MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, NAIC Director, Securities Valuation Office
    Eric Kolchinsky, NAIC Director, Structured Securities Group
    Edward Toy, NAIC Director, Capital Markets Bureau
    Todd Sells, NAIC Director, Financial Regulatory Services

DATE: October 2, 2014

RE: Referral from the Financial Condition (E) Committee Requesting a Review of the NAIC Derivative Instruments Model Regulation

1. Introduction – The Financial Condition (E) Committee has requested that the Task Force review the Derivatives Instruments Model Regulation (#282) (“Model #282”) and opine whether it should be retained as a model law, amended, converted to a guideline or archived. The request was referred to the Financial Condition (E) Committee by the Executive (EX) Committee, which is conducting a Model Law Review Initiative1 under the NAIC’s Procedures for Model Law Development (“Procedures”). The Procedures require NAIC members to affirmatively support adopted NAIC model laws.2 To identify those adopted models that NAIC members may no longer want to support, the Procedures’ provide for a review of the rates of adoption and an assessment whether the rates imply a consensus that the subject of the model requires a minimum national standard or uniformity among the states and a commitment by NAIC members to devote the resources necessary to support the model (the “Review”).4

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1 In support of the Review, the NAIC Legal Division performs a preliminary review to identify model laws that should be reviewed in the coming year. The model laws are selected because they were: 1) adopted and/or amended after the 2007 Model Law criteria became effective; 2) are not associated with an accreditation standard; and 3) are not associated with a federal law directive.

2 Implementation of the Model Law “Upon NAIC adoption of the Model Law, it will be a priority of the NAIC, through the collective efforts of the Members, to uniformly adopt the Model Law in a majority of states within three years after its adoption by the NAIC membership. The NAIC Members will devote significant regulator and NAIC resources to communicate, educate and support the Model Law. The NAIC staff will provide briefing materials, testimony, make state visits and answer questions. The Executive Committee shall provide updates to the NAIC Plenary on the status of adoption by states of the Model Law.” From Procedures for Model Law Development, adopted May 2007 and amended September 2008 and July 2013.

3 Review of Existing Model Laws The Executive (EX) Committee may undertake a review of the adoption rates of existing Model Laws. If the Executive (EX) Committee determines the existing Model Law does not meet the criteria, it shall be reclassified as a Guideline as defined above. If the Executive (EX) Committee determines the existing Model Law meets the criteria, it will be made a priority of the NAIC to pursue uniform adoption in the remaining states.

4 Model Law Development Criteria The Executive (EX) Committee of the NAIC, upon a recommendation of the Parent Committee, will determine if a proposed new Model Law (or Regulation) or amendment to an existing Model Law (or Regulation) meets a two-pronged test (Model Law Development Criteria) as follows: 1) the issue that is the subject of the Model Law necessitates a minimum national standard and/or requires uniformity amongst all states; and 2) where NAIC Members are committed to devoting significant regulator and association resources to educate, communicate and support a model that has been adopted by the membership. From Procedures for Model Law Development, adopted May 2007 and amended September 2008 and July 2013.
2. **A Threshold Issue** – Since its most recent revision and re-adoption by the NAIC in 2009, one state has adopted Model #282. Nine other states have adopted some other related legislation, which could be an older version of the NAIC model or legislation or regulation derived from other sources. The threshold issue before the Task Force is whether the Review is intended to be a mechanic assessment of rates. If so, the above information would indicate that NAIC members do not see a need for a national or a uniform derivatives standard and are not willing to support Model #282. However, a referral to the Task Force would not have been necessary if the Procedures contemplated that the Review would be a purely mechanical assessment as such an assessment could have been performed by NAIC staff.

