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IRREGULATORY  
REVIEW COMMISSION

IRRC Number: #2263

# Regulatory Analysis Form

(1) Agency  
Insurance Department

(2) I.D. Number (Governor's Office Use)  
11-204

(3) Short Title  
Safeguarding Insurer Securities

(4) PA Code Cite  
31 Pa. Code, Chapter 148a

(5) Agency Contacts & Telephone Numbers  
Primary Contact: Peter J. Salvatore, Regulatory Coordinator, 1326 Strawberry Square, Harrisburg, PA 17120, (717) 787-4429  
Secondary Contact: Elaine M. Leitzel, Program Analyst, Office of Regulation of Companies, 1345 Strawberry Square, Harrisburg, PA 17120 (717) 787-8840

(6) Type of Rulemaking (check one)  
 Proposed Rulemaking  
 Final Order Adopting Regulation  
 Final Order, Proposed Rulemaking Omitted

(7) Is a 120-Day Emergency Certification Attached?  
 No  
 Yes: By the Attorney General  
 Yes: By the Governor

(8) Briefly explain the regulation in clear and nontechnical language.  
The regulations prescribe permissible methods of holding securities owned by the various types of insurance entities regulated by the Department (insurers) and requirements for insurer securities held under custodial agreements. Securities owned by insurers are liquid assets held to allow the payment of the insurer's obligations as they come due. Insurers must comply with the regulations in order for their securities to be reported as assets (admitted assets) in financial statements filed with the Department. This rulemaking replaces the regulations relating to insurer securities initially adopted June 12, 1981, with updated regulations. This rulemaking will update the regulations to recognize changes in the securities marketplace and to better safeguard against the theft or loss of insurer securities. The updated regulations are the result of the Department's consideration of the need for domestic insurers to participate efficiently in the securities market while preserving the value and safety of their assets. Specific protections have been added as a result of a review by state insurance regulators of the circumstances in a recent highly publicized case where a number of insurer insolvencies were caused by the alleged theft of their securities. The Department participated in the review of this case, known as the Frankel case, which also resulted in the update of a model regulation relating to insurer securities adopted by the National Association of Insurance Commissioners (NAIC).

(9) State the statutory authority for the regulation and any relevant state or federal court decisions.  
This rulemaking is proposed under the authority of sections 206, 506, 1501 and 1502 of The Administrative Code of 1929 (71 P. S. §§ 66, 186, 411 and 412) relating to the general rulemaking authority of the Department; The Insurance Department Act of 1921 (40 P. S. §§ 1-324); The Insurance Company Law of 1921 (40 P. S. §§ 341-991); 40 Pa.C.S. §§ 6101-6127 and 6301--6335 (relating to hospital plan corporations and professional health services plan corporations); the Voluntary Nonprofit Health Service Act of 1972 (40 P.S. §§ 1551-1568); the Fraternal Benefit Society Code (40 P. S. §§ 1142-101--1142-701); the Health Maintenance Organization Act (40 P.S. §§ 1551-1567); the Pennsylvania Fair Plan Act (40 P.S. §§ 1600.101-1600.502); the act of October 15, 1975, P.L. 390, No. 111 (40 P.S. §§ 1301.801-811) (relating to joint underwriting associations).

(10) Is the regulation mandated by any federal or state law or court order, or federal regulation? If yes, cite the specific law, case or regulation, and any deadlines for action.

No.

(11) Explain the compelling public interest that justifies the regulation. What is the problem it addresses?

This rulemaking is needed to update the regulations to better safeguard against the theft or loss of insurer securities and to establish up-to-date, comprehensive and clear requirements for insurer securities held under custodial arrangements.

(12) State the public health, safety, environmental or general welfare risks associated with nonregulation.

There are no public health, safety, environmental or general welfare risks associated with this rulemaking.

(13) Describe who will benefit from the regulation. (Quantify the benefits as completely as possible and approximate the number of people who will benefit.)

Domestic insurers and custodians will benefit from the improved clarity and efficiency of the regulation, including the consolidation of three separate affidavit forms and provisions for electronic reporting. The general public will benefit to the extent that these improvements enhance regulatory safeguards against the loss or theft of assets held for payment of insurance obligations.

Regulation Analysis Form

(14) Describe who will be adversely affected by the regulation. (Quantify the adverse effects as completely as possible and approximate the number of people who will be adversely affected.)

No adverse effects are anticipated as a result of this rulemaking.

(15) List the persons, groups or entities that will be required to comply with the regulation. (Approximate the number of people who will be required to comply.)

Domestic insurers (including health maintenance organizations and preferred provider organizations) will be required to comply with the regulation in order for their assets to be admissible in financial statements filed with the Department. Custodians who wish to hold insurer securities will be required to agree to the terms and conditions prescribed in the regulation for custodial agreements. As of December 19, 2001, about 320 domestic insurers would be required to comply with the regulation.

(16) Describe the communications with and input from the public in the development and drafting of the regulation. List the persons and/or groups who were involved, if applicable.

The Department requested comments from The Insurance Federation of Pennsylvania, Inc., the Pennsylvania Association of Mutual Insurance Companies, the Managed Care Association of Pennsylvania, the Pennsylvania Fraternal Congress, Highmark, Inc., Capital Blue Cross, Independence Blue Cross and the Hospital Service Association of Northeastern Pennsylvania in the drafting of the regulation. The comments received in response to the Department's request were considered in the development of this rulemaking.

(17) Provide a specific estimate of the costs and/or savings to the regulated community associated with compliance, including any legal, accounting or consulting procedures which may be required.

The updated reporting requirements in this regulation will impose no significant additional costs on the regulated community.

**(18) Provide a specific estimate of the costs and/or savings to local governments associated with compliance, including any legal, accounting or consulting procedures which may be required.**

**There are no costs or savings to local governments associated with this rulemaking.**

**(19) Provide a specific estimate of the costs and/or savings to state government associated with the implementation of the regulation, including any legal, accounting, or consulting procedures which may be required.**

**The efficiency of the Department's review of custodial agreements in the conduct of financial examinations will be improved to the extent this rulemaking promotes compliance with acceptable terms and conditions for custodial agreements and timely availability of complete and accurate information relating to insurer security accounts.**

**Regulatory Analysis Form**

(20) In the table below, provide an estimate of the fiscal savings and costs associated with implementation and compliance for the regulated community, local government, and state government for the current year and five subsequent years.

