



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: May 27, 2021

1. Overview –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 proposed several amendments to the P&P Manual fund guidelines at the Spring National Meeting of the Task Force on March 22, 2021. The Task Force voted to receive the proposal and expose it for 45 days. The Task Force received comments from interested parties during the exposure period, aspects of which the SVO has incorporated into a new proposed amendment to the P&P Manual fund guidelines.

2. Recommendation Summary – The new proposal would adhere much more closely to Rule 18f-4 (the Rule) under the Investment Company Act of 1940 related to the use of derivatives by registered investment companies, including funds, which the Securities Exchange Commission (SEC) adopted in October 2020. Unlike the previous amendment which had two separate tests for derivatives depending on the NAIC Fund List on which a fund is listed, this amendment would create a single test. Pursuant to the new proposal a fund’s exposure to: (i) derivatives 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 payments or otherwise, (ii) short sale borrowings and (iii) reverse repurchase agreements or similar financing, would be limited to 10% of the fund’s net assets in normal market conditions. Exposure would be calculated based on the gross notional amounts of derivatives, the value of assets sold short for short sale borrowings, and the proceeds received by the fund but not repaid for reverse repurchase agreements. Consistent with the Rule, interest rate derivatives and option contracts exposure could be calculated with other defined methods consistent with market practice. Also consistent with the Rule, certain currency

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and interest rate derivatives that hedge currency or interest rate risk associated with one or more specific equity or fixed-income investments of the fund would be exempt from the 10% exposure calculation.

One difference between our proposal and the SEC Rule is that the P&P Manual's methodology requires a look-through assessment of all funds which, in turn, includes a requirement that a fund "predominantly hold" bonds or preferred stock, as applicable. As defined in the P&P Manual, "Predominantly Hold" means, in part, "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." This existing requirement, therefore, limits total derivatives, short sale borrowing and reverse repurchase agreement exposure in any fund to 20%, exclusive of the currency and interest rate derivatives mentioned above. We propose calculating that exposure as explained above. However, for derivatives under which a fund *shall not* 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 payments or otherwise, exposure would be calculated based on the derivative's market value. These derivatives would include, for example, certain options pursuant to which the fund would have no possible future payment obligation following the initial premium payment. Due to diminished risk of loss to the fund it is more appropriate to calculate the exposure based on the less conservative market value measure rather than the gross notional amount. The Credit Risk Assessment portion of our existing methodology would also be updated to include a calculation of derivative exposure and, if analytically appropriate, the inclusion of derivatives in the WARF analysis.

Derivative documentation can be complex and its review time consuming. To expedite reviews of funds with derivatives while ensuring that the fund does not breach the proposed exposure thresholds, we propose a new filing requirement to include certain derivatives information in the schedule of portfolio securities and assets which is provided to the SVO for its review. Such additional information would include (i) derivative type, (ii) might the derivative require the fund to make a future payment or delivery of cash or other assets, (iii) is the derivative an "excluded derivative transaction," (iv) the counterparty credit rating, and (v) the derivative exposure and how it is calculated. Our expectation is that a complete and accurate summary of derivatives in the schedule will obviate the need for the SVO to review derivative legal documentation, but we would reserve the right to request it if we deem it necessary.

Based on comments we received from interested parties, we have decided to remove the initially proposed management assessment from this amendment. Interested parties expressed concern that the management assessment could further weaken market clarity and predictability.

2. 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.

PART THREE
SVO PROCEDURES AND METHODOLOGY FOR PRODUCTION
OF NAIC DESIGNATIONS

NAIC FUND LISTS

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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. ~~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 any derivatives instrument or derivatives transaction, the WARF analysis may incorporate each derivative counterparty and the credit risk assessment may include a determination of derivatives exposure.

280. **Derivatives Exposure** – means the sum of the gross notional amounts of the fund’s *derivatives transactions*, described in clause (1) of the definition, below, of the term “*derivatives transaction*”; in the case of short sale borrowings, the value of the assets sold short; and, in the case of reverse repurchase agreements or similar financing transactions, the fund’s derivatives exposure also includes, for each transaction, the proceeds received but not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with the transaction. Consistent with Securities Exchange Commission Rule 18f-4 under the Investment Company Act of 1940, in determining derivatives exposure a fund may convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts and exclude any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund.
281. **Derivatives Transaction** – means: (1) 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 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; (2) any short sale borrowing; and (3) any reverse repurchase agreement or similar financing transaction.
- ~~282. **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.~~
283. **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. *A fund’s use of derivatives shall be deemed fixed income like if it meets the guidelines in this section.*
284. **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.

285. **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 holds* 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.

Note: A fund that invests in another fund will need to have that other underlying fund approved by the SVO and maintained on the appropriate fund list, if not already done.

286. **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. *The derivatives exposure of derivatives transactions (exclusive of excluded derivatives transactions, as defined in “Speculative Characteristics Analysis”), and the market value of all other assets will be used when determining whether a fund predominantly holds bonds or preferred stock, as applicable, according to this clause.*

287. **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 derivatives 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.”, the resulting derivatives exposure not to exceed 10% of the fund’s net assets in normal market conditions, excluding, for this purpose, currency or interest rate derivatives that hedge currency or interest rate risks associated with one or more specific (i) equity or fixed-income investments held by the fund (which must be foreign-currency-denominated in the case of currency derivatives), or (ii) the fund’s borrowings, provided that the currency or interest rate derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts of such derivatives do not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10 percent (each, an “excluded derivatives transaction”).~~

NOTE: For the avoidance of doubt, Funds on the NAIC U.S. Government Money Market Fund List are not permitted to use any derivatives transaction or other derivatives instrument. ~~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*

288. 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 *speculative characteristics analysis*.
- Determine whether the fund’s cash flow can or cannot be appropriately characterized as *fixed income like* for regulatory purposes.

- 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.**
- 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

289. 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. A fund with *derivatives transactions* or other *derivative instruments* may be considered a Highly Customized Transaction if the SVO determines it necessary to review a derivative's operative legal documentation.
- 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 transactions* or other *derivative instruments*, the applicable operative legal documentation, if requested by the SVO.
- 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.

- 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. For funds which use *derivative transactions* or other *derivative instruments*, the schedule shall include for each derivative:
 - The derivative type (e.g. ISDA swap, purchase call option, written put option, short sale borrowing, reverse repurchase agreement);
 - Is or may the fund be required, pursuant to the derivative, 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;
 - Is the derivative a *derivatives transaction* (as defined above), an *excluded derivatives transaction* (as defined in “Speculative Characteristics Analysis”) or neither;
 - The counterparty credit rating;
 - (i) The *derivative exposure* or market value, as applicable, both as a dollar amount and converted to a percentage of the fund’s net assets in normal market conditions, and (ii) a summary of how the amount is calculated (e.g. gross notional amount, convert the notional amount of interest rate derivative to 10-year bond equivalent, delta adjust the notional amount of option contract, market value, value of assets sold short, proceeds received but not yet paid or returned).

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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