National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

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)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: 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 Additional Instructions to the Review of Funds

DATE: March 1, 2021

1. **Summary** –At the request of the Task Force to provide greater clarity and predictability to fund sponsors and investors regarding the acceptable use of derivatives in funds and permit some funds to have greater flexibility in their use of derivatives, the SVO proposes creating two new tests. One test would be for all funds other than those on the NAIC Fixed Income-Like SEC Registered Funds List and the other test would apply only to funds on that list. Pursuant to the P&P Manual, the SVO's stated objective regarding funds is to "*…assess whether for NAIC regulatory purposes …, the fund's portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.*" The P&P Manual further requires the SVO, in its opinion, to determine if the fund is Fixed Income Like, meaning the SVO must determine whether, *"a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings of bonds or of preferred stock of a known credit quality were held individually.*" Currently, the P&P Manual grants the SVO discretion in determining whether a fund's use of derivatives is consistent with a fixed income like security.

On October 28, 2020, the Securities Exchange Commission (SEC) adopted Rule 18f-4 (the Rule) under the Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds. The SEC designed the Rule to create a more comprehensive approach to the regulation of the use of derivatives by funds. While the Rule imposes rigorous management, reporting and leverage requirements on funds which use derivatives, limited users of derivatives are exempt from those requirements. Under the Rule, a fund is considered a limited user of derivatives if its gross notional derivatives exposure, exclusive of certain currency and interest rate hedges associated with specific fixed-income or equity investments held by the fund, does not to exceed 10 percent of the fund's net assets. The SEC recognized the risk derivative transactions pose to funds and wrote, "Many derivatives transactions, such as futures, swaps, and written options, involve leverage or the potential for leverage because they enable the fund to magnify its gains and losses compared to the fund's investment, while also obligating the fund to make a payment or deliver assets to a counterparty under specified future conditions."[1] The SEC specifically noted

[1] SEC Release No. IC-34084; File No. S7-24-15, p.11.

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the differences in risk to a fund between the hedging, for example, the currency risk of a fund investment denominated in a different currency and the fund taking a speculative position on price movements of two currencies. The SVO contends that such leverage is inconsistent with the "predictable and periodic" standard in the P&P Manual definition of Fixed Income Like and therefore proposes using the Rule's limited user standards as a guidepost for updated P&P Manual guidance on what is an acceptable use of derivatives use by a fund so that the fund payments can be considered fixed income like.

2. Recommendation – Based on requests from Task Force members that a more definitive limitation on the use of derivatives in funds be established we propose the following two tests. For funds on the SVO-Identified Bond ETF List[2], the SVO-Identified Preferred Stock ETF List[3] and the NAIC List of Schedule BA Non-Registered Private Funds with Underlying Assets Having Characteristics of Bonds or Preferred Stock[4], we propose, similar to the limited user exception in the Rule, a threshold whereby the gross notional amount of derivatives which impose no future payment or margin posting obligation on the fund, cannot exceed 10% of the net asset value of the fund, under normal market conditions, except for certain currency and interest rate hedges, certain futures or forwards on fixed-income or preferred stock to be held in the fund's portfolio, reverse-repurchase agreements associated with specific fixed-income or preferred stock investment held by the fund, and non-margin borrowing for purposes other than investment, each of which could impose a future payment or margin posting obligation on the fund.

Funds on the NAIC Fixed Income-Like SEC Registered Funds List are in scope of SSAP No. 30R-Unaffiliated Common Stock and reported on Schedule D, Part 2, Section 2. Based on such reporting, if the Task Force deems it appropriate, NAIC Designations assigned to those funds could be permitted to include assessments of risk other than credit risk, including market and liquidity risk, both risks introduced by derivatives. This also addresses requests by several Task Force members that a wider range of funds be eligible to receive an NAIC Designations. Therefore, if the Task Force thinks it appropriate, these funds could be permitted a larger derivative threshold of up to 20% of the net asset value of the fund, under normal market conditions. This threshold would also prevent violation of the P&P Manual fund methodology's "predominantly hold" requirement that a fund, "will hold *at least* 80% of its assets in bonds if the fund is a bond fund or 80% of its assets in preferred stock if the funds is a preferred stock fund, *in normal market conditions* . . ." We are not proposing that any types of derivatives be exempt from the 20% threshold calculation because such exemptions could potentially cause such a breach in the aggregate. For both tests we recommend incorporating an assessment of counterparty risk into our Credit Risk Assessment.

