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

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,

CC: Charles Therriault, Director, NAIC Securities Valuation Office
Dan Daveline, Director, NAIC Financial Regulatory Services
Julie Gann, NAIC Senior Manager, NAIC Financial Regulatory Services

DATE: March 7, 2017

RE: Staff Memorandum Related To Previous Referral on Mutual Funds and Schedule BA Assets

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1. **Background** – In a previous referral (Attachment One) the Valuation of Securities (E) Task Force recommended that the Statutory Accounting Principles (E) Working Group consider whether a conflict exists in paragraph 3d of *SSAP No. 30—Unaffiliated Common Stock*. Paragraph 3d characterizes shares of a mutual fund as common stock irrespective of the types or mix of securities held by the fund, but also recognizes exceptions of certain mutual funds and exchange-traded funds (ETFs)—i.e., NAIC Securities Valuation Office (SVO)-identified funds—that qualify for bond or preferred stock treatment. In a second referral, the Task Force noted that SVO's Schedule BA activities have not been properly integrated into NAIC guidance or processes. This is relevant because insurers file fund investments that originate as Schedule BA assets, which may indicate a lack of instructions on the issue.

2. **Research** – This memorandum presents information and research about funds that staff believe could assist the Working Group to evaluate the issue in the previous referral.

a. *Major Considerations* – There are a number of considerations that support the recommendation in the referral. Staff note that shares in a fund are not actually common stock. Common stock refers to a residual interest in the assets of a business enterprise, usually one organized as a corporation. Fund shares represent an undivided, proportionate ownership interest in the assets held by the fund, as well as a proportionate liability to pay the costs and expenses of the fund. A second consideration is that funds are pass-through entities, meaning they pass through the cash flows generated by its portfolio. If the fund only holds equity, or a combination of debt and equity, the investor will receive equity-like cash flows proportionate to its ownership interest. The same pass-through mechanism operates to deliver debt-like cash flows if the fund only holds debt. SSAP No. 30, paragraph 3d seems to contain an inherent conflict in that it specifies that shares of a mutual fund are reported as common stock *irrespective of the securities held by the fund* and then states that shares of a mutual fund that only holds bonds can be debt-like. We recognize that SSAP No. 30 refers only to mutual funds that are those issued by an open-end management company and are structured to reflect characteristics imposed on those companies by the federal Investment Company Act of 1940 (ICA). However, the ICA imposes differing characteristics on other types of investment companies (i.e., face amount certificate companies; closed-end management companies and unit investment trusts) that result in funds that have differing, but nevertheless predictable, characteristics. While funds issued by investment companies other than open-end management companies would have characteristics that reflect the business model and regulations applicable to those companies it seems that such other investment companies can adopt investment strategies that focus on bonds and result in funds that distribute bond-like cash flows.

b. About Funds

(i). The Definitional Hierarchy – The ICA provides the federal regulatory framework applicable to investment companies. An investment company[1] is defined as one primarily engaged in the business of investing, reinvesting or trading in securities. The ICA recognizes three classes of investment companies:[2] a face-amount certificate company; a unit investment trust; and a management company. Management companies are further defined as open-end management companies and closed-end management companies. In turn, closed-end management companies are further divided into diversified and non-diversified companies.[3] Registered investment companies contract with other businesses to provide the services that a fund needs to operate. Fund boards oversee fund management and represent shareholder interests. The board approves all major contracts between the fund and service providers, including the contract with a fund's investment adviser. A variety of financial services companies offer registered funds. At year-end 2015, 79% of fund complexes were independent fund advisers managing 67% of investment company assets. Other types of fund complexes in the U.S. include non-U.S. fund advisers, insurance companies, banks, thrifts and brokerage firms. Fund sponsors and third-party service providers offer advisory, recordkeeping, administrative, custody and other services to funds.[4]

(ii). The Class of Investment Company and Fund Characteristics

- Face-amount certificate companies[5] are rare, but they issue debt and are, therefore, not immediately relevant to our discussion.

