The Regulator®
INSURANCE REGULATORY EXAMINERS SOCIETY

New York, others, come up with a far better system — in principle

By Scott Hoober
Special to *The Regulator*

This just in: Chinese manufacturers have just agreed in principle to "lawfully conduct their business with integrity, due skill and diligence," and to "take reasonable care to organize and control their affairs responsibly and effectively, with adequate risk management systems."

Congress, which had been readying legislation to prevent lead in children's toys and tainted pharmaceuticals and dog food, appears ready to take them at their word and decline to legislate product safety and reliability.


New York's Dinallo

We're kidding, of course.

Anyone can agree to high-sounding principles, but without enforcement, that's not enough to ensure compliance.

And that seems to sum up opposition to principles-based insurance regulation: It sure sounds good, but why should we assume it will work? As one observer put it, "It's like removing all the criminal statutes from the books and replacing them with the Ten Commandments."

The imaginary principles cited above happen to be paraphrases of principles that Eric Dinallo, New York's insurance commissioner, has proposed in draft regulations for his state (see p. 7).

As one former regulator put it: "I don't know how well the idea of principled regulation would work. Instead of laws that prohibit anti-competitive behavior, I mean, what are you going to do? Tell them to go out there and be a good guy?"

How it would work

It's easy to get agitated at the thought of replacing hard-and-fast rules and regulations with general statements of goodwill. Trouble is, that's not what's being proposed.

The problem seems to be that in their enthusiasm, some supporters of principles-based regulation have forgotten to mention that the idea is to overlay principles on top of the current system. At least for now.

continued on page 4

From 'Good Hands' to Boxing Gloves

How one reporter decided to go 'dark'

by Brian Sullivan

It's time to surrender. After two years of trying to help different media outlets understand the dynamics behind Allstate's infamous "McKinsey slides," we are swearing off the hours-long conversations we have been regularly holding with various newspapers, television, and wire service reporters as each "discovers" the story anew.

We just can't seem to communicate effectively enough. It's time to go dark on the matter, and instead let this article do the heavy lifting.

Here is the tale: a number of large insurers have engaged McKinsey & Co. to help them better manage claims. In the process, McKinsey has apparently advised, among a zillion other things, that claimants who engage attorneys need to be treated differently (read rougher) than claimants dealing

continued on page 8

JAN 2008

The Regulator

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THE REGULATOR is published every other month by the

INSURANCE REGULATORY EXAMINERS SOCIETY

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From the President

Our Amazing Project: The Pilot MC+ Class

The first class of our new Market Conduct Management (MC+) Program took place in Kansas City, November 12-14.

I congratulate the 29 dedicated pioneers who attended this wonderful pilot course. In addition to the captioned, "Our Amazing Project" comment, follow-up surveys revealed that most students agreed that the class represented an excellent start and that the course helped them hone their professional skills. Participants particularly enjoyed the case studies which offered practical and valuable information.

In addition, the Accreditation and Ethics Committee voted to issue 15 continuing education credits to individuals successfully completing the MC+ Program. Over the coming weeks, the MC+ Subcommittee, led by Gary Domer, will review participant feedback in order to further improve the program. Please see Gary's article in this issue for dates and locations of upcoming classes (p. 10).

In pursuit of other learning opportunities, Doug Freeman, Joe Bieniek, and Kirk Yeager, Chair of the IRES Past Presidents Council, met with representatives from the AICP (Association of Insurance Compliance Professionals) at the October AICP Annual Conference. An IRES/AICP Collaborative Initiatives/ Strategic Alliance 2007-2008 Project plan has been submitted to our Executive Committee. The Executive Committee will evaluate the proposed plan of action.

Furthermore, SOFE (the Society of Financial Examiners) and IRES have resumed discussions as part of both organizations' desire to enhance communications between them. In fact, we are currently engaged in discussions to explore the possibility of holding a combined SOFE/IRES Career Development Seminar (CDS) in 2012. Wanda LaPrath will continue to be the IRES contact, while Dennis Kluk serves as SOFE's contact.

Internally, at the request of the Budget & Finance Committee, chaired by Karen Dyke, various committees have discussed ways in which IRES could reduce postage expenses. As a result, IRES plans to expand its use of technology to reduce paper communication.

NICE (National IRES Continuing Education Program) members will review their individual transcripts online instead of receiving hard copies by mail. Also, the web site subcommittee is planning to develop a method for online membership renewal that will include an option to pay by credit card. More details will be announced in the future. Interested members may review the meeting minutes at www.go-ires.org/members/minutes.cfm.

The Membership and Benefits Committee, chaired by Wanda LaPrath, has worked on membership promotion, retention, and benefits. IRES members please stay tuned and be sure TO RENEW YOUR 2008 MEMBERSHIP.

The MC+ project has proven to be a success. However, I believe the good feedback is just the beginning of another IRES success story. Therefore, I would like to encourage our members to initiate or get involved with more amazing projects. Yes, the best is yet to come.

In the meanwhile, Happy New Year to you and your families!

God Bless,

Polly Chan

Polly Chan, CIE
IRES President

Welcome, new members!

Gregory F. Bronson, TN
John R. Cronin, VT
Connie S. Nowland, UT
Mary Ellen Sasseville, NH
Angie Thomas, UT

Quote of the Month

"I hear lots of people, including regulators, saying that they could see this as a great new field of business for Tony Soprano."

— Faith Williams, legislative counsel for the Association of Ohio Life Insurance Companies, discussing stranger-oriented life insurance (STOLI). Ohio is considering banning or limiting the sale of such products.

A better system? It's the principle of the thing

continued from page 1

When we asked Dinallo whether his proposed move to principles-based regulation would mean the end of regulation as we know it, he was taken aback, to say the least.

"It wouldn't work if that's all there were," he said. "But that's not the intent at all."

So you're not going to replace statutes with the Ten Commandments? "That's a very interesting [misconception]. I need to confront that head-on. The intent was never to replace everything."

As a matter of fact, except for training them to approach exams with a different orientation, he said the job of the regulators won't change much at all.

"We are going to use these to help and guide us in our interpretation of insurance law," the superintendent said.

