VIA E-MAIL [SECRETARY@CFTC.GOV]

Commodity Futures Trading Commission
Chairman Gary Gensler
Commissioner Jill E. Sommers
Commissioner Bart Chilton
Commissioner Scott D. O'Malia
Commissioner Mark P. Wetjen

Division of Swap Dealer and Intermediary Oversight
Gary Barnett, Director
Frank N. Fisanich, Chief Counsel

Office of the General Counsel
Dan M. Berkovitz, General Counsel

Re: Applicability of Commodity Pool Regulation to Insurance Linked Securities

Dear Chairman Gensler, Commissioners Sommers, Chilton, O'Malia and Wetjen and Director Barnett:

The Securities Industry and Financial Markets Association ("SIFMA")[1] requests that the Commodity Futures Trading Commission ("Commission" or "CFTC"), or its staff, provide interpretive guidance and other appropriate relief with the result that insurance-linked securities ("ILS") transactions will not be regulated as commodity pools under the Commodity Exchange Act (as amended, the "CEA") by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), including those ILS transactions that do not satisfy the non-exclusive safe harbor for certain insurance transactions not being a swap as a result of (i) the cedant's primary regulator being outside the United States and consequently failing to meet the "Provider"

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

test and/or (ii) the form or terms of documentation failing to meet the "Product" or "Enumerated Product" tests under the safe harbor. We further request that outstanding ILS transactions be exempted.

Since 1996 there have been approximately 262 issuances of ILS transactions with an aggregate of approximately $45.4 billion of bonds issued. As of November 1, 2012, approximately 76 ILS transactions involving $15.6 billion of bonds were outstanding, many of which are subject to potentially becoming commodity pools. Most of these transactions have no ability to amend the underlying documents to comply with the relevant CFTC regulations. It is critical that relief be granted for outstanding transactions and that this important aspect of the worldwide insurance and reinsurance industry continue to function in the manner in which it is currently regulated.

Historically, ILS entities have not been regulated as commodity pools and do not hold commodity interests as defined under prior law and regulation. However, due to the expanded scope of the definition of "commodity pool" under the Dodd-Frank Act, which includes the broadly defined term "swaps" as commodity interests, it is unclear whether existing and new ILS entities could be treated as commodity pools. The commodity pool regulatory scheme is designed for structures that are very different from ILS transactions. As described below, ILS transactions lack many of the defining characteristics of a commodity pool. Historically, ILS transactions have not presented any of the issues or abuses that drove Congress to enact the CEA, create the CFTC or adopt the Dodd-Frank Act.

SIFMA respectfully submits that it is critical that the CFTC or its staff provide clear and unambiguous interpretative guidance and other appropriate relief in respect of ILS transactions. Due to the imminent effectiveness of the relevant new provisions of the CEA and related regulations, and the chilling effect they would have on the ILS markets in the absence of clarifying guidance, we request a meeting at your earliest convenience to discuss how the interpretative guidance and other relief we believe necessary to avoid market disruption can be most effectively and expeditiously achieved, and to answer any questions you may have.

Background

ILS transactions were first developed in the 1990s as a means of bringing additional capital to support the insurance industry in the devastating wake of Hurricane Andrew, which forced several insurers to file for bankruptcy. ILS transactions allow sponsoring insurance companies and reinsurance companies to obtain collateralized reinsurance or retrocession (i.e. reinsurance of reinsurance) cover by ceding insurance risk to the capital markets pursuant to a risk transfer contract with a special purpose vehicle ("Issuer"). ILS transactions provide cover for losses resulting from events such as earthquake, hurricane, tornado, hailstorm, fire, flood and other property and casualty related events, extreme mortality, extreme disease, longevity and other risks that are typically covered by insurance. An insurer or reinsurer typically initiates an ILS transaction to secure risk protection from the capital markets relating to its insurance exposure, which exposure originally arises in connection with policies issued or risks assumed in the ordinary course of its business as a regulated insurance or reinsurance company in the applicable jurisdictions.

