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Mr. David A. Stawick  
Secretary, Commodity Futures Trading Commission  
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Washington, D.C. 20581

Ms. Elizabeth M. Murphy  
Secretary, Securities and Exchange Commission  
100 F Street N.E.  
Washington, D.C. 20549-1090

Re: Request for Comment on Core Definitions in Title VII of the Dodd-Frank Act; [Release No. 34-62717](#); File No. S7-16-10

Dear Mr. Stawick and Ms. Murphy:

The American Council of Life Insurers (“ACLI”) is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and the annuity industry. Life insurers actively participated in the legislative dialogue concerning regulation of derivatives markets and look forward to providing constructive input to both the Commodity Futures Trading Commission and the Securities and Exchange Commission (collectively, the “Commissions”) on the rulemaking that will implement Title VII in the Dodd-Frank Act (the “Act”). The advance notice of proposed rulemaking elicits comments on several “core” definitions in the Act. Our comments address the definitions of “Major Swap Participant” and “Major Security-Based Swap Participant,” which we refer to interchangeably throughout this letter as “MSP.”<sup>1</sup>

Life insurers support the Act’s goals of systemic risk reduction and transparency in the derivatives markets. In Title VII, there are over 95 rules and studies required of the Commissions. This critical process must carefully evaluate the different regulatory structures, operations and practices under which each financial service segment operates in order to fully and equitably effectuate the reform intended by Congress. These commendable goals were emphasized in the legislative history supporting the Act.

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<sup>1</sup> As context for our discussion, we attach the MSP definitions in Appendix A.

## Legislative Goals and Congressional Intent

One of the key goals of Title VII of the Act is to prevent entities from engaging in irresponsible practices and excessive risk-taking in the derivatives markets.<sup>2</sup> Yet Congress also recognized that derivatives are an important tool businesses use to manage costs and market volatility that must be preserved.<sup>3</sup> The Commissions are charged with balancing these interests as they implement Title VII through regulation.

These goals are also explained in the legislative history of the Act. For example, a July 15, 2010, colloquy between Senator Hagan and Senator Lincoln, Chair of the Senate Agriculture, Nutrition and Forestry Committee indicates that:

[I]t is the intent of the conference committee that both the CFTC and the SEC focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions....

When determining whether a person has a “substantial position,” the CFTC and the SEC should consider the person’s relative position in cleared versus the uncleared swaps and may take into account the value and quality of the collateral held against counterparty exposures. The committee wanted to make it clear that the regulators should distinguish between cleared and uncleared swap positions when defining what a “substantial position” would be. Similarly where a person has uncleared swaps, the regulators should consider the value and quality of such collateral when defining “substantial position.” Bilateral collateralization and proper segregation substantially reduces the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently.<sup>4</sup>

Another July 15, 2010, colloquy between Senator Dodd, Chairman of the Senate Banking Committee and Senator Lincoln, Chair of the Senate Agriculture, Nutrition and Forestry Committee further indicates that:

It is also important to note that few end users will be major swap participants, as we have excluded “positions held for hedging or mitigating commercial risk” from being considered as a “substantial position” under that definition....

It is also the intent of this bill to distinguish between commercial end users hedging their risk and larger, riskier market participants. Regulators should distinguish between these types of companies when implementing new regulatory requirements.<sup>5</sup>

Below we offer several specific suggestions for the Commissions to consider as they define key terms in the Act. Our suggestions have taken into consideration the policy goals of Title VII and

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<sup>2</sup> See Senate Banking Committee [Summary](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf) of Conference Report on Dodd-Frank Act at [http://banking.senate.gov/public/\\_files/070110\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_comprehensive\\_summary\\_Final.pdf](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf)

<sup>3</sup> 124 Cong. Rec. S5904 (daily ed. July 15, 2010) (colloquy between Sen. Dodd and Sen. Lincoln.)

<sup>4</sup> Appendix F contains the original colloquy letter and its enrollment in the Congressional Record.

<sup>5</sup> Appendix G contains the original colloquy letter and its enrollment in the Congressional Record.

reflect an approach that appropriately recognizes, and encourages, business practices that do not create or contribute to risk within the financial system (and may actually contribute to the mitigation of such risk).

### **Definition of MSP**

The definition of MSP sets forth three independent tests for determining whether a market participant that is not a swap dealer shall be deemed an MSP, subject to registration with the Commissions and certain capital and other requirements. These tests are:

*Substantial Position Test (Test 1).* The first test entails measuring whether a market participant’s swaps aggregate to a “substantial position” after *excluding* “positions held for hedging or mitigating commercial risk.”

*Substantial Counterparty Exposure Test (Test 2).* The second test turns on whether a market participant’s outstanding swaps create “substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.”

*Highly Leveraged and Substantial Position Test (Test 3).* The third test of the MSP definition applies to (a) a financial entity that is highly leveraged relative to the amount of capital that it holds and is not otherwise subject to the capital requirements of a Federal banking agency **and** (b) maintains a “substantial position” in outstanding swaps.

Whether an entity meets any of these three tests will depend upon how the Commissions define several key terms used in formulating the tests, including:

- Commercial risk;
- Substantial position;
- Substantial counterparty exposure; and,
- Highly leveraged.

As more particularly described below, we respectfully submit that the Commissions’ approach to defining MSP must balance the need to capture entities that may be engaged in derivatives-related activities that generate risk to the financial system, while not discouraging the appropriate and prudent use of derivatives as an important tool for managing business risks. We believe that our specific suggestions below effectively strike the right balance between these two interests.

### **Recommendations for Defining Key MSP Terms**

#### *Commercial Risk (as used in Test 1)*

We recommend that the term “commercial risk” be construed to include risks of financial as well as non-financial end-users of derivatives. This would be consistent with the historic approach that the CFTC has taken in the past, including through its interpretations of the “bona fide hedging” definition in Regulation 1.3(z) under the Commodity Exchange Act. In other words, the Commissions should not operate under a presumption that a company does not hedge or mitigate commercial risk just because a company is a financial company. Life insurers, for example, have become significant end-users of derivatives as they prudently manage the commercial risks

associated with both their obligations to policyholders and the investment portfolios designed to meet those liabilities. Although they are financial entities, life insurers’ use of derivatives is not unlike use by manufacturers seeking to ensure that they can lock in a fixed future price of key production input or to protect themselves from the risk of a promise to deliver a product at today’s prices over a period of years. Efficient and cost-effective access to the derivatives markets is fundamental to life insurers’ ability to responsibly manage these risks. Given that life insurers’ core commercial activity is creating liabilities to policyholders and purchasing assets to cover those liabilities, the definition of commercial risk adopted by the Commissions should be broad enough to encompass these types of risks, rather than be based upon an entity’s industry classification.

*Substantial Position (as used in Tests 1 & 3)*

Section 1a(33)(B) clarifies that in defining “substantial position,” the Commissions should establish a threshold “that [it] determines to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States.” The same section also provides guidance that the Commissions should consider an entity’s relative position in uncleared swaps as opposed to cleared swaps and take into consideration the value and quality of collateral held against counterparty exposures.

Therefore, in setting the substantial position threshold and determining how entities will calculate whether they meet the threshold, we recommend that the Commissions:

- Set a threshold that is not calculated by reference to notional or gross amount, as notional amount is not a true measure of exposure and would be an inappropriate point of reference for determining risk, but is based on actual exposure;
- Set a threshold that is sufficiently high to capture only entities whose derivatives activities are systemically important or can significantly impact the U.S. financial system;<sup>6</sup>
- Not include cleared positions in the threshold, because Congressional intent in the adoption of the Act reflects a determination that transactions cleared through well-capitalized and appropriately regulated clearinghouses do not present systemic risk; and
- Establish an appropriate reduction for contractual netting and collateralization requirements, which are already in place to mitigate counterparty risk.<sup>7</sup>

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<sup>6</sup> The use of the term “systemic risk” in Title VII should only relate to entities that pose a systemic risk because of their derivatives activities; entities that pose a systemic risk for other reasons are already regulated under Title I of the Act.

<sup>7</sup> It is noteworthy that the majority of life insurers’ over-the-counter derivatives transactions do incorporate credit support annexes and require the exchange of high quality collateral between the parties, thereby significantly reducing, if not eliminating, counterparty exposure. It is also worth noting that many state insurance codes require life insurers to aggregate their derivatives exposure to particular counterparties with other investment exposures to the same counterparty. For example, a life insurer that owned bonds issued by J.P. Morgan Chase Bank, N.A. (“JPM”) and had derivatives transactions with JPM would have to combine those exposures. Because most state codes contain single issuer limits, the use of collateral to offset counterparty exposure in derivatives transactions becomes essential to remain under those limits.

Other relevant factors in the determination of “substantial position” include the purpose of the swaps and whether the entity is subject to state or federal prudential regulation in effecting the swap transactions. All of these factors directly relate to the determination of whether the measuring threshold is prudent for the effective monitoring, management and oversight of systemically important entities or those that can significantly impact the U.S. financial system.

#### *Substantial Counterparty Exposure*

Like the definition of substantial position, the definition of substantial counterparty exposure must be set sufficiently high to capture only entities whose exposure to counterparties could have serious adverse effects on the financial stability of the U.S. banking or financial markets. The actual calculation of counterparty exposure should be the sum of the losses that all counterparties to the entity would realize if all derivative transactions were immediately terminated at market value, less the value of collateral posted by the entity and giving effect to all contractual netting arrangements reflected in ISDA Master and Credit Support Agreements.<sup>8</sup> The threshold amount of exposure for identifying Major Swap Participants should be measured over a reasonable period, such as quarterly or annually, in order to avoid having entities qualifying as MSPs due to market conditions on a given day.

#### *Highly Leveraged*

In adopting the Act, Congress clearly intended to more closely regulate highly leveraged entities, such as hedge funds, engaging primarily in speculative transactions. This intent is reflected in the fact that entities subject to capital requirements set by the federal banking agencies will not be deemed MSPs under Test 3. Similarly, the Commissions should consider whether business entities in compliance with other state or federally-mandated minimum capital requirements can be appropriately classified as “highly leveraged.” For example, in the case of insurance companies, insurance regulators are charged with overseeing the financial strength of life insurers and do impose such minimum capital requirements, which we believe would prevent any insurance company that is in compliance with such requirements from being found to be highly leveraged.<sup>9</sup>

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<sup>8</sup> The NAIC Investments of Insurers Model Act contains definition of “Counterparty Exposure” and “Counterparty Exposure Amount” that provide relevant measures of counterparty risk and points of parallel reference in the Commissions’ development of its proposal on the MSP definition. These definitions are explained in Appendix B at Appendix Page No. 10.

<sup>9</sup> For example, the colloquy between Senator Hagan and Senator Lincoln states that:

In addition, it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or a major security-based swap participant. For instance, entities such as registered investment companies and employee benefit plans are already subject to extensive regulation relating to their usage of swaps under other titles of the U. S. Code. They typically post collateral, are not overly leveraged and may not pose the same types of risks as unregulated major swap participants. See 124 Cong. Rec. S5904 (daily ed. July 15, 2010) (colloquy between Sen. Hagan and Sen. Lincoln), which is also set forth in Appendix E.

The reasoning reflected in the above quoted colloquy applies equally to the extensive state insurance laws and regulations governing life insurers. Appendix B summarizes explicit limitations and guidelines on life

## **Resulting Impact**

The result of applying our suggested definitions generally will ensure that end-users in any segment of the economy, who are employing prudent risk management practices to avoid contribution to systemic risk, will not be deemed MSPs. As applied to the insurance industry, we believe that most, if not all, insurers will not be deemed to be MSPs. This result should not be seen as a de facto insurance industry exemption, but rather a reflection of the fact that most, if not all insurers, already engage in derivatives usage in a controlled and prudent manner that does not pose systemic risk. In addition, these definitions do not create unintended loopholes inviting exploitation by entities that would contort themselves to fit into a certain industry in order to avoid regulation as an MSP. Consistent with Congressional intent, it is not the label on the company that causes it to fall outside the definition of an MSP, but rather the actual practices it employs with respect to its utilization of derivatives. We believe that our suggestions fully embrace the risk-based approach contained in both the statute and legislative history and achieve a reasonable balance of the policy interests reflected in the adoption of the Act.

## **The Business of Life Insurance and Managing Commercial Risk**

While our suggested approaches to the definitions of key terms in Title VII would have applicability across industries, we thought it would be helpful to provide some context about the use of derivatives in the life insurance industry, current regulation of insurers’ use of derivatives, and our views on how the key terms might apply to insurance companies if our definitional suggestions are adopted.

Life insurers’ financial products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care and disability income insurance. These products provide Americans with financial security through various stages of life and enable them to plan for their financial future, including retirement. Life insurers’ obligations to policyholders are generally long-term, often extending for decades.

