Investment Classification Project
Overview

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Senior Manager Accounting and RBC

Investment Project

Comprehensive Project to review the “investment SSAPs” with suggestions to clarify definitions, scope, and the accounting method / related reporting.

This project suggests possible revisions to existing SSAPs, or the development of new SSAPs to capture investments that are outside of SSAP definitions, to consider the elimination of “exceptions” within specific SSAPs and address specific characteristics of those investments to ensure consistent and appropriate valuation and reporting.
Key SSAPs Subject to Discussion:

- SSAP No. 21—Other Admitted Assets - (collateral loans)
- SSAP No. 26—Bonds
- SSAP No. 30—Investments in Common Stock
- SSAP No. 32—Investments in Preferred Stock
- SSAP No. 43R—Loan-backed and Structured Securities
- SSAP No. 48—Joint Ventures, Partnerships and LLCs

Why Review Investment SSAPs?

- Definitions vary from market definitions
- Inconsistent interpretations of definitions
- “Look-through” allowed for some investments
- Reporting inconsistencies (measurement / schedules)
- Different treatment for similar investments
SSAP No. 26 - Bonds

Definition: Any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments.

Not all included investments are “bonds”

What is a “Security”? Very Broad

A S instructions prescribe bond reporting for some items not noted in the SSAP.

Bonds

<table>
<thead>
<tr>
<th>Reporting</th>
<th>Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schedule D- Part 1, Long-Term Bonds (Unless Short-Term Investment)</td>
<td>Amortized Cost or Lower of Amortized Cost of Fair Value (depends on designation and whether AVR)</td>
</tr>
</tbody>
</table>

Why is Bond Classification Desired?

- Favorable RBC
- Amortized Cost Valuation
- Fewer State Investment Limitations
Is the distinction of a ‘security’ the only characteristic between a loan and a bond?

Does a loan represent a creditor relationship with a fixed schedule for one or more future payments??

Maybe this is a Bond?

How is “security” defined?

Expected Next Steps


- Identification of discussion topics & prioritization
  Investment Matrix Exposure –
  http://www.naic.org/committees_e_app_sapwg.htm

- Expecting Summer National Meeting Discussion on Investment Matrix and Prioritization of discussion topics

- Referrals to VOSTF, Blanks & Capital Adequacy requesting participation and collaboration.
Investment Classification

- Initial Discussion Topics
  - Security Distinction: Factor for D/BA?
  - Similar Assets / Different Measurements? (Life/PC)
  - Collateral Loans: Bonds or BA?
  - Investment Definitions: Bonds, Stock, & LBSS
  - Bank Participations: Structure & Reporting?
  - Single Member/Single Asset LLCs: Look-through?
  - “Funds”: New Schedule/SSAP?

- Investment Classification Review – QUESTIONS?

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August 8, 2014

U.S. ETF Market

• Quick Overview of ETFs
  ▪ Basic Operating Structure
  ▪ Various Legal Structures

• Trends in ETFs
  ▪ Asset Concentration
  ▪ Recent Demand

• Insurers Use of ETFs
## What Are ETFs?

- Vast majority are registered open-end management investment companies under the Investment Company Act of 1940
- Trade on an exchange like shares of stock
- Disclose information about portfolio holdings to the public daily
- Disclose estimate of underlying value every 15-60 seconds throughout the trading day
- Typically trade at market prices close to the value of their underlying assets

## Creation of an ETF

1. **Fund or trust**
2. **Creation basket and/or cash**
3. **Authorized participant**
4. **Hold shares**
5. **Investors**
6. **Trade on an exchange**

**One creation unit (e.g., 50,000 shares of an ETF)**
Arbitrage – ETF Trading at Premium

ETF shares issued by market maker to meet increased demand on the secondary market (shares trading at premium to underlying value)

Arbitrage – ETF Trading at Discount

ETF shares redeemed by market maker to absorb excess supply on the secondary market (shares trading at discount to underlying value)
ETFs by Legal Structure

