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Abstract

Building on companion work investigating the efficacy of financial statement insurance (FSI) as an alternative to traditional auditor liability, this Article presents the terms of a national enabling statute to implement this concept. The Model Financial Statement Insurance Act uses the architecture of the U.S. Trust Indenture Act of 1939. It authorizes issuer application for qualification, in connection with annual proxy statement filings, of policies of financial statement insurance. The Model FSI Act deems a series of provisions necessary to achieve securities law objectives to be part of all financial statement insurance policies so proposed, and requires insurers to possess characteristics relating to financial capacity, independence from issuers and adequate regulatory supervision. It empowers the U.S. Securities and Exchange Commission to issue stop orders against such applications in cases where insurers lack such qualifications. Qualifying policies are put to security holder vote and become effective when a registered public accounting firm engaged by the insurer issues an unqualified opinion that the financial statements provide a fair presentation in accordance with generally accepted accounting principles. Later-discovered material misstatements result in covered losses under the policy, administered in accordance with terms the Model FSI Act deems included, along with other tailored policy terms not in contravention of the Act. While using a United States template, the Model FSI Act is designed to be adaptable for use in other countries and jurisdictions of the world.

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INTRODUCTION

The accounting function in contemporary public-company corporate governance uses third-party auditor attestation with accompanying auditor liability exposure. Weaknesses in this voucher-mechanism appeared in the late 1990s; reforms tinkered with the model by strengthening auditing-profession oversight using the Public Company Accounting Oversight Board (PCAOB),[1] enhancing auditor independence in particular audit engagements[2] and reducing capture risk by vesting engagement oversight in board audit committees.[3]

Other proffered reform proposals likewise tinkered with the existing model, including mechanisms adjusting auditor liability exposure.[4] A bolder innovation would replace the traditional auditor-engagement and liability model with financial statement insurance (FSI).[5] In a separate Article, I evaluate the merits of this concept, concluding that its potential efficacy warrants further consideration;[6] in this Article, I elaborate

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[1] Sarbanes-Oxley Act of 2002, § 101, Pub. L. No. 107-204, 116 Stat. at ___ ; 15 U.S.C. ____.

[2] Sarbanes-Oxley Act of 2002, § 203, Pub. L. No. 107-204, 116 Stat. at ___ ; 15 U.S.C. ____ (restricting the scope of non-audit services auditors may perform for audit clients); *see also* S.E.C. Reg. S-X, 17 C.F.R. § 210.2-01(c) (4)(i)-(ix) (same); Sarbanes-Oxley Act of 2002, § 301, Pub. L. No. 107-204, 116 Stat. at ___ ; 15 U.S.C. ____ (requiring audit firms to rotate lead audit partners on audit engagements every five years).

[3] Sarbanes-Oxley Act of 2002, § 301, Pub. L. No. 107-204, 116 Stat. at ___ ; 15 U.S.C. ____.

[4] *E.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (proposing semi-strict liability for auditors with damages set at a multiple of audit engagement revenue); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540-46 (2001) (proposing strict liability for auditors with damages set at a portion of total losses).

[5] A somewhat bold innovation is the new requirement to provide formal audits of internal control over financial reporting. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), RELEASE ACCOMPANYING AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (March 9, 2004). However, this remains a concept tied to traditional auditing practice. *See* Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 HASTINGS L. J. ___ (2004).

[6] Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. ___ (Winter 2004). The FSI proposal evaluated originated in Joshua Ronen, *Post-Enron Reform: Financial Statement*

details necessary to implement FSI in the form of federal legislation dubbed the Model Financial Statement Insurance Act (the "Model FSI Act").[7]

FSI would be an optional alternative to traditional financial statement auditing (FSA), with public companies required to use one of the two. Under FSI, a company buys insurance covering a given set of financial statements, paying a premium, and an insurer engages an auditor to assess risk and establish coverage. When losses occur due to materially misstated financials, the insurer pays the issuer's covered security holders up to the amount of policy coverage. The Model FSI Act requires disclosure of premium and coverage to provide public information concerning financial statement reliability, along with disclosure of material policy terms, and imposes certain mandatory terms and minimum FSI insurer qualifications.

By making auditors employees of FSI insurers, FSI neutralizes risks of auditor capture and conflict besetting traditional FSA. It diminishes regulatory concern about and needs for auditor independence and oversight. Insurers decide questions concerning auditor independence, including other services auditors could provide to insured audit clients, and how frequently audit firms or lead partners should be rotated through audit cycles to minimize capture risks. At the same time, FSI insurers are required to be independent of issuers whose financial statements they insure, and meet other regulatory supervision and financial (claims-paying) capacity requirements.

To be effective, FSI must differ from existing insurance policies used in corporate governance, such as directors' and officers' (D&O) insurance and related entity-level policies. Key differences include that FSI policies must be occurrence-based (not claims-made) and must be primary insurance (not excess insurance or otherwise limited by other-insurance clauses).[8] Illustrative implementation differences include interpreting insurance law's fortuity requirement (concerning the insurability of intentional acts), and evaluating traditional insurance law problems such as application fraud and other insurer defenses.[9] Other differences relate to the determination and meaning of insurance

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Insurance and GAAP Revisited, 8 STAN. J. L. BUS. 39, 54 (2002) [hereinafter, Ronen, *Post-Enron Reform*].

[7] The term Model is used to describe the FSI Act because while it contemplates application to the existing US securities law framework, it could be attractive for application to other systems, ranging from the European Union and other such blocs to those of individual countries, whether boasting emerging or developed capital markets.

[8] *See infra* text accompanying notes ___ to ___ (providing analysis of such provisions); *infra* text accompanying notes ___ to ___ (presenting draft Model FSI Act language).

[9] *See infra* text accompanying notes ___ to ___ (providing analysis of such provisions); *infra* text accompanying notes ___ to ___ (presenting draft Model FSI Act language).

premiums paid and coverage bought (for example, as to requirements for self-insurance through deductibles and retentions) and the claims-settlement process.[10]

The Model FSI Act harnesses traditional insurance practice and state insurance law in the service of federal securities regulation. Three tools facilitate achieving requisite marriage between state insurance law and insurance markets on the one hand and federal securities regulation on the other: contract, disclosure, and some judicial/regulatory adaptation. For each, a federal regulatory overlay achieved principally through the Model FSI Act is designed to create a streamlined process by which FSI policies are originated, qualified, become effective, and are enforced in the interest of investors.

Part I of this Article discusses the key concepts of FSI, beginning with the originating and underwriting processes, identifying and explaining the need for various mandatory policy terms, discussing common tailor-able terms and related required disclosure and addressing issues of judicial administration. Part II draws upon these concepts and, using the architecture of the U.S. Trust Indenture Act of 1939,[11] presents a draft Model FSI Act implementing these and related provisions.

Brief commentary on the Model FSI Act draft follows. It notes how the Model FSI Act's provisions concerning qualifications of FSI insurers and SEC power to reject applications on this basis is intended, in part, to address federal securities regulation objectives that may otherwise go unmet given that state insurance law governs insurer solvency and insurer regulation generally. A stronger federal role may be necessary and could be met by additional separate federal legislation concerning reinsurance and insurer-solvency mechanisms to support this insurance line.

I. ANALYSIS

The Model FSI Act begins by reciting perceived public policy advantages of the FSI alternative, including reducing systemic burdens posed by auditor conflict and capture risk. It contains the mechanisms necessary for a policy to be authorized, qualified with the SEC and become effective. The Model FSI Act follows the pattern of the U.S. Trust Indenture Act of 1939 by deeming all FSI policies to include a series of provisions designed to achieve federal securities law objectives FSI implicates.[12] The

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[10] *See infra* text accompanying notes ___ to ___ (providing analysis of such provisions); *infra* text accompanying notes ___ to ___ (presenting draft Model FSI Act language).

[11] Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (specifying a variety of provisions required to appear in a bond indenture for public debt securities in order for the agreement to qualify under federal securities laws) [hereinafter, the TIA].

[12] The Model FSI Act set forth in Part II follows the Trust Indenture Act in architecture, including the order of its sections. From scratch, the Model FSI Act could be ordered in slightly different ways for greater coherence; the TIA pattern is followed to facilitate comparison by securities law experts who are familiar with the TIA.

Model FSI Act also specifies minimum requirements FSI insurers must meet, requires certain disclosure and contemplates particular judicial administrative engagement to advance its objectives. Each of these aspects is discussed in this Part, before presenting in the following Part the draft text of the Model FSI Act implementing this discussion.

A. Authorization, Qualification, Effectiveness

For a company to use FSI as an alternative to FSA, the Model FSI Act requires audit committee approval, qualification of the proposed policy with the Securities and Exchange Commission (SEC) and a favorable security holder vote. Each requirement is designed to assure that the FSI policy will provide at least as much protection to investors and capital markets as they are provided by traditional financial statement auditing (FSA) accompanied by auditor liability exposure.

A company wishing to buy FSI requests proposals from independent insurance carriers, stating maximum coverage sought and contemplated premium (as well as lesser coverage amounts and associated premiums). Coverage amounts are linked to a company's equity market capitalization and principal debt outstanding while premiums are a function of financial statement reliability.