	<b>Current FY Year</b>	<b>FY +1 Year</b>	<b>FY +2 Year</b>	<b>FY +3 Year</b>	<b>FY +4 Year</b>	<b>FY +5 Year</b>
<b>SAVINGS:</b>	\$	\$	\$	\$	\$	\$
<b>Regulated Community</b>						
<b>Local Government</b>						
<b>State Government</b>						
<b>Total Savings</b>						
<b>COSTS:</b>						
<b>Regulated Community</b>						
<b>Local Government</b>						
<b>State Government</b>						
<b>Total Costs</b>						
<b>REVENUE LOSSES:</b>						
<b>Regulated Community</b>						
<b>Local Government</b>						
<b>State Government</b>						
<b>Total Revenue Losses</b>						

(20a) Explain how the cost estimates listed above were derived.

There are no significant measurable costs or savings associated with this rulemaking.

**Regulation Title**

(20b) Provide the past three-year expenditure history for programs affected by the regulation. N/A

Program	FY -3	FY -2	FY -1	Current FY

(21) Using the cost-benefit information provided above, explain how the benefits of the regulation outweigh the adverse effects and costs.

This rulemaking will impose no significant additional costs on affected parties or the Department. Domestic insurers and custodians will benefit from the improved clarity and efficiency of the regulation, including the elimination of three separate affidavit forms and provisions for electronic reporting. The general public will benefit to the extent that these improvements enhance regulatory safeguards against the loss or theft of assets held for payment of insurance obligations.

(22) Describe the nonregulatory alternatives considered and the costs associated with those alternatives. Provide the reasons for their dismissal.

This rulemaking is the most efficient means to establish requirements to safeguard insurer securities.

(23) Describe alternative regulatory schemes considered and the costs associated with those schemes. Provide the reasons for their dismissal.

This rulemaking updates an existing regulation. No other regulatory schemes were considered.

Regulatory Analysis Form

(24) Are there any provisions that are more stringent than federal standards? If yes, identify the specific provisions and the compelling Pennsylvania interest that demands stronger regulation.

No.

(25) How does this regulation compare with those of other states? Will the regulation put Pennsylvania at a competitive disadvantage with other states?

The regulation is substantially similar to a model regulation developed by the NAIC. The model regulation or similar regulations have been adopted by 21 other states. This rulemaking will not put Pennsylvania at a competitive disadvantage with other states.

(26) Will the regulation affect existing or proposed regulations of the promulgating agency or other state agencies? If yes, explain and provide specific citations.

This rulemaking updates an existing regulation of the promulgating agency. No other regulations are affected.

(27) Will any public hearings or informational meetings be scheduled? Please provide the dates, times, and locations, if available.

No public hearings or informational meetings are anticipated.

(28) Will the regulation change existing reporting, record keeping, or other paperwork requirements? Describe the changes and attach copies of forms or reports which will be required as a result of implementation, if available.

The proposed rulemaking reduces paperwork to the extent that it replaces three different affidavit forms required under the current regulations with one consolidated form. The proposed rulemaking also may reduce paperwork by allowing reports and confirmations to be transmitted in electronic form. The proposed rulemaking will require custodial agreements to provide for notice to the Department if the agreement is terminated or if 100% of the assets are withdrawn from one or more of an insurer's custodial accounts. The reporting and record-keeping requirements in the proposed rulemaking are necessary to safeguard insurer securities from loss or theft and to allow the Department to readily verify insurer assets when conducting financial examinations under the law.

(29) Please list any special provisions which have been developed to meet the particular needs of affected groups or persons including, but not limited to, minorities, elderly, small businesses, and farmers.

Affected parties will have one year from the effective date of the final-form rulemaking to bring existing custodial agreements into compliance with the regulation.

(30) What are the anticipated effective date of the regulation; the date by which compliance with the regulation will be required; and the date by which any required permits, licenses or other approvals must be obtained?

The regulation will take effect after a 30-day public comment period and upon final approval by the legislative standing committees, the Independent Regulatory Review Commission, the Attorney General and final publication in the *Pennsylvania Bulletin*.

(31) Provide the schedule for continual review of the regulation.

All Department regulations are reviewed for continued effectiveness on a triennial basis.



<p>CDL-1</p> <p style="text-align: center;"><b>FACE SHEET FOR FILING DOCUMENTS WITH THE LEGISLATIVE REFERENCE BUREAU</b></p> <p style="text-align: center;">(Pursuant to Commonwealth Documents Law)</p> <p style="text-align: center; font-size: 2em; font-family: cursive;"># 2263</p>	<p>RECEIVED</p> <p>2002 APR -1 PM 9:37</p> <p>LEGISLATIVE REFERENCE BUREAU LEGISLATIVE DOCUMENTARY REVIEW COMMISSION</p>
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DO NOT WRITE IN THIS SPACE

<p>Copy below is hereby approved as to form and legality. Attorney General</p> <p>By: <u><i>Christina S. Quinn</i></u> (Deputy Attorney General)</p> <p style="text-align: center; font-size: 1.5em;">MAR 27 2002</p> <p style="text-align: center;">Date of Approval</p> <p><input type="checkbox"/> Check if applicable. Copy not approved. Objections attached.</p>	<p>Copy below is hereby certified to be a true and correct copy of a document issued, prescribed or promulgated by:</p> <p style="text-align: center;"><b>Insurance Department</b></p> <p style="text-align: center;">(AGENCY)</p> <p>DOCUMENT/FISCAL NOTE NO. <u>11-204</u></p> <p>DATE OF ADOPTION: _____</p> <p>BY: <u><i>M. Diane Koken</i></u> (M. Diane Koken Insurance Commissioner</p> <p>TITLE: _____ (EXECUTIVE OFFICER, CHAIRMAN OR SECRETARY)</p>	<p>Copy below is hereby approved as to form and legality. Executive or Independent Agencies</p> <p>BY: <u><i>John V. Turner</i></u></p> <p style="text-align: center; font-size: 1.5em;">3/7/02</p> <p style="text-align: center;">DATE OF APPROVAL</p> <p style="text-align: center;">(DEPUTY GENERAL COUNSEL) (<del>CHIEF COUNSEL, INDEPENDENT AGENCY</del>) (STRIKE INAPPLICABLE TITLE)</p> <p><input type="checkbox"/> Check if applicable. No Attorney General approval or objection within 30 days after submission.</p>
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**NOTICE OF PROPOSED RULEMAKING**

