

PROPOSED RULEMAKING

ENVIRONMENTAL QUALITY BOARD

[25 PA. CODE CH. 78]

Oil and Gas Wells

The Environmental Quality Board (Board) proposes to amend Chapter 78, Subchapter B (relating to permits, transfers and objections) by adding a new § 78.19 (relating to permit application fees schedule) as set forth in Annex A. The Board has the authority to establish fees, by regulation, under section 201 of the Oil and Gas Act (act) (58 P. S. § 601.201). Under this provision, the Board has the authority to set fees at an amount that bears a reasonable relationship to the cost of administering the program.

This proposal was adopted by the Board at its meeting of December 16, 2008.

A. *Effective Date*

The amendments will go into effect upon publication in the *Pennsylvania Bulletin* as final-form rulemaking.

B. *Contact Persons*

For further information contact Ronald Gilius, Director, Bureau of Oil and Gas Management, Rachel Carson State Office Building, 5th Floor, 400 Market Street, P. O. Box 8765, Harrisburg, PA 17105-8461, (717) 772-2199; or Scott Perry, Assistant Counsel, Bureau of Regulatory Counsel, P. O. Box 8464, Rachel Carson State Office Building, Harrisburg, PA 17105-8464, (717) 787-7060. Persons with a disability may use the Pennsylvania AT&T Relay Service by calling (800) 654-5984 (TDD users) or (800) 654-5988 (voice users). This proposed rulemaking is available on the Department of Environmental Protection's (Department) web site at www.depweb.state.pa.us.

C. *Statutory Authority*

This proposed rulemaking is being made under the authority of section 201(d) of the act which authorizes the Department to establish, by regulation, well permit fees that bear a reasonable relationship to the cost of administering the act, section 604 of the act (58 P. S. § 601.604) which directs the Board to adopt regulations necessary to implement the act, and section 1920-A of The Administrative Code of 1929 (71 P. S. § 510-20), authorizing and directing the Board to adopt regulations necessary for the proper performance of the work of the Department.

D. *Background of the Amendments*

The act was passed on December 19, 1984, and established a \$100 fee for oil and gas well permits. Section 201(d) of the act allows the Department to increase the fee by regulation. Under this provision, fees must be set at a level that "bears a reasonable relationship to the cost of administering" the act. The Department has never increased the current \$100 permit fee.

There are three considerations that support the promulgation of a regulation to increase the permit application fees authorized by the act. First, the costs of administering the act have increased significantly since 1984 when the General Assembly established the \$100 fee that the Department currently charges. This \$100 per permit application fee does not currently bear a reasonable relationship to the cost of administering the act.

In addition, the number of permit applications that the Department reviews annually has grown dramatically over the past several years. In 2000, 1,354 wells were drilled in this Commonwealth. Last year in 2007 the Department issued 7,241 well permits applications. In 2009, the Department expects to receive over 11,000 permit applications. The Department's current staffing levels for the oil and gas program were established at a time when the Department reviewed considerably fewer permit applications than it reviews today. To properly review the number of applications that the Department currently receives and to inspect the operations of sites that currently possess a permit, the Department needs additional staff that the current \$100 fee cannot support.

Finally, there is significant and recent interest in the development and recovery of natural gas resources in the Marcellus Shale formation that underlies much of this Commonwealth. The development of this geologic formation, which also extends beneath portions of West Virginia and New York, has long been considered prohibitively expensive to access. Recent advances in natural gas drilling technology and rising natural gas prices have attracted considerable interest in the previously untapped formation.

The recent technological advances that allow recovery of natural gas found in the Marcellus Shale present new and expanded environmental considerations that the Department must evaluate properly to ensure the gas is recovered in the most environmentally sensitive manner feasible. Many of the new or expanded environmental considerations are directly related to the use of water to recover natural gas from the Marcellus Shale formation. Extracting natural gas from the Marcellus Shale formation requires horizontal drilling within the formation after vertical drilling reaches the formation. The horizontal drilling and a process known as "hydraulic fracturing" are used to allow the natural gas to flow freely from the Marcellus Shale formation. Hydraulically fracturing the Marcellus Shale uses far greater amounts of water than traditional natural gas exploration. Large volumes of water are pumped into the formation, along with sand and other materials under high pressure, to fracture the rock surrounding the horizontal well bore. A single well can use millions of gallons of water to hydraulically fracture the rock. After the hydraulic fracturing process is completed, the wastewater must be properly managed.

The significantly greater use of water at Marcellus Shale wells creates a series of environmental issues during the drilling and development of a Marcellus Shale well. First, there are a number of considerations associated with withdrawal of water, including the need to monitor and restrict the amount of withdrawal to avoid dewatering streams and causing pollution. Under State water law, a person who withdraws water in the amounts generally associated with Marcellus shale well development shall register the withdrawal with the Department. Second, there are a number of considerations associated with the use and storage of the water used for hydraulic fracturing at the well site or at other locations. Third, there are a number of considerations associated with the proper management, treatment and discharge of the wastewater.

To address these additional environmental considerations associated with development of Marcellus Shale, the Department prepared a permit application addendum

specifically for Marcellus Shale Gas Well development. The Department expends considerable staff resources to review the additional information in the Marcellus Shale Addendum. Because the Department's review of the Addendum includes several water quality and quantity issues not normally associated with gas well permit application reviews, the Department needs to coordinate its Marcellus Shale permit application review among several water resource related program areas. Within the Susquehanna and Delaware River Basins, the Department also needs to coordinate its review with the Susquehanna and Delaware River Basin Commissions which have regulatory authority over water withdrawals within their respective river basins.

To properly evaluate the proposals to recover gas from the Marcellus Shale formation, the Department has expended additional staff resources. The current \$100 per permit application fee does not have any "reasonable relationship" to the actual cost to implement this portion of the act program covering development of the Marcellus Shale. The Department needs additional resources to properly allow the development of the Marcellus Shale natural gas resources and to protect the environment. This regulatory fee increase is needed to provide the Department with the resources to perform the additional work associated with the review of Marcellus Shale gas well permit applications and with the oversight of any permits that are issued.

E. *Summary of Proposed Rulemaking*

Section 78.19(a) contains three fee schedules for the following types of wells: Vertical wells, deviated wells and Marcellus Shale wells. Vertical wells are those that only have vertical well bores to reach the oil or gas producing formation. Nonvertical wells are those that have nonvertical portions of the well bore, in addition to the vertical portion, that are intentionally drilled to develop the oil and gas producing formations. The nonvertical well category does not include Marcellus Shale wells. The final type is the Marcellus Shale wells. Marcellus Shale wells are those that may have nonvertical portions of the well bore, in addition to the vertical portion, that are intentionally drilled to develop the gas producing Marcellus Shale formation. For nonvertical and Marcellus Shale wells, the vertical well bore and the nonvertical well bore are added together to determine the total well bore length for purposes of determining the fee.

In § 78.19(b), the proposed regulation provides that applicants for vertical well permits that have a total well bore greater than 12,000 feet shall pay an additional fee of \$100 for every 500 feet drilled beyond 12,000 feet. In § 78.19(c), the proposed regulation provides that applicants for nonvertical and Marcellus Shale well permits that have a total well bore greater than 12,000 feet shall pay an additional fee of \$100 for every 500 feet drilled beyond 12,000 feet. Section 78.19(d) establishes an additional fee for well bores that are actually drilled beyond the depth requested in the application. Section 78.19(e) provides that fees are nonrefundable. Section 78.19(f) provides that applicants for a vertical well with a well bore length of 1,500 feet or less for home shall use an application fee of \$200. Finally, § 78.19(g) provides that the Department will provide the Board with an evaluation, at least every 3 years, concerning the adequacy of the fees to cover program implementation costs.

The proposed rulemaking makes one other minor conforming change to the permitting regulations. Section 78.15(b), which covers application requirements and com-

pleteness requirements, includes a cross-reference to the new regulatory fee schedule in § 78.19.