In order to meet their obligations to policyholders, life insurers must acquire assets that match their liabilities. Accordingly, they are major institutional investors. In 2008, life insurance industry assets of approximately \$4.6 trillion were invested across the following asset classes: corporate bonds (42%), stocks (24%), government bonds (14%), commercial mortgages (7%) and other assets (13%). With 56% of their assets invested in bonds, it is not surprising that life insurers provide the single largest source of corporate bond financing and are indispensable to American businesses and state and local governments, allowing them to cost-effectively raise capital. Moreover, in keeping with their long term liabilities, 41% of the corporate bonds purchased by life insurers had maturities of more than 20 years at time of purchase.<sup>10</sup>

Insurers use both standardized or exchange-traded derivatives and customized, over-the-counter (“OTC”) derivatives to assist them in the core commercial activity of matching investments with their

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insurers’ use of derivatives. Comprehensive reserving and risk-based capital standards under state insurance laws also apply to life insurers.

<sup>10</sup> These calculations are based on data from the NAIC and the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S. See American Council of Life Insurers, *Life Insurers Fact Book (2009)*.

obligations to policy and contract holders. Although standardized derivatives are a core hedging tool for life insurers, they do not offer the flexibility needed to properly manage risks associated with the full range of insurers’ assets and liabilities. Consequently, OTC derivatives account for a large portion of life insurers’ derivatives transactions and are utilized to provide a closer offset of the market risks of insurance products that are tailored to fit customer needs and to precisely hedge risk in assets held to manage insurance liabilities.

The following examples of life insurers’ use of derivatives are informative. An insurer might use an interest rate swap to match a floating rate liability, such as a guaranteed investment contract, with a fixed rate asset purchased to support the liability. Many insurance liabilities, such as structured settlements, long term care insurance and single premium immediate annuities have long durations which may extend beyond 30 years. Assets at the long end of the curve may not be available or attractive and insurers may prudently decide to invest in much shorter duration assets. However, to protect against reinvestment risk, an insurer may purchase a forward-starting interest rate swap to ensure that it can achieve the interest rate return built into the pricing of the product. Floors may be used to protect against the risk that interest rates fall below a minimum guaranteed crediting rate contained in a liability. Credit default protection may be purchased by an insurer to protect against credit losses in an asset that would generate significant realized losses if the asset were sold. Indeed, during the recent financial crisis and related freeze in the trading markets, one of the only means of protecting against further credit deterioration was the purchase of credit derivatives.

Unreasonable restrictions on the use of OTC derivatives would create unnecessary, non-economic frictional costs for delivering life insurance, long term care and retirement savings products to millions of Americans. In some instances, insurance products will need to be priced higher or removed from the market altogether if risks cannot be hedged effectively. Ultimately, policyholders will incur greater costs or be unable to acquire these products to manage their retirement savings, estate planning or long-term care coverage if regulation of risk-mitigating derivatives activity becomes overly burdensome.

### **State Regulation of Life Insurers’ Use of Derivatives**

A critical factor that the Commissions should consider in determining the appropriate regulation of insurers’ use of derivatives is the extent to which these activities are already regulated under state law. State insurance regulators oversee virtually every aspect of life insurers’ business in the United States, including their use of derivatives.<sup>11</sup> The insurance codes of most states contain specific authorization and constraints on derivative transactions.<sup>12</sup> In all cases, an insurer must

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<sup>11</sup> The Commissions should carefully consider that life insurers are otherwise and substantively regulated by the states. In fact, with respect to derivatives, many insurers are doubly regulated by their domiciliary state and by New York’s Department of Insurance to the extent that they conduct a substantial amount of business in New York. There is strong precedent for the Commissions to consider the ‘otherwise regulated’ status of certain market participants – particularly state-regulated insurers -- and consequently for it to avoid imposing unnecessary, duplicative regulations. See, e.g., CFTC Reg. 4.5 (excluding insurers from commodity pool operator status). The Commissions should proceed from the premise that otherwise regulated insurers will act in accordance with their governing laws and regulations.

<sup>12</sup> Section 18(A)(2) of the NAIC Investments of Insurers Model Act (Defined Limits Version), which has been generally followed in a majority of states, specifically requires an insurer to be able to demonstrate to its regulators “the intended hedging characteristics and the effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analysis.” Section 18 of the Model Act further limits the

report its derivatives transactions, both OTC and exchange-traded, as part of its annual statutory accounting statements. Accordingly, life insurers’ derivatives activities already benefit from significant transparency and regulation designed for risk reduction.

Appendix B to our submission highlights the scope of the National Association of Insurance Commissioners (“NAIC”) Investments of Insurers Model Act regarding derivatives. Appendix C contains Schedule DB and its accompanying instructions from the NAIC Annual Statement for Life and Health Insurers. Appendix D contains pages from the NAIC Financial Condition Examiners Handbook relevant to derivatives matters. These state regulatory materials demonstrate that life insurers’ use of derivatives instruments is strictly regulated, transparently reported and specifically examined by state insurance regulators.<sup>13</sup>

Although state laws vary, life insurers’ use of derivatives is generally relegated to three types of derivatives transactions: hedging, replication and income generation. As discussed more fully above, hedging transactions employ derivatives to reduce risks associated with existing or anticipated assets or liabilities. Such risks include currency exchange risk (or the degree of exposure thereto) as well as the risk of change in value, yield, price, cash flow or quantity. Use of derivatives in this manner is an essential component of the core commercial activity in which life insurers engage for the benefit of policy and contract holders.

Replication transactions use the sale of a credit derivative combined with a highly-liquid cash instrument to reproduce the risk and return exposure of one or more assets that the life insurer would otherwise be authorized to acquire under applicable state laws. Generally, insurers utilize replication strategies because equivalent cash-market securities are simply not available, so replicated asset transactions allow insurers to diversify credit risk and obtain exposure to infrequent issuers in the cash security markets. In order for the insurer to include the replication transaction on its balance sheet, it must submit data concerning both the credit derivative and the related cash instrument, together with a unique private placement CUSIP identifier, to the Securities Valuation Office of the NAIC. Accordingly, the sale of credit derivatives in this instance is not leveraged and the insurer can cover future obligations under the credit derivative with the proceeds of the cash instrument if needed. Replication transactions represent an important investment tool for insurance companies, are regulated under state law, and do not present the type of systemic risk the Act is designed to regulate. Life insurers’ income-generating transactions are generally restricted to writing covered put and call options and covered caps and floors.

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aggregate potential exposure of swaps used in hedging transactions to not more than 6.5% of the insurer’s admitted assets and also contains limits on replication transactions and income generation transactions.

<sup>13</sup> The New York insurance investment law, which governs many of the nation’s largest life insurers, sets out a regime that is, in all material respects, similar to the NAIC Investment of Insurers Model Act. N.Y. Ins. Law §1410 (McKinney’s 2010 Supp.) But New York law adds a requirement for a Derivatives Use Plan (“DUP”) that must be approved by the New York Department of Insurance. And an insurer’s compliance with its DUP is audited annually by an independent certified public accountant. §1410(a)(B)(5).

## Conclusion

Through state insurance oversight, life insurers' derivatives activities are already subject to effective monitoring, management and oversight. Indeed, the entire insurance regulatory regime is designed to ensure insurer solvency and protect the interests of policy and contract holders. We respectfully submit that life insurers engaging in such activities in compliance with state law are highly unlikely to produce risk having the potential to significantly impact the financial system of the United States. We acknowledge that a life insurer could be deemed systemically important in other parts of the Act outside of Title VII. However, its derivatives positions alone should not be the cause of such classification, not because it is a life insurer, but because of the prudent, well-regulated, commercial risk-mitigating nature of the activities in which it is engaged.<sup>14</sup>

In conclusion, therefore, we ask the Commissions to carefully consider the negative impact on life insurers and their policyholders if the regulations implementing Title VII do not strike an appropriate balance of the policy interests in the Dodd-Frank Act. We believe our recommendations on "core" definitions in Title VII of the Act can assist the Commissions in developing an effective and equitable approach to these objectives.

ACLI greatly appreciates your attention to our views. If any questions develop, please let me know.

Sincerely,



Carl B. Wilkerson

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<sup>14</sup> It is important to distinguish between regulated life insurance companies and entities affiliated with life insurance companies. AIG's challenges during the financial crisis arose in its derivatives trading unit which was not part of its regulated life insurance companies. Indeed, the regulated domestic insurance companies proved to be a source of financial stability and value for the AIG enterprise, due in substantial part to detailed substantive insurance regulation that precludes speculative derivatives positions, imposes significant reserving and risk-based capital requirements, and requires transparent reporting of derivatives positions.

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# Appendix A

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Major Swap Participant: Section 721(a)(16) of the Dodd-Frank Act:

“(33) Major Swap Participant.— (A) In general.—The term ‘major swap participant’ means any person who is not a swap dealer, and— (i) Maintains a substantial position in swaps for any of the major swap categories as determined by the [Commodity Futures Trading] Commission, excluding— (I) Positions held for hedging or mitigating commercial risk; and (II) Positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; (ii) Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (iii)(I) Is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) Maintains a substantial position in outstanding swaps in any major swap category as determined by the [Commodity Futures Trading] Commission. (B) Definition of substantial position.—For purposes of subparagraph (A), the [Commodity Futures Trading] Commission shall define by rule or regulation the term ‘substantial position’ at the threshold that the [Commodity Futures Trading] Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the [Commodity Futures Trading] Commission shall consider the person’s relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures. (C) Scope of designation.—For purposes of subparagraph (A), a person may be designated as a major swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps. (D) Exclusions. The definition under this paragraph shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company.”

Major Security-Based Swap Participant: Section 761(a)(6) of the Dodd-Frank Act:

“(67) Major Security-Based Swap Participant.— (A) In general.—The term ‘major security-based swap participant’ means any person— (i) Who is not a security-based swap dealer; and (ii)(I) Who maintains a substantial position in security-based swaps for any of the major security-based swap categories, as such categories are determined by the [Securities and Exchange] Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; (II) Whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (III) That is a financial entity that— (aa) Is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (bb) Maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the [Securities and Exchange]

Commission. (B) Definition of substantial position.—For purposes of subparagraph (A), the [Securities and Exchange] Commission shall define, by rule or regulation, the term ‘substantial position’ at the threshold that the [Securities and Exchange] Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the [Securities and Exchange] Commission shall consider the person’s relative position in uncleared as opposed to cleared security-based swaps and may take into consideration the value and quality of collateral held against counterparty exposures. (C) Scope of designation.—For purposes of subparagraph (A), a person may be designated as a major security-based swap participant for 1 or more categories of security-based swaps without being classified as a major security-based swap participant for all classes of security-based swaps.”

# Appendix B

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## The Use of Derivative Financial Instruments by Life Insurers Under State Insurance Law

Carl B. Wilkerson, Vice President & Chief Counsel- Securities & Litigation  
American Council of Life Insurance

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### I. The National Association of Insurance Commissioners (NAIC) Investments of Insurers Model Acts Govern Derivatives Transactions by Life Insurers

- A. Purpose of Investment Law Provisions, as noted in the NAIC Investments of Insurers Model Act (*Defined Limits Version*) (1996):
1. The development of regulation of the investments of insurers requires an analysis of the complexities, uncertainties, competitive forces and frequent changes in the investment markets and in the insurance business, the diversity among insurers, and the need for a balance among risk, reward and liquidity of an insurer's investments. NAIC Model Reporting Service, Vol. II, Section 1, at 280-1.
  2. It also requires an analysis of how to safeguard the financial condition of domestic insurers and at the same time to permit domestic insurers to be competitive with insurer's domiciled in other states and with other financial industries that operate under different regulatory regimes. *Id.*
  3. The NAIC advises each state to determine through independent study which methods are best suited to its needs and whether its existing regulatory structure may be improved by using provisions of model laws recommended by the National Association of Insurance Commissioners (NAIC) or existing regulatory structures in other states or industries. *Id.*
  4. This model law is not considered by the NAIC to exhaust regulatory methods to address the regulation of investments of insurers. Nor is this model law recommended by the NAIC to be used as a standard for the examination of insurers unless *substantially similar* provisions are found in the statutes and regulations of the state of domicile of the insurer. *Id.* (emphasis added).
- B. The NAIC has addressed these goals with two different approaches:
1. The NAIC Investments of Insurers Model Act (*Defined Limits Version*) sets forth specific limits on insurers investments, including derivatives, and is discussed below.
  2. A second alternate choice exists in the NAIC Investments of Insurers Model Act (*Defined Standards Version*) which implements modern portfolio management practices.
    - a. The Defined Standards version serves as an alternative to the

Defined Limits version of the Investments of Insurers Model Act which requires that investments be made only in assets that are specifically identified and with quantitative limits for assets invested in each category.

- b. The Defined Standards version provides a “prudent person” approach to investments that implements modern portfolio theory, and establishes the following type of investment authority:
  - (1) An insurer is obligated to fulfill the “minimum asset requirement” as that term is defined in the model act.
    - (a) The minimum asset requirement is made up of an insurer’s liabilities and what is called the “financial security benchmark.”
    - (b) This benchmark equals either the company’s minimum capital surplus as required by statute or the authorized control level risk-based capital which applies to the insurer as set forth in the risk-based capital law of the state, whichever is greater; and,
  - (2) An insurer invests its assets after fulfilling the minimum asset requirement according to a prudence standard. The Defined Standards version establishes factors that must be evaluated and considered by the insurer in determining whether its investment portfolio is prudent.