**INSURANCE DEPARTMENT**

**31 Pa. Code, Insurance, Part VIII**  
**Miscellaneous Provisions**  
**Chapter 148a**  
**§§148a.1-148a.5**

**SAFEGUARDING INSURER SECURITIES**

## PREAMBLE

The Insurance Department (Department) proposes to delete Chapter 148 (relating to securities held under custodial agreements and participation by insurers in depository trust companies and federal reserve book entry systems) and adopt Chapter 148a (relating to safeguarding insurer securities) to read as set forth in Annex A. This rulemaking is proposed under the authority of sections 206, 506, 1501 and 1502 of The Administrative Code of 1929 (71 P. S. §§ 66, 186, 411 and 412) relating to the general rulemaking authority of the Department; The Insurance Department Act of 1921 (40 P. S. §§ 1-324); The Insurance Company Law of 1921 (40 P. S. §§ 341-991); 40 Pa.C.S. §§ 6101-6127 and 6301--6335 (relating to hospital plan corporations and professional health services plan corporations); the Voluntary Nonprofit Health Service Act of 1972 (40 P.S. §§ 1551-1568); the Fraternal Benefit Society Code (40 P. S. §§ 1142-101--1142-701); the Health Maintenance Organization Act (40 P.S. §§ 1551-1567); the Pennsylvania Fair Plan Act (40 P.S. §§ 1600.101-1600.502); the act of October 15, 1975, P.L. 390, No. 111 (40 P.S. §§ 1301.801-811) (relating to joint underwriting associations). The regulations prescribe permissible methods of holding securities owned by the various types of insurance entities regulated by the Department (insurers) and requirements for insurer securities held under custodial agreements. Insurers must comply with the regulations in order for their securities to be reported as assets (admitted assets) in financial statements filed with the Department.

### *Purpose*

This rulemaking replaces the regulations relating to insurer securities initially adopted June 12, 1981, with updated regulations. Securities owned by insurers are liquid assets held to allow the payment of the insurer's obligations as they come due. This rulemaking will update the regulations to recognize changes in the securities marketplace and to better safeguard against the theft or loss of insurer securities. The updated regulations are the result of the Department's consideration of the need for domestic insurers to participate efficiently in the securities market while preserving the value and safety of their assets. Specific protections have been added as a result of a review by state insurance regulators of the circumstances in a recent highly publicized case where a number of insurer insolvencies were caused by the alleged theft of their securities. The Department participated in the review of this case, known as the Frankel case, which also resulted in the update of a model regulation relating to insurer securities adopted by the National Association of Insurance Commissioners (NAIC).<sup>1</sup> Therefore, this rulemaking is needed to update the regulations to better safeguard against the theft or loss of insurer securities and to establish up-to-date, clear requirements for insurer securities held under custodial arrangements.

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<sup>1</sup> The updated Model Regulation on the Use of Clearing Corporations and Federal Reserve Book-Entry System by Insurance Companies was adopted in October 2001.

### *Explanation of Regulatory Requirements*

Section 148a.1 (relating to definitions) includes definitions of “agent,” “clearing corporation,” “custodian,” “Federal Reserve book-entry system,” and “securities” consistent with the definitions in the NAIC model regulation. The definition of “insurer” expands the definition in the existing regulations to add health maintenance organizations and preferred provider organizations and to clarify the scope of the regulations with respect to other regulated entities. This broader definition is needed to clearly apply the safeguards in the regulations to all types of insurers. Definitions of “instructions” and “authorized person” are included to clarify who may issue instructions on behalf of an insurer to a custodian and the proper form of the instructions. The definition allows both written and verbal instructions subject to certain criteria and conditions. Definitions of “investment company” and “investment company securities” are included to differentiate between investments in mutual funds and other types of securities. Finally, the terms “foreign country,” “registered form,” and “state” are defined to clarify these terms for purposes of the regulations.

Section 148a.2 (relating to permissible methods of holding securities) lists what types of entities, as defined in the regulations, are permitted to hold insurer securities and how the securities may be held. An insurer may hold its own securities in definitive certificates. A custodian may hold insurer securities under a written agreement if the agreement contains at least the terms and conditions prescribed by the regulations. Investment company (mutual fund) securities may be held by the investment company that issued the securities if specific requirements are met. Insurer securities also may be held by a state treasurer or other state regulatory authority if required as a condition of doing business in that state.

Section 148a.3 (relating to requirements for custodial agreements) requires an agreement between an insurer and a custodian to be in writing, properly authorized by both parties and to contain the provisions listed in § 148a.3(b), as follows: Section 148a.3(b)(1) requires the securities to be deposited and withdrawn as instructed by the insurer and provides for verbal instructions to be superseded by written instructions in the event of a discrepancy or dispute. In addition, Section 148a.3(b)(2) prohibits the custodian from having a security interest or lien in the securities because the securities must be available to the insurer immediately upon request. Section 148a.3(b)(3) allows the custodian to utilize an agent for electronic transactions if the custodian enters into a written agreement with the agent and remains ultimately responsible for the safekeeping of the securities and for compliance with the provisions of the custodial agreement. Sections 148a.3(b)(4)-(8) establish how securities may be registered, held and identified in the custodian’s records according to the form of the securities. Sections 148a.3(b)(9)-(11) relate to a custodian’s duties to maintain adequate insurance protection as required by banking regulators and to indemnify the insurer for any loss of the securities under the circumstances and conditions described in the regulations. The custodian’s obligation to indemnify the insurer includes the immediate replacement of the securities or the value of the securities, plus the value of any loss of rights or privileges resulting from the loss of the securities. Section 148a.3(12) requires the custodian to notify the Department if the

agreement is terminated or if 100% of the assets are withdrawn from one or more of the insurer's custodial accounts. This provision was added to safeguard against securities fraud or theft as a result of a review of the afore-mentioned Frankel case. A similar provision has been added to the NAIC model regulation. Sections 148a.3(b)(13)-(17)(ii) establish record-keeping and reporting duties under custodial agreements. These requirements provide the insurer with timely information needed to monitor custodial account transactions, be informed about audits and reports on the custodian's trust accounts and system of internal controls, and to have sufficient information to comply with financial statement reporting and audit requirements. In addition, these sections assure that the custodian is aware of its responsibility to provide the Department with timely access to information required in a financial examination conducted under Article IX of The Insurance Department Act of 1921 (40 P.S. §§ 323.1—323.8). Finally, § 148a.3(17)(iii) prescribes the form of an affidavit that must be provided by the custodian upon the insurer's request. The affidavit is needed to confirm the value and location of insurer securities for purposes of financial examinations conducted by the Department. The requirements relating to custodial agreements will clarify and strengthen regulatory provisions for the protection and availability of insurer securities held under these arrangements.

