



MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office,
Julie Gann, NAIC Senior Manager, Financial Regulatory Services

CC: Charles Therriault, Director, NAIC Securities Valuation Office
Dan Daveline, Director, Financial Regulatory Services

DATE: February 23, 2017

RE: Staff Memorandum Related to SVO Assessment of Fund Investments

1. Background – The Valuation of Securities (E) Task Force previously referred to the Statutory Accounting Principles (E) Working Group a referral (Attachment One) pertaining to *SSAP No. 30—Unaffiliated Common Stock* as it applies to investments in funds. Pending consideration of that referral by the Working Group, NAIC staff requests that the Task Force consider amending the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to clarify that fund investments are not filed with the Securities Valuation Office (SVO) for an NAIC Designation and that fund investments are not eligible for filing exemption, except for the specific exceptions recognized in the P&P Manual and the Accounting Practices and Procedures Manual (AP&P Manual). These three exceptions are:

- Exchange-traded funds, which qualify for bond or preferred stock treatment, as identified in Part Six, Section 2, of the P&P Manual.
- Bond mutual funds, which qualify for bond treatment, as identified in Part Six, Section 2, of the P&P Manual.
- Money market mutual funds on the U.S. Direct Obligations/Full Faith and Credit Exempt List, as identified in Part Six, Section 2, of the P&P Manual.

2. Observations – The SVO receives a number of filings in the form of fund investments. It appears that filers believe that the logic of the filing exemptions can be applied to any fund that holds bonds and passes through cash flows. The analysis that follows indicates that it is not appropriate for insurers to file any fund investments with the SVO other than the three specific exceptions noted above. The SVO is concerned that the filing process/exceptions is not clear and that the danger exists that the assignment of an NAIC Designation, either by the SVO independently or under the Filing Exempt process, facilitates a recharacterization of the investment on investment schedules inconsistent with regulatory expectations.

a. Statutory Accounting and Reporting Framework

- **Mutual Funds:** Pursuant to SSAP No. 30, shares of mutual funds, regardless of the type of mix of securities owned by the fund (e.g., bonds, stocks, etc.), are within scope of SSAP No. 30 and reported on Schedule D, Part 2 – Section 2 (D-2-2). None of the investments reported on Schedule D-2-2 are reported with an NAIC Designation, and all

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items captured within schedule D-2-2 receive the same risk-based capital (RBC) charge. As such, there is no need for an NAIC Designation for mutual funds in scope of SSAP No. 30.

- **Schedule BA Funds:** The AP&P Manual does not contain explicit guidance for other funds, although discussion of other funds (i.e., non-mutual funds) is planned under the Working Group’s investment classification project. As noted in the *Annual Statement Instructions*, venture capital funds is an example of a common stock structure captured as a joint venture/partnership interest under *SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. All SSAP No. 48 investments are reported on Schedule BA – Other Long-Term Invested Assets. Schedule BA securities are not required to be reported with an NAIC Designation. However, guidance in the P&P Manual and the *Annual Statement Instructions* permit life and fraternal insurers to file certain (i.e., fixed-income) Schedule BA securities with the SVO for a fixed-income determination and an NAIC Designation. The *Annual Statement Instructions* limit the investments subject to the NAIC Designation guidance as follows:
- **Fixed or variable rate instruments that have the underlying characteristics of a bond, mortgage loan or other fixed-income instrument.** This category would encompass fixed-income instruments that are not corporate or government unit obligations (Schedule D) or secured by real property (Schedule B). Investments are not reported in this category unless they qualify for a filing exemption or the SVO has affirmed that a specific Schedule BA investment fits in this category. Investments deemed by the reporting entity to possess the underlying characteristics of a bond, or other fixed-income instrument, but that do not qualify for a filing exemption, or have not been affirmed by the SVO, are to be reported on Schedule BA (without an NAIC designation) as an “Any Other Class of Asset.”
- **Joint ventures or partnership interests for which the primary underlying investments are considered to be fixed-income instruments.** Investments shall not be reported in this category unless the investment qualifies for a filing exemption or the SVO has affirmed that a specific Schedule BA investment fits in this category. Investments deemed by the reporting entity to possess the underlying characteristics of a fixed-income instrument, but that do not qualify for a filing exemption, or have not been affirmed by the SVO, are to be reported on BA (without an NAIC Designation) in the “Other” subcategory.

Pursuant to the *Annual Statement Instructions*, the NAIC Designation field should be zero-filled for those Schedule BA investments with the underlying characteristics of a bond or a preferred stock instrument that have not been filed with the SVO and do not meet the requirements of a filing exemption, as well as for any other investments reported in the respective “Other” categories (i.e., non-fixed income-like Schedule BA investments). For example, venture capital funds are provided as an example included within the “Common Stock” subcategory for joint ventures, partnerships or limited liability company interests. Investments within scope of this category would not be considered fixed-income; therefore, they would not be captured within the limited guidance permitting the use of NAIC Designations for certain fixed-income securities. (Specifically, the *Annual Statement Instructions* do not contain provisions that allow an NAIC Designation for joint ventures, partnerships or limited liability companies that have the underlying characteristics of common stocks, real estate, or mortgage loans.)

b. *Analytical and Administrative Considerations*

- As an investment instrument, common stock is not assigned credit ratings or NAIC Designations because common stock does not contain a promise to repay. SSAP No. 30 is, therefore, consistent with analytical constructs in the P&P Manual.
- Funds that hold predominantly bonds can be assigned NAIC Designations under the specific noted exemptions only. These exemptions exist on the basis of a process that quantifies the debt-like cash flow from the bonds in the portfolio and the pass-through nature of funds. In the absence of this specific scenario, a fund would not typically be designated for quality by the SVO.

- The SVO believes that the three exceptions identified in SSAP No. 30 and the P&P Manual apply only to the specific situations described and that it would be inappropriate to extend the logic of the exception to a different situation.
- No guidance exists to permit the SVO to determine whether a fund investment has the underlying characteristics of a bond or other fixed-income investment.
- No guidance exists to permit the SVO to determine whether a fund investment has fixed-income instruments as primary underlying investments.

3. Conclusion – NAIC staff request that the Task Force receive this memorandum and expose it for a 30-day public comment period and that it thereafter consider directing the SVO to formulate an amendment to the P&P Manual that would clarify that NAIC Designations are only assigned to those funds that are the subject of the exceptions discussed above and that would otherwise provide guidance on the various issues identified in this memorandum. It is recommended that the Task Force also sponsor a blanks proposal to clarify the reporting of fund investments outside of the “fixed-income instrument” categories in Schedule BA.

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