**C. Overview of the Investments of Insurers Model Act (Defined Limits Version) and its application to derivatives**

**1. Scope**

- a. That applies only to investments and investment practices of domestic insurers and United States branches of alien insurers entered through the individual states.
- b. The Act does not apply to investments for separate accounts of an insurer except to the extent the provisions of the NAIC Model Holding Compact so provide.

**2. Purpose to the defined limits version**

- a. The purpose of this Act is to protect the interests of insureds by promoting insurer solvency and financial strength. This will be accomplished through the application of investment standards that facilitate a reasonable balance of the following objectives:
  - (1) To preserve principal;

- (2) To assure reasonable diversification as to type of investment, issuer and credit quality; and
- (3) To allow insurers to allocate investments in a manner consistent with principles of prudent investment management to achieve an adequate return so that obligations to insureds are adequately met and financial strength is sufficient to cover reasonably foreseeable contingencies.

### 3. **Treatment of Derivatives**

- a. Article II Section 18 governs derivative transactions
- b. The NAIC Commentary indicates that derivatives by insurers should be limited to hedging and, to a limited extent, income generation transactions.

### 4. **Definitions**

- a. "Derivative instrument" [ Article I, Section 2 (V)] means an agreement, option, instrument or a series or combination thereof:
  - (1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
  - (2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
- b. "Derivative instruments" include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof and any agreements, options or instruments permitted under regulations adopted under Section 8. *Id.*
- c. "Derivative transaction" means a transaction involving the use of one or more derivative instruments. [Article I, Section 2 ( W)].

### 5. Substantive provisions permitting life insurers to engage in derivative transactions.

#### a. **General conditions**

(1) **Limitations on Hedging Transactions**

- (a) An insurer may use derivative instruments under Section 18 of the Model Act to engage in hedging transactions and certain income generation transactions, as these terms may be further defined in regulations promulgated by the commissioner.
- (b) An insurer shall be able to demonstrate to the commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analyses.

(2) An insurer may enter into hedging transactions under Section 18 of the Model Act if, as a result of and after giving effect to the transaction :

- (a) The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;
- (b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and
- (c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

(3) **Limitations on Income Generation Transactions**

- (a) An insurer may only enter into the following types of income generation transactions if as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of its admitted assets:

- i) Sales of covered call options on non-callable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the noncallable period or derivative instruments based on fixed income securities;
- ii) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;
- iii) Sales of covered puts on investments that the insurer is permitted to acquire under this Act, if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or
- iv) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding.

(4) **Counterparty Exposure**

- (a) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations of Section 10 of the Model Act, which governs diversification standards and certain foreign investments.
- (b) **Additional Transactions**
  - i) Pursuant to regulations to implement the Model Act which may promulgated under the authority of Section 8, the insurance commissioner may approve additional transactions involving the use of derivative instruments in excess of the limits imposed by Section 8(B) or for other risk management purposes under regulations

promulgated by the commissioner, but replication transactions shall not be permitted for other than *risk management* purposes.

- (c) Definition: "Counterparty Exposure Amount" means:
- i) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse ("over-the-counter derivative instrument")
  - ii) The amount of credit risk equals:
    - a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or
    - b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.
  - iii) If over-the-counter derivative instruments are entered into under a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:
    - a) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer; and

- b) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

a. **Written Agreement and Conditions Required Under the Act**

- (1) The insurer shall enter into a written agreement for all transactions authorized in this section other than dollar roll transactions.
  - (a) "Dollar roll transaction" means two (2) simultaneous transactions with different settlement dates no more than ninety-six (96) days apart, so that in the transaction with the earlier settlement date, an insurer sells to a business entity, and in the other transaction the insurer is obligated to purchase from the same business entity, substantially similar securities of the following types:
    - i) Asset-backed securities issued, assumed or guaranteed by the Government National Mortgage Association, the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their respective successors; and
    - ii) Other asset-backed securities referred to in Section 106 of Title I of the Secondary Mortgage Market Enhancement Act of 1984 (15 U.S.C. s 77r- 1), as amended.
- (2) The written agreement shall require that each transaction terminate no more than one year from its inception or upon the earlier demand of the insurer.
- (3) The agreement shall be with the business entity counterparty.

D. **NAIC Derivative Instruments Model Regulation, NAIC Model Reporting Service, Volume III at 282-1(1996).**

- 1. This model regulation was adopted together with the NAIC Investments of Insurers Model Act (Defined *Limits* Version).

2. It provides additional guidance and clarification for application of the model law.
3. **Selected provisions**
  - a. Guidelines and Internal Control Procedures are set forth at Section 4
    - (1) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:
      - (a) Address investment or, if applicable, underwriting objectives, and risk constraints, such as credit risk limits;
      - (b) Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and
      - (c) Require compliance with internal control procedures.
    - (2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective.
    - (3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.
  - b. **Documentation Requirements are set forth at Section 5**
    - (1) An insurer shall maintain documentation and records relating to each derivative transaction, such as:
      - (a) The purpose or purposes of the transaction;
      - (b) The assets or liabilities to which the transaction relates;
      - (c) The specific derivative instrument used in the transaction;
      - (d) For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount; and

- (e) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.
- (2) **Trading Requirements** are set forth at Section 6, which mandates that each derivative instrument shall be:
- (a) Traded on a qualified exchange;
  - (b) Entered into with, or guaranteed by, a business entity;
  - (c) Issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or
  - (d) Entered into with a qualified foreign exchange.

4. **Overview of the Defined Standards Version of the NAIC Investments of Insurers Model Act**

- a. This Model Act is premised on specific capital standards, and provides a framework in which these standards relate to the investment laws, and established consequences for failure to meet capital standards. To the extent an insurer's investment program is imprudent, the insurer is deemed unsound.
- b. The minimum financial security benchmark and the minimum asset requirement jointly form the foundation for regulating life insurer investments according to a modern portfolio or prudence standard.
  - (1) These twin tools allow a high level of investment discretion above the minimum asset requirement while still providing meaningful regulatory protections for policyholders and claimants from adverse investment management.
  - (2) Section 3 of the Defined Standards Proposal creates limitations and restrictions on investments counted toward the minimum asset requirement; Assets in excess of the minimum asset requirement would not be subject to these limitations and restrictions and may be invested according to the insurer's individual written investment policy.
- c. Three philosophies to capital requirements are central to the Act's approach to regulating investments according to a prudence standard.

- (1) The Act's "minimum capital" (for stock insurance companies) and "minimum surplus" (for mutual insurance companies) ensure financial stability at the inception of a new insurance enterprise. The amount of capital or surplus needed depends on what types of business the insurer intends to conduct, and are established based on the information the insurer gives the insurance commissioner at the time of formation. See, Annotations to Section 3 of NAIC Investments of Insurers Model Act (Defined Standards Version) at 17 (1997).
  - (2) The "minimum financial security benchmark" measures the minimum capital requirements of an established enterprise, and expand as the financial needs to the enterprise expand, but may also contract with them. *Id.*
  - (3) The "proper surplus" appropriate for a particular company's operation is determined by the insurer's board of directors in consultation with management. *Id.*
- d. The fundamental enforcement mechanism under the defined standards proposal appears in Section 11 which provides that if an insurer does not meet the minimum asset requirement, then under Section 11D, the insurer may be deemed to be in financially hazardous condition, and the commissioner may initiate liquidation and rehabilitation proceedings against the insurer. *Id.* at 21.

**(5) Status of Investments of Insurers Model Acts in the States**

- (A) A state by state chart appears on the next page.

## NAIC INVESTMENTS OF INSURERS MODEL ACT STATUS CHART

STATE	LAWS AND REGULATIONS
Alabama	ALA. CODE §§ 27-41-1 to 27-41-41 (1977/1993) (Life).
Alaska	ALASKA ADMIN. CODE tit. 3, §§ 21.201 to 21.399 (2001/2005). ALASKA STAT. §§ 21.21.010 to 21.21.420 (1966/2001) (Includes authority to adopt regulations consistent with defined limits version).
Arizona	ARIZ. REV. STAT. ANN. §§ 20-531 to 20-561 (1954/2000).
Arkansas	ARK. CODE ANN. §§ 23-63-801 TO 23-63-841 (1959/2009).
California	CAL. INS. CODE §§ 1170 to 1212 (1935/2009). CAL. CODE REGS. Tit. 10, §§ 2690.90 to 2690.94 (2007); BULLETIN 95-5A (1995).
Colorado	COLO. REV. STAT. §§ 10-3-213 to 10-3-242 (1969/2000).
Connecticut	CONN. GEN. STAT. §§ 38a-102 to 38a-102 <i>i</i> (1991/2009); BULLETIN FS-14c-00 (2000).
Delaware	DEL. CODE ANN. Tit. 18, §§ 1301 to 1332 (1953/2002).
District of Columbia	D.C. CODE §§ 31-1371.01 to 31-1375.01 (2002).
Florida	FLA. STAT. §§ 625.301 to 625.340 (1959/1993).
Georgia	GA. CODE ANN. §§ 33-11-50 to 33-11-67 (2000).
Guam	GUAM GOV'T. CODE § 43166 (1951).
Hawaii	HAW. REV. STAT. §§ 431:6-101 to 431:6-501 (1987/2009); §§431:6-601 to 431:6-602 (1987/2008).
Idaho	IDAHO CODE ANN. §§ 41-701 to 41-736 (1961/2006).
Illinois	215 ILL. COMP. STAT. 5/126.1 to 5/126.32 (1997). ILL. ADMIN. CODE tit. 50, §§ 806.10 to 806.60 (1998/2001). Company Bulletin 92-2 (1992).
Indiana	IND. CODE §§ 27-1-12-2 to 27-1-12-3.5 (1935/2004) (Life); §§ 27-1-13-3 to 27-1-13-3.5 (1935/2004) (P/C).
Iowa	IOWA CODE §§ 511.8 to 511.8A (1868/2000) (Life); § 515.35 (1868/1997) (P/C). IOWA ADMIN. CODE r. 191-93.6; BULLETIN 2008-18 (2008).
Kansas	KAN. STAT. ANN. §§ 40-2a01 to 40-2a28 (1972/2005) (P/C); §§ 40-2b01 to 40-2b29 (1972/2005) (Life).

## NAIC INVESTMENTS OF INSURERS MODEL ACT STATUS CHART

STATE	LAWS AND REGULATIONS
Kentucky	KY. REV. STAT. ANN. §§ 304.7-010 to 304.7-473 (2000).
Louisiana	LA. REV. STAT. ANN. §§ 22:581 to 22:601 (2007/2010).
Maine	ME. REV. STAT. ANN. Tit. 24-A, §§ 1101 to 1137 (1969/2000) (P/C); §§ 1151 to 1161 (1987/2000) (Life).
Maryland	MD. CODE ANN., INS §§ 5-501 to 5-512 (1922/2003) (Life); §§ 5-601 to 5-609 (1943/1997) (P/C); MD. ADMIN. CODE CH. 650 §§ 1 to 011 (1998/2008).
Massachusetts	MASS. GEN. LAWS. Ch. 175 §§ 63 to 68 (1817/1996).
Mississippi	MISS. CODE ANN. §§83-19-51 to 83-19-55 (1892/2010).
Missouri	MO. REV. STAT. §§ 375.325 TO 375.355 (1939/2002); §§ 375.532 TO 375.534 (1991/2005) (All insurers); §§ 376.300 to 376.311 (1939/2002) (Life) §§ 376.311, 379.083 (1997/2002); § 375.345 (2002); MO. CODE REGS. ANN. Tit. 20, § 200-12.020 (2009).
Montana	MONT. CODE ANN. §§ 33-12-101 to 33-12-312 (1999/2001).
Nebraska	NEB. REV. STAT. §§ 44-5101 to 44-5154 (1991/2009).
Nevada	NEV. REV. STAT. §§682A.010 to 682A.290 (1971/2003).
New Hampshire	N. H. REV. STAT. ANN. §§ 402:27 to 402:29-d (1917/1991) (All insurers); §§ 411-A:37 (1978/1990) (Life).
New Jersey	N.J. STAT. ANN. §§ 17:24-1 to 17:24-16 (1902/1995) (P/C); §§ 17B:20-1 to 17B:20-8 (1971/2005) (Life).
New Mexico	N.M. STAT. ANN. §§ 59A-9-1 to 59A-9-27 (1984/1988).
New York	N.Y. INS. LAW §§ 1401 to 1413 (1984/2008). N.Y. COMP. CODES R. & REGS. Tit. 11, §§ 178.0 to 178.10 (Regulation 168) (2001).
North Carolina	N.C. GEN. STAT. §§ 58-7-165 to 58-7-205 (1991/2005).
North Dakota	N.D. CENT. CODE §§ 26.1-05-18 to 26.1-05-22 (1983/2001).
Ohio	OHIO REV. CODE ANN. §§ 3907.14 to 3907.141; §§ 3925.20 to 3925.21 (1953/2001) (Life); §§ 3925.05 to 3925.06 (1953) (P/C).
Oklahoma	OKLA. STAT. tit. 36, §§ 1601 to 1629 (1957/2005).
Oregon	OR. REV. STAT. §§ 733.510 to 733.780 (1959/2006).

