insurance Commissioner may make a finding that the insurer shall be subject to these regulations notwithstanding these threshold totals.

Foreign insurers are exempt only if their domiciliary state has similar reporting requirements in effect. Reinsurers that have only assumed premiums also come within the scope of these proposed regulations.

These provisions are necessary to explain the reasons for developing the NAIC Model and for explaining the changes from the NAIC Annual Statement Instructions. They are also necessary to ensure that the vast majority of insurers come within the ambit of the regulations' requirements while avoiding undue hardship to smaller insurers.

In all substantial respects, Section 2309.2 is identical to the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.3: DEFINITIONS

In conformity with the NAIC Model, Section 2309.3 defines technical terms used in the proposed regulations. Most of the definitions provided herein are standard for the insurance industry. Subsections (k), (l), and (m) make references to Section 404 of the Sarbanes-Oxley Act

of 2002. Section 404 requires that a public company's management disclose in an annual report its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The Section 404 report must also contain management's assessment of the effectiveness of its internal control structure and its procedures for financial reporting. The company's auditor must also attest to, and report on, management's assertions.

Subsection (m) defines "SOX [Sarbanes-Oxley Act of 2002] Compliant Entity" and the attendant SOX sections with which the entity must comply.

These sections are necessary to provide definitional guidance for all affected parties.

Section 2309.3 is identical to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.4: GENERAL REQUIREMENTS RELATED TO FILING AND EXTENSIONS FOR FILING OF ANNUAL AUDITED FINANCIAL REPORTS AND AUDIT COMMITTEE APPOINTMENT

In conformity with the NAIC Model, this section specifies the date by which insurers are required to file an annual audited report and also provides that extensions of the filing deadline are permitted pursuant to controlling statutes. This section also requires that insurers that file an annual audited report must also establish an Audit Committee.

This section is necessary to establish filing deadlines and to allow for extensions of those deadlines under certain circumstances. It is also necessary to inform affected insurers of the requirement that they must establish an Audit Committee.

Section 2309.4 is substantially similar to the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.5: CONTENTS OF ANNUAL AUDITED FINANCIAL REPORT

In conformity with the NAIC Model, this section provides the details of what must be included in the annual audited financial report and lists the principal financial statement components.

This section is necessary to inform insurers of the exact categories of financial data that must be included in audited financial reports.

Section 2309.5 is substantially similar to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is

important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.6: DESIGNATION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

In conformity with the NAIC Model, subsection (a) requires that an insurer that is required to file an annual audited financial report must, within a specified period, register with the Insurance Commissioner the name and address of the independent CPA that will conduct the audit.

Subsection (a) is reasonably necessary so that the Insurance Commissioner has advance notice of the person chosen to conduct the audit. Advance notice is necessary in the event the Insurance Commissioner may have an objection to the person chosen.

In conformity with the NAIC Model, subsection (b) requires that the insurer must obtain from that independent CPA a letter wherein the CPA states that he/she is aware of the provisions of the insurance code and the regulations of the insurance department of the state of domicile that relate to accounting and financial matters and that the CPA will express his/her opinion in conformity with the state of domicile's statutory accounting practices.

Subsection (b) is reasonably necessary to hold the auditor accountable for having knowledge of the domiciliary state's insurance laws and regulations and statutory accounting practices.

Subsection (c) provides that when an accountant who was the auditor for the immediately preceding audited financial report is dismissed or resigns, the insurer must send a letter notifying the Insurance Commissioner of this event within five (5) days. An additional letter is required to be sent to the Insurance Commissioner within ten (10) days if there were any disagreements between the insurer and the former accountant within the past twenty-four (24) months on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which, if not resolved to the satisfaction of the former accountant would have caused him/her to make reference to the subject matter of the disagreement in connection with his/her opinion. The disagreements that are required to be reported include those that were resolved to the satisfaction of the former accountant and those that were not.

Subsection (c) is reasonably necessary so the Insurance Commissioner is aware of a change in auditors and is aware of material disagreements between the former auditor and the company as this may affect the Insurance Commissioner's review of the audited financial reports.

