



Carl B. Wilkerson

Vice President & Chief Counsel, Securities & Litigation
(202) 624-2118 t (866) 953-4096 f
carlwilkerson@acli.com

November 12, 2010

Mr. Julian Hammar, Assistant General Counsel
Office of General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20851

Re: Clarifying the Status of Insurance Products under the Definition of “Swap” in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Hammar:

ACLI greatly appreciates the courtesy of your CFTC and SEC colleagues to meet with representatives of the life insurance industry on November 8, 2010, to discuss the definition of the terms “Major Swap Participant,” “Major Security-Based Swap Participant,” “Swap,” and “Security-Based Swap.” The dialog was constructive and informative.

During the meeting, CFTC staff indicated that it would be helpful for ACLI to address the status of insurance products under the definitions of Swap and Security-Based Swap in writing. In an effort to respond promptly to the suggestion, we quickly convened our policy groups and developed the material below as a preliminary endeavor. We would be happy to discuss this letter further with the CFTC or SEC staff, and to answer any questions that may develop.

I. Need for Clarification

The Dodd-Frank Act includes within clause (A)(ii) of the swap definition any contracts that “provides for any purchase, sale, payment, or delivery . . . 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.”¹

Nothing occurred during countless meetings with Congressional staff and others during the lengthy process leading up to the adoption of the Act that ever suggested Congressional intent to regulate insurance products.² The specific terms used in the above-quoted swap definition, in the eyes of

¹ Dodd-Frank Act Section 721(a)(47).

² In fashioning the Federal Insurance Office, for example, Congress was careful to make sure that the Office had no general supervisory or regulatory authority over the business of insurance. The CFTC or the SEC should not use the intentionally broad term “swap” under the Dodd-Frank Act Title VII as an indirect means to regulate insurance, an authority that was expressly denied in Dodd-Frank Act Title V.

some observers³, have injected a degree of uncertainty concerning the application of Congress's intentionally broad swap definition to life insurance products.

Moreover, the Act's very clear preemption of the authority of states to regulate swaps as insurance further increases the demand for clarity.⁴ Any traditional insurance contract offered by an insurer that falls on the swap-side of the dividing line will fall out of the state regulatory scheme and come under the Commissions' regulations, and could be deemed as an unlawful non-insurance contract for an insurer to offer in the first instance, even assuming that the swap complied with federal law.⁵ In short, it is important to eliminate any potential suggestion that traditional, decades-old forms of insurance that fulfill consumer demands for financial and retirement security may unreasonably be exposed to unclear legal status.

To achieve legal certainty and avoid unnecessary disruption to a broad range of insurance products, we recommend that the CFTC and the SEC issue parallel guidance aimed at clarifying the scope of the swap definition. Such guidance should draw a more explicit line between swaps, on the one hand, and insurance, on the other. The potential disruption to the traditional insurance marketplace posed by an unclear application of the swap definition warrants interpretive clarification or rulemaking to prevent disruption of the insurance marketplace.⁶ We do not believe Congress intended to provoke a disruption to the marketplace for insurance products. The proper test of what is "insurance" should be premised on state-level authorization and regulation of insurance products and life insurers.⁷

³ Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010 at <http://sec.gov/comments/s7-16-10/s71610-63.pdf>.

⁴ Dodd-Frank Act Section 722(b). States may be inclined to amend their insurance laws to define the permissible kinds of insurance that may be transacted by an insurer to exclude any contracts that are determined to be federally regulated swaps. This would be necessary given the core functions of insurance regulators to supervise the solvency of insurance companies and determine the sufficiency of assets supporting insurance company contract obligations, which would be impossible with preemption of state insurance law for these products.