In a typical ILS transaction, the sponsoring insurance or reinsurance company causes a special purpose vehicle to be created to act as the Issuer. The sponsor enters into a risk transfer contract with the Issuer pursuant to which the sponsor cedes risk for specified and clearly defined trigger events to which the sponsor has exposure in its portfolio and anticipates having for the life of the transaction (typically one to five years). For example, an insurance company that has historically had exposure to California earthquakes and wants to purchase protection against a major event might look to cede a portion of that risk to the capital markets. In order to support its potential obligations under the risk transfer contract, the Issuer sells bonds in an amount equal to its maximum exposure under the risk transfer contract. The cedant insurance company makes payments under the risk transfer contract sufficient to cover the expenses of the Issuer and to pay interest to the bondholders. The bondholder's interest payments consist of that portion of the cedant's payment designated for that purpose, plus the earnings on the investment of the proceeds from the bond issuance (net of any payments made to the cedant under the risk transfer contract).

All proceeds of the bonds sold by the Issuer are deposited into a security account that serves as security for the cedant and the bondholders. Upon the occurrence of a specified trigger event, the contractual payment amount is paid to the cedant from the security account. Coverage ceded to the Issuer is 100% secured by liquid collateral and consequently there can be no competing insurance claims on the Issuer's capital. Coverage provided by the Issuer cannot exceed the collateralized amount. Other than passing through interest payments, there are no further ongoing obligations for additional payments or collateral to be exchanged under the risk transfer contract. If a payment is made by the Issuer to the cedant under the risk transfer contract, the aggregate principal amount of the bonds will be written down in the amount of such payment. At maturity, funds not used to meet obligations to the cedant are returned to the investors as principal payments on the bonds. The Issuer's bonds are offered and sold only to investors who are qualified institutional buyers that, with respect to U.S. persons, are also qualified purchasers.

The bonds in ILS transactions are typically offered by means of an offering memorandum that is accompanied by a risk analysis report prepared by an independent company expert in the statistical modeling of insurance risk. The modeling company uses standard models widely employed by insurers and reinsurers in their own portfolio risk evaluations. The output of these models is expressed as estimates of expected loss, probability of attachment (where the first loss would be triggered under the bonds) and probability of exhaustion (where the bond principal would be reduced to zero). The risk analysis forms much of the basis on which the bonds are evaluated, rated and priced. The risk analysis is the output of many computer generated simulations of the relevant events run against the modeling company's database of property valuations and a notional portfolio of insurance risk.

ILS transactions can be categorized into three basic categories reflective of the trigger by which losses are calculated: indemnity transactions, non-indemnity transactions and indemnity transactions with non-indemnity triggers.

- **Indemnity Transactions**: ILS transactions with an indemnity feature provide for payment by the Issuer to the sponsoring insurer or reinsurer up to a specified amount corresponding to claims actually incurred by the cedant in excess of a specified level arising from one or more clearly defined events. In indemnity transactions, the Issuer is licensed and regulated as a reinsurer in its domicile jurisdiction. The risk transfer contract is in the form of a reinsurance agreement and the insurer or reinsurer is indemnified as if it had purchased traditional "excess of loss" reinsurance for claims in excess of a specified amount of loss. Typically, upon the occurrence of a specified trigger event, an independent claims reviewer will, by sampling, verify the cedant's losses before any payment may be made to sponsor. To permit the cedant to be indemnified for events occurring shortly before the bond maturity, the maturity may be extended for up to a specified period of time to permit this calculation and verification process to be completed. If necessary, a claim may be paid at maturity in an amount equal to the amount determined by an independent actuary to account for claims incurred by the cedant but not paid by maturity.

- **Non-Indemnity Transactions**: Non-indemnity ILS transactions generally fall into three principal types: parametric, indexed and modeled loss. Parametric triggered transactions provide the sponsor protection against losses from certain specified events based on objective measures related to the events, which are calculated to correspond to expected claims under the sponsor's reinsurance or insurance obligations above a certain level. Such objective measures may consist of natural parameters such as wind speeds, earthquake location, depth and shake intensities, or mortality rates of defined population sets. The parameters that trigger payments are typically derived from statistics published by government sources such as the National Hurricane Center, the United States Geological Survey, the Japan Meteorological Agency or various European government agencies that report wind speeds.

Index triggered transactions have a trigger based on an index. The index could be a mathematical formula based on weighted parameters related to an event or could be based on estimates of aggregate insured industry losses that are published by independent companies whose reports are widely used in the insurance and reinsurance industry.

