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NAIC REGULATORY UPDATE

This quarterly issue of the *NAIC Regulatory Update* summarizes the National Association of Insurance Commissioners' financial activities affecting health entities at the 2006 Fall National Meeting. The meeting took place September 9-12, 2006 in St. Louis, Missouri.

NAIC Hot Topics

The Capital Adequacy Task Force adopted a proposal for reporting hybrid securities in the 2006 RBC formulas...**see page 1**

The Blanks Working Group adopted the new Medicare Part D Supplemental filing for the 2007 quarterly statements.....**see page 3**

The Statutory Accounting Principles Working Group adopts new SSAP No. 95 on accounting and reporting for nonmonetary transactions**see page 4**

The Emerging Accounting Issues Working Group adopted accounting guidance on prepaid loss and loss adjustment expenses**see page 5**

The Valuation of Securities Task Force adopted several changes to the *Purposes and Procedures Manual*.....**see page 6**

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The Risk Assessment Working Group adopted the "risk-focused surveillance guidance" for inclusion in the 2007 *Financial Condition Examiners Handbook*.....**see page 7**

The Financial Examiners Handbook Technical Group discussed a standardized data request template for inclusion in the *Examiners Handbook***see page 7**

Financial Regulation—Risk-Based Capital

The **Capital Adequacy Task Force** adopted a short-term solution to address reporting "hybrid securities" in the 2006 Risk-Based Capital formulas (Health, Life, and Property & Casualty). The proposal was fashioned by the Hybrid RBC (E) Working Group which has been addressing hybrid securities over the past several months.

The Working Group worked in conjunction with the Valuation of Securities Task Force to examine risk-based capital factors as they pertain to the classification of hybrid securities. Hybrid securities are investments structured with characteristics of both equity (common and preferred stock) and debt. The primary purpose of the Working Group was to gather information to determine whether the statutory classification and risk-based capital for hybrid securities are appropriate.

The issues emanates from the fact that there are only two categories of RBC risk factors that can be assigned to hybrid securities. Either the security receives the more favorable factor assigned to bond and preferred or it receives the 30% factor assigned to common stock in the Life formula or the 15% factor in the Health and P&C formulas. Consequently the Working Group had to determine the differences between hybrids and preferred stock and the risks that are or are not captured by an NRSRO credit rating.

The Working Group decided not to make any changes to the 2006 formulas. Instead the Capital Adequacy Task Force will provide insurance companies with reporting guidance for hybrid securities for the year-end 2006 RBC formulas in the RBC Instructions. A review of structural changes to the 2007 RBC formulas will be addressed during 2007.

At the 2006 NAIC Fall National Meeting, the Working Group adopted the following definition and reporting guidance for hybrid securities:

Hybrid Securities – Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations and/or which are recognized as regulatory capital by the issuer's primary regulatory authority. Hybrid securities are designed with characteristics of debt and of equity and are intended to provide protection to the issuer's senior note holders. Hybrid securities products are sometimes referred to as capital securities.

For 2006 this definition of hybrids specifically excludes:

- Surplus notes (file in Schedule BA),
- Subordinated debt issues which have no coupon deferral features (file in Schedule D - Part 1),
- "Traditional" preferred stocks (file in Schedule D - Part 2 - Section 1), including (but not limited to) issues which:
 - for U.S. issuers do not allow tax deductibility for dividends; and
 - are issued as preferred stock of the entity or an operating subsidiary, not through a trust or a special purpose vehicle.

