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Funds Talk

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Kramer Levin's Funds Talk provides legal commentary on the news and events that matter most to alternative asset managers and funds.

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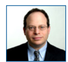
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Final Swap Margin Rules For Non-cleared Swaps — Impact on Investment Funds

On Oct. 22, 2015, the Board of Directors of the Federal Deposit Insurance Corporation approved a joint final rule (the "final rule") establishing minimum initial and variation margin requirements for non-cleared swaps. The rules have been approved by the Office of the Comptroller of the Currency and are expected to also be adopted by the other prudential regulators (the Federal Reserve Board, the Farm Credit Administration, and the Federal Housing Finance Agency). Investment funds trading non-cleared swaps with registered swap dealers supervised by these prudential regulators ("covered swap dealers") will be indirectly impacted by these final rules.

The final rule essentially requires covered swap dealers to collect and, in some instances, post initial and variation margin with respect to non-cleared swaps with their counterparties. With respect to investment funds, the obligations of the swap dealer will depend upon whether the fund has material swaps exposure.

A fund has material swaps exposure if it and its affiliates have an average daily aggregate notional amount of non-cleared swaps, foreign exchange forwards, and foreign exchange swaps for June, July, and August of the previous calendar year (calculated only for business days and counting affiliate trades only once) exceeding $8 billion. Affiliate determinations are largely based on the consolidation of financial statements as opposed to a "control" standard, which will likely save fund complexes from more onerous requirements under the final rule. However, fund complexes may need to consider how they structure seed accounts for purposes of aggregating affiliate exposures.

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With respect to initial margin and a fund *with* material swaps exposure, a covered swap dealer must both *collect and post* margin on a daily basis (in amounts not less than the amount specified by table or an approved margin model) with respect to any non-cleared swap, and qualified segregation is required for both parties (but not necessarily under tri-party documentation) with one or more third-party independent custodians.

Affected market participants will need to amend their non-cleared swaps documentation before the rule becomes effective to comply with these requirements.

With respect to initial margin and any other fund, a covered swap dealer must *collect* (with no requirement to post) initial margin at times and in the forms/amounts (if any) that the covered swap dealer determines appropriately address the credit risk posed by the fund and the risks of the relevant non-cleared swaps. Segregation for margin (if any) posted by the swap dealer is also required.

In each case, initial margin must be posted on or before the first business day following the day of execution, and a threshold of up to a $50 million may be applied to the aggregate credit exposures resulting from all non-cleared swaps between the fund and a covered swap dealer (and their respective affiliates). In that respect, the final rule explicitly notes that separate accounts having multiple managers will not receive a separate threshold for each manager of a sleeve of that account despite operational issues that are likely to result.

With respect to variation margin, *regardless* of whether a fund has material swaps exposure, a covered swap dealer must both *collect and post* mark-to-market margin on each business day, for a period beginning on or before the business day following the day of execution and ending on the date of termination/expiry. Variation margin is not required to be segregated, and no threshold applies. Accordingly, for any fund *without* material swaps exposure, the final rule should not significantly change current practice with respect to its margin posting obligations.

A minimum transfer amount will apply such that a covered swap dealer will not be required to collect or post margin from or to a fund unless the combined initial and variation margin that would otherwise be required to be delivered by a party exceeds $500,000 (or such lesser amount agreed by the parties). Eligible collateral for these purposes includes (i) any G11 currency, (ii) the currency of settlement for the non-cleared swap, and (iii) certain liquid U.S. or foreign government or corporate debt securities, certain listed equity securities, shares in certain pooled investment vehicles and gold. Non-cash collateral will be subject to haircuts specified (by table) in the final rule. An additive 8% cross-currency haircut applies whenever collateral is denominated in a currency other than the currency of settlement or (with respect to initial margin only) a currency other than an agreed termination currency under the relevant "eligible master netting agreement," *except* where cash variation margin is in a major currency.

In determining exposures, a covered swap dealer may net initial margin requirements on a portfolio basis in certain circumstances and net variation margin requirements on an aggregate, net basis for swaps covered by an eligible master netting agreement. The parties may elect to margin pre-compliance and post-compliance date swaps under one eligible master netting agreement but separate credit support annexes, with the effect of excluding pre-compliance date swaps from the requirements of the final rule.