"Occasionally it may be the case that we might say to someone, 'You may have comported with the letter of the law, but you're so outside the principle that we really need to talk.' Or vice versa, which is when a company says, 'Look, I may have violated the letter, but I was trying to stay within the principle.'"

Come to think of it, the idea of tossing out the current system, with its excellent track record, and replacing it with a new and largely unproven concept would be a pretty radical move.

If a seasoned veteran like Joel Ario, newly appointed commissioner in Pennsylvania and formerly in the same post in Oregon, would favor a principles-based system, it may just have merit.

And as he said in an interview in August, published recently in *The Regulator:* "Trying to get behind the rules to the standards that drive the rules is going to get you to a better solution than trying to fight over rules that don't necessarily connect to your purpose any more."

Now that we think about it, we wonder whether it would have been easier to have prevented the recent spate of trouble with inappropriate sales of annuities had we had a set of principles in place.

After all, life companies were moving into new markets, where regulations hadn't yet been written. If a regulator were to contact a company in an effort to protect elderly consumers, the insurer could easily argue, "There's no law against it."

Under principles-based regulation, the department could come back with, "No, but I can think of three or four of our new principles that have been violated."

Paul Altruda, an attorney formerly with the New York department, put it this way: "I would fall back and say, 'OK, that's an untrustworthy act. I can demonstrate that this product is not appropriate for this person, and that you caused damage.'"

But, he added, "There has to be a will to regulate to that level."

One temptation might be to ease back on regulation, perhaps with fewer exams for companies that seem to be playing by the rules. But Dinallo says that's not his view of things.

"One of the things I'd like to see is the exams to occur more regularly, with more of a risk-focused aspect," he said.

"I think one of the mistakes we make is we do these triennial exams. I'd rather see us go in more often but be more focused on what we're looking at, and actually begin to have a dialogue with the companies about what their business plans are, so we can go in and start to audit in the areas that we should be concerned with, whether they're expanding or they're trying new products, new markets, etc."

Misconceptions

Many of the loudest complaints against principles-based regulation seem to be based on the misconception that it's either principles-based or rules-based, and never the twain shall meet.

A news release by the National Association of Professional Insurance Agents (PIA), for instance, started out: "The newest fad in insurance regulatory reform seems to be the concept of 'principles-based' regulation. In simple terms, a principles-based system is one that merely states broad objectives to companies and then puts the onus on them to meet the objectives.

"A 'rules-based' regulatory system, like those the United States uses, relies on stating specific requirements or prohibiting certain actions by law."

PIA went on to say that proposals such as New

York's have been touted as a means of streamlining regulation.

But, they add, "principles-based regulation may represent either looser or tougher regulation, depending on how a company's performance is judged — and who is doing the judging — with regulators having much greater latitude to interpret just what constitutes compliance or violation.

"Principles-based regulation could grant very broad new power to regulators, while denying carriers the certainty of knowing specifically what is required of them."

Dinallo agrees that it might be possible to save a few bucks with a principles-based system — after all, the U.K.'s Financial Services Authority (FSA), an early adopter of the concept, gets by with far fewer regulators than the U.S. — something that might be a boon for smaller states, in particular.

But the plus side he sees is a system that's more risk-focused, more aimed at companies' business plans and outcomes.

"Our current system has the tendency at times to be very prescriptive and sort of box-checking," he said. "That doesn't really serve consumers all that well. I think we could use our resources a lot better and smarter this way."

Hmm. Smarter use of resources, huh? How do I know this isn't just a scheme to keep the companies happy so they'll stop seeking a federal regulator?

Dinallo, whose work history includes stints with the New York Attorney General's Office, Morgan Stanley and Willis Group Holdings, replies: "I think if someone looked at my history with the attorney general's office and so on, they would not really conclude that very easily."

He insists the change he proposes is a fairly modest and entirely positive one.

"I think it's healthy," Dinallo said. "You want people to be held to the standard of the spirit of the law as much as possible in our modern age.

"I've been on the other side," he added. "I've been there. I actually tried to do the right thing, but it would technically violate the letter of the law.

"One of the examples has been the anti-rebating laws," the superintendent said. "There are times when something that is probably well-intended and good for everybody could violate the anti-rebating laws. And nobody's trying to discriminate in that situation.

"For instance, contingent commissions. If you wanted to give back money, you've got to be careful. Sometimes it's gotten a little bit crazy."

On the other hand . . .

So principles-based regulation is an entirely positive idea with a proven track record.

Well, not really. The one place it's been tried is in England, where the experience of that nation's Financial Services Authority (FSA) has gotten mixed reviews.

It started out on a positive note, with Dan Waters, FSA's director of retail policy, declaring early on that the "move towards principles-based regulation means focusing on the outcomes that really matter rather than on procedural box-ticking. It also gives firms the flexibility to achieve these outcomes in the context of their particular business model."

The FSA — a combination of nine previous agencies that's the equivalent of our SEC, state insurance departments and a raft of other agencies — also promised to rip up half the rule book used to regulate all manner of financial services companies, in order to implement the European Union's recently enacted Markets in Financial Instruments Directive (MiFID).

As many Americans began singing the praises of the FSA approach, *The Wall Street Journal* published a bit of a debunking.

This past July, reporter Alistair MacDonald wrote, "Even as Britain's market watchdog, the Financial Services Authority, is lauded across the Atlantic, it and its new chief executive, a former investment banker, face tough questions at home about whether it does enough to protect individual investors.

"In some corners of the City of London, equivalent to Wall Street . . . the FSA is often looked on as a toothless tiger with little appetite for the harsh enforcement tactics often employed by U.S. regulators," he added.

As a British observer put it, "The FSA knows the

continued on next page

A better system? It's the principle of the thing

continued from page 5

professional investment market well and is aware of the commercial context that we all live in and doesn't want to stifle that commerce."

This laid-back approach appeals to those on this side of the Atlantic who believe that regulatory overkill is stifling innovation and driving business to other markets.

One instance cited in the *Journal* is the FSA's five-year investigation into the improper marketing and trading of shares in public funds called split-capital investment trusts. Retail investors lost millions of pounds when the values of these funds — which often had been sold as low-risk — plummeted when stock markets collapsed after 2000.

"Under a deal with the FSA, the banks and funds involved, without admitting blame, agreed to set up a [$400.8 million] compensation fund," MacDonald wrote.