Payment triggers in non-indemnity transactions can also be determined on a modeled loss basis. Modeled loss triggered transactions effectively "re-model" a sponsor's portfolio of insured exposure to estimate the probable outcome from a catastrophic event in determining the potential magnitude of loss. The notional portfolio used in the model is designed by the sponsor to closely resemble its portfolio of policies so that the result will be a realistic estimate of its insured losses from the simulated events. In a "modeled loss" transaction, the parameters of a specified actual event are entered into the same model against the exposure database and the notional portfolio of insurance risk to produce a modeled loss value. If that value is greater than the trigger amount specified for the bonds, a payment will be made by the Issuer to the cedant in an amount based on that difference.

- **Indemnity Transactions with non-indemnity triggers**: Many transactions contain the trigger mechanics of a non-indemnity transaction (either parametric, indexed or modeled loss) with an added ultimate net loss feature ("UNL"). The risk transfer contract, typically in the form of a reinsurance agreement, contains a UNL provision limiting the Issuer's payment obligations to the sponsor to its actual losses from the trigger event. The result is generally not expected to be different from other non-indemnity transactions because the payment triggers in non-indemnity transactions are carefully designed in an effort to reimburse the cedant for actual losses. The UNL provision merely makes certain that, regardless of where the triggers are set, payments to the cedant cannot exceed its actual losses and is generally employed so that the risk transfer contract can be treated as reinsurance for the cedant's regulatory capital purposes and under GAAP and IFRS.

There are several reasons for the use of non-indemnity triggers in the ILS market. Their purpose and design is to provide coverage for potential losses in the sponsor's insurance portfolio, which would typically be covered by reinsurance. In an indemnity transaction it can take extended periods of time for the cedant to actually receive and pay its claims, which can delay its recoveries under the ILS transaction. In a non-indemnity transaction, as soon as the parameters of the event are known, the appropriate steps can be taken to cause a payment to the cedant in a much shorter period of time. Payments to a cedant in a non-indemnity transaction can provide liquidity for it to pay claims. To the extent there may be a mismatch between actual losses that would have been covered by indemnity and amounts recovered in a parametric, indexed or modeled loss transaction, the cedant takes the basis risk in exchange for the timing and certainty. Cedants carefully analyze the basis risk because they have no incentive to pay more for coverage than their anticipated actual loss from an event. The risk modeling experts assist in structuring the transaction to meet the cedant's needs. In any non-indemnity transaction, the ceding company is comfortable that the trigger mechanism provides them with economical risk capital for their insurance or reinsurance business.

It is also important to note that some ILS investors prefer non-indemnity transactions because the triggers are more readily understandable, may be considered to be more objective and involve shorter periods of uncertainty after an event. In an indemnity transaction the investors need to analyze large amounts of data related to the cedant's actual exposures, the manner in which the cedant settles its claims, the cedant's reputation for integrity and other factors that might influence the loss experience. Disclosure of this information may create confidentiality issues for cedants and more extensive analysis for investors. None of this information is particularly relevant to a non-indemnity transaction.

The Sponsor

Non-U.S. sponsors of ILS transactions, typically major European, Asian or Bermudian insurers or reinsurers, do not meet the safe harbor's Provider test primarily because they are not regulated domestically (nor are they on the NAIC's Quarterly Listing of Alien Insurers). They are, however, regulated in the jurisdictions where they are organized. In indemnity transactions (including indemnity transactions with non-indemnity triggers) the Issuer is also a regulated insurance or reinsurance entity in its jurisdiction of organization, which is typically outside the United States (generally Bermuda, the Cayman Islands or Ireland). Non-indemnity transactions without a UNL clause do not require that the Issuer be a regulated insurer. Sponsors could also be domestic or foreign governments seeking parametric, indexed or modeled loss coverage for events where such coverage is not available from the traditional insurance market at a competitive cost. Such transactions may not involve an insurance company, but the cover sought from the capital markets is designed to protect the sponsors from anticipated losses caused by the trigger events. One notable program in this regard is the Multi-Cat program sponsored by the World Bank to encourage developing countries to utilize ILS transactions in order to provide funds for needed relief efforts in case of a catastrophe.