⁵ State insurance laws often regulate the kinds of derivative instruments that an insurer may use and the specific derivative transactions with which they may be used. New York Insurance Law Section 1410 (with applicable definitions found in Section 1401(a)) is illustrative, especially since New York imposes its derivative regulation on not just New York domestic insurers but all insurers licensed to do insurance business in New York. Under New York law, a "swap" is a permitted derivative instrument (Section 1401(a)(7)), but it can only be used in a hedging transaction (Section 1401(a)(12)), a replication transaction (Section 1401(a)(18)) or limited kinds of income generation transactions (see Sections 1410(c), 1410(l) and 1410(d), respectively). Sale of an insurance policy or annuity would constitute none of these permissible kinds of derivative transactions, and therefore it would not be an authorized use of derivatives for life insurers under New York law.

⁶ The preemption was specifically designed to preclude the opportunity for state legislatures to regulate the issuance of credit default swap as financial guarantee insurance subject to state insurance laws. The development that precipitated Congressional concern was a model law developed by the National Conference of Insurance Legislators (NCOIL), to regulate the issuance of credit default swap as financial guarantee insurance subject to state insurance laws. Congress wanted to prevent expansion of states' jurisdiction over the issuance of CDS, but did not act to cut back on existing state regulatory authority to govern the activities of life insurers. Congress did not intend to overturn greater than 150 years of state regulation of insurance. State insurance regulation has been and remains capable of protecting the public against abusive insurance products. But if the CFTC or the SEC are concerned that state insurance regulators might license insurers intent upon circumventing the rules, the SEC and CFTC both have means at their disposal under the Dodd-Frank Act to thwart any such efforts through direct and specific rulemaking as contemplated by proposed clarifying language set forth in this letter.

⁷ Nothing in this letter about the swap definition, or our November 8, 2010, discussion with your CFTC and SEC colleagues, relates to any existing exclusions provided by the Dodd-Frank Act or to stable value contracts that will be the subject of a study mandated by the Act within 15 months of enactment.

II. Clarification of Swap Definition

The CFTC and the SEC should clarify the swap definition in order to exclude an insurance contract or transaction from the definitions of swap and security-based swap based on a three part test. First, under the mechanics of our proposal below, the contract must be issued by an insurance company and subject to state insurance regulation⁸ as described in paragraph (1) of the exclusion. Second, the contract must be type of contract issued by insurance companies as described in section (2) of the exclusion. Third, the insurance contract must not be a type of contract that the CFTC or the SEC wishes to regulate.

A. Proposed Clarification of the Swap Definition Concerning Insurance Contracts⁹

“The terms ‘swap’ and ‘security-based swap’ do not include any agreement, contract or transaction that:

- (1) Is issued or engaged in by an insurance company (as defined by Section (2)(a)(17) of the Investment Company Act of 1940)(15 U.S.C. 80a-2(a)(17) in respect of which the sale, reserving, payment or performance of such agreement, contract or transaction is subject to supervision by an insurance commissioner or similar official or agency of a State, or any receiver or similar official or liquidating agent for such company, in his capacity as such;
 - (2) Is an insurance contract, including, without limitation, a life insurance contract, annuity contract, endowment, funding agreement, guaranteed investment contract, settlement option , long-term care insurance contract, disability insurance contract, or any reinsurance contract in respect thereof, that is issued on an individual, group or other basis, whether fixed, variable or otherwise, and is supported by such insurance company’s general assets or separate accounts, as permitted under state insurance law; *and*,
 - (3) The CFTC or the SEC has not determined by rule or regulation to be a swap or security-based swap, based on an individual determination that state regulation of the contract is insufficient to warrant the exclusion following a notice and opportunity for a hearing on the record under the Administrative Procedure Act.
-

⁸ ACLI’s September 20, 2010, [submission](#) on the “core” definitions under the advance notice of proposed rulemaking provided a discussion about the comprehensive nature of state insurance regulation over life insurers’ investments at Appendix B. ACLI also provided a larger discussion about the extensive scope of state insurance regulation in an August 20, 2010 [submission](#) with the SEC on aspects of Title IX of the Dodd-Frank Act in a section entitled A Comprehensive System of Regulation Governs the Distribution of Insurance and Annuity Contracts at page 204 of <http://sec.gov/comments/4-606/4606-2669.pdf> . See also page 27 *Id.*

⁹ A parallel revision to the term “security-based swap” should also be implemented along these lines.