Section 2309.6 is substantially similar to the corresponding section of the NAIC Model. This section is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.7: QUALIFICATIONS OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

In conformity with the NAIC Model, subsection (a) provides that the Insurance Commissioner shall not recognize a person or firm as an "independent CPA" within the meaning of these regulations if that person or firm is not in good standing in all states in which that person or firm is licensed or if that person or firm has entered into an agreement of indemnity or release from liability with insurer to be audited.

This subsection (a) is necessary to ensure that the insurer's auditor has complied with all requirements for maintaining a professional license and is professionally responsible for the quality of the audit.

Subsection (b) provides that the Insurance Commissioner shall recognize an independent CPA as qualified to conduct an audit pursuant to these regulations as long as that person conforms to certain, specified professional standards.

This subsection (b) is necessary to provide guidance to insurers as to the standards the Insurance Commissioner will apply in reviewing the qualifications of the insurer's auditor.

Subsection (c) provides that a qualified independent CPA may enter into an agreement with the insurer to have disputes resolved by mediation or arbitration but in the event of any delinquency proceeding, such agreement shall operate at the option of the statutory successor.

This subsection (c) is necessary to inform insurers and auditors that they may enter into alternative dispute resolution agreements and to inform the auditor that the agreement is subject to cancellation in the event of any delinquency proceeding against the insurer.

Subsection (d) provides that the lead or coordinating audit partner must be rotated every five years and shall neither serve on the board of an insurer nor be part of its management. However, an insurer may file an application with the Insurance Commissioner for relief from this rotation requirement on the basis of unusual circumstances. This subsection also lists some factors for the Insurance Commissioner to consider in review of the application.

This subsection (d) is necessary to increase auditor independence but also recognizes there may be circumstances under which the rotation requirement is not feasible or practicable. This subsection (d) is necessary so that insurers and auditors know how many consecutive years one auditor may audit the same insurer.

Subsection (e) provides that the Insurance Commissioner shall not recognize as a qualified independent CPA nor accept an annual audited report prepared, in whole or in part, by an accountant who has been convicted of certain crimes or demonstrated a pattern of failing to detect or disclose material information in past reports filed pursuant to these regulations.

This subsection (e) is necessary to clearly inform insurers and auditors as to factors in

determining automatic disqualification as an auditor pursuant to these regulations.

Subsection (f) provides that the Insurance Commissioner may hold a hearing to determine whether an independent CPA is qualified pursuant to these regulations.

Subsection (f) is necessary to provide a forum for determining whether an independent CPA is qualified pursuant to these regulations.

Subsection (g) provides that the Insurance Commissioner shall not recognize as a qualified independent CPA nor accept an annual audited report prepared, in whole or in part, by an accountant who provides certain, specified non-audit services. This subsection also provides that the independence of CPAs is predicated on three main principles: the accountant cannot function in the role of management; the accountant cannot audit his/her own work; the accountant cannot serve in an advocacy role for the insurer.

This subsection (g) is necessary to prevent conflicts of interest for an auditor. This also enhances an auditor's independence because it prohibits other income earning relationships with the insurer that he/she audits.

Subsection (h) provides that insurers with direct written premium of less than \$100,000,000 may apply for an exemption from subsection (g)(1) [list of non-audit services the auditor may not provide].

Subsection (h) is necessary to provide an appeal process for an insurer if compliance with subsection (g)(1) would constitute a financial or organizational hardship on the insurer.

Subsection (i) provides that an independent CPA may provide certain non-audit services that are not described in (g)(1) or that do not conflict with (g)(2) [the three basic principles of auditor independence] only if the activity is approved in advance by the Audit Committee.

Subsection (i) is necessary because it recognizes that (g)(1) cannot cover all circumstances and that there should be an internal review by the Audit Committee when such circumstances arise. However, it is also necessary to maintain the inviolate nature of the three principles of auditor independence.

