TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force  
 Members of the Valuation of Securities (E) Task Force

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RE: Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual

DATE: November 28, 2022

**Summary –** The SVO has processed several private letter rating (PLR) filings for investments in notes issued by, and of equity or limited partnership interests in, a special purpose vehicle, trust, limited liability company, limited partnership or other legal entity that operates as a feeder fund which itself invests, directly or indirectly, in one or more funds or other equity investments. The SVO is concerned about this general structure for the following reasons:

1. Circumvent Regulatory Guidance - With the introduction of an intervening entity as debt issuer, if the investment is in substance an equity investment, the format of the investment circumvents regulatory guidance established by this Task Force, the Statutory Accounting Principles (E) Working Group and the Capital Adequacy (E) Task Force for the reporting of equity investments unless, in the case of funds, the SVO determines that the fund produces fixed-income like cash flows and is therefore eligible for specific classification, and that equity and fund investments are ineligible to use credit rating provider (CRP) ratings in the assignment of an NAIC Designation. **All non-SEC registered funds are required to be reported on Schedule BA. Life insurance entities are permitted to file investments in private equity funds, partnerships, limited liability companies and joint ventures to the SVO for specific classification on Schedule BA.;**
2. Reliance on Ratings - These investments are being reported as bonds and receiving a bond risk-based capital (RBC) factor based upon the mechanical assignment of NAIC Designations that rely upon Credit Rating Provider (CRP) ratings through the filing exempt process. The use of CRP ratings would not be permitted for the fund or equity investments which underly these notes if the equity or fund investment were held directly;
3. RBC / Investment Limit Arbitrage - The structure may permit in-substance equity and fund investments to obtain improved RBC treatment than what would be received if the investment had been directly reported. In addition to improved RBC treatment, the structures could permit entities to hold more underlying equity / fund investments than what would be permitted under state investment law; and
4. Transparency - The structures typically use two or more interconnected non-public private entities through which the non-public and privately rated “bond” securities are issued that are backed by investments in non-public assets. The many non-public private layers deny regulators, and possibly insurer investors, transparency into the true underlying risks, credit exposure and nature of the investment. The notes issued are described generically as a “senior note” or “term loan” further obscuring their actual structure and complexity. These structures can invest in any asset including affiliate investments, non-fixed income investments, derivatives, borrowings for the purpose of leverage and non-admitted assets.

It is possible that many of the transactions the SVO has processed would not qualify as bonds eligible for Schedule D-1 reporting according to the principles-based bond definition currently being drafted by the Statutory Accounting Principles (E) Working Group, while others likely will qualify. The bond definition requires a review of the substance of the investment to determine whether it has the substance of a bond; most significantly, that the ultimate underlying collateral has fixed income cash flows. In either case however, the use of a fund intermediary has the potential to be abused and requires significant judgment to understand the substance and nature of the ultimate underlying risk. This has already been recognized by the establishment of processes for the SVO to provide NAIC Designations for fixed-income-like funds. It would then follow that debt instruments backed by the types of funds that would ordinarily be required to be filed with the SVO, should follow the same process.

**Regulatory Guidance** - As noted in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual), Part One, Policies of the NAIC Valuation of Securities (E) Task Force, paragraph 112:

*The “fixed-income-like” regulatory treatment accorded under this Section only applies to funds that the SVO has verified meet eligibility criteria established by the VOS/TF and been assigned NAIC Designations or reviewed under the verification procedures and added to an NAIC List or other NAIC compilation process as hereafter discussed in this section. The use of NAIC CRP credit ratings under the filing exempt process discussed in Part Three of this Manual shall not be an acceptable basis to apply for and receive the regulatory treatment specified in this section.*

Equity and fund investments that are structured through another legal entity have been able to qualify as ‘bonds’ under the current definition due to their legal form (instead of substance as with the proposed bond definition) and bypass reporting requirements for equity and fund investments. These structures have sometimes been referred to generically as “Rated Notes”, but they may be called other names. The name may change but the general framework is the same: an equity or fund investment is transformed into what the insurer reports as a bond through the insertion of an intervening entity, which issues a note that, due to a CRP rating, receives the statutory treatment of a bond for accounting, reporting, RBC and NAIC Designation purposes. This process exploits the inherent weakness within the Filing Exempt process where anything with a CRP rating is assumed to be a “bond” and automatically treated as such despite its underlying assets, structure, or risk. These transactions can also permit the deferral of interest and/or principal payments, sometimes without capitalization and without being an event of default, introducing additional other non-payment risks not reflected in the CRP ratings used in the FE process.

