To: Statutory Accounting Principles (E) Working Group
From: Julie Gann (NAIC Staff)
Re: Discussion – Requirement for “Contractual Amount of Principal Due”
Date: January 5, 2015  - (Exposed for Comment on March 28, 2015)

This memo discusses the proposal for a “contractual amount of principal due” for SSAP No. 26 investments for Working Group consideration under the investment classification project.

Proposal: This item proposes to incorporate guidance to require all SSAP No. 26 investments to have a “contractual amount of principal due,” with concurrent consideration of new guidance for “funds.” Although a preliminary draft SSAP for “funds” has been proposed based on existing guidance, it is recommended that the Working Group complete a full assessment of “funds” to review the variety of items that can be captured within this definition and consider statutory accounting guidance for all types.

Rationale: The following elements support the consideration of revised accounting treatment:

- Existing statutory accounting guidance has resulted in “funds” being captured throughout various investment schedules. This process has resulted in a lack of transparency and makes it difficult to assess the amount of “funds” held as investments. (Existing guidance allows some mutual funds and ETFs to be classified as bonds, common stock or preferred stock based on SVO assessment.)

- SSAP No. 26 uses an amortized cost measurement. The bond investment schedule (D - Part 1) is not conducive to the reporting of “funds” or other items that do not have an amortized cost. Without a contractual amount of principal due, there is no actual “amortized cost” for fund investments. As such, the “amortized cost” reported is a calculated amount determined by the reporting entity and is not consistently determined.

- The rationale for the current process of including “funds” in different schedules was based on the assessed risk of the funds. (For example, allocating funds based on credit quality, market risk, redemption process, underlying investments, etc.) This process was supported as a lower-risk investment was deemed to warrant a lower RBC charge. (This proposal suggests that lower RBC charges – if appropriate – are feasible with a collective reporting process as different types of investments would be coded separately. Furthermore, having similar investments reported together, but bifurcated by type, will assist regulators in understanding the extent of investments.

- Some concerns with moving “funds” into a single SSAP/schedule are based on the expectation that funds previously in scope of SSAP No. 26 will no longer be considered “bonds” for state investment purposes. Per info from some states, mutual funds or ETFs classified as bonds for reporting do not result in those items being considered bonds under state investment guidelines. If some states do allow such funds to be considered “bonds” within their guidelines, this is still possible with the proposed coding of investments within a new schedule. In short, recognition in accounting and reporting does not impact state investment law limitation requirements.

Impact: By requiring all SSAP No. 26 investments to have a “contractual amount of principle due”, ETF’s and mutual funds would be eliminated from the scope of SSAP No. 26. Additionally, this requirement would prevent future inclusion of other “fund” investments from being classified as bonds. This memo also proposes consideration of new accounting and reporting guidance for “funds”.

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Bonds

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for bonds and fixed-income investments specifically identified to be within the scope of this statement.

2. This statement excludes:
   a. Loan-backed and structured securities. These investments are addressed in SSAP No. 43R—Loan-Backed and Structured Securities.
   b. Bonds that meet the definition in paragraph 3, but have a maturity date of one year or less from the date of acquisition. These investments are addressed in SSAP No. 2—Cash, Drafts and Short-Term Investments.
   c. Mortgage loans and other real estate lending activities made in the ordinary course of business. These investments are addressed in SSAP No. 37—Mortgage Loans and SSAP No. 39—Reverse Mortgages.

SUMMARY CONCLUSION

3. Bonds shall be defined as any securities\(^1\) representing a creditor relationship, whereby there is a contractual amount of principal due with a fixed schedule for one or more future payments. This definition includes:
   a. U.S. Treasury securities,\(^{\text{INT 01-25}}\)
   b. U.S. government agency securities,
   c. Municipal securities, and
   d. Corporate bonds
   e. Convertible bonds, including mandatory convertible bonds as defined in paragraph 9,
      i. Exchange Traded Funds, which qualify for bond treatment, as identified in the Purposes and Procedures Manual of the NAIC Investment Analysis Office, and

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\(^1\) This SSAP adopts the GAAP definition of a security as it is used in FASB Codification Topic 320 and 860: Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:
   a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
   b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
   c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.
Class 1 Bond Mutual Funds, as identified in the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

NOTE: Other items currently included in SSAP No. 26 will be subsequently discussed. The intent of this memo is simply to consider the requirement for a “contractual amount of principal due” resulting in the exclusion of ETFs and Mutual Funds from the scope of SSAP No. 26.

Proposed New SSAP – Accounting for Funds

Investments in Funds

SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for investments in Mutual Funds\(^2\) and Exchange Traded Funds\(^3\). Other types of fund investments (e.g., closed-end funds, hedge funds, and unit investment trusts that are not ETFs) are not specifically addressed within statutory accounting guidance and pursuant to SSAP No. 4 are considered nonadmitted assets.

NOTE: The scope of this SSAP has been limited to funds currently addressed within statutory accounting principles. It is proposed that subsequent consideration occur on other types of funds not currently addressed. This proposal should not imply that all other funds should be admitted; however, staff suggests that clear guidance and direction for the different types of funds would eliminate confusion and improve consistency. Other types of funds for future discussion include: closed-end investment companies, unit investment trusts, hedge funds, and investments in “trust funds” that do not currently fit within the confines of SSAP No. 48.