Five people involved in selling the funds agreed to either retire or be temporarily barred from working in financial markets, but under terms of the deal, FSA didn't say they had violated regulations.

"The SEC would not have accepted such an outcome, indicating the generally weaker processes of enforcement in the British system," Jim Cousins, a member of Parliament, told the *Journal*. He called the FSA's response "extremely feeble."

An FSA spokesman says it was a "pragmatic approach to settling a very complex case" and that it did return to investors a portion of their losses.

Bradley Kading, president and executive director of the Association of Bermuda Insurers & Reinsurers, in a November talk in New York, used another comparison.

"Principles-based regulation is a great current topic," Kading said, adding that "if you look at the pronouncements ten years ago on finite risk," those too were principles-based.

In the end, in practice, the guidelines didn't prevent abuse, and the result was a series of investigations by the SEC and several state attorneys general.

State regulation

Come to think of it, except for finite risk and relatively few other such examples, insurance hasn't seen the kind of crises common to banking and other areas of financial services. If we're going to consider radical change to the current system of insurance regulation, maybe we should figure out why that is, then keep the system's good parts.

New York's Dinallo thinks he knows the secret.

"There's at least an argument," he said, "that the state-based system is working pretty well because we're much closer to the consumer, and we're much more aware of consumer issues.

"This has nothing to do with whether it's rules-based or principles-based, but . . . that's possibly why we haven't had problems with S&Ls or credit card issues or mutual fund issues or some of the subprime issues."

The Principles: page 7

Though he doesn't favor federal regulation, Dinallo said, a centralized federal agency would "do markets really well." But, he added, "It doesn't do individual consumer protection as well."

One of the reasons he feels the state-by-state system works so well is that each department specializes in its local market. But there's another factor: The states in a sense compete with each other to find best practices in each area. They also come together frequently to compare notes — such as at IRES's Career Development Seminar and at quarterly NAIC meetings.

"That's called the theory of plurality," Dinallo said, "the theory that the states come up with great ideas, [with the best of them] being adopted by the federal government, like Clinton's adoption of Wisconsin's welfare plan. There is a constant recirculating and discussion that is quite good, frankly."

So if principles-based regulation isn't all it's cracked up to be, the rest of the states will learn from New York's experience and stick to rules-based. And if it works out, we'll have a living, breathing model for everyone else to emulate.

"I think insurance regulators should feel empowered by this, not disenfranchised by it or intimidated by it, " says Superintendent Dinallo "It's a very positive opportunity for regulators to have a much more holistic view about what they're doing." ■

The New York Principles

Principles for the Industry

(1) A licensee shall lawfully conduct its business with integrity, due skill and diligence.

(2) A licensee shall take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.

(3) A licensee shall maintain adequate financial resources.

(4) A licensee shall observe proper standards of market conduct.

(5) A licensee shall pay due regard to the interests of its clients and treat them fairly.

(6) A licensee shall pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading.

(7) A licensee shall manage conflicts of interest fairly, both between the licensee and its clients and between clients.

(8) A licensee shall take reasonable care to ensure the appropriateness or suitability of its advice and discretionary decisions for any person or other entity that is entitled to rely upon such.

(9) A licensee shall ensure that the assets of any client for which the licensee is responsible are adequately protected.

(10) A licensee shall interact with the superintendent and other regulators in an open and cooperative way, and shall disclose to the superintendent any information relating to the licensee of which the superintendent would reasonably expect notice.

Principles for Regulators

(1) Regulators, and the regulatory system as a whole, should assess risk comprehensively and concentrate resources on the most important areas.

(2) Regulators should be accountable for the efficiency and effectiveness of their activities, while remaining independent and objective in the decisions they make.

(3) Guidance from the regulator should be readily available and easily understood.

(4) Interested parties should be consulted as appropriate prior to issuance of written guidance by the regulator.

(5) When developing new regulations, the regulator should consider how they can be implemented and enforced using existing systems and data to minimize the administrative burden on regulated entities.

(6) No investigation or inquiry should take place without an appropriate basis.

(7) The regulator should not require a regulated entity to provide unnecessary or needlessly duplicative information.

(8) All regulatory action should be proportionate to the issue being addressed.

(9) Regulators should allow and encourage competition and innovation, while ensuring against insolvency and protecting consumers and markets, and only intervene as necessary to protect consumers and markets.

(10) Regulators should respect the responsibility of a firm's senior management for its activities and for ensuring that its business complies with requirements and hold senior management responsible for risk management and controls.

From 'Good Hands' to Boxing Gloves

continued from page 1

with the insurer directly. When no attorney is involved, settle quickly. When an attorney gets involved, that means there is trouble down the road and don't play patty-cake.

The gist of these and other recommendations was captured in a very ill-advised PowerPoint presentation, which featured, for Allstate, a graphic of Allstate's iconic "good hands" logo turned into boxing gloves. We suppose it seemed like a good idea at the time – certainly a clever and arresting image. But we doubt anyone associated with Allstate or McKinsey would disagree now that it was a very bad idea. (**Editor's Note:** For more detail on the Allstate story, see Scott Hoober's feature in the November 2007 issue of *The Regulator*.)

> ***"The celebrated McKinsey slides are just one snapshot of the perpetual fight between insurers and trial lawyers."***

The idea is so bad, in fact, that Allstate has gone to the mat and even defied some judges in refusing to release the slides as part of discovery within court cases. Some plaintiff lawyers have seen the slides under cover of confidentiality, which is how the concepts have become public. This leads us to the rash of news stories that has flowed from McKinsey's liaison with Allstate in particular and big insurers in general.

Trial attorneys have latched on to the McKinsey slides as part of an argument that insurers are systematically defrauding customers by intentionally paying less on claims than they owe. If they can prove that all claimants are subject to an organized plan to improperly lowball claimants, then at best a lucrative class-action lawsuit could be filed, or at the least attorneys across the nation can win their individual cases more easily by pointing to this allegedly fraudulent strategy.

The leader in this fuss is the recent book, "*From Good Hands to Boxing Gloves — How Allstate Changed Casualty Insurance in America. The Definitive Guide to Handling Allstate Claims*" by David Berardinelli, Michael Freeman, and Aaron DeShaw. The book is written from Berardinelli's reading of the slides in one of his cases against Allstate. He could not copy the slides but certainly made copious mental notes that turned into the book.