3. Proposed Amendment – The text referencing the Investments in Funds is shown below, edits in red, as it would appear in the 2020 P&P Manual format.

[2] In scope of *SSAP No. 26R- Bonds* and reported on Schedule D, Part 1.

[3] In scope of *SSAP No. 32 – Preferred Stock* and reported on Schedule D, Part 2, Section 1.

[4] In scope of *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies* or *SSAP No. 97 – Investments in Subsidiary, Controlled and Affiliated Entities*, reported on Schedule BA.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION OF NAIC DESIGNATIONS

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NAIC FIXED INCOME-LIKE SEC REGISTERED FUNDS LIST

Description

269. This section encompasses SEC registered funds issued by any type of investment-company registered with the SEC under the Investment Company Act of 1940 that sponsors a fund that will predominantly hold bonds or preferred stock. This listing excludes money market mutual funds as those securities are subject to different accounting treatment.) Different type of investment companies can be considered to have business models that operate differently as to redemption of shares, the life of the fund, whether the portfolio is held to maturity or traded over the life of the fund. The four types of investment companies are summarized below:

- **Open End Management Company (OEMC)** – An OEMC sell redeemable shares, directly or through a broker, on a continuous basis at the fund's approximate net asset value (NAV) per share and invests the proceeds in highly liquid bonds. Investors redeem shares of an OEMC fund by selling them back to the fund or to a broker. OEMC's may include exchange-traded funds.
- **Closed End Fund (CEFC)** – A CEFC lists its shares on a stock exchange or trades in the over-the-counter market. The assets of a CEFC are professionally managed in accordance with the fund's investment objectives and policies. The market price of a CEFC share is determined by supply and demand in the marketplace. Because a CEFC does not maintain cash reserves or sell securities to meet redemptions, it can invest in less-liquid portfolio securities. A CEFC has a stated termination date.
- **Unit Investment Trust (UIT)** – A UIT issues a fixed number of securities called "units" in a public offering and uses the proceeds to buy a diversified professionally selected portfolio of securities. UITs have a preset termination date tied to its portfolio investments and investment goals. The portfolio is held for the life of the UIT; but is not actively managed or traded. Although UITs are required by law to redeem outstanding units, the UIT sponsor usually maintains a secondary market so investors can sell units back and other investors can buy units. UIT's may include exchange-traded funds.

- **Exchange-Traded Fund (ETF)** – An ETF is an investment company that is registered under the Investment Company Act of 1940 either as an OEMC or as a UIT. An ETF combines the valuation feature of an OEMC or UIT, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

Regulatory Treatment of Eligible Funds

270. An SEC registered fund on the NAIC Fixed Income-Like SEC Registered Funds List is in the scope of *SSAP No. 30R—Unaffiliated Common Stock* and reported on Schedule D, Part 2, Section 2 with an NAIC Designation. The NAIC Designation for such funds may reflect assessments of risk other than credit risk, including market risk and liquidity risk. ~~These investments are reported at fair value although reporting at net asset value is permitted if there is no readily determinable fair value.~~

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REQUIRED DOCUMENTATION, ANALYTICAL PROCEDURES AND ELIGIBILITY CRITERIA

Objective

277. The objective of the SVO's review is to assess whether for NAIC regulatory purposes discussed above, the fund's portfolio will generate predictable and periodic cash flows so similar to a bond (or a preferred stock) that it should be assigned an NAIC Designation and obtain applicable risk-based capital charges.

Definitions

278. **Bond** – For fund investment purposes, Bond means debt securities defined or encompassed within *SSAP No. 26R–Bonds* and *SSAP No. 43R–Loan-Backed and Structured Securities*.

279. **Credit Risk Assessment** – A calculation of the credit risk of a fund's underlying investment portfolio using a weighted average rating factor methodology (WARF). The WARF factor for each portfolio security (issue/security specific) is determined by first translating its NAIC CRP rating into an NAIC Designation. For securities that are unrated but have an NAIC Designation, the Designation is used. The WARF factor for that NAIC Designation is then market value-weighted. The weighted factor for each investment is summed to determine the fund's credit rating which is then translated into the equivalent NAIC Designation. For funds which use derivatives transactions, the WARF analysis will incorporate the derivative counterparties and the credit risk assessment will include an estimate of the fund's obligations to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise.

280. **Derivative Transaction Exposure** – means the sum of the gross notional amounts of the fund's derivative instruments described in the definition of "Derivative Transactions".

281. **Derivative Transactions** – means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or shall not be required, except in the case of exempt derivatives, to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise.