Transactions with UNL clauses limit recoveries to actual losses incurred by the cedant and are reinsurance transactions. In all cases coverage under ILS is provided for events beyond the control of the cedant. ILS is a worldwide market and foreign sponsors are insurance or reinsurance companies that are subject to regulation by insurance regulations in their home jurisdictions should be provided exemptive relief from the commodity pool regulations. With respect to ILS, the Commission should have discretion to exempt ILS transactions involving foreign insurers or reinsurers from commodity pool regulation notwithstanding failure of the transaction to meet the non-exclusive safe harbor due to the cedant not meeting the Provider test. This is more compelling because regulation of the cedant in an ILS transaction is less relevant to investors than commodity regulation would be to an investor in a commodity pool.

ILS Transactions do not have Defining Characteristics of Commodity Pools

ILS transactions lack many of the defining characteristics of commodity pools. As noted above, ILS entities have historically not been regulated as commodity pools by the CFTC and do not hold commodity interests as they were defined under prior law and regulation. The Issuer's sole business activities are limited to the particular ILS transaction and are not formed or operated for the purpose of buying and selling commodity interests. The risk transfer contract in each ILS transaction is held for the entire life of the transaction and cannot be traded, assigned or otherwise separated away from the ILS transaction.

Additionally, ILS transactions lack the other defining characteristics of commodity pools:

ILS are not "investment trusts"

> ILS transactions are passive securitizations of insurance risk, reinsurance risk or similar type risks and are not "investment trusts." The only financial asset of the Issuer other than the investments held as collateral for the cedant and the bondholders is the risk transfer contract.

There is no ability to sell or trade the risk transfer contract and each risk transfer contract is related to a separate class or series of bonds.

ILS investors do not share in profits or losses

ILS bonds are debt instruments with a stated interest rate or yield and principal balance and a specified maturity date. Investors do not share in profits or losses of the Issuer. The bonds are more analogous to the debt of an operating insurance company than to a commodity pool. Investors in ILS transactions are exposed to clearly defined traditional insurance-type risks.

The Issuer has no discretion over investments

The collateral is governed by investment guidelines that permit investments only in high-grade securities (typically U.S. Treasury money market funds, or government or government agency debt) or cash. The Issuer is not permitted to acquire additional assets or trade or dispose of assets and has no discretion over the investments, which are governed by specified contractual guidelines.

No "net asset value" for issued securities

Issuers are special purpose vehicles that passively hold the proceeds of the bonds as collateral. The Issuers do not calculate a "net asset value" for their issued securities. Additionally, the Issuers have little to no ability to amend their governing documents.

No right of redemption

ILS investors do not have a right of redemption. ILS transactions could, but typically do not, include a right for the Issuer to call the bonds except in certain prescribed early redemption events, such as a "clean-up call" or upon the failure of certain service providers to perform their contractual obligations.

It is important to note that there is no ability to call the bonds or have the bonds redeemed in order to realize gains on the Issuer's investments.

Potential Negative Effects on the ILS and Insurance Markets

Regulations not intended to apply to insurance

The Commissions have stated that they do not interpret the statutory definition of the term "swap" to include traditional insurance products.[2] The risk transfer contracts used in ILS transactions are forms of traditional reinsurance products. As discussed above, ILS transactions lack many of the defining characteristics of commodity pools. Bonds issued in an ILS transaction are fixed income securities that are exposed to clearly defined traditional reinsurance-type risks and are owned by sophisticated institutional investors.

Adverse effects on availability of capital for reinsurance

An insurer or reinsurer typically initiates an ILS transaction to secure risk protection from the capital markets relating to its insurance exposure, which originally arises in connection with policies issued or risks assumed in the ordinary course of business and regulated as insurance or reinsurance in the applicable jurisdictions. ILS transactions provide insurance and reinsurance companies with an important tool with which to manage risk associated with exposures to natural disasters, man-made catastrophes, pandemics or similar events. ILS transactions have provided critical risk capital to cover losses incurred by ceding insurance companies after Hurricane Katrina, the Japanese Tohoku earthquake and tsunami of 2011 and the Midwest tornadoes of 2011.