Financial Regulation—Risk Based Capital, *Continued*

Until the earlier of 1/1/08 or adoption of a long-term proposal by the NAIC, the following short-term proposal is adopted:

- All defined hybrid securities are reported as preferred stock.
- All hybrid securities issued after 8/18/2005 and those hybrids classified in 2006 by the SVO as common stock are notched down by 1 NAIC designation.
- Those hybrid securities classified by the SVO as preferred stock in 2006 will not be notched.
- Those hybrid securities classified by the SVO as debt in 2006 will be reported as debt and not notched.
- All FE hybrids issued subsequent to the effective date will be reported as preferred stock and notched down 1 NAIC designation, unless they are filed with the SVO and classified as debt or preferred stock by the SVO (in which case they are reported as debt or preferred stock appropriately with no notching).
- An Insurer holding a "notched" hybrid security issued subsequent to the effective date of this proposal may request SVO review of the security in an attempt to eliminate the notch. For hybrid securities filed with the SVO, the designation assigned by the SVO must be used by the insurer. As per normal practice, SVO classification will apply to all holders of the security.

The reporting guidance serves only as short-term solution. A long-term solution must now be developed for 2007 where a full review of the risks can be done to arrive at appropriate RBC charges. A actuarial study group of Life, Casualty and Health actuaries has been formed to study the underlying risks in order to address the long-term solution. Individuals from the investment sector will also participate with the group.

Although hybrid securities are mainly concentrated in Life companies P&C companies may also have some investments as well. It is not known how many, if any, Health companies have them. Nevertheless each of the three formulas will be changed.

The Health RBC Working Group is also reviewing the following issues which are expected to impact the 2007 Health RBC Formula:

- The Working Group will look to develop individual risk factors for healthcare receivables. The credit risk items are found on Page XR019 in the Credit Risk H3 Component of the Health RBC formula. Currently all healthcare receivable carry a uniform risk factor of .05.
- Review the risk factors for expenses with regard to the recent changes in the Health blank in regard to cost containment expenses that are broken out on the health blank. Currently a variable risk factor is applied to claim adjustment expenses, which is inclusive of cost containment expenses.
- Establish a trend test for Health RBC similar to the Property/Casualty trend test. The AAA has been asked to review the differences between the Life and Health and the Property/Casualty trend test for recommendations for the Health trend test. A Trend Test will trigger a Company Action Level when an RBC percentage is between 200% and 300% (Total Adjusted Capital divided by Authorized Control level RBC) and there is a combined ratio of greater than 120%. The combined ratio is calculated as follows:

$$\text{Combined Ratio} = \text{Loss Ratio} + \text{Dividend Ratio} + \text{Expense Ratio}$$

Financial Reporting

The **Blanks Working Group** adopted 15 blank proposals affecting the 2006/2007 Life, Property/Casualty (P&C) and Health Blank forms and instructions including the addition of a new “Medicare Part D Supplemental” filing for the 2007 Health Quarterly Statement. The Supplement is also applicable to the 2007 Life and P&C quarterly statements. Many of the new items exposed for comment are proposed modifications to the invested asset schedules.

The Hybrid RBC Working Group adopted proposed disclosure requirements for the 2006 annual statement to address the reporting and classification of hybrid securities (see discussion under Capital Adequacy Task Force). It is expected that disclosure requirement will be added to the “Other” Note to the Financial Statement (Note 21), in the same way that a new disclosure requirement from the Statutory Accounting Principles Working Group falls under Note 21. The required disclosure will be included as an editorial change to the Annual Statement Instructions in December with a memo further explaining the disclosure requirement. It will be adopted as part of the adoption of the editorial changes and will then be included on the NAIC Web site as a change to the Annual Statement Instructions in the notes to financial statements. Note 21 will require the reporting entity to disclose each hybrid security in which it has invested.

The Working Group adopted other items affecting the Health and other statements including:

Item	Effective Date
Added a new interrogatory to “Part I – General” of the General Interrogatories disclosing the code of ethics standards for senior officers of a reporting entity. This change is related to disclosure requirement coming from Sarbanes-Oxley.	1 st Quarter 2007
Revised the annual statement instructions for Schedule T and the Life, Health & Annuity Guaranty Association Model Act Assessment Base Reconciliation Exhibit (Life Supplement) in the Life Blank to be consistent with the instructions found in the in the Health Blank.	1 st Quarter 2007
Updated the annual and quarterly Schedule D instructions for changes to the SVO Purposes and Procedures Manual for three new codes to be used on stock investments. The changes will affect the Quarterly Schedule D, Parts 3 & 4 and the Annual Schedule D, Part 2, Sections 1.	1 st Quarter 2007
Revised the annual and quarterly instructions to delete CUSIP column from Schedule E-Part 2, Cash Equivalents, just as the CUSIP column was removed from Schedule DA Part 1, Short-Term Investments.	1 st Quarter 2007
Deleted the P&C Cash Flow Statement reference to Page 4, Line 2 (Losses Incurred) for the Commissions Incurred line because those are reported in lines 3, 4 and 5	1 st Quarter 2007
Revised the annual and quarterly instruction references within the Investment Schedule pages from market value to fair value.	1 st Quarter 2007
Added the Medicare Part D Supplement as a new quarterly filing. The Quarterly Supplement is consistent with the Annual Supplement but has less detailed information requirements than the Annual Supplement. It is expected to provide information to regulator regarding the solvency and cash flow of the Medicare Part D product.	1 st Quarter 2007
Revised the annual and quarterly instructions for the “income amounts” reported on each of the applicable detail investment schedules.	1 st Quarter 2007
Modified certain heading on the Life Exhibit of Number of Policies as it Relates to A&H Contracts	2007 Annual Statement
Expanded the P&C Statement of Actuarial Opinion Exhibits and requires electronic submission of data to allow for query capabilities	2007 Annual Statement
Revised the annual instructions for Schedule D and Schedule DB to indicate TBAs that meet the definition of derivatives should be reported on Schedule DB.	2007 Annual Statement
Revised the annual instructions for Schedule DA, Part 1, for Money Market Mutual Funds and Class One Money Market Mutual Funds that instructs the reporting entity to report zero in the Par Value Column.	2007 Annual Statement

Financial Reporting, Continued

Added separate line categories to Schedule DB, Part E, Counterparty Exposure	2007 Annual
Added a new line to the Jurat Page to capture a "Government Relations" contact person with name, address, phone number and email address. The addition of this new contact person is believed to provide regulators with a contact person for things such as publicizing new bulletins, distributing company and producer licensing information, notifying the companies about changes in departmental procedures and other communicating general non-financial information to the companies.	2007 Annual Statement
Revised the annual instructions to clarify the instructions for reporting the top 10 exposures under the Supplemental Investment Risk Interrogatories.	2007 Annual Statement

Financial Regulation—Accounting

The **Statutory Accounting Principles Working Group** adopted new **SSAP No. 95 - Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions**.

SSAP No. 95 updates statutory accounting principles for nonmonetary transactions by updating conclusions reached in SSAP No. 28 related to Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions (APB 29) with those included in FAS 153.

Based on FAS 153 companies will no longer be permitted to use the "similar productive assets" concept to account for nonmonetary exchanges at book value with no gain being recognized. Nonmonetary exchanges have to be accounted for at fair value, recognizing any gain or loss, if the transactions meet a commercial substance criterion and fair value is determinable.

SSAP No. 95 is effective for reporting periods ending on or after January 1, 2007. The adoption of SSAP 95 is accounted for as a change in accounting principle in accordance with SSAP 3, which requires a cumulative effect adjustment.

The Working Group also adopted the following nonsubstantive amendments to the Accounting Practices and Procedures Manual:

1. Adopted **Ref No. 2006-07 - Update Disclosure of Supplemental Information Within the Annual Audit Report**. The amendment to SSAP No. 1 adds specific disclosure requirements in the annual statement for companies filing the Life, Accident and Health (Blue) blank.

The Life, Accident and Health and Fraternal Annual Statement Instructions currently include instructions for completing Schedule I Selected Financial Data. The amendment to SSAP No. 1 will now require the Supplemental schedule to be included in the annual audit report for Life, Accident and Health and Fraternal reporting entities.