When facing a fund, a covered swap dealer must execute documentation specifying methods, procedures, rules, and inputs for (i) determining

The final rule is effective on Apr. 1, 2016, and phased-in compliance will occur between Sept. 1, 2016, and Sept. 1, 2020. Margin requirements will be phased in as follows:

Compliance Date:	Covered swaps exposure (determined similarly to material swaps exposure) for both a fund and its affiliates and a swap dealer and its affiliates exceeds:
Initial margin requirements	
Sept. 1, 2016	$3 trillion
Sept. 1, 2017	$2.25 trillion
Sept. 1, 2018	$1.5 trillion
Sept. 1, 2019	$.75 trillion
Sept. 1, 2020	*All other funds*
Variation margin requirements	
Sept. 1, 2016	$3 trillion
Mar. 1, 2017	*All other funds*

the value of each non-cleared swap for purposes of calculating variation margin requirements, and (ii) calculating the amount of initial margin required for each non-cleared swap. The procedures for disputes of valuation of non-cleared swaps or valuation of assets posted as margin must be specified. Affected market participants will need to amend their non-cleared swaps documentation before the rule becomes effective to comply with these requirements and those described above.

Once the final rule is effective for a fund, if a fund becomes subject to more strict margin requirements (e.g., a fund exceeds the material swaps exposure threshold), then the more strict margin requirements will apply only for trades entered into after the change is effective, and if a fund becomes subject to less strict margin requirements (e.g., a fund no longer has material swaps exposure), then the less strict margin requirements will apply for trades entered into after the change as well as for any outstanding trades.

The joint final rule was developed in consultation with the U.S. Commodity Futures and Trading Commission and the U.S. Securities and Exchange Commission, which have yet to release their respective final rules establishing minimum margin requirements for swap dealers not supervised by a prudential regulator (including non-bank subsidiaries of a bank holding company). ■

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A Reminder — Private Fund Advisers on Notice to Remain Vigilant

The private fund adviser industry has fallen under the SEC's registration authority only since the 2010 Dodd-Frank Act granted the regulator increased oversight beginning in 2012. Fee and expense practices in particular have come under increased scrutiny since mid-2014, when SEC examinations identified high rates of fee- and expense-related violations. In that round of inspections, the SEC's Office of Compliance Inspections and Examinations identified "violations of law or material weaknesses in controls" in more than half of the 112 examinations of fee and expense practices of registered investment advisers to PE funds. During the past year – through various speeches, examinations and regulatory settlements – the SEC has reminded the industry (PE and hedge fund advisers) that it expects transparent and detailed disclosures.

Others have also been pushing for greater transparency. For example, in July, 13 state treasurers and comptrollers wrote to the SEC to demand the regulator ensure that all private equity fees be reported to investors in a clear and consistent manner. In October, California Treasurer John Chiang, who also sits on the governing board of the California Public Employees' Retirement System (CalPERS), appealed for state legislation that would require PE firms to clearly disclose all fees they receive from public pension funds. Interestingly, a substantial part of the demand for greater scrutiny of fees has come from the private funds' investors, with pension funds specifically leading calls for enhanced disclosure. CalPERS, the nation's largest pension, decided in October to require the private equity managers it invests with in the future to expressly disclose the fees they're paid by portfolio companies. The decision is likely to cause other pension funds to follow suit. On top of that, the Institutional Limited Partners Association (ILPA) is seeking feedback on its draft for a set of standards outlining how PE firms should more uniformly and with greater detail disclose fees, expenses and incentive compensation paid to the investment managers and their affiliates. In its current form, the template would require the investment managers to report, for example, specific categories of fees they receive from portfolio companies.

As a fundamental matter, the U.S. Supreme Court has recognized that the Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest. And the SEC views the disclosure of fees, expenses and allocation practices as part of a registered adviser's fiduciary duty. It is the concern about conflicts of interest between an adviser and its fund clients that has led the SEC to focus on fees and expense allocations.

The private fund industry remains a high inspection priority of the SEC, and with the multipronged focus from the SEC, state administrators, pensions and the ILPA, the demand for increased or enhanced disclosure is unlikely to subside.

The law imposes a broad duty on advisers to act in the best interest of their clients. Advisers have an affirmative obligation to their clients of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser and a duty to employ reasonable care not to mislead their clients. Failing to adequately disclose (e.g., that broken deal expenses are allocated to limited partners but not to co-investment vehicles that may include investment manager executives, or that the investment adviser to private funds receives greater discounts for legal services than such private funds

receive from shared outside counsel) can lead to a loss of investor confidence, if not litigation, and regulatory trouble, with the SEC continuing to issue precedent-setting, multimillion-dollar fines in 2015. Amid this environment of heightened regulation and oversight, fund managers must remain vigilant with respect to fee and expense practices and, in particular, the related disclosures.

