February 18, 2011

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F St., NE
Washington, D.C. 20549

David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: S7-39-10: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant."

Dear Ms. Murphy and Mr. Stawick:

We write on behalf of the National Association of Insurance Commissioners (NAIC) to submit this comment regarding the Security and Exchange Commission's and Commodity Futures Trading Commission's (the Commissions) proposed rule to further define the terms "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," Major Security-Based Swap Participant," and "Eligible Contract Participant" contained in Title VII of the Dodd-Frank Wall Street and Consumer Protection Act (the Act),[1] and related implementing regulations. Founded in 1871, the NAIC is the voluntary association of the chief insurance regulatory officials of the 50 states, the District of Columbia and the five U.S. territories. The NAIC serves the needs of state insurance regulators as they protect consumers and maintain the financial stability of the marketplace. The NAIC respectfully submits the following comments to the proposed rules published in the December 21 issue of the Federal Register as well as on the Commissions' websites.

Guiding Principles for NAIC Comment

As we indicated in our September 20, 2010 response to the Commissions' Request for Advance Comment to implement the definitions contained in Title VII of the Act, our comments to the Commissions' proposed rules is governed by two guiding principles. First, any implementing rules must not conflict with the states' regulation of insurance products and insurers. Implicit in this first principle

[1] Pub. L. No. 111-203.

is recognition that the state-based system of insurance regulation allows insurers to engage in derivatives transactions provided they comply with state investment and reporting laws, both of which were the subject of our follow-up letter dated November 9, 2010. Such transactions are permitted because, in conjunction with the state-based system's risk-based capital regime and reporting requirements, they ensure insurers remain solvent, pay claims as they come due, and keep premiums as low as possible.

Second, we indicated that any implementing rules should not create an unlevel playing field for insurers as compared to other institutions. An unlevel playing field can be created when there is not appropriate recognition of the different business models and regulatory regimes that apply to such entities. As we explained previously, insurance companies predominantly use derivatives for hedging commercial risks, most notably insurance risk, and approximately 92 percent of the derivatives that insurers hold are used for hedging, an activity that insurance regulators encourage. Annuity products that reduce market risk require significant hedging and those products are integral to the retirement planning of millions of consumers. We noted that state insurance regulation permits certain other well-defined uses of derivatives, but these are proportionately small in comparison to the industry's hedging activities.

We have reviewed the proposed rules further defining "Major Swap Participant," "Major Security-Based Swap Participant," "Swap Dealer," and "Security-Based Swap Dealer," as well as the supplementary information provided with the proposed rules. We are concerned that, in certain aspects, the proposed rules do not sufficiently account for the insurer business model, the important role of derivatives in that model, and the nature and extent of state regulation of both insurers generally and derivatives specifically. Moreover, while we acknowledge that some of our concerns might be alleviated by the interpretative guidance provided by the Commissions in the "supplementary information" section of the notice, we are troubled that the interpretative guidance is not incorporated in the rule itself. Set forth below are our specific comments to the proposed rules and related interpretative guidance.

Swap Dealer

As a general matter, the characteristics that the Commissions have identified in the supplementary information section of the notice to determine whether an entity is a swap or security-based swap dealer appear to capture the characteristics of swap and security-based swap dealers. We agree with the Commissions that swap dealers and security-based swap dealers 1) tend to accommodate demand for swaps and security-based swaps; 2) are available to facilitate other parties' interests in entering those instruments; and 3) tend to enter into swap arrangements on their own standard terms or on terms they arrange in response to other parties' interests. We also agree that the SEC's use of the dealer/trader distinction is a reasonable approach to identify entities that are security-based swap dealers, and that entities engaged in hedging activities would not typically be considered security-based swap dealers.[2]

However, we are concerned that the proposed test does not sufficiently acknowledge cases where entities entering into swaps or security-based swaps for purposes other than those delineated in the test could incidentally fall within its ambit. Indeed, it is possible that an insurer may enter into a swap for the purposes of hedging insurance risk, but also at the same time be accommodating demand and responding to interests of another party. **In this regard, we believe the rule should clarify that entering into swaps as part of a regular business involves entering into swaps "for the purpose of**

[2] Notice of Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant." 75 Fed. Reg. 80178 (December 21, 2010).

accommodating demand," and "for the purpose of facilitating other parties' interest in engaging in such swap transactions."