F. *Relationship to Final-Omit Rulemaking to Increase Fees*

This proposed rulemaking was approved at the same meeting that the Board approved a final-omitted rulemaking that is intended to quickly increase permit application fees for permits that are issued for the Marcellus Shale formation for the "good cause" reasons set forth in that rulemaking. This proposed rulemaking also includes the new Marcellus Shale permit application fees included in the final-omitted rulemaking to allow interested persons to provide comments on the new Marcellus Shale permit application fees as part of this proposed rulemaking. When this proposed rulemaking is adopted as final, the Board will make appropriate changes to the Marcellus Shale permit application fees as part of this rulemaking in response to public comments. The final-omitted fees for Marcellus shale permit applications will only be in effect until these proposed amendments are adopted as final.

G. *Benefits and Costs*

Benefits

The residents of this Commonwealth and the regulated community will benefit from this proposed rulemaking because the Department will be able to continue to uphold the purposes of the act. The purposes of the act are:

- (1) Permit the optimal development of the oil and gas resources of this Commonwealth consistent with the protection of the health, safety, environment and property of the citizens of this Commonwealth.
- (2) Protect the safety of personnel and facilities employed in the exploration, development, storage and production of natural gas or oil or the mining of coal.
- (3) Protect the safety and property rights of persons residing in areas where the exploration, development, storage or production occurs.
- (4) Protect the natural resources, environmental rights and values secured by the Pennsylvania Constitution. See 58 P. S. § 601.102.

The public will benefit in two general ways. The public will benefit from a fiscal perspective when the costs of the regulatory program are imposed on the regulated community, as the act provides. For Marcellus Shale gas well development, the need for timely and special reviews has significantly increased the Department's cost of implementation of the program and it is in the public interest to impose these costs on the regulated community. The public also benefits from an environmental perspective since the review of the Marcellus Shale permit applications require new and extensive reviews to ensure that the development of this natural gas resource occurs in an environmentally protective manner which State law requires. The higher fees will support the Department's newly developed and extensive efforts to review Marcellus Shale permit applications.

The regulated community will also benefit because the regulated community wants timely reviews of permit applications, which State law also requires. Having the staff to evaluate these Marcellus Shale permit applications in a timely and environmentally protective manner will benefit the regulated community and the public.

Costs

This rulemaking will not impose any additional costs on the Department. This proposal will help the Department

offset the greater implementation costs to support new and extensive reviews of oil and gas permit applications.

The base fee would include a vertical well base fee of \$250 with an additional \$50 per 500 feet of well bore drilled from 2,000 feet to 5,000 feet and an additional \$100 per 500 feet for the well bore drilled past 5,001 feet. Nonvertical wells, which are also called horizontal wells, would have a base fee of \$900 with an additional \$100 per 500 feet of well bore drilled past 1,500 feet. An applicant for a vertical well with a well bore length of 1,500 feet or less for home use shall pay a permit application fee of \$200.

Compliance Assistance Plan

A compliance assistance plan is not necessary because the new fee structure does not create a situation where a well operator will be out of compliance with the regulation. Well permits that do not contain the appropriate fee will be deemed incomplete. The Department will return the application to the applicant and tell the applicant what the appropriate fee is. To minimize this circumstance from occurring, the Department will publicize the new permit fee requirements on its web site and inform potential applicants of the new fee structure at upcoming industry trainings.

Paperwork Requirements

No additional paperwork will be required as a result of this rulemaking. However, the Department will need to amend its well permit application form and instructions to incorporate and explain the new permit fee structure.

H. Sunset Review

These proposed regulations will be reviewed in accordance with the sunset review schedule published by the Department to determine whether the regulations effectively fulfill the goals for which they were intended.

I. Regulatory Review

In accordance with section 5(a) of the Regulatory Review Act (71 P. S. § 745.5(a)), on February 4, 2009, the Department submitted a copy of the proposed amendments to the Independent Regulatory Review Commission (IRRC) and the Chairpersons of the House and Senate Environmental Resources and Energy Committees (Committees). In addition to submitting the proposed amendments, the Department has provided IRRC and the Committees with a copy of a detailed Regulatory Analysis Form prepared by the Department. A copy of this material is available to the public upon request.

Under section 5(g) of the Regulatory Review Act, IRRC may convey any comments, recommendations or objections to the proposed amendments within 30 days of the close of the public comment period. The comments, recommendations or objections shall specify the regulatory review criteria that have not been met. The act specifies detailed procedures for review of these issues by the Department, the General Assembly and the Governor prior to final-form publication of the regulations.

J. Public Comments

Written Comments—Interested persons are invited to submit comments, suggestions or objections regarding the proposed regulations to the Environmental Quality Board, P. O. Box 8477, Harrisburg, PA 17105-8477 (express mail: Rachel Carson State Office Building, 16th Floor, 400 Market Street, Harrisburg, PA 17101-2301). Comments submitted by facsimile will not be accepted. Comments, suggestions or objections must be received by the Board by March 16, 2009. Interested persons may also submit a summary of their comments to the Board. The summary may not exceed one page in length and must also be received by March 16, 2009. The 1-page summary will be provided to each member of the Board in the agenda packet distributed prior to the meeting at which the final-form regulations will be considered.

Electronic Comments—Comments may be submitted electronically to the Board at RegComments@state.pa.us and must also be received by the Board by March 16, 2009. A subject heading of the proposal and a return name and address must be included in each transmission.

JOHN HANGER,
Acting Chairperson

Fiscal Note: 7-431. No fiscal impact; (9) recommends adoption.

Annex A

TITLE 25. ENVIRONMENTAL PROTECTION PART I. DEPARTMENT OF ENVIRONMENTAL PROTECTION

Subpart C. PROTECTION OF NATURAL RESOURCES

ARTICLE I. LAND RESOURCES

CHAPTER 78. OIL AND GAS WELLS

Subchapter B. PERMITS, TRANSFERS AND OBJECTIONS

PERMITS AND TRANSFERS

§ 78.15. Application requirements.

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(b) The permit application will not be considered complete until the applicant submits a complete and accurate plat, an approvable bond or other means of complying with section 215 of the act (58 P. S. § 601.215), the fee in **compliance with § 78.19 (relating to permit application fees schedule)**, proof of notification, necessary requests for variance or waivers or other documents required to be furnished by law or the Department. The person named in the permit shall be the same person named in the bond or other security.

(Editor's Note: The following section is new. It has been printed in regular text to enhance readability.)

§ 78.19. Permit application fees schedule.

(a) An applicant shall pay a permit application fee according to the following schedule:

Vertical Wells		Nonvertical Wells		Marcellus Shale Wells	
Total Well bore Length in Feet	Total fee for a vertical well	Total Well bore Length in Feet	Total fee for a nonvertical well	Total Well bore Length in Feet	Total fee for a Marcellus Shale well
0 to 2,000	\$250	0 to 1,500	\$900	0 to 1,500	\$900
2,001 to 2,500	\$300	1,501 to 2,000	\$1,000	1,501 to 2,000	\$1,000
2,501 to 3,000	\$350	2,001 to 2,500	\$1,100	2,001 to 2,500	\$1,100
3,001 to 3,500	\$400	2,501 to 3,000	\$1,200	2,501 to 3,000	\$1,200
3,501 to 4,000	\$450	3,001 to 3,500	\$1,300	3,001 to 3,500	\$1,300
4,001 to 4,500	\$500	3,501 to 4,000	\$1,400	3,501 to 4,000	\$1,400
4,501 to 5,000	\$550	4,001 to 4,500	\$1,500	4,001 to 4,500	\$1,500
5,001 to 5,500	\$650	4,501 to 5,000	\$1,600	4,501 to 5,000	\$1,600
5,501 to 6,000	\$750	5,001 to 5,500	\$1,700	5,001 to 5,500	\$1,700
6,001 to 6,500	\$850	5,501 to 6,000	\$1,800	5,501 to 6,000	\$1,800
6,501 to 7,000	\$950	6,001 to 6,500	\$1,900	6,001 to 6,500	\$1,900
7,001 to 7,500	\$1,050	6,501 to 7,000	\$2,000	6,501 to 7,000	\$2,000
7,501 to 8,000	\$1,150	7,001 to 7,500	\$2,100	7,001 to 7,500	\$2,100
8,001 to 8,500	\$1,250	7,501 to 8,000	\$2,200	7,501 to 8,000	\$2,200
8,501 to 9,000	\$1,350	8,001 to 8,500	\$2,300	8,001 to 8,500	\$2,300
9,001 to 9,500	\$1,450	8,501 to 9,000	\$2,400	8,501 to 9,000	\$2,400
9,501 to 10,000	\$1,550	9,001 to 9,500	\$2,500	9,001 to 9,500	\$2,500
10,001 to 10,500	\$1,650	9,501 to 10,000	\$2,600	9,501 to 10,000	\$2,600
10,501 to 11,000	\$1,750	10,001 to 10,500	\$2,700	10,001 to 10,500	\$2,700
11,001 to 11,500	\$1,850	10,501 to 11,000	\$2,800	10,501 to 11,000	\$2,800
11,501 to 12,000	\$1,950	11,001 to 11,500	\$2,900	11,001 to 11,500	\$2,900
		11,501 to 12,000	\$3,000	11,501 to 12,000	\$3,000

(b) An applicant for a vertical well exceeding 12,000 feet in total well bore length shall pay a permit application fee of \$1,950 + \$100 for every 500 feet the well bore extends over 12,000 feet. Fees shall be rounded to the foot interval.