Section 148a.4 (relating to requirements for investment company securities) establishes the conditions under which an insurer's investment company securities may be held by the investment company that issued the securities. The conditions assure that the investment company provides at least monthly reports of transfers of investments to or from the insurer's account and maintains adequate records for financial statement reporting and financial examination purposes.

Section 148a.5 (relating to penalty and existing custodial agreements) establishes that failure to comply with the regulations will result in the insurer's securities being nonadmitted assets for purposes of financial statements filed with the Department. The section also allows insurers one year to bring existing agreements into compliance with the regulations.

#### *External Comments*

In drafting this proposed rulemaking, the Department requested comments from The Insurance Federation of Pennsylvania, Inc., the Pennsylvania Association of Mutual Insurance Companies, the Managed Care Association of Pennsylvania, the Pennsylvania Fraternal Congress, Highmark, Inc., Capital Blue Cross, Independence Blue Cross and the Hospital Service Association of Northeastern Pennsylvania.. The comments received in response to the Department's request were considered in the development of this rulemaking.

#### *Fiscal Impact*

The proposed safeguards and reporting requirements for custodial arrangements are not materially different from existing regulatory requirements and will impose no

significant additional costs on insurers or custodians. Department costs in conducting financial examinations associated with the review of custodial arrangements and verification of insurer securities will not increase as a result of this rulemaking. This rulemaking will not affect costs to political subdivisions. While this rulemaking has no immediate fiscal impact on the general public, the general public will benefit to the extent that adoption of this rulemaking enhances regulatory safeguards against the loss or theft of securities held by insurers to meet obligations under insurance policies.

#### *Paperwork*

The proposed rulemaking reduces paperwork to the extent that it replaces three different affidavit forms required under the current regulations with one consolidated form. The proposed rulemaking also may reduce paperwork by allowing reports and confirmations to be transmitted in electronic form. The proposed rulemaking will require custodial agreements to provide for notice to the Department if the agreement is terminated or if 100% of the assets are withdrawn from one or more of an insurer's custodial accounts. The reporting and record-keeping requirements in the proposed rulemaking are necessary to safeguard insurer securities from loss or theft and to allow the Department to readily verify insurer assets when conducting financial examinations under the law.

#### *Persons Regulated*

The proposed rulemaking applies to all types of domestic insurers regulated by the Department. Custodians and investment companies holding insurer securities also are affected by the proposed rulemaking to the extent it prescribes the terms and conditions of agreements entered into with domestic insurers.

#### *Contact Person*

Questions or comments regarding this proposed rulemaking may be addressed in writing to Peter J. Salvatore, Regulatory Coordinator, Office of Special Projects, 1326 Strawberry Square, Harrisburg, PA 17120, (717) 787-4429 within 30 days following the publication of this notice in the *Pennsylvania Bulletin*. Questions or comments also may be e-mailed to [psalvatore@state.pa.us](mailto:psalvatore@state.pa.us) or faxed to (717) 772-1969.

#### *Regulatory Review*

Under section 5(a) of the Regulatory Review Act (71 P.S. § 745.5(a)), on April 1, 2002, the Department submitted a copy of this proposed rulemaking to the Independent Regulatory Review Commission (IRRC) and to the Chairpersons of the Senate Banking and Insurance Committee and the House Committee on Insurance. In addition to submitting this proposed rulemaking, the Department has provided IRRC and the Committees with a copy of a detailed Regulatory Analysis Form prepared by the agency in compliance with Executive Order 1996-1, "Regulatory Review and Promulgation." A copy of this material is available to the public upon request.

Under section 5(g) of the Regulatory Review Act, if IRRC has objections to any portion of the proposed rulemaking, it will notify the Department within 10 days of the close of the Committees' review period. The notification shall specify the regulatory review criteria that have not been met by that portion. The Regulatory Review Act specifies detailed procedures for review, prior to final publication of the regulations by the Department, the General Assembly and the Governor of objections raised.

M. DIANE KOKEN,  
*Insurance Commissioner*

CONTINUATION SHEET FOR FILING DOCUMENTS  
WITH THE LEGISLATIVE REFERENCE BUREAU  
Pursuant to Commonwealth Documents Law

ANNEX A

Title 31. Insurance, Part VIII. Miscellaneous Provisions, Chapter 148. Securities Held Under Custodial Agreements and Participation by Insurers in Depository Trust Companies and Federal Reserve Book Entry Systems.

Sec.

148.1. [Purposes.] **Reserved.**

148.2. [Definitions.] **Reserved.**

148.3. [Permissible methods of holding securities.] **Reserved.**

148.4. [Required custodian affidavits.] **Reserved.**

§ 148.1. [Purposes.] **Reserved.**

(a) This chapter expedites the verification of insurer assets during examinations conducted by the Department, to reduce costs and simplify delivery and receipt procedures involved in security transactions by insurers, to reduce the exposure of securities to loss, theft, misplacement, damage and other destruction, and to better provide for the storage, inspection, transportation, counting and insuring of securities.

(b) Further purposes are to establish procedures for the verification of securities which insurers deposit in banks under custodial agreements, to permit insurers to hold securities in other than definitive certificates, to better safeguard the actual securities, to facilitate checking assets of an insurer and to recognize that definitive securities no longer represent the only tangible evidence of security obligations held by an insurer.] **Reserved.**

§ 148.2. [Definitions.] **Reserved.**

[The following words and terms, when used in this chapter, have the following meanings, unless the context clearly indicates otherwise:

*Department* -- The Insurance Department of the Commonwealth.

