SVIA

November 10, 2010

By Electronic Submission

Mr. Stephen Kane
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Stable Value Contracts

Dear Mr. Kane:

On behalf of the Stable Value Investment Association ("SVIA") and its members, we want to thank you for your continued efforts to understand stable value funds and the important role that stable value investment contracts have played in protecting the $561 billion invested by more than 25 million participants and their beneficiaries in the more than 173,000 defined contribution plans that offer stable value funds as an investment. On October 26, 2010, you relayed to us a request from Michael Kreps in Senator Tom Harkin's office to provide additional detail regarding the negative impact that collateral and margin requirements would have on stable value funds relative to other fixed income products.

Collateral and margin requirements would result in higher operating costs and potentially higher capital requirements to providers of stable value products. These added costs, which we believe unnecessarily duplicate costs already applied to these products, would diminish (or eliminate) the risk-reward premium available to investors in stable value funds. This premium is one of the primary benefits of stable value funds as compared to money market funds. Lowering this premium would threaten the long-term viability of this popular, low-risk investment vehicle. As discussed in greater detail below, this is one of many problems that may arise if stable value contracts are included within the definition of "swap" in Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We do not believe that Congress intended this result.

SVIA does not believe that stable value contracts fall within the definition of a "swap." Even though "swap" is defined broadly in the Dodd-Frank Act, stable value contracts possess few, if any, of the characteristics commonly associated with these instruments. For example:

- <u>Benefit Responsiveness.</u> The stable value investment contract (or "wrap") ensures that all participants in a stable value fund may withdraw from the fund at contract value contract value regardless of the market value of the fund's underlying assets. Significantly, because of the nature of the stable value product, all participant contract value transactions occur at contract value. Any difference between the market and contract value of the fund is a difference that can never be realized by the participant through the exercise of stable value investment contract.

- No Trading. Each stable value contract is tailored to meet the specific needs of the associated fund and its participants. Stable value contracts cannot be traded or even assigned. There is no market for stable value contracts, nor will such a market exist.

- No Leverage. Stable value funds are not leveraged. On the contrary, each stable value fund is well-collateralized and supported by a diverse portfolio of high quality bonds, typically rated on average AA or AAA, with an average maturity date of approximately 3 years. Any exposure to the issuers of stable value contracts is limited to the difference between the market value of the underlying portfolio and the contract value of the portfolio at a certain point in time – a difference that is generally less than 4% of the fund's overall value.[1] At the height of the financial crisis, the market to contract ratio for stable value funds averaged 95% (December 2008). As of September 2010, stable value funds' market to contract ratio averaged 104%.[2]

- No Clearing. Each stable value contract is the product of a lengthy underwriting process that includes a comprehensive review of the associated fund's investment strategy, relevant benchmarks (*e.g.*, bond indices, money market funds), and cash flow history. In addition, through the underwriting process, the stable value contract is designed and tailored to take into account the demographics of the particular benefit plan's participants, the other investment options offered by the plan, and the plan's management. As a result, stable value investment contracts are intrinsically non-standardized agreements that cannot be cleared by a clearinghouse.

Should the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission, (SEC) nevertheless, conclude that stable value contracts fit within the literal definition of swap, SVIA urges the Commission to support a preemptive exemption for stable value contracts from the swap definition. Such an exemption is consistent with Section 719(d)(1)(B) of the Dodd-Frank Act and Congress's intent to provide relief where, as here, the request is "appropriate and in the public interest."

Regulating stable value contracts as swaps is unnecessary and incompatible with the way in which stable value products have operated for more than 35 years. Stable value funds and investment contract issuers are already pervasively regulated by a combination of federal and state authorities, including the Office of the Comptroller of the Currency, the Department of Labor, the Securities and Exchange Commission, and state insurance departments. For example,

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1 The difference between market value and contract value can be (and often is) positive, meaning that the market value of the fund actually exceeds its obligations to fund participants.