Issuers procure FSI proposals before a company's annual proxy statement is circulated (so, for a company reporting on a calendar basis, in November or December of the year before the year coverage will apply; call this Year-*X-1*). During this period, the FSI insurer engages an auditor to perform a preliminary review of the company and its internal-control and external-competitive environment and other relevant factors. On the basis of this investigation, FSI carriers furnish proposals, specifying coverage, premium and other policy terms.

The issuer's audit committee decides whether to select one of the proposals. If it does, the company discloses related material information in its proxy statement circulated during the year coverage is contemplated (call it Year-*X*). This sets the stage for federal qualification of the FSI policy and a security holder vote on whether to opt for it.

1. *SEC Qualification* — The Model FSI Act contemplates permitting issuers opting for the FSI alternative to apply for qualification of a proposed FSI policy in connection with the filing with the SEC of its proxy statement.[13] Application review follows the pattern charted in the U.S. Trust Indenture Act of 1939 for public bond indentures: the Model FSI Act deems all qualifying FSI policies to include a variety of mandatory provisions and prescribes minimum qualifications for the FSI insurer.[14] The SEC is empowered to issue stop orders if it determines that an FSI insurer is not qualified, either because of inadequate regulatory supervision, insufficient financial

[13] MODEL FSI ACT, § 4(a), *infra* text accompanying notes ___ to ___.

[14] MODEL FSI ACT, § 7, *infra* text accompanying notes ___ to ___.

capacity or lack of independence from the issuer.[15] Absent a stop order, the FSI application is deemed qualified and the proposing issuer may proceed to seek security holder approval at the meeting for which its proxy statement is circulated.[16]

2. *Security Holder Approval* — Proposed adoption of FSI is put to a security holder vote. Investors of issuers not opting for FSI would effectively opt for FSA; those opting for FSI would be relieved of federal securities law obligations to have financial statements audited under the traditional FSA framework (and the Model FSI Act so amends related federal securities laws).[17] The Model FSI Act also provides enabling mechanisms to deal with multiple classes of stock and voting by non-equity security holders, by contemplating using corporate charters or debt instruments to specify whether particular creditors or other claimants are entitled to vote on such matters.[18]

3. *Effects of Security Holder Approval* — The chief regulatory effect of security holder FSI approval is to relieve the issuer of obligations to provide FSA in the traditional manner. Instead, FSI contemplates that the FSI insurer would engage an auditor to perform this function and provide requisite opinions. The chief legal effect is to limit investor recoveries against auditors or issuers for financial misstatements to the FSI policy and its specified coverage amount. The Model FSI Act thus eliminates damages payable by auditors and issuers for financial statements covered by an FSI policy (though not of other parties, such as directors, officers, attorneys or underwriters).[19]

4. *Security Holder Alternatives* — In connection with the security holder vote on an FSI proposal, proxy statement disclosure and balloting offer three choices: (1)

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[15] MODEL FSI ACT, § 5(c), *infra* text accompanying notes ___ to ___; *see also* MODEL FSI ACT, § 6(b), *infra* text accompanying notes ___ to ___ (stop order after initial qualification); MODEL FSI ACT, § 8, *infra* text accompanying notes ___ to ___ (eligibility and disqualification of FSI insurer).

[16] MODEL FSI ACT, §§ 6(a) & 4(b), *infra* text accompanying notes ___ to ___. Given the innovative character of FSI, it may be desirable to implement it gradually, initially limiting availability to issuers meeting certain size or other requirements. *See* Cunningham, *Choosing Gatekeepers*, *supra* note ___, at ___. The Model FSI Act could give the SEC power to screen applications for meeting such requirements as well.

[17] MODEL FSI ACT, § 4(a), *infra* text accompanying notes ___ to ___ (operative amending language); *see also* MODEL FSI ACT, § 4(c), *infra* text accompanying notes ___ to ___ (cross-reference to such operative amending language).

[18] MODEL FSI ACT, § 4(c), *infra* text accompanying notes ___ to ___.

[19] MODEL FSI ACT, § 4(c), *infra* text accompanying notes ___ to ___; *see also* MODEL FSI ACT, § 20(a), *infra* text accompanying notes ___ to ___ (no effect on existing law except as expressly provided).

accepting the maximum offered coverage, paying related premium; (2) accepting lower levels management recommends; or (3) taking no insurance. For companies opting to take no insurance, traditional FSA procedures and related liability rules remain in place for that year. For companies opting for one of the FSI alternatives, the next step is for the FSI insurer to engage an auditor to conduct a full audit of the company's Year-*X* financial statements.

5. *The Audit Condition* — For companies opting into FSI coverage, the audit plan is developed, for the fiscal year in which the related security-holder vote is held and for which coverage is contemplated (that is, Year-*X*). The audit plan is designed by the auditor, subject to FSI insurer oversight, and the audit for Year-*X* conducted and concluded in the early months of the following year (call it Year-*X+1*). The audit plan and other auditing procedures are governed by generally accepted auditing standards in effect from time to time.

The FSI policy must contain a condition making it effective only if the auditor gives an unqualified financial statement audit opinion.[20] Otherwise, the policy does not become effective and the issuer remains subject to the FSA regime and all related liability rules. An unqualified audit report, issued in Year-*X+1,* must include a paragraph disclosing coverage associated with the Year-*X* financial statements and related premium. The Model FSI Act directs the SEC to direct the Public Company Accounting Oversight Board to amend generally accepted auditing standards to achieve this result.[21] FSI thus replaces auditor and issuer liability arising from material financial misstatements for Year-*X*, approved by investor vote in that year, and taking effect in Year-*X+1*.

6. *Coverage Amounts* — Markets can be relied upon substantially to set relevant FSI coverage amounts for particular issuers. However, federal securities laws may need to specify metrics establishing bands of minimum and maximum coverage. These would vary principally with each issuer's equity market capitalization, adjusted for the principal amount of its outstanding public debt. The Model FSI Act authorizes and directs the SEC to establish by rule and regulation the appropriate coverage parameters based upon its study and evaluation.[22]

B. Deemed Terms

Apart from these mechanics concerning authorization, qualification and effectiveness of FSI policies, all FSI policies would necessarily contain a variety of provisions to make FSI a suitable alternative to FSA. While other policy terms could be tailored as particular issuers and FSI insurers prefer, the Model FSI Act establishes the

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[20] MODEL FSI ACT, § 4(d), *infra* text accompanying notes ___ to ___.

[21] MODEL FSI ACT, § 4(d)(2), *infra* text accompanying notes ___ to ___.

[22] MODEL FSI ACT, § 4(e), *infra* text accompanying notes ___ to ___.

mandatory minimum by deeming all qualifying FSI policies to contain the following provisions.

1. *Occurrences, not Claims Made* — All FSI policies must be occurrence-based policies. FSI insures a particular year's financial statements, with coverage extending to discoveries made in future periods. In insurance parlance, this means FSI is retroactive coverage, to be provided on an "occurrence" basis. There invariably will be a time lag between the event causing damages (a material financial misstatement) and their manifestation (revelation with value-destroying effects on securities). As retroactive coverage, FSI covers a particular year's financial statements, and extends coverage for numerous subsequent years. The Model FSI Act contemplates defining the coverage period in parallel with analogous statutes of limitation and repose.[23]

2. *Primary, not Excess* — FSI would play a central role in financial reporting and securities trading, including by providing a signaling function reflected in the premium-coverage mix various companies are offered.[24] This means FSI policies must be the primary insurance source, not subordinated to coverage under other overlapping policies and not exposed to disputation concerning which of multiple overlapping policies apply. To achieve this, FSI would be designated as primary, not excess, and contain no other-insurance clauses. The Model FSI Act therefore provides that FSI policies are deemed to contain provision specifying primary coverage and omit any other-insurance clauses.[25]

3. *Claims* — In traditional insurance law and practice, processes to determine, measure and pay recoveries for losses follow a rigid pattern: the insured must notify the insurer of a claim; the insurer investigates; the insurer becomes liable only when the insured is held liable; the insurer typically defends the claim; and settlements are reached or the case goes to trial. The Model FSI Act contemplates a more streamlined approach.[26] The FSI policy reflects joint selection by the FSI insurer and the issuer of a fiduciary organization to assess claims, notify the insurer of claims, and represent investor interests. When losses are claimed, and notice provided, the FSI insurer and fiduciary

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[23] MODEL FSI ACT, § 7(a)(1), *infra* text accompanying notes ___ to ___.

[24] FSI's key information-generation is the premium-coverage mix, which meets conditions of a signaling equilibrium. *See* Ronen, *supra* note ___. While premium amount varies with coverage level, for a given coverage level, premiums vary inversely with quality (positively with assessed risk). Optimality is reinforced by higher-quality risk assessment and audit. Likewise, for a given premium, coverage varies positively with quality (negatively with assessed risk).

[25] MODEL FSI ACT, § 7(a)(2), *infra* text accompanying notes ___ to ___. The Model FSI Act also requires related disclosure. MODEL FSI ACT, § 5(a)(2)(D), *infra* text accompanying notes ___ to ___.