Percentage of total net assets, May 2014

Investment company ETFs1
($1.711 trillion) 96%
Physical commodity ETFs2
($49 billion) 3%
Derivatives-based commodity ETFs3
($16 billion) 1%

Total: $1.775 trillion

1Registered under the Investment Company Act of 1940 and the Securities Act of 1933.
2Registered under the Securities Act of 1933.
3Registered under the Securities Act of 1933 and regulated by the Commodity Futures Trading Commission under the Commodity Exchange Act of 1936
Note: Data for ETFs that invest primarily in other ETFs are excluded from the totals. Components may not sum to the total because of rounding.
Source: Investment Company Institute

Investment Company Act ETFs

- Invest >40% of assets in securities
- Regulated like mutual funds, with limited exemptions.
- Investment Company Act (ICA) imposes:
  - Prohibitions on affiliated transactions and self-dealing
  - Tight restrictions on leverage
  - Daily valuation of fund shares using mark-to-market valuation
  - Requirement to redeem shares daily
  - Separate custody of fund assets
  - Extensive disclosure requirements
  - Significant fund governance requirements, including independent directors


### Non-1940 Act ETFs

- **Physical Commodity ETFs (Grantor Trusts)**
  - Hold physical commodities or currencies
  - Are not managed/do not have an investment adviser

- **Derivatives-Based Commodity ETFs**
  - Hold < 40% of assets in securities
  - Invest in commodity derivatives
  - Run by Commodity Pool Operators registered with CFTC
  - Subject to regulation by CFTC
  - Structured as partnerships, so no entity-level tax: issue K-1 tax forms

### ETFs<sup>1</sup> Becoming More Popular With Investors

**Billions of dollars, 2005–2014<sup>2</sup>**

- Total net assets of investment company ETFs<sup>3</sup>
- Total net assets of non-investment company ETFs<sup>4</sup>

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014&lt;sup&gt;2&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>301</td>
<td>423</td>
<td>608</td>
<td>531</td>
<td>36</td>
<td>777</td>
<td>891</td>
<td>939</td>
<td>1,217</td>
<td>1,675</td>
</tr>
<tr>
<td>ETFs</td>
<td>204</td>
<td>359</td>
<td>629</td>
<td>728</td>
<td>797</td>
<td>923</td>
<td>1,134</td>
<td>1,194</td>
<td>1,294</td>
<td>1,346</td>
</tr>
</tbody>
</table>

<sup>1</sup>Data for ETFs that invest primarily in other ETFs are excluded from the totals.

<sup>2</sup>Data is through May 2014.

<sup>3</sup>The funds in this category are registered under the Investment Company Act of 1940.

<sup>4</sup>The funds in this category are not registered under the Investment Company Act of 1940 and invest primarily in commodities, currencies, and futures.

Note: Components may not add to total because of rounding.

Source: Investment Company Institute
Total Net Assets of ETFs Concentrated in Domestic Large-Cap Stocks

Billions of dollars, May 2014

- Large-cap: 446
- Mid-cap: 90
- Small-cap: 82
- Other: 156
- Domestic sector equity: 230
- Global: 45
- International: 239
- Emerging markets: 144
- Commodities: 65
- Bond and hybrid: 278

Broad-based domestic equity

Global/International equity

1Data for ETFs that invest primarily in other ETFs are excluded from the totals.
2This category includes funds both registered and not registered under the Investment Company Act of 1940.
3This category includes international, regional, and single country ETFs.
4This category includes funds—both registered and not registered under the Investment Company Act of 1940—that invest primarily in commodities, currencies, and futures.
Source: Investment Company Institute