Subsection (j) provides that all audit and non-audit services provided to the insurer by the independent CPA must be pre-approved by the insurer's Audit Committee. This pre-approval requirement is waived if the insurer is a SOX Compliant Entity. There are other exceptions to the pre-approval requirement as well.

Subsection (j) is necessary to provide an additional layer (in addition to the auditor) of review in order to enhance auditor independence. The exceptions are necessary to provide a process to balance the insurance company's operational needs with the need to enhance auditor independence.

Subsection (k) provides that an Audit Committee may delegate the pre-approval decision as required by (j) to one or more members of the Audit Committee; however, that person must report such pre-approval decisions to the full Audit Committee.

This subsection (k) is necessary to permit insurers to make decisions more efficiently while maintaining the oversight responsibility for the full Audit Committee.

Subsection (l) provides that the Insurance Commissioner shall not recognize an independent CPA as qualified for a particular insurer if a member of the board or other top manager was employed by the independent CPA and participated in the audit of that insurer during the preceding one-year period. This prohibition applies only to partners and senior managers involved in the audit. However, an insurer may file an application with the Insurance Commissioner for relief from this prohibition on the basis of unusual circumstances.

This subsection (l) is necessary to further enhance auditor independence while recognizing that there may be circumstances under which the prohibitions should not be applied, which can be determined only on a case-by-case basis.

Section 2309.7 is substantially similar in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.8: CONSOLIDATED OR COMBINED AUDIT

In conformity with the NAIC Model, this section provides that insurers may request approval from the Insurance Commissioner to consolidate annual audited financial reports that combine all their underwriting and loss results through “pooling agreements.” When results are combined, consolidated information may be more meaningful. This section includes specific requirements for consolidated reports.

Section 2309.8 is necessary because it recognizes that some insurers are part of a pool such that the financial results of one member of the pool can affect the solvency of all members of the pool. Under such circumstances, a combined audit report is usually a more meaningful report.

Section 2309.8 is identical in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary in order to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.9: SCOPE OF AUDIT AND REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

In conformity with the NAIC Model, this section specifies the standards for conducting the annual audit of the insurer's financial statements. The AICPA AU Section 319 - "Consideration of Internal Control in a Financial Statement Audit," provides guidance on an auditor's consideration of an entity's internal control in the audit of financial statements. The AICPA Statement on Auditing Standards ("SAS") Number 102 is now included in AICPA AU Section 120 - "Defining Professional Requirements in Statement on Auditing Standards." This section defines several terms used in the SAS's issued by the Auditing Standards Board to describe the professional requirements for auditors.

This section is necessary to provide express requirements regarding specific audit standards to be utilized by auditors for insurance company audits.

Section 2309.9 is identical in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.10: NOTIFICATION OF ADVERSE FINANCIAL CONDITION

In conformity with the NAIC Model, this section requires the independent auditor to notify an insurer's board of directors or audit committee if he or she determines that an insurer has either materially misstated its financial condition in its report to the Insurance Commissioner or does not meet the minimum statutory capital and surplus requirements. The auditor's report must be written and be sent within five (5) days after the determination. This section further requires that the report must be provided to the Insurance Commissioner within five (5) days after the board of directors or audit committee receives its notice. An independent CPA acting in good faith will not be held liable for any statement made pursuant to this section. If the accountant becomes aware of facts that may have affected the report, subsequent to the balance sheet date, action is to be taken by the accountant in accordance with Volume 1, AU Section 561 of the Professional Standards of the AICPA, which sets forth procedures for auditors to follow when they become aware of facts subsequent that may have affected their opinion.

This section is necessary to provide the insurer's board of directors or audit committee a reasonable amount of time to take timely action. Such additional notification to the Insurance Commissioner is necessary to allow the Insurance Commissioner to take timely action as necessary. The good faith clause is necessary to allow the auditor to report problems he/she honestly believes needs to be reported but also protects him/her from any legal liability as a result of such report.