Also, as we indicated in our letter of September 20, 2010, many insurers have both a general account and separate investment accounts for certain regulated lines of business. Both are still subject to state mandated disclosure, capital, and reserving requirements. However, the investments in separate accounts are legally separate, not subject to creditors in a solvency proceeding, and typically done on behalf of customers with some level of customer direction. For example, certain variable annuity products, which are subject to dual regulation by the SEC and the state insurance regulators, are kept in separate accounts. The extent of customer direction for investments contained in such accounts varies based on the product. In most circumstances, per the terms of the contract, customers direct the insurer to take on a certain amount of investment risk. The insurer is responsible for managing that risk and covering the liability, which could mean an insurer deciding to enter into a swap to hedge such risk. **We believe insurers that have only a modicum of customer direction in their investment activities should not be considered swap dealers, and the requirement of an entity receiving specific direction by a customer to enter into a swap transaction should be incorporated into the final rule further clarifying a swap dealer.**

Entering into Swaps as Part of Regular Business

As you may recall, in our letter comment of September 20, 2010, we specifically requested that the Commissions provide further clarity as to the third prong of the "swap dealer" and "security-based swap dealer" definitions as well as the exception that allows entities to enter into swaps for its own account, but not as part of a regular business. As with the other statutory definitions of swap dealer and security-based swap dealer, the text of the recently published proposed rule provides no guidance in these critical respects. Indeed, with the exception of providing additional clarity relating to the *de minimis* exception and the insured depository institution exception contained in the statutory definition of swap dealer, the proposed rule merely restates the definitions contained in Title VII itself. Many insurers would fall within the scope of the statutory language without further clarification, despite the important role swaps play in the insurance model. While we acknowledge the Commissions provided interpretative guidance within the "supplementary information" portion of the rule in an effort to address this third definition, this guidance is, in our opinion, relatively unclear, and does not substitute for inclusion in the rule itself.

In interpreting this provision and the related exception, the Commissions explain that "clause A(iii) of the definition of swap dealer and security-based swap dealer should be read in combination with the express exception set forth in subparagraph (C) of the swap dealer definition."[3] The Commissions interpret the two provisions together to mean that "the difference between inclusion in clause (A)(iii) and the exclusion in subparagraph (C) is whether or not the person enters into swaps as a part of, or as an ordinary course of, a 'regular business,'" and, consistent with the general guidance relating to the interpretation of the definition of swap dealer, those individuals are "those persons whose function is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties."[4]

As a preliminary matter, the discussion of the interpretation of this specific provision and the related exception are found in the subsection entitled "Application to swap dealers" and is not discussed

[3] *Id.* at 80177.
[4] *Id.*

in the subsection relating to "Application to security-based swap dealers." We assume based on the discussion that the intent is to apply the interpretation to both the definition and exception of swap dealer and security-based swap dealer.[5] If that is not the case, we respectfully request either 1) that the Commissions interpret such exception consistent with the interpretation of the exception for swap dealers and the discussion clarifying the definition of security-based swap dealers, particularly the clarification regarding hedging activities, taking into account, as appropriate, comments from the public; or 2) that the Commissions publish a clarifying notice addressing the exception as it applies to security-based swap dealers, and provide individuals and entities an opportunity to comment on the interpretation of such exception before issuing a final rule. As it stands presently, it is not entirely clear how this part of the definition of security-based swap dealer and its related exception would be interpreted.

Subject to our comments above, the Commissions' interpretation of this third prong is generally reasonable. Beyond that, though, **the rule should also make clear that persons who regularly enter into such swaps for the purpose of hedging commercial risks for their own account including, as described above, insurers who do so as part of their general account investment activities or separate account investment activities would typically not be considered swap dealers, absent other swap or security-based swap dealer-like activities.** Such an interpretation would be consistent with the guidance describing the functional role that the Commissions believe swap and security-based swap dealers fulfill in the market,[6] and, at the same time, ensure that insurance company hedges, a necessary part of the insurance business, are not brought within the ambit of the rule.[7]

Major Swap and Security-Based Swap Participant

We have significant concerns that the proposed rules and interpretative guidance relating to defining major swap or security-based swap participant creates an unlevel playing field by not taking into account the distinguishing features of the insurance business model and the state insurance regulatory regime. In this regard, we urge that the rules incorporate a limited insurer exception for activities relating to hedging. In lieu of such exemption, we respectfully request that the Commissions amend their proposed rules to take into account these distinguishing characteristics.