While many investment advisers have formal policies regarding, for example, expense allocations, all advisers should regularly examine their written policies and current practices as they pertain to fees and expenses. In addition to confirming that the policies continue to be reasonably equitable and applied in the best interests of clients, advisers should audit whether the policies, practices and methodologies have been disclosed and followed.

Current disclosures (Form ADV, offering materials, limited partnership agreement, etc.) should be clear, consistent, timely, relatively detailed and, of course, adhered to. The disclosures should include what is charged to the adviser versus the funds, and the methodology for allocation between multiple funds or clients. Disclosures should address any potential benefits, savings or fees received by the adviser or its affiliates in connection with their underlying fund investments, including for services, monitoring, consulting, administering and/or general operations or back office functions. The current disclosures should be compared to actual practices and a determination made as to whether the operational reality is consistent with what has been disclosed to clients. If there is a lack of clarity or an inconsistency exists, the adviser will need to determine the scope of the problem and how to rectify the situation (enhancing existing disclosures, amending organizational documents, client consent, reimbursement, right to redemption, etc.). Investment advisers should ultimately review their disclosure process to ensure the approach to fees, expenses and any potential fallout benefits and other conflicts between fund clients and the adviser are adequately and accurately disclosed as operational practices and business opportunities evolve.

The private fund industry remains a high inspection priority of the SEC, and with the multi-pronged focus from the SEC, state administrators, pensions and the ILPA, the demand for increased or enhanced disclosure is unlikely to subside. Private fund advisers, therefore, would be well served by continued and regular evaluation of fee, expense and disclosure practices. ■

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Funds Face Further Responsibilities as DOJ Shifts Focus From Corporate to Individual Wrongdoing

On Sept. 9, 2015, the Department of Justice (“DOJ”) announced new measures to fortify its pursuit of corporate wrongdoing in criminal and civil matters. The policy shift, set forth in a memorandum from Deputy Attorney General Sally Yates, seeks to hold individuals accountable for corporate wrongdoing and ensure full cooperation from corporations in “ferreting out” individual misconduct.

Funds are already facing heightened regulatory requirements. The newly announced policy now marks an additional shift for funds under investigation. Most significantly, the memorandum departs from prior policy in announcing that no credit for cooperation will be given to corporations that fail to satisfy prosecutors that they have cooperated “completely” with respect to investigating individuals within their firm. The new standard for full cooperation requires companies to identify

the individuals responsible for the misconduct the government is investigating — to learn who they are — and disclose that information to the prosecutors. The rules also explicitly apply to employees at all levels, including top-level management.

The DOJ believes it has placed too much emphasis on extracting large amounts of money in corporate investigations and not enough emphasis on bringing charges against individuals.

As the first major policy the department has announced since Attorney General Loretta Lynch took over in April, the new rules have been interpreted as an acknowledgment of criticism that the DOJ hasn't done enough to punish specific executives involved in the housing crisis, the financial meltdown and other corporate scandals, despite the record fines it has secured from banks and corporations.

Indeed, Deputy Yates stated that the DOJ believes it has placed too much emphasis on extracting large amounts of money in corporate investigations and not enough emphasis on bringing charges against individuals.

"It's only fair that the people who are responsible for committing those crimes be held accountable," the memorandum states. "The public needs to have confidence that there is one system of justice and it applies equally regardless of whether that crime occurs on a street corner or in a boardroom."

The memorandum enumerated six measures that the department intends to implement in corporate investigations:

1. To be eligible for any cooperation credit, corporations must provide to the department all relevant facts about the individuals involved in corporate misconduct. The DAG's memorandum explains that corporations must be forthright and timely in turning over all nonprivileged information "relating to the [corporate] misconduct," and identify the individual wrongdoers regardless of their "position, status, or seniority." If a corporation either "declines to learn" or to provide to the DOJ complete factual information about individual wrongdoers, the corporation will not receive any credit for cooperation.
2. Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation. According to the memorandum, a focus on individual culpability is the most effective way to determine the facts and encourage individuals with knowledge of misconduct to cooperate with the government and provide information that allows the DOJ to prosecute others higher up in the organization.
3. Criminal and civil DOJ attorneys handling corporate investigations should be in routine communication with one another. Criminal and civil attorneys are expected to notify each other "as early as permissible" of conduct that may be worthy of inquiry by the other.
4. Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals. DOJ attorneys are directed not to agree to a corporate resolution that includes an agreement to dismiss charges against, or provide immunity for, individual officers or employees, except in extraordinary circumstances. Any such agreement must be approved by an Assistant Attorney General or United States Attorney.
5. Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires, and declinations as

to individuals in such cases must be memorialized. The memorandum further directs that "every effort should be made to resolve a corporate matter within the statutorily allotted time" and that tolling agreements should be the "rare exception."

6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay. An individual's ability to pay "should not control" the evaluation of whether to bring a civil case. DOJ attorneys should also consider the seriousness of the misconduct, the individual's misconduct and past history, the circumstances relating to the misconduct, and the provability of the claims through admissible evidence, among other factors.

The memorandum states that the policies should apply not only to future investigations, but also to matters currently pending "to the extent practicable to do so." Only after the new policy has been in effect for a substantial period will it be possible to determine whether it will have its desired effect of facilitating successful prosecutions of individuals in investigations of corporate wrongdoing.

There is, however, a possibility that the heightened cooperation standard will deter some corporations from heading down the road of cooperation, especially where the corporation is concerned that, despite significant effort and expense, it will fail in meeting the higher bar that the DOJ has now put in place. ■

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Court Rules Against Lehman Brothers Over ISDA Loss Calculation Methodology

The United States Bankruptcy Court for the Southern District of New York recently ruled in favor of Intel Corp. in relation to lengthy proceedings brought by Lehman Brothers OTC Derivatives Inc. ("LOTC") and Lehman Brothers Holdings Inc. ("LBHI," and together with LOTC, "Lehman"), against Intel from which Lehman sought to recover a portion of the closeout amount that was calculated, and set off against collateral held, by Intel resulting from a terminated forward share repurchase agreement.

In her Sept. 16 decision, Judge Shelley Chapman held that Intel, as the non-defaulting party under a 1992 ISDA Master Agreement (as published by the International Swaps and Derivatives Association, or "ISDA"), as modified by a schedule (together, the "ISDA Master") between the two parties, has broad discretion in calculating the early termination payment where the parties have elected the ISDA Master's "loss" methodology, provided its calculation is reasonable and made in good faith.

The court's opinion is a blow to Lehman, which will likely lose leverage in many current and future valuation disputes it faces as it navigates its ongoing Chapter 11 proceedings. Previously, Lehman had exploited the relative lack of clarity on early termination calculations during many of its settlement negotiations and mediation proceedings. However, the court's ruling clarifies that, at least for those counterparties with respect to which Lehman has agreed to the election of "loss" as the applicable calculation method for termination amounts under an ISDA Master, Lehman will likely have to demonstrate the non-defaulting party's calculation of the termination amount to be unreasonable.

The case focused on the ISDA Master between Intel and LOTC entered into on Feb. 1, 2008, governing all future over-the-counter derivatives transactions between the two, including a subsequent forward share repurchase agreement in August 2008. While LBHI and several of its subsidiaries filed for Chapter 11 protection on Sept. 15, 2008, LOTC did not do so until Oct. 5, 2008, during which time it continued to purchase Intel shares pursuant to the agreement. However, due to the insolvency events involving other Lehman entities, LOTC was unable to deliver to Intel the 50,552,943 shares it owed, determined as the volume-weighted average price of the shares during a specified calculation period leading up to the delivery date, prompting Intel to declare an early termination of the transaction and the ISDA Master.

The court's opinion is a blow to Lehman, which will likely lose leverage in many current and future valuation disputes it faces as it navigates its ongoing Chapter 11 proceedings.

Using the "loss" calculation methodology agreed to by the parties in the ISDA Master, Intel calculated it was owed an early termination amount of $1,001,966,256. This amount was based on the $1 billion Intel remitted to Lehman as prepayment for the delivery of Intel shares on Sept. 29, 2008, plus unearned interest on that amount. Lehman, meanwhile, argued that the only reasonable calculation of Intel's damages should be based on the fair market value of the undelivered shares as of market close on the delivery date, or approximately $873 million.

