September 26, 2011

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Re: Study of Stable Value Contracts (Release No. 34-65153; File No. S7-32-11)

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to comment on the study of stable value contracts ("**SVCs**")[2] being conducted by the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**," and together with the CFTC, the "**Commissions**"). Section 719(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") requires that the Commissions complete a study by October 21, 2011 to determine whether SVCs fall within the

[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, plans subject to the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**") and state and local government pension funds, many of whom invest in commodity futures, options, and swaps as part of their respective investment strategies.

[2] Dodd-Frank defines an SVC as "any contract, agreement or transaction that provides a crediting interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity offered by a bank, insurance company, or other State or federally regulated financial institution for the benefit of any individual or commingled fund available as an investment in an employee benefit plan (as defined in section 3(3) of the Employee Retirement Income Security Act of 1974, including plans described in section 3(32) of such Act) subject to participant direction, an eligible deferred compensation plan (as defined in section 457(b) of the Internal Revenue Code of 1986) that is maintained by an eligible employer described in section 457(e)(1)(A) of such Code, an arrangement described in section 403(b) of such Code, or a qualified tuition program (as defined in section 529 of such Code)." Section 719(d)(2) of Dodd-Frank.

definition of "swap" under Title VII of Dodd-Frank and, if so, whether SVCs should be exempted from that definition in the public interest.[3]

AMG members have significant experience with SVCs. Many AMG members advise stable value funds ("**SVFs**"),[4] which purchase SVC "wraps" from banks and insurance companies ("**wrap providers**"). SVFs are a popular, conservative investment for many retirement plans because they provide capital preservation and liquidity similar to money market funds, but typically at higher yields. SVFs are a $540 billion market and are available in over 127,000 defined contribution retirement savings plans.[5] They "are included in half of all 401(k) plans,"[6] and represent 10% to 13% of all defined contribution plan assets.[7]

As discussed in greater detail below, the AMG believes that the statutory exclusion for options from the definition of swap, as well as the unique characteristics of SVCs, place them outside the definition of "swap" and "security-based swap." If, however, the Commissions find that SVCs are within those definitions, the AMG believes that the Commissions should exercise their authority to exempt SVCs from regulation under Title VII for the following reasons:

- SVCs do not present the type of systemic risk that Title VII is intended to mitigate;
- SVCs are not suitable for mandatory clearing or exchange trading;
- SVC trade reporting is unlikely to be informative to the Commissions or the marketplace;

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[3] Section 719(d)(1) of Dodd-Frank.

[4] Unless otherwise stated, references to SVCs refer to synthetic GICs (as defined below).

[5] Stable Value Investment Association, 15th Annual Stable Value Funds' Investment and Policy Survey covering $540 billion in assets as of Dec. 31, 2010.

[6] Investment Company Institute Research Perspective, 401(k) Plan Asset, Allocation Account, Balance and Loan Activity in 2008, Oct. 2009, Vol. 15, No. 3.

[7] Independent Directors' Council on Retirement Assets as of First Quarter 2011 (finding SVFs hold 10% of all defined contribution plan assets); Investment Company Institute Research Perspective, 401(k) Plan Asset, Allocation Account, Balance and Loan Activity in 2008, Oct. 2009, Vol. 15, No. 3 (finding SVFs hold 13% of all defined contribution plan assets).

- if SVCs were treated as swaps, wrap providers may be considered to be fiduciaries under Department of Labor ("**DOL**") regulations, causing SVCs to be prohibited for plans subject to ERISA; and

- while swap regulation of SVCs is unlikely to provide significant benefits, it would be costly for retirees and other groups that Dodd-Frank seeks to protect.

Overview of Stable Value Contracts

SVFs were introduced in the 1970s with the advent of defined contribution plans. In their first incarnation, SVFs consisted of a portfolio of guaranteed investment contracts issued by insurance companies ("**GICs**") and banks ("**BICs**," and together with GICs, "**traditional GICs**"). In traditional GICs, the underlying assets are owned by the insurance company or bank, rather than by the plan itself, and the plan is paid a guaranteed rate of return regardless of the performance of the underlying assets.