Demand for ETFs a Bit Slower in 2014

Net share issuance, billions of dollars, 2005-2014

- Equity
- Bond and hybrid
- Commodities

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity</th>
<th>Bond and hybrid</th>
<th>Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>57</td>
<td>3</td>
<td>7</td>
</tr>
<tr>
<td>2006</td>
<td>74</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>2007</td>
<td>128</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>2008</td>
<td>150</td>
<td>23</td>
<td>11</td>
</tr>
<tr>
<td>2009</td>
<td>116</td>
<td>28</td>
<td>118</td>
</tr>
<tr>
<td>2010</td>
<td>118</td>
<td>8</td>
<td>118</td>
</tr>
<tr>
<td>2011</td>
<td>118</td>
<td>3</td>
<td>118</td>
</tr>
<tr>
<td>2012</td>
<td>185</td>
<td>9</td>
<td>53</td>
</tr>
<tr>
<td>2013</td>
<td>180</td>
<td>13</td>
<td>197</td>
</tr>
<tr>
<td>2014</td>
<td>47</td>
<td>26</td>
<td>22</td>
</tr>
</tbody>
</table>

1ETF data exclude ETFs that invest primarily in other ETFs.
2Data is through May 2014.
3ETFs not registered under the Investment Company Act of 1940.
Source: Investment Company Institute
Corporate Bond ETFs Account for Largest Share of Bond ETF Net Issuance

Net share issuance, billions of dollars, 2006-2014¹

<table>
<thead>
<tr>
<th>Year</th>
<th>Government Bond</th>
<th>Municipal</th>
<th>Corporate</th>
<th>High-Yield</th>
<th>International Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>5.7</td>
<td>13.3</td>
<td>23.0</td>
<td>2.4</td>
<td>0.2</td>
</tr>
<tr>
<td>2007</td>
<td>5.9</td>
<td>0.6</td>
<td>24.0</td>
<td>3.6</td>
<td>1.7</td>
</tr>
<tr>
<td>2008</td>
<td>12.4</td>
<td>14.7</td>
<td>29.7</td>
<td>9.2</td>
<td>11.4</td>
</tr>
<tr>
<td>2009</td>
<td>16.5</td>
<td>1.7</td>
<td>22.2</td>
<td>7.3</td>
<td>3.6</td>
</tr>
<tr>
<td>2010</td>
<td>24.0</td>
<td>1.0</td>
<td>29.7</td>
<td>10.9</td>
<td>0.8</td>
</tr>
<tr>
<td>2011</td>
<td>12.2</td>
<td>11.6</td>
<td>25.5</td>
<td>9.0</td>
<td>9.9</td>
</tr>
<tr>
<td>2012</td>
<td>16.5</td>
<td>10.2</td>
<td>25.5</td>
<td>9.9</td>
<td>3.6</td>
</tr>
<tr>
<td>2013</td>
<td>52.3</td>
<td>6.5</td>
<td>6.0</td>
<td>3.6</td>
<td>7.0</td>
</tr>
<tr>
<td>2014</td>
<td>20.0</td>
<td>3.6</td>
<td>25.5</td>
<td>3.6</td>
<td>7.0</td>
</tr>
</tbody>
</table>

¹Data is through May 2014.
²Data for high-yield bond ETFs included in corporate bond category prior to 2011.
Source: Investment Company Institute

Primary Application of ETFs by Insurers

Percent of insurance company responses, 2013

- Strategic: 44%
- Tactical: 56%

Note: Based on responses from 18 insurance companies in 2013.
Source: Greenwich Associates 2013 U.S. Exchange-Traded Funds Study
How Insurers Are Using ETFs

Percent of insurance company responses, 2013

- Hedging: 33%
- ETF overlay/Liquidity sleeve: 50%
- Tactical adjustments: 89%
- Portfolio completion: 50%
- Passive exposure in the core: 72%
- Rebalancing: 56%
- Transitions: 56%
- Cash equitization/Interim beta: 61%

Note: Based on responses from 18 insurance companies in 2013.
Source: Greenwich Associates 2013 U.S. Exchange-Traded Funds Study

ETF Asset Classes Used by Insurers

Percent of insurance company responses, 2013

- REITs: 50%
- Commodities: 39%
- International fixed income: 44%
- Domestic fixed income: 78%
- International equity: 83%
- Domestic equity: 94%