*Depository trust company* -- The Depository Trust Company which is organized as a limited purpose trust company under the banking law of New York State and a member of the Federal Reserve System or other like entity which meets similar standards of depository safeguards and regulatory control.

*Federal Reserve book-entry system* -- The systems, sponsored by the United States Department of the Treasury and certain agencies and instrumentalities of the United States, under which the issuing, holding and transferring of securities of the United States Government and the agencies and instrumentalities, respectively, through Federal Reserve Banks and member and nonmember banks the Federal Reserve System are recorded through a series of interconnected accounts.

*Insurer* -- The term includes the following domestics licensed to and transacting business in this Commonwealth: an insurance company, association or exchange; a reciprocal or interinsurance exchange; a hospital plan corporation; a professional health services plan corporation; a corporation coming under

the Voluntary Nonprofit Health Service Act of 1972 (40 P. S. §§ 1551-1568); a fraternal benefit society or beneficial association.

*Securities* -- The term includes but are not limited to bonds, notes, debentures, stock certificates and other like evidence of indebtedness.] **Reserved.**

**§ 148.3. [Permissible methods of holding securities.] Reserved.**

(a) An insurer may hold securities in definitive certificates.

(b) An insurer may participate in the Federal Reserve book-entry system through a member bank of the Federal Reserve System which, as a custodian, may transact and maintain book-entry securities for the insurer. This subsection does not preclude an insurer from participation in the Federal Reserve book-entry system under a custodial agreement with a nonmember bank through a member bank.

(c) An insurer may participate in depository trust companies or like entities through a custodian bank.] **Reserved.**

**§ 148.4. [Required custodian affidavits] Reserved.**

(a) Insurers shall have executed the appropriate custodian affidavits -- Form A, Form B, or Form C--- for its securities held under custodial agreements. The executed forms shall be available for purposes of insurers' examinations. Failure to provide the appropriate custodian affidavits will result in the Department's treating as nonadmitted assets those of an insurer's securities held by the custodian. Further, for the purposes of such examinations, the underlying agreement between an insurer and a custodian shall be available. The custodial agreements shall provide: a standard of responsibility on the part of the custodian which may not be less than the responsibility of a bailee for hire or a fiduciary under statutory or case law of the jurisdiction of the custodian's state of domicile, that securities held by the custodian are subject to instructions of the insurer, and that the securities may be withdrawn immediately upon demand of the insurer.

(b) It shall be the responsibility of each insurer which enters into a custodial agreement to determine that the custodian maintains sufficient records to enable the insurer to complete its appropriate investment schedules of its Annual Statement Blank.

(c) The following forms are promulgated as part of this chapter:] **Reserved.**

**[FORM A**

**CUSTODIAN AFFIDAVIT**

(For use by a custodian bank where securities entrusted to its care have not been re-deposited elsewhere.)

STATE OF            )  
                          ) SS:  
COUNTY OF        )

\_\_\_\_\_, being duly sworn deposes and says that he is \_\_\_\_\_ of \_\_\_\_\_, a banking corporation organized under and pursuant to the laws of the \_\_\_\_\_ with the principal place of business at \_\_\_\_\_ (hereinafter called the "bank");



That his duties involve supervision of activities of the bank as custodian and records relating thereto;  
That the bank is custodian for certain securities of \_\_\_\_\_, having a place of business at \_\_\_\_\_ (hereinafter called the "insurer") pursuant to an agreement between the bank and the insurer;

That the schedule attached hereto is a true and complete statement of securities (other than those caused to be deposited with The Depository Trust Company or like entity or a Federal Reserve Bank under the Federal Reserve book entry system) which were in the custody of the bank for the account of the insurer as of the close of business on \_\_\_\_\_ that, unless otherwise indicated on the schedule, the next maturing and all subsequent coupons were then either attached to coupon bonds or in the process of collection; and that, unless otherwise shown on the schedule, all such securities were in bearer form or in registered form in the name of the insurer or its nominee or a nominee of the bank, or were in the process of being registered in such form;

That the bank as custodian has the responsibility for the safekeeping of such securities as that responsibility is specifically set forth in the agreement between the bank as custodian and the insurer; and

That, to the best of his knowledge and belief, unless otherwise shown on the schedule, said securities were the property of said insurer and were free of all liens, claims or encumbrances whatsoever.

Subscribed and sworn to  
before me this \_\_\_\_ day  
of \_\_\_\_\_ 19 \_\_\_\_

\_\_\_\_\_  
(L. S.)  
Vice President or other  
authorized officer]

**[FORM B**

**CUSTODIAN AFFIDAVIT**

(For use where ownership is evidenced by book entry at a Federal Reserve Bank).

STATE OF        )  
                  ) SS:  
COUNTY OF    )

\_\_\_\_\_, being duly sworn deposes and says that he is \_\_\_\_\_ of the \_\_\_\_\_, a banking corporation organized under and pursuant to the laws of the \_\_\_\_\_ with its principal place of business at \_\_\_\_\_ (hereinafter called the "bank");

That his duties involve the supervision of activities of the bank as custodian and records relating thereto;

That the bank is custodian for certain securities of \_\_\_\_\_ with a place of business at \_\_\_\_\_ (hereinafter called the "insurer") pursuant to an agreement between the bank and the insurer;

That it has caused certain of such securities to be credited to a book-entry account with a Federal Reserve Bank under the Federal Reserve book entry system; and that the schedule attached hereto is a true and complete statement of the securities of the insurer of which the bank was custodian as of the close of business on \_\_\_\_\_ which were in a book-entry account maintained in the name of \_\_\_\_\_ on the books and records of a Federal Reserve Bank at such date;

That the bank has the same responsibility for the safekeeping of such securities whether in the possession of the bank or in said book-entry account as that responsibility is specifically set forth in the agreement between the bank as custodian and the insurer; and

That, to the best of his knowledge and belief, unless otherwise shown on the schedule, said securities were the property of said insurer and were free of all liens, claims or encumbrances whatsoever.

Subscribed and sworn to  
before me this \_\_\_\_ day  
of \_\_\_\_ 19 \_\_\_\_

\_\_\_\_ (L. S.)  
Vice President or other  
authorized officer]

[FORM C

CUSTODIAN AFFIDAVIT

(For use in instances where a custodian bank maintains securities on deposit with The Depository Trust Company or like entity).