2. Adopted **Ref No. 2006-15: Treatment of Class I Bond Funds in SSAP No. 26 - Bonds, excluding Loan-backed and Structured Securities**

The amendment clarifies language in SSAP No. 26, paragraph 2, to include Class I Bond Funds as part of the definition of bonds. These funds are excluded from the definition of common stock in SSAP No. 30 - *Investments in Common Stock* paragraph 3.

3. Adopted **Ref No. 2006-16: Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments**. FASB Staff Position 115-1 and FAS 124-1 addresses the meaning of "Other Than Temporary Impairment and Its Application to Certain Investments." The FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The amendment places the disclosures required under the FSP into existing SSAP Nos. 26, 30, 32, 40.

Financial Regulation—Accounting, Continued

The Working Group exposed for comment **SSAP No. 96 - Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25**. SSAP No. 96 establishes additional guidance for affiliate and other related party transactions requiring intercompany transactions to be in writing and settled within 90 days of the due date. The SSAP is expected to be adopted at the NAIC Winter National Meeting with an effective date of January 1, 2007.

The Working Group also exposed for comment **Ref. No. 2006-18 - Accounting for Uncertainty in Income Taxes**. The issue addresses an insurer's financial statement that may reflect accounting for income taxes based on positions that have not been sustained by IRS or other taxing entity examination. As tax law is the basis for tax positions and much of the tax law may have varied interpretations, accounting for this uncertainty has led to inconsistent accounting and reporting for uncertain tax positions in both GAAP and SAP. This FASB interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. An industry interested party group will be formed to assist NAIC staff in drafting an issue paper.

The **Emerging Accounting Issues Working Group** adopted as final several Interpretations that were previously exposed for comment, including:

1. INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)

A CAPCO is a state legislated venture capital firm that can be a partnership, corporation, trust or limited liability company, profit or not-for-profit, for which investors who invest cash to acquire an equity interest or qualified debt instrument receive state premium or income tax credit.

The Working Group came to a consensus position that reporting entities should account and report for investments in CAPCO's consistent with the agreement structure which could be structured as an investment per SSAP No. 26, 30, 32, or 48.

The Working Group also came to a consensus that position reporting entities should account for any prepaid interest received by the insurer to be recorded as an unearned interest liability and should be amortized over the life of the security.

2. INT 02-21: Accounting for Prepaid Loss Adjustment Expenses and Claim Adjustment Expenses

The issue on INT 02-21 was whether the liability for unpaid loss adjustment expenses should be established regardless of any payments made to third party administrators, management companies or other liabilities.

The Working Group reached a consensus position that the liability for unpaid LAE should be established regardless of any payments made to third party administrators, management companies or other entities. In addition, the guidance states that the liability for claim adjustment expenses on indemnity accident and health contracts should be established in an amount necessary to adjust all unpaid claims irrespective of payments made to third party administrators and other similar entities.

The Working Group updated paragraph 5 of SSAP No. 55 to read:

The liability for claim adjustment expenses on non-capitated payments under managed care contracts should be established in an amount necessary to adjust all unpaid claims irrespective of payments to third party administrators, etc. The working group determined that capitated payments under managed care contracts are not included within the scope of this issue.

The paragraph is effective for reporting periods ending on or after December 31, 2006.

INT 06-01: Accounting for Revenue as a Result of the Sale of Claims Data was withdrawn from consideration at the request of the sponsor. INT 06-01 was tentatively adopted to include guidance to SSAP No. 55 that revenues associated with sales of claims data must be recorded as "other income" and not as a reduction to of claims expense as originally proposed.

Financial Regulation—Investments

The **Valuation of Securities Task Force** exposed for a 30-day comment period a series of proposals applicable to surplus notes. The purpose of the proposals are to clarify Part Fourteen of the P&P Manual that insurance companies are to file surplus notes with the SVO for purposes of valuation but not for credit assessment or classification.

The proposal also will seek to amend the Annual Statement Instructions and SSSAP No. 41 – Surplus Notes to add capital notes and to develop accounting and reporting guidance for them.