Note: Based on responses from 18 insurance companies in 2013.
Source: Greenwich Associates 2013 U.S. Exchange-Traded Funds Study
Expected Change in Allocations to ETFs for Insurers by Year-End 2013

<table>
<thead>
<tr>
<th>Percent of insurance company responses, 2013</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease &gt;10%</td>
<td>0%</td>
</tr>
<tr>
<td>Decrease 1-10%</td>
<td>0%</td>
</tr>
<tr>
<td>No Change</td>
<td>44%</td>
</tr>
<tr>
<td>Increase 1-10%</td>
<td>44%</td>
</tr>
<tr>
<td>Increase &gt;10%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Note: Based on responses from 18 insurance companies in 2013.  
Source: Greenwich Associates 2013 U.S. Exchange-Traded Funds Study
What are fixed income ETFs?

Fixed income ETFs are funds that hold a portfolio of bonds (like a mutual fund) but trade on an exchange.

- They are listed and traded on an exchange
  - Trading flexibility intraday

- They provide exposure to segments of the fixed income market
  - Broad markets, like the total US bond market (Barclays Aggregate Index)
  - Targeted segments by sector, quality or maturity

- They are index funds
  - Consistent diversified exposure
  - Track a specific index
  - Low expense ratios
  - Low turnover

- They are often designed to be tax efficient
  - ETF creation/redemption mechanism can reduce capital gains distributions
  - In 2013, only 4 iShares ETFs paid capital gains
Why are fixed income ETFs different?

**Bond markets**
- In the “over-the-counter” (OTC) bond market, buyers and sellers negotiate one-on-one to reach a deal for each bond.
- Bonds can be hard to find, and an investor may get different prices from different brokers.
- This opacity—“Where can I find bonds? Can I get a good price?”—is a defining characteristic of the OTC bond market.

**Equity markets**
- Most stocks are traded on centralized exchanges, such as the NYSE.
- Through the exchange, investors can easily see execution prices throughout the trading day.
- Fixed income ETFs provide transparency to the bond market, allowing investors to trade bonds like stocks.

What do ETF investors actually hold?

**ETF shares represent a pro-rata slice of the portfolio of securities in the fund**
- Authorized Participants have the option to redeem their shares in the ETF for a vertical slice of the bonds within it.
- Concurrently, ETF investors also have the option to use either parts of, or their entire, portfolio to create shares of an ETF.

![Graph showing portfolio breakdown of iShares Core U.S. Aggregate Bond ETF (AGG) and Individual ETF Investor Portfolio (AGG)]
Legal and structural design of ETFs

ETF design helps protect shareholders

1. Almost all iShares ETFs are set up as separate investment portfolios under the Investment Company Act of 1940.
2. The custodian maintains the securities and assets of each Fund in separate accounts.
3. The assets in an ETF are separate and distinct from the assets of the various service providers such as asset managers, index providers, custodians, etc.
4. Generally the ETF is not directly subject to the credit risk of a service provider.

Creation and redemption process

The ability to trade an ETF on-exchange and create and redeem shares work to create an equilibrium of liquidity

- The supply and demand of an ETF is managed by market participants (e.g. market makers, authorized participants)
- If a large order to buy or sell shares of an ETF exceeds on-exchange liquidity, market participants react accordingly to create or redeem shares of the ETF

When there is excess ETF supply and the price of the ETF is out of line with value of underlying securities, market participants remove ETF shares from the market by exchanging shares of the ETF for the underlying securities

When there is excess ETF demand in the market, market participants add ETF shares to the market by exchanging the underlying securities for shares of the ETF

Shares of iShares Funds may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from a Fund by Authorized Participants, in very large creation/redemption units. There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.
Low cost: ETFs offer market access for less

Fees and Expenses
- The average bond mutual fund has a 0.97% expense ratio
- iShares ETFs have much lower expense ratios and do not charge front or back end sales loads