2 The market to contract ratios referenced are from SVIA's Stable Value Funds Quarterly Characteristics Survey. The survey tracks 25 stable value managers who collectively manage $437 billion, which is a subset of the $621 billion under management by all SVIA members.

stable value investment contract issuers are already subject to capital requirements that are based on dynamic risk-based models. Stable value funds must also comply with various reporting obligations and submit to periodic independent reviews (typically quarterly or on a more frequent basis).

Subjecting stable value investment contracts to additional regulation by the CFTC would add significant cost and would not reduce systemic risk. Paradoxically, collateral and margin requirements, particularly daily margining based on the relatively volatile value of the funds' underlying bond assets, would introduce unpredictability and risk to a conservative investment product that was specifically designed to minimize the impact of short-term market fluctuations. The cost of collateral and margin requirements also would increase the operating costs of issuing stable value contracts and lower the return on stable value funds. In today's capital-scarce environment, requirements that increase operating costs such as margin and collateral may also drive some investment contract issuers out of the stable value market.

Stable value funds are an attractive investment alternative, not only because of the benefit responsiveness feature, but also due to the risk-reward premium they provide. The risk-reward premium rewards investors for investing in longer term (year or more) rather than short term investments such as money market funds. The premium is typically 50 basis points +/- 10 basis points. The crediting rate, which is set by formula in the contract, passes through the underlying gains and losses of the supporting portfolio of securities. Imposing margin and collateral requirements could significantly increase the costs borne by stable value funds. If stable value funds are unable to offer a significant premium over other conservative investment products, they will cease to be a viable and competitive investment option. No other investment alternative exists in defined contribution retirement plans that provide stable value's unique combination of benefits: principal preservation and a steady, positive return that consistently outperforms money market funds.

Treating stable value investment contracts as swaps also may create conflicts with other regulatory regimes. For example, stable value investment contracts are often regulated as a form of annuity contract under state insurance laws. As such, the form of a stable value investment contract generally must be filed with and approved by a state insurance department before an associated stable value investment contract can be sold in the state. Stable value investment contracts also are subject to state insurance laws regulating the reserves an insurer must maintain to support its obligations under a stable value contract.

If stable value contracts are regulated as swaps, Section 722(b) of the Dodd-Frank Act would preempt state insurance law and prohibit such investment contracts from being regulated as insurance products.[3] The result would potentially pose another paradox: insurance companies would be authorized under state law to *issue* stable value contracts, but state insurance departments would lack the authority to *regulate* stable value contracts as insurance products. In such a situation, state governments may be required to amend their insurance laws defining the

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[3] Section 722(b) of the Dodd-Frank Act provides that "[a] swap… may not be regulated as an insurance contract under the law of any State."

products that insurers may offer to exclude stable value investment contracts to eliminate this conflict.[4]

Existing restrictions on the use of derivatives by insurance companies also may limit the continued viability of stable value products. For example, under New York Insurance Law Section 1410, although a "swap" is a permitted derivative instrument, it can only be used in a limited few categories of transactions that do not include issuing stable value investment contracts.[5] As a result, any insurance company that issues stable value investment contracts would presumably violate New York law if it continues to do so. This is particularly significant because New York imposes its derivative regulation on not just insurers located in New York, but all insurers licensed to conduct insurance business in New York. Consequently, stable value providers would be forced from a safe and well-established line of business, and the personal investments of the more than 25 million 401(k) participants and beneficiaries who rely on stable value products would be seriously disrupted.

We hope that this answers the question posed by Senator Harkin's staff. SVIA is willing and able to continue to serve as a resource to you and your colleagues on this important issue. Please let us know if you have any further questions.

Best regards,

Gina Mitchell

Gina Mitchell
President, Stable Value Investment Association

4 This action may 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 they would no longer be able to determine due to preemption of state insurance law.

5 Under New York law, a "swap" is a permitted derivative instrument (New York Insurance Law Section 1401(a)(7)), but it can only be used in a hedging transaction (New York Insurance Law Section 1401(a)(12)), a replication transaction (New York Insurance Law Section 1401(a)(18)) or limited kinds of income generation transactions (*see* New York Insurance Law Sections 1410(c), 1410(l) and 1410(d)).