*Diagram

Description automatically generated***Example Structures and RBC Impact** – The typical structure for these investments starts with a source entity, the Main Fund in *Figure 1*, that holds the underlying assets, which may be fixed income investments, but there can be many variations in the type and nature of the underlying asset. If the Main Fund, managed by General Partners (GP), were to sell Limited Partnership Interests (LP Interest) directly to an insurer, as investor, the LP Interest would typically fall under *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies* and be reported on Schedule BA. The investment would then receive an equity RBC charge unless filed with the SVO for a NAIC Designation. However, in a structured equity and funds transaction, an investor in the Main Fund is able to circumvent regulatory guidance when the LP Interest is routed through an intermediate private entity, the Debt Feeder Fund in *Figure 1*, which issues one or more tranches of notes and possibly a small equity or limited partnership interest in itself.

Figure 1

In the PLR filing that alerted the SVO to this type of investment, the assets underlying the structure were purported to be “B” quality fixed income investments. Specific details about the underlying investments were not provided and there was no transparency as to whether they were bonds, mortgage loans, real estate, affiliate notes or some other type of asset. The transaction was described as a Debt Feeder Fund issuing “investment units” comprised of 90% Senior Notes and 10% limited partnership interest, implying that the investor must participate in both, though this joining of the note to equity may not always be required in other structures. The weighted average life of the assets was identified as four-years but the Senior Notes had a remaining term of 12 years and paid interest of 8.00%, which could be deferred without capitalization. The Senior Notes were rated BBB+ by a CRP.

The issuing Debt Feeder Fund sells the “investment units” (a note and LP Interest) to insurers who report the note as a “bond” under *SSAP No. 26R – Bonds* and the small portion of equity as a joint venture or LP Interest under *SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies.*  There is no transparency that the notes issued by the Debt Feeder Fund are backed only by a separate LP Interest in the Main Fund. Either directly or indirectly, an investment in a limited partnership interest or equity investment is transformed into a “bond” because of its legal structure, without any review of its substance as a fixed-income instrument, which would be required under the proposed bond definition and is required today in the P&P Manual in order to assign an NAIC Designation to non-registered private funds with underlying assets having characteristics of bonds or preferred stock.

Continuing this example in *Figure 2,* the Debt Feeder Fund, as issuer, issues $90 million in notes and $10 million in LP interests that are purchased by insurers. The $100 million in total proceeds are used by the Debt Feeder Fund to acquire an LP Interest in the Main Fund. The Main Fund uses proceeds from Debt Feeder Fund’s LP Interest investment to invest in what are reported to be “B” rated fixed income securities

By investing in the investment units issued by the Debt Feeder Fund, an insurer is able circumvent regulatory guidance by transforming the Main Fund’s investments in “B” rated loans into a much higher rated note due to the intervening legal entity. An insurer investing in the investment unit (note and equity) would be able to dramatically reduce its risk-based capital versus reporting an LP Interest investment in the main fund holding “B” rated loans but be exposed to identical economic risk. Using the information provided in the PLR implies, as noted in *Figure 2*, the insurer making this investment could reduce its risk-based capital by 56.6%, an RBC factor reduction of 5.40%, if it invested in the investment unit (note and equity) with the note rated by a CRP instead of investing in the underlying assets directly while maintaining the exact same economic exposure. If a Health or Property Casualty insurer invested in this structure the risk-based capital arbitrage advantage could be significantly higher because those insurers cannot take advantage of an SVO assigned NAIC Designation for a Schedule BA Non-Registered Private Fund with Underlying Assets Having the Characteristics of Bonds or Preferred Stock in their RBC reporting schedules. If the note’s NAIC Designation was not derived from this CRP PLR rating, the risk-based capital arbitrage neutral NAIC Designation Category for the notes would be an NAIC 4.A and the LP Interest would receive an NAIC 6 equivalent treatment. It is worth noting that the difference in this example is similar in concept to the RBC reduction that occurs through a CLO from owning the underlying loans directly.

