From: Sagat, Mark <MSagat@naic.org>
Sent: Monday, September 20, 2010 5:32 PM
To: dfadefinitions <dfadefinitions@CFTC.gov>
Subject: Definitions
Attach: NAIC Comment to SEC and CFTC.pdf

Dear Sir or Madam,

Please find attached the National Association of Insurance Commissioners' response to the CFTC and SEC's joint request for advanced comment to implement the Definitions contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Please don't hesitate to contact me if you have any questions.

Sincerely,
Mark Sagat

<<NAIC Comment to SEC and CFTC.pdf>>
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September 20, 2010

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

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

Re: S7-12-10: Request for Advance Comment to Implement Dodd-Frank Wall Street Reform and Consumer Protection Act; Definitions Contained in Title VII.

Dear Ms. Murphy and Mr. Stawick:

We write on behalf of the National Association of Insurance Commissioners (NAIC) to submit this advance comment regarding the Security and Exchange Commission's and Commodity Futures Trading Commission's (the Commissions) planned rulemaking to implement and provide clarity to the definitions contained in Title VII of the Dodd-Frank Wall Street and Consumer Protection Act (the Act) [1]. Founded in 1871, the NAIC is the voluntary association of the chief insurance regulatory officials of the 50 states, the District of Columbia and five U.S. territories. Congress delegated the regulation of insurance to the states through the McCarran-Ferguson Act of 1945; that statute remains in force today. The NAIC serves the needs of state insurance regulators as they protect consumers and maintain the financial stability of the marketplace.

Pursuant to §§712(d), 721(b), and 761(b) of the Act, the Commissions have broad rulemaking authority to further define the terms *swap, security-based swap, swap dealer, security-based swap dealer, major swap participant, and major security-based swap participant*. The request for advance comment for these definitions is set forth in the August 20, 2010 publication of the Federal Register[2] as well as the Commissions' websites. The NAIC respectfully submits the following comments to these definitions below.

Guiding Principles for NAIC Review and Comment

Our review and comment of the proposed rules to be promulgated by the Commissions are guided by two overarching principles. First, any implementing rules for Title VII may not conflict with the states' regulation of insurance products and insurers. Title VII neither repeals nor infringes upon the primacy of state-based insurance regulation and the Commissions are proscribed from regulating insurance products as contemplated by the McCarran-Ferguson Act. State insurance laws prescribe specific accounting rules that ensure accurate reporting of derivatives transactions and investment rules that govern the use and size of derivatives positions by insurance companies. These laws are part of a robust state

[1] Pub. L. No. 111-203.
[2] Advance Notice of Proposed Rulemaking: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer protection Act, 75 Fed. Reg. 51429-51433 (August 20, 2010).

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insurance regulatory regime designed to protect consumers, ensure insurance company solvency, and maintain competitive and stable insurance markets.

Second, any implementing rules should not create an unlevel playing field for insurers as compared to other financial institutions. Regulations that impose significant additional compliance costs on insurers using derivatives could cause a competitive disadvantage for some insurers within insurance markets by adding to the cost of insuring certain risks and within the capital markets by adding to the cost of derivatives. Financial institutions utilize derivatives differently to achieve their varying institutional goals. Insurance companies predominately use derivatives for hedging commercial risks, particularly the type of risks for which they write insurance policies. State insurance regulation permits certain other well-defined permitted uses of derivatives, but these are proportionately small in comparison to the industry's hedging activities. The implementing rules should be crafted to recognize these differences while at the same time ensuring no particular category of financial institution has an unfair competitive advantage in the capital markets. For example, state insurance laws and regulations govern the nature of an insurance company's hedge activities and the determination of hedge effectiveness to ensure the continued solvency of the insurer. Clearinghouse rules implemented by the Commissions should not conflict with such laws and regulations that protect insurance consumers—whether policyholders, third-party claimants, or other beneficiaries. With these principles in mind, we now turn to six specific definitions contained in the Act.

Swap and *Security-Based Swap*

Section 721(a)(21) of the Act sets forth the definitions of a swap. Among other definitions, a swap is defined as any agreement, contract, or transaction that:

> "provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic or commercial consequence."

Similarly, Section 761(a)(6) of the Act sets forth the definitions of a security-based swap. Among other definitions, a security-based swap is defined as any agreement, contract, or transaction that is based on:

> "the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer."

Given the breadth of these definitions, we are concerned that they could theoretically encompass a multitude of insurance products that are regulated under state law. For example, insurance policies such as auto insurance, homeowner's insurance, and life insurance all involve contracts that provide for payment of money that is "dependent on the occurrence, non-occurrence or the extent of an event or contingency associated with a financial, economic or commercial consequence." Similarly, bond and financial guaranty insurance, which insure against defaults in municipal bonds and other securities could be encompassed not only by the definition of swap under Section 721(a)(21) but also the definition of security-based swap under Section 761(a)(6) because they involve contracts based on the occurrence of an event relating to issuers of securities that affect the financial statements, conditions, and obligations of the issuer.