Because a traditional GIC is the direct obligation of the issuing insurance company or bank, it exposes the plan to significant risk of loss if the insurance company or bank becomes insolvent. This potential credit exposure led to the creation of "**separate-account GICs**," in which the assets backing the traditional GIC continue to be owned by the insurance company or bank, but are held in a separate account for the benefit of the plan and its participants. Instead of a guaranteed rate of return, separate-account GICs provide payouts at a fixed rate, indexed rate or a rate reset periodically based on actual performance. Custody and ownership of the asset portfolio remain with the insurance company or bank. If the insurance company or bank fails, there may be an extended delay in getting the separate account paid out, resulting in significant potential opportunity cost because the plan is unable to immediately reinvest the funds.

With the savings and loan crisis of the late 1980s and growing concerns about the solvency of insurance companies and banks generally, plan sponsors sought even more protection from insurance companies' and banks' credit risk in "**synthetic GICs**." Synthetic GICs typically consist of high quality diversified portfolios of fixed income investments directly held by the plan or a trust on behalf of the plan and wrap contracts issued by an insurance company or bank. In exchange for a fee, the "wrap" contract—the SVC—guarantees the underlying portfolio's book value to the extent needed to fund participant-initiated redemptions (*i.e.*, after the SVF's market value has been exhausted). The "book value" of the SVF refers to the principal invested *plus* accumulated interest. Any market value gains or losses in the portfolio are amortized over a multi-year period, usually the time-to-maturity or duration of the portfolio being wrapped, and the crediting rate is adjusted periodically (typically monthly) by this amortized gain or loss. During the life of the SVC, wrap providers reduce the risk of an early mass participant exodus—which, by reducing the market value available to pay participant-initiated withdrawals, increases the likelihood that the wrap provider will have to make a payment—using "equity wash" and "employer-initiated event" provisions. Equity wash provisions prevent participants from arbitraging between SVFs and other fixed income, low-volatility funds by requiring that plan participants wait approximately 90 days before reinvesting redemption proceeds in "competing funds" (*i.e.*, a money market fund or a short-term bond fund).[8] Employer-initiated events that may cause withdrawals *en masse* from the SVF are either not covered or receive limited coverage by most SVCs. Both equity wash and employer-initiated event provisions also allow synthetic GICs to have a longer average maturity than typical money market funds (generally three years rather than 30-60 days), which leads to higher returns over time.[9]

Using SVCs, plan managers seek to provide stability of principal and a relatively smooth yield to investors over time, even as interest rates fluctuate. Thus, SVFs are popular investments for risk-averse participants in defined contribution plans.

Options are excluded from the statutory definition of swap and SVCs are the economic equivalent of put options.

Virtually all SVCs are specifically exempt from the definition of swap under the statutory language itself. SVCs are merely a guaranty that the value of a portfolio of securities—which portfolio may be fixed at the contract's inception or actively managed over its duration—does not fall below book value at maturity

[8] Without equity wash provisions, plan participants would be able to withdraw funds from SVFs in rising interest rate environments, thereby avoiding having to participate in the SVF's losses.

[9] MetLife, *Stable Value Study: A Survey of Plan Sponsors and Stable Value Fund Providers*, April 2010, 4, available at http://stablevalue.org/wp-content/uploads/2009/06/MetLife-Stable-Value-Study1.pdf (the "**MetLife Study**") ("On average, stable value returns range from 140% to 160% of those of money market funds, with average returns for stable value and money market over the past 10 years through 2008 of 4.7% and 2.9%, respectively; for 2008, the figures were 4.7% and 2.0%, respectively.").

of the contract. That guaranty essentially is a cash-settled put option on a basket of securities. On maturity of the contract (or at certain other times), the wrap provider may have to make payments equal to the excess, if any, of the portfolio's book value over its market value. The term "swap" excludes "(iii) any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to—(I) the Securities Act of 1933 (15 U.S.C. 77a et seq.); and (II) the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.)."[10] For this reason, the AMG believes that SVCs should be excluded from the definition of swap by virtue of the statutory exclusion for options.

The unique characteristics of SVCs place them outside the swap definitions.

The AMG believes that SVCs are distinguishable from swaps in that they are highly customized, unleveraged, non-speculative instruments individually designed to meet the specific needs of a particular investment portfolio of an SVF. Each SVF has unique investment strategies, relevant benchmarks and cash flow history, and the SVC written for a particular SVF will provide terms and conditions for contract payments (including adjustments to book value, if any), termination conditions, reporting requirements and explicit investment guidelines for the underlying portfolio, including minimum credit quality, concentration limits and leverage prohibitions, all specifically tailored to that particular SVF.[11]

A useful analogy can be found in the Commissions' treatment of insurance products in their proposed further definitions of "swap" and "security-based swap."[12] The Commissions' proposed rules would clarify that contracts issued by certain regulated insurance companies are not swaps or security-based

[10] Section 721 of Dodd-Frank.