<table>
<thead>
<tr>
<th>Category</th>
<th>Avg. Mutual Fund</th>
<th>iShares ETF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermediate Term Bonds</td>
<td>0.91%</td>
<td>0.08% (AGG)</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>0.84%</td>
<td>0.25% (MUB)</td>
</tr>
<tr>
<td>High Yield</td>
<td>1.11%</td>
<td>0.50% (HYG)</td>
</tr>
<tr>
<td>Emerging Market Bonds</td>
<td>1.20%</td>
<td>0.60% (EMB)</td>
</tr>
</tbody>
</table>

Lower Transaction Costs
- Transactions costs, in the form of bid-offer spreads, can be high in the bond markets
- iShares ETFs tend to trade at much tighter bid-offer spreads than the underlying bond market

Diversification: exposure to hundreds of bonds with a single purchase

With the iShares Core U.S. Aggregate Bond ETF (AGG), you can access the entire US investment grade bond market and over 1,700 bonds in a single trade.
Liquidity: ETFs help address challenges with bond trading

Most bonds do not trade daily

- The underlying bond market can be very illiquid and individual bonds can trade very infrequently.
- Most investment grade and high yield corporate bonds have historically traded fewer than half the days each month (see below).
- Finding actionable bids & offers in volatile markets can be particularly challenging

iShares bond ETFs can trade millions every day

- Constructing broad credit portfolios from bonds available at dealers can be challenging given low inventory levels and market fragmentation.
- Because ETFs trade on an exchange, investors can access bonds as easily as they can access stocks.

ETFs offer investors ability to increase or decrease their fixed income exposure more easily

Source: BlackRock, Bloomberg as of 3/31/2013. Primary dealer inventory is measured by the Primary Dealer Positions Oublit Level of Corporate Securities Due Greater Than 1 Year. Credit ETF assets include US listed corporate and credit bond ETFs, excluding leveraged or inverse funds, bank loan funds, floating rate funds and convertible funds.

Transparency

Single share class ETFs offer complete daily transparency into underlying holdings.

Evaluate ETFs and their individual components:

- View details on each underlying CUSIP in the portfolio (e.g., maturity, coupon, sector, rating, etc.).
- View risk characteristics such as effective duration, effective convexity, partial durations, and OAS.

Understand the impact of including ETFs in your portfolios:

- Assess your combined portfolio’s industry, asset, ratings, and sector-level exposures.
- Perform total return / horizon analysis on ETF and portfolio holdings across different scenarios.
- Portfolio analytic solution providers (e.g., Bloomberg, BondEdge, Yield Book) have integrated many bond ETFs into their platforms.
## Applications of ETFs by Insurers

### Insurance ETF investment strategies

<table>
<thead>
<tr>
<th>General account</th>
<th>Funds asset management</th>
<th>VA Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reserve assets:</strong></td>
<td><strong>Equity:</strong></td>
<td><strong>Delivery vehicle:</strong></td>
</tr>
<tr>
<td>• Efficient core exposure</td>
<td>• Multi-asset strategies</td>
<td>• Single ETF exposure</td>
</tr>
<tr>
<td>• Targeted asset class exposure</td>
<td>• Tactical / macro strategies</td>
<td>• Portfolio of iShares ETFs</td>
</tr>
<tr>
<td>• Diversified subsidiary portfolios</td>
<td>• Cash equitization</td>
<td>• Wrap accounts</td>
</tr>
<tr>
<td>• Interim beta</td>
<td>• Transitions</td>
<td>• Variable insurance trust (VIT)</td>
</tr>
<tr>
<td>• Transitions</td>
<td>• Portfolio completion</td>
<td>• Sub-advised accounts</td>
</tr>
<tr>
<td>• Cash equitization</td>
<td></td>
<td><strong>Investment strategy:</strong></td>
</tr>
<tr>
<td><strong>Surplus assets:</strong></td>
<td><strong>Fixed Income:</strong></td>
<td><strong>Single ETF exposure</strong></td>
</tr>
<tr>
<td>• Equity core</td>
<td>• Interim beta</td>
<td>• Model portfolios</td>
</tr>
<tr>
<td>• Portfolio completion</td>
<td>• Active beta strategies</td>
<td>• Managed volatility</td>
</tr>
</tbody>
</table>

### NAIC Designations Definitions

- **NAIC 1** is assigned to obligations exhibiting the highest quality. Credit risk is at its lowest and the issuer’s credit profile is stable. This means that interest, principal or both will be paid in accordance with the contractual agreement and that repayment of principal is well protected. An NAIC 1 obligation should be eligible for the most favorable treatment provided under the NAIC Financial Conditions Framework.

