

## DERIVATIVE INSTRUMENTS MODEL REGULATION

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### Section 1. Authority

This regulation is adopted and promulgated by the Commissioner of Insurance pursuant to [insert citation to state law equivalent to Section 8 of the Investments of Insurers Model Act].

### Section 2. Purpose

The purpose of this regulation is to set standards for the prudent use of derivative instruments in accordance with [insert citation to state law equivalent to Section 9 and 18 of the Investments of Insurers Model Act].

### Section 3. Definitions

For the purposes of this regulation, the following definitions shall apply:

- A. “Business entity” includes a sole proprietorship, corporation, limited liability company, association, partnership, joint stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether for-profit or not-for-profit.
- B. “Counterparty exposure amount” means:
  - (1) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse (“over-the-counter derivative instrument”). The amount of credit risk equals:
    - (a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurance company; or
    - (b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurance company.
  - (2) If over-the-counter derivative instruments are entered into pursuant to a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the *Purposes and Procedures of the Securities Valuation Office* as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:
    - (a) The market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment to the insurance company; and
    - (b) The market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment by the insurance company to the business entity.

- (3) For open transactions, market value shall be determined at the end of the most recent quarter of the insurance company's fiscal year and shall be reduced by the market value of acceptable collateral held by the insurance company or placed in escrow by one or both parties.
- C.
- (1) "Derivative instrument" means an agreement, option, instrument or a series or combination thereof:
    - (a) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
    - (b) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
  - (2) Derivative instruments include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof. Derivative instruments shall additionally include any agreements, options or instruments permitted under regulations adopted pursuant to [insert citation to state law equivalent to Section 8 of the Investments of Insurers Model Act]. Derivative instruments shall not include an investment authorized by [insert state law equivalent to Sections 11 through 17, 19 and 24 through 30 of the Investments of Insurers Model Act].
- D. "Qualified clearinghouse" means a clearinghouse for, and subject to the rules of a qualified exchange or a qualified foreign exchange, which clearinghouse provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.
- E. "Qualified exchange" means:
- (1) A securities exchange registered as a national securities exchange, or a securities market regulated under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78 *et seq.*), as amended;
  - (2) A board of trade or commodities exchange designated as a contract market by the Commodity Futures Trading Commission or any successor thereof;
  - (3) Private Offerings, Resales and Trading through Automated Linkages (PORTAL);
  - (4) A designated offshore securities market as defined in Securities Exchange Commission Regulation S, 17 C.F.R. Part 230, as amended; or
  - (5) A qualified foreign exchange.
- F. "Qualified foreign exchange" means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions:
- (1) That has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC's Regulations, 17 C.F.R. Part 30);
  - (2) That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC's Regulations, 17 C.F.R. Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or

- (3) Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC's Office of General Counsel, but an exchange, board of trade or contract market that qualifies as a "qualified foreign exchange" only under this paragraph shall only be a "qualified foreign exchange" as to foreign stock index futures contracts that are the subject of such no-action relief under this paragraph.

**Section 4. Guidelines and Internal Control Procedures**

- A. Before engaging in a derivative transaction, an insurance company shall establish written guidelines, approved by the Commissioner, that shall be used for effecting and maintaining derivative transactions. The guidelines shall:
  - (1) Specify insurance company objectives for engaging in derivative transactions and derivative strategies and all applicable risk constraints, including credit risk limits;
  - (2) Establish counterparty exposure limits and credit quality standards
  - (3) Identify permissible derivative transactions and the relationship of those transactions to insurance company operations; for example, a precise identification of the risks being hedged by a derivative transaction; and
  - (4) Require compliance with internal control procedures.
- B. An insurance company shall have a written methodology for determining whether a derivative instrument used for hedging has been effective.
- C. An insurance company shall have written policies and procedures describing the credit risk management process and a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.
- D. An insurance company's board of directors shall, in accordance with [insert citation to state law equivalent of Section 4 of the Investments of Insurers Model Act]:
  - (1) Approve the written guidelines, methodology and policies and procedures required by Subsection A, B and C respectively, of this section and the systems required by Subsections B and C of this section; and
  - (2) Determine whether the insurance company has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.
  - (3) Review whether derivatives transactions have been made in accordance with the approved guidelines and consistent with stated objectives.
  - (4) Take action to correct any deficiencies in internal controls relative to derivative transactions.

**Section 5. Commissioner Approval**

Written documentation explaining the insurance company's internal guidelines and controls governing derivative transactions shall be submitted for approval to the Commissioner. The Commissioner shall have the authority to disapprove the guidelines and controls proposed by the company if the insurance company cannot demonstrate the proposed internal guidelines and controls would be adequate to manage the risks associated with the derivative transactions the insurance company intends to engage in.

**Section 6. Documentation Requirements**

An insurance company shall maintain documentation and records relating to each derivative transaction, such as:

- A. The purpose or purposes of the transaction;
- B. The assets or liabilities to which the transaction relates;
- C. The specific derivative instrument used in the transaction;
- D. For over-the-counter derivative instrument transactions, the name of the counterparty and the market value; and
- E. For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade and the market value.

**Section 7. Trading Requirements**

Each derivative instrument shall be:

- A. Traded on a qualified exchange;
- B. Entered into with, or guaranteed by, a business entity;
- C. Issued or written with the issuer of the underlying interest on which the derivative instrument is based; or
- D. Entered into with a qualified foreign exchange.

**Section 8. Effective Date**

This regulation shall become effective [insert date].

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*Chronological Summary of Action (all references are to the Proceedings of the NAIC).*

*1996 Proc. 2<sup>nd</sup> Quarter 10, 33, 264 (adopted).*

*2009 Proc. 2<sup>nd</sup> Quarter, Vol. II 116, 119-129 (amended).*