## NAIC INVESTMENTS OF INSURERS MODEL ACT STATUS CHART

STATE	LAWS AND REGULATIONS
Pennsylvania	40 PA. STAT. ANN. §§ 504.1 to 506.1 (1986/2004) (Life).
Puerto Rico	P. R. LAWS ANN. tit. 26, §§ 648-662 (2003).
Rhode Island	R.I. GEN. LAWS §§ 27-11-1 to 27-11-3 (1947/1956); §§ 27-11.1 to 27-11.1-8 (1984/2002).
South Carolina	S.C. CODE ANN. §§ 38-12-10 to 38-12-510 (2002).
South Dakota	S.D. CODIFIED LAWS §§ 58-27-1 to 58-27-111 (1966/2005); S.D. ADMIN. R. 20:06:26:01 (2005/2008). S.D. ADMIN. R. 20:06:26:01 (1995/2008).
Tennessee	TENN. CODE ANN. §§ 56-3-301 to 56-3-409 (1907/1998) (Life); §§ 56-3-401 to 56-3-409 (1979/1984) (P/C).
Texas	TEX. INS. CODE ANN. §§ 424.001 to 424.218 (2005/2007).
Utah	UTAH CODE ANN. §§ 31A-18-101 to 31A-18-110 (1985/2006).
Vermont	VT. STAT. ANN. tit. 8, §§ 3461 to 3472 (1967/2000).
Virginia	VA. CODE ANN. §§ 38.2-1400 to 38.2.1447 (1986/2002).
Washington	WASH. REV. CODE ANN. §§ 48.13.010 to 48.13.360 (1947/2004).
West Virginia	W. VA. CODE §§ 33-8-1 to 33-8-32 (1957/2004).
Wisconsin	WIS. STAT. §§ 620.01 to 620.25 (1971/1992).
Wyoming	WYO. STAT. ANN. §§ 26-7-101 to 26-7-116 (1967/2001).

# Appendix C

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## SCHEDULE DB

### DERIVATIVE INSTRUMENTS

All derivatives, regardless of maturity date, are to be reported on Schedule DB. Forward commitments where a Company cannot determine at the inception of the contract, with certainty, if delivery will be made at the earliest opportunity are essentially forward contracts and should be reported on Schedule DB.

This schedule should be used to report derivative instruments (including insurance futures and options on insurance futures). Specific accounting procedures for each derivative instrument will depend on the definition below and documented intent that best describes the instrument. Uses of derivative instruments that are reported in this schedule include hedging, income generation and other. State investment laws and regulations should be consulted for applicable limitations and permissibility on the use of derivative instruments. If the derivative strategy meets the definition of hedging as outlined in paragraph 7 of SSAP No. 86, Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions, then the underlying derivative transactions composing that strategy should be reported in that category of Schedule DB. If the underlying derivative strategy does not meet the definition of hedging, then the underlying derivative transactions composing that strategy should be reported as either income generation or other.

### **DEFINITIONS OF DERIVATIVE INSTRUMENTS**

A hedge transaction is “Anticipatory” if it relates to:

- a. A firm commitment to purchase assets or incur liabilities, or
- b. An expectation (but not obligation) to purchase assets or incur liabilities in the normal course of business.

“*Underlying Interest*” means the asset(s), liability(ies), or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments, or other financial market instruments.

“*Option*” means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, level, performance, or value of, one or more Underlying Interests.

“*Cap*” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance, or value of one or more Underlying Interests exceed a predetermined number, sometimes called the strike/cap rate or price.

“*Floor*” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price exceeds a reference price, level, performance or value of one or more Underlying Interests.

“*Collar*” means an agreement to receive payments as the buyer of an Option, Cap or Floor and to make payments as the seller of a different Option, Cap or Floor.

“*Swap*” means an agreement to exchange or net payments at one or more times based on the actual or expected price, level, performance, or value of one or more Underlying Interests.

“*Forward*” means an agreement (other than a Future) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of, one or more Underlying Interests.

“*Future*” means an agreement traded on an exchange, Board of Trade, or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value, one or more Underlying Interests.

“*Insurance Futures Contract*” means a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto, or such other definition as may be specified under the statutes, regulations and administrative rulings of a particular state.

“*Insurance Futures Option*” means a put or call option on an Insurance Futures contract.

“*Insurance Futures Call Option*” means a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date.

“*Insurance Futures Put Option*” means a contract under which the holder has the right to sell the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date.

“*Option Premium*” means the consideration paid (received) for the purchase (sale) of an Insurance Future Option.

“*Margin Deposit*” means a deposit that an insurer is required to maintain with a broker with respect to the underlying Insurance Futures Contracts purchased.

### **GENERAL INSTRUCTIONS FOR SCHEDULE DB**

Each derivative instrument should be reported in Parts A, B, C, or D according to the nature of the instrument, as follows:

- Part A: Options\*, Caps, Floors and Insurance Futures Options Owned
- Part B: Options\*, Caps, Floors and Insurance Futures Options Written
- Part C: Collars, Swaps and Forwards\*\*
- Part D: Futures Contracts and Insurance Futures Contracts Open

\* Warrants acquired in conjunction with public or private debt or equity that are more appropriately reported in other schedules do not have to be reported in Schedule DB.

\*\* Forward commitments that are not derivative instruments (for example, the commitment to purchase a GNMA security two months after the commitment date, or a private placement six months after the commitment date) should be disclosed in the Notes to Financial Statements rather than on Schedule DB.

Part E should be used to report the counterparty exposure, (i.e., the exposure to credit risk on derivative instruments) to each counterparty (or guarantor as appropriate).

**SCHEDULE DB – PART A**  
**SECTIONS 1, 2, AND 3**

**GENERAL INSTRUCTIONS**

In each Section, separate derivative instruments into the following categories:

<u>Category</u>	<u>Line Number</u>
Call Options:	
Hedging .....	0199999
Other .....	0399999
Subtotal – Call Options .....	0499999
Put Options:	
Hedging .....	0599999
Other .....	0799999
Subtotal – Put Options .....	0899999
Caps:	
Hedging .....	0999999
Other .....	1199999
Subtotal – Caps .....	1299999
Floors:	
Hedging .....	1399999
Other .....	1599999
Subtotal – Floors .....	1699999
Insurance Futures Call Options:	
Hedging .....	1799999
Other .....	1999999
Subtotal – Insurance Futures Call Options .....	2099999
Insurance Futures Put Options	
Hedging .....	2199999
Other .....	2399999
Subtotal – Insurance Futures Put Options .....	2499999
Totals:	
Subtotal – Hedging .....	2599999
Subtotal – Other .....	2799999
Total .....	9999999

Column 1 – Description

Give a complete and accurate description of the derivative instrument, including description of underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.

Column 2 – Number of Contracts or Notional Amount

Where instrument positions are traded based on number of contracts, such as exchange traded options, show the number of contracts. For other instruments, such as caps and floors, show the notional amount (i.e., the amount upon which the next cash payment is based). Notional amount should be based on current U.S. equivalent of the amount receivable from the counterparty as of the (purchase/sale/reporting) date.

- Column 3 – Date of Maturity, Expiry or Settlement  
Show the date of maturity, expiry, or settlement, as appropriate.
- Column 4 – Strike Price, Rate or Index  
Show the strike price, rate, or index for which an option could be exercised or which would trigger a cash payment on a cap or floor. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$).
- Column 5 – Date of Acquisition  
Show the date of the original transaction. The reporting entity may summarize on one line all identical derivative instruments with the same exchange or counterparty showing the date of last acquisition, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
- Column 6 – Exchange or Counterparty  
If exchange traded, show the name of the exchange, Board of Trade, or contract market. If OTC traded, show the counterparty or guarantor upon whose credit the insurer relies.
- Column 7 – Cost/Option Premium  
Indicate the cost of the instrument purchased. For insurance futures, indicate the consideration paid for the purchase of the instrument.

**SCHEDULE DB – PART A – SECTION 1****OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS OWNED**  
**DECEMBER 31 OF CURRENT YEAR**

Column 8 – Book Value

Book value is the sum of cost plus cumulative increase (decrease) by adjustment in book value.

Column 9 – \* Column

Insert “\*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.

Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.

Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

Column 10 – Statement Value

Instruments shall be valued as follows, providing the transaction is permitted by law or regulations of an insurer’s state of domicile:

a. For Hedges of Items Carried at Amortized Cost

(i) Value at amortized cost, (or alternatively at cost if less than one year maturity).

(ii) If during the life of the instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the instrument shall be valued at current market value (marked to market).

b. For Hedges of Items Carried at Market Value

Value at current market price (marked to market).

c. For Hedges Adjusting the Basis of the Hedged Item

The book value of an instrument may be used to adjust the basis of the hedged item directly. In this case the statement value of the instrument would be zero.

d. For Other Derivative Transactions

Value at current market price (marked to market).

e. For Insurance Options

- Column 11 – Fair Value
- Fair value can be obtained from any one of five sources:
- a. Public Market Quotes
  - b. Fair Value Provided by Broker
  - c. Management Estimate
  - d. Pricing Service
  - e. Pricing Matrix
- Column 12 – Increase (Decrease) by Adjustment
- This represents the current year's amortization of the initial cost. For insurance futures options, this represents the current year's increase or decrease in the market value.
- Column 13 – Used to Adjust Basis of Hedged Item
- This represents the amortized book value used to adjust the basis of the hedged item(s) during the current year.
- Column 14 – Other Investment/Miscellaneous Income
- Include current year earned income on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued). For insurance futures options, this represents any increase or decrease (in the value of the instruments) that corresponds to incurred losses for the current reporting period.

**SCHEDULE DB – PART A – SECTION 3****OWNED OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS TERMINATED  
DURING CURRENT YEAR**

- Column 8 – Indicate Exercise, Expiration, Maturity or Sale  
Indicate the cause of termination.
- Column 9 – Termination Date  
Show the date in which the contract/agreement was terminated. Companies may summarize on one line all identical instruments with the same exchange or counterparty, using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
- Column 10 – Book Value  
Book value is the sum of cost plus cumulative increase (decrease) by adjustment in book value.
- Column 11 – \* Column  
Insert “\*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.  
Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.  
Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.
- Column 12 – Consideration Received on Terminations  
Show the amount of consideration received.
- Column 13 – Increase (Decrease) by Adjustment  
This represents the current year’s amortization of the initial cost.
- Column 14 – Gain (Loss) on Termination - Recognized  
This represents gain (loss) on termination that is not deferred or used to adjust basis of hedged items.
- Column 15 – Gain (Loss) on Termination - Used to Adjust Basis of Hedged Item  
This represents the gain (loss) on termination that was used to adjust the basis of a hedged item in the current year. It includes the book value of premiums that were allocated to the purchase cost on exercise of an option.
- Column 16 – Gain (Loss) on Termination - Deferred  
This represents the gain (loss) on termination that was deferred over yearend.  
This equals consideration received less book value at termination.
- Column 17 – Other Investment/Miscellaneous Income  
Include current year earned income on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).

**SCHEDULE DB – PART B**  
**SECTIONS 1, 2, AND 3**

**GENERAL INSTRUCTIONS**

In each Section, separate derivative instruments into the following categories:

<u>Category</u>	<u>Line Number</u>
Call Options:	
Hedging .....	0199999
Income Generation .....	0299999
Other.....	0399999
Subtotal – Call Options .....	0499999
Put Options:	
Hedging .....	0599999
Income Generation .....	0699999
Other.....	0799999
Subtotal – Put Options.....	0899999
Caps:	
Hedging .....	0999999
Income Generation .....	1099999
Other.....	1199999
Subtotal – Caps.....	1299999
Floors:	
Hedging .....	1399999
Income Generation .....	1499999
Other.....	1599999
Subtotal – Floors .....	1699999
Insurance Futures Call Options:	
Hedging .....	1799999
Income Generation .....	1899999
Other.....	1999999
Subtotal – Insurance Futures Call Options .....	2099999
Insurance Futures Put Options:	
Hedging .....	2199999
Income Generation .....	2299999
Other.....	2399999
Subtotal – Insurance Futures Put Options .....	2499999
Totals:	
Subtotal – Hedging .....	2599999
Subtotal – Income Generation .....	2699999
Subtotal – Other .....	2799999
Total.....	9999999

Column 1 – Description

Give a complete and accurate description of the derivative instrument, including a description of underlying securities, currencies, rates, indices, commodities, derivative instruments or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.