SUMMARY CONCLUSION

2. A mutual fund is a type of investment company that pools money from many investors and invests the money in stocks, bonds, money-market instruments, other securities, or even cash. Per the SEC, some characteristics of mutual funds include:

   a. Investors purchase shares in the mutual fund from the fund itself, or through a broker for the fund, and cannot purchase the shares from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market. The price that investors pay for mutual fund shares is the fund’s approximate net asset value (NAV) per share plus any fees that the fund may charge at purchase, such as sales charges, also known as sales loads.

   b. Mutual fund shares are "redeemable." This means that when mutual fund investors want to sell their fund shares, they sell them back to the fund, or to a broker acting for the fund, at their current NAV per share, minus any fees the fund may charge, such as deferred sales loads or redemption fees.

   c. Mutual funds generally sell their shares on a continuous basis, although some funds will stop selling when, for example, they reach a certain level of assets under management.

\(^2\) A mutual fund is legally known as an open-end company.

\(^3\) Exchange traded funds (ETFs) are investment companies that are legally classified as open-end companies or Unit Investment Trusts (UITs). For the scope of this statement, UITs that are not ETFs are currently excluded. Additionally, although potentially formed as an open-end company, because of the limited redeemability of ETF shares, ETFs are not considered to be - and may not call themselves - mutual funds.
The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC. In addition, mutual funds themselves are registered with the SEC and subject to SEC regulation.

There are many varieties of mutual funds, including index funds, stock funds, bond funds, and money market funds. Each may have a different investment objective and strategy and a different investment portfolio. Different mutual funds may also be subject to different risks, volatility, and fees and expenses. (Fees reduce returns on fund investments.)

Exchange-traded funds, or ETFs, are investment companies that are legally classified as open-end companies or Unit Investment Trusts (UITs), but that differ from traditional open-end companies and UITs in the following respects:

ETFs do not sell individual shares directly to investors and only issue their shares in large blocks that are known as "Creation Units."

Investors generally do not purchase Creation Units with cash. Instead, they buy Creation Units with a basket of securities that generally mirrors the ETF’s portfolio. Those who purchase Creation Units are frequently institutions.

After purchasing a Creation Unit, an investor often splits it up and sells the individual shares on a secondary market. This permits other investors to purchase individual shares (instead of Creation Units).

Investors who want to sell their ETF shares have two options: (1) they can sell individual shares to other investors on the secondary market, or (2) they can sell the Creation Units back to the ETF. In addition, ETFs generally redeem Creation Units by giving investors the securities that comprise the portfolio instead of cash.

An ETF will have annual operating expenses and may also impose certain shareholders fees.

Investments in mutual funds and ETFs meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Acquisitions and Sales

At acquisition, mutual funds and exchange traded funds shall be reported at their cost, including brokerage and other related fees. Acquisitions and dispositions shall be recorded on the trade date.

Balance Sheet Amount

Investments in mutual funds shall be valued at fair value. Exchange traded funds shall be valued at… (Valuation is currently subject to Working Group discussion. No proposed language at this time.)

For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.
Impairment

8. For any decline which is determined to be other than temporary (INT 06-07) the mutual fund shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines in fair value which are determined to be other than temporary shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value. (This guidance will be subsequently considered for ETFs based on the valuation approach.)

Income

9. Dividends shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of the dividend. Dividends received as additional shares of the mutual fund or ETF (e.g., ETF coupons used to acquire additional shares of the ETF) shall be reported at the fair value / NAV of the mutual fund or ETF as of the date of receipt.

10. For reporting entities required to maintain an AVR, the accounting for realized capital gains and losses on sales of mutual funds or ETFs shall be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, realized gains and losses on sales of mutual funds or ETFs shall be reported as realized gains/losses in the statement of operations.

11. If fees and expenses of mutual funds and ETFs are not netted with the return of investment (e.g., ETF shareholder fees), such costs shall be expensed when incurred.

Reporting

12. Mutual funds shall be reported separately from ETFs on the investment schedule (Schedule D – Part 7) and by type of mutual fund:
   a. Index Fund
   b. Stock Fund
   c. Bond Fund
   d. Bond Fund on the NAIC SVO Bond List
   e. Money Market Fund
   f. Money Market Fund on the NAIC SVO Class 1 List
   g. Money Market Fund on the NAIC SVO U.S. Direct Obligations / Full Faith and Credit Exempt List

13. ETFs shall be reported separately from mutual funds on the investment schedule (Schedule D – Part 7) and by type of ETF:
   a. Index Fund
   b. Index Fund - on the NAIC SVO Bond List
c. Index Fund – on the NAIC SVO Preferred Stock List

d. Leveraged or Inverse ETF

e. Actively Managed ETF

Disclosures

14. The following disclosures regarding mutual funds and ETFs shall be made in the financial statements:

a. A description, as well as the amount, of mutual funds and ETFs not under the exclusive control of the reporting entity (e.g., restricted) and the nature of the restriction.

b. For each balance sheet presented, all mutual funds and ETFs (separately) in an unrealized loss position for which other-than-temporary declines in value have not been recognized:

i. The aggregate amount of unrealized losses (that is, the amount by which cost or exceeds fair value / NAV), and

ii. The aggregate fair value / NAV of mutual funds or ETFs with unrealized losses.

c. The disclosures in (i) and (ii) above should be segregated by mutual funds and ETFs that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer.

d. As of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.

Effective Date and Transition

15. This statement is effective for __________. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

REFERENCES

Other

• Purposes and Procedures Manual of the NAIC Investment Analysis Office

Relevant Issue Papers

• Issue Paper No._____—Investment Classification Project

4 Leveraged or inverse ETFs seek to achieve a daily return that is a multiple or an inverse multiple of the daily return of a securities index. An important characteristic of these ETFs is that they seek to achieve their stated objectives on a daily basis, and their performance over longer periods of time can differ significantly from the multiple or inverse multiple of the index performance over those longer periods of time.

5 ETFs that pursue active management strategies and publish their portfolio holdings on a daily basis.