State Regulated Insurer Exception

As part of the supplementary information section of the notice of the proposed rule, the Commissions specifically request comments on whether it would be appropriate to create an exception to the major swap and security-based swap participant definitions for state regulated insurance companies. We believe that certain aspects of the proposed rules create such an unlevel playing field for insurers that such an exception would be appropriate. Given that insurers primarily use derivatives to hedge risks and in light of the existing regulation of their use of such derivative instruments, **we respectfully request that the Commissions exempt state regulated insurers from being considered Major Swap or Security-Based Swap Participants to the extent that such insurers are 1) using derivatives for the purpose of hedging; and 2) are not engaging in systemically significant**

---

[5] *Id.*

[6] *Id.* at 80178.

[7] We also note that, as the Commissions recognized, the definition of swap dealer in the Act excludes an insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." *See,* Pub. L. No. 111-203, § 721. While we understand that Congress included such exclusion in the statute itself, we believe such exclusion creates an unlevel playing field by giving insured depository institutions special treatment in swaps regulation as compared to other financial institutions. We believe such treatment also calls for recognition of other financial institutions' unique characteristics and regulatory regimes, and, for this reason as well, we urge the Commissions to provide an exclusion for insurer hedging activities as described herein.

derivatives activities determined by the Financial Stability Oversight Council (FSOC) in consultation with the Commissions and the state insurance regulators.[8]

If the Commissions do not believe such an exception appropriate, we respectfully request that the Commissions incorporate the following specific comments relating to each test of the Major Swap Participant Definition.

Test 1: "Substantial Position" and "Hedging Commercial Risks"

The Act has three tests for Major Swap or Security-Based Swap Participant. The first defines a Major Swap or Security-Based Swap Participant as an entity with a substantial position in any category of swaps excluding those used for hedging commercial risks. In this regard, we do not have concerns with the categories identified by the Commissions as "major swap categories" or the thresholds set by the Commissions for the purpose of identifying what constitutes a "substantial position" in swaps or security-based swaps.

We are troubled, however, that the rules proposed by the Commissions relating to this exception are different for swaps and security-based swaps. Specifically, though the approaches are consistent in other respects, only the exception for swaps incorporates an additional approach by excluding any derivative that 1) either qualifies as bona fide hedging for purposes of an exemption to position limits under the Commodity Exchange Act or qualifies hedging treatment under Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 815, and 2) such position is not held for speculation or investing or not held to hedge or mitigate the risk of other swaps. We believe inconsistent approaches undermine regulatory predictability and could lead to inconsistent applications for different types of swaps. In this regard, we request the Commissions, to the extent possible and recognizing the differences between the two types of swaps, further harmonize their approaches.

Moreover, **we specifically request that the Commissions add to the exception those swaps or security based swaps that qualify as an effective hedge under the statutory accounting rules specific to insurers** (attached as exhibit A). State insurance laws and regulations require insurers to follow statutory accounting rules. Several insurers are not public companies and, as a result, are not required to follow Generally Accepted Accounting Principles (GAAP) set up by FASB. Incorporating the state accounting treatment into the Commissions' proposed rule will create a more level playing field for insurers and non-insurers.