Column 2	–	<p>Number of Contracts or Notional Amount</p> <p>Where instrument positions are traded based on number of contracts, such as exchange traded options, show the number of contracts. For other instruments, such as caps and floors, show the notional amount (i.e., the amount upon which the next cash payment is based). Notional amount should be based on current U.S. equivalent of the amount receivable from the counterparty as of the (purchase/sale/reporting) date.</p>
Column 3	–	<p>Date of Maturity, Expiry or Settlement</p> <p>Show the date of maturity, expiry or settlement, as appropriate.</p>
Column 4	–	<p>Strike Price, Rate or Index</p> <p>Show the strike price, rate or index for which an option could be exercised or which would trigger a cash payment on a cap or floor. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$).</p>
Column 5	–	<p>Date of Issuance/Purchase</p> <p>Show the date of the original transaction. The reporting entity may summarize on one line, all identical derivative instruments used in hedging transactions with the same exchange or counterparty showing the date of last transaction, but only if the instruments are identical in their terms; e.g., type, maturity, expiry or settlement, and strike price, rate or index. Similarly, the reporting entity may summarize on one line, all identical derivative instruments used in income generation transactions with the same exchange or counterparty inserting last transaction date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).</p> <p>Hedging and income generation derivative instruments for which the alternative accounting treatment is chosen should be summarized separately.</p>
Column 6	–	<p>Exchange or Counterparty</p> <p>If exchange traded, show the name of the exchange, Board of Trade, or contract market. If OTC traded, show the counterparty or guarantor upon whose credit the insurer relies.</p>
Column 7	–	<p>Consideration Received</p> <p>Indicate the consideration received for sale of the instrument written.</p>

**SCHEDULE DB – PART B – SECTION 1****OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS WRITTEN AND  
IN FORCE DECEMBER 31 OF CURRENT YEAR**

Column 8 – Book Value

Book value is the sum of consideration received plus cumulative increase (decrease) by adjustment in book value, if any.

Income Generation Transactions

For covered calls and covered puts, book value equals consideration received. For covered caps and floors, book value is the sum of consideration received plus cumulative increase (decrease) by adjustment in book value, if any.

Column 9 – \* Column

Insert “\*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.

Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.

Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

Column 10 – Statement Value

Hedging Transactions

Instruments shall be valued as follows providing the transaction is permitted by law or regulations of an insurer’s state of domicile (for more complete and detailed explanation, see the NAIC *Accounting Practices and Procedures Manual*):

a. For Hedges of Items Carried at Amortized Cost

(i) Value at amortized cost, (or alternatively at cost if less than one year maturity).

(ii) If during the life of the instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the instrument shall be valued at current market value (marked to market) and changes will be recognized currently.

b. For Hedges of Items Carried at Market Value

Value at current market price (marked to market) and changes will be recognized currently.

c. For Hedges Adjusting the Basis of the Hedged Item (Fixed Income Only)

The book value of an instrument may be used to adjust the basis of the hedged item directly. Prior to entering into the transaction, the insurer must state its intent to use this alternative and may not change methods while the transaction remains open.

Income Generation Transactions

- a. If Underlying/Covering Item Carried at Amortized Cost:
  - (i) For covered puts and calls, value at consideration received.
  - (ii) For covered caps and floors, value at amortized value. If less than one year maturity to from date of acquisition, item may be carried at consideration received (unamortized).
- b. If Underlying/Covering Item Carried at Market Value:
  - (i) Value at current market price (marked to market) and changes will be recognized currently.
- c. If Adjusting the Basis of the Underlying/Covering Item (Fixed Income Only):
  - (i) The book value of a call option may be used to adjust the basis of the underlying/covering asset directly if the call option has a maturity of greater than one year from date of acquisition.

Other Derivative Transactions

Instruments shall be valued at current market price (marked to market). For insurance options, this statement value represents the value as of December 31, of the prior year.

Column 11 – Fair Value

Fair value can be obtained from any one of five sources:

- a. Public Market Quotes
- b. Fair Value Provided by Broker
- c. Management Estimate
- d. Pricing Service
- e. Pricing Matrix

Column 12 – Increase (Decrease) by Adjustment

This represents the current year's amortization of the initial proceeds.

Column 13 – Used to Adjust Basis

Hedging Transactions:

This represents the consideration used to adjust the basis of the hedged item(s) during the current year.

Income Generation Transactions:

This represents the consideration used to adjust the basis of the underlying/covering asset during the current year.

## Column 14 – Other Investment/Miscellaneous Income

## Hedging Transactions:

Include current year incurred interest expense on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).

## Income Generation Transactions:

Include current year incurred interest expense on caps and floors as a negative number. The reporting entity should keep records for more detailed reporting of expense (i.e. incurred versus paid).

## Other Derivative Transactions:

Include current year incurred interest expense on caps and floors as a negative number.

**SCHEDULE DB – PART B – SECTION 3****WRITTEN OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS TERMINATED  
DURING CURRENT YEAR**

- Column 8 – Indicate Exercise, Expiration, Maturity, or Closing Purchase Transaction
- Indicate the cause of termination.
- Column 9 – Termination Date
- Show the date in which the contract/agreement was terminated. Companies may summarize on one line all identical derivative instruments used in hedging transactions with the same exchange or counterparty, using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index). Similarly, the reporting entity may summarize on one line, all identical derivative instruments used in income generation transactions with the same exchange or counterparty using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
- Hedging and income generation derivative instruments, for which the alternative accounting treatment is chosen, should be summarized separately.
- Column 10 – Book Value
- Hedging Transactions:
- Book value is the sum of consideration received plus cumulative increase (decrease) by adjustment in book value, if any.
- Income Generation Transactions:
- For covered calls and covered puts, book value equals consideration received. For covered caps and floors, book value is the sum of consideration received plus cumulative decrease by adjustment in book value, if any.
- Other Derivative Transactions:
- For other derivative transactions, book value equals consideration received.
- Column 11 – \* Column
- Insert “\*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.
- Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.
- Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

- Column 12 – Consideration Paid on Termination  
Show the amount of consideration paid.
- Column 13 – Increase/(Decrease) by Adjustment  
This represents the current year's amortization of the initial proceeds.  
This equals book value at termination less consideration paid on termination.
- Column 14 – Gain (Loss) on Termination - Recognized  
This represents gain (loss) on termination that is not deferred or used to adjust basis of hedged or underlying/covering items.
- Column 15 – Gain (Loss) on Termination - Used to Adjust Basis  
Hedging Transactions:  
This represents the gain (loss) on termination that was used to adjust the basis of a hedged item in the current year. It includes the book value of premiums that were allocated to the sale proceeds on exercise of an option.  
Income Generation Transactions:  
This represents the gain (loss) on termination that was used to adjust the basis of an underlying/covering item in the current year. It includes the book value of premiums that were allocated to the sale proceeds on exercise of an option.
- Column 16 – Gain (Loss) on Termination - Deferred  
This represents the gain (loss) on termination that was deferred over yearend.
- Column 17 – Other Investment/Miscellaneous Income  
Hedging Transactions:  
Include current year incurred interest expense on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., paid versus accrued).  
Income Generation Transactions:  
Include current year incurred interest expense on caps and floors as a negative number. The reporting entity should keep records for more detailed reporting of expense (i.e. paid versus accrued).  
Other Derivative Transactions:  
Include current year incurred interest expense on caps and floors as a negative number.

**SCHEDULE DB – PART C**  
**SECTIONS 1, 2 AND 3**

**GENERAL INSTRUCTIONS**

In each Section, separate derivative instruments into the following categories:

	<u>Category</u>	<u>Line Number</u>
Collars:		
	Hedging.....	0199999
	Other .....	0399999
	Subtotal – Collars.....	0499999
Swaps:		
	Hedging.....	0599999
	Other .....	0799999
	Subtotal – Swaps.....	0899999
Forwards:		
	Hedging.....	0999999
	Other .....	1199999
	Subtotal – Forwards .....	1299999
Totals:		
	Subtotal – Hedging.....	2599999
	Subtotal – Other .....	2799999
Total.....		9999999

Column 1 – Description

Give a complete and accurate description of the derivative instrument, including description of underlying securities, currencies, rates, indices, commodities, derivative instruments or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.

Column 2 – Notional Amount

Where instrument positions are traded based on number of contracts, such as exchange traded options or futures, show the number of contracts. For other instruments, such as swaps, show the notional amount (i.e., the amount upon which the next cash payment is based).

Column 3 – Date of Maturity, Expiry or Settlement

Show the date of maturity, expiry or settlement, as appropriate.

Column 4 – Strike Price, Rate, or Index Rec (Pay)

Show the price, rate or index relative to which profits and losses on the transaction are determined (such as (paid) and received interest rate on an interest rate swap), or that is locked in, as under a currency forward. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$).

- Column 5 – Date of Opening Position or Agreement
- Show the date of the original transaction. The reporting entity may summarize on one line, all identical instruments with the same exchange or counterparty using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
- Column 6 – Exchange or Counterparty
- If exchange traded, show the name of the exchange, Board of Trade, or contract market. If OTC traded, show the counterparty or guarantor upon whose credit the insurer relies.
- Column 7 – Cost or (Consideration Received)
- Indicate the cost or (consideration received), if any.

**SCHEDULE DB – PART C – SECTION 1****COLLAR, SWAP AND FORWARDS OPEN  
DECEMBER 31 OF CURRENT YEAR**

- Column 8 – Book Value
- Book value is the sum of cost paid or consideration received plus cumulative increase (decrease) by adjustment in book value.
- Column 9 – \* Column
- Insert “\*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.
- Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.
- Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.
- Column 10 – Statement Value
- Instruments shall be valued as follows providing the transaction is permitted by law or regulations of an insurer’s state of domicile.
- a. For Hedges of Items Carried at Amortized Cost:
    - (i) Value at amortized cost, (or alternatively at cost if less than one year maturity).
    - (ii) If during the life of the instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the instrument shall be valued at current market value (marked to market) and changes will be recognized currently.
  - b. For Hedges of Items Carried at Market Value
 

Value at current market price (marked to market) and changes will be recognized currently.
  - c. For Hedges Adjusting the Basis of the Hedged Item
 

The book value of an instrument may be used to adjust the basis of the hedged item directly. In this case the statement value of the instrument would be zero.
  - d. For Other Derivatives Transactions
 

Value at current market price (marked to market) and changes will be recognized currently.

- Column 11 – Fair Value
- Fair value can be obtained from any one of five sources:
- a. Public Market Quotes
  - b. Fair Value Provided by Broker
  - c. Management Estimate
  - d. Pricing Service
  - e. Pricing Matrix
- Column 12 – Increase (Decrease) by Adjustment
- This represents the current year’s amortization of the initial cost or proceeds.
- Column 13 – Used to Adjust Basis of Hedged Item
- This represents the amortized book value used to adjust the basis of the hedged item(s) during the current year.
- Column 14 – Other Investment/Miscellaneous Income
- Include current year earned income on collars and swaps. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).
- Column 15 – Potential Exposure
- Potential Exposure is a statistically derived measure of the potential increase in derivative instrument credit risk exposure, for derivative instruments which generally do not have an initial cost paid or consideration received, resulting from future fluctuations in the underlying interests upon which derivative instruments are based.
- For collars, swaps and forwards, the Potential Exposure = 0.5% x “Notional Amount” x Square root of (Remaining Years to Maturity).

**SCHEDULE DB – PART C – SECTION 3**  
**COLLAR, SWAP AND FORWARDS TERMINATED**  
**DURING CURRENT YEAR**

Column 8	–	Indicate Exercise, Expiration, Maturity or Sale  Indicate the cause of termination.
Column 9	–	Termination Date  Show the date in which the contract/agreement was terminated. Companies may summarize on one line all identical instruments with the same exchange or counterparty, using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
Column 10	–	Book Value  Book value is the sum of cost plus cumulative increase (decrease) by adjustment in book value.
Column 11	–	* Column  Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.  Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.  Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.
Column 12	–	Consideration Received or (Paid) on Termination  Show the amount of consideration received or paid.
Column 13	–	Increase/(Decrease) by Adjustment  This represents the current year’s amortization of the initial cost or proceeds.
Column 14	–	Gain (Loss) on Termination - Recognized  This represents gain (loss) on termination that is not deferred or used to adjust the basis of hedged items.
Column 15	–	Gain (Loss) on Termination - Used to Adjust Basis of Hedged Item  This represents the gain (loss) on termination that was used to adjust the basis of a hedged item in the current year.
Column 16	–	Gain (Loss) on Termination - Deferred  This represents the gain (loss) on termination that was deferred over yearend.  This equals consideration received less book value at termination.
Column 17	–	Other Investment/Miscellaneous Income  Include current year earned income on collars and swaps. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).

**SCHEDULE DB – PART D**  
**SECTIONS 1, 2 AND 3**

**GENERAL INSTRUCTIONS**

In each Section, separate derivative instruments into the following categories:

<u>Category</u>	<u>Line Number</u>
Long Futures:	
Hedging .....	0199999
Other .....	0399999
Subtotal – Long Futures .....	0499999
Short Futures:	
Hedging .....	0599999
Other .....	0799999
Subtotal – Short Futures .....	0899999
Insurance Futures Call Options:	
Hedging .....	1799999
Other .....	1999999
Subtotal – Insurance Futures Call Options .....	2099999
Insurance Futures Put Options:	
Hedging .....	2199999
Other .....	2399999
Subtotal – Insurance Futures Put Options .....	2499999
Totals:	
Subtotal – Hedging .....	2599999
Subtotal – Other .....	2799999
Total .....	9999999

At the end of each Section, list, in alphabetical sequence, brokers with whom cash deposits have been made.