[11] During the initial underwriting process, wrap providers review plan demographics (*e.g.*, age and employment status (active, inactive/retired) of participants), the underlying fund's cash flow history, the structure of the underlying fund, the underlying fund manager's proposed investment strategy and benchmark, investment options available to plan participants, and the presence or absence of competing funds and equity wash provisions. Wrap providers also evaluate the plan sponsor (*e.g.*, credit rating, financial health, business prospects) and the state of the plan sponsor's industry.

[12] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Proposing Release, Release No. 33-9204, 34-64372, 76 Fed. Reg. 29,818, 29,821 (May 23, 2011) (the "**Product Definitions Proposing Release**").

swaps if they meet certain transactional and issuer requirements. The transactional requirements state that the contract must: (i) require the beneficiary to have an insurable interest that is the subject of the contract and thereby carry the risk of loss with respect to that interest continuously throughout the duration of the contract; (ii) require a loss to occur and be proved and that any payment therefor be limited to the value of the interest; and (iii) not be traded separately from the interest.[13]

SVCs share these transactional traits with insurance contracts. By being tied to the SVF's investment portfolio and investor base, SVCs effectively require the SVF to have the equivalent of an insurable interest. By only requiring payout if the SVF experiences participant-initiated redemptions at a time when the SVF's book value exceeds its market value, SVCs are tied to the performance of the underlying investment portfolio of the SVF. Finally, SVCs do not trade separately from the SVF. They are not traded on exchanges or over-the-counter; rather, the SVC is tied to the SVF to which it is issued. In fact, many SVCs contain provisions that, though developed for other purposes, have the effect of further limiting transfers that could plausibly be seen as altering the parties to the SVC where they constitute "employer-initiated events." If an "employer-initiated event" occurs, the plan participants may lose their entitlement to receive book value from the wrap provider.

In addition to these transactional criteria, proposed Rule 1.3(xxx)(4)(ii) under the CEA and proposed Rule 3a69-1(b) under the Exchange Act require that the contracts be issued by certain regulated insurance companies to qualify for the insurance exemption from the definitions of "swap" and "security-based swap." Therefore, the AMG believes that, while SVCs issued by regulated insurance companies would be subject to the insurance exemption, those issued by banks or other financial institutions would not, and so a separate finding that all SVCs are excluded from the swap definitions is appropriate and necessary.

Even if the Commissions determine that SVCs fit within the swap definitions, SVCs should not be regulated as swaps.

SVCs do not present the type of systemic risk that Title VII is intended to mitigate. Instead, SVCs are structured to minimize exposure to the issuing company. In typical SVC structures the investment portfolio that is the subject of the SVC is owned by the SVF, thereby significantly mitigating any credit

[13] Product Definitions Proposing Release at 29,888 (adding 17 CFR § 1.3(xxx)(4)).

exposure of the SVF to the wrap provider. In this sense, the SVC is generally fully (or nearly fully) collateralized. The wrap provider's exposure, on the other hand, is limited to the excess of the underlying high quality portfolio's book value over its market value and only then to the extent needed to fund participant-initiated redemptions. In this sense, the plan's market value provides a buffer for the wrap provider; the wrap provider is only required to make payments after the market value is exhausted. SVCs reduce the risk of exhausting the plan's market value by reducing the risk of mass exodus using equity wash and employer-initiated event provisions (described above). Finally, the crediting rate mechanism works to pull the market-to-contract value ratio back to par, functioning as a risk-sharing mechanism by requiring the contract participants to share in those gains and losses.

SVCs are not suitable for mandatory clearing or exchange trading. Through mandatory clearing and exchange trading of standardized swaps, Dodd-Frank seeks to decrease counterparty and systemic risk and increase pre-trade price transparency in the swaps market. However, SVCs have a number of characteristics that make them not suitable for mandatory clearing and exchange trading and unlikely to obtain the benefits those features provide.