This proposal addresses an SVO position that although surplus notes are not given classification or credit assessment, they should be filed with the SVO for verification that the reported value conforms to accounting guidance. This reflects current reporting guidance that requires surplus notes to be reported as Schedule BA assets on a surplus notes line and that SSAP No. 41 provides the sole valuation method for this asset class. Now that certain BA assets are filed with the SVO, the SVO has recommended that the FE administrative symbol should be permitted for Schedule BA filings; it also recommended that the administrative symbol FE not be permitted for surplus notes, as this may lead to misreporting on Schedule D.

The Task Force adopted a proposal to use as a definition for a “foreign investment” for annual statement reporting purposes the definition used in the NAIC Model Investment Law. The guidance will apply to reporting foreign country exposure captured in the Summary by Country and Supplemental Investment Risk Interrogatories.

The primary question is whether the security should be evaluated for this purpose on issue or an issuer basis. The issue came out of the Investment Schedules Subgroup which believed the definition should be “issue” driven while the SVO believe it should be “issuer” driven. The staff of the Investment Schedules Subgroup believes the reporting should be issue-based; i.e., if a security is traded in the United States in U.S. dollars, then it should be considered a U.S. investment. The SVO staff believes the reporting should be issuer-based to incorporate sovereign risk.

The Task Force adopted a recommendation to revise annual Schedule D – Part IA and quarterly Schedule D- Part IB to eliminate requirement to report and summarize credit quality designations for short-term and cash-equivalent bonds. Schedule D, Part IA summarizes long-term bonds, Class One BMFs, short-term bonds including EMMMFs and Class One MMMFs and Cash Equivalents based on quality or NAIC designation.

The amount reported is the security’s book/adjusted carrying value. However no instructions are provided on how a reporting entity should obtain and report a credit quality designation for short-term and cash-equivalent bonds. Consequently, the requirement to report credit quality designations for these security types will be removed and the two schedules will be revised (likely 2006 Annual and 2007 Quarterly) to reflect the new guidance.

Other Financial Regulatory Issues

The **NAIC/AICPA Working Group** received a report from the American Institute of Certified Public Accountants (AICPA) regarding projects that affect state insurance regulators and the insurance industry. The AICPA reported that the Auditing Standards Board recently issued Statement on Auditing Standard No. 112, Communication of Internal Control Matters. SAS 112 replaces SAS No. 60, Communication of Internal Control Related Matters Noted in an Audit. The SAS is effective for periods ending on or after December 15, 2006.

SAS 60 is adopted in the current Model Audit Rule as the standard for reporting on internal controls to state insurance departments. The SAS:

- Requires the auditor to communicate control deficiencies that are significant deficiencies or material weaknesses in internal control. The definitions of significant deficiency and material weakness are consistent with PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. The term reportable condition no longer is used.

Other Financial Regulatory Issues, *Continued*

- Provides guidance about evaluating the severity of control deficiencies.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, as well as indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the report release date.

The **Risk Assessment Working Group – “Handbook Revisions Subgroup”** adopted the “Revised Risk-Focused Surveillance Guidance” for inclusion in the 2007 Financial Condition Examiners Handbook (*Revised Examiners Handbook*).

The Risk Assessment Working Group (Working Group) received the *Revised Examiners Handbook* and exposed it for review to Working Group members and other interested parties. At a conference call on October 3rd the Working Group adopted the *Revised Examiners Handbook*.

The *Revised Examiners Handbook* will now be forwarded to the Financial Condition E Committee for adoption. The E Committee will hold a conference in late October 2006 to adopt and forward the *Revised Examiners Handbook* NAIC Executive Committee/Plenary for adoption at the NAIC Winter National Meeting. The *Revised Examiners Handbook* will become effective January 1, 2007.

In addition, the Risk Assessment Implementation Subgroup exposed proposed revisions to the NAIC Financial Regulation Standards and Accreditation Program Review Team Guidelines. These revisions update the accreditation guidelines to reflect the revised risk-focused surveillance approach. These revisions were likewise adopted will have been forwarded to the Financial Regulation Standards and Accreditation (F) Committee for consideration and likely adoption in 2007.