[26] MODEL FSI ACT, § 7(a)(3), *infra* text accompanying notes ___ to ___; MODEL FSI ACT, § 12(c), *infra* text accompanying notes ___ to ___.

organization mutually select an independent expert to determine the claim's validity and amount. The expert reports results to the FSI insurer, which then provides funds to the fiduciary organization to compensate investor losses.

4. *Notice* — Most insurance policies impose strict notice requirements, making compliance with specified procedures a condition to an insurer's obligation to pay proceeds. Typical requirements include notice given *by the insured* being made promptly after an occurrence that might create covered liability. For FSI, effective notice can arise from numerous sources, including the insurer's own auditor or management, as well as independent investigations by the SEC or securities lawyers. Because such notice would provide the FSI insurer with a basis and opportunity to investigate, the Model FSI Act provides that FSI policies are deemed to include more liberal notice provisions than apply to other types of insurance.[27]

5. *No-Action Clauses* — Insurance policies commonly contain no-action clauses restricting rights of third-party loss victims to recover directly from the insurer, requiring them instead to obtain judgments against the insured. This route would diminish the utility of FSI as a device to protect investors from issuer misconduct, manifested in its materially misstated financial statements that trigger FSI loss payouts. To avoid this result, the Model FSI Act deems FSI policies to permit direct actions against FSI insurers by investors or their fiduciary representative.[28]

6. *Issuer Bankruptcy* — FSI policies must include provisions making the insured's bankruptcy or insolvency irrelevant to the insurer's obligations. Otherwise, without a judgment against the insured, investors have no way to sue the insurer. And the Bankruptcy Code stays claims against debtors,[29] preventing investors from obtaining a judgment that would trigger liability under the policy. The Model FSI Act expresses its public policy preference for making issuer bankruptcy irrelevant by deeming FSI policies to contain related provisions.[30] These furnish a public-policy and contractual basis for bankruptcy courts to lift the automatic stay and allow judgments (providing that any judgment not be executed against the debtor's assets but only against the insurer).[31]

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[27] MODEL FSI ACT, § 7(a)(4), *infra* text accompanying notes ___ to ___; MODEL FSI ACT, § 12(d), *infra* text accompanying notes ___ to ___.

[28] MODEL FSI ACT, § 7(a)(5), *infra* text accompanying notes ___ to ___. To make FSI attractive to the insurance industry, these provisions may need to be relaxed.

[29] 11 U.S.C. § 362.

[30] MODEL FSI ACT, § 7(a)(6), *infra* text accompanying notes ___ to ___.

[31] *See* ROBERT JERRY, UNDERSTANDING INSURANCE LAW (3d ed. 2002), at 655-56.

[31] *See id.,* 657-58.

7. *Loss Payees* — For FSI, companies are the insured and policies name as loss payees those investors holding the company's securities during the reporting period for a set of covered financial statements. The Model FSI Act addresses apportionment issues among investors in issuers with complex capital structures by mirroring relevant voting rules determining FSI approval.[32] FSI policies are deemed to include such apportionment provisions.[33]

8. *Good Faith to Investors* — In third-party insurance, insurers are obliged to exhibit good faith towards the insured and may be subject to tort liability to insureds when acting in bad faith. For FSI, good faith requirements are necessary not so much to the insured as to the loss payees, to investors. Enlisting insurers so directly in the auditing function under FSI requires imposing on them the public watchdog and investor protection functions associated with traditional financial statement auditing. Accordingly, the Model FSI Act deems to be part of FSI policies provisions imposing on FSI insurers the duty of good faith towards investors, not issuers.[34]

C. Tailoring and Disclosure

FSI aspires to maximal standardization to provide as much informational content to the premium-coverage mix as possible, while allowing for tailoring, consistent with the Model FSI Act, to maximize premium-risk accuracy (and requiring disclosure of material policy-tailoring).[35] Disclosure upon FSI policy authorization, qualification and

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[32] A related issue concerns competing claims to treat FSI as an asset of the insured. When losses occur, payees may face competition from other parties for claims on that asset. While an FSI policy's contract rights may accrue only to the insured and investors as loss payees, third parties may assert rights to the policy's value. Most state laws limit this maneuver, under so-called state exemption statutes that put insurance policies outside the reach of an insured's creditors. These laws may be of limited utility for FSI policies naming as loss payees both shareholders and debt-holders, however, leaving unresolved a competition between them and with other creditors. Insurers and issuers may therefore find it desirable to identify intended loss payees, rank priorities and provide mechanisms substantially as comprehensive as relevant bankruptcy rules addressing the relation between an insured and loss payees on the one hand and the insured's non-covered creditors on the other. Directive legislation may also be useful, although the Model FSI Act that follows does not attempt to delineate these matters.

[33] MODEL FSI ACT, § 7(a)(7), *infra* text accompanying notes ___ to ___.

[34] MODEL FSI ACT, § 7(a)(8), *infra* text accompanying notes ___ to ___; MODEL FSI ACT, § 12(e), *infra* text accompanying notes ___ to ___. Public disclosure may be necessary or appropriate to explain the meaning of such provisions and remaining potential conflicts. The SEC can prepare requisite disclosure. *See* MODEL FSI ACT, § 5(b), *infra* text accompanying notes ___ to ___ (following the Trust Indenture Act approach of directing the SEC to prepare requisite supplementary disclosure).

[35] *See* MODEL FSI ACT, § 20(b), *infra* text accompanying notes ___ to ___.

effectiveness is made in the issuer's proxy statement;[36] periodic disclosure is made in its other periodic reports containing covered financial statements.[37]

1. *Premium-Coverage Mix* — FSI's key information-generation is the premium-coverage mix, creating a signaling equilibrium as to the reliability of an issuer's financial statements. The premium-coverage is an integrated expression of risk, but numerous other FSI policy terms can be used to adjust risk in ways that alter the premium-coverage mix. Some standardization will be desirable to promote FSI's efficacy (and as the previous section discussed, the Model FSI Act deems certain provisions to be standard). The Model FSI Act requires material tailored terms to be disclosed.[38]

2. *Self-Insurance* — Provisions that can be tailored and accompanying disclosure required include self-insurance as through deductibles, retentions and co-insurance on the insured. These are designed to address *moral hazard*, disincentives to take precautionary measures when resulting losses are paid by others. The Model FSI Act does not impose substantive limits on these terms, but requires related disclosure.[39]

3. *Insurer Duties* — Some insurance lines, including traditional D&O policies used in corporate governance, do not impose on insurers duties to defend, but duties to indemnify only. Most public companies possess requisite resources and expertise to mount effective defenses without the need for the insurer's resources. As a result, demand for FSI would probably be for indemnity-only policies. Federal securities law should be indifferent to this choice, permitting either. The Model FSI, however, requires disclosure to explain the effects of the defend-versus-indemnity-only policy term on the premium-coverage mix.[40]

4. *Post-Policy Discoveries* — A key issue in making FSI efficacious concerns FSI insurer and auditor incentives to disclose accounting irregularities discovered in

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[36] MODEL FSI ACT, § 5(b), *infra* text accompanying notes ___ to ___.

[37] MODEL FSI ACT, § 5(a), *infra* text accompanying notes ___ to ___.

[38] MODEL FSI ACT, § 5(a)(2)(A), *infra* text accompanying notes ___ to ___. As to potential liability for disclosure deficiencies, see *infra* note ___. Materiality in this context can be treated in a functionally equivalent manner to its general treatment under federal securities laws (matters reasonable investors would consider important in making investment decisions), with due regard for its particular contextual relation to effects on an FSI policy's premium-coverage mix. The Model FSI Act provided below does not provide special definition of the materiality concept, leaving this to judicial interpretation and application on a case-by-case basis.

[39] MODEL FSI ACT, § 5(a)(2)(B), *infra* text accompanying notes ___ to ___.

[40] MODEL FSI ACT, § 5(a)(2)(C), *infra* text accompanying notes ___ to ___.

periods after an FSI policy becomes effective. An FSI audit for a given year, say Year-X_1, creates incentives to discover, correct and/or disclose all irregularities; but Year-X_2 may bring opposite pressure to conceal irregularities the auditor failed to discover during Year-X_1. To address this disclosure disincentive, the Model FSI Act requires FSI insurers to disclose any post-policy issuance discoveries triggering possible coverage under the FSI policy.[41] Failure results in penalties against the FSI insurer measured as a multiple of the loss payouts the FSI insurer otherwise faced under the FSI policy.[42]

D. Administration

The Model FSI Act is an ambitious innovation addressing numerous potentially complex issues. Most of these can be handled directly through its provisions, supplemented by particular FSI policy terms and requisite disclosure. In addition, however, certain provisions can only be addressed in the process of administering FSI policies under the Model FSI Act. These provisions require judicial engagement, which is given direction in the Model FSI Act.[43]

1. *Fortuity* — Traditional insurance law prohibits insuring losses arising other than through fortuity, thus excluding coverage for losses due to intentional acts. The Model FSI Act contemplates applying judicial strategies to balance insurance law's fortuity requirement with FSI's public policy goals to permit coverage for a broad range of financial misstatement causes, including intentional acts.[44] These strategies interpret the fortuity requirement to vary depending on the viewpoint adopted (for liability policies, whether the insured or a third party).[45] Injury to the third party is seen as fortuitous (to it, injury is not certain), even though from the insured's viewpoint injury would not be fortuitous.[46] This approach is justified since FSI makes insurers central

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[41] MODEL FSI ACT, § 10(b), *infra* text accompanying notes ___ to ___.