- **NAIC 2** is assigned to obligations of high quality. Credit risk is low but may increase in the intermediate future and the issuer’s credit profile is reasonably stable. This means that for the present, the obligation’s protective elements suggest a high likelihood that interest, principal or both will be paid in accordance with the contractual agreement, but there are suggestions that an adverse change in circumstances or economic, financial or business conditions will affect the degree of protection and lead to a weakened capacity to pay. An NAIC 2 obligation should be eligible for relatively favorable treatment under the NAIC Financial Conditions Framework.

- **NAIC 3** is assigned to obligations of medium quality. Credit risk is intermediate and the issuer’s credit profile has elements of instability. These obligations exhibit speculative elements. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is reasonable for the present, but an exposure to an adverse change in circumstances or economic, financial or business conditions would create an uncertainty about the issuer’s capacity to make timely payments. An NAIC 3 obligation should be eligible for less favorable treatment under the NAIC Financial Conditions Framework.

- **NAIC 4** is assigned to obligations of low quality. Credit risk is high and the issuer’s credit profile is volatile. These obligations are highly speculative, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is low and that an adverse change in circumstances or business, financial or economic conditions would accelerate credit risk, leading to a significant impairment in the issuer’s capacity to make timely payments. An NAIC 4 obligation should be accorded stringent treatment under the NAIC Financial Conditions Framework.

- **NAIC 5** is assigned to obligations of the lowest credit quality, which are not in or near default. Credit risk is at its highest and credit profile is highly volatile, but currently the issuer has the capacity to meet its obligations. This means that the likelihood that interest, principal or both will be paid in accordance with the contractual agreement is significantly impaired given any adverse business, financial or economic conditions. An NAIC 5 Designation suggests a very high probability of default. An NAIC 5 obligation should incur more stringent treatment under the NAIC Financial Conditions Framework.

- **NAIC 6** is assigned to obligations that are in or near default. This means that payment of interest, principal or both is not being made, or will not be made, in accordance with the contractual agreement. An NAIC 6 obligation should incur the most severe treatment under the NAIC Financial Conditions Framework.
Important information regarding iShares ETFs

Carefully consider the Funds' investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds' prospectuses, and, if available, summary prospectuses, which may be obtained by visiting www.iShares.com or www.blackrock.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities. An investment in the Fund(s) is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Securities with floating or variable interest rates may decline in value if their coupon rates do not keep pace with comparable market interest rates.

When comparing stocks or bonds and iShares Funds, it should be remembered that management fees associated with fund investments, like iShares Funds, are not borne by investors in individual stocks or bonds. The annual management fees of iShares Funds may be substantially less than those of most mutual funds. Buying and selling shares of iShares Funds will result in brokerage commissions, but the savings from lower annual fees can help offset these costs.

The strategies discussed are strictly for illustrative and educational purposes and should not be construed as a recommendation to purchase or sell, or an offer to sell or a solicitation of an offer to buy any security. There is no guarantee that any strategies discussed will be effective.

Important information regarding iShares ETFs

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Not FDIC insured • No Bank Guarantee • May Lose Value
• Any request submitted to the SVO for classification of an ETF that is believed to meet these SEC Exemptive conditions, must be submitted through the Regulatory Treatment Analysis Service ("RTAS").

• ETFs eligible for reporting as a Schedule D bond are listed in Part Six, Section 2(i) of the P&P while those ETFs eligible for reporting as a Schedule D preferred stock are listed in Part Six, Section 2(j) of the P&P.