282. **Exempt Derivative** – means a (a) currency or interest rate derivative that hedges currency or interest rate risks associated with one or more specific investments held by the fund (which must be foreign-currency-denominated in the case of a currency derivative) and which shall not be speculative in nature or constitute a borrowing, (b) repurchase agreement, meaning a form of short-term borrowing by which the fund agrees to sell securities for cash and simultaneously agrees to repurchase the same or substantially similar securities at a stated price on a specified date, (c) forward or futures contract by which the fund contracts to purchase for a fixed price at a future date fixed-income securities or preferred stock it intends to hold in the fund portfolio, and for which the fund maintains until the settlement date, cash or other liquid assets sufficient to meet the purchase price and (d) non-margin borrowing for purposes other than investment.

~~283. **Financial Commitment Transactions** – Refers to reverse repurchase agreements, short sale borrowing, any firm or standby commitment or similar agreement as these terms are defined and as they may be subsequently amended by the SEC as part of proposed Rule 18-f-4.~~

284. **Fixed Income Like** – An SVO determination that a fund will generate predictable and periodic cash flows in a manner broadly similar to a situation where the holdings of bonds or of preferred stock of a known credit quality were held individually.

285. **Fundamental Policy** – A policy adopted by a fund that requires shareholder approval to change or a policy to provide at least 60 days' notice to fund shareholders of an intended change of a stated policy. The subject of the policy is that under normal circumstances the fund will invest at least 80% of its net assets plus any leverage for investment purposes in the type of bonds indicated by its name in compliance with Section 13 (a) of the Investment Company Act of 1940 and/or Rule 35d-1 of the 1940 Act. If the fund's prospectus does not state that this investment objective is a fundamental policy for the fund, the SVO will assume it is not.

286. **Look-through Assessment** – A qualitative and quantitative evaluation of the fund, encompassing the following criteria:

- Verify that the fund's portfolio, in the case of a bond fund or, preferred stock, in the case of a preferred stock fund *predominantly hold*s bonds or preferred stock.

- Confirm that the fund has adopted its investment objective as part of its *fundamental policy* and that other policies are consistent with fixed income investment.
- Review the fund's stated investment objective to ensure it is consistent with a fixed income investment, and evaluate the fund's investment policies and investment strategies for consistency with the investment objective and the fund's portfolio.
- Evaluate the extent to which the composition of the fund's portfolio can vary under normal market conditions given the fund's policies and investment strategies and the extent to which the composition of the fund's portfolio may vary under abnormal market conditions and the extent to which changes in composition of the fund's portfolio in abnormal market. conditions may persist given the fund's leverage profile or other relevant factors.

287. **Management Assessment –** The SVO may consider the fund's:

- management and organization, including key-man risk and investment and asset class experience;
- risk management and compliance infrastructure, including operational risk controls;
- credit management standards;
- credit research staff and capabilities;
- and, the derivatives risk management program, for funds required to adopt and implement a written derivatives risk management program pursuant to Rule 18f-4 under the Investment Company Act or 1940.

The SVO may notch the final NAIC Designation down from the quantitative Credit Risk Assessment or, in its in its sole discretion and based on its analytical judgement, choose not to assign any NAIC Designation, based upon its Management Assessment.

288. **Predominantly Hold** – The fund will hold *at least* 80% of its assets in bonds if the fund is a bond fund or at least 80% of its assets in preferred stock if the fund is a preferred stock fund, *in normal market conditions* and will deviate from this policy only temporarily to respond to abnormal market conditions. In the case of an ETF, predominantly hold also means that the fund will track a specified bond or preferred stock index, if passively managed, or refers to the bond or preferred stock portfolio the fund will actually hold, if actively managed—under normal market conditions.

289. **Speculative Characteristics Analysis** – Means: ~~(a)~~ an assessment of the fund's use of ~~leverage, including, but not limited to, its use of derivatives, financial commitment~~ derivative transactions ~~and borrowings~~, to examine the impact ~~the fund's use of leverage~~ they may have on the fund's portfolio cash flow as assessed under the *credit risk assessment* under normal and abnormal market conditions~~; and (b) a review and evaluation of the fund's policy and approaches to covering leverage obligations in relation to current and potential future guidance on the issue provided by the SEC. As used herein potential future guidance refers to proposed SEC Rule 18-f-4, "Use of Derivatives by Registered Investment Companies and Business Development Companies, ICA Release No. 31933 (December 11, 2015) [17 CFR Parts 270 and 274] Proposed Rule 18-f-4."~~, such *derivative transaction exposure* not to exceed:

- (i) for funds other than funds on the NAIC Fixed Income-Like SEC Registered Funds List, 10% of the fund's net assets in normal market conditions, excluding, for purposes of determining derivatives transaction exposure, *exempt derivatives*;

and

- (ii) for funds on the NAIC Fixed Income-Like SEC Registered Funds List, 20% of the fund's net assets in normal market conditions.