[42] MODEL FSI ACT, § 19(b), *infra* text accompanying notes ___ to ___.

[43] The Model FSI Act also vests the federal judiciary with power to review SEC orders and jurisdiction over litigation arising out of its provisions. MODEL FSI ACT, §§ 16(a) & 16(b), *infra* text accompanying notes ___ to ___.

[44] MODEL FSI ACT, § 16(c)(1), *infra* text accompanying notes ___ to ___. For fuller discussion of these strategies as applied to FSI, and defending rationales, see Cunningham, *Choosing Gatekeepers*, *supra* note ___.

[45] *See* Jeffrey W. Stempel, *Construing the Fortuity Requirement in Coverage for "Accident*," 4 CONN. INS. L. J. 855 (discussing *Nationwide Mutual Fire Ins. Co. v. Pipher*, 140 F.3d 222 (3d Cir. 1998) (applying Pennsylvania law) where the court adopted approach of analyzing fortuity requirement and related policy provision excluding intentional or expected acts using insured's standpoint and finding coverage).

[46] JERRY, UNDERSTANDING INSURANCE LAW, *supra* note ___, at 452.

participants as monitors of auditors. By hypothesis, FSI insurers would set FSI premiums in anticipation of this approach to the fortuity requirement.

2. *Application Fraud* — The Model FSI Act calls for limiting the circumstances under which FSI insurers may assert as a grounds to refuse coverage application fraud, an otherwise commonly available insurer defense. FSI applications are required, but the information contained is used to make an initial determination of whether to investigate a proposed policy risk. No policy will issue until after the insurer's auditor completes a full financial statement audit and issues an unqualified opinion on financial statements. This audit condition gives insurers access to information and enhances risk-assessment capabilities, negating the credibility of any subsequent insurer claim of reliance on managerial assertions. While even an audit provides imperfect information, to assure FSI's efficacy, the Model FSI Act therefore directs that judicial construction of FSI policies and disputes to limit the traditional scope of the application fraud defense.[47]

3. *Other FSI Insurer Defenses* — Under third-party (liability) insurance policies, the insurer's duty to pay proceeds is subject to the insured meeting various conditions, over which loss payees lack control. Insurers may be discharged from obligation when the insured makes misrepresentations, fails to give proper notice, cooperate with the insurer, and commits other failures. For FSI, the insured's conduct likely will be central to the claims process. This is the case even when a fiduciary organization is designated in the FSI policy as an investor representative. To minimize adverse effects of this risk, the Model FSI Act directs strict judicial construction of insurer defenses to protect investors.[48] FSI insurers would again likely set policy premiums in anticipation of this approach.

E. Other TIA-Type Terms

Additional provisions of the Model FSI Act direct the coordination of its overall framework. These likewise follow the pattern of the U.S. Trust Indenture Act of 1939.

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[47] MODEL FSI ACT, § 16(c)(2), *infra* text accompanying notes ___ to ___. A misrepresented application means the insured was assigned to a lower risk tier than was appropriate, effectively seeking more coverage for less premium than otherwise available. Rejecting or diluting the misrepresentation defense forces lower-risk insureds to fund the costs of covering higher-risk insureds. The trade-off, therefore, is between protecting the insurer's risk-classification model and extending coverage to those not meeting it. For FSI, the balance tips in favor of limiting the application fraud defense. Given the insurer's full opportunity to investigate, risk classifications should be precisely tailored to that investigation. Extending coverage to protect harmed investors should not impair the insurer's risk-classification methodology nor increase costs for other investors.

[48] MODEL FSI ACT, § 16(c)(3), *infra* text accompanying notes ___ to ___.

1. *Information Flows* — In addition to public disclosures, the Model FSI Act requires issuers to furnish a variety of information to FSI insurers.[49] Key information includes the loss payee list, the list of security holders entitled to share in any proceeds paid under a policy covering a given set of financial statements.[50] Issuers are obliged to furnish such lists to FSI insurers and the latter are required to maintain custody thereof for use in the event of payout. The FSI insurer is required to provide reports to investors whenever developments occur affecting its qualifications to serve as FSI insurer and whenever it discovers, or should have discovered, accounting irregularities at an issuer covered by an FSI policy it issued.[51]

2. *SEC Role* — The SEC is given administrative authority in the Model FSI Act. In the origination and qualification process, its chief role is to review the FSI insurer's qualifications, and is empowered to refuse recognition of FSI policies backed by FSI insurers lacking regulatory supervision, financial capability or independence vis-à-vis issuers.[52] It is not, however, required to conduct any particular investigation beyond such matters. Further, the Model FSI Act deems provisions to be included in FSI policies, relieving the SEC of any duty or need to examine particular policies.[53] More generally, the SEC is given power to issue related rules and regulations to administer the Model FSI Act and achieve its public policy objectives.[54]

3. *Liability Matters* — Of key concern are the liability exposures that could be generated by the disclosure and other provisions of the Model FSI Act. In general, these are restricted. Following the pattern of the U.S. Trust Indenture Act of 1939, disclosure concerning policy terms and FSI insurer qualifications do not expose the issuer or FSI insurer to liability for misrepresentations.[55] On the other hand, multiple damages are

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[49] MODEL FSI ACT, § 11, *infra* text accompanying notes ___ to ___.

[50] MODEL FSI ACT, § 9, *infra* text accompanying notes ___ to ___.

[51] MODEL FSI ACT, § 10, *infra* text accompanying notes ___ to ___ (also requiring the FSI insurer to provide copies to stock exchanges where covered securities are listed).

[52] MODEL FSI ACT, § 6(e), *infra* text accompanying notes ___ to ___.

[53] MODEL FSI ACT, § 13, *infra* text accompanying notes ___ to ___.

[54] MODEL FSI ACT, §§ 14 & 15, *infra* text accompanying notes ___ to ___.

[55] MODEL FSI ACT, §§ 5(a), 5(d), 6(d), *infra* text accompanying notes ___ to ___; *compare* TIA, §§ 777eee & 777iii. The Trust Indenture Act excludes from liability under the federal securities laws material misstatements or omissions in disclosure concerning the indenture terms. *See* TIA, § 777eee(d). The theory, in part, is this information abstracts from publicly disclosed contracts. A similar approach can be taken in the Model FSI Act to the extent FSI policies are publicly disclosed. On the other hand, to the extent those terms change significantly in ways affecting significantly the premium-coverage mix and its interpretation, liability threats may be desirable. More likely warranting exact

imposed on FSI insurers who fail to disclose accounting irregularities discovered after an FSI policy is issued.[56] Furthermore, general prohibitions against misleading statements or omissions concerning operation of the Model FSI Act apply, exposing guilty parties to both SEC and private actions.

II. TEXT

To recapitulate the prior discussion of how to make FSI efficacious as a matter of securities regulation: audit committees of issuers decide whether to opt for FSI as an alternative to FSA and file proxy statement materials with the SEC subject to its stop order and to security holders for an approval vote. The SEC can issue a stop order preventing qualification of policies for which the FSI insurer is not qualified. All mandatory terms specified in the Model FSI Act are deemed to be part of the FSI policy, including terms as to occurrence-based policies, primary coverage, notice effectiveness, good faith duties to investors and other matters. Other policy terms are subject to disclosure, and various information and administrative provisions are included. The following draft text of the Model FSI Act implements these provisions, using the template of the U.S. Trust Indenture Act of 1939 governing public debt instruments and their trustees.

A Model Financial Statement Insurance Act

§ 1. Short Title.[57]

This subchatper may be cited as the "Model FSI Act," and is so referred to herein.

§ 2. Advantages of Legislation.[58]

(a) *Positive Effects on the Public*. Upon the basis of investigation, it is hereby declared that the national public interest and the interest of investors in public securities, offered to the public or traded on public securities exchanges, can be positively affected: (1) when issuers, with audit committee and security holder approval, procure insurance to provide compensation to investors when the issuer's financial statements, accompanied by an unqualified opinion of a registered public accounting firm, do not comply with applicable accounting and disclosure requirements under the federal securities laws; (2)

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replication are the no-liability provisions relating to information concerning the FSI insurer. As drafted, the Model FSI Act follows the Trust Indenture Act approach.

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[56] MODEL FSI ACT, § 10(b), *infra* text accompanying notes ___ to ___ (FSI insurer duty to disclose discovered accounting irregularities); MODEL FSI ACT, § 19(b), *infra* text accompanying notes ___ to ___ (imposing on FSI insurer penalties for violating this provision).

[57] This section is equivalent to TIA, § 77aaa, Short Title.

[58] This section is equivalent to TIA, § 77bbb, Advantages of Regulation.

when the insurer is appropriately qualified as to regulatory supervision, independence and financial capacity; and (3) financial statement insurance policies contain certain provisions relating to various terms necessary in the public interest and for the protection of investors.