It is anticipated that incorporation of this guidance as an accreditation standard will follow the established accreditation procedures and include a two-year exposure and two-year implementation period before being required for accreditation purposes. Under the normal accreditation procedures, it is anticipated that application of the *Revised Examiners Handbook* approach will be mandated as an accreditation standard for examinations commencing after January 1, 2010.

The **Financial Examiners Handbook Technical Group** discussed a standardized data request template that was drafted by the Audit Software Working Group and referred to the Technical Group for inclusion in the Examiners Handbook.

The Templates provide insurers under examination a mechanism for identifying what baseline electronic information (electronic premiums, claim detail tapes, etc.) is to be provided on examination and the format the information is to be provided in. A separate template was developed for Life, P&C and Health companies. The data request templates address only premiums, claims and reserves data.

The Technical Group has formed a subgroup consisting of the states of Indiana, Nebraska, New Jersey, Oregon and Wisconsin to review the templates and provide a recommendation at the NAIC Winter National Meeting.

Other Financial Regulatory Issues, *Continued*

The Technical Group adopted revisions to Exhibit C: *Evaluation of Internal Controls in Information Systems Questionnaire Revision* in the Examiners Handbook to reflect changes in the information technology environment. Exhibit C was re-organized, prioritized, and questions were updated or deleted to reflect changes in the information technology environment.

Additionally, an Information Systems Planning Questionnaire (ISPQ) was created and is included in the first section of the revised Exhibit C. The ISPQ is a tool designed to assist the examiner in planning the extent of information systems (IS) control work that may be necessary on an examination.

The Pre-Examination Planning ISQ, which is to be distributed to the insurer during the planning phase of examinations in order to provide the examiner with high-level information pertaining to the company's information systems. The information obtained through the use of this questionnaire will allow the examiner to plan the extent of information technology (IT) testing needed during the testing phase of the exam.

2006 NAIC Meeting Schedule

Spring National Meeting:	March 4-7, Orlando, FL
Summer National Meeting:	June 10-13, Washington, DC
Fall National Meeting:	September 9-12, St. Louis, MO
Winter National Meeting:	December 9-12, San Antonio, TX

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2006 Millennium Consulting Group Seminars

Seminar	Seminar Date	Seminar Site
Investment Accounting and Reporting Workshop	June 26-27	Scottsdale, AZ
Introduction to Health Statutory Accounting and Reporting Seminar	July 24-26	Chicago, IL
2006 Health Annual Statement Preparation Seminar	August 28 – 31	Miami, FL
Claims Accounting and Reporting Workshop	September 14-15	Dallas, TX
Regulatory Update for Health Organizations Workshop - Midwest	September 25	Chicago, IL
Regulatory Update for Health Organizations Workshop - West	September 26	Newport Beach, CA
Regulatory Update for Health Organizations Workshop - East	September 27	Atlanta, GA
Regulatory Update for Health Organizations Workshop - Southwest	September 28	Dallas, TX
Introduction to Health Statutory Accounting and Reporting Seminar	November 27–29	Orlando, FL
2006 Health Annual Statement Preparation Seminar	December 4 - 7	Las Vegas, NV
2006 Risk-Based Capital Preparation Workshop	December 7-8	Las Vegas, NV
2006 Risk-Based Capital Preparation Workshop	January 15-16, 2007	Orlando, FL

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Disclaimer

Since a variety of viewpoints and issues are discussed at task force and committee meetings taking place at the NAIC meetings, and because not all task forces and committees provide copies of agenda material to industry observers at the meetings, it is often difficult to characterize all of the conclusions reached. The items included in this Newsletter may differ from the formal task force or committee meeting minutes. In addition, the NAIC operates through a hierarchy of subcommittees, task forces and committees. Decisions of a task force may be modified or overturned at a later meeting of the appropriate higher-level committee. Although we make every effort to accurately report the results of meetings we observe and to follow issues through to their conclusion at senior committee level, no assurance can be given that the items reported

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