Section 2309.10 is substantially similar in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.11: COMMUNICATION ON INTERNAL CONTROL RELATED MATTERS

In conformity with the NAIC Model, this section requires the insurer to provide the Insurance Commissioner with written notice of any unremediated material weaknesses in an insurer's internal controls in addition to those reported in the Annual Audited Financial report. Statement on Auditing Standards 60 – "Communication of Internal Control Related Matters Noted in an Audit" provides guidance on standards for communication and defines what is considered to be a significant deficiency and material weakness.

This is necessary because the Insurance Commissioner must know if an insurer continues to allow deficiencies and/or material weaknesses in its internal controls because they could affect the insurer's solvency. A time period of 60 days is specified to allow the insurer a reasonable amount of time to cure deficiencies and/or weaknesses. The reference to Statement on Auditing Standard 60 is necessary so that all parties are aware of the standards to be applied to the report.

Section 2309.11 is substantially similar in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.12: ACCOUNTANT'S LETTER OF QUALIFICATIONS

In conformity with the NAIC Model, this section requires the accountant to include a letter with the Annual Audited Financial report that provides the insurer with an affirmative statement regarding the accountant's independence and his/her qualifications as outlined in section 2309.7. This section also requires the accountant to make affirmative statements regarding compliance with section 2309.13 regarding availability and maintenance of workpapers.

This is necessary because it provides an additional layer of review as to the qualifications and independence of the auditor pursuant to these regulations.

Section 2309.12 is substantially similar in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.13 DEFINITION, AVAILABILITY AND MAINTENANCE OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS WORKPAPERS

In conformity with the NAIC Model, this section specifies that the CPA will maintain copies of workpapers that support the Annual Audited Financial Report for a period of up to seven (7) years and will allow CDI examiners to have access to those workpapers. The section also specifies that reviews of CPA workpapers are considered examinations, and as such, the workpapers shall be afforded the same confidentiality as other examination workpapers.

This section is necessary because the CDI examiners must have available all workpapers that cover a given period of examination and insurers must be assured that confidential materials are treated as such.

Section 2309.13 is identical to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.14: REQUIREMENTS FOR AUDIT COMMITTEES

In conformity with the NAIC Model, this section requires insurers to establish Audit Committees; lists the Audit Committee's responsibilities; establishes membership requirements for Audit Committee members; and establishes the requirements for an Audit Committee member to be considered "independent." This section does not apply to nondomestic insurers because reviews of such insurers' Audit Committees are performed by the state of domicile. This section also requires the auditor to report to the Audit Committee regarding the subjects specified in "Statements on Auditing Standards 61 – Communication with Audit Committees," including discussions with company management about accounting policies. The percentage of Audit Committee members that must be independent is based on direct and assumed premium volume. Insurers with less than \$500,000,000 in direct and assumed premiums may apply to the Insurance Commissioner for a waiver of the requirements of this section due to economic hardship.

This section is necessary because Audit Committees can more effectively oversee the audit function and strengthen corporate governance practices through enhanced communication between the auditors and the board of directors. This section also is necessary because it recognizes that smaller insurers may have some difficulty in finding independent Audit Committee members.

Section 2309.14 is identical to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.15: CONDUCT OF INSURER IN CONNECTION WITH THE PREPARATION OF REQUIRED REPORTS AND DOCUMENTS

In conformity with the NAIC Model, this section requires that no director or officer of an insurer may take any direct or indirect action that would result in false or misleading reports to the CDI. Directors and officers are also prohibited from attempting to exert undue influence on the auditor if such action could result in rendering the insurer's financial statements materially misleading.

This section is necessary to increase the reliability of the annual audited financial reports.

Section 2309.15 is identical to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.16: MANAGEMENT'S REPORT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

In conformity with the NAIC Model, this section provides that any insurer with \$500,000,000 or more in direct and assumed premiums is required to file Management's Report of Internal Control over Financial Reporting with the Insurance Commissioner. This section also details the content of the report and requires that management maintain documentation to support the assertions in the report. To minimize expense and duplicate filings, insurers that file Sarbanes-Oxley Section 404 reports may file copies of those reports to satisfy most of this section's requirements. However, this section also provides that notwithstanding the premium threshold requirement cited, the Insurance Commissioner may require an insurer to file the report if the insurer is in any RBC (Risk-Based Capital) level event or is deemed to be in hazardous financial condition as defined in the CIC.