3. **Background** - The Task Force conducted a review of Model #282 beginning in 2006 before the Procedures had been adopted. It completed the review in 2007 as the Procedures were being phased in and implemented changes to NAIC guidance in 2009, after the Procedures had been adopted. In 2005 and 2006, the Task Force noted that although the rate of adoption of Model #282 itself was low (four states), 19 states had adopted one or both of the derivatives section of the *Investments of Insurers Model Act (Defined Limits Version)* (Model #280) of which Model #282 was companion legislation. More importantly, the Task Force focused on the nature of the derivatives industry and instruments and concluded that the subject matter required a national standard irrespective of state rates of adoption. Accordingly, the Task Force formed the Derivative Market Study (E) Working Group and charged it with conducting a study of changes in the derivatives market and of insurer’s use of derivatives. The study led to a significant streamlining and revision of the reporting schedules to obtain more meaningful information about insurer derivative activity. It also led to referrals to other NAIC groups to modify other regulatory guidance for derivatives, which resulted in revisions to Model #282 and a recommendation that the NAIC retain it as a national standard. The NAIC adopted the recommendation of the Task Force that Model #282 be retained as a national standard.

4. **Recommendation** – The financial landscape has been significantly altered since the Task Force concluded its review of Model #282 in 2007. The SVO and Structured Securities Group (SSG) recommend that the Task Force undertake an evaluation of changes in federal laws and regulation governing derivatives, current insurer uses of derivatives and changes in the derivatives marketplace. This evaluation could be implemented in a series of public meetings supported by staff research and staffed by legal and derivatives industry experts, federal regulators and insurance company investment professionals supporting and knowledgeable about insurer derivatives activity. The

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5 The 2013 Model Review Criteria Worksheet for Model #282 created by the NAIC Legal Department indicates one state adopted the 2009 version. The new as part of the current Review. The Model Regulation Service as of April 2012 identifies the states that have the same or related activity. Please see Attachment Ten-A.

6 To: Jeffrey C. Johnston, Director, Financial Regulatory Services – NAIC; Todd Sells, Senior Financial Regulatory Services Manager - NAIC, Leslie Geel, Financial Research Manager

From: Michael Moriarty, Chair of the Valuation of Securities Task Force; Bob Carcano, Senior Counsel, SVO - NAIC

Re: Model Regulation 282 — Derivatives Model Law — Referral from NAIC Staff

Date: November 18, 2005

"... The senior staff has asked the Task Force to review the staff recommendation and to provide any comments and/or revisions the Task Force deemed appropriate. The Task Force considered the staff recommendation and discussed it in two interim meeting conference calls held on August 18 and October 4. It is the sense of the Task Force that it would be inappropriate to delete Model Regulation 282 without first assessing whether developments in the derivatives marketplace require changes in regulation. However, a study of developments in the derivatives market would require a significant commitment of time and resources. Accordingly, the Task Force has agreed to direct a study of the derivatives marketplace as a 2006 project and has instructed the SVO to research current regulation and to provide feedback to the Task Force early next year. During the discussions held on Model Regulation 282, interested persons questioned whether enough states had adopted the Model Regulation to warrant the dedication of time and resources that a thorough review of the derivatives markets would require. While the SVO found that only four states (CA, CT, IL and NY) have adopted Model Regulation 282, 19 states have adopted one or both of the derivatives section of the Investment of Insurers Model Act (Defined Limits Version). We concluded that this was a better indicator of regulatory interest in an updated understanding of the derivatives marketplace."

NAIC Proceedings 2005 4th Qt at page 2065; 2128 - Attachment Fourteen, Valuation of Securities (E) Task Force meeting of 12/4/05.

7 The activity of the Task Force and of the Working Group are documented in the following NAIC Proceedings:

2005 – 2nd Quarter (Q); 3rd Qt at page 543; 4th Qt at page 2065
2006 – 3rd Qt at page 1581; 4th Qt at page 1902
2007 - 1st Qt at page 1243; 2nd Qt at page 1045; 3rd Qt at page 1323; 4th Qt at page 10-616
2008 - 2nd Qt at page 10-625; 3rd Qt at page 10-742; 4th Qt at page 10-717
2009 - 1st Qt at page 10-562.
result of staff research and the information gathered at the meetings could then be used to evaluate whether changes are needed to existing NAIC guidance on derivatives, including, but not limited to, statutory accounting and reporting instructions. In turn, these considerations would provide a holistic perspective from which the Task Force could determine how best to respond to the Financial Condition (E) Committee.