Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

## **Issue: SSAP No. 32R – Publicly Traded Preferred Stock Warrants**

**Check (applicable entity):**

 P/C Life Health

Modification of Existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue: NAIC staff received inquiries on which standard and reporting schedule would be most appropriate for publicly traded preferred stock warrants. A stock warrant represents the right to purchase a company's stock at a specific price and at a specific date and are typically issued directly by a company to an investor. When a stock warrant is exercised, the shares of the stock received are issued directly from the company itself, rather than another investor.

Stock warrants generally fall into scope of *SSAP No. 86—Derivatives*, although there is a special carveout for publicly traded common stock (see existing authoritative literature section). However due to the fact that the only difference between publicly traded common and preferred stock warrants is the type of stock an entity would receive (i.e. common or preferred stock), NAIC staff believe that publicly traded preferred stock warrants should receive a similar carveout from SSAP No. 86 and similar accounting and reporting treatment.

This agenda item proposes 1) to expand the scope of *SSAP No. 32R—Preferred Stock* to include publicly traded preferred stock warrants and 2) require publicly traded preferred stock warrants to be reported at fair value.

Existing Authoritative Literature:

Warrants, both public and private are described in SSAP No. 86*,* however publicly traded (common) stock warrants are scoped into *SSAP No. 30—Unaffiliated Common Stock* as highlighted below. (Note: only relevant excerpts have been included below.)

SSAP No. 86:

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal/original investment loss based on the terms of the agreement (in addition to default risk), and any other agreements or instruments substantially similar thereto or any series or combination thereof.

j. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity. Publicly traded stock warrants are captured in scope of *SSAP No. 30R—Unaffiliated Common Stock.* All other warrants, including non-publicly traded stock warrants, shall be captured in scope of SSAP No. 86.

Accordingly, as referenced in SSAP No. 86, publicly traded common stock warrants are captured within the scope of SSAP No. 30R, as highlighted below.

SSAP No. 30R:

1. In addition, the following equity investments are captured within scope of this statement:
2. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York or NASDAQ exchange;
3. **Publicly traded common stock warrants;**
4. Shares of SEC registered Investment Companies captured under the Investment Company Act of 1940 (open-end investment companies (mutual funds), closed-end funds and unit investment trusts), regardless of the types or mix of securities owned by the fund (e.g., bonds or stocks);
5. Exchange Traded Funds, except for those identified for bond or preferred stock treatment, as identified in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and published on the SVO’s web page of [*www.NAIC.org*](http://www.NAIC.org);
6. Foreign open-end investment funds governed and authorized in accordance with regulations established by the applicable foreign jurisdiction. Other foreign funds are excluded from the scope of this statement; and
7. Equity interests in certified capital companies in accordance with *INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO)*.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:**

None

**Convergence with International Financial Reporting Standards (IFRS): N/A**

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as nonsubstantive and expose revisions to *SSAP No. 32R—Preferred Stock* and *SSAP No. 86—Derivatives,* which would scope publicly traded preferred stock warrants into SSAP No. 32R. This would result in publicly traded preferred stock warrants receiving similar treatment as publicly traded common stock warrants. Additionally, the publicly traded preferred stock warrants would be accounted for as perpetual preferred stock, thus requiring to be accounted for at fair value.

Proposed edits to *SSAP No. 86—Derivatives*:

5. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, structured notes with risk of principal/original investment loss based on the terms of the agreement (in addition to default risk), and any other agreements or instruments substantially similar thereto or any series or combination thereof.

j. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity. Publicly traded stock warrants are captured in scope of *SSAP No. 30R—Unaffiliated Common Stock or SSAP No. 32R—Preferred Stock.* All other warrants, including non-publicly traded stock warrants, shall be captured in scope of SSAP No. 86.

Proposed edits to *SSAP No. 32R—Preferred Stock*:

## **SUMMARY CONCLUSION**

1. Preferred stock which may or may not be publicly traded is a security that represents ownership of a corporation and gives the holder a claim prior to the claim of common stockholders on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the common stock dividend, stated in a dollar amount or as a percentage of par value. Preferred stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt. Preferred stock shall include:
2. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is at the option of the holders. Redeemable preferred stock is any stock which 1) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; or 2) is redeemable at the option of the holders. Preferred stock which meet one or more of these criteria would be classified as redeemable preferred stock, regardless of other attributes such as voting rights or dividend rights.
3. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to paragraph 3.a.
4. Publicly traded preferred stock warrants.

### Balance Sheet Amount

1. Preferred stock shall be valued based on (a) the underlying characteristics (redeemable, perpetual or mandatory convertible), (b) the quality rating expressed as an NAIC designation, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:
2. For reporting entities that do not maintain an AVR:
3. Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost, amortized cost, or fair value.
4. Perpetual preferred stock and publicly traded preferred stock warrants shall be reported at fair value, not to exceed any currently effective call price.
5. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
6. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus)
7. For reporting entities that maintain an AVR:
8. Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3) shall be valued at amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of amortized cost or fair value.
9. Perpetual preferred stock and publicly preferred stock warrants shall be valued at fair value, not to exceed any currently effective call price.
10. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
11. For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.*

### Impairment of Perpetual Preferred Stock

14. For any decline in the fair value of perpetual preferred stock or publicly traded preferred stock warrants, which is determined to be other-than-temporary (INT 06-07), the perpetual preferred stock or warrant shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines, which are determined to be other-than-temporary, shall be recognized as realized losses. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a preferred stock at an amount below its carrying value.

Staff Review Completed by: Jim Pinegar, NAIC Staff – September 2020

**Status:**

On November 12, 2020, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as nonsubstantive, and exposed revisions to *SSAP No. 32R—Preferred Stock* and *SSAP No. 86—Derivatives,* as illustrated above, to scope publicly traded preferred stock warrants into SSAP No. 32R with accounting at fair value.

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