This section is necessary to ensure that the insurer's management takes responsibility for understanding and following its internal controls. In the past, management has sometimes contended that they are not liable for deficiencies because they were either unaware of, or did not understand, the internal controls. The exception to the premium threshold requirement is necessary because it is prudent to impose additional reporting and oversight requirements on any insurer deemed to be in a hazardous financial condition.

Section 2309.16 is substantially similar in all respects to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.17: EXEMPTIONS AND EFFECTIVE DATES

In conformity with the NAIC Model, subsection (a) provides that the commissioner may grant an exemption from compliance with any of the provisions of these proposed regulations if compliance would cause an undue hardship to an insurer.

Subsection (a) is necessary to provide relief for insurers that might otherwise incur a financial or organizational hardship in complying with these regulations.

Subsection (b) provides that insurers that have retained a qualified independent CPA as of the effective date of these regulations are required to file a report for the year ending December 31, 2010.

Subsection (b) is necessary to inform affected parties as to the period covered by the first Annual Audited Financial Report.

Subsection (c) provides that insurers that have not retained a qualified CPA as of the effective date of these regulations are required to file a report for the year ending December 31, 2010.

Subsection (c) is necessary to inform affected insurers that even if they have not retained a qualified independent CPA as of January 1, 2010, they are still required to file a report for the year ending December 31, 2010.

Subsection (d) provides that foreign insurers are required to comply with these regulations for the year ending December 31, 2010.

Subsection (d) is necessary to inform foreign insurers of the period covered by their first Annual Audited Financial Report.

Subsection (e) provides that the rotation requirements of section 2309.7(d) begin with audits that cover calendar year 2010.

Subsection (e) is necessary to inform all affected parties as to when the rotation requirements begin.

Subsection (f) provides that if an insurer is not initially subject to the requirements of section 2309.14 [percentage of Audit Committee members that must be independent based on premium threshold] and then subsequently becomes subject to 2309.14, the insurer has one (1) year following the year the threshold is exceeded to comply with the independence requirements.

This section is necessary to provide clear deadline dates for affected insurers.

Subsection (g) provides that the requirements of 2309.16 [Management's Report of Internal Control over Financial Reporting] are effective beginning with the reporting period ending December 31, 2010. An insurer that is not subject to 2309.16 but subsequently becomes subject to it because of a change in its total written premium shall have two (2) years following the year the threshold is exceeded to file a report.

This subsection is necessary to provide guidance to affected insurers.

Section 2309.17 is identical to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for

California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.18: CANADIAN AND BRITISH COMPANIES

In conformity with the NAIC Model, this section allows audit reports for Canadian and British insurers to cover the entire company, not just the United States branch that transacts the insurer's U.S. business. This section also requires that the independent CPA submit the same type of letter as required by 2309.6.

This section is necessary to save these companies from the expense of conducting separate audits and filing separate reports just because they are domiciled in Canada or Great Britain.

Section 2309.18 is identical to the corresponding section of the NAIC Model Regulation and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.19: SEVERABILITY PROVISION

In conformity with the NAIC Model, this section provides that if any section(s) of these proposed regulations is invalidated, the remainder of the sections shall not be affected.

Section 2309.19 is identical to the corresponding section of the NAIC Model and is therefore reasonably necessary to carry out the purpose of CIC 900.2, the NAIC Model, and the California Legislature as the California Legislature has evinced legislative intent that it is important for California to work in coordination with the NAIC. See, e.g., Insurance Code Sections 923 and 930, et seq.

SECTION 2309.20: ADDRESS INFORMATION

Section 2309.20 provides the specific contact information regarding reports, requests, and general correspondence in connection with these regulations.

Section 2309.20 is reasonably necessary in order for insurers to send reports, requests, and general correspondence to the correct CDI location.