If you work for an insurance company, don't run out to buy the $295 tome. The Web site touting the book says it is a "Legal textbook only available to plaintiffs lawyers. [Buyers] subject to approval."

We have spent untold hours talking with reporters about the story, trying to put things into context for them. Inevitably, our comments are either disregarded, or tossed in with industry apologists (often good company, such as Bob Hartwig from the Insurance Information Institute, but still . . .).

So, for the record, we thought it would be useful to write out our ideas on this issue, saving us from being labeled an industry shill, and saving us time from talking with reporters who are not particularly interested in the nuances of the debate. Herewith some thoughts:

The images in the McKinsey slides for Allstate were a colossal mistake. There is no way to put lipstick on this pig. The boxing gloves analogy is a terrible idea. It sends all the wrong messages, not just to consumers who might see the slides, but more importantly to Allstate employees. Even if the slides were meant for internal use only, this is a bad image. Even if the idea is only used in the context of fighting fraud, it is a bad idea. Especially if it is applied to claimants using lawyers, it is a bad idea.

We suspect that the errors go beyond the boxing gloves image, or else Allstate would not be fighting so hard to keep them secret. We believe that many insurers have done the work — both alone and with McKinsey — to prove that once a lawyer gets involved in a claim the prospect of trouble and cost rises exponentially, thus requiring a different claims-handling procedure.

This rather rational way of thinking for an insurance executive is extraordinarily hard to explain well, and we are almost certain that the McKinsey slides explain the concept terribly. And of course any effort to reduce claims looks miserly on paper.

Allstate and McKinsey should just release the slides and deal with the fallout. In one of the recent articles in which this author is used as a naïve industry apologist, Consumer Union's Bob Hunter makes a very astute comment: "The stuff has to come out sometime." We agree. Just let it go and deal with it. One of H.R. Haldeman's "modified limited hang-outs" just won't suffice. The longer the slides are secret, the bigger deal they appear.

Will they be taken out of context? Of course! That's happening now. So shape the debate, don't react to it. Public Relations 101. Allstate has taken it on the chin before. Remember the story about Scientology training at Allstate? We didn't think so. But there was a big *Wall Street Journal* article on such in 1995. How about the 2003 *Journal* article about Allstate's alleged abuse of claims tools such as Colossus? At the time these stories looked fatal. Now they're gone from the public consciousness, largely because the case was overstated or Allstate cleared up any internal problems and the point became moot.

The celebrated McKinsey slides are just one snapshot of the perpetual fight between insurers and trial lawyers. This fight is both healthy and very important to the proper functioning of the insurance process. For every insurance industry meeting seeking to lower claims costs, there is a *doppelganger* to be found in the trial bar community. Just look on the Web. At trialguides.com, the offer for Berardinelli's book comes with reference to many other books on how best to squeeze money out of insurers.

Such conferences are held all the time. The lawyers keep the insurers honest. If some foolish insurer implemented a formal scheme to pay less than it owed, lawyers would shove a billion dollar lawsuit down its throat. That's why we recently told *The Kansas City Star* that "Allstate is too big a company to carry out massive wrongdoing and get away with it." That comment sounds so naïve in the context of a story that outlines an alleged conspiracy to defraud policyholders, but in fact, the many cases in which the McKinsey slides figure so prominently only prove our point.

If this indeed is the "smoking gun," why has relatively little happened? Trial lawyers say it is because Allstate cleverly buys off its weak-kneed brethren and settles the cases before the truth can come to light. If that is so, what of David Berardinelli, he of the boxing gloves book fame? Couldn't he bring the hammer down on this wrongdoing? Of course not.

Because as much of a public relations nightmare as the slides may be, they fall short of a smoking gun pinning a claims conspiracy on Allstate (or other insurers). Rather, the slides are part of the continuum of insurer/trial lawyer struggle. Berardinelli's book is nothing more than a tactical guide to fighting Allstate. We contend this insurer/lawyer struggle is healthy and desirable.

For the trial bar, the insurers are the weight on the other side of the scales of justice. Insurers protect consumers from run-away fraudulent and excessive claims, and ensure that lawyers don't line their pockets while claimants collect pennies. Insurers want to keep costs down, not only for profit (not to mention mutual insurers that don't care about profits), but also to keep down prices so they can compete more effectively for customers.

Insurers that defraud their customers won't just lose lawsuits. They'll lose customers. Losing customers puts you out of business. Insurers have longer-term relationships with consumers than lawyers. Insurers have a greater stake than lawyers in building good relationships. Though some think insurers have a vested interest in low-balling claims, they in fact have no such thing. Insurers must keep claims costs down while delighting customers. Low-balling is a short-term strategy that just won't work.

Reporters: we hope this helps. And for those of you not interested in writing at this level of detail, please don't call!

Brian Sullivan is editor of the Auto Insurance Report, where this article first appeared. It is reprinted with permission. Information regarding Auto Insurance Report is available through www.riskinformation.com.

New IRES MC+ program up and running

by Gary Domer

November 12-14, 2007 will long be remembered by IRES members, for these were the dates on which the initial pilot class for our new MC+ program was held. The program, which was years in development, has now reached its final stages.

Twenty-nine regulators and industry participants successfully completed the class and will be awarded the Market Conduct Management (MCM) designation. In order to receive their designation, participants must complete a 20-hour class and pass a written examination.

> **“*The class is the first of its kind. It provides enrollees with the tools to actually conduct an examination in accordance with the NAIC Market Regulation Handbook.*”**

The class is the first of its kind in that it provides enrollees with the tools to actually conduct an examination in accordance with the NAIC Market Regulation Handbook and the IRES code of ethics. Since every state handles market conduct examinations somewhat differently, this course was designed to provide consistency in the way examinations are conducted.

This is the first class in which individuals will learn the mechanics of conducting a market conduct examination in an efficient and effective manner. It will also allow participants to learn how states handle different situations during the course of an examination.

One of the responsibilities of pilot class members is to evaluate the textbook and provide feedback to the MC+ subcommittee so that authors can make appropriate changes to the text to enhance the learning experience of future participants.