- Unit investment trusts (UIT) have characteristics of mutual funds and closed-end funds: they issue a specific, fixed number of redeemable shares (called units). The UIT has a preset termination date based on the portfolio's investments and does not actively manage or trade the portfolio. When the UIT is dissolved, proceeds are paid to unit holders or, at a unit holder's election, reinvested in another trust. Bond trusts are either taxable or tax-

[1] Investment Company Act, Section 3 – A company that: Is or holds itself out as being primarily engaged in the business of investing, reinvesting or trading in securities; Issues face amount certificates of the installment type; Is or will be engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets) on an unconsolidated basis.

[2] Investment Company Act, Section 4 – 1) Face-amount certificate company – an investment company engaged or proposed to engage in issuance of face-amount certificates of the installment type. Unit investment trust – an investment company that is: a) organized under a trust indenture, contract of custodianship or agency, or similar instrument; b) not having a board of directors; and c) issuing only redeemable securities, each representing an undivided interest in a unit of specified securities, but not a voting trust. Management company – any investment company other than a face-amount certificate company or a unit investment trust.

[3] Investment Company Act, Section 5 – Management companies are divided into 1) open-end companies (i.e., management companies offering for sale or having outstanding *redeemable securities*); and 2) closed-end companies (i.e., management companies other than open-end companies), which can be further divided into: a) ***diversified companies***, where at least 75% of the value of total assets is represented by cash and cash items (including receivables), government securities, securities of other investment companies, and other securities for purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of such management company and to not more than 10% of the outstanding voting securities of such issuer; and b) ***non-diversified companies***, which are management companies other than diversified companies.

[4] Investment Company Institute, *2016 Investment Company Fact Book*.

[5] A face-amount certificate is a contract between an investor and the issuer (the face-amount certificate company) in which the issuer guarantees the investor payment of a stated (face amount) sum at a set future date. In return, the investor pays the issuer a set amount of money as a lump sum or in periodic installments. Very few face-amount certificate companies are in operation today because tax law changes have eliminated their tax advantages. *See*, SEC Form N-8B-4 Registration Statement of Face Amount Certificate Companies: … *Title of Securities:* Wherever the "title" of securities is required to be stated there shall be given such information as will indicate the type and general character of the securities, including the following: a) in the case of shares, the par or stated value, if any; the rate of dividends, if fixed, and whether cumulative or noncumulative; a brief indication of the preference, if any; and if convertible, a statement to that effect; b) in the case of funded debt, the rate of interest; the date of maturity, or if the issue matures serially, a brief indication of the serial maturities, such as "maturing serially from 1950 to 1960"; if the payment of principal or interest is contingent, an appropriate indication of such contingency; a brief indication of the priority of the issuer; and if convertible, a statement to that effect; c) In the case of face-amount certificates, the full designation of the issue and, if not included therein, the number of years to maturity, assuming no delinquency in making payments, and whether of the installment or fully-paid type; and d) in the case of any other kind of security, "appropriate information of comparable character ..."

free. Most UITs hold a diversified portfolio, described in detail in the prospectus, with securities professionally selected to meet a stated investment goal, such as growth, income or capital appreciation. Units are typically redeemable at a floating net asset value (NAV), but UIT sponsors often register the units on a stock exchange that provides the unit holder and other investors the ability to buy and sell on the secondary market.[6]

- An open-end management companies issues an unlimited number of redeemable shares.[7] Funds issued by open-end management companies will continue to offer shares as long as investors want to buy them. The obligation to redeem means these funds maintain a cash reserve and focus on liquid assets. If faced with large redemptions, these funds sell investments to pay investors. Shares trade at floating NAV; i.e., the value of the fund's underlying securities calculated at the end of the trading day (floating NAV).[8] To calculate NAV, the mutual fund marks portfolio securities to current market or determines a fair value.[9]

