

**Note: If any category is left blank, it will be calculated as zero.
No descriptive text.**

**Count by whole WAC sections only, from the WAC number through the history note.
A section may be counted in more than one category.**

The number of sections adopted in order to comply with:

Federal statute:	New	_____	Amended	_____	Repealed	_____
Federal rules or standards:	New	_____	Amended	_____	Repealed	_____
Recently enacted state statutes:	New	_____	Amended	_____	Repealed	_____

The number of sections adopted at the request of a nongovernmental entity:

New	_____	Amended	_____	Repealed	_____
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The number of sections adopted in the agency's own initiative:

New	7	Amended	_____	Repealed	_____
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The number of sections adopted in order to clarify, streamline, or reform agency procedures:

New	_____	Amended	_____	Repealed	_____
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The number of sections adopted using:

Negotiated rule making:	New	_____	Amended	_____	Repealed	_____
Pilot rule making:	New	_____	Amended	_____	Repealed	_____
Other alternative rule making:	New	<u>7</u>	Amended	_____	Repealed	_____

DERIVATIVE INSTRUMENTS

NEW SECTION

WAC 284-13-900 Purpose. The purpose of this rule is to set standards for the prudent use of hedging and income generation derivative instruments under RCW 48.13.171.

NEW SECTION

WAC 284-13-910 Definitions. The definitions in this section apply to WAC 284-13-920 through 284-13-960.

"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.

"Cap" means an agreement obligating the seller to make payments to the buyer, with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

"Collar" means an agreement to receive payments as the buyer of an option, cap, or floor and to make payments as the seller of a different option, cap, or floor.

"Counterparty exposure amount" means:

(1) The net 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:

(a) The market value of the over-the-counter derivative instrument if the liquidation of the instrument would result in a final cash payment to the insurance company; or

(b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurance company.

(2) 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 domiciliary jurisdiction 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 must be the greater of zero or the net sum of:

(a) 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 insurance company; and

(b) 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 insurance company to the business entity.

(3) For open transactions, market value must be determined at the end of the most recent quarter of the insurance company's fiscal year and must be reduced by the market value of acceptable collateral held by the insurance company or placed in escrow by one or both parties.

"Covered" means that an insurer owns or can immediately acquire, through the exercise of options, warrants, or conversion rights already owned, the underlying interest in order to fulfill or secure its obligations under a call option, cap or floor it has written, or has set aside under a custodial or escrow agreement cash or cash equivalents with a market value equal to the amount required to fulfill its obligations under a put option it has written in an income generation transaction.

"Derivative instrument" means an agreement, option, instrument, or a series or combination thereof:

(1)(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.

(2) Derivative instruments include options, warrants, 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 WAC 284-13-920 through 284-13-960. Derivative instruments shall not include an investment authorized by RCW 48.13.061 (2) through (10).

"Floor" means an agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance, or value of one or more underlying interests.

"Future" means an agreement, traded on a qualified exchange or qualified foreign exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of, one or more underlying interests.

"Hedging transaction" means a derivative transaction which is entered into and maintained to reduce:

(1) The risk of change in value, yield, price, cash flow, or quantity of assets or liabilities which an insurer has acquired or incurred or anticipates acquiring or incurring; or

(2) The currency exchange rate risk or the degree of exposure as to assets or liabilities which an insurer has acquired or incurred or anticipates acquiring or incurring.

"Insurer" includes domestic insurance companies authorized under chapter 48.05 RCW, United States branches of alien insurers entered through this state, alien insurers admitted and using this state as their port of entry, domestic fraternal benefit societies formed pursuant to chapter 48.36A RCW, domestic health care service contractors registered under chapter 48.44 RCW, domestic health maintenance organizations registered under chapter 48.46 RCW, and domestic self-funded multiple employer welfare arrangements registered under chapter 48.125 RCW.

"Option" means an agreement giving the buyer the right to buy or receive (a "call option"), sell or deliver (a "put option"), enter in-

to, extend, or terminate or effects a cash settlement based on the actual or expected price, level, performance, or value of one or more underlying interests.

"Qualified clearinghouse" means a clearinghouse for, and subject to the rules of a qualified exchange or a qualified foreign exchange, which clearinghouse provides clearing services, including acting as a counterparty to each of the parties to a transaction so that the parties no longer have credit risk to each other.