After completing the pilot program, Don Koch, of North Star Examinations and a Past President of IRES, said: “This is probably the best session on market conduct that I have ever attended.”

And Don was not alone. Larry Hawkins, Director of the Market Conduct Division Office of Financial Solvency for the Louisiana Department of Insurance, said: “I was extremely blessed to be one of the first participants in the MC+ ‘Best Practices of Conducting Market Conduct Examinations’ course. This course was the best I have ever participated in. From the textbook to the facilitators, it was excellent. I highly recommend the MC+ course to all EICs and those desiring to further their professional development.”

Larry’s comments pretty well reflect the thoughts of all those who completed the pilot course. IRES members should be extremely proud of this significant achievement.

Upcoming Classes

IRES will schedule four classes during 2008. The first class will be at the Wisconsin Insurance Department, March 17-19. The second is scheduled for Baton Rouge, LA in late May or early June. The third will be on the Wednesday, Thursday and Friday following the 2008 CDS in St. Louis in August. Our final 2008 class will be conducted in the fall at the Virginia Insurance Department in Richmond.

Only 30-35 participants will be permitted to enroll in each class. The class is open not only to regulators, but also to independent contractors, industry personnel and attorneys. ■

In the Beginning: The MCM Class of 2007

In Kansas City, MCM course instructor Paul Heacock [right] quizzes insurance examiners and industry executives about compliance with state insurance regulations.

The cost for each MCM class is as follows:

IRES Regulator member $395.00

Non-member regulator.............................. $495.00

IRES Sustaining member $750.00

IRES non-Sustaining Member $950.00

If you are interested in enrolling in one of the classes, please contact Susan Morrison at the IRES office (913-768-4700) so your name can be added to the list. In the near future there will be a registration form on the IRES Web site for enrolling online.

IRES CHAPTER NEWS

LOUISIANA — On December 5, the Chapter welcomed **Madonna Jones**, Market Analyst in the Market Conduct Division. Ms. Jones spoke on identity theft and provided participants with brochures from the Federal Trade Commission (FTC) and other agencies. The address also featured a PowerPoint presentation along with an FTC video. The session focused on the various ways identities can be stolen and detailed steps individuals can take to protect themselves. There were 30 attendees.
— Larry Hawkins; lhawkins@ldi.state.la.us

NEBRASKA — **Martin Swanson**, Attorney, with the Nebraska Department of Insurance, addressed the Chapter's October meeting. Martin's presentation addressed the changes to the Coordination of Benefits regulation and issues for upcoming legislation.
Holly Blanchard is the new Nebraska State Chair.
— Karen Dyke; kdyke@doi.state.ne.us

NEW YORK — **Charles Rapacciuolo**, Assistant Deputy Superintendent and Chief of the New York Insurance Department's Health Bureau, has been presented with the most prestigious honor in the field of insurance regulation, the NAIC's Dineen Award. The Award was presented to Mr. Rapacciuolo at the organization's most recent Quarterly Meeting. Mr. Rapacciuolo was a pioneer in the development of the NAIC's System for Electronic Rate and Form Filing, commonly known as SERFF. *— Maurice Morgenstern; MMorgens@ins.state.ny.us*

Rapacciuolo

C.E. News

The first class of the Society's new MC+ Program was held November 12-14, 2007 (see full story on page 10).

The Accreditation & Ethics Committee has approved 15 automatic continuing education hours for full attendance at this new program. The IRES CE Office will record the 15 hours automatically for those who currently hold an IRES designation and are required to submit continuing ed credit hours annually.

IRES is moving toward relying on electronic means of communication as the primary method of communicating with its membership.

The annual NICE continuing ed transcript, traditionally distributed via regular mail, will be replaced with an e-mail message reminding AIE and CIE designees to visit **www.go-ires.org** to view their continuing education credits.

2008 dues notices

When completing the back of your dues invoice, review it carefully to make sure your profile information is accurate, especially the e-mail address. It is vital that we have accurate contact information for all members. The e-mail address is especially important. Without it you may miss important notices regarding IRES educational programs and pending deadlines. An e-mail address is required to access the "members only" area of the IRES Web site.

If you haven't already provided an e-mail address, please contact the IRES office immediately at ireshq@swbell.net.

N · I · C · E

National IRES Continuing Education

The mandatory continuing education program for AIE and CIE designees

Improving the integrity of our public pensions

by Arthur Levitt, Jr.

The following article was excerpted from an address by former Securities and Exchange Commission (SEC) Chairman Arthur Levitt, Jr. before the New York Private Equity Conference in October 2007.

We cannot begin to improve the fiscal standing of public pension funds until we can accurately assess their financial health. And we cannot do that until we have accounting standards that give all stakeholders an accurate diagnosis. Currently, weak disclosure rules fail to reflect accurately the assets and liabilities of public pension plans.

Alternative and varied actuarial procedures can be abused to lower reported costs and liabilities. Consider what has happened in New Jersey. The state reported in a bond offering statement that it contributed $551 million to a pension fund for its teachers in fiscal year 2005. In an audited financial statement, the contribution was said to be $56 million. Yet, the actual figure was neither — it was zero.

Makes you wonder if New Jersey used the same accountant as Tony Soprano.

The Governmental Accounting Standards Board — or GASB — recently has taken some important steps toward improving reporting and transparency — especially with regards to liabilities for healthcare costs and other post-employment benefits. But GASB rules still lag far behind similar rules laid down for public companies.

It's time to improve accounting standards for public pension and healthcare obligations to make sure that all liabilities are reported in the balance sheets of state and municipal governments, not just in their footnotes. We need to stop the manipulation of actuarial projections and make them consistent and comparable from city to city. Earnings manipulation in the private sector and actuarial smoothing in the public are two sides of the same coin. And public pension funds that have been strenuous opponents of the former must be equally vocal in opposing the latter.

Quite simply, pension plans need to practice what they preach.

We need to continue to move to a system in which assumptions are realistic, in which a clear picture of a plan's financial health can be seen, and in which it's difficult for politicians to pressure accountants to squeeze numbers for their partisan gain.

We need stronger oversight and standard-setting. That will take a GASB with an independent funding source and with its members chosen not based on their membership in a particular constituency group, but on who is best qualified. To make this happen, the SEC should be the one who selects the trustees who choose GASB members.