We also have concerns that, as written, the definition of hedging commercial risk does not include the use of cash-flow hedges. Specifically, the language in 1.3(ttt)(1)(i) and section 240.3a67-4 of the rules defining "hedging or mitigating commercial risk" of swaps and security-based swaps limits asset hedges to hedges of a "potential change" in such assets. However, many insurers as well as other institutions use cash-flow hedges, which do not relate to the "potential change" in the value of such assets, but can be related to asset yields or earnings. For example, in that case, a simple interest rate swap would not be related to the value of the bond or underlying loan. To this end, **we request that you modify the language to state that asset hedges would qualify for this exception where the risks**

[8] Even then, we believe the state insurance regulatory regime's risk based capital rules are sufficiently robust such that it would be inappropriate to impose capital requirements inconsistent with such rules, though we recognize that there could be extraordinarily rare circumstances where an insurer might be part of a holding company structure considered systemically significant or engage in other non-insurance related systemically significant activities that would merit additional capital requirements.

"arise from the assets a person owns, produces, manufactures" as opposed to the "potential change in value of such assets."

Test 2: "Substantial Counterparty Exposure" that could have "serious adverse effects" on the financial stability of the "banking or financial markets"

The second test defines major swap participant or major security-based swap participant as entities that have "substantial counterparty exposure" that could have "adverse effects on the financial stability of the banking and financial markets." In other words, this second test seeks to identify those firms with systemically risky swap and security-based swap exposures. We recognize that Title VII of the Act includes this test in the definition of major swap (and security-based swap) participant and that Title VII provides authority to the Commissions to further define these terms. However, the Act also establishes a Financial Stability Oversight Council with the specific mission of addressing risks to the stability of the financial system. In this respect, Section 120 of Title I of the Act specifically grants the FSOC the authority to issue recommendations to primary financial regulatory agencies for more stringent regulation of activities of bank holding companies and non-bank financial companies under their jurisdiction that could "create or increase the risk of significant liquidity, credit, or other problems" spreading among such companies. The FSOC has three insurance expert members: a state insurance regulator, the Director of the Federal Insurance Office and a member with insurance expertise. Given that the Act established the FSOC to address systemic risks, and in light of the unique characteristics of the insurance business model and the nature of existing insurance regulatory requirements, the application of this second test to an insurer should be done by the FSOC and in consultation with the relevant state insurance commissioner, the primary financial regulatory authority for the entity in question. **We respectfully request that this procedure be incorporated into the rule and that the Commissions defer to FSOC's authority when considering the designation of major swap participants under this second test**.[9]

Should the Commissions decide to apply the second test of the major swap and security-based swap participants approach in the absence of full participation by FSOC and its membership, certain adjustments should be made to reflect the extent to which hedging activities by insurers (and others) do not typically pose systemic risks to the financial markets. Barring circumstances where an entity has a substantial, concentrated position with a limited number of counterparties, who themselves pose a systemic risk, hedging activities typically would not have adverse effects on the financial markets. They would limit the risk in the financial markets by mitigating the risks of the individual participants.

In the case of insurers, as you are aware, state investment laws limit the extent of their derivatives transactions and, through robust reporting and examination requirements, the state insurance regulators monitor their derivatives positions closely. Under such circumstances, it is highly unlikely that an insurance company would be able to maintain large and concentrated swaps and security-based swaps positions with a small number of counterparties that would cause adverse impacts on the financial markets. **We, therefore, urge the Commissions to exclude from the determination of "substantial counterparty exposure" any swaps and security-based swap positions used for hedging**

[9] It would also be appropriate for the application of this test to be done by the FSOC for other types of financial entities with the appropriate consultation and consent of the primary financial regulator.

<u>commercial risk[10] provided that such positions are subject to state investment laws and ongoing monitoring by a state insurance regulatory authority.[11]</u>

<u>Test 3: Any "financial entity" that is "highly leveraged" and maintains a "substantial position" in swaps or security-based swaps</u>

The third test of the "Major Swap Participant" definition relates to "financial entities" that are "highly leveraged" and maintain a "substantial position" in swaps or security-based swaps. This test excludes entities that are subject to capital requirements established by an appropriate federal banking agency. We believe that if this rule is applied as proposed, it could effectively bring most of the insurance industry within its scope.