(b) *Declaration of Policy*. Providing financial statement insurance can benefit the capital markets, investors, and the general public; and it is hereby declared to be the policy of this Model FSI Act, in accordance with which policy all provisions of this Model FSI Act shall be interpreted, to meet the goals and aspirations enumerated in this section.

§ 3. Definitions.[59]

Terms defined in section 2 of the Securities Act of 1933,[60] and not otherwise defined in this section shall have the meaning assigned to such term in such section 2. When used in this Model FSI Act, unless the context otherwise requires:

"application" or "application for qualification" means the application provided for in § 5 of this Model FSI Act, and includes any amendment thereto and any report, document, or memorandum accompanying such application or incorporated therein by reference.

"Commission" means the Securities and Exchange Commission.

“FSI” means financial statement insurance.

“FSI insurer” means each insurance company under the FSI policy to be qualified, and each successor insurer.

“FSI policy” means any policy of insurance issued with respect to the financial statements of an issuer.

“FSI policy to be qualified" means (x) the FSI policy under which there has been or is to be issued a set of financial statements in respect of which a particular annual report, registration statement or other filing has been made requiring a set of financial statements; or (y) the FSI policy in respect of which a particular application has been filed.

“institutional insurer” has the meaning specified in § 8 of this Model FSI Act.

"insured financial statement" means any financial statement covered or to be covered by an FSI policy to be qualified.

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[59] This section is equivalent to TIA, § 77ccc, Definitions.

[60] 15 U.S.C. § 77b.

"insured," when used with respect to any such insured financial statement, means the issuer.

"State" means any State of the United States.

§ 4. Financial Statements Permitted to be Insured.[61]

(a) *Authorization*. (1) Section ___ of the Securities Exchange Act of 1934, 15 U.S.C. 78m(a)(2), is hereby amended to provide that, in lieu of the requirement that an issuer's financial statements be audited by a registered public accounting firm,[62] that the financial statements be accompanied by a qualified and effective FSI policy as provided in this Model FSI Act. (2) To the same extent specified in the preceding clause (1), Section ___ of the Securities Act of 1933, 15 U.S.C. 77aa, is hereby amended with respect to financial statements of issuers subject to the provisions of Section 14 of the Securities Exchange Act of 1934.

(b) *Qualification*. In order for an FSI policy to be eligible for qualification, the following procedures must be followed:

(1) the application must be approved by the issuer's audit committee, duly constituted in accordance with the Sarbanes-Oxley Act of 2002;

(2) the application must be disclosed in the issuer's proxy statement filed with the Commission and circulated to security holders in accordance with § 5 of this Model FSI Act; and

(3) the Commission must not have issued any stop order in accordance with §§ 5 or 6 of this Model FSI Act.

(c) *Effectiveness*. The FSI policy must be approved by the issuer's security holders in accordance with applicable voting requirements under the laws of the issuer's jurisdiction of organization and its by-laws, charter documents, and relevant contracts and other agreements addressing security holder voting. Such approval of a qualified FSI policy (1) relieves the issuer of the obligations referred to in subsection (a) of this section and (2) entitles the security holders to the benefits of the FSI policy as contemplated therein and in this Model FSI Act, and relieves the issuer and the FSI insurer's agents, including registered public accounting firms, from liability for material misstatements in covered financial statements.

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[61] This section has no parallel in the TIA.

[62] This Section uses the language registered public accounting firm, adopted under the Sarbanes-Oxley Act of 2002, whereas the original 1934 Act uses different equivalent language then prevalent to denominate such firms.

(d) *Audit Condition*. (1) Notwithstanding any other provision of this Model FSI Act, no FSI policy shall become effective absent the issuance by a registered public accounting firm engaged by the FSI insurer for an issuer's financial statements of an unqualified audit opinion letter as to their fair presentation and compliance with generally accepted accounting principles. Such an opinion letter shall be included as a component part of the issuer's financial statements filed with the Commission. (2) The Commission shall direct the Public Company Accounting Oversight Board to adopt as generally accepted auditing standards provision for an unqualified audit opinion letter accompanying financial statements covered by a qualified and effective FSI policy to include a paragraph disclosing coverage and associated premium.

(e) *Coverage Amount*. The Commission shall determine, based upon necessary and appropriate study, relevant maximum and minimum coverage amounts for FSI applicable to classes of issuers based in part upon relevant aggregate equity market capitalization and principal amount of debt outstanding.

§ 5. Information Required; Filing.[63]

(a) *Information Required in Periodic Reports*. Subject to the provisions of § 4 of this Model FSI Act, a filing containing financial statements covered or to be covered by an FSI policy shall include the following information and documents:[64]

(1) such information and documents as the Commission may by rules and regulations prescribe in order to enable the Commission to determine whether any person designated to act as FSI insurer under the FSI policy covering such financial statements is eligible to act as such under § 8 of this Model FSI Act; and

(2) an analysis of any provisions of such FSI policy with respect to:

(A) the premium and coverage associated with such FSI policy;

(B) the nature and amount of any self-insurance provisions, including relating to deductibles, co-insurance, retentions and other such matters;

(C) the nature and scope of the FSI insurer's duties with respect to defending claims or providing indemnification for claims and the effect thereof on the FSI policy's premium and coverage terms;

(D) any overlapping insurance policies and the significance thereof, the meaning of the concept of primary insurance and the relation of any other excess or other potentially applicable insurance policies.

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[63] This section is equivalent to TIA, § 77eee, _____.

[64] *Compare* 15 U.S.C. § 77g.

Any information and documents required by paragraph (1) of this subsection with respect to the person designated to act as FSI insurer shall be contained in a separate part of such filing, which part shall be signed by such person. Such part of the filing shall be deemed to be a document filed pursuant to this Model FSI Act.[65]

(b) *Information Required in Proxy Statement*. A proxy statement proposing a security holder vote concerning any FSI policy shall include, to the extent the Commission may prescribe by rules and regulations as necessary and appropriate in the public interest or for the protection of investors, as though such inclusion were required by § 14 of the Securities Exchange Act of 1934, a written statement containing the analysis of any FSI policy provisions with respect to the matters specified in paragraph (2) of subsection (a) of this section, together with a supplementary analysis, prepared by the Commission, of such provisions and of the effect thereof, if, in the opinion of the Commission, the inclusion of such supplementary analysis is necessary or appropriate in the public interest or for the protection of investors, and the Commission so declares by order after notice and, if demanded by the issuer, opportunity for hearing thereon. Such order shall be entered prior to the security holder vote, except that if opportunity for hearing thereon is demanded by the issuer such order shall be entered within a reasonable time after such opportunity for hearing.

(c) *Refusal of Filing*. The Commission shall issue an order prior to the related annual meeting refusing to permit a security holder vote on an FSI application, if it finds that any person designated as FSI insurer under such FSI policy is not eligible to act as such under § 8 of this Model FSI Act; but no such order shall be issued except after notice and opportunity for hearing. If and when the Commission deems that the objections on which such order was based have been met, the Commission shall enter an order rescinding such refusal order, and the security holder vote may proceed.

(d) *Applicability of Other Statutory Provisions*. The provisions of sections 11, 12, 17, and 24 of the Securities Act of 1933,[66] and §§ 10 and 14 of the Securities Exchange Act of 1934 and the provisions of §§ 17 and 19 of this Model FSI Act, shall not apply to statements in or omissions from any analysis required under the provisions of this section.

(e) *Integration of Procedure with Securities Act and other Acts*.[67] The Commission, by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, shall (1) authorize the filing of any information or documents required to be filed with the Commission under this Model FSI

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[65] *Compare* 15 U.S.C. §§ 77k, 77l, 77q, 77x.

[66] 15 U.S.C. §§ 77k, 77l, 77q, 77x.

[67] This subsection is equivalent to TIA, § 77hhh, Integration of Procedure with Securities Act and other Acts.

Act, or under the Securities Act of 1933,[68] the Securities Exchange Act of 1934,[69] or other applicable statutes, by incorporating by reference any information or documents on file with the Commission under this Model FSI Act or under any such Act and (2) provide for the consolidation of applications, reports, and proceedings under this Model FSI Act with registration statements, proxy statements, applications, reports, and proceedings under the Securities Act of 1933 and the Securities Exchange Act of 1934.

§ 6. Effective Time of Qualification.[70]

(a) *Effective time of Application for Qualification of FSI Policy*. The FSI policy covering a set of financial statements shall be deemed to have been qualified under this Model FSI Act when an application for the qualification of such FSI policy becomes effective pursuant to § 4(b) of this Model FSI Act.

(b) *Stop Orders after Effective Time of Qualification*. After qualification has become effective as to the FSI policy covering a set of financial statements, no stop order shall be issued pursuant to section 77h(d) of this title, suspending the effectiveness of the application for qualification of such FSI policy, except on one or more of the grounds specified therein, or the failure of the issuer to disclose publicly the information as specified in § 5 of this Model FSI Act.

(c) *Effect of Subsequent Rule or Regulation on Qualification*. The making, amendment, or rescission of a rule, regulation, or order under the provisions of this Model FSI Act shall not affect the qualification, form, or interpretation of any FSI policy as to which qualification became effective prior to the making, amendment, or rescission of such rule, regulation, or order.