And throughout the larger market for municipal securities, we need to greatly improve transparency, governance, accountability, and investor protections.

The Next Step

Once stronger rules and the independent regulatory body to enforce them are in place, we will begin to get a clearer picture of funds' fiscal situation. But better accounting standards and a stronger standard-setter are only part of the solution. Public pension boards themselves need to improve their governance to meet the great challenges pension systems now face — and to adequately assess the wide-range of investments they may make.

I am concerned that trustees lack the necessary information and education to oversee their employees and advisors. With growing latitude in asset allocation and the complexity of investment vehicles chosen, many trustees are inexperienced with the types of investments being made — whether they are structured financial products or complex trading formulas used by a certain hedge fund.

Or they lack the knowledge to be able to judge the risks the fund may be taking with a specific investment — or how to judge the conflicts of interest the experts they rely on may have. A recent survey of state pension systems found that of the 25 that reported results, only nine of them — a little more than one-third — had any formal education policy for members.

It is unrealistic to expect that trustees drawn from the ranks of employees would be experts in pension

continued on next page

Improving the integrity of our public pensions

continued from p. 13

finance and investing. But it is unfair to workers to put their retirements in the hands of a board that does not have the wherewithal to be true trustees.

To boost the quality and competence of the board, there should be, at the very least, mandatory minimum annual educational requirements for all pension trustees. Serious thought also should be given to mandating that a number of trustees be qualified as financially literate much in the same way Sarbanes-Oxley mandates those requirements for the audit committees of public companies.

Conflicts of Interest

I also am deeply concerned with the conflicts of interest seemingly built into public pension plans. Too often, politicians serving as trustees — or acting as the plan sponsor — use workers' retirements to make a political statement. Recently, this is taking the form of divestment from companies that do business with Iran or the Sudan.

Neither of these regimes merits a defense for their odious behavior and offensive policy statements. But it is wrong to play politics with the retirements of state workers. This is their money — deducted from their paychecks and from matching contributions that they have earned.

That's why the only investment consideration a trustee should make is whether or not a decision is good for the financial well-being of the pension plan. If using that criterion, divestment is warranted — then such a step should be taken. If not, then politicians should find other avenues through which to make political statements.

There are other instances where the overall health of the plan is not placed first and foremost. On many boards, trustees are beneficiaries of the plans themselves — representing large groups of workers and retirees. While having the best of intentions, too many trustees put short-term considerations for their — or their colleagues' — retirements above the long-term interest of the entire plan.

They are too slow to address the legitimate concerns of taxpayers, and — I fear — that they will inadvertently or — even at times intentionally — game the system. In response, it's important that boards include a balance of representation — not just with financially-qualified individuals, but also with enough disinterested, public-minded citizens sitting on them to ensure that the big picture is always in focus.

Of course, this is easier said than done. Democracy requires that all voices be heard — and when it comes to their retirements, people absolutely must have their say. However, having that sort of representation combined with the vast amounts of money at stake also creates the potential for abuse. This is inevitable. Trustees are human.

But the potential for this mischief-making is significantly increased if we put good people into a bad system. Right now, we have done just that.

With the escalating costs of political campaigns; the enormous sums of money to be invested; and the prospect of huge payoffs for private equity firms, hedge funds, and their agents if they are able to attract even a sliver of this capital, we have created a situation in which workers' retirement savings are being used for private gain.

What I'm talking about is pay-to-play — the selection of investment advisers to manage public funds based on their — or their representatives' — political contributions.

I first wrestled with this issue eight years ago during my tenure as SEC Chairman. After seeing the success we had in stopping pay-to-play in the municipal bond market, I believed that the time had come to do the same with public pension investing. I directed the staff of the SEC to investigate the situation, and they uncovered a whole raft of suspicious and criminal activity.

Since then, the amount of money in play has increased exponentially as has the pressure to produce out-sized returns. With thousands of hedge fund and private equity firms now in operation, the competition for investment dollars is fierce — as intense as the competition for campaign dollars.

Unsurprisingly, we have not seen a let-up in pay-to-play problems. It is not rare for a pension fund board member to call an investment adviser for the fund and ask them to make campaign contributions to a political official who will keep that pension board member on the board —- or if the trustee is an elected official himself, ask for a contribution outright.

And Chicago, Philadelphia, Illinois, Ohio, and California — not to mention New York State — are just some of the places that have had to deal with pay-to-play scandals over the past half-decade.

When I first spoke out about this in 1999, the state treasurers and Government Finance Officers Association claimed they'd take care of the problem — and strenuously opposed my proposal for reform. In light of these events, the time to end pay-to-play in public pension funds is long overdue. To that end, the SEC should revisit the 1999 proposal never acted upon to bar investment advisers from making political contributions to certain elected officials.

At the same time, the private sector should move aggressively on its own to end pay-to-play. First, public pension funds should follow the lead of funds like CalSTERS and the New Jersey State Investment Council and voluntarily decide to halt any business dealings with financial investment firms that contribute large sums to statewide elected officials who serve on their boards. They should fully disclose in what firms they are investing, what pension advisers they may be using, and any relationships that any trustee may have with them.

Second, pension consultants also need to be scrupulous in defending their independence. They must not only disclose to their clients any relationships they or their top executives may have with any investment firms. They also must do so in a way that is relevant and understandable. To that end, pension consultants should disclose any relevant potential conflicts to their pension plan clients each time they give advice on an investment — and be prepared to discuss the impact those relationships may have on their actual and perceived independence.

Third, private equity firms and hedge funds should undertake an effort along similar lines as the Municipal Securities Rulemaking Board's Rule G-37 and require the disclosure of any contributions by the firm or its executives to elected officials or party entities with any connection to public pension business. If a contribution is disclosed, that should trigger a two-year time-out from doing business with that client.

Moreover, I urge alternative investment firms to voluntarily reject the use of paying finder's fees to non-employees who deliver them pension fund business. This practice has already caused them perceptual and actual problems, and when you're dealing with close calls in such an important area as the management of a pension fund, coming down on the side of appearance as well as substance is important.

Let me be clear: I speak as someone who works for a private equity firm; my interest and experience lie with that. But these recommendations are equally valid – if not more so – for hedge funds and other investment vehicles, which are sometimes even less transparent. I hope that they would join with private equity in this effort.

