



MEMORANDUM

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)

CC: Marc Perlman, Investment Counsel, NAIC Securities Valuation Office (SVO)
Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Proposed Amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to Add Instructions for ETFs that Contain a Combination of Preferred Stocks and Bonds

DATE: September 30, 2019

1. Summary – The P&P Manual authorizes the SVO to review and determine that a fund’s cash flow can be appropriately characterized as fixed income for regulatory purposes, and if so, assign an NAIC Designation to reflect the credit risk associated with the fund’s cash flow and include the name of the fund on the appropriate NAIC List. For inclusion on the SVO-Identified bond or preferred stock ETF list, the ETF must predominantly hold either a portfolio of bonds or preferred stock. This guidance restricts the SVO from reviewing ETFs that hold a portfolio of both bonds and preferred stock. This proposed amendment would provide authorization for the SVO to review ETFs that hold both bonds and preferred stock for possible inclusion on the preferred stock ETF list.

2. Proposed Amendment – The text referencing the Investments in Funds is shown below, edits in red-underline, as it will appear in the 2019 P&P Manual format.

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2019 P&P Manual

**Part Three – SVO Procedures and Methodology for Production of NAIC Designations
Investment in Funds**

The SVO-Identified Bond ETF List and the SVO-Identified Preferred Stock ETF List

255. Description – At this time, ETFs operate under an Exemptive Order granted by the SEC that provides relief from the application of provisions of the Investment Company Act of 1940 that would otherwise apply. ETFs issue creation units to initial investors in exchange for a specified portfolio of bonds. The initial investor can hold the creation units or sell the ETF shares that constitute the creation unit on the exchange on which the ETF is registered. Other investors may purchase ETF shares; including to reconstitute and redeem a creation unit. Shares of ETF are not redeemable to the fund but are traded on registered exchanges at a price set by the market. Shares of ETFs are expected to trade at or near par because of arbitrage related to the value of the portfolio or of the ETF shares. For inclusion on the SVO-Identified bond ETF list, the ETF must hold a portfolio of bonds, ~~preferred stock or a combination of bonds and preferred~~ (or preferred stock) that tracks a specified bond index (a passive investment); or it must a portfolio of bonds, ~~preferred stock or a combination of bonds and preferred~~ (or preferred stock) that it actively manages pursuant to a specified investment objective.

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257. An ETF on the SVO-Identified Preferred Stock ETF List is in scope of SSAP No. 32—Preferred Stock and reported on Schedule D, Part 2, Section 1. The SVO may include ETFs that hold a portfolio of bonds and preferred stock on the SVO-Identified Preferred Stock ETF List. These investments are reported at either amortized cost or fair value based on assigned NAIC Designation.

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