

§ 58-7-205. Derivative transactions.

- (a) As used in this section, the following terms have the following meanings:
- (1) "Business entity" includes a sole proprietorship, corporation, limited liability company, association, partnership, joint stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether for-profit or not-for-profit.
 - (2) "Counterparty exposure" amount means:
 - a. The amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse ("over-the-counter derivative instrument"). The amount of credit risk equals:
 1. The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or
 2. Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.
 - b. If over-the-counter derivative instruments are entered into under a written master agreement which provides for netting of payments owed by the respective parties and the domicile of the counterparty is either within the United States or, if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office of the NAIC as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:
 1. The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer; and
 2. The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.
 - c. For open transactions, market value shall be determined at the end of the most recent quarter of the insurer's fiscal year and shall be reduced by the market value of acceptable collateral held by the insurer or placed in escrow by one or both parties.
 - (3) "Derivative instrument" means an agreement, option, instrument, or a series or combination thereof:
 - a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
 - b. That has a price, performance, value, or cash flow based primarily upon the actual or expected price level, performance, value, or cash flow of one or more underlying interests.

Derivative instruments include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, and any other agreements, options, or instruments substantially similar thereto or any series or combination

thereof. Derivative instruments shall additionally include any agreements, options, or instruments permitted under rules adopted under subsection (c) of this section. Derivative instruments shall not include an investment authorized by G.S. 58-7-173, 58-7-175, 58-7-178, 58-7-179, 58-7-180, and 58-7-187.

- (4) "Derivative transaction" means any transaction involving the use of one or more derivative instruments.
- (5) "Qualified clearinghouse" means a clearinghouse for, and subject to the rules of, a qualified exchange or a qualified foreign exchange. The clearinghouse provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.
- (6) "Qualified exchange" means:
 - a. A securities exchange registered as a national securities exchange, or a securities market regulated under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78, et seq.), as amended;
 - b. A board of trade or commodities exchange designated as a contract market by the Commodity Futures Trading Commission, or any successor thereof;
 - c. Private Offerings, Resales and Trading through Automated Linkages (PORTAL);
 - d. A designated offshore securities market as defined in Securities Exchange Commission Regulation S, 17 C.F.R. Part 230, as amended; or
 - e. A qualified foreign exchange.
- (7) "Qualified foreign exchange" means a foreign exchange, board of trade, or contract market located outside the United States, its territories or possessions:
 - a. That has received regulatory comparability relief under Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC's Regulations, 17 C.F.R. Part 30);
 - b. That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief under Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC's Regulations, 17 C.F.R. Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade, or contract market is located; or
 - c. Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC's Office of General Counsel, but an exchange, board of trade, or contract market that qualifies as a "qualified foreign exchange" only under this paragraph shall only be a "qualified foreign exchange" as to foreign stock index futures contracts that are the subject of the no-action relief under this paragraph.
- (8) "Replication transaction" means a derivative transaction that is intended to replicate the investment in one or more assets that an insurer is authorized to acquire or sell under this section or G.S. 58-7-165. A derivative transaction that is entered into as a hedging transaction shall not be considered a replication transaction.

- (b) An insurer may, directly or indirectly through an investment subsidiary, engage in derivative transactions under this section under the following conditions:
- (1) An insurer may use derivative instruments under this section to engage in hedging transactions and certain income generation transactions as may be further defined by rules adopted by the Commissioner.
 - (2) An insurer shall be able to demonstrate to the Commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analyses.
- (c) The Commissioner may adopt reasonable rules for investments and transactions under this section including, but not limited to, rules which impose financial solvency standards, valuation standards, and reporting requirements.
- (d) An insurer may enter into hedging transactions under this section if, as a result of and after giving effect to the transaction:
- (1) The aggregate statement value of options, caps, floors, and warrants not attached to another financial instrument purchased and used in hedging transactions then engaged in by the insurer does not exceed seven and one-half percent (7.5%) of its admitted assets;
 - (2) The aggregate statement value of options, caps, and floors written in hedging transactions then engaged in by the insurer does not exceed three percent (3%) of its admitted assets; and
 - (3) The aggregate potential exposure of collars, swaps, forwards, and futures used in hedging transactions then engaged in by the insurer does not exceed six and one-half percent (6.5%) of its admitted assets.
- (e) An insurer may enter into the following types of income generation transactions if, as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of its admitted assets:
- (1) Sales of covered call options on noncallable fixed-income securities, callable fixed-income securities if the option expires by its terms before the end of the noncallable period, or derivative instruments based on fixed income securities;
 - (2) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants, or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;
 - (3) Sales of covered puts on investments that the insurer is permitted to acquire under this Chapter, if the insurer has escrowed or entered into a custodian agreement segregating cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or
 - (4) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding.
- (f) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations of G.S. 58-7-170.

(g) Under rules that may be adopted by the Commissioner, additional transactions involving the use of derivative instruments in excess of the limits of subsection (d) of this section or for other risk management purposes may be approved by the Commissioner.

(h) An insurer shall establish guidelines and internal procedures as follows:

(1) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:

- a. Address investment or, if applicable, underwriting objectives, and risk constraints such as credit risk limits;
- b. Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and
- c. Require compliance with internal control procedures.

(2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective.

(3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

(4) An insurer's board of directors shall, in accordance with G.S. 58-7-168:

- a. Approve the guidelines required by subdivision (1) of this subsection and the systems required by subdivisions (2) and (3) of this subsection; and
- b. Determine whether the insurer has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.

(i) An insurer shall maintain documentation and records relating to each derivative transaction, such as:

- (1) The purpose or purposes of the transaction;
- (2) The assets or liabilities to which the transaction relates;
- (3) The specific derivative instrument used in the transaction;
- (4) For over-the-counter derivative instrument transactions, the name of the counterparty and counterparty exposure amount; and
- (5) For exchange-traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

(j) Each derivative instrument shall be:

- (1) Traded on a qualified exchange;
- (2) Entered into with, or guaranteed by, a business entity;
- (3) Issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or
- (4) Entered into with a qualified foreign exchange. (2001-223, s. 8.17.)