Column 1 – Description

Give a complete and accurate description of the derivative instrument, including description of underlying securities, currencies, rates, indices, commodities, derivative instruments or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.

Column 2 – Number of Contracts

Show the number of contracts.

Column 3 – Maturity Date

Show the date of maturity.

**SCHEDULE DB – PART D – SECTION 1****FUTURES CONTRACTS AND INSURANCE FUTURES CONTRACTS OPEN  
DECEMBER 31 OF CURRENT YEAR**

- Columns 4 and 5 – Original Value & Current Value
- Column 4 (Original Value) and 5 (Current Value) –
- Represent the original or current value of open contracts even though this amount was not paid or received in cash. It equals (# of contracts) x (underlying value per contract) x (price per contract).
- Column 6 – Variation Margin
- On long contracts, it is the difference between Current Value minus Original Value (Column 5 – Column 4). On short contracts, it is the difference between Original Value minus Current Value (Column 4 – Column 5).
- Column 7 – Date of Opening Position
- Show the date of the original transaction. Summarize on one line and use the date of last transaction for instruments with the same exchange sign.
- Column 8 – Exchange or Counterparty
- Show the name of the exchange, Board of Trade, or contract market.
- Column 9 – Cash Deposit
- Show at the end of this section the amount of outstanding cash deposits at December 31, by broker, in alphabetical sequence.
- Column 10 – Variation Margin Information - Recognized
- This represents the variation margin recognized as an unrealized or realized gain (loss) or as investment income from inception of the contract.
- Column 11 – Variation Margin Information - Used to Adjust Basis of Hedged Item
- This represents the variation margin used to adjust the basis of a hedged item.
- Column 12 – Variation Margin Information - Deferred
- This represents the variation margin that has been deferred from inception of the contract.
- Column 13 – Potential Exposure
- Potential Exposure is a statistically derived measure of the potential increase in derivative instrument credit risk exposure, for derivative instruments which generally do not have an initial cost paid or consideration received, resulting from future fluctuations in the underlying interests upon which derivative instruments are based.
- For futures, the Potential Exposure = (Initial Margin per contract on the valuation date, set by the exchange on which contract trades) x (the number of contracts open on the valuation date).

**SCHEDULE DB – PART D – SECTION 2****FUTURES CONTRACTS AND INSURANCE FUTURES CONTRACTS OPENED  
DURING CURRENT YEAR**

- Column 4 – Original Value
- Original value represents the original value of the contracts purchased or sold even though this amount was not paid or received in cash. It equals (# of contracts) x (underlying value per contract) x (price per contract).
- Column 5 – Date of Opening Position
- Show the date of the original transaction. Companies may summarize on one line all identical instruments with the same exchange using the date of last transaction.
- Column 6 – Exchange or Counterparty
- Show the name of the exchange, Board of Trade, or contract market.
- Column 7 – Net Additions to Cash Deposits
- Show at the end of this section the net additions of cash deposits during the year, by broker, in alphabetical sequence.

**SCHEDULE DB – PART D – SECTION 3****FUTURES CONTRACTS AND INSURANCE FUTURES CONTRACTS TERMINATED  
DURING CURRENT YEAR**

- Column 4 and 5 – Original Value & Termination Value
- Column 4 (Original Value) and 5 (Termination Value) –
- Represent the original or termination value of terminated contracts even though this amount was not paid or received in cash. It equals (# of contracts) x (underlying value per contract) x (price per contract) less commission on terminated contracts.
- Column 6 – Variation Margin
- On long contracts it is the difference between Termination Value minus Original Value (Column 5 – Column 4). On short contracts it is the difference between Original Value minus Termination Value (Column 4 – Column 5).
- Column 7 – Date of Opening Position
- Show the date of the original transaction. Summarize on one line and use the date of last transaction for instruments with the same exchange sign.
- Column 8 – Exchange or Counterparty
- Show the name of the exchange, Board of Trade, or contract market.
- Column 9 – Net Reduction to Cash Deposits
- Show at the end of this section the net reductions of cash deposits during the year by broker, in alphabetical sequence.
- Column 10 – Termination Date
- Show the date in which the contract was terminated. Summarize on one line and use the date of last transaction for instruments with the same exchange sign, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement).
- Column 11 – Variation Margin Information – Gain (Loss) Recognized
- This represents the total variation margin that was recognized as realized or unrealized gain (loss), or as investment income from inception of the contract.
- Column 12 – Variation Margin Information – Gain (Loss) Used to Adjust Basis of Hedged Item
- This represents the variation margin that was used to adjust the basis of a hedged item. It includes the variation margin that was allocated to the purchase cost or sales proceeds when delivery was taken or made on the underlying items of the futures contract.
- Column 13 – Variation Margin Information – Gain (Loss) Deferred
- This represents the variation margin that was deferred over yearend.

**SCHEDULE DB – PART E – SECTION 1****COUNTERPARTY EXPOSURE FOR DERIVATIVE INSTRUMENTS OPEN  
DECEMBER 31 OF CURRENT YEAR**

Counterparty Exposure to any one counterparty is the exposure to credit risk associated with the use of derivative instruments with that counterparty. This part displays the statement value exposure and market value exposure to each counterparty, net of collateral. Also displayed is the total potential exposure for each counterparty for Schedule DB, Parts C and D.

On the first line, show the aggregate sum for exchange traded derivatives. On subsequent lines, show separately six groups of OTC (over-the-counter) derivative counterparties by SVO Rating. Within each group, list the counterparties in alphabetical order. For each counterparty with a master agreement, show on a second line, if applicable, totals for derivative instruments not covered by the master agreement, and use additional lines as needed if multiple master agreements with the counterparty exist that do not provide for netting of offsetting amounts by the insurer against the counterparty upon termination in the event that the counterparty defaults. Show subtotals for each group.

If an insurer has any detail lines reported for any of the following required groups, it shall report the subtotal amount of the corresponding group with the specified subtotal line number appearing in the same manner and location as the pre-printed total.

Aggregate Sum of Exchange Traded Derivatives.....	0199999
Total NAIC 1 Designation.....	0299999
Total NAIC 2 Designation.....	0399999
Total NAIC 3 Designation.....	0499999
Total NAIC 4 Designation.....	0599999
Total NAIC 5 Designation.....	0699999
Total NAIC 6 Designation.....	0799999
Total.....	0899999

Column 1 – Description Counterparty or Exchange Traded

On the first line, show the phrase: Exchange Traded. On subsequent lines, show the name of the counterparty.

Column 2 – Master Agreement (Yes or No)

Show XXX for the aggregate reporting of Exchange Traded derivatives. For OTC Counterparties, indicate yes if:

1. The insurer has a written International Swaps and Derivatives Association (ISDA) master agreement with the counterparty that provides for the netting of offsetting amounts by the insurer against the counterparty upon termination in the event that the counterparty defaults, or if such netting provisions of an ISDA master agreement are either incorporated by reference in transaction confirmations or are otherwise contractual provisions to which derivative instrument confirmations with the counterparty are subject, or if the insurer has a written non – ISDA master agreement with the counterparty that provides for the netting of offsetting amounts or the right of offset by the insurer against the counterparty upon termination in the event that the counterparty defaults; and
2. The domiciliary jurisdiction of such counterparty is either within the United States or if not within the United States, is within a foreign (non-United States) jurisdiction listed in the *Purposes and Procedures* Manual of the NAIC Securities Valuation Office as eligible for netting.

Column 3 – Fair Value of Acceptable Collateral

Leave blank for the aggregate reporting of Exchange Traded derivatives. For OTC Counterparties, show the market value of acceptable collateral pledged by the counterparty.

“Acceptable collateral” means cash, cash equivalents, securities issued or guaranteed by the United States or Canadian governments or their government-sponsored enterprises, letters of credit, publicly traded obligations rated 1 by the SVO, government money market mutual funds, and such other items as may be defined as acceptable collateral in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. For purposes of this definition, the term “letter of credit” means a clean, irrevocable and unconditional letter of credit issued or confirmed by, and payable and presentable at, a financial institution on the list of financial institutions meeting the standards for issuing such letter of credit published pursuant to the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. The letter of credit must have an expiration date beyond the term of the subject transaction.

Statement values that are debit balances on the balance sheet are positive numbers; those that are credit balances are negative numbers.

Column 4 – Contracts with Statement Value > 0 (i.e., debit balance on balance sheet)

On the first line, show the aggregate sum for exchange traded derivatives that have a positive statement value. For futures, this equals deferred variation margin losses (Part D, Section 1, Column 12); plus the sum of all cash deposits with brokers (Part D, Section 1, Column 9). On subsequent lines, show the sum of the statement values of all derivative instruments with the counterparty that have a positive statement value.

Column 5 – Contracts with Statement Value < 0 (i.e., credit balance on balance sheet)

On the first line, show the sum of the statement values in parentheses ( ) of all exchange traded derivatives that have a negative statement value. For Futures, this equals deferred variation margin gains (Part D, Section 1, Column 12). For written options, caps and floors on Part B, the positive statement values will be shown here in parentheses ( ). On subsequent lines, show the sum of the statement values in parentheses ( ) of all derivative instruments with the counterparty that have a negative statement value.

Column 6 – Exposure Net of Collateral

For the aggregate reporting of exchange traded derivatives, show amount in Column 4. For OTC Counterparties, if no master agreement is in place, show the sum of the statement values of all derivative instruments with the counterparty, which have a positive statement value, less any Acceptable Collateral (Column 4 – Column 3). If a master agreement is in place, show the net sum of the statement values of all derivative instruments with the counterparty, less any acceptable collateral (Column 4 + Column 5 – Column 3). This amount should not be less than zero.

Market values that would be debit balances on the balance sheet are positive numbers; those that would be credit balances are negative numbers.

Column 7 – Contracts With Fair Values > 0 (i.e., would be a debit balance on the balance sheet)

On the first line, show the sum of the market values of all exchange traded derivatives that have a positive market value. For futures, this equals the sum of all cash deposits with brokers (Part D, Section 1, Column 9). On subsequent lines, show the sum of the market values of all derivative instruments with the counterparty that have a positive market value.

- Column 8 – Contracts With Fair Values < 0 (i.e., would be a credit balance on the balance sheet)
- On the first line, show the sum of the market values in the parentheses ( ) of all exchange traded derivatives that have a negative market value. For futures this equals zero. For written options, caps and floors on Part B, the positive market values will be shown here in parentheses ( ). On subsequent lines, show the sum of the market values in parentheses ( ) of all derivative instruments with the counterparty that have a negative market value.
- Column 9 – Exposure Net of Collateral
- For the aggregate reporting of exchange traded derivatives, show amounts in Column 7. For OTC counterparties, if no master agreement is in place, show the sum of the market values of all derivative instruments with the counterparty which have a positive market value, less any acceptable collateral (Column 7 – Column 3). If a master agreement is in place, show the net sum of the market values of all derivative instruments with the counterparty, less any acceptable collateral (Column 7 + Column 8 – Column 3). This amount should not be less than zero.
- Column 10 – Potential Exposure
- Show the potential exposure for Parts C and D for exchange traded derivatives in aggregate and for each OTC counterparty.
- Column 11 – Off-Balance Sheet Exposure
- For Exchange Traded Derivatives, show Column 10.
- For OTC counterparties:
- If Column 2 = yes; show [Column 4 + Column 5 – Column 3 + Column 10] – Column 6 but not less than zero.
- If Column 2 = no; show Column 10.
- Optional: If there is no master netting agreement, companies may still encounter double counting in cases where a premium is received for an off balance sheet derivative transaction, such as an interest rate swap. In such cases, report “no” in Column 2 and calculate off balance sheet exposure on a contract-by-contract basis using the first formula.