"Qualified exchange" means:

(1) 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. Sec. 78 et seq.), as amended;

(2) A board of trade or commodities exchange designated as a contract market by the Commodity Futures Trading Commission (CFTC) or any successors thereto;

(3) Private Offerings, Resales and Trading through Automated Linkages (PORTAL);

(4) A designated offshore securities market as defined in Securities Exchange Commission Regulation S, 17 C.F.R. Part 230, as amended; or

(5) A qualified foreign exchange.

"Qualified foreign exchange" means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions:

(1) 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);

(2) 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

(3) 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 contracts market that qualifies as a "qualified foreign" only under this subsection shall be a "qualified foreign exchange" as to foreign stock index futures contracts that are the subject of the no-action relief under this subsection.

"Swap" means an agreement to exchange or to net payments at one or more times based on the actual or expected price, level, performance, or value of one or more underlying interests.

"Underlying interest" means the assets, liabilities, other interests, or a combination thereof underlying a derivative instrument, such as any one or more securities, currencies, rates, indices, commodities, or derivative instruments.

"Warrant" means an instrument that gives the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

NEW SECTION

WAC 284-13-920 Derivative transactions. (1) An insurer may, directly or indirectly through an investment subsidiary, only engage in hedging and income generation derivative transactions. Use of derivative instruments for replication, speculative or any other purpose is prohibited.

(2) An insurer may enter into hedging transactions under this section if, as a result of and after giving effect to the transaction, the insurer can demonstrate to the satisfaction of the commissioner the intended hedging characteristics and ongoing effectiveness of the derivative transaction or combination of transactions through cash flow testing or other appropriate analysis.

(3) An insurer may only enter into covered 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 and floors, plus the face value of the fixed income securities underlying a derivative instrument subject to call plus the amount of the purchase obligations under the puts, does not exceed chapter 48.13 RCW limitations.

(4) An insurer must include all counterparty exposure amounts in determining compliance with general diversification requirements and medium and low-grade investment limitations under chapter 48.13 RCW.

(5) Side-letter or similar agreements that directly or indirectly alter the original derivative transaction in any way are prohibited.

NEW SECTION

WAC 284-13-930 Guidelines and internal control procedures. (1) Before engaging in a derivative transaction, an insurance company must establish written guidelines approved by the commissioner, that must be used for effecting and maintaining derivative transactions. The guidelines must:

(a) Specify insurance company objectives for engaging in derivative transactions and derivative strategies and all applicable risk constraints, including credit risk limits;

(b) Establish counterparty exposure limits and credit quality standards;

(c) Identify permissible derivative transactions and the relationship of those transactions to insurance company operations; for example, a precise identification of the risks being hedged by a derivative transaction; and

(d) Require compliance with internal control procedures.

(2) An insurance company must have a written methodology for determining whether a derivative instrument used for hedging has been effective using cash flow testing or other appropriate analysis.

(3) An insurance company must have written policies and procedures describing the credit risk management process and a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

(4) An insurance company's board of directors must, in accordance with RCW 48.13.051:

(a) Approve the written guidelines, methodology and policies, and procedures required by subsections (1), (2), and (3) of this section and the systems required by subsection (2) and (3) of this section;

(b) Determine whether the insurance company has adequate professional personnel, technical expertise, and systems to implement investment practices involving derivatives;

(c) Review whether derivatives transactions have been made in accordance with the approved guidelines and consistent with stated objectives; and

(d) Take action to correct any deficiencies in internal controls relative to derivative transactions.

NEW SECTION

WAC 284-13-940 Commissioner approval. Written documentation explaining the insurance company's internal guidelines and controls governing derivative transactions must be submitted for approval to the commissioner. The commissioner shall have authority to disapprove the guidelines and controls proposed by the company if the insurance company cannot demonstrate the proposed internal guidelines and controls would be adequate to manage the risks associated with the derivative transactions the insurance company intends to engage in.

NEW SECTION

WAC 284-13-950 Documentation requirements. An insurance company must maintain all 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 the market value; and

(5) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade and the market value.

NEW SECTION

WAC 284-13-960 Trading requirements. Each derivative instrument must be:

(1) Traded on a qualified exchange;

(2) Entered into with, or guaranteed by, a business entity;

(3) Issued or written with the issuer of the underlying interest on which the derivative instrument is based; or

(4) Entered into with a qualified foreign exchange.