(c) An applicant for a nonvertical well or Marcellus Shale well exceeding 12,000 feet in total well bore length shall pay a permit application fee of \$3,000 + \$100 for every 500 feet the well bore extends over 12,000 feet. Fees shall be rounded to the foot interval.

(d) If, when drilled, the total well bore length of the well exceeds the length specified in the permit application, the operator shall pay the difference between the amount paid as part of the permit application and the amount required by subsections (a)—(c) plus 10% of the total amount required by subsections (a)—(c).

(e) Fees are nonrefundable.

(f) An applicant for a vertical well with a well bore length of 1,500 feet or less for home use shall pay a permit application fee of \$200.

(g) At least every 3 years, the Department will provide the Board with an evaluation of the fees in this chapter and recommend regulatory changes to the EQB to address any disparity between the program income generated by the fees and the Department's cost of administering the program with the objective of ensuring fees meet all program costs and programs are self-sustaining.

[Pa.B. Doc. No. 09-255. Filed for public inspection February 13, 2009, 9:00 a.m.]

INSURANCE DEPARTMENT

[31 PA. CODE CH. 147]

Annual Audited Insurers' Financial Report Required

The Insurance Department (Department) proposes to amend Chapter 147 (relating to annual audited insurers'

financial report required) to read set forth in Annex A, under the authority of sections 206, 506, 1501 and 1502 of The Administrative Code of 1929 (71 P. S. §§ 66, 186, 411 and 412) regarding to the general rulemaking authority of the Department; sections 320, 630, 1007 and 2452 of The Insurance Company Law of 1921 (40 P. S. §§ 443, 764a, 967 and 991.2452) regarding to the authority of the Insurance Commissioner (Commissioner) to require insurance companies, associations, exchanges, fraternal benefit

societies and preferred provider organizations to file statements concerning their affairs and financial condition; and sections 205 and 206 of The Pennsylvania Fair Plan Act (40 P. S. §§ 1600.205 and 1600.206); section 731 of the Medical Care Availability and Reduction of Error (MCARE) Act (40 P. S. § 1303.731); 40 Pa.C.S. §§ 6125, 6331 and 6701 (relating to reports and examinations; and regulation); sections 11 and 14 of the HMO Act (40 P. S. §§ 1561 and 1564); sections 7 and 25 of the Continuing-Care Provider Registration and Disclosure Act (40 P. S. §§ 3207 and 3225) which respectively, relate to the specific regulatory and rulemaking authority of the Department regarding financial reporting by the Pennsylvania Fair Plan, the Pennsylvania Professional Liability Joint Underwriting Association, hospital plan corporations, professional health service corporations, beneficial associations, health maintenance organizations and continuing care providers.

Purpose

The purpose of this rulemaking is to update Chapter 147, commonly referred to as the "CPA Audit Rule." Chapter 147 was initially adopted in 1979 and requires insurers to have annual audits of their year-end statutory financial statements performed by independent certified public accountants (CPAs). It is based on a model regulation developed by the National Association of Insurance Commissioners (NAIC) and included in the NAIC's Financial Regulation Standards and Accreditation Program.

The amendments in this rulemaking are consistent with a new version of the NAIC model adopted in 2006, entitled "Annual Financial Reporting Model Regulation" (Model Regulation 205). The revised NAIC model was developed as a result of the NAIC's review of the Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 or the Sarbanes-Oxley Act of 2002, (SOX), and includes provisions related to auditor independence, corporate governance and internal control over financial reporting. The Department expects that the proposed amendments to Chapter 147 will be required for the Department to maintain accreditation by the NAIC beginning in 2010.

Explanation of Regulatory Requirements

The following is a description of the changes contained in the proposed rulemaking:

The heading of Chapter 147 is being updated to reflect the content of the regulations.

Section 147.1 (relating to purpose) is being amended to reflect the additional financial reporting requirements related to audits included in this rulemaking.

Section 147.2 (relating to definitions) is being amended to: (1) reference definitions of terms used in the regulation as defined in the law relating to insurance holding companies; and (2) add definitions to clarify new terms relating to audit committee requirements, internal control over financial reporting and other SOX-related terms consistent with the revised NAIC model.

Subsection 147.3(a) (relating to filing and extensions for filing required reports and communications) is being amended to reference supplemental guidance published in the NAIC *Accounting Practices and Procedures Manual*, defined for purposes of this regulation as the "NAIC Implementation Guide." The Department is also proposing to amend the provisions in § 147.3(b) relating to requesting an extension of the June 1 annual filing date for audited financial reports by reducing the time period for extensions from 30 to 15 days. The reliability of

annual financial statements filed by insurers with state regulators is crucial to the Department's solvency monitoring and financial regulation efforts. Reducing the time period for any extensions is based on the Department's experience in dealing with financially troubled insurers and is an important part of the Department's efforts over the past several years to promote the submission of timely filings and reduce a relatively high number of annual requests for extensions. Because of the inter-relationship of the various reports and communications required under the chapter, the amendments also clarify that an extension of the filing date for an audited financial report provides for an extension of the due dates for these other filings.

Section 147.3a (relating to requirements for audit committees) is being added consistent with the revised NAIC model to require domestic insurers subject to the regulation to establish audit committees. The section includes requirements relating to the qualifications and independence of audit committee members and audit committee responsibilities. These new requirements allow for the designation of an audit committee for one or more controlled insurers and include exemptions based on the amount of premiums written by an insurer, whether the insurer is subject to audit committee requirements under SOX or Pennsylvania laws relating to insurance holding company systems, and for continuing care providers.

Section 147.4 (relating to contents of annual audited financial report) is being amended to update terminology to reflect current financial reporting requirements. In addition, § 147.4(b)(2) is being amended to provide the Commissioner with discretion in determining whether an insurer is required to file an amendment to its annual financial statement to reflect differences between that statement and the insurer's audited financial statement. The paragraph requires all differences to be disclosed and reconciled in the notes to the annual financial statements. This amendment would allow the Commissioner to determine whether the differences also require the filing of an amended statement.

Section 147.5 (relating to designation of independent certified public accountant) is being amended to clarify current requirements for notice provided to the Department relating to accountants retained by insurers to conduct the annual audits required under this chapter, particularly in instances where the accountant is replaced, dismissed or resigns.

Section 147.6 (relating to recognition, qualification and responsibilities of an independent certified public accountant) is being amended to include provisions from the revised NAIC model to avoid conflicts of interest in the engagement of accountants to conduct annual audits. The restrictions include situations when a current officer or director of an insurer was involved in an audit of the insurer during the year before the beginning of the current audit period and also specify what types of other services an accountant retained to conduct an audit may or may not provide to the insurer. In addition, § 147.6(d) is being amended to shorten the consecutive time period that an accountant may be primarily responsible for an insurer's audit from 7 to 5 years. Subsection 147.6(h) provides for application for relief and exemptions from these restrictions based on unusual circumstances, financial or organizational hardship. The criteria for determining whether relief may be granted include the size or amount of business written by the insurer. The new requirements do not apply to continuing care providers.

The provisions currently found in § 147.15 (relating to letter of qualifications of independent certified public accountant) are being moved to new § 147.6a to follow the related section establishing the accountant's qualifications and responsibilities. This change will facilitate efforts to understand and comply with these requirements and is in response to past questions and comments the Department has received from users of the regulation. In addition, § 147.6a(3) is being amended to clarify that descriptions of auditing experience is required for only the key staff assigned by an accountant to work on an audit.