STATE OF     )  
                  ) SS:  
COUNTY OF   )

\_\_\_\_, being duly sworn deposes and says that he is \_\_\_\_ of the \_\_\_\_\_, a banking corporation organized under and pursuant to the laws of the \_\_\_\_\_ with its principal place of business at \_\_\_\_\_ (hereinafter called the "bank");

That his duties involve supervision of activities of the bank as custodian and records relating thereto;

That the bank is custodian for certain securities of \_\_\_\_\_ with a place of business at \_\_\_\_\_ (hereinafter called the "insurer") pursuant to an agreement between the bank and the insurer;

That the bank has caused certain of such securities to be deposited with \_\_\_\_\_ and that the schedule attached hereto is a true and complete statement of the securities of the insurer of which the bank was custodian as of the close of business on \_\_\_\_\_, and which were so deposited on such date;

That the bank as custodian has the same responsibility for the safekeeping of such securities whether in the possession of the bank or deposited as that responsibility is specifically set forth in the agreement between the bank as custodian and the insurer; and

That, to the best of his knowledge and belief, unless otherwise shown on the schedule, said securities were the property of said insurer and were free from all liens, claims or encumbrances whatsoever.

Subscribed and sworn to  
before me this \_\_\_\_ day  
of \_\_\_\_ 19 \_\_\_\_

\_\_\_\_ (L. S.)  
Vice President or other  
authorized officer]

CONTINUATION SHEET FOR FILING DOCUMENTS  
WITH THE LEGISLATIVE REFERENCE BUREAU  
Pursuant to Commonwealth Documents Law  
ANNEX A

Title 31. Insurance, Part VIII. Miscellaneous Provisions, Chapter 148a. Safeguarding Insurer Securities.

Sec.

148a.1. Definitions.

148a.2. Permissible methods of holding securities.

148a.3. Requirements for custodial agreements.

148a.4. Requirements for investment company securities.

148a.5. Penalty and existing custodial agreements.

§ 148a.1. Definitions.

The following words and terms, when used in this chapter, have the following meanings, unless the context clearly indicates otherwise:

Agent –

(i) A national bank, state bank or trust company that does any of the following:

(A) Maintains an account in its name in a clearing corporation.

(B) Is a member of the Federal Reserve System through which a custodian participates in a clearing corporation or the Federal Reserve book-entry system.

(ii) With respect to securities issued by institutions organized or existing under the laws of a foreign country or securities used to meet the deposit requirements under the laws of a foreign country as a condition of doing business in that country, the term may include a corporation organized or existing under the laws of a foreign country and legally qualified under those laws to accept custody of securities.

Authorized person – A person authorized in writing by an insurer's board of directors to issue instructions relating to the insurer's securities held by a custodian.

Clearing corporation –

(i) A clearing corporation as defined in section 8102 of the Uniform Commercial Code, Article 8, Investment Securities (13 Pa.C.S. § 8102) and organized for the purpose of effecting transactions in securities by computerized book-entry.

(ii) With respect to securities issued by institutions organized or existing under the laws of a foreign country or securities used to meet the deposit requirements under the laws of a foreign country as a condition of doing business in that country, the term may include a corporation organized or existing under the laws of a foreign country and legally qualified under those laws to effect transactions in securities by computerized book-entry.

Custodian –

(i) A national bank, state bank, or trust company that is:

(A) Adequately capitalized as determined by the standards adopted by United States banking regulators.

(B) Either regulated by state banking laws or a member of the Federal Reserve System.

(C) Legally qualified to accept custody of securities as required under § 148a.3 (relating to requirements for custodial agreements).

(ii) With respect to securities issued by institutions organized or existing under the laws of a foreign country or securities used to meet deposit requirements under the laws of a foreign country as a condition of doing business in that country, the term may include a bank that is:

(A) Incorporated or organized under the laws of a foreign country.

(B) Regulated as a bank by that country's government, or an agency thereof.

(C) Adequately capitalized as determined by the standards adopted by international banking authorities.

(D) Legally qualified to accept custody of securities as required under § 148a.3 (relating to requirements for custodial agreements).

Department -- The Insurance Department of the Commonwealth.

Federal Reserve book-entry system -- The computerized systems sponsored by the United States Department of the Treasury and certain agencies and instrumentalities of the United States for holding and transferring securities of the United States Government and its agencies and instrumentalities in Federal Reserve Banks through banks that are members of the Federal Reserve System or that otherwise have access to the computerized systems.

Foreign country -- A nation, province or territory other than the United States or a state thereof.

Instructions --

(i) A written statement that:

(A) States the specific purpose of the requested action.

(B) Identifies the specific transaction or type of transaction to which the requested action relates.

(C) Contains the signature of at least one authorized person.

(D) Is received by letter, facsimile or other form of electronic transmission whereby a custodian is able to verify with a reasonable degree of certainty the identity of the sender.

(ii) The verbal instructions of an authorized person if:

(A) The custodian is able to verify with a reasonable degree of certainty the identity of the sender.

(B) The verbal instructions are confirmed promptly by written instructions.

Insurer -- The following entities domiciled and licensed to transact business in this

Commonwealth:

(i) An insurance company, association or exchange.

(ii) A reciprocal or interinsurance exchange.

(iii) An employers' mutual liability insurance association.

(iv) A nonprofit health plan corporation, whether operating a hospital plan or a professional health services plan, or both.

(v) A fraternal benefit society or beneficial association.

(vi) A health maintenance organization.

(vii) A preferred provider organization.

(viii) The Industry Placement Facility under the Pennsylvania Fair Plan Act (40 P.S. §§ 1600.101--1600.502).

(ix) A joint underwriting association under the act of October 15, 1975, P.L. 390, No. 111 (40 P.S. §§ 1301.801-811).

(x) Another person, corporation, company, partnership, association or other entity acting as an insurer.

Investment company -- An entity registered and regulated as an investment company under the Investment Company Act of 1940 (54 Stat. 789, 15 U.S.C. §§ 80a-1--80a-52).

Investment company securities -- Stocks or shares issued by an investment company.

Registered form – A form of certificated security as defined in section 8102 of the Uniform Commercial Code, Article 8, Investment Securities (13 Pa.C.S. § 8102).