Crossroads

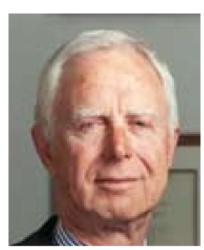
Right now, pension trustees are at a crossroads — they can decide right now to demand honest accounting and find a way to put pension plans on solid financial footing — or they can continue to rely on a mixture of actuarial sleight-of-hand and old-fashioned hope that plans will stay solvent.

They can make sure that trustee boards reflect the full breadth of stakeholders and that their members have the training and resources to ask the tough questions — or settle for a Darwinian type of management in which it's every man for himself.

And trustees can choose to help end pay-to-play once and for all – or prolong the life of a bad system that produces sub-standard results for retirees.

Ultimately, the choice before all of us — public pension trustees, the investment community, legislators, and regulators — is not just a matter of creating rules or imposing penalties. It's about creating a public pension system that considers the retirement funding of municipal employees a trust rather than an obligation, an unbreakable covenant rather than a legal mandate, a pledge to the future civil guardians of our society rather than a vehicle for extracting entitlements.

If we do that, we'll create a community that will protect — as a matter of honor and duty — the future livelihoods of millions of our nation's workers.



Arthur Levitt, Jr., the longest-serving chairman of the Securities and Exchange Commission (1993-2001), is a senior advisor to the Carlyle Group, a Washington, D.C.-based private equities firm.

This article, reprinted with permission, is excerpted from remarks delivered Oct. 30, 2007, before public pension officials.

Regulatory Roundup

by
Stroock & Stroock & Lavan LLP

Florida — Office of Insurance Regulation issues draft rule reducing collateral requirements for foreign reinsurers

On November 21, the Florida Office of Insurance Regulation issued Draft Rule No. 69O-144.007 that would implement new legislation, which gives the insurance commissioner discretion in allowing unaccredited reinsurance companies to conduct business in Florida without having to post 100% collateral.

Under the Draft Rule, with respect to reinsurance contracts entered into or renewed on or after January 1, 2008, a ceding insurer may elect to take credit for reinsurance ceded to an alien "eligible reinsurer" in an amount tied to the reinsurer's rating.

To be approved as an eligible reinsurer, the assuming insurer must, among other things, possess a surplus in excess of $100 million and maintain, on a stand-alone basis separate from its parent or any affiliated entities, a secure financial strength rating from at least two recognized rating agencies.

Alien reinsurers traditionally were required to post collateral for the full amount of the risk transferred in order for the ceding insurer to get favorable accounting credit for reinsurance ceded. The Florida Office held a workshop on November 26 to seek public input whether the Draft Rule will lead to increased reinsurance capacity thereby reducing the cost of insurance for Florida homeowners.

To view Draft Rule No. 69O-144.007, visit **www.floir.com/pdf/Reinsurance_Coll_Rule_Draft_112107.pdf**.

The New York-based Stroock & Stroock & Lavan LLP Insurance Practice Group includes Donald D. Gabay, Martin Minkowitz, William D. Latza and William Rosenblatt. The Insurance Practice Group also includes insurance finance consultants Vincent Laurenzano and Charles Henricks. They gratefully acknowledge the assistance of Robert Fettman, an associate in the group. This column is intended for informational purposes only and does not constitute legal advice.

New York — Insurance Department issues draft principles-based regulation

On November 5, the New York Insurance Department (the "Department") released a draft regulation (the "Regulation") that would make New York the first state to establish principles-based regulation, according to a press release issued by the Department on the same date.

The Regulation, which seeks to encourage licensees to think in broader terms about the basic principles underlying the existing requirements, lists ten principles for industry and ten for regulators.

Industry principles, which do not pre-empt existing statutory or regulatory requirements, mandate that each licensee comply with the following requirements:

(1) conduct its business with integrity, due skill, and diligence; (2) take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems; (3) maintain adequate financial resources; (4) observe proper standards of market conduct; (5) pay due regard to the interests of its clients and treat them fairly; (6) pay due regard to the information needs of its clients, and communicate information to them in a way that is clear, fair and not misleading; (7) manage conflicts of interest fairly, both between the licensee and its clients and between clients; (8) take reasonable care to ensure the appropriateness or suitability of its advice and discretionary decisions for any person or other entity that is entitled to rely upon such; (9) ensure that the assets of any client for which the licensee is responsible are adequately protected; and (10) interact with the superintendent

and other regulators in an open and cooperative way, and shall disclose to the superintendent any information relating to the licensee of which the superintendent would reasonably expect notice.

The Department has also developed a proposed list of principles for regulators, which will establish a baseline for interactions between the Department and regulated entities, and are intended to focus regulatory action on key areas of risk, while fostering competition and innovation.

The regulator's principles, however, will be issued as a Circular Letter, which is advisory in nature with no binding effect. To view the draft regulation and the Insurance Department's press release, visit the New York Insurance Department's Web site at **www.ins.state.ny.us**.

(**Editor's Note**: See Scott Hoober's feature, p. 1.)

United States — House of Representatives passes Homeowners Defense Act

On November 8, the U.S. House of Representatives passed H.R. 3355, the Homeowners Defense Act of 2007 with the declared purpose of providing a federal backstop for state-sponsored insurance programs designed to assist homeowners prepare for and recover from damage caused by natural catastrophes.

The Act would have two main components. The first component is the National Catastrophe Risk Consortium, which would be a federal non-governmental entity in which states could choose to participate.

Its main functions would include:

(i) gathering an inventory of catastrophe risk obligations held by participating states' reinsurance funds, risk pools, or primary insurance corporations; (ii) issuing securities and other financial instruments linked to the catastrophe risk in the capital markets; (iii) entering into reinsurance contracts with private parties, on a conduit basis; (iv) acting as a centralized repository of state risk information accessible by private-market participants interested in underwriting risk-linked securities or entering into reinsurance contracts; and (v) using an acquired catastrophe risk database to perform research and analysis that encourages standardization of the risk-linked securities market.

The second component of the Act is the establishment of the National Homeowners' Insurance Stabilization Program at the Treasury Department. Through the Stabilization Program, the Treasury Department would provide medium- and long-term loans to state insurance programs as liquidity loans or catastrophic loans.