Section 147.8 (relating to scope of audit and report of independent certified public accountant) is being amended to incorporate current National auditing standards relating to internal controls over financial reporting.

Section 147.9a (relating to establishment and communication of internal control over financial reporting) is being added consistent with the revised NAIC model to require insurers to establish policies and procedures providing for internal control over financial reporting. The section lists the required elements or outcomes of policies and procedures for internal control over financial reporting and requires insurers to file a written communication prepared by the accountant retained to conduct the audit describing internal control related matters identified in the audit. The communication must state whether any unremediated material weaknesses in the insurer's internal control over financial reporting were identified in the audit and what actions have or will be taken to eliminate any unremediated material weaknesses.

Section 147.9b (relating to management's report of internal control over financial reporting) is also being added consistent with the revised NAIC model to require insurers to file an annual report of internal control over financial reporting prepared by the insurer's management, including an assertion, made to the best of management's knowledge and belief after diligent inquiry, as to whether the insurer's internal control is effective to provide reasonable assurance regarding the reliability of its annual financial statement filed with the Department. The section includes a premium threshold for automatic annual filings of the report and criteria for the Department's acceptance of an annual report on internal control over financial reporting and related attestation filed under SOX, defined in § 147.2 (relating to definitions) as a "Section 404 Report."

Section 147.10 (relating to report on significant deficiencies in internal controls) is being rescinded as outdated since this report is being replaced by the new reporting requirements proposed in the amendments to this chapter.

Section 147.12 (relating to examinations) is also being rescinded as outdated and unnecessary. The Department is implementing a new risk-focused approach to the conduct of financial examinations that includes a consideration of an insurer's internal controls over financial reporting. The Department believes a reference to its statutory authority under the laws and regulations related to the Department's conduct of onsite financial examinations is not needed for purposes of this regulation, which relates to annual audited financial reports filed by insurers with the Department.

Section 147.13 (relating to effective date and exemption) is being amended to establish a January 1, 2010, effective date for the final-form rulemaking amending the chapter and to update and clarify current exemptions.

Affected Parties

The chapter applies to all types of insurers and continuing care providers licensed to transact business in this Commonwealth and the accountants retained by these entities to conduct audits of their annual financial statements.

Fiscal Impact

State Government

The rulemaking will strengthen and clarify existing regulatory requirements. There will be no material increase in cost to the Department as a result of this rulemaking.

General Public

The public will benefit to the extent the rulemaking strengthens financial solvency regulatory requirements for insurers, thereby promoting the ability of the insurance industry to meet obligations under insurance policies.

Political Subdivisions

The rulemaking will not impose additional costs on political subdivisions.

Private Sector

The rulemaking would impose additional costs on insurers that are not currently subject to audit committee and internal control reporting requirements. However, the strengthened requirements are consistent with National standards to be adopted by all states participating in the NAIC Financial Regulation Standards and Accreditation Program. The rulemaking minimizes costs by including a number of exemptions for smaller insurers and insurers already subject to similar requirements under insurance holding company and Security Exchange Commission laws and regulations.

Paperwork

The rulemaking would not impose additional paperwork on the Department. The amendments would require insurers to file new reports relating to internal control over financial reporting; however, the rulemaking may reduce paperwork to the extent that it provides for the filing of documents in electronic form.

Effectiveness/Sunset Date

The rulemaking will become effective January 1, 2010. The Department continues to monitor the effectiveness of regulations on a triennial basis; therefore, no sunset date has been assigned.

Contact Person

Questions or comments regarding the proposed rulemaking may be addressed in writing to Peter J. Salvatore, Regulatory Coordinator, Insurance Department, 1326 Strawberry Square, Harrisburg, PA 17120, within 30 days following the publication of this notice in the *Pennsylvania Bulletin*. Questions and comments may also be e-mailed to psalvatore@state.pa.us or faxed to (717) 705-3873.

Regulatory Review

Under section 5(a) of the Regulatory Review Act (act) (71 P. S. § 745.5(a)), on February 3, 2009, the Department submitted a copy of this proposed rulemaking to the Independent Regulatory Review Commission (IRRC) and to the Chairpersons of the Senate Banking and Insurance Committee and the House Insurance Committee (Committees). In addition to the submitted proposed rulemaking, the Department has, as required by the act,

provided IRRC and the Committees with a copy of a detailed Regulatory Analysis Form prepared by the Department. A copy of that material is available to the public upon request.

IRRC will notify the Department of any objections to any portion of the proposed rulemaking within 30 days of the close of the public comment period. The notification shall specify the regulatory review criteria that have not been met by that portion. The Regulatory Review Act specifies detailed procedures for the Department, the Governor, and the General Assembly to review these objections before final publication of the regulations.

JOEL SCOTT ARIO,
Insurance Commissioner

Fiscal Note: 11-238. No fiscal impact; (8) recommends adoption.

Annex A

TITLE 31. INSURANCE

PART VIII. MISCELLANEOUS PROVISIONS

CHAPTER 147. ANNUAL [AUDITED INSURERS' FINANCIAL REPORT REQUIRED] FINANCIAL REPORTING REQUIREMENTS

§ 147.1. Purpose.

The purpose of this chapter is to improve the Department's surveillance [for] of the financial condition of insurers by requiring an annual audit by independent certified public accountants of the financial statements reporting the financial condition and the results of operations of insurers, **a written communication detailing internal control related matters noted in the audit, and a written report by management of internal control over financial reporting.**

§ 147.2. Definitions.

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

Affiliate—As defined in section 1401 of The Insurance Company Law of 1921 (40 P. S. § 991.1401).

Assumed premiums—Total premiums assumed by an insurer from nonaffiliated insurers.

Audit committee—

(i) A committee or equivalent body established by the board of directors or equivalent body of an insurer for the purpose of overseeing the accounting and financial reporting processes, audits of financial statements, and internal control structure of the insurer or insurer group.

(ii) The term includes a committee established under section 1405(c)(4) or (5) of The Insurance Company Law of 1921 (40 P. S. § 991.1405(c)(4) and (5)).

* * * * *

Control, controlling, controlled by and under common control with—As defined in section 1401 of The Insurance Company Law of 1921.

* * * * *

Direct written premiums—Total premiums directly written by an insurer.

Insurer—

* * * * *

(ii) Except as otherwise noted, the term also includes a continuing care provider licensed to transact business in this Commonwealth **under the Continuing Care Provider Registration and Disclosure Act (40 P. S. §§ 3201—3255)).**

Insurer group—Two or more affiliated insurers identified by a controlling entity for the purpose of evaluating the effectiveness of internal control over financial reporting.

Internal control over financial reporting—The process effected by the board of directors, management and other personnel of an insurer or insurer group, which provides reasonable assurances regarding the reliability of the financial statements in accordance with § 147.9a (relating to establishment and communication of internal control over financial reporting).

NAIC—The National Association of Insurance Commissioners or successor organization.

NAIC Implementation Guide—The "Implementation Guide for the Annual Financial Reporting Model Regulation" published in the *NAIC Accounting Practices and Procedures Manual*, or successor publication, prescribed for financial reporting under section 320(a)(2) of The Insurance Company Law of 1921 (40 P. S. § 443(a)(2)).

Person—As defined in section 1401 of The Insurance Company Law of 1921.

Sarbanes-Oxley Act—The Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 (15 U.S.C.A. §§ 7201—7266).

Sarbanes-Oxley Act compliant entity—An entity that is either required to be or is voluntarily compliant with the following:

(i) The preapproval requirements of section 201 of the Sarbanes-Oxley Act (15 U.S.C.A. § 78j-1).

(ii) The audit committee independence requirements of section 301 of the Sarbanes-Oxley Act (15 U.S.C.A. § 78f).

(iii) The internal control over financial reporting requirements of section 404 of the Sarbanes-Oxley Act (15 U.S.C.A. § 7262) and 17 CFR 229.308.

Section 404 Report—The annual report on internal control over financial reporting and the related attestation report of the independent certified public accountant filed under section 404 of the Sarbanes-Oxley Act (15 U.S.C.A. § 7262) and 17 CFR 229.308 (relating to Item 308 internal control over financial reporting).