The implementing rules must expressly exclude insurance products regulated under state law. First, in drafting and subsequently passing Title VII of the Act, Congress did not intend for federal regulation of state-regulated insurance products as swaps. In passing Title VII of the Act, Congress intended to provide regulatory oversight for over-the-counter derivatives, an historically unregulated financial market,[3] not insurance products that are regulated by the states. Indeed, other titles of the Act further confirm Congressional intent in this regard. Title X specifically excludes the business of insurance from regulation by the newly formed Bureau of Consumer Financial Protection and Title V significantly limits the newly formed Federal Insurance Office's ability to preempt state insurance laws. Second, state laws impose a multitude of regulatory requirements relating to licensing, accounting, investment, solvency, capital, reporting, and consumer protection. Regulation by the Commissions of insurance products as swap or security-based swap products is likely to conflict with these requirements and disturb the state-based insurance regulatory regime.

For these reasons, the Commissions should expressly exclude insurance products regulated by the states from the definitions of swap and security-based swap.

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[3] *See generally,* H.R. Rep. No. 111-517, at 869 (2010)(Joint Explanatory Statement of the Committee of Conference).

Major Swap Participant and *Major Security-Based Swap Participant*

Section 721(a)(16) and Section 761(a)(6) of the Act define a major swap participant and major security-based swap participant as any person (who is not a swap dealer or security-based swap dealer) that maintains a "substantial position" in swaps or security-based swaps for any major swap categories. Under the definition, the entity's outstanding swaps or security-based swap positions must create "substantial counterparty exposure that could have serious effects on the financial stability of the United States," or the entity must be highly leveraged relative to the amount of capital it holds and maintain a substantial position in outstanding swaps in any major swap category. In determining what constitutes a "substantial position," positions held for hedging or mitigating "commercial risk" are to be excluded.

Insurers, in the aggregate, are not insignificant users of derivatives. As of the first quarter 2010, insurers held derivatives worth approximately $899 billion (notionally). However, given the extent to which insurers use derivatives, insurance companies could potentially fall within the definition of major swap participant or major security-based swap participant. While from an insurance regulatory perspective identifying certain insurers as major swap participants or major security-based swap participants and imposing additional regulatory requirements over such entities is not inherently problematic, any rules further defining such terms should endeavor to create a level field among all users of derivatives and not disadvantage insurers as compared to other financial institutions.

To this end, it is important to note that insurance companies predominately purchase derivatives to hedge against various commercial risks. On the liability side, the primary risk insurer's hedge against is insurance risk. They also hedge certain asset risks such as interest rate risk, currency risk, credit risk, and political risk. Hedging accounts for approximately 92 percent of the derivatives insurers hold – a notional value of $831 billion. Insurance companies also utilize derivatives for generating additional income as part of an overall investment strategy, but derivatives used for these purposes typically represent a small fraction of their total holdings of such instruments. It is worthy of note that state insurance laws regulate an insurer's investment and use of derivatives and their disclosure is governed by state mandated insurance accounting and reporting procedures developed by regulators through the NAIC. These laws govern how much an insurer can include in regulatory capital for various types of investments including equities, bonds, and derivatives in an effort to ensure that insurers are not overly leveraged and have sufficient amounts of liquid assets to pay policyholder claims. **In providing clarity to the definition of major swap participant and major security-based swap participant and defining substantial position as well as commercial risk, we urge the Commissions to take into consideration the unique nature of insurers' use of derivatives as well as the existence of state regulatory requirements governing the nature and extent of their use.**

Swap Dealer and *Security-Based Swap Dealer*

The Commissions also seek comment on the definition of swap dealer and security-based swap dealer. Section 721(a)(7) and 761(a)(6) define a swap dealer and a security-based swap dealer as any person:

> "(i) who holds itself out as a dealer in swaps (or security-based swaps);
> (ii) makes a market in swaps (or security-based swaps);
> (iii) regularly enters into swaps (or security-based swaps) with counterparties as an ordinary course of business for its own account; or
> (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or a market maker in swaps (or security-based swaps)."

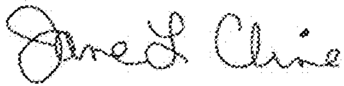
Both definitions provide an exception for those persons that enter into a swap or a security-based swap for such person's "own account, either individually or in a fiduciary capacity," provided it is not a part of a "regular business."

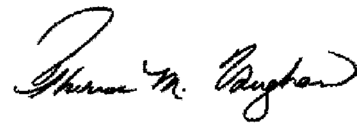
The definitions of swap dealer and security-based swap dealer, particularly (iii) and the exception, are unclear and need to be further defined in order to achieve certainty as to whether or not insurers fall within the scope of the definition. Insurance companies enter into swaps for the purpose of hedging commercial risks and generating income, and these definitions do not make clear the nature and extent of one's holdings of swaps to be "any person" that "regularly enters into swaps" nor what constitutes an "ordinary course of business" or "regular business." It is also worth noting that certain insurance companies have separate investment accounts for their regulated lines of business. In this regard, it is not clear whether investment in swaps for such accounts, as opposed to the general account of the insurer, would constitute their

"own account" and thereby fall within the definitions or exceptions above. If such accounts do constitute their "own account," that could, in turn, have implications for whether the insurer would be treated as regularly entering swaps for its own business and fall within the definition of swap dealer. As with the definitions of major swap participant and major security-based swap participant, our chief concern is that any rules implemented to clarify such terms do not unfairly disadvantage insurance companies in the capital markets. We hope you will take into account these considerations as you promulgate rules clarifying these definitions.

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

Sincerely,





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