- Shares of a closed-end management company fund are listed on a stock exchange or traded in the over-the-counter market. Assets are professionally managed pursuant to the fund's investment objectives and policies, and capital may be invested in equities, bonds and other securities. The market price of a closed-end fund share fluctuates like that of other publicly traded securities and is determined by supply and demand. A closed-end fund will have an initial public offering for a fixed number of common shares. Subsequent issuance of common shares can occur. Closed-end funds may also issue one class of preferred shares. Shares of a closed-end fund are not subject to redemption by the fund, although some funds may adopt stock repurchase programs or periodically tender for shares. Because a closed-end fund does not redeem shares it invests in less-liquid securities.[10]

(iii). Type of Funds [11]

- Mutual funds are issued by open-end management companies. The investment portfolio of a mutual fund is structured to match its investment objectives, and a money manager invests capital for capital gains and income.

- A money market fund is a mutual fund that functions under an exception from the valuation rules that apply to mutual funds; i.e., Rule 270.2a-7.[12] This rule permits money market funds to use amortized cost valuation and penny-rounding pricing to calculate a stable net asset value of $1 per share.[13] The exception exists because of an assumption that amortized cost value of high-quality short-term debt securities will not deviate significantly from market value.[14] The major forms of money market mutual funds are: (i) prime funds (invest primarily in short-term private debt instruments (i.e., commercial paper, bank certificates of deposit and privately issued floating-rate notes); (ii) government funds (typically hold at least 95.5% of their assets in cash, U.S. government

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[6] Investment Company Institute, *2016 Investment Company Fact Book*.
[7] ICA Section 2(a)(32) provides that a redeemable security is entitled to a price that does not vary substantially from its proportionate share of issuer's current net assets, or cash equivalent. ICA Section 22(d) and Rule 22c-1 require that sale of redeemable security be at a current public offering price described in a prospectus and based on NAV. ICA Section 22(e) requires an investment company to redeem a redeemable security in seven calendar days following tender.
[8] Forward Pricing – An SEC regulation requiring that investment companies price all of their buy-and-sell orders of fund shares according to the next NAV. This valuation process is for open-end mutual fund transactions in which the mutual fund itself is constantly issuing and redeeming mutual fund shares at the most recent NAV per share. Forward pricing is implemented when a trade is placed to buy or sell shares of an open-end mutual fund. This occurs because open-end funds only recalculate the NAV of their mutual fund shares after the market closes each trading day. As a result, any mutual fund order placed by an investor cannot be quoted at a previous NAV, and must instead be given according to the next computed NAV.
[9] As a consequence, the price of mutual fund shares fluctuates daily with changes in the value of the fund's portfolio securities.
[10] Investment Company Institute, *2016 Investment Company Fact Book*.
[11] In 2015, there were 9,521 mutual funds, 558 closed-end funds, 1,594 ETFs and 5,188 UITs; Investment Company Institute, *2016 Investment Company Fact Book*.
[12] Title 17, Part 270 of the Code of Federal Regulations [17 CFR Part 270.2a-7].
[13] Under the amortized cost method, securities are valued at cost plus any amortization of premium or accumulation of discount. The penny-rounding pricing method permits a fund to compute its price per share by rounding current NAV per share to the nearest 1%.
[14] Rule 270.2a-7 requires money market funds to periodically measure the disparity between amortized cost value and mark-to-market value (referred to as "shadow pricing") and if the deviation in values is more than one-half of 1% (or $0.005) per share, to promptly consider whether to discontinue amortized cost valuation and reprice portfolio securities to a floating NAV. Repricing from stable NAV to floating NAV is referred to as "breaking the buck."

securities (agencies, government-sponsored enterprises) and repurchase agreements collateralized with such instruments); (iii) tax-exempt money market funds, which generally hold municipal securities; and (iv) institutional funds, which require an investment minimum larger than a retail investor is likely to invest.[15] Money market funds experienced unprecedented losses in 2007–2008 occasioned by a run on (primarily) prime funds. The U.S. Securities and Exchange Commission (SEC) amended Rule 270.2a-7 in 2010[16] to make money market funds more resilient to short-term market risks and provide greater protections when a fund moves from stable NAV. The SEC further amended Rule 270.2a-7 in 2014,[17] at which time it reversed the exception from mutual fund valuation of institutional/prime money market funds, which returns them to using floating NAV and instituting other changes (including permitting the board to impose a liquidity fee on shareholders and to temporarily suspend redemptions under defined circumstances).