ANNUAL STATEMENT FOR THE YEAR 2009 OF THE  
**SCHEDULE DB - PART A - SECTION 1**

Showing all Options, Caps, Floors and Insurance Futures Options Owned December 31 of Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry or Settlement	Strike Price, Rate or Index	Date of Acquisition	Exchange or Counterparty	Cost/Option Premium	Book Value		Statement Value	Fair Value	Increase/ (Decrease) by Adjustment	Used to Adjust Basis of Hedged Item	Other Investment/ Miscellaneous Income
2599999 Subtotal - Hedging Transactions								XXX					
2799999 Subtotal - Other Derivative Transactions								XXX					
9999999 Totals								XXX					

**SCHEDULE DB - PART A - SECTION 2**

Showing all Options, Caps, Floors and Insurance Futures Options Acquired During Current Year

1	2	3	4	5	6	7
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry or Settlement	Strike Price, Rate or Index	Date of Acquisition	Exchange or Counterparty	Cost/Option Premium
2599999 Subtotal - Hedging Transactions						
2799999 Subtotal - Other Derivative Transactions						
9999999 Totals						

E18

**ANNUAL STATEMENT FOR THE YEAR 2009 OF THE  
SCHEDULE DB - PART A - SECTION 3**

Showing all Owned Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry or Settlement	4 Strike Price, Rate or Index	5 Date of Acquisition	6 Exchange or Counterparty	7 Cost/Option Premium	8 Indicate Exercise, Expiration, Maturity or Sale	9 Termination Date	10 Book Value	11 *	12 Consideration Received on Terminations	13 Increase/ (Decrease) by Adjustment	14 Gain/(Loss) on Termination			17 Other Investment/ Miscellaneous Income	
													15 Recognized	16 Used to Adjust Basis of Hedged Item	17 Deferred		
2599999 Subtotal - Hedging Transactions							XXX	XXX		XXX							
2799999 Subtotal - Other Derivative Transactions							XXX	XXX		XXX							
9999999 Totals							XXX	XXX		XXX							

**SCHEDULE DB - PART B - SECTION 1**

Showing all Options, Caps, Floors and Insurance Futures Options Written and In-Force December 31 of Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry or Settlement	4 Strike Price, Rate or Index	5 Date of Issuance/ Purchase	6 Exchange or Counterparty	7 Consideration Received	8 Book Value	9 *	10 Statement Value	11 Fair Value	12 Increase/ (Decrease) by Adjustment	13 Used to Adjust Basis	14 Other Investment/ Miscellaneous Income
2599999 Subtotal - Hedging Transactions									XXX				
2699999 Subtotal - Income Generation Transactions									XXX				
2799999 Subtotal - Other Derivative Transactions									XXX				
9999999 Totals									XXX				

E19

**ANNUAL STATEMENT FOR THE YEAR 2009 OF THE  
SCHEDULE DB - PART B - SECTION 2**

Showing all Options, Caps, Floors and Insurance Futures Options Written During Current Year

1	2	3	4	5	6	7
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry or Settlement	Strike Price, Rate or Index	Date of Issuance/Purchase	Exchange or Counterparty	Consideration Received
2599999 Subtotal - Hedging Transactions						
2699999 Subtotal - Income Generation Transactions						
2799999 Subtotal - Other Derivative Transactions						
9999999 Totals						

**SCHEDULE DB - PART B - SECTION 3**

Showing all Written Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	Gain/(Loss) on Termination			17
													14	15	16	
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry or Settlement	Strike Price, Rate or Index	Date of Issuance/Purchase	Exchange or Counterparty	Consideration Received	Indicate Exercise, Expiration, Maturity or Closing Purchase Transaction	Termination Date	Book Value	Consideration Paid on Terminations	Increase/(Decrease) by Adjustment	Recognized	Used to Adjust Basis	Deferred	Other Investment/Miscellaneous Income	
2599999 Subtotal - Hedging Transactions																
2699999 Subtotal - Income Generation Transactions							XXX	XXX		XXX						
2799999 Subtotal - Other Derivative Transactions							XXX	XXX		XXX						
9999999 Totals							XXX	XXX		XXX						

E20

**ANNUAL STATEMENT FOR THE YEAR 2009 OF THE  
SCHEDULE DB - PART C - SECTION 1**

Showing all Collar, Swap and Forwards Open December 31 of Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Description	Notional Amount	Date of Maturity, Expiry or Settlement	Strike Price, Rate or Index Rec (Pay)	Date of Opening Position or Agreement	Exchange or Counterparty	Cost or (Consideration Received)	Book Value		Statement Value	Fair Value	Increase/ (Decrease) by Adjustment	Used to Adjust Basis of Hedged Item	Other Investment/ Miscellaneous Income	Potential Exposure
2599999 Subtotal - Hedging Transactions								XXX						
2799999 Subtotal - Other Derivative Transactions								XXX						
9999999 Totals								XXX						

**SCHEDULE DB - PART C - SECTION 2**

Showing all Collar, Swap and Forwards Opened During Current Year

1	2	3	4	5	6	7
Description	Notional Amount	Date of Maturity, Expiry or Settlement	Strike Price, Rate or Index Rec (Pay)	Date of Opening Position or Agreement	Exchange or Counterparty	Cost or (Consideration Received)
2599999 Subtotal - Hedging Transactions						
2799999 Subtotal - Other Derivative Transactions						
9999999 Totals						

EN1

**ANNUAL STATEMENT FOR THE YEAR 2009 OF THE  
SCHEDULE DB - PART C - SECTION 3**

Showing all Collar, Swap and Forwards Terminated During Current Year

1 Description	2 Notional Amount	3 Date of Maturity, Expiry or Settlement	4 Strike Price, Rate or Index Rec (Pay)	5 Date of Opening Position or Agreement	6 Exchange or Counterparty	7 Cost or (Consideration Received)	8 Indicate Exercise, Expiration, Maturity or Sale	9 Termination Date	10 Book Value	11 *	12 Consideration Received or (Paid) on Terminations	13 Increase/ (Decrease) by Adjustment	Gain/(Loss) on Termination			17 Other Investment/ Miscellaneous Income
													14 Recognized	15 Used to Adjust Basis of Hedged Item	16 Deferred	
2599999 Subtotal - Hedging Transactions																
2799999 Subtotal - Other Derivative Transactions																
9999999 Totals													XXX	XXX	XXX	
													XXX	XXX	XXX	
													XXX	XXX	XXX	

**SCHEDULE DB - PART D - SECTION 1**

Showing all Futures Contracts and Insurance Futures Contracts Open December 31 of Current Year

1 Description	2 Number of Contracts	3 Maturity Date	4 Original Value	5 Current Value	6 Variation Margin	7 Date of Opening Position	8 Exchange or Counterparty	9 Cash Deposit	Variation Margin Information			13 Potential Exposure
									10 Recognized	11 Used to Adjust Basis of Hedged Item	12 Deferred	
2599999 Subtotal - Hedging Transactions												
2799999 Subtotal - Other Derivative Transactions												
9999999 Totals												
							XXX	XXX				
							XXX	XXX				
							XXX	XXX				

E22

**ANNUAL STATEMENT FOR THE YEAR 2009 OF THE  
SCHEDULE DB - PART D - SECTION 2**

Showing all Futures Contracts and Insurance Futures Contracts Opened During Current Year

1	2	3	4	5	6	7
Description	Number of Contracts	Maturity Date	Original Value	Date of Opening Position	Exchange or Counterparty	Net Additions to Cash Deposits
2599999 Subtotal - Hedging Transactions				XXX	XXX	
2799999 Subtotal - Other Derivative Transactions				XXX	XXX	
9999999 Totals				XXX	XXX	

**SCHEDULE DB - PART D - SECTION 3**

Showing all Futures Contracts and Insurance Futures Contracts Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	Variation Margin Information		
										11	12	13
Description	Number of Contracts	Maturity Date	Original Value	Termination Value	Variation Margin	Date of Opening Position	Exchange or Counterparty	Net Reduction to Cash Deposits	Termination Date	Gain (Loss) Recognized	Gain (Loss) Used to Adjust Basis of Hedged Item	Gain (Loss) Deferred
2599999 Subtotal - Hedging Transactions						XXX	XXX		XXX			
2799999 Subtotal - Other Derivative Transactions						XXX	XXX		XXX			
9999999 Totals						XXX	XXX		XXX			

E23

# Appendix D

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# Examiners Handbook



*National Association of Insurance Commissioners*

# Financial Condition

	Exam Obj.	Identified Risk	Examiner/ Completion Date	Work Paper Ref.
15.	Scan the cash receipts/disbursements journal and bank statements for unusual debits or credits.			
16.	Test whether account balances and disclosures comply with the NAIC <i>Accounting Practices and Procedures Manual</i> and <i>Annual Statement Instructions</i> .			
17.	Review the Notes to the Financial Statements and General Interrogatories and evaluate the completeness of information.			
18.	Consider the reasonableness of accrued interest and interest received during the year based on prior years.			
19.	Select a sample of interest payments included on the bank statements. Trace those amounts to the cash receipts journal.			
20.	Trace the total accrued interest to the detailed investment income exhibit and balance sheet.			
21.	Trace the total interest received to the detailed investment income exhibit.			
22.	Ensure that the net amounts of all cash accounts are reported jointly. If in the aggregate the insurer has a net negative cash balance, ensure that the amount is reported as a negative asset and not recorded as a liability, in accordance with SSAP No. 2, paragraph 5.			
<p><u>Aggregate Write-ins for Invested Assets / Liabilities (Derivative Instruments)</u> ← <b>Elements of NAIC Financial Examiners Handbook Regarding Derivatives Start Here</b></p>				
1.	Review available independent audit reports and management letters for evidence of inappropriate hedge accounting practices.			
2.	Obtain contracts that the insurer has entered into and agree them to the documentation provided in the insurer's records and Schedule DB.			



	Exam Obj.	Identified Risk	Examiner/Completion Date	Work Paper Ref.
9.	Verify that the insurer has properly documented derivative instruments opened during the year, derivative instruments terminated, expired or exercised during the year and derivative instruments open at quarter-end in accordance with SSAP No. 86, paragraphs 34-36.			
10.	Select a sample of transactions and test whether all significant terms (e.g., maturity, expiration or settlement date, contractual payments, purchase and sale price) were specified and documented, and whether the amounts and terms are consistent with those established by the insurer's hedging techniques.	CO AC		
11.	Select a sample of values from Schedule DB and trace to appropriate source documents.	CO AC		
12.	Test transactions settled after year-end for recording in the proper period.	CT		
13.	Verify that disclosure requirements for derivative contracts in accordance with SSAP 86, paragraph 53 have been met.	PD		
<b><u>Other Invested Assets</u></b>				
1.	Review investment committee minutes and determine whether investment transactions have been properly authorized.	EX		
2.	Review available independent audit reports and management letters for joint ventures, partnerships and limited liability companies in which the insurer has an interest.	AC		
3.	Make inquiries to ascertain any conflicts of interest or improprieties affecting the directors, officers or employees of the company. (Review conflict of interest statements.)	CM		

# Appendix E

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COLLOQUY  
Collateralized Investments  
Sen. Lincoln and Sen. Hagan

July 15, 2010

Ms. HAGAN. Mr. President, I would like to engage Senator Lincoln, Chairman of the Agriculture, Nutrition and Forestry Committee, in a colloquy.

Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, which Chairman Lincoln was the primary architect of, creates a new regulatory framework for the over-the-counter derivatives market. It will require a significant portion of derivatives trades to be cleared through a centralized clearinghouse and traded on an exchange, and it will also increase reporting and capital and margin requirements on significant players in the market. The new regulatory framework will help improve transparency and disclosure within the derivatives market for the benefit of all investors.

Under the bill, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) are instructed to further define the terms ‘major swap participant’ and ‘major security-based swap participant.’ The definitions of major swap participant and major security-based swap participant included in the bill require the CFTC and the SEC to determine whether a person dealing in swaps maintains a ‘substantial position’ in swaps, as well as whether such outstanding swaps create ‘substantial counterparty exposure’ that could have ‘serious adverse effects on the financial stability of the United States banking system or financial markets.’ The definition also encompasses ‘financial entities’ who are highly leveraged relative to the amount of capital it holds, are not already subject to capital requirements set by a federal banking regulator and maintain a substantial position in outstanding swaps.

I understand when the CFTC and SEC are making the determination as to whether a person dealing in swaps is a major swap participant or major security-based swap participant, it is the intent of the Conference Committee that both the CFTC and the SEC focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions. Is this correct?

Mrs. LINCOLN. Yes. My good friend from North Carolina is correct. We made some important changes during the Conference with respect to the “major swap participant” and “major security-based swap participant” definitions. When determining whether a person has a “substantial position” the CFTC and the SEC should consider the

person's relative position in cleared versus the uncleared swaps and may take into account the value and quality of the collateral held against counterparty exposures. The Committee wanted to make it clear that the regulators should distinguish between cleared and uncleared swap positions when defining what a "substantial position" would be. Similarly where a person has uncleared swaps, the regulators should consider the value and quality of such collateral when defining "substantial position." Bilateral collateralization and proper segregation substantially reduces the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently.

In addition, it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or a major security-based swap participant. For instance, entities such as registered investment companies and employee benefit plans are already subject to extensive regulation relating to their usage of swaps under other titles of the U.S. Code. They typically post collateral, are not overly leveraged and may not pose the same types of risks as unregulated major swap participants.

Ms. HAGAN. Thank you. If I may, I have one additional question. When considering whether an entity maintains a substantial position in swaps, should the CFTC and the SEC look at the aggregate positions of funds managed by asset managers or at the individual fund level?

Mrs. LINCOLN. As a general rule, the CFTC and the SEC should look at each entity on an individual basis when determining its status as a major swap participant.

interest because they exist predominantly to enable gambling through supposed “event contracts.” It would be quite easy to construct an “event contract” around sporting events such as the Super Bowl, the Kentucky Derby, and Masters Golf Tournament. These types of contracts would not serve any real commercial purpose. Rather, they would be used solely for gambling.

Mrs. FEINSTEIN. And does the Senator agree that this provision will also empower the Commission to prevent trading in contracts that may serve a limited commercial function but threaten the public good by allowing some to profit from events that threaten our national security?