Figure 2

Another example transaction that the SVO received as a PLR filing in which a private equity interest is converted into a “bond” involves a limited liability corporation (LLC) whose sole asset is an equity interest in a commercial real estate investment brokers partnership. The LLC issues two term loans, Term Loan A for $55 million with a CRP rating of BBB- and Term Loan B for $55 million with a CRP rating of BB. The LLC’s only source of revenue to make scheduled payments is from distributions on the partnership equity investment but this is not transparent because the investments are reported as bonds. Interest and principal payments on the Term Loans are both permitted to accrue and non-payment does not constitute an event of default. The Term Loans are subordinate to other payment obligations of the LLC including administrative fees. The PLR mentioned that a prior issuance prioritized the payment of the LLC’s management fees above payments to investors, which implies it possessed additional risk.

Figure 3

From this information the SVO estimated in *Figure 3* that an insurer could reduce its risk-based capital by 88.8%, an RBC factor reduction of 26.65%, if they purchased the two Term Loans instead of reporting the equity investment in the partnership. If the notes did not rely upon a CRP rating for assignment of an NAIC Designation, the risk-based capital arbitrage neutral NAIC Designation Category for them would be an NAIC 6 as the underlying investment is equity.

**Recommendation** – Given the magnitude of these RBC arbitrage opportunities, the judgment involved in assessing the nature of the ultimate risk, the lack of transparency, circumvention of regulatory guidance and the reliance on CRP ratings to accomplish these ends, the SVO proposes amending the P&P Manual to include a definition for Structured Equity and Fund and to exclude such investments from Filing Exemption eligibility. The proposed amendment would not change how the investment is classified for reporting by the insurer but it would ensure that the NAIC Designation and Category assigned are appropriate for the risk and eliminate this version of RBC arbitrage.

**Proposed Amendment -** The proposed text changes to the P&P Manual are shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2022 P&P Manual format.

# **Part One Policies of the NAIC Valuation of Securities (E) Task Force**

## **Policies Applicable to Specific Asset Classes**

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### Structured Equity and Funds

#### **Intent**

1. Transactions meeting the criteria of Structured Equity and Funds as defined in Part Three of this Manual must be submitted to the SVO for review.

**NOTE:** See “Structured Equity and Funds” in Part Three for filing instructions, documentation requirements and methodology applicable to Structured Equity and Funds investments.

**Part Three**

**SVO Procedures and Methodology for Production of NAIC Designations**

## **Procedure Applicable to Filing Exempt (FE) Securities and Private Letter (PL) Rating Securities**

**…**

#### **Specific Populations of Securities Not Eligible for Filing Exemption**

1. The filing exemption procedure does not apply to:

…

* **Structured Equity and Funds -** Transactions meeting the criteria of Structured Equity and Funds as specified in this Manual are not eligible for filing exemption and are subject to assessment by SVO.

## **Structured Equity and Fund**

**Definition**

1. A Structured Equity and Fund investment is a note issued by, or equity or limited partnership interest in, a special purpose vehicle, trust, limited liability company, limited partnership, or other legal entity type, as issuer, the contractually promised payments of which are wholly dependent, directly or indirectly, upon payments or distributions from one or more underlying equity or fund investments. The inclusion of an intervening legal entity or entities between the Structured Equity and Fund investment issuer and the underlying equity or fund(s), does not change the risk that the insurer investment is ultimately dependent, in whole or in part, upon an investment in equity or one or more funds and its underlying investments. Any design that circumvents this definition, and related examples, through technical means but which in substance achieves the same ends or poses the same risk, shall be deemed a Structured Equity and Fund.

**Example Transactions**

1. *Example 1* - The Structured Equity and Fund issuing entity issues a note and a small equity or limited partnership interests in itself. The Structured Equity and Fund investment issuer invests the issuance proceeds directly or indirectly in other underlying investments that may or may not be admitted assets or fixed income like. The insurer may invest in the notes or equity, and may be required to invest in both as part of an investment unit.   
   The Structured Equity and Fund issuer in this example is a feeder fund that issues $90 million in notes and $10 million in limited partnership interests and uses the $100 million in total proceeds to invest, either directly or indirectly through a main fund, in “B” rated securities. Insurers purchase investment units comprised of 90% Senior Notes and 10% limited partnership interest. The bonds are described as Senior Notes with and interest of 8.00% but interest payments can be deferred without capitalization. The Senior Notes were rated BBB+ by the CRP.
2. *Example 2* – The Structured Equity and Fund issuing entity is a limited liability corporation (LLC) whose sole asset is an equity interest in a commercial real estate investment brokers partnership. The private equity interest is converted into a bond through an intervening LLC entity that issues two Term Loans, both of which received a NAIC CRP rating. The LLC issues two term loans, Term Loan A for $55 million with a NAIC CRP rating of BBB- and Term Loan B for $55 million with a NAIC CRP rating of BB. The LLC’s only source of revenue to make scheduled payments on the Term Loans is from distributions from its equity investment in the partnership. Interest and principal payments on the Term Loans are both permitted to accrue and non-payment does not constitute an event of default. The Term Loans are subordinate to other payment obligations of the LLC including administrative fees and management fees.