Securities –

(i) Certificated securities and uncertificated securities as defined in section 8102 of the Uniform Commercial Code, Article 8, Investment Securities (13 Pa.C.S. § 8102).

(ii) The term includes short-term and long-term investments but does not include investment company securities.

State –

(i) A state, territory or possession of the United States.

(ii) The District of Columbia.

(iii) Puerto Rico.

§ 148a.2. Permissible methods of holding securities.

(a) An insurer may hold its securities in definitive certificates.

(b) An insurer may provide for its securities to be held by a custodian under a custodial agreement as required under § 148a.3 (relating to requirements for custodial agreements).

Securities held under a custodial agreement shall be held by:

(1) The custodian.

(2) The custodian's agent.

(3) A clearing corporation.

(4) The Federal Reserve book-entry system.

(c) An insurer's investment company securities may be held by the investment company that issued the investment company securities as required under § 148a.4 (relating to requirements for investment company securities).

(d) An insurer may provide for its securities to be held in the custody of a state treasurer or other state regulatory authority to meet deposit requirements as a condition of doing business in that state.

§ 148a.3. Requirements for custodial agreements.

(a) An agreement between an insurer and a custodian providing for the custody of the insurer's securities shall be:

(1) In writing.

(2) Authorized by a resolution of either the insurer's board of directors or an authorized committee of its board of directors.

(3) Signed by at least one officer of the insurer and one officer of the custodian.

(b) A custodial agreement shall contain at least the following provisions:

(1) The custodian shall hold the securities subject to the insurer's instructions. In the event of a discrepancy or dispute, verbal instructions shall be superseded by written instructions. The securities shall be withdrawable immediately upon receipt of the insurer's written instructions.

(2) The custodian may not have a security interest or lien in any securities held under the agreement.

(3) The custodian may utilize an agent to gain entry in a clearing corporation or in the Federal Reserve book-entry system or for other services if:



(i) The custodian enters into a written agreement with the agent whereby the securities will be held as required under this chapter.

(ii) The custodian retains ultimate responsibility for the safekeeping of the insurer's securities and for compliance with the terms and conditions of the custodial agreement as required under this chapter.

(4) Securities in registered form shall be registered in the name of the insurer, the insurer's nominee, the custodian's nominee or, if held by a clearing corporation, in the name of the clearing corporation or its nominee.

(5) Certificated securities shall be held by the custodian in a separate account established to hold only the insurer's securities under the custodial agreement.

(6) Securities held in a clearing corporation or in the Federal Reserve book-entry system shall be separately identified on the custodian's records as being owned by the insurer.

(7) The custodian's records shall identify which securities are held by the custodian or by its agent and which securities are in a clearing corporation or in the Federal Reserve book-entry system.

(8) The custodian's records shall identify the location of securities held in a clearing corporation or in the Federal Reserve book-entry system and, if applicable, the name of the clearing corporation and the name of the agent.

(9) The custodian shall provide a statement that it has secured and will maintain adequate insurance protection as required by the custodian's banking regulator to cover its duties and activities as custodian of the insurer's assets.

(10) The custodian shall be obligated to indemnify the insurer for any loss of securities occasioned by the negligence or dishonesty of the custodian's officers or employees, or by

burglary, robbery, holdup, theft or mysterious disappearance, including loss by damage or destruction; except that the agreement may provide that the custodian will not be liable for failure to take an action required under the agreement in the event and to the extent that the taking of the action is prevented or delayed by war (whether declared or not and including existing wars), revolution, insurrection, riot, civil commotion, act of God, accident, fire, explosion, stoppage of labor, strikes or other differences with employees, laws, regulations, orders or other acts of any governmental authority, or any other cause whatever beyond its reasonable control.

(11) In the event of a loss of securities for which the custodian is obligated to indemnify the insurer under paragraph (10), the custodian shall immediately replace the following:

(i) The securities or the value thereof.

(ii) The value of any loss of rights or privileges resulting from the loss of the securities.

(12) The custodian shall provide the Department with written notice if the agreement is terminated or if 100% of the assets are withdrawn from one or more custodial accounts established under the agreement. The notice shall be directed to the attention of the Deputy Insurance Commissioner for the Office of Regulation of Companies and provided within 3 business days of the custodian's receipt of the insurer's notice terminating the agreement or within 3 business days of the withdrawal of 100% of the assets in one or more custodial accounts established under the agreement. The notice shall include the date of termination or 100% withdrawal and a list of the securities held on that date.

(13) The custodian shall provide the insurer with the following:

(i) Written reports on at least a monthly basis of holdings of the insurer's securities, including written confirmations of all transfers of securities to or from the insurer's account.

(ii) Annual reports of the review of the insurer's trust accounts by the custodian's trust committee.

(14) If requested in writing by an authorized person, the custodian shall provide the following:

(i) Reports from a clearing corporation or the Federal Reserve book-entry system.

(ii) Reports on the custodian's system of internal control prepared by an outside auditor retained by the custodian.

(15) Reports and confirmations provided by the custodian may be transmitted in electronic or paper form.

(16) The custodian shall maintain records and information sufficient to enable the insurer to:

(i) Comply with accounting and reporting requirements for financial statements and supporting schedules filed with the Department, to the extent that information maintained by the custodian is relied upon by the insurer to prepare its financial statements.

(ii) Provide information required in an audit or financial examination of the insurer, including, but not limited to, the identifying numbers assigned to the securities by the Committee on Uniform Securities Identification Procedures (CUSIP).

(17) Upon receipt of a written request signed by an authorized person, the custodian shall:

(i) Allow officers or employees of the insurer, independent accountants retained by the insurer, and representatives of regulatory agencies to examine the custodian's records relating to the insurer's account on the custodian's premises and during the custodian's normal business hours.

(ii) Provide copies of its records relating to the insurer's account.