In their rules providing the process for review of swaps for mandatory clearing,[14] the Commissions have reiterated the statutory factors necessary to determine that a swap be made subject to mandatory clearing.[15] These factors generally rely on standardization of a particular type or class of swap, including the "existence of significant outstanding notional exposures, trading liquidity, and

[14] The CFTC's rule is final and effective September 26, 2011. Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464 (published Jul. 27, 2011) (amending 17 CFR Parts 39 and 140). The SEC has proposed, but not finalized, its rule. Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies, 75 Fed. Reg. 82,490 (proposed Dec. 30, 2010) (amending 17 CFR Parts 240 and 249).

[15] These include: (i) the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data; (ii) the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded; (iii) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the clearinghouse available to clear the contract; (iv) the effect on competition, including appropriate fees and charges applied to clearing; and (v) the existence of reasonable legal certainty in the event of the insolvency of the relevant clearinghouse or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

adequate pricing data." Because of their highly individualized purpose and terms, SVCs by nature are not standardized and there exists no trading market for SVCs. In addition, because of the highly idiosyncratic terms and conditions of SVCs which depend on the specific characteristics of the SVF, including the underlying investment portfolio and the contribution and redemption history of the plan's participants, clearinghouses will not have the "operational expertise and resources, and credit support infrastructure to clear the contract."[16] Therefore, the Commissions are unlikely to designate SVCs as subject to the mandatory clearing requirements.

SVCs are similarly unsuitable for mandatory exchange trading, as they do not trade. Rather, an SVF typically selects one or more wrap providers with whom to enter into an SVC based on, among other considerations, the contract terms and wrap providers' credit risk profile. Those providers remain on the other side of the contract for its duration with rare exceptions; there exists no secondary market. Consequently, price information from an SVC entered into by one SVF is of little value to another SVF looking to enter into an SVC. Therefore, SVFs looking to enter into an SVC would not benefit from a formalized exchange for price discovery.

SVC trade reporting is unlikely to be informative to the Commissions or the marketplace. Title VII requires that information about swaps be reported in both real-time and on an ongoing basis. While trade reporting provides valuable information for swap contracts that are standardized and liquid, SVCs are complex non-fungible and path-dependent contracts individually negotiated over extended periods of time. As a result, the information the Commissions would obtain from trade reporting by one SVF would have very limited use when applied to another SVF. Indeed, publication of SVC prices might be harmful to the SVC market by discouraging wrap providers from accommodating a SVF's unique situation if to do so would lead to a "headline" price term that might give the Commissions or the public the wrong impression.

If SVCs were treated as swaps, wrap providers may be considered to be fiduciaries under DOL regulations, causing SVCs to be prohibited for plans subject to ERISA.

The CFTC's proposed Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties[17] (the "**Business Conduct**

[16] *See* Sections 723 and 763 of Dodd-Frank.

[17] 75 Fed. Reg. 80638 (Dec. 22, 2010).

Proposal") imposes stringent business conduct standards for swap dealers in their dealings with "**Special Entities**," which includes employee benefit plans and governmental plans within the meaning of Section 3 of ERISA. For example, swap dealers are required to conduct scenario and suitability analyses, among other requirements, and act in the best interests of a Special Entity if it is deemed to be an "advisor" to the Special Entity. The provisions of the Business Conduct Proposal were not coordinated with either the DOL's existing fiduciary regulations or its recent proposal to significantly broaden the types of communications that could constitute investment advice and cause a party to be deemed an ERISA fiduciary.[18] By imposing fiduciary-like responsibilities on swap dealers that transact with ERISA plans, there is significant uncertainty as to whether swap dealers would fall within the definition of an ERISA fiduciary under the DOL regulations. If swap dealers are treated as fiduciaries under the DOL regulations, then any swap transaction with an ERISA plan would violate ERISA's prohibited transaction rules.[19]

The DOL recently announced that it will re-propose its fiduciary rule in early 2012.[20] Acknowledging the uncertainty created by the Business Conduct Proposal and the DOL's proposed fiduciary rule, the DOL stated that it will "coordinate closely with the Securities and Exchange Commission and the Commodity Futures Trading Commission to ensure that the effort is harmonized with other ongoing rulemakings" and that it "anticipates revising provisions of the rule including, but not restricted to . . . clarifying the limits of the rule's

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[18] 75 Fed. Reg. 65263 (Oct. 22, 2010) (the "**DOL Proposal**"). Under the DOL Proposal § 2510.3-21(c)(1)(i), the DOL proposed to substitute the conjunctive five-part test with a disjunctive list of characteristics, thereby making any service provider a fiduciary if they render any advice that is individualized and that may be used in connection with the investment decision of an employee benefit plan subject to ERISA. There is a limited exception for advice provided by a party in the context of sales or purchases of securities or other property, provided that the ERISA plan knows, or under the circumstances reasonably should know, that the party is providing the advice in its capacity as an adverse seller or purchaser. The exception, however, does not appear to apply to security-based swap transactions.