ILS transactions complement insurers' reinsurance programs and provide reinsurers with a mechanism for transferring insurance risks. ILS transactions also enable insurers to transfer risk when reinsurance may not otherwise be readily available to cover certain risks at reasonable prices or in necessary amounts, for example, following a large earthquake or hurricane with major insured damage. Such events can reduce the capacity of traditional reinsurers to write coverage and can also result in high premiums. Other benefits to insurance companies include obtaining

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[2] See *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 FR 48208 (August 13, 2012).

fully collateralized protection in contrast to the unfunded commitments that are typical in the traditional reinsurance market, thereby minimizing counterparty credit risk, and diversifying access to capital to cover risk. ILS transactions typically provide fixed cost multi-year protection to insurance companies, which is generally not available in the traditional reinsurance market. Regulating ILS transactions as commodity pools will limit the ability of insurers and reinsurers to manage risk and plan their businesses, reduce their financial flexibility and could raise insurance costs.

Insurance availability

Without very substantial insurance capacity the world economies cannot function. Homes and businesses require insurance. Investment and credit will not be made available to enterprises that cannot insure their risks. Mortgages are not available on uninsured homes. Insurance companies have finite capital and consequently limited capacity to write coverage. One of the most significant portions of the capital of an insurance company is its reinsurance. To the extent its potential claims are reinsured, an insurance company need not provide capital from other sources. Reinsurance represents the most flexible form of capital for insurance companies because it can be adjusted as needed to meet requirements. The capital markets represent an important and growing source of capital for insurance and reinsurance companies. Any unnecessary impediments to providing insurance capital through the capital markets could have a serious negative effect on the U.S. and foreign economies. Access to the capital markets for reinsurance is particularly significant in times of distress after natural disasters.

Market uncertainty

In the absence of clarifying interpretative guidance from the CFTC, the ILS market may suffer significant harm due to uncertainty with respect to the status of ILS entities under new law and regulation. This uncertainty could have a significant chilling effect on any new ILS transactions and would be particularly harmful to existing ILS entities.

No public policy served by regulating ILS transactions as commodity pools

We see no public policy reason for regulating ILS transactions as commodity pools where the sponsors are in the business of insurance or reinsurance but such transactions do not satisfy the non-exclusive safe harbor merely because (i) the cedant is regulated by foreign insurance regulators, (ii) the coverage fails to meet the technical requirements of the "Products" test, or (iii) the risk transfer documentation is in a form other than a typical insurance or reinsurance contract.

Commodity pool regulatory requirements serve no constructive purpose in the ILS context

The commodity pool regulatory requirements are burdensome and would produce no benefit to ILS investors in existing or new transactions. ILS transactions are issued in compliance with securities laws and are sold only to sophisticated large institutions—investors who are qualified institutional buyers that, with respect to U.S. persons, are also qualified purchasers. Many transactions are also governed by relevant insurance laws. The potential for conflicting regulation and the reporting requirements (such as net asset value reporting) are not relevant to investors in ILS transactions.

Adverse effect on existing transactions

Most existing ILS transactions have no ability to amend their underlying documents to comply with the commodity pool regulations. Additionally, at the time of their formation, ILS Issuers estimate anticipated expenses and provide for coverage of those expenses but have no ability to raise additional capital. Consequently there may be no source of funds available for additional expenses involved in complying with unforeseen newly applicable regulations. The uncertainty regarding application of the commodity pool regulations, coupled with the difficulty of compliance for existing entities, could result in some entities being considered a commodity pool but not having a person identified as a commodity pool operator that is registered or eligible for exemption from registration.

For the reasons discussed in this letter, in the absence of generalized interpretive clarification relating to ILS transactions, the CFTC and its staff could receive an extraordinary volume of individual petitions for interpretive clarification and relief on a multitude of issues concerning the application of commodity pool regulation to ILS transactions. This could strain the Commission's resources and would be unlikely to produce the necessary regulatory guidance to market participants on a timely basis, or to do so in a comprehensive manner that would avoid the potentially severe adverse consequences discussed in this letter.

We greatly appreciate your consideration of the views set forth in this letter, and look forward to the opportunity to discuss these matters further with the Commission and its staff. Please contact Sean Davy of SIFMA at (212) 313-1118 or our counsel of the matter, Malcolm Wattman of Cadwalader, Wickersham & Taft LLP at (212) 504-6222.

Very truly yours,

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