In the first instance, this definition creates an unlevel playing field between federally regulated banks and state regulated insurers by excluding those entities that are subject to capital requirements imposed by the federal banking agencies and not those imposed by state insurance regulators. While there are differences in the approaches that the regulators take, the capital requirements imposed by state insurance regulators on insurers are at least as stringent, and in some areas more stringent, than those imposed by the federal banking agencies. The state insurance regulatory risk-based capital regime is quite conservative and requires insurers to calculate capital charges based on the extent of the risks on their balance sheet including the relative riskiness of the investments they hold in their portfolio. In addition, there are fixed minimum capital and surplus requirements in order to be licensed as a specific type of insurer in each state. **<u>For these reasons, we urge the Commissions to adopt a rule that excludes state regulated insurers from this third test of the major swap and major security-based swap participant definition.</u>**

If the Commissions decide they can't or won't adopt such exclusion for state regulated insurers, we urge the Commissions to reevaluate the proposed rule defining "highly leveraged" financial entities. According to the proposed rule, the Commissions are considering defining "highly leveraged" as a ratio of total liabilities to equity of 15 to 1 or 8 to 1. Such ratio would be determined using GAAP.

As indicated above, there are many insurers who do not utilize GAAP in their financial statement reporting. State law requires that insurers file statements with the state insurance regulators on an annual and quarterly basis using the insurance regulatory regime's statutory accounting principles. Such principles form the foundation of the insurance regulatory regime's reporting and capital requirements. While it is true that publicly traded insurers who file quarterly and annual financial statements with the SEC do utilize GAAP for such filings, those insurers that are not publicly traded do not. Indeed, there are approximately 3,200 insurers that are not public companies, and, therefore, not required to file financial reports according to the GAAP. We have strong concerns that asking insurers to do so would create an unnecessary regulatory burden.

Of even greater concern are the leverage ratios themselves. The statute requires an analysis of whether an institution is "highly leveraged." Applying a single, simple ratio across all institutions to make such a determination does not adequately take into account the differences in business models,

[10] We incorporate by reference our comments relating to the definition of "hedging commercial risk" in the first test of the major swap and security-based swap participant definitions.

[11] We also recognize that this exclusion could reasonably be applied to other types of financial entities that are subject to similar regulatory requirements and such application may be appropriate to ensure a level playing field among different financial institutions. We defer to the considerable expertise of the other primary financial regulators and the Commissions to determine whether an exclusion would be appropriate for the entities they regulate.

liability structures, and regulatory models. Insurers typically maintain higher liabilities because regulators require them to carry high reserves relative to potential claims. Thus, the "higher leverage" of insurers reflects a more conservative accounting regime, and not a higher risk profile.

Our analysis of the leverage ratios of the insurers we regulate is that applying a simple ratio would lead to many false positives. Indeed, many insurers have ratios that are well in excess of those proposed by the Commission and, yet, are healthy, solvent companies with strong claims paying ability. It is true that there are also companies with very high leverage ratios that are troubled, but, in those cases, the insurance regulator has become more engaged in the company's day-to-day operations and may have even placed it in receivership for rehabilitation, conservation, or liquidation. In such circumstances, it would be extraordinarily counterproductive for the Commissions to designate such entities as major swap participants and impose more stringent capital or other regulatory requirements.

Another example of different structures is the risk retention group (RRG) authorized by federal statute. RRGs operate with very low capital and surplus levels compared to non-RRG insurance entities, so their leverage ratios are typically very high. However, the nature of their business is highly restricted, therefore resulting in significantly lower operational risk. Simple leverage ratios in the absence of additional analysis of the entity's accounting/reserving requirements and business risk are simply not a useful tool for evaluating whether an insurance company is "highly leveraged." A better approach might be to determine whether the insurer or other entity is "highly leveraged" specifically with respect to its swaps positions, and not the balance sheet as a whole.

Conclusion

We appreciate the opportunity to comment and look forward to continuing the open and constructive dialogue we have had with the Commissions to date about the rulemaking process. Should you wish to discuss this comment or any other matter relating to the NAIC's views on the rulemaking process, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980, Moira Campion McConaghy, Government Relations Manager, at (202) 649-4997, or Mark Sagat, Government Relations Analyst and Counsel, at (202) 471-3987.

Sincerely,

Susan E. Voss

Susan E. Voss, Commissioner
Iowa Insurance Division
NAIC President

Therese M. Vaughan

Therese M. Vaughan, Ph.D.
NAIC Chief Executive Officer