A qualified reinsurance program could, under prescribed circumstances, be eligible for a five-to-ten year liquidity loan at, generally, three percentage points above the applicable Treasury rate. A catastrophe loan of at least ten years would be available to a qualified reinsurance program under prescribed circumstances at not less than 20 basis points above the applicable Treasury rate. A substantially identical bill was introduced in the United States Senate on November 7, 2007. To view H.R. 3355, visit the House of Representatives Web site at **www.house.gov**.

Washington — Voters Approve Referendum 67

On November 7, Washington voters approved Referendum 67 ("R-67"), which allows insureds in some instances to collect triple damages if an insurer unreasonably denies a claim or violates unfair practice rules.

According to news reports, the battle on the fate of R-67 was one of the most contentious and expensive in state history with campaign finance reports showing that opponents and supporters spent a combined $14.5 million leading up to the vote. Supporters claimed that R-67 would encourage auto and property/casualty insurers to investigate and settle cases in a reasonable time frame and for reasonable amounts.

Opponents countered that it was an unnecessary magnet for unfounded lawsuits and would drive up insurance rates. The law took effect Dec. 6, 2007.

To view Referendum 67, **visit www.secstate.wa.gov/elections/initiatives/text/r067.pdf.**

Casual Observations

Principles-based regulaton: Daffodils, champagne & caviar?

"An [advertisement] is no longer the words and images inserted between prescribed risk warnings. The full canvas is yours with no constraints on the creative process. So if you are setting Wordsworth to rap, you need not wander or be lonely, but can take in the beauty of the daffodils in the comfort of a hot air balloon with chilled champagne and caviar."

— Tony Katz, FSA Manager, on the impact of principles-based regulation on financial-services advertising in the U.K.

Every now and again, we find ourselves pondering principles-based regulation, trying to figure out if we really get it. This month's lead article by Scott Hoober prompted us to visit the issue once again. We're still not sure we get it — but we keep trying.

As Hoober notes in his piece, the idea of principles-based regulation began to generate interest in the U.S. after the Financial Services Authority (FSA) adopted the approach in the late 1990s. This U.K. super-agency, formed in 1997, regulates banks, insurers and securities firms under one roof, a veritable one-stop approach to financial services regulation.

The principles-based approach in the U.K. developed, as we understand it, when the new agency found itself confronting a myriad of arcane rules and regulations with too few people to enforce them. In addition, it was thought that introducing a few overriding principles could help the new agency focus on consumer protection, not picayune rules.

The approach has met with some success. The FSA, for example, has significantly scaled back its rulebook, putting the onus on insurers to chronicle how their products, underwriting standards, advertising, and claims-handling measures stack up against the guiding principles developed by the Authority.

Moreover, the Authority hopes to trim 10% of its workforce by the year 2010, largely as a result of its principles-based approach. The FSA currently employs about 2,700, a number roughly equivalent to the workforce of the three largest state insurance departments in the U.S. To be fair, the U.K. is about one-fifth the size of the United States.

Enter U.S. insurance regulators, specifically, New York Superintendent Eric Dinallo who tells *The Regulator* he has no intention of scaling back New York rules and regulations — at least, not initially — should a principles-based approach be adopted. The New York-proposed principles, he says, would simply overlay existing rules and regulations. As a result, regulators would be in a better position to deal with those insurers prone to follow the letter of the law, but not its spirit.

We've always had a certain fondness for rules — even picayune ones. It's a fondness that probably harkens back to our school days. However, we readily acknowledge that for certain insurance functions (e.g., new product development, advertising), no set of rules can keep pace with the private sector's capacity to bend them.

It wasn't that long ago that we thought introducing a principles-based approach to the regulatory process would be like supplanting our criminal code with the Ten Commandments. Now that Hoober's excellent piece has helped us learn more about the issue, we've softened our stance.

But we still want to know: *When can we expect the daffodils, champagne and caviar?*

— W.C.

ST. LOUIS

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CANCELLATIONS AND REFUNDS

Your registration fee minus a $25 cancellation fee can be refunded if we receive written notice before July 10, 2008. No refunds will be given after that date. However, your registration fee may be transferred to another qualifying registrant. Refund checks will be processed after Sept. 1, 2008.

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Seating for all events is limited. IRES reserves the right to decline registration for late registrants due to seating limitations.

Call for more details: 913-768-4700. Or see IRES web site: www.go-ires.org

BULLETIN BOARD

√ 2008 IRES dues renewals have been mailed. Remember: AIE and CIE designations require current membership as well as compliance with continuing ed requirements. Address changed lately? Be sure to notify our office: 913-768-4700.

√ We are pleased to announce Cristi S. Owen of Alabama as the newest member of the IRES Board of Directors.

√ Register now for the 2008 St Louis CDS. Don't delay — hotel rooms and seating availability go quickly! **See registration form, page 19.**

√ Charlie Rapacciuolo, CIE, assistant deputy superintendent and bureau chief for the NYS Insurance Department,was awarded the NAIC's prestigious Robert Dineen Award for regulatory excellence. Rapacciuolo, a long-time IRES member, played an instrumental role in the implementation of reforms at the NAIC's Speed to Market Task Force and to the System for Electronic Rate and Form Filing (SERFF).

In the next REGULATOR:

Fighting Insurance Fraud in a Post-Katrina Environment

Bulletin Board items must be no more than 75 words, and must be accompanied by the sender's name, e-mail address and phone contact information. Submit plain, unformatted text (no special font stylings, underlined hyperlinks or special margins). Email to Wayne Cotter at: quepasa1@optonline.net.

√ IRES members enrolled in state pension plans owe it to themselves to read *Promises with a Price,* a Pew Center study on public pensions released on December 18 (www.pewtrusts.org/news_room_ektid32368.aspx). Also, see the article on public pensions by Arthur Levitt, Jr. in this issue of ***The Regulator.*** It's your future!

At press time, Bloomberg Markets published an article highly critical of state insurance regulation. The article, in this editor's opinion, is highly flawed. Judge for yourself at: **www.bloomberg.com/apps/news?pid=20601109&sid=aZ6fBu_fvkBc&refer=home**

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New York's better idea? See story, page 1.