(iii) Provide an affidavit sworn to and subscribed by an authorized officer of the custodian and containing language substantially similar to the following:

#### CUSTODIAN AFFIDAVIT

\_\_\_\_\_, being duly sworn deposes and says that he/she is  
\_\_\_\_\_ of \_\_\_\_\_, a banking corporation organized under and  
pursuant to the laws of the \_\_\_\_\_ with the principal place of business at  
\_\_\_\_\_ (hereinafter called the "bank");

That his/her duties involve supervision of activities of the bank as custodian and records relating thereto;

That the bank is custodian for certain securities of \_\_\_\_\_, having a place of business at \_\_\_\_\_ (hereinafter called the "insurer") pursuant to an agreement between the bank and the insurer;

That the schedules attached hereto are true and complete statements of securities that, as of the close of business on \_\_\_\_\_ were:

(check all that apply)

(1) In the custody of the bank for the account of the insurer; that, unless otherwise indicated on the schedule, the next maturing and all subsequent coupons were either attached to coupon bonds or in the process of collection; and that, unless otherwise indicated on the schedule, all such securities were in bearer form or in registered form in the name of the insurer, the insurer's nominee, the custodian's nominee or, if held by a clearing corporation, in the name of the clearing corporation or its nominee, or were in the process of being registered in such form.

(2) Credited to a book-entry account with a Federal Reserve Bank under the Federal Reserve book-entry system and in a book-entry account maintained in the name of \_\_\_\_\_ on the books and records of a Federal Reserve bank at such date.

(3) Deposited with \_\_\_\_\_ (a clearing corporation).

That the custodian has the responsibility for the safekeeping of such securities whether in the possession of the bank, credited to a book-entry account with a Federal Reserve Bank under the Federal Reserve book-entry system or deposited with a clearing corporation, as that responsibility is specifically set forth in the agreement between the bank as custodian and the insurer; and

That, to the best of his/her knowledge and belief, unless otherwise shown on the schedule, said securities were the property of said insurer and were free of all liens, claims or encumbrances whatsoever.

§ 148a.4. Requirements for investment company securities.

An insurer's investment company securities may be held by the investment company that issued the investment company securities if:

(1) The investment company provides the insurer with written reports on at least a monthly basis of the insurer's investment, including written confirmations of all transfers of investments to or from the insurer's account. The reports and confirmations may be transmitted in electronic or paper form.

(2) The investment company maintains records and information sufficient to enable the insurer to:

(i) Comply with accounting and reporting requirements for financial statements and supporting schedules filed with the Department, to the extent that information maintained by the investment company is relied upon by the insurer to prepare its financial statements.

(ii) Provide information required in an audit or financial examination of the insurer's financial statements, including, but not limited to, the identifying numbers assigned to the securities by the Committee on Uniform Securities Identification Procedures (CUSIP).

§148a.5. Penalty and existing custodial agreements.

Failure to comply with this chapter will result in the treatment of an insurer's securities or investment company securities as nonadmitted assets for purposes of financial reports filed with the Department; except that, with respect to custody agreements entered into prior to (the effective date of this rulemaking) and in compliance with laws or regulations in existence immediately preceding (the effective date of this rulemaking), insurers shall have until (1 year from the effective date of this rulemaking) to achieve compliance with this chapter.



**COMMONWEALTH OF PENNSYLVANIA  
INSURANCE DEPARTMENT**

OFFICE OF SPECIAL PROJECTS  
1326 Strawberry Square  
Harrisburg, PA 17120

Phone: (717) 787-4429  
Fax: (717) 705-3873  
E-mail: [psalvato@ins.state.pa.us](mailto:psalvato@ins.state.pa.us)

April 1, 2002

Mr. Robert Nyce  
Executive Director  
Independent Regulatory Review Comm.  
333 Market Street  
Harrisburg, PA 17101

Re: Insurance Department Proposed  
Regulation No. 11-204, Safeguarding  
Insurer Securities

Dear Mr. Nyce:

Pursuant to Section 5(a) of the Regulatory Review Act, enclosed for your information and review is proposed regulation 31 Pa. Code, Chapter 148, Safeguarding Insurer Securities.

This rulemaking intends to replace the regulations relating to insurer securities initially adopted June 12, 1981. Securities owned by insurers are liquid assets held to allow the payment of the insurer's obligations as they come due. This rulemaking will recognize changes in the securities marketplace and better safeguard against the theft or loss of insurer securities. The updated regulations are the result of the Department's consideration of the need for domestic insurers to participate efficiently in the securities market while preserving the value and safety of their assets. Specific protections have been added as a result of a review by state insurance regulators of the circumstances in a recent highly publicized case where a number of insurer insolvencies were caused by the alleged theft of their securities. The Department participated in the review of this case, known as the Frankel case, which also resulted in the update of a model regulation relating to insurer securities adopted by the National Association of Insurance Commissioners (NAIC). Therefore, this rulemaking is needed to update the regulations to better safeguard against the theft or loss of insurer securities and to establish up-to-date, clear requirements for insurer securities held under custodial arrangements.

If you have any questions regarding this matter, please contact me at (717) 787-4429.

Sincerely yours,

A handwritten signature in cursive script that reads "Peter J. Salvatore".

Peter J. Salvatore  
Regulatory Coordinator



**TRANSMITTAL SHEET FOR REGULATIONS SUBJECT TO THE  
REGULATORY REVIEW ACT**

I.D. NUMBER: 11-204  
 SUBJECT: Safeguarding Insurer Securities  
 AGENCY: DEPARTMENT OF INSURANCE # 2263

**TYPE OF REGULATION**

- X Proposed Regulation
- Final Regulation
- Final Regulation with Notice of Proposed Rulemaking Omitted
- 120-day Emergency Certification of the Attorney General
- 120-day Emergency Certification of the Governor
- Delivery of Tolled Regulation
  - a. With Revisions
  - b. Without Revisions

RECEIVED  
 2002 APR -1 AM 9:37  
 INDEPENDENT REGULATORY  
 REVIEW COMMISSION

**FILING OF REGULATION**

DATE	SIGNATURE	DESIGNATION
4-1-02	<i>D. Traphagen</i>	HOUSE COMMITTEE ON INSURANCE
	<i>W.E. Hetchel</i>	
4/1/02	<i>Denise Yatten</i>	SENATE COMMITTEE ON BANKING & INSURANCE
4/1/02	<i>J. McDaniel</i>	
4/1/02	<i>Peri Eckert</i>	INDEPENDENT REGULATORY REVIEW COMMISSION
		ATTORNEY GENERAL
4/1/02	<i>Mayra Casas</i>	LEGISLATIVE REFERENCE BUREAU

March 28, 2002