• To date, the SVO has reviewed and determined that 123 ETFs are eligible for Schedule D bond treatment and 2 ETFs are eligible for Schedule D preferred stock treatment.

• In its analysis, the SVO determines whether the component securities held in the ETF portfolio have the characteristics of debt or preferred stock and whether the ETF structure permits a “see-through” analysis of its portfolio securities on a daily basis.
• The insurance company, or ETF sponsor, as RTAS applicant shall submit:
  ✓ Copies of the prospectus or other document describing the ETF;
  ✓ The application of the fund sponsor requesting regulatory exemptions and identifying the agreed upon conditions (the “SEC Application”); and,
  ✓ The corresponding final SEC Order, with the RTAS application.

• If the ETF is not rated by a CRP, we request at least six months of the fund's underlying security ratings broken down into the six NAIC Designation categories.

• Sponsors are to use the filing exempt (“FE”) protocol when determining what NAIC Designation category to assign to the underlying bond or preferred stock. That is, the lower of the two CRP ratings or the second lowest of three or more CRP ratings.

• When reviewing the submitted information, depending on the ETF, we examine fund sector allocation and, if applicable, sovereign allocation.

• As for the distribution of the fund’s underlying ratings and associated NAIC Designation categories, we review the consistency of the ratings distribution for that period.

• In addition, the following factors are also analyzed:
  - Index vs. actively managed
  - Currency risk
  - Non-credit risks
  - Structural risks
  - Investment characteristics of the underlying assets
  - Allowed usage of derivatives
  - Consistency of assets to stated investment objective(s)
  - Nested structures (ETFs of ETFs)
  - Inadmissible assets, related to Statement of Statutory Accounting Principles #4 (Assets and Nonadmitted Assets)
  - Allowable limit of unrated securities (unrated securities are assigned a NAIC 5)

• Finally, we utilize a weighted average approach in determining the overall credit risk profile of the fund and associated ETF.
ETFs are growing in both size and activity

- Strong growth in ETF activity over the last decade, in both assets under management (AUM) and trading activity
- Annual growth rate since 2000 has been ~30%
- Mutual fund growth during the same period has been a much lower 6%;
- ETFs comprise approximately 13% of aggregate managed fund assets (ETF+MF)
- The total number of issued ETPs around the world is now just under 5000

Source: Deloitte, “Exchange-Traded Funds: Challenging the Dominance of Mutual Funds!”
And have become price-discovery vehicles

Post-crisis, ETFs generally average around 30% of total intraday share volume. That percentage generally increases with market stress.

Volume is often concentrated in only a few, large ETFs.

ETF growth has been relatively stronger during bearish periods.

Increased use as price discovery vehicle, especially for small cap stocks/illiquid instruments (Hasbrouck, 2003).

This has particular importance for ETF with underlying assets that are illiquid, have high search costs, or are difficult to "short".

Risk transfer capacity in the underlying may depend in part on the composition of participants on the ETF side of the market.

Source: Goldman Sachs, "ETFs for the Single Stock Manager"

ETF concepts – regulatory and otherwise

- Premium / discount and NAV concept
- Tracking error and liquidity
- Potential liquidity and/or maturity mis-match to underlying
- A word on redemptions
- Securities lending
- Synthetic, geared, leveraged ETFs (including rebalancing)
- Asset class “cross-dressing”
- Short interest
- Settlement “fails”
- What happens if a fund fails or closes?
- Regulatory “pass-through” treatment
- Recent developments – fixed income / defined maturity, actively managed, new asset classes
ETF Price Discovery
Two case studies: HYG and EEM

HYG: iShares High Yield Corporate Bond Fund

EEM: iShares Emerging Markets Index

5-day chart: orange = share price, white = indicative NAV

5-day chart: orange = share price, white = indicative NAV
Barry Pershkov
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Division of Investment Management
U.S. Securities and Exchange Commission