Securities Exchange Act—The Securities Exchange Act of 1934 (15 U.S.C.A. §§ 78a—78mm).

Ultimate controlling person—A person which is not controlled by another person. The term may include one or more of the following: individual, corporation, limited liability company, partnership, association, joint stock company, trust, unincorporated organization, or any similar entity or combination of the foregoing who controls another person.

§ 147.3. Filing and extensions for filing [of annual audited financial report] required reports and communications.

(a) Every insurer, unless exempted by the Commissioner under § 147.13 (relating to effective date and exemption), shall have an annual audit performed by an independent certified public accountant and shall file as instructed by the Commissioner an audited financial report for that year on or before June 1 for the year ending December 31 immediately preceding unless an extension is granted under subsection (b). The Commissioner may require an insurer to file an audited financial report earlier than June 1 by providing 90 days' advance notice to the insurer. The Commissioner may require audited financial reports and related information required under this chapter to be filed with the Department and the National Association of Insurance Commissioners in a form of electronic transmission acceptable to the Commissioner. **Supplemental information related to reporting required under this chapter is published in the NAIC Implementation Guide.**

(b) Extensions of the filing date may be granted by the Commissioner for [30-day] 15-day periods upon showing, by the insurer and its independent certified public accountant, the reasons for requesting an extension by the Commissioner. The request for extension shall be submitted in writing at least 10 days prior to the due date in sufficient detail to permit the Commissioner to make an informed decision with respect to the requested extension. **A 15-day extension of the filing date granted by the Commissioner for an audited financial report must provide for 15-day extensions of the filing dates for communication of internal control related matters noted in an audit under § 147.9a (relating to establishment and communication of internal control over financial reporting) and for management's report of internal control over financial reporting under § 147.9b (relating to management's report of internal control over financial reporting).**

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§ 147.3a. Requirements for audit committees.

(a) Every insurer required to file an annual audited financial report under this chapter shall establish an audit committee.

(b) An ultimate controlling person may designate an audit committee of a controlling person to be the audit committee for one or more controlled insurers. The designation must:

- (1) Be in writing.
- (2) Identify the ultimate controlling person.
- (3) Explain the basis for the designation in sufficient detail for the Department to determine compliance with this chapter.
- (4) Be provided by the ultimate controlling person or the insurer to the Department and the chief insurance regulatory official of each other state in which the controlled insurers are domiciled no later than April 1 of the year in which the insurer's audited financial report is required to be filed under this chapter.
- (5) Be effective upon receipt by the Department and remain in effect unless modified or rescinded

by subsequent notice provided by the ultimate controlling person or the insurer as required under paragraph (4).

(c) Each member of the audit committee shall be a natural person who is either a member of the board of directors of the insurer or a member of the board of directors of a controlling person whose audit committee has been designated as the insurer's audit committee under subsection (b).

(d) If an audit committee other than the entire board of directors of the insurer has not been established by the insurer or designated by an ultimate controlling person under subsection (b), the insurer's entire board of directors shall constitute the audit committee.

(e) A proportion of an audit committee's members shall be independent in accordance with the following requirements:

(1) The proportion of audit committee members who shall be independent shall be calculated as follows:

(i) When an insurer's direct written and assumed premiums are less than or equal to \$300,000,000 at the end of the most recent calendar year, 0% of the members are required to be independent.

(ii) When an insurer's direct written and assumed premiums exceed \$300,000,000 but are not more than \$500,000,000 at the end of the most recent calendar year, at least 50% of members are required to be independent.

(iii) When an insurer's direct written and assumed premiums exceed \$500,000,000 at the end of the most recent calendar year, at least 75% of members of the audit committee are required to be independent.

(2) If an audit committee of a controlling person has been designated to be the audit committee for one or more controlled insurers, the proportion of audit committee members who shall be independent shall be based on the insurer in the group with the greatest direct written and assumed premium.

(3) If an insurer's direct written and assumed premiums meet or exceed the direct written and assumed premiums threshold in paragraph (1)(i) or (iii) as of the end of a calendar year, the insurer shall comply with the required minimum proportion of independent audit committee members by January 1 following the next full calendar year, as described in the NAIC Implementation Guide.

(4) To be considered independent for purposes of this subsection, an audit committee member may not:

- (i) Be an affiliate of the insurer.
- (ii) Accept any consulting, advisory or other compensatory fee from the insurer or an affiliate of the insurer other than in the member's capacity as a member of the audit committee, board of directors or any other board committee.

(5) If an audit committee member ceases to be independent under this chapter, the person may remain an audit committee member until the earlier of the next annual meeting of the insurer or controlling person or 1 year from the occurrence of the event that caused the member to be no longer

independent, if the insurer or ultimate controlling person provides the Department with written notice within 15 days of the occurrence of the event.

(f) The audit committee shall retain an independent certified public accountant to conduct the annual audit and issue an audited financial report under this chapter in accordance with the following requirements:

(1) The audit committee shall be directly responsible for the appointment, compensation and oversight of the work of the independent certified public accountant and resolve disagreements between management and the independent certified public accountant relating to financial reporting for the purpose of preparing or issuing the audited financial report or related work under this chapter.

(2) The independent certified public accountant retained to conduct the annual audit under this chapter shall report directly to the audit committee. The audit committee shall require the independent certified public accountant to report to the audit committee in sufficient time to enable the committee to take appropriate action as required by Statement on Auditing Standards 114 (SAS 114), *The Auditor's Communication with Those Charged With Governance*, or successor publication and all of the following requirements:

(i) All significant accounting policies and material permitted practices.

(ii) All material alternative treatments of financial information within statutory accounting principles that have been discussed with the management of the insurer, ramifications of the use of alternative disclosures and treatments, and the treatment preferred by the independent certified public accountant.

(iii) Other material written communications between the independent certified public accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.

(3) The report required under paragraph (2) may be provided to the audit committee on an aggregate basis for insurers in an insurer group, if the report identifies any substantial differences in reported items among the insurers in the group.

(g) Exemptions are as follows:

(1) This section does not apply to an insurer with direct written and assumed premiums less than \$500,000,000, excluding premiums reinsured with the Federal Crop Insurance Corporation and the Federal Flood Program, which has been granted an exemption by the Department on the basis of financial or organizational hardship under § 147.13(g) (relating to effective date and exemption).

(2) This section does not apply to continuing care providers, foreign insurers, Sarbanes-Oxley compliant entities or direct or indirect wholly-owned subsidiaries of Sarbanes-Oxley compliant entities.

(3) The requirements of subsections (b)—(e) do not apply to insurers subject to section 1405(c)(4) and (5) of The Insurance Company Law of 1921 (40 P. S. § 991.1405(c)(4) and (5)).

(h) This section may not be interpreted to limit the Department's authority to require an insurer to

take specific corrective action relating to the independence of audit committee members under sections 501—563, 501-A—515-A, and 501-B—515-B of The Insurance Department Act of 1921 (40 P. S. §§ 221.1—221.63, 221-1A—221-15A and 221.1-B—221-B) regarding suspension of business and risk-based capital requirements), Chapter 160 (relating to standards to define insurers deemed to be in hazardous financial condition) or other provisions of law.

§ 147.4. Contents of annual audited financial report.

* * * * *

(b) The annual audited financial report [shall] must, at a minimum, include the following:

(1) Financial statements that present in a comparable manner, as of the end of the current and the preceding calendar year, the financial condition of the insurer, including the following:

(i) [Balance sheet reporting] Statement of admitted assets, liabilities, capital and surplus.

* * * * *

(2) Notes to financial statements. These notes shall be those required by the appropriate National Association of Insurance Commissioners Annual Statement Instructions and Accounting Practices and Procedures Manual. The notes [shall] must include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statements filed with the Department, with a written description of the nature of these differences, particularly with respect to surplus or stockholder equity and the results of operations. The [insurer shall] Commissioner may require the insurer to file an amendment to its annual statement with the Department, the [National Association of Insurance Commissioners] NAIC and other states in which the insurer is licensed, to reflect differences between the audited statutory financial statement and the annual statement filed with the Department within 60 days of the filing date of the audited financial report. The Commissioner may require amendments to financial statements to be filed with the Department and the [National Association of Insurance Commissioners] NAIC in a form of electronic transmission acceptable to the Commissioner.