III. Analysis of other Commentators' Observations in the Advanced Notice of Proposed Rulemaking on "Core" Definitions

One comment letter on the "core" definition proposal attempted to prescribe tests for defining the functional distinction between federally-regulated swaps and state-regulated insurance products.¹⁰ The commentator's suggested multi-part definitions of insurance that rely on linking payments to loss contingencies and insurable interests are unworkable and fall well short of covering a wide range of common insurance products, particularly those used in the retirement markets. For example, using the following factors to validate that an insurance product is not a "swap" would be incompatible with many traditional insurance products:

- *Contingent payment does not vary with the price of any asset.* This factor is not consistent with common variable life insurance and variable annuity products, which deliver insurance guarantees that do vary with the performance of specified assets, generally specific assets allocated to insurance company separate accounts. Also, equity indexed annuities promise a payment based on the performance of an index or other basket of assets.
- *Contract owner has an "insurable interest" or reasonable expectation of loss upon the occurrence of the contingency.* Insurable interest is a term of art used in the insurance industry to avoid wagering or gambling to profit from an insurance contract. It is the insurance principle, for example, that prevents any person from taking life insurance on a stranger or insuring the property of a stranger for speculative gain. However, this insurance principle is not universally applied to other types of insurance products, such as annuity contracts, where the moral hazard of gaining from someone's loss is not present. The absence of uniform insurable interest standards that apply to all traditional insurance products makes this an unworkable measure for distinguishing between a swap and insurance.
- *Contract limits payment or performance to the actual loss arising.* This insurance concept of indemnification is standard for property/casualty contracts and reinsurance transactions, which attempt to put the insured in the same position as prior to the insured loss (i.e., "make whole"). But this factor does not apply generally to wide range of insurance products that provide for payments not directly connected to the amount of any loss incurred. For example, long-term care policies may provide for payment of a fixed amount per day, regardless of the amount of actual losses arising from the inability to perform activities of daily living. The same is true for disability income insurance policies, which may pay a periodic benefit without regard for the actual losses arising from the disability. Annuity products may provide for guaranteed lifetime payments or withdrawal benefits, which are not

¹⁰ Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010. <http://sec.gov/comments/s7-16-10/s71610-63.pdf>. ACLI fully disagrees with the conclusions in this letter that insurance contracts fall within the definition of the term swap; the letter appears to be based solely on the intentionally broad wording, without regard to the extensive deliberative context that provides much greater basis for interpreting Congressional intent. Following the near economic collapse of 2008, the administration and Congress worked for over 18 months to develop comprehensive reform that would prevent future similar incidents. The scope of the task facing Congress was profound, and in order for Congress to complete the legislation before the summer 2010 recess and campaigns for fall 2010 mid-term elections, many aspects of the legislation were left intentionally broad and unfinished, with significant details delegated to regulatory agencies for implementation. Interpretation of the legislation, therefore, must consider the legislative environment and the broad approach taken by Congress with the explicit instruction for implementing regulations. A simple review of the language alone is insufficient.

Mr. Julian Hammar, Assistant General Counsel
Office of General Counsel, CFTC
November 12, 2010

in the form of an indemnity for any loss event. Similarly, ordinary life insurance death benefits under a term or whole life insurance policy generally are not directly related to the specific economic losses of a beneficiary; not only does the purchaser of the life insurance simply select the death benefit amount but the beneficiary can be changed after the policy has been purchased so there may be absolutely no nexus between the payment of the death benefit and anything that could be labeled an "actual loss."

* * * *

In conclusion, we greatly appreciate your accessibility, and your attention to our views. Please let me know if you have any questions

Sincerely,

Carl B. Wilkerson
Carl B. Wilkerson