Importantly, the court rejected Lehman's arguments that "loss" requires the non-defaulting party to determine a closeout amount based on the "market quotation" method of calculation under the ISDA Master under certain circumstances or that "loss" be disregarded and replaced by damage calculation principles under New York state law where the parties had instead entered into an ISDA Master to govern the transaction. The court found that ISDA's user's guide "makes clear that 'Loss' is intended to provide parties flexibility in selecting a method to calculate early termination payments, meaning non-defaulting parties such as Intel may use any methodology for calculating loss, as long as the methodology is 'reasonable and in good faith.'" Moreover, Judge Chapman stated that parties agreeing to the use of standard ISDA forms to govern their transactions do so deliberately as a result of "market participants' desire for certainty and predictability" and should expect such agreements to be "enforced so as to promote legal certainty and hence, market stability."

As Lehman continues to work its way through current and future proceedings, this ruling is likely to discourage attempts to challenge calculations of "loss" termination amounts that appear to use the benefit of hindsight in order to reach a lower amount. The decision should provide some clarity and guidance for future proceedings in U.S. bankruptcy courts in cases based on such ISDA agreements, an area that previously had little precedence for derivatives market participants. ■

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NAIC Proposes Tougher Risk-Based Capital Requirements and Disclosures on Investment Affiliates, Reserve Funding Transactions

Two proposals recently circulated by the National Association of Insurance Commissioners ("NAIC") highlight changes in the risk-based capital ("RBC") regime that could significantly impact deal activity in the insurance space. The proposals would require:

- property-casualty insurers to hold additional capital against investments held through the insurer's subsidiaries.
- life insurers that employ captives to manage A-XXX risks (that is, reserves associated with universal life policies with supplemental guarantees, such as "no lapse" policies), to disclose the impact of these arrangements on the insurer's RBC.

Investment Affiliates for Property-Casualty Companies

The NAIC's Capital Adequacy Task Force is currently deliberating on whether to ascribe a capital charge to "investment affiliates" of property-casualty insurers and has recirculated a proposal to impose such a charge. The NAIC defines an "investment affiliate" as any affiliate of the insurer, other than a holding company, that is engaged or organized primarily to engage in the ownership and management of the insurer's investments. An insurer might use an investment affiliate for administrative purposes or as a "blocker" for legal, tax or other motivations.

Currently, the RBC charge for a property-casualty insurer's investment in an investment affiliate is based on the RBC of the underlying assets, prorated to account for such an insurer's degree of ownership of these underlying assets. This "look through" approach assumes that the charge for an investment affiliate should be the same as if the insurer held the assets directly. The insurer's equity interest in the affiliate itself is thus disregarded, and the insurer does not incur a capital charge in respect of such equity interest (ordinarily, insurers must hold more capital against equity investments than debt).

This "look through" approach assumes that the charge for an investment affiliate should be the same as if the insurer held the assets directly.

In its Oct. 1 release, the Task Force stated it would abandon this "look through" approach and impose an RBC charge for an investment in an investment affiliate to be based upon a certain, as of yet undetermined, percentage multiplied by the carrying value of the investment affiliate's common and preferred stocks and bonds. According to the proposal, the current capital charge of zero cannot be "verified" and therefore is not justified as an automatic matter.

While the NAIC has not yet proposed a specific percentage associated with such a capital charge, any change may have significant implications for how insurers structure merger and acquisition transactions, joint ventures and other structured investments in their asset portfolios. The benefits of using an investment subsidiary (administrative simplicity, legal remoteness, etc.) would have to be weighed against the incremental capital cost, potentially frustrating such benefits.

This change to the RBC regime is already being applied to health insurers. At the NAIC's March 29, 2015, Spring National Meeting, the Task Force adopted the proposal to amend the RBC

standards with respect to health insurers, whereby now a health insurer's investment in an investment affiliate will incur a charge of 0.300. Accordingly, health insurers are required to set an RBC charge for an investment in an investment affiliate equal to 30% of the investment affiliate's carrying value. In addition, a working group of the Task Force is currently considering whether the investment affiliate charge ought to be uniform across life, P&C and health lines.

The proposal and comments submitted to the NAIC are likely to be considered at the NAIC's Fall National Meeting to be held Nov. 19-22.

Reserves for Universal Life With Supplemental Guarantees Reinsured by Captive

The NAIC's Principle-Based Reserving Implementation Task Force proposed that life carriers be required to disclose, as part of their annual statement reporting, certain effects on RBC of the carrier's use of reinsurance to an A-XXX captive.