### Required Documentation and Analytical Procedures

#### **Documentation**

1. An insurance company investing in a Structured Equity and Fund issuance shall provide information sufficient for the SVO to conduct a look through assessment and credit risk assessment, as described below in this section. The entity issuing the Structured Equity and Fund may also provide this information through a completed RTAS Application sponsored by the insurer (Information about the RTAS process is contained here: [www.naic.org/documents/svo\_rtas\_app.pdf](http://www.naic.org/documents/svo_rtas_app.pdf)). The following additional information is required for a Structured Equity and Fund:

* Disclosure of any Subsidiary, Controlled or Affiliated relationship, as described in this manual and the *Accounting Practices & Procedures Manual*, between the issuer, any intermediate entity, any of the underlying investments, including the parties from which they were acquired, and the insurer.
* Prior four quarterly financial statements, if produced, and trustee or collateral agent reports from the Structured Equity and Fund issuer sufficient to identify: security specific details of each underlying investment (security identifier, descriptive information, all Eligible NAIC CRP Credit Ratings (if any), par value, market value, and explanation as to how the market value was determined).
* The legal agreement(s) governing the Structured Equity and Fund structure, the securities it issues, investments it has made and any other agreement potentially impacting payments to investors; including, but not limited to, Prospectus and Statement of Additional Information (SAI), the Private Placement Memorandum, Limited Partnership Agreement or Limited Liability Company Agreement, the Subscription Agreement, the Form D, if one has been filed, and any sale or transfer agreements.
* 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 information for each derivative.

#### **Analytical Procedures**

1. Credit Risk Assessment – The SVO may, in accordance with authority granted to it Part One, apply any methodology it deems appropriate to assess the credit risk of a Structured Equity and Fund issuance and its ultimate underlying assets identified pursuant a look-through assessment. Such methodologies include, but are not limited to, a weighted average rating factor (WARF) methodology or a CRP’s rating rationale analysis of the issuance, notched as the SVO deems appropriate to eliminate any risk-based capital arbitrage that may exist through this structure.

The NAIC Designation and Category assigned to each security issued by the Structured Equity and Fund issuer may also be adjusted to reflect any credit support within the structure including, but not limited to, subordination, guarantees, insurance, or equity. The objective of the SVO’s analysis is to ensure that the overall risk assessment will be risk-based capital neutral when comparing the ultimate underlying assets to the securities issued by the Structured Equity and Fund.

1. Look-through Assessment – A qualitative and quantitative evaluation of all securities and assets underlying a Structured Equity and Fund investment, encompassing the following criteria:

* Verify the type of assets and assess their credit risk, including performing an independent assessment of credit risk, as necessary.
* Assess which assets are consistent with a fixed income like investment and which assets are equity in nature.
* Review each underlying fund for consistency with the NAIC Funds List guidelines provided in this manual. Those which do not meet the guidelines for inclusion on a NAIC Funds List shall be deemed to have a NAIC 6 Designation for purposes of the credit risk assessment.
* Evaluate the extent to which the composition of a Structured Equity and Fund’s underlying investment(s) in a fund(s) can vary under normal market conditions given the underlying fund’s policies and investment strategies and the extent to which the composition of the underlying fund’s portfolio may vary under abnormal market conditions and the extent to which changes in composition of the underlying fund’s portfolio in abnormal market conditions may persist given the underlying fund’s leverage profile or other relevant factors.

#### **Methodology**

1. The SVO shall:

* Conduct a look-through assessment (as explained above in this section).
* Conduct a credit-risk assessment (as explained above in this section) to determine the credit risk of the Structured Equity and Fund’s underlying assets and cash flows sufficient to make cash payments to the investors in the securities issued.

https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/00 Work in Progress/Structured Equity and Funds/2022-xxx.xx Task Force 2022 Amend PP Structured Equity and FundsV10.docx