(d) *Liability of FSI Insurer under Qualified FSI Policy*. No FSI insurer under an FSI policy which has been qualified under this Model FSI Act shall be subject to any liability because of any failure of such FSI policy to comply with any of the provisions of this Model FSI Act, or any rule, regulation, or order hereunder, except to the extent that all terms deemed by this Model FSI Act to be part of the FSI policy shall be binding on the FSI insurer.

(e) *Commission Investigation*. Nothing in this Model FSI Act shall be construed as empowering the Commission to conduct an investigation or other proceeding for the purpose of determining whether the provisions of an FSI policy which has been qualified under this Model FSI Act are being complied with, or to enforce such provisions.

§ 7. FSI Policy Terms.[71]

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[68] 15 U.S.C. §§ 77a *et seq*.

[69] 15 U.S.C. §§ 78a *et seq*.

[70] This section is equivalent to TIA, § 77iii, Effective Time of Qualification.

(a) *Deemed Terms*. The FSI policy to be qualified shall automatically be deemed to provide as follows:

(1) the FSI policy is an occurrence-based policy, not a claims-made policy, with a limitations-on-actions period extending for a term equivalent to the related period of limitations or repose otherwise applicable under the Securities Act of 1933, the Securities Exchange Act of 1934, or other relevant statute;

(2) the FSI policy is primary coverage, not excess coverage, and does not contain any other-insurance clauses;

(3) provision governing the making of claims as set forth in § 12(c) of this Model FSI Act;

(4) provision governing the effectiveness of notice as set forth in § 12(d) of this Model FSI Act;

(5) provision authorizing direct actions against the FSI insurer by security holders or their duly constituted representative;

(6) an issuer's bankruptcy shall have no effect on the FSI insurer's obligations under the FSI policy;

(7) the category of loss payees under the FSI policy shall be those security holders entitled to vote on an FSI policy approval under § 4(c) of this Model FSI Act and particular loss payees shall be those appearing in the records of the issuer furnished to the FSI insurer in accordance with § 9 of this Model FSI Act;

(8) provision governing insurer good faith as set forth in § 12(e) of this Model FSI Act; and

(9) other terms set forth in this Model FSI Act.

(b) *Additional Terms*. The FSI policy to be qualified shall automatically be deemed to contain such other terms as the Commission from time to time adopts by rules and regulations as necessary and appropriate in the public interest or for the protection of investors.

§ 8. Eligibility and Disqualification of FSI Insurer.[72]

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[71] This section has no precise equivalent in the TIA, but draws its architecture from provisions contained in TIA §§ 77jjj through 77qqq; *see* TIA § 77rrr.

[72] This section is equivalent to TIA § 77jjj, Eligibility and Disqualification of Indenture Trustee.

(a) *Authority and Supervision*. There shall at all times be at least one FSI insurer under every FSI policy qualified or to be qualified pursuant to this Model FSI Act, which shall at all times be organized and doing business under the laws of the United States or of any State or Territory or of the District of Columbia or otherwise permitted to act as FSI insurer by the Commission (referred to in this Model FSI Act as the institutional insurer), which (1) is authorized under such laws to underwrite insurance, and (2) is subject to supervision or examination by Federal, State, Territorial, or District of Columbia authority.

(b) *Non-US FSI Insurers*. The Commission may, pursuant to such rules and regulations as it may prescribe, or by order on application, permit a corporation or other person organized and doing business under the laws of a foreign government to act as FSI insurer under an FSI policy qualified or to be qualified pursuant to this Model FSI Act, if such person (1) is authorized under such laws to underwrite insurance, and (2) is subject to supervision or examination by authority of such foreign government or a political subdivision thereof substantially equivalent to supervision or examination applicable to United States institutional insurers. In prescribing such rules and regulations or making such order, the Commission shall consider whether under such laws, a United States institutional insurer is eligible to act as insurer under any equivalent or analogous insurance relating to financial statements prepared and/or securities sold within the jurisdiction of such foreign government.

(c) *Financial Capacity*. The institutional insurer shall have at all times a combined capital and surplus of a specified minimum amount, which shall not be less than $150,000.[73] If such institutional insurer publishes reports of condition at least annually, pursuant to law or to the requirements of said supervising or examining authority, the FSI policy may provide that, for the purposes of this paragraph, the combined capital and surplus of such insurer shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published. The Commission shall establish such additional or supplemental requirements concerning FSI insurer claims-paying capacities by rules and regulations as necessary and appropriate in the public interest or for the protection of investors.

(d) *Multiple FSI Insurers*. If the FSI policy to be qualified requires or permits the designation of one or more co-insurers or re-insurers in addition to the institutional insurer, the rights, powers, duties, and obligations conferred or imposed upon the insurers or any of them shall be conferred or imposed upon and exercised or performed by such institutional insurer, or such institutional insurer and such co-insurers or re-insurers jointly, except to the extent that under any law of any jurisdiction in which any particular act or acts are to be performed, such institutional insurer shall be incompetent or unqualified to perform such act or acts, in which event such rights, powers, duties, and obligations shall be exercised and performed by such co-insurers or re-insurers.

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[73] The TIA sets the minimum combined capital and surplus figure at $150,000, TIA § 77jjj, which should be adjusted upward substantially for FSI.

(e) *Issuer Independence*. No issuer or person directly or indirectly controlling, controlled by, or under common control with such issuer, shall serve as FSI insurer with respect to its financial statements.

(f) *FSI Insurer Independence*. No FSI insurer or person directly or indirectly controlling, controlled by, or under common control with it, shall serve as insurer with respect to the financial statements of any issuer in which:

(1) the insurer shall be or shall become a creditor of the issuer (except as a result of an issuer's obligations to pay premiums and related FSI insurance costs or expenses) or be the beneficial owner of any of its equity securities (excluding certain derivative financial instruments created and used solely for the purpose of providing functional reinsurance with respect to the FSI insurer's obligations under an FSI policy);

(2) such insurer or any of its directors or executive officers is a securities underwriter for an issuer upon its securities;

(3) such insurer directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with a securities underwriter for an issuer upon its securities;

(4) such insurer or any of its directors or executive officers is a director, officer, partner, employee, appointee, or representative of an issuer upon any securities, or of an underwriter (other than the insurer itself) for such an issuer who is currently engaged in the business of securities underwriting, except that:

(A) one individual may be a director and/or an executive officer of the insurer and a director and/or an executive officer of such issuer, but may not be at the same time an executive officer of both the insurer and of such issuer;

(B) if and so long as the number of directors of the insurer in office is more than nine, one additional individual may be a director and/or an executive officer of the insurer and a director of such issuer; and

(C) such insurer may be designated by any such issuer or by any securities underwriter for any such issuer, to act in the capacity of transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent, or depositary, or in any other similar capacity, or, subject to the provisions of paragraph (a) of this subsection, to act as insurer, whether under an FSI policy or otherwise.

(g) 10% or more of the voting securities of such insurer is beneficially owned either by an issuer or by any director, partner or executive officer thereof, or 20% or more

of such voting securities is beneficially owned, collectively by any two or more of such persons; or 10% or more of the voting securities of such insurer is beneficially owned either by a securities underwriter for any such issuer or by any director, partner, or executive officer thereof, or is beneficially owned, collectively, by any two or more such persons.

§ 9. Loss Payee Lists.[74]

(a) *Periodic Filing of Information by Issuer with FSI Insurer.* Each issuer covered by an FSI policy shall furnish or cause to be furnished to the related institutional insurer at stated intervals of not more than six months, and at such other times as such insurer may request in writing, all information in the possession or control of such issuer, or of any of its paying agents, as to the names and addresses of its security holders, and requiring such FSI insurer to preserve, in as current a form as is reasonably practicable, all such information so furnished or received.

(b) *Access of Information to Security Holders*. The FSI insurer shall have no obligation to provide such information to any security holder.

(c) *Disclosure of Information Deemed Not to Violate Any Law*. The disclosure of any such information as to the names and addresses of security holders in accordance with the provisions of this Model FSI Act, regardless of the source from which such information was derived, shall not be deemed to be a violation of any existing law, or of any law hereafter enacted which does not specifically refer to this section.

§ 10. Reports by FSI Insurer.[75]

(a) *Eligibility and Qualification Reports to Security Holders*. The FSI insurer shall transmit to the insured's security holders as hereinafter provided, at stated intervals of not more than 12 months, a brief report with respect to any of the following events which may have occurred within the previous 12 months (but if no such event has occurred within such period no report need be transmitted):

(1) any change to its eligibility and its qualifications under § 8 of this Model FSI Act;

(2) the creation of or any material change to a relationship specified in paragraph § 8 of this Model FSI Act; or

(3) the character and amount of any advances made by it, as FSI insurer, which remain unpaid on the date of such report, and for the reimbursement of which it claims or may claim a lien or charge against the issuer, if such advances so

[74] This section is equivalent to TIA § 77lll, Security Holder Lists.

[75] This section is equivalent to TIA § 77mmm, Reports by Indenture Trustee.

remaining unpaid aggregate more than one-half of 1% of the issuer's average market capitalization during the preceding 12 months.