By way of background, historically A-XXX policies have been subject to overly conservative reserving requirements under the NAIC's standard valuation law and related regulations, including the so-called Regulation XXX/A-XXX. These requirements are in the process of being relaxed by state regulators pursuant to the emerging principle-based reserving ("PBR") regime, in which more discretion could be used in valuing policies rather than strict formulas. (Under the Reg. XXX/A-XXX formulas, reserves were ascribed by time segments over the life of the policy to account for changes in premium levels and benefits, creating redundancies as compared with "standard" reserving techniques that were based on present value over the entire, unsegmented life of the policy.)

In connection with these reforms, new guidelines have been issued by the NAIC in recent months governing reserve financing arrangements, in which a life company, seeking capital relief from the onerous reserving requirements of Reg. XXX/A-XXX, cedes XXX or A-XXX risks to a reinsurer, often a captive. The NAIC's Actuarial Guideline XLVIII ("AG 48") sets forth the actuarial framework for establishing reserves for these transactions, and the proposed Non-Universal Life and Universal Life with Secondary Guarantees Credit for Reinsurance Model Regulation governs the "credit for reinsurance" available for such transactions (i.e., the ability to treat such reinsurance as an asset on the cedent's balance sheet).

Under the proposal that was the subject of a recent comment solicitation, a life company would be required to disclose the effects of these new RBC items on its overall Total Adjusted Capital ("TAC").

Generally, under these proposals, when ceding XXX or A-XXX reserves to a reinsurer (e.g., a captive), an insurer will be able to claim balance sheet credit if (i) certain high-grade assets ("Primary Security") are posted to secure liabilities up to a threshold referred to as the "Required Level of Primary Security" and (ii) other assets, as permitted by the applicable regulator, are posted to secure liabilities in excess of that threshold up to the full statutory level (i.e., the Reg. XXX/A-XXX-mandated level). In other words, the entire statutory reserve need not be secured by the highest-grade collateral specified in the law; only the Required Level of Primary Security is required to be so collateralized. This level is determined actuarially pursuant to AG 48, and not pursuant to the strict formulas of Regulation XXX/A-XXX, and thus represents the incorporation of principle-based reserving into the credit-for-reinsurance arena.

In September, certain revisions to RBC calculations became effective incorporating these changes. Under these revisions, a life company

would be required to hold more capital against reinsurance transactions or captives where (i) Primary Security is insufficient, (ii) non-admissible assets (i.e., assets that are statutorily ineligible for surplus) exceed the portion of statutory reserves not covered by the Required Level of Primary Security and (iii) non-admissible assets are being used to secure such financing transactions.

Under the proposal that was recently the subject of a comment solicitation, a life company would be required to disclose the effects of these new RBC items on its overall Total Adjusted Capital ("TAC"). Specifically:

- For each captive for which non-admissible assets exceed the difference between the total statutory reserve and the Required Level of Primary Security, requiring a downward RBC adjustment, the captive and the dollar amount of this shortfall must be identified.
- The insurer must specify its TAC for the current year, along with the sum of TAC plus the total of the RBC shortfalls shown in the first bullet above. The NAIC intends for this to "provide perspective on how much the TAC has been impacted by any captive RBC shortfalls," as opposed to merely showing the resulting net TAC (which is already required in the annual statement).
- For each reinsurer for which Primary Security is insufficient to fully secure the Required Level of Primary Security (a "Primary Security Shortfall"), the insurer must disclose (i) the name of the reinsurer and the amount of the Primary Security Shortfall and (ii) the total shortfall from that exhibit across all reinsurers.
- The insurer must specify the sum of the RBC charges it has incurred for certain letters of credit, parental guarantees and similar arrangements that are ineligible for credit for reinsurance. According to the NAIC, this is intended to "provide perspective on the amount of certain non-admitted assets associated with the ceding company's A-XXX/XXX business, relative to the overall size of the ceding company."

The adoption of these disclosure requirements could have an in terrorem effect on life insurers structuring reserve funding transactions, insofar as any defect in a transaction from a credit-for-reinsurance standpoint would have to be specifically identified, rather than merely being one of numerous, unidentified factors in the calculation of RBC. This, in turn, might increase demand for high-quality reserve assets and more efficient execution in A-XXX contexts, as principle-based reserving continues its lengthy evolution. ■

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