- ETFs are issued by operating management companies or UITs. An investment in an ETF is made by depositing a portfolio of securities that matches the fund's portfolio in exchange for a "creation unit." A creation unit is a bundle of a specified number of ETF shares (e.g., 50,000). To begin operations, the ETF sells one or more of these creation units. The creation unit holder can then sell some or all of the ETF shares on the stock exchange on which the ETF has registered. Once ETF shares are in the secondary market, other investors can buy the shares. ETF shares are not redeemable from the sponsor, but creation units are. If an investor wants to redeem a creation unit, it buys ETF shares in the secondary market equal to the creation unit, presents it for redemption and receives the corresponding portfolio of securities. The investor could instead sell the remaining shares it holds into the secondary market. ETF characteristics, not limited to ETF shares not being redeemable, create legal uncertainty under the ICA. This prompts ETF sponsors to seek relief from the application of certain ICA provisions from the SEC. The SEC has not formulated a rule for ETFs, so to sponsor an ETF, one has to ask and receive authorization to do so from the SEC by issuance of an exemptive order.[18]

(iv). Potential Forms of Bond-Only Funds Based on Class of Investment Company and Associated Fund Type – If we use the above information, we can outline the core characteristics of the funds that may choose to only hold bonds as follows:

- Units issued by a UIT with a defined termination date holding a fixed, unmanaged portfolio of bonds.

- Mutual fund shares of an open-end management company perpetually issuing redeemable shares and investing capital in highly liquid bonds.

- Money market fund shares of an open-end management company perpetually issuing redeemable shares and investing in high-quality short-term bonds.

[15] Patrick McCabe, Board of Governors of the Federal Reserve System, *The Cross Section of Money Market Fund Risks and Financial Crisis*, Sept. 12, 2010.
[16] *See*, SEC, Money Market Fund Reform, 17 CFR Parts 270 and 274: Release No. IC–28807; File No. S7–11–09] RIN 3235–AK33, July 8, 2009 (and Release No. IC–29132; File Nos. S7–11– 09, S7–20–09, March 4, 2010.
[17] Money Market Fund Reform; Amendments to Form PF, Final Rule: 17 CFR Parts 230, 239, 270, 274 and 279; Release No. 33-9616, IA-3879; IC-31166; FR-84; File No. S7-03-13, RIN 3235-AK61.
[18] The process requires an application, a notice of hearing and a hearing (if requested) followed by an order granting or denying the requested relief. The exemptive order process is authorized by several sections of the ICA. Section 6(c) of the ICA provides that the SEC may exempt any person, security or transaction, or any class of persons, securities or transactions, from any provision of the ICA, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the ICA. Section 17(a)(1) and Section 17(b)(2) provides that the SEC is authorized to exempt a proposed transaction from Section 17(a) of the ICA if evidence establishes that the terms of the transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned, and the proposed transaction is consistent with the policies of the registered investment company and the general provisions of the ICA. Section 12(d)(1)(J) of the ICA provides that the SEC may exempt any person, security or transaction—or any class or classes of persons, securities or transactions—from any provision of Section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.

- Fund shares of a closed-end management company having a stated termination date issuing non-redeemable shares and investing in a specialized portfolio of illiquid bonds of issuers in a specific industry, geographic market or sector that is actively managed.

- An ETF operating under an exemptive order issuing creation units and trading ETF shares on a registered exchange, holding a portfolio of bonds that track a specified bond index (a passive investment) or a portfolio of bonds under active management pursuant to a specified investment objective.

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