Mrs. LINCOLN. I do. National security threats, such as a terrorist attack, war, or hijacking pose a real commercial risk to many businesses in America, but a futures contract that allowed people to hedge that risk would also involve betting on the likelihood of events that threaten our national security. That would be contrary to the public interest.

Mrs. FEINSTEIN. I thank the Senator for including this provision. No one should profit by speculating on the likelihood of a terrorist attack. Firms facing financial risk posed by threats to our national security may take out insurance, but they should not buy a derivative. A futures market is for hedging. It is not an insurance market.

#### COLLATERALIZED INVESTMENTS

Mrs. HAGAN. Mr. President, I would like to engage Senator LINCOLN, chairman of the Agriculture, Nutrition and Forestry Committee, in a colloquy.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which Chairman LINCOLN was the primary architect of, creates a new regulatory framework for the over-the-counter derivatives market. It will require a significant portion of derivatives trades to be cleared through a centralized clearinghouse and traded on an exchange, and it will also increase reporting and capital and margin requirements on significant players in the market. The new regulatory framework will help improve transparency and disclosure within the derivatives market for the benefit of all investors.

Under the bill, the Commodity Futures Trading Commission, CFTC, and the Securities and Exchange Commission, SEC, are instructed to further define the terms “major swap participant” and “major security-based swap participant.” The definitions of major swap participant and major security-based swap participant included in the bill require the CFTC and the SEC to determine whether a person dealing in swaps maintains a “substantial position” in swaps, as well as whether such outstanding swaps create “substantial counterparty exposure” that could have “serious adverse effects on the financial stability of the United States banking system or financial markets.”

The definition also encompasses “financial entities” that are highly leveraged relative to the amount of capital it holds, are not already subject to capital requirements set by a Federal banking regulator, and maintain a substantial position in outstanding swaps.

I understand when the CFTC and SEC are making the determination as to whether a person dealing in swaps is a major swap participant or major security-based swap participant, it is the intent of the conference committee that both the CFTC and the SEC focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions. Is this correct?

Mrs. LINCOLN. Yes. My good friend from North Carolina is correct. We made some important changes during the conference with respect to the “major swap participant” and “major security-based swap participant” definitions. When determining whether a person has a “substantial position,” the CFTC and the SEC should consider the person’s relative position in cleared versus the uncleared swaps and may take into account the value and quality of the collateral held against counterparty exposures. The committee wanted to make it clear that the regulators should distinguish between cleared and uncleared swap positions when defining what a “substantial position” would be. Similarly where a person has uncleared swaps, the regulators should consider the value and quality of such collateral when defining “substantial position.” Bilateral collateralization and proper segregation substantially reduces the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently.

In addition, it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or a major security-based swap participant. For instance, entities such as registered investment companies and employee benefit plans are already subject to extensive regulation relating to their usage of swaps under other titles of the U.S. Code. They typically post collateral, are not overly leveraged, and may not pose the same types of risks as unregulated major swap participants.

Mrs. HAGAN. I thank the Senator. If I may, I have one additional question. When considering whether an entity maintains a substantial position in swaps, should the CFTC and the SEC look at the aggregate positions of funds managed by asset managers or at the individual fund level?

Mrs. LINCOLN. As a general rule, the CFTC and the SEC should look at each entity on an individual basis when de-

termining its status as a major swap participant.

#### SWAP DEALER PROVISIONS

Ms. COLLINS. Mr. President, I rise today as a supporter of the Wall Street Transparency and Accountability Act, but also as one who has concerns over how the derivatives title of the bill will be implemented. I applaud the chairman of the Senate Banking Committee for his work on the underlying bill. At the same time, I am concerned that some of the provisions in the derivatives title will harm U.S. businesses unnecessarily.

I would like to engage the chairman of the Senate Banking Committee in a colloquy that addresses an important issue. The Wall Street Transparency and Accountability Act will regulate “swap dealers” for the first time by subjecting them to new clearing, capital and margin requirements. “Swap dealers” are banks and other financial institutions that hold themselves out to the derivatives market and are known as dealers or market makers in swaps. The definition of a swap dealer in the bill includes an entity that “regularly enters into swaps with counterparties as an ordinary course of business for its own account.” It is possible the definition could be read broadly and include end users that execute swaps through an affiliate. I want to make clear that it is not Congress’ intention to capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates.

I would ask the distinguished chairman whether he agrees that end users that execute swaps through an affiliate should not be deemed to be “swap dealers” under the bill just because they hedge their risks through affiliates.

Mr. DODD. I do agree and thank my colleague for raising another important point of clarification. I believe the bill is clear that an end user does not become a swap dealer by virtue of using an affiliate to hedge its own commercial risk. Senator COLLINS has been a champion for end users and it is a pleasure working with her.

Mr. McCAIN. Mr. President, we are poised to pass what some have termed a “sweeping overhaul” of our Nation’s financial regulatory system. Unfortunately, this legislation does little, if anything—to tackle the tough problems facing the financial sector, nor does it institute real, meaningful and comprehensive reform. This bill is simply an abysmal failure and serves as yet another example of Congress’s inability to make the choices necessary to bring our country back into economic prosperity.

What this bill does represent is a guarantee of future bailouts. In a recent Wall Street Journal op-ed titled “The Dodd-Frank Financial Fiasco,” John Taylor—a professor of economics at Stanford and a senior fellow at the Hoover Institution—wrote:

The sheer complexity of the 2,319-page Dodd-Frank financial reform bill is certainly

# Appendix F

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July 15, 2010

## COLLOQUY

End Users

Senator Dodd and Senator Lincoln

Mr. DODD: I yield to my colleague, the gentlewoman from Arkansas, Mrs. Lincoln, the Chairman of the Committee on Agriculture, Nutrition, and Forestry.

Mrs. LINCOLN. Thank you Chairman Dodd. Mr. President, I would like to enter into the record a letter that Chairman Dodd and I wrote to Chairmen Frank and Peterson during House consideration of this Conference Report regarding the derivatives title. The letter emphasizes Congressional intent regarding commercial end users who enter into swaps contracts.

As we point out, it is clear in this legislation that the regulators only have the authority to set capital and margin requirements on Swap Dealers and Major Swap Participants for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing.

As the letter also makes clear, it is our intent that the any margin required by the regulators will be risk-based, keeping with the standards we have put into the bill regarding capital. It is in the interest of the financial system and end user counterparties that Swap Dealers and Major Swap Participants are sufficiently capitalized. At the same time, Congress did not mandate that regulators set a specific margin level. Instead, we granted a broad authority to the regulators to set margin. Again, margin and capital standards must be risk-based and not be punitive.

It is also important to note that few end users will be major swap participants, as we have excluded "positions held for hedging or mitigating commercial risk" from being considered as a "substantial position" under that definition. I would ask Chairman Dodd whether he concurs with my view of the bill.

Mr. DODD. I agree with the Chairman's assessment. There is no authority to set margin on end users, only Major Swap Participants and Swap Dealers. It is also the intent of this bill to distinguish between commercial end users hedging their risk and larger, riskier market participants. Regulators should distinguish between these types of companies when implementing new regulatory requirements.

to the insured depository institution's activities, acting as a swaps entity for swaps or security-based swaps that are permissible for investment, and acting as a swaps entity for cleared credit default swaps. U.S. branches and agencies of foreign banks should, and are willing to, meet the push out requirements of section 716 as if they were insured depository institutions.

This oversight on our part is unfortunate and clearly unintended. Does my colleague agree with me about the need to include uninsured U.S. branches and agencies of foreign banks in the safe harbor of section 716?

Mr. DODD. Mr. President, I agree completely with Senator LINCOLN's analysis and with the need to address this issue to ensure that uninsured U.S. branches and agencies of foreign banks are treated the same as insured depository institutions under the provisions of section 716, including the safe harbor language.

## END USERS

Mrs. LINCOLN. Mr. President, I will ask unanimous consent to have printed in the RECORD a letter that Chairman DODD and I wrote to Chairmen FRANK and PETERSON during House consideration of this Conference Report regarding the derivatives title. The letter emphasizes congressional intent regarding commercial end users who enter into swaps contracts.

As we point out, it is clear in this legislation that the regulators only have the authority to set capital and margin requirements on swap dealers and major swap participants for uncleared swaps, not on end users who qualify for the exemption from mandatory clearing.

As the letter also makes clear, it is our intent that the any margin required by the regulators will be risk-based, keeping with the standards we have put into the bill regarding capital. It is in the interest of the financial system and end user counterparties that swap dealers and major swap participants are sufficiently capitalized. At the same time, Congress did not mandate that regulators set a specific margin level. Instead, we granted a broad authority to the regulators to set margin. Again, margin and capital standards must be risk-based and not be punitive.

It is also important to note that few end users will be major swap participants, as we have excluded "positions held for hedging or mitigating commercial risk" from being considered as a "substantial position" under that definition. I would ask Chairman DODD whether he concurs with my view of the bill.

Mr. DODD. I agree with the Chairman's assessment. There is no authority to set margin on end users, only major swap participants and swap dealers. It is also the intent of this bill to distinguish between commercial end users hedging their risk and larger, riskier market participants. Regulators should distinguish between these

types of companies when implementing new regulatory requirements.

Mrs. LINCOLN. Mr. President, I ask unanimous consent to have printed in the RECORD the letter that Chairman DODD and I wrote to Chairmen FRANK and PETERSON to which I referred.

## INVESTMENT ADVISER

Mrs. LINCOLN. Mr. President, I rise to discuss section 409 of the Dodd-Frank bill, which excludes family offices from the definition of investment adviser under the Investment Advisers Act. In section 409, the SEC is directed to define the term family offices and to provide exemptions that recognize the range of organizational, management, and employment structures and arrangement employed by family offices, and I thought it would be worthwhile to provide guidance on this provision.

For many decades, family offices have managed money for members of individual families, and they do not pose systemic risk or any other regulatory issues. The SEC has provided exemptive relief to some family offices in the past, but many family offices have simply relied on the "under 15 clients" exception to the Investment Advisers Act, and when Congress eliminated this exception, it was not our intent to include family offices in the bill.

The bill provides specific direction for the SEC in its rulemaking to recognize that most family offices often have officers, directors, and employees who may not be family members, and who are employed by the family office itself or affiliated entities owned, directly or indirectly, by the family members. Often, such persons co-invest with family members, which enable those persons to share in the profits of investments they oversee and better align the interests of those persons with those of the family members served by the family office. In addition, family offices may have a small number of co-investors such as persons who help identify investment opportunities, provide professional advice, or manage portfolio companies. However, the value of investments by such other persons should not exceed a de minimis percentage of the total value of the assets managed by the family office. Accordingly, section 409 directs the SEC not to exclude a family office from the definition by reason of its providing investment advice to these persons.

Mr. DODD. I thank the Senator. Pursuant to negotiations during the conference committee, it was my desire that the SEC write rules to exempt certain family offices already in operation from the definition of investment adviser, regardless of whether they had previously received an SEC exemptive order. It was my intent that the rule would: exempt family offices, provided that they operated in a manner consistent with the previous exemptive policy of the Commission as reflected in exemptive orders for family offices in effect on the date of enactment of the Dodd-Frank Act; reflect a recognition of the range of organizational,

management and employment structures and arrangements employed by family offices; and not exclude any person who was not registered or required to be registered under the Advisers Act from the definition of the term "family office" solely because such person provides investment advice to natural persons who, at the time of their applicable investment, are officers, directors or employees of the family office who have previously invested with the family office and are accredited investors, any company owned exclusively by such officers, directors or employees or their successors-in-interest and controlled by the family office, or any other natural persons who identify investment opportunities to the family office and invest in such transactions on substantially the same terms as the family office invests, but do not invest in other funds advised by the family office, and whose assets to which the family office provides investment advice represent, in the aggregate, not more than 5 percent of the total assets as to which the family office provides investment advice.

Mrs. LINCOLN. I appreciate the Senator's explanation and ask that the Senator work with me to make this point in a technical corrections bill.

Mr. DODD. I agree that this position should be raised in a corrections bill and I look forward to working with the Senator towards this goal on this point.

Mrs. LINCOLN. I thank the Senator for his leadership and his assistance and cooperation in ensuring the passage of this important bill.

## VOLCKER RULE

Mrs. BOXER. Mr. President, I wish to ask my good friend, the Senator from Connecticut and the chairman of the Banking Committee, to engage in a brief discussion relating to the final Volcker rule and the role of venture capital in creating jobs and growing companies.

I strongly support the Dodd-Frank Wall Street Reform and Consumer Protection Act, including a strong and effective Volcker rule, which is found in section 619 of the legislation.

I know the chairman recognizes, as we all do, the crucial and unique role that venture capital plays in spurring innovation, creating jobs and growing companies. I also know the authors of this bill do not intend the Volcker rule to cut off sources of capital for America's technology startups, particularly in this difficult economy. Section 619 explicitly exempts small business investment companies from the rule, and because these companies often provide venture capital investment, I believe the intent of the rule is not to harm venture capital investment.

Is my understanding correct?

Mr. DODD. Mr. President, I thank my friend, the Senator from California, for her support and for all the work we have done together on this important issue. Her understanding is correct.