(b) *Discovery Reports to Security Holders*. The FSI insurer shall promptly transmit to the insured's security holders a reasonably detailed report with respect to any event or circumstance that would have the effect of either (1) changing materially the terms on which any future FSI policy would be issued, including material changes in the premium or coverage of any future FSI policy and (2) any knowledge it obtains, from whatever source, indicating financial statement irregularities with respect to financial statements covered by an existing FSI policy it has underwritten.

(c) *Parties*. Reports pursuant to this section shall be transmitted by mail: (1) to all registered holders of issuer securities, as the names and addresses of such holders appear upon the registration books of the issuer; (2) to such holders of issuer securities as have, within the two years preceding such transmission, filed their names and addresses with the FSI insurer for that purpose; and (3) to all holders of issuer securities whose names and addresses have been furnished to or received by the FSI insurer pursuant to § 9 of this Model FSI Act.

(d) *Filing of Report with Securities Exchanges and Commission*. A copy of each such report shall, at the time of such transmission to security holders, be filed with each securities exchange upon which the issuer's securities are listed, and also with the Commission.

§ 11. Reports by Issuer.[76]

(a) *Periodic Reports*. Each person who, as set forth in the proxy statement or application, is or is to be an issuer of securities covered by an applicable FSI policy shall:

(1) file with the FSI insurer copies of the annual reports and of the information, documents, and other reports (or copies of such portions of any of the foregoing as the Commission may by rules and regulations prescribe) which such issuer is required to file with the Commission pursuant to section 78m or 78o(d) of this title; or, if the issuer is not required to file information, documents, or reports pursuant to either of such sections, then to file with the FSI insurer and the Commission, in accordance with rules and regulations prescribed by the Commission, such of the supplementary and periodic information, documents, and reports which may be required pursuant to section 78m of this title, in respect of a security listed and registered on a national securities exchange as may be prescribed in such rules and regulations;

(2) file with the FSI insurer and the Commission, in accordance with rules and regulations prescribed by the Commission, such additional information, documents, and reports with respect to compliance by such issuer with any conditions and

[76] This section is equivalent to TIA § 77nnn, Reports by Obligor.

covenants provided for in the FSI policy, as may be required by such rules and regulations; and

(3) transmit to the holders of the issuer's securities, in the manner and to the extent provided in subsection (c) of § 10 of this Model FSI Act, such summaries of any information, documents, and reports required to be filed by such issuer pursuant to the provisions of paragraph (1) or (2) of this subsection as may be required by rules and regulations prescribed by the Commission.

The rules and regulations prescribed under this subsection shall be such as are necessary or appropriate in the public interest or for the protection of investors, having due regard to the types of FSI policies, and the nature of the business of the class of issuers affected thereby, and the amount of issuer securities outstanding and market capitalization, and, in the case of any such rules and regulations prescribed after the FSI policies to which they apply have been qualified under this Model FSI Act, the additional expense, if any, of complying with such rules and regulations. Such rules and regulations may be prescribed either before or after the qualification of any such FSI policy.

(b) *Optional Reports*. Nothing in this section shall be construed either as requiring the inclusion in the FSI policy to be qualified of provisions that the issuer shall furnish to the FSI insurer any other information or as preventing the inclusion of such provisions in such FSI policy, if the parties so agree.

§ 12. Duties and Responsibilities of FSI Insurers.[77]

The FSI policy to be qualified shall automatically be deemed to provide as follows.

(a) *Duty to Investigate*. The FSI insurer shall conduct such investigations of the financial statements of an issuer, including using and relying upon public accounting firms, as it deems necessary and appropriate to evaluate risk, establish policy premium and coverage levels and otherwise perform its obligations under such FSI policy.

(b) *Duty to Examine*. The FSI insurer shall be responsible for ascertaining the reliability and truth of the statements and the correctness of the financial statement assertions covered by the FSI policy, including examining the evidence furnished to it pursuant to § 11 of this Model FSI Act.

(c) *Claims*. The FSI insurer shall promptly process claims under an FSI policy. The FSI insurer and issuer shall jointly specify in the FSI policy an independent fiduciary organization to assess claims, notify the insurer of claims, and represent security holder interests. When losses are claimed, and notice provided, the FSI insurer and fiduciary organization shall mutually select an independent expert to determine the claim's validity

[77] This section is equivalent to TIA § 77ooo, Duties and Responsibilities of Indenture Trustee.

and amount. The FSI policy shall provide that the expert report its results to the FSI insurer and fiduciary organization, and that the FSI insurer promptly provide funds to the fiduciary organization and the latter will distribute these to security holders to compensate losses.

(d) *Notice*. Notice of claims shall be deemed effective when the FSI insurer becomes aware, or reasonably should have become aware, of their existence.

(e) *Duty of Good Faith*. The FSI insurer shall exercise good faith to and for the benefit of the issuer's security holders in all matters arising under the FSI policy and shall exercise such rights and powers vested in it by the FSI policy and this Model FSI Act and related rules and regulations hereunder, and to use the same degree of care and skill in their exercise, as prudent persons would exercise or use under the circumstances in the conduct of their own affairs.

(f) *Responsibility of the FSI Insurer*. The FSI policy to be qualified shall not contain any provisions relieving the FSI insurer from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct.

§ 13. Effect of Prescribed FSI Policy Provisions.[78]

(a) *Imposed Duties Control*. If any provision of the FSI policy to be qualified limits, qualifies, or conflicts with the duties imposed by operation of subsection (c) of this section, the imposed duties shall control.

(b) *Additional Provisions*. The FSI policy to be qualified may contain, in addition to provisions specifically authorized under this Model FSI Act to be included therein, any other provisions the inclusion of which is not in contravention of any provision of this Model FSI Act.

(c) *Provisions Governing Qualified FSI Policies*. The provisions of §§ 7 to and including 12 of this Model FSI Act that impose duties on any person (including provisions automatically deemed included in an FSI policy) are a part of and govern every qualified FSI policy, whether or not physically contained therein, and shall be deemed to govern each FSI policy qualified under this Model FSI Act.

§ 14. Rules, Regulations, Orders.[79]

(a) *Authority of Commission; Rules*. The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary or appropriate in the public interest or for the protection of investors to carry out the provisions of this Model FSI Act, including rules and

[78] This section is equivalent to TIA § 77rrr, Effect of Prescribed Indenture Provisions.

[79] This section is equivalent to TIA § 77sss, Rules, Regulations and Orders.

regulations defining accounting, technical, and trade terms used in this Model FSI Act. Among other things, the Commission shall have authority for purposes of this Model FSI Act, to prescribe the form or forms in which information required in any statement, application, report, or other document filed with the Commission shall be set forth. For the purpose of its rules or regulations the Commission may classify persons, securities, FSI policies, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, FSI policies or matters.

(b) *Rules and Regulations Effective upon Publication*. Subject to the provisions of chapter 15 of title 44 and regulations prescribed under the authority thereof,[80] the rules and regulations of the Commission under this Model FSI Act shall be effective upon publication in the manner which the Commission shall prescribe, or upon such later date as may be provided in such rules and regulations.

(c) *Limited Exemption from Liability*. No provision of this Model FSI Act imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

§ 15. Special Commission Powers.[81]

(a) *Investigatory Powers*. For the purpose of any investigation or any other proceeding which, in the opinion of the Commission, is necessary and proper for the enforcement of this Model FSI Act, any member of the Commission, or any officer thereof designated by it, is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such books, papers, correspondence, memoranda, contracts, agreements, or other records may be required from any place in the United States or in any Territory at any designated place of investigation or hearing. In addition, the Commission shall have the powers with respect to investigations and hearings, and with respect to the enforcement of, and offenses and violations under, this Model FSI Act and rules and regulations and orders prescribed under the authority thereof, provided in sections 77t and 77v(b), (c) of this title.

(b) *Availability of Reports*. The Treasury Department, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Reserve Banks, and other authorities within the United States having jurisdiction or regulatory authority are authorized, under such conditions as they may prescribe, to make available to the Commission such reports, records, or other information as they may have available with respect to insurers or prospective insurers under FSI policies qualified or to be

[80] These refer to various administrative procedures.

[81] This section is equivalent to TIA § 77uuu, Special Powers of the Commission.

qualified under this Model FSI Act, and to make through their examiners or other employees for the use of the Commission, examinations of such insurers or prospective insurers. Every such insurer or prospective insurer shall, as a condition precedent to qualification of such FSI policy, consent that reports of examinations by Federal, State, Territorial, or District authorities may be furnished by such authorities to the Commission upon request therefor.

(c) *Restrictions*. Notwithstanding any provision of this Model FSI Act, no report, record, or other information made available to the Commission under this subsection, no report of an examination made under this subsection for the use of the Commission, no report of an examination made of any insurer or prospective insurer by any Federal, State, Territorial, or District authority having jurisdiction to examine or supervise such insurer, no report made by any such insurer or prospective insurer to any such authority, and no correspondence between any such authority and any such insurer or prospective insurer, shall be divulged or made known or available by the Commission or any member, officer, agent, or employee thereof, to any person other than a member, officer, agent, or employee of the Commission; *provided, however*, that the Commission may make available to the Attorney General of the United States, in confidence, any information obtained from such records, reports of examination, other reports, or correspondence, and deemed necessary by the Commission, or requested by the Attorney General, for the purpose of enabling the performance of the Attorney General's duties under this Model FSI Act.

