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A business of Prudential Financial, Inc.

September 26, 2011

Mr. David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-32-11C, "Stable Value Contract Study"

Dear Mr. Stawick and Ms. Murphy:

Prudential Financial, Inc. ("Prudential Financial") appreciates this opportunity to respond to the Securities Exchange Commission's (the "SEC") and the Commodity and Futures Trading Commission's (the "CFTC" and together with the SEC, the "Commissions") joint request for comments (the "Request for Comments") in connection with the joint study regarding stable value contracts ("SVCs") under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Prudential Financial is a financial services leader with approximately $883 billion of assets under management as of June 30, 2011 and operations in the United States, Asia, Europe, and Latin America. Prudential is committed to helping individual and institutional customers grow and protect their wealth through a variety of products and services, including life insurance, annuities, retirement-related services, mutual funds, investment management, and real estate services.

Prudential Financial's retirement business ("Prudential Retirement") delivers retirement plan solutions for public, private, and non-profit organizations. Services include state-of-the-art record keeping, administrative services, investment management, comprehensive employee investment education and communications, and trustee services. With over 85 years of retirement experience, Prudential Retirement helps meet the needs of over 3.6 million participants and annuitants. Prudential Retirement has $220.7 billion in retirement account values as of June 30, 2011. Prudential Retirement also has been a pioneer, industry leader, and active issuer of stable value products to qualified defined contribution ("DC") retirement plans since the early 1980s.

Stable Value Products Issued by State-Regulated Insurance Companies

Prudential Retirement shares the concerns and supports the recommendations concerning stable value contracts issued by state-regulated insurance companies expressed in the responses to the Request for Comments submitted by the Stable Value Investment Association ("SVIA"), the American Council of Life Insurers ("ACLI"), and the Committee of Annuity Insurers ("CAI"), each of which we have reviewed in draft form prior to submission. In particular, for the reasons outlined in these submissions, Prudential Retirement strongly agrees that stable-value contracts issued by state-regulated insurance companies should not be determined to fall within the definition of swap in the Dodd-Frank Act, or, alternatively, such contracts should be exempted from that definition because the issuer, contract, and distribution process is subject to existing and comprehensive state insurance regulation.

As explained in detail by these commenters, stable value contracts used in retirement plans and arrangements fall into three general categories: (1) general account/traditional guaranteed investment contracts; (2) segregated or separate account guaranteed investment contracts; and (3) synthetic guaranteed investment contracts ("synthetic GICs" or "insurance wrap contracts"). Prudential Retirement strongly agrees with the view expressed in the ACLI response that general and separate account stable value contracts under which a plan makes a deposit with an insurance company in exchange for a contractual guarantee from the insurer to return principal plus interest simply defy characterization as a swap.[1] To avoid any uncertainty regarding these categories of stable value contracts, Prudential Retirement supports the ACLI's request that the Commissions conclude in the stable value study that such contracts are appropriately and successfully regulated as insurance products and should continue to be treated as such.

Synthetic Guaranteed Investment Contracts

Prudential Retirement submits this letter to provide additional background and details relative to why the third category of stable value contracts issued by state-regulated insurance companies, synthetic GICs, should not be regulated as swaps. Unless otherwise indicated, Prudential Retirement's discussion and responses hereafter focus solely on synthetic GICs issued by state-regulated insurance companies.

Prudential Retirement is a leading insurance company issuer of synthetic GICs, with outstanding contracts totaling over $35 billion as of June 30, 2011 as measured by the account balances held by DC plan participants. As explained more fully below, insurance company synthetic GICs are crucial to the retirement savings of millions of Americans, are inherently different from swaps, are already extensively regulated, and pose no systemic risk to the financial markets. In fact, regulating them as swaps would preclude insurance companies from selling stable value contracts, to the detriment of **thousands** of retirement programs and **millions** of plan participants.

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1 As noted in the ACLI letter, such contracts have no reference asset, cannot be cleared or traded, and require an initial net investment unlike a derivatives contract.

Characteristics of Synthetic GICs

Synthetic GICs provide a "wrap" or contract value guarantee, which includes a guarantee of both principal and credited interest. The contract value guarantee is supported primarily by a high-quality intermediate bond portfolio owned directly by the DC retirement plan. The combination of the synthetic GIC and investment portfolio creates a stable value investment option. The guaranteed interest crediting rate is reset at pre-determined intervals and is based upon a formula set forth in the synthetic GIC. The formula is designed to keep the contract value in line with the market value of the underlying bonds over time, stabilizing the impact of fluctuations in the bond markets on the retirement savings of plan participants.

The primary difference between a traditional guaranteed investment contract and a synthetic GIC is the ownership of the underlying assets. Rather than being owned by the insurance company, as in the case of a general or separate account stable value option, the assets in a synthetic GIC are owned by the retirement plan investing in the stable value product. Otherwise, the contracts