[19] When a prohibited transaction occurs, the fiduciary must reverse the transaction when detected and put the plan in the same position it would be in had the transaction not occurred. 29 U.S.C. § 1109(a). Both the adviser to the ERISA plan and the swap dealer could be subject to liability if the swap dealer is deemed to be an ERISA fiduciary. "Parties in interest" to an ERISA plan that enter into prohibited transactions are subject to a 15% excise tax for every full or partial calendar year that the transaction is outstanding. 26 U.S.C. § 4975(a). If a prohibited transaction is not corrected promptly upon enforcement action by the DOL or the Internal Revenue Service, the tax is raised to 100% of the amount involved. 26 U.S.C. § 4975(b).

[20] *See* DOL Release No. 11-1382-NAT (Sept. 19, 2011).

application to arm's length commercial transactions, such as swap transactions."[21] While these assurances are helpful, absent a clear statement from the DOL in the re-proposed rule or a legally binding advisory opinion that compliance with the Business Conduct Proposal will not result in a swap dealer becoming a fiduciary, swap dealers will likely refuse to engage in swap transactions with ERISA plans to avoid the risks of violating ERISA's costly prohibited transaction rules. If SVCs are treated as swaps, wrap providers would generally be deemed to be swap dealers subjecting them to the Business Conduct Rules when they transact with ERISA plans. Any uncertainty that complying with the Business Conduct Rules would cause a wrap provider to become an ERISA fiduciary would serve as a disincentive for wrap providers to enter into SVCs with ERISA plans. If wrap providers become hesitant or unwilling to offer SVCs to ERISA plans, plans will suffer the consequences of losing the benefits of an attractive and popular investment option. Any SVCs that are offered to ERISA plans would charge higher fees to the plans to compensate wrap providers for their costs to register and comply with the business conduct rules, as further described below.

While swap regulation of SVCs is unlikely to provide significant benefits, it would be costly for retirees and other groups that Dodd-Frank seeks to protect.

As stated above, SVCs are contracts that pose little risk, are highly collateralized, are unsuitable for clearing and exchange trading and will not provide informative trade reporting information. As a result, there is little benefit to be gained from treating SVCs as swaps. However, if SVCs are treated as swaps, wrap providers will incur significant costs registering as swap dealers, developing compliant policies and procedures for internal and external business conduct, satisfying business conduct requirements developed with trading instruments in mind and complying with all the other significant regulations that becoming a swap dealer entails. These costs will either put wrap providers out of this business or force them to raise the price of the SVCs they enter into with SVFs. In both cases, the investors in SVFs, primarily retirees through 401(k) plans, will suffer.

Such a result is inconsistent with congressional intent. Senator Harkin, chairman of the Health, Education, Labor, and Pension Committee, proposed the SVC study to make sure that Title VII did not "cause unintended harm to people's pension plans"[22] and that SVCs would only be regulated as swaps if doing so

[21] *Id.*

[22] 111 CONG. REC. S5,906 (daily ed. July 15, 2010) (statement of Sen. Thomas Harkin).

would "achieve[] goals underlying the derivatives title."[23] However, because of the unique nature of SVCs—they are nonstandard contracts, employ little or no leverage, are fully (or almost fully) collateralized, are not traded, and are provided by entities already subject to extensive regulation—many of the benefits of treating SVCs as swaps would either not be applicable or would be duplicative. As Senator Lincoln, a primary architect of Title VII, put it: "We should try to avoid doing any harm to pension plan beneficiaries."[24]

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The AMG appreciates the opportunity to provide the Commissions with the foregoing comments regarding their study on SVCs.

Respectfully submitted,

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[23] *Id.*

[24] 111 CONG. REC. S5,906 (daily ed. July 15, 2010) (statement of Sen. Blanche Lincoln).