(d) *Investigation of Prospective FSI Insurers*. Any investigation of a prospective FSI insurer, or any proceeding or requirement for the purpose of obtaining information regarding a prospective FSI insurer, under any provision of this Model FSI Act, shall be limited: (1) to determining whether such prospective FSI insurer is qualified to act as FSI insurer under the provisions of § 8 of this Model FSI Act; (2) to requiring the inclusion in the proxy statement or application of information with respect to the eligibility of such prospective FSI insurer under § 8 of this Model FSI Act; and (3) to requiring the inclusion in the proxy statement or application of the most recent published report of condition of such prospective insurer, as described in § 8 of this Model FSI Act.

§ 16. Judicial Review.[82]

(a) *Orders*. Orders of the Commission under this Model FSI Act (including orders pursuant to the provisions of § 5 of this Model FSI Act) shall be subject to review in the same manner, upon the same conditions, and to the same extent, as provided in § 9 of the Securities Act of 1933,[83] with respect to orders of the Commission under such Act.

[82] Subsections (a) and (b) of this section are equivalent to TIA § 77vvv, Judicial Review; subsection (c) has no equivalent in the TIA.

[83] 15 U.S.C. § 77i.

(b) *Jurisdiction*. Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability or duty created by, this Model FSI Act, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 22(a) of the Securities Act of 1933.[84]

(c) *Construction*. For purposes of achieving the overall public policy expressed in this Model FSI Act, judicial construction of the terms hereof and of particular FSI policies shall (1) treat as fortuitous losses arising when these would be fortuitous from the perspective of the security holders for whose benefit FSI policies are adopted, (2) treat information provided by issuers to FSI insurers and their representatives, including registered public accounting firms, as providing a basis and opportunity for investigation and verification thereof by the FSI insurer and its representatives and (3) treat the conduct of the issuer and its agents in dealing with the FSI insurer as undertaken without regard to its effect on the FSI insuer's obligations under this Model FSI Act and the FSI policy.

§ 17. Liability for Misleading Statements.[85]

(a) *Liability*. Any person who shall make or cause to be made any statement in any application, report, or document filed with the Commission pursuant to any provisions of this Model FSI Act, or any rule, regulation, or order thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or who shall omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall be liable to any person (not knowing that such statement was false or misleading or of such omission) who, in reliance upon such statement or omission, shall have purchased or sold a security covered by an FSI policy to which such application, report, or document relates, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading or of such omission. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit and assess reasonable costs, including reasonable attorneys' fees, against either party litigant, having due regard to the merits and good faith of the suit or defense. No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.[86]

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[84] 15 U.S.C. § 77v(a). This provision could be drafted for particular linkage between relevant filings accompanied by FSI policies and securities law sections requiring the related filing.

[85] This is equivalent to TIA § 77www, Liability for Misleading Statements.

[86] As to the statute of limitations, the TIA provides for one year. TIA § 77www. The Model FSI Act could adjust this as appropriate.

(b) *Remedies*. The rights and remedies provided by this Model FSI Act shall be in addition to any and all other rights and remedies that may exist under the Securities Act of 1933,[87] or the Securities Exchange Act of 1934,[88] or otherwise at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this Model FSI Act shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of such person's actual damages on account of the act complained of.

§ 18. Unlawful Representations.[89]

It shall be unlawful for any person in offering, selling or issuing any security to represent or imply in any manner whatsoever that any action or failure to act by the Commission in the administration of this Model FSI Act means that the Commission has in any way passed upon the merits of, or given approval to, any FSI insurer, FSI policy or security, or any transaction or transactions therein, or that any such action or failure to act with regard to any statement or report filed with or examined by the Commission pursuant to this Model FSI Act or any rule, regulation, or order thereunder, has the effect of a finding by the Commission that such statement or report is true and accurate on its face or that it is not false or misleading.

§ 19. Penalties.[90]

(a) *General*. Any person who willfully violates any provision of this Model FSI Act or any rule, regulation, or order thereunder, or any person who willfully, in any application, report, or document filed or required to be filed under the provisions of this Model FSI Act or any rule, regulation, or order thereunder, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.[91]

(b) *Discovery Reports*. Any FSI insurer, including persons acting on its behalf, who willfully violates the provisions of § 10(b) of this Model FSI Act requiring discovery reports to security holders, shall upon conviction be fined amounts which, in aggregate, total three times the amount of losses otherwise payable under the related FSI policy.

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[87] 15 U.S.C. § 77a *et seq*.

[88] 15 U.S.C. § 78a *et seq*.

[89] This is equivalent to TIA § 77xxx, Unlawful Representations.

[90] This is equivalent to TIA § 77yyy, Penalties.

[91] As to the amounts and sentences, the TIA provides for $10,000 and five years. TIA § 77yyy. The Model FSI Act could adjust these as appropriate, particularly in light of enhanced penalties imposed under the Sarbanes-Oxley Act of 2002 concerning matters within the competence of FSI that are outside the TIA.

§ 20. Miscellaneous.

(a) *Effect on Existing Law*.[92] Except as otherwise expressly provided, nothing in this Model FSI Act shall affect: (1) the jurisdiction of the Commission under the Securities Act of 1933,[93] or the Securities Exchange Act of 1934,[94] over any person, security, or contract, or (2) the rights, obligations, duties, or liabilities of any person under such acts; nor shall anything in this Model FSI Act affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person or security, insofar as such jurisdiction does not conflict with any provision of this Model FSI Act or any rule, regulation, or order thereunder.

(b) *Contrary Stipulations Void*.[95] Any condition, stipulation, or provision binding any person to waive compliance with any provision of this Model FSI Act or with any rule, regulation, or order thereunder shall be void.

(c) *Separation of Provisions*.[96] If any provision of this Model FSI Act or the application of such provision to any person or circumstance shall be held invalid, the remainder of the Model FSI Act and the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby.

The foregoing provisions of the Model FSI Act are substantially comprehensive.[97] As with most federal securities legislation, the Act vests substantial administrative power in the SEC. The SEC's plenary power would likewise be available to enable it to adopt rules and regulations from time to time necessary or appropriate in the public interest and for the protection of investors to advance the purposes of FSI as a matter of policy. In addition to these technical federal provisions governing FSI, a federal supervisory role with respect to related insurance markets may be necessary, as discussed briefly next.

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[92] This subpart is equivalent to TIA § 77zzz, Effect on Existing Law.

[93] 15 U.S.C. § 77a *et seq*.

[94] 15 U.S.C. § 78a *et seq*.

[95] This subpart is equivalent to TIA § 77aaaa, Contrary Stipulations Void.

[96] This subpart is equivalent to TIA § 77bbbb, Separability.

[97] Additional issues not addressed in the foregoing that may usefully be addressed in an actual statute include transition rules, experimental-period rules (such as limiting availability to qualified issuers measured by seasoning or size) and sunset provisions pending results of any experimental period.

B. Concluding Commentary Concerning Reinsurance and Insolvency

FSI as an alternative to FSA would depend critically and ultimately upon justifiable confidence in the solvency of the insurance industry, and of particular carriers underwriting FSI policies. Insurer solvency is a central concern of all insurance law, with state law generally providing the mechanisms to promote it. But since FSI would form a central part of the federalized enterprise of securities regulation, additional coordination efforts might be necessary.

The Model FSI Act uses a minimalist approach, authorizing the SEC to issue stop orders against applications for FSI to be issued by FSI insurers lacking requisite qualifications as to both regulatory supervision and financial capacity. It authorizes the SEC to adopt additional or supplemental rules and regulations to meet related public policy objectives.

This minimalist approach reflects federal traditions of deference to state insurance law. Federal entrée in insurance regulation attempts to narrow any preemption of related state insurance law.[98] State insurance law, in turn, defers to markets for efficient and fair insurance products, pricing and operation, with regulatory intervention requiring a specific justification. The commonest justification relevant to FSI concerns risks of excessive competition among insurers yielding low premiums, leading to loss-payouts exceeding aggregate premium volume, and producing industry insolvencies.

The SEC's authority to adopt additional FSI insurer qualifications equips it to monitor for such issues as they arise. The SEC could apply similar attention to tools the FSI industry likely would use to manage solvency risks in markets, such as financial derivative instruments that can hedge and distribute risks of FSI loss[99] (and which the Model FSI Act specifically contemplates allowing FSI insurers to use).[100]

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[98] This role is usually reserved for providing reinsurance mechanisms or programs to stimulate insurance coverage for extraordinary matters of national public policy. Leading examples include insurance covering nuclear reactors; reinsurance for damages to urban property damaged by riot or civil disorder; promoting political risk insurance covering private business investment in developing countries; funding of a national flood insurance program; and terrorism insurance.

[99] Ronen, *Post-Enron Reform, supra* note ___, at 54. For example, insurers would buy tailored put options on insured-company securities with durations matching the FSI policy period. Puts would be exercisable when securities prices fall due to financial misstatements, spreading risk. *Id*. (puts become exercisable "upon a stock price decline of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements").

[100] Model FSI Act, § ___, *supra* text accompanying notes ___ to ___.