(3) The report of an independent certified public accountant prepared in compliance with this chapter, including notification of adverse financial condition, [report on significant deficiencies in internal controls] communication of internal control related matters noted in the audit, and letter of qualifications of the independent certified public accountant.

* * * * *

§ 147.5. Designation of independent certified public accountant.

(a) Each insurer required by this chapter to file an annual audited financial report shall, within 60 days after becoming subject to the requirement, register with the Commissioner in writing the name and address of the independent certified public accountant or accounting firm retained to conduct the annual audit set forth in this chapter. [Insurers which have not retained an independent certified public accountant by November

11, 1995, shall engage and register the name and address of an independent certified public accountant with the Commissioner at least 6 months before the date when the first audited financial report is required to be filed. This subsection does not apply to insurers which registered with the Commissioner in writing the name and address of an independent certified public accountant in compliance with this chapter prior to November 11, 1995.]

(b) The insurer shall obtain a letter from its independent certified public accountant and file a copy with the Commissioner, in accordance with the Department's instructions, stating that the independent certified public accountant is aware of the provisions of the insurance statutes and regulations that relate to accounting and financial matters of the State in accordance with whose regulation the audited financial report is made and affirming that the independent certified public accountant will express an opinion on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by the Department, specifying the exceptions the independent certified public accountant may believe appropriate.

(c) If an independent certified public accountant who was the independent certified public accountant for the immediately preceding filed audited financial report is dismissed, resigns or is otherwise replaced, the insurer shall within 5 business days notify the Department of the dismissal, resignation or replacement.

* * * * *

(3) Within 60 business days of submitting a notification of dismissal, resignation or replacement, the insurer shall register with the Commissioner in writing the name and address of the independent certified public accountant or accounting firm retained to conduct the annual audit required under this chapter and shall obtain and file an awareness letter from the independent certified public accountants as required under subsection (b).

* * * * *

§ 147.6. [Qualifications of] Recognition, qualification and responsibilities of an independent certified public accountant.

(a) [The] An annual audited financial report must be prepared by a qualified independent certified public accountant recognized by the Commissioner.

(b) Except for insurers organized in Canada or the United Kingdom of Great Britain and Northern Ireland, the Commissioner will not recognize a person or firm as a qualified independent certified public accountant nor accept an annual audited financial report prepared in whole or in part by the person or firm under any of the following conditions:

* * * * *

(5) The person or firm employed a partner or senior manager who was involved in an audit of the insurer during the 1 year period preceding the date that the most current annual audited financial report is due and who currently serves as a member of the board of directors, president, chief executive officer, controller, chief financial officer, chief accounting officer, or in any equivalent position for the insurer.

(6) The person or firm provides to the insurer contemporaneously with the audit any of the following nonaudit services:

(i) Bookkeeping or other services relating to the insurer's accounting records or financial statements.

(ii) Financial information systems design and implementation.

(iii) Appraisal or valuation services, fairness opinions or contribution-in-kind reports.

(iv) Actuarial advisory services.

(v) Internal audit outsourcing services.

(vi) Management functions or human resource services.

(vii) Broker or dealer, investment adviser or investment banking services.

(viii) Legal or expert services unrelated to the audit.

[(b)] (c) For an insurer organized in Canada or the United Kingdom of Great Britain and Northern Ireland, the Commissioner will not recognize a person or firm as a qualified independent public accountant nor accept an annual audited financial report prepared in whole or in part by the person or firm under any of the following conditions:

* * * * *

(3) The person or firm meets the criteria of subsection (b)(5) or provides to the insurer contemporaneously with the audit any of the nonaudit services prohibited under subsection (b)(6) and the insurer has not been granted an exemption under subsection (h).

[(c) Except as otherwise provided in this section, the Commissioner will recognize an independent certified public accountant as independent and qualified who conforms to the standards of the profession as contained in the "Code of Professional Ethics of the American Institute of Certified Public Accountants, Inc." and The CPA Law (63 P. S. §§ 9.1—9.16b) or similar laws.]

(d) [A] The qualified independent certified public accountant's lead partner or other person [responsible for rendering an audited financial report] primarily responsible for an insurer's audit may not act in that capacity for more than [7] 5 consecutive years. Following a [7-year] 5 year period of service, the person will be disqualified from acting in that or a similar capacity for the same insurer or its insurance subsidiaries or affiliates for 2 years. [An insurer may apply to the Commissioner for relief from the rotation requirement on the basis of unusual circumstances. In determining if the relief should be granted, the Commissioner may consider the following factors:

(1) The number of partners, the expertise of the partners or the number of insurance or continuing care provider clients in the currently registered firm.

(2) The premium volume of the insurer or revenue volume of the continuing care provider.

(3) The number of jurisdictions in which the insurer transacts business.]

(e) A qualified independent certified public accountant who performs an audit for an insurer may only engage in nonaudit services, including tax services, for the insurer if all of the following requirements are met:

(1) The services are not prohibited under subsection (b)(6).

(2) The independent certified public accountant does not function in the role of management, audit his own work or serve in an advocacy role for the insurer.

(3) The services have been approved in advance by the insurer's audit committee under subsection (f).

(f) Auditing and nonaudit services provided to an insurer by the insurer's qualified independent certified public accountant shall be preapproved in writing by the insurer's audit committee, except that preapproval of nonaudit services is not required if any of the following criteria are met:

(1) The insurer is a Sarbanes-Oxley compliant entity.

(2) The insurer is a direct or indirect wholly-owned subsidiary of a Sarbanes-Oxley compliant entity.

(3) The aggregate amount of the nonaudit services constitute 5% or less of the total amount of fees paid or owed by the insurer to the qualified independent certified public accountant.

(g) An insurer's audit committee may delegate the authority to grant the preapprovals required under subsection (f) to one or more designated members of the audit committee. A decision of any member to whom this authority is delegated shall be presented to the full audit committee at the next scheduled meeting.

(h) The following provisions apply to applications for relief and exemptions:

(1) An insurer may apply to the Commissioner for relief from subsection (b)(5) or subsection (d), or both, on the basis of unusual circumstances. In determining whether relief should be granted, the Commissioner may consider the following factors:

(i) The number of partners, the expertise of the partners or the number of insurance or continuing care provider clients in the currently registered firm.

(ii) The premium volume of the insurer or revenue volume of the continuing care provider.

(iii) The number of jurisdictions in which the insurer transacts business.

(2) If relief is granted, the insurer shall include a copy of the granted relief with its audited financial report filed under § 147.3(a) (filing and extensions for filing required reports and communications).

(3) An insurer with direct written and assumed premium less than \$100,000,000 in a calendar year may apply for exemption from subsection (b)(6) on the basis of financial or organizational hardship under § 147.13(g) (relating to effective date and exemption).

(4) The requirements of subsection (b)(5) and (6) and subsections (e), (f) and (g) do not apply to continuing care providers.

[(e)] (i) * * *

* * * * *

[(f)] (j) * * *

[(g)] (k) * * *

[(h)] (l) * * *

[(i)] (m) * * *

§ 147.6a. Letter of qualifications of independent certified public accountant.

The independent certified public accountant shall furnish the insurer for inclusion in the filing of the annual audited financial report a letter of qualifications that includes the following:

(1) A statement that the certified public accountant is independent from the insurer and conforms to the standards of the profession as contained in the Code of Professional Ethics and pronouncements of the American Institute of Certified Public Accountants, Inc. and The C.P.A. Law (63 P.S. §§ 9.1—9.16(b)) or similar laws.

(2) A general description of the independent certified public accountant's background and experience.

(3) A specific description of the insurer auditing experience of partners, senior managers, in-charge auditors or other key staff persons assigned to the engagement and a statement as to whether each staff person is an independent certified public accountant. This provision does not prohibit the independent certified public accountant from utilizing staff as the independent certified public accountant deems appropriate when consistent with the standards prescribed by generally accepted auditing standards.

(4) A statement that the independent certified public accountant understands that the annual audited financial report that the independent certified public accountant's opinion thereon will be filed in compliance with this chapter and that the Commissioner will be relying on this information in the monitoring and regulation of the financial position of insurers.

(5) A statement that the independent certified public accountant consents to the requirements of § 147.11 (relating to definitions, availability and maintenance of independent certified public accountant workpapers) and that the independent certified public accountant consents and agrees to make available for review by the Commissioner, the Commissioner's designee or Department examiners, the workpapers, as defined in § 147.11.

(6) A declaration that the independent certified public accountant is properly licensed by an appropriate state licensing authority and is a member in good standing in the American Institute of Certified Public Accountants, Inc.

(7) A declaration that the independent certified public accountant is in compliance with § 147.6 (relating to recognition, qualification and responsibilities of an independent certified public accountant).

§ 147.6b. Conduct of insurer relating to audits.

(a) When communicating with any accountant relating to an audit, review or communication required under this chapter, an officer or director of an insurer may not directly or indirectly:

(1) Make or cause to be made a materially false or misleading statement.

(2) Omit or cause another person to omit any material fact necessary to make statements made, in light of the circumstances under which the statements are made, not misleading.

(b) An officer or director of an insurer or any other person acting under the direction thereof, may not, directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence an accountant performing an audit under this chapter if he knows or should have known that the action, if successful, could render the insurer's financial statements materially misleading.

(c) For purposes of subsection (b), actions that could render an insurer's financial statements materially misleading include, but are not limited to, actions which would result in the accountant:

(1) Issuing or reissuing a report on an insurer's financial statements that materially violates statutory accounting principles prescribed by the Commissioner, generally accepted auditing standards, or other professional or regulatory standards.

(2) Failing to perform an audit, review or other procedures required by generally accepted auditing standards or other professional standards.

(3) Failing to comply with § 147.9(d) (relating to notification of adverse financial condition).

(4) Failing to communicate matters to an insurer's audit committee.

(5) Violating any provision of this chapter.

§ 147.8. Scope of audit and report of independent certified public accountant.

* * * * *

(b) The scope of the audit and data testing procedures shall be conducted as required by the appropriate *Annual Statement Instructions* adopted by the [National Association of Insurance Commissioners] NAIC. Consideration shall also be given to other procedures in the *Financial Condition Examiner's Handbook* adopted by the [National Association of Insurance Commissioners] NAIC. The independent certified public accountant shall obtain an understanding of internal control sufficient to plan the audit in accordance with AU Section 319 of the Professional Standards of the American Institute of Certified Public Accountants, *Consideration of Internal Control in a Financial Statement Audit* (AU 319). To the extent required by AU 319 and as part of the independent certified public accountant's professional requirements defined in Statement on Auditing Standards (SAS) No. 102, *Defining Professional Requirements in Statements on Auditing Standards* or its replacement, the independent certified public accountant shall consider the most recently available Management's Report of Internal Control over Financial Reporting, as required under § 147.9b, in planning and performing the audit of an insurer's statutory financial statements.

* * * * *

§ 147.9. Notification of adverse financial condition.

(a) An insurer required by this chapter to [furnish the] file an annual audited financial report shall require the independent certified public accountant to report, in writing, within 5 business days to the board of directors or audit committee of the insurer, any of the following:

* * * * *

§ 147.9a. Establishment and communication of internal control over financial reporting.

(a) An insurer or insurer group shall establish internal control over financial reporting policies and procedures designed to provide reasonable assurance that:

(1) The financial statements of the insurer or insurer group as required under § 147.4(b) and (c) (relating to contents of annual audited financial report) are reliable.

(2) Records are created and maintained to accurately and fairly reflect dispositions of assets and other transactions.

(3) Transactions are recorded as needed to prepare financial statements.

(4) Receipts and expenditures are made only as authorized by the management or board of directors of the insurer or insurer group.

(5) Unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements of the insurer or insurer group are prevented or detected in a timely manner.

(b) An insurer required under this chapter to file an annual audited financial report shall provide the Department with a written communication prepared by the independent certified public accountant describing internal control related matters identified in the audit. The written communication shall be filed with the Department within 60 days after the filing of the annual audited financial report.

(c) The communication must include a description of any unremediated material weakness in the insurer's internal control over financial reporting as of the immediately preceding December 31 or a statement that no unremediated material weaknesses were identified in the audit. For purposes of this subsection, the term "material weakness" is as defined by AU Section 325 of the Professional Standards of the American Institute of Certified Public Accountants, (SAS 112) *Communicating Internal Control Related Matters Identified in an Audit*, or its replacement.

(d) If a communication of internal control related matters filed under subsection (b) includes a description of unremediated material weaknesses, either the independent certified public accountant or the insurer shall provide the Department, within 60 days after the filing of the annual audited financial report, a written description of actions taken or proposed to eliminate the unremediated material weaknesses.

§ 147.9b. Management's report of internal control over financial reporting.

(a) An insurer that is required to file an audited financial report and that has annual direct written

and assumed premiums equal to or greater than \$500,000,000, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, shall file with the Department a management's report of internal control over financial reporting of the insurer or insurer group. A management's report of internal control over financial reporting shall be filed for an insurer group if the annual direct written and assumed premiums of any one insurer in the group is equal to or greater than \$500,000,000, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program. However, the Commissioner may require an insurer that has less than \$500,000,000 in annual direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, to file a management's report of internal control over financial reporting under sections 501—563, 501-A—515-A, and 501-B—515-B of The Insurance Department Act of 1921 (40 P. S. §§ 221.1—221.63, 221.1-A—221.15-A and 221.1-B—221.15-B) regarding suspension of business and risk-based capital requirements, Chapter 160 (relating to standards to define insurers deemed to be in hazardous financial condition) or other provisions of law. If an insurer previously not required to file a management's report of internal control over financial reporting because it did not meet the \$500,000,000 threshold is subsequently required to file the report because its premiums equal or exceed the threshold, the insurer or the insurer group shall have 2 years following the year the threshold is exceeded to file the report.

(b) The management's report of internal control over financial reporting shall be prepared by management as of the immediately preceding December 31, filed with the report of internal control related matters required under § 147.9a (relating to establishment and communication of internal control over financial reporting) and include:

(1) Statement that management is responsible for establishing and maintaining adequate internal control over financial reporting.

(2) Statement that management has established internal control over financial reporting.

(3) Brief description of the approach or processes by which management evaluated the effectiveness of its internal control over financial reporting.

(4) Disclosure of any unremediated material weaknesses in the internal control over financial reporting identified by management as of the immediately preceding December 31.

(5) Assertion to the best of management's knowledge and belief, after diligent inquiry, as to whether its internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles.

(A) Management may base its assertion, in part, upon its review, monitoring and testing of internal controls undertaken in the normal course of its activities.

(B) Management may not assert that internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statu-

tory accounting principles if one or more unremediated material weaknesses in internal control over financial reporting are disclosed as required by paragraph (4).

(C) Management shall create and maintain documentation relating to the basis upon which its assertion in management's report of internal control over financial reporting is made. Management shall have discretion as to the nature and extent of documentation to make its assertion in a cost-effective manner, including assembly of or reference to existing documentation. The documentation shall be made available to Department examiners and given confidential treatment under the authority of sections 901—908 of The Insurance Department Act of 1921 (40 P. S. §§ 323.1—323.8).

(6) Statement regarding the inherent limitations of internal control systems.

(7) Signatures of chief executive officer and chief financial officer or individuals holding equivalent positions. A management's report of internal control over financial reporting filed for an insurer group must include a statement identifying the officers or individuals in equivalent positions who have been authorized by management to sign the report on behalf of the affiliated insurers in the group.

(c) An insurer may satisfy the requirements of subsection (a) by filing a Section 404 report of the insurer or insurer group if:

(1) The insurer or insurer group is at least one of the following:

(i) Directly subject to Section 404.

(ii) A Sarbanes-Oxley compliant entity not directly subject to Section 404.

(iii) A member of a holding company system whose parent is directly subject to Section 404.

(iv) A member of a holding company system whose parent is not directly subject to Section 404 and is a Sarbanes-Oxley compliant entity.

(2) The scope of the Section 404 report includes internal controls of the insurer or insurer group that have a material impact on the preparation of the audited statutory financial statements of the insurer or insurer group as required under § 147.4(b) and (c) (relating to contents of annual audited financial report).

(3) The Section 404 report includes an addendum consisting of a positive statement by management that no material processes relating to the preparation of the audited statutory financial statements of the insurer or insurer group, as required under § 147.4 (b) and (c) are excluded from the Section 404 report.

(d) An insurer or insurer group that satisfies the requirements of subsection (c)(1) and (3) but the scope of its Section 404 report does not satisfy the requirements of subsection (c)(2) may satisfy the requirements of subsection (a) by filing one of the following:

(1) A management's report of internal control over financial reporting as required under subsection (b).

(2) A Section 404 report and a management's report of internal control over financial reporting for those internal controls that have a material impact on the preparation of the audited statutory financial statements of the insurer or insurer group and that are not included within the scope of the Section 404 report.

(e) This section does not apply to continuing care providers.

§ 147.10. [Report on significant deficiencies in internal controls] (Reserved).

[(a) Concurrently with the filing of the annual audited financial reports, each insurer shall furnish the Commissioner with a written report prepared by the independent certified public accountant describing significant deficiencies in the insurer's internal control structure noted by the independent certified public accountant during the audit. The *Statement of Auditing Standard No. 60, Communication of Internal Control Structure Matters Noted in an Audit (AU Section 325 of the Professional Standards of the American Institute of Certified Public Accountants, Inc.)* requires an independent certified public accountant to communicate significant deficiencies, known as "reportable conditions," noted during a financial statement audit to the appropriate parties within an entity. A report should not be issued if the independent certified public accountant does not identify significant deficiencies.

(b) The insurer is required to provide, within 60 days of the date of the independent certified public accountant's report on significant deficiencies, a description of remedial actions taken or proposed to correct significant deficiencies, if the actions are not described in the independent certified public accountant's report.]

§ 147.12. [Examinations] (Reserved).

[(a) The Commissioner will determine the nature, scope and frequency of examinations conducted by Department examiners under the laws relating to the conduct of examinations. Examinations may, but need not, cover all aspects of the assets, condition, affairs and operations of the insurer and may include and be supplemented by audit procedures performed by the independent certified public accountant as provided in this chapter. Scheduling of examinations will take into account matters such as early warning test results, changes in management, results of market conduct examinations and annual audited financial reports. The type of examinations performed by Department examiners will be as follows:

(1) Compliance examinations will consist of a review of the workpapers of the independent certified public accountant defined under § 147.11 (relating to definition, availability and maintenance of independent certified public accountant workpapers) and a general review of the corporate affairs and insurance operations of the insurer to determine compliance with the Pennsylvania insurance statutes and this title. The examiners may perform alternative or additional examination procedures to supplement those performed by the independent certified public accountant when the

examiners determine that the procedures are necessary to verify the financial condition of the insurer.

(2) Limited scope examinations may cover areas such as life reserve valuations, claims analyses and organizational and capital changes and other areas the Commissioner may deem appropriate.

(3) Comprehensive examinations will be performed when the report of the independent certified public accountant as provided for in § 147.8 (relating to scope of audit and report of independent certified public accountant), the notification required by § 147.9 (relating to notification of adverse financial condition), the results of compliance or limited scope examinations, or other circumstances indicate in the judgment of the Commissioner that a complete examination of the condition and affairs of the insurer is necessary.

(b) Upon the completion of each examination described in subsection (a), the examiners appointed by the Commissioner will make a full and true report on the results of the examination. Each report will include a general description of the audit procedures performed by Department examiners and the procedures of the independent certified public accountant which the examiners may have utilized to determine the nature, timing and extent of their examination procedures. The cost of the examination shall be paid by the insurer examined in accordance with the laws and regulations relating to Department examinations.

(c) This chapter does not prohibit, preclude or in any way limit the Commissioner from ordering and conducting, or performing examinations of insurers under the laws and regulations of the Commonwealth and the practices and procedures of the Department.]

§ 147.13. Effective date and exemption.

* * * * *

(b) [For those insurers retaining an independent certified public accountant on November 11, 1995, the 7-year period of service referred to in § 147.6(d) (relating to qualifications of independent certified public accountant) begins when the independent certified public accountant or other person responsible for rendering the annual audited financial report was first retained or assigned that responsibility. The requirement that an insurer retain the services of a new independent certified public accountant in order to comply with the 7-year rotation provision in § 147.6(d) shall become effective November 11, 1997] Insurers shall comply with this chapter for annual audited financial reports beginning January 1, 2010.

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(f) Foreign insurers filing annual audited financial reports in another state, pursuant to that state's requirements for annual audited financial reports whose requirements [have been found by the Commissioner to be] are substantially similar to the requirements of this chapter, are exempt from this chapter [if the insurer meets the following conditions:

(1) A copy of the annual audited financial report, report of evaluation of accounting procedures and system of internal controls, report on significant

deficiencies in internal controls, and the independent certified public accountant's letter of qualifications which are filed with the other state are filed as instructed by the Commissioner in accordance with the filing dates specified in this chapter. Canadian insurers may submit independent certified public accountant's reports as filed with the Canadian Dominion Department of Insurance.

(2) A copy of a notification of adverse financial condition report filed with the other state is filed with the Commissioner within the time frames specified in § 147.9 (relating to notification of adverse financial condition).]

(g) Upon written application of an insurer, the Commissioner may grant an exemption from compliance with **all or part of** this chapter if the Commissioner finds, upon review of the application, that compliance with this chapter would constitute a financial or organizational hardship upon the insurer. An exemption may be granted at any time and from time to time for specified periods. **If an exemption is granted, the insurer shall file a copy of the exemption with the NAIC and as required by the chief insurance regulatory official in all states where the insurer is licensed or is doing business.** Within 10 days from a denial of the written [request] application of an insurer for an exemption from this chapter, the insurer may request in writing a hearing on its application for an exemption. Hearings will be held in accordance with 2 Pa.C.S. §§ 501—508 and 701—704 (relating to Administrative Agency Law) and Chapters 56[and]—58 (relating to special rules of administrative practice and procedure; [and] publication of citations and notice of hearings; and objections and procedure for hearings on reports of examinations).

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(i) In the case of insurers organized in Canada or the United Kingdom of Great Britain and Northern Ireland, the annual audited financial report is defined as the annual statement of total business on the form filed by the insurers with their domiciliary supervision authority, audited by an independent chartered accountant. For these insurers, the letter required in [§ 147.15 (relating to letter of qualifications of independent certified public accountant) shall] § 147.6a (relating to letter of qualifications of independent certified public accountant) must state that the independent certified public accountant is aware of the requirements relating to the annual audited financial report filed with the Commissioner under § 147.3 (relating to filing and extensions for filing **required reports and communications**) and [shall] affirm that the opinion expressed is in conformity with those requirements.

§ 147.15. [Letter of qualifications of independent certified public accountant] (Reserved).

[The independent certified public accountant shall furnish the insurer for inclusion in the filing of the annual audited financial report a letter including the following:

(1) A statement that the certified public accountant is independent with respect to the insurer and conforms to the standards of the profession as contained in the Code of Professional Ethics and pronouncements of the American Institute of Certified Public Accountants, Inc., and The C.P.A. Law (63 P. S. §§ 9.1—9.16(b)) or similar laws.

(2) A description of the background and experience in general and the experience in audits of insurers of the staff assigned to the engagement and whether each staff person is an independent certified public accountant. This chapter does not prohibit the independent certified public accountant from utilizing staff as the independent certified public accountant deems appropriate when consistent with the standards prescribed by generally accepted auditing standards.

(3) A statement that the independent certified public accountant understands that the annual audited financial report and the independent certified public accountant's opinion thereon will be filed in compliance with this chapter and that the Commissioner will be relying on this information in the monitoring and regulation of the financial position of insurers.

(4) A statement that the independent certified public accountant consents to the requirements of § 147.11 (relating to definitions, availability and maintenance of independent certified public accountant workpapers) and that the independent certified public accountant consents and agrees to make available for review by the Commissioner, the Commissioner's designee or Department examiners, the workpapers, as defined in § 147.11.

(5) A representation that the independent certified public accountant is properly licensed by an appropriate state licensing authority and is a member in good standing in the American Institute of Certified Public Accountants, Inc.

(6) A representation that the independent certified public accountant is in compliance with § 147.6 (relating to qualifications of independent certified public accountant).]

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