~~NOTE:~~ For the avoidance of doubt, funds are not permitted to use (a) derivative instruments, under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise and (b) any short sale borrowing or other borrowings, except for exempt derivatives. Funds on the NAIC U.S. Government Money Market Fund List are not permitted to use any derivative instruments. ~~Examples of speculative characteristics may include the need to sell assets to meet leverage obligations at a loss; instability in the cash flow introduced by the use of leverage; the need to employ alternative portfolio management strategies as a result of the need to meet payment obligations; the extent to which changes in the composition of the fund's portfolio in response to abnormal market conditions may persist given the fund's leverage profile or other relevant factors. The purpose of an analysis of speculative characteristics is to determine whether the fund's cash flow is inconsistent with a fixed income like determination.~~

Methodology*

290. The SVO shall:

- Conduct a *look-through assessment*
- Conduct a *credit-risk assessment* to determine the credit risk of the fund's cash flows.
- Conduct a *management assessment*
- Conduct a *speculative characteristics analysis*.

- Determine whether the fund's cash flow can or cannot be appropriately characterized as *fixed income like* for regulatory purposes.
- For funds on the NAIC Fixed Income-Like SEC Registered Funds List, conduct an assessment of other, non-credit risks, including market and liquidity risk.
- If the SVO determines that the fund's cash flow can be appropriately characterized as fixed income for regulatory purposes, it assigns an NAIC Designation to reflect the credit risk associated with the fund's cash flow and includes the name of the fund on the appropriate NAIC List.** Since funds on the NAIC Fixed Income-Like SEC Registered Funds List are reported on Schedule D, Part 2, Section 2, in scope of *SSAP No. 30R-Unaffiliated Common Stock*, the NAIC Designation for such funds may reflect assessments of risks other than credit risk, including market risk and liquidity risk.
- If the SVO determines that the fund's cash flow cannot be appropriately characterized as fixed income for regulatory purposes it shall communicate the determination to the insurance company or fund sponsor in writing.

* **NOTE**: *Italicized text* indicates that the term used is a defined term. Please refer to the definition of the term for a description of SVO criteria associated with the methodology component being described.
** **NOTE**: The NAIC Designation does not address the fund's ability to meet payment obligations because the insurer/shareholder does not own the bonds in the portfolio; the NAIC Designation instead conveys the credit risk/quality of the fixed income like cash flow generated by the ETF.

Documentation

291. An insurance company or the sponsor of a bond or preferred stock fund that request that the SVO conduct the look through and credit assessment submits the following required documentation to the SVO:

- A completed RTAS Application (Information about the RTAS process is contained here: *www.naic.org/documents/svo_rtas_app.pdf*. Funds with derivatives may be considered a Highly Customized Transaction.
- For all funds subject to look-through and credit risk assessment and to speculative characteristics analysis: the Prospectus and Statement of Additional Information (SAI) for the fund.
- For funds which use derivative instruments or repurchase agreements, the applicable legal documentation.
- In the case of an ETF, copies of the Application, Notice and Order associated with the fund sponsor's request for Exemptive Relief from the SEC or a link to the SEC's EDGAR where the SVO can obtain the documents.

- In the case of a private equity fund, the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement and the Form D, if one has been filed.

NOTE: The documentation provided must enable the SVO to conduct the analysis described below. Applicants are free to provide any supplemental material they believe will assist the SVO to:

- Verify that the fund has adopted a *fundamental (stated) policy* to *predominantly hold bonds* (or preferred stock).
- Evaluate the fund's use of leverage in relation to the management of portfolio risk and in relation to other purposes relevant to the *speculative characteristics analysis*.
- Understand the fund's policy and approaches to coverage of obligations arising from the use of leverage, in relation to SEC guidance on the subject.
- Schedules of the fund's portfolio securities and assets with a description of the security, the CUSIP or other security identifier and NRSRO credit ratings for the last four quarters of the fund's existence.
- A description of likely changes in the fund's composition under normal market conditions given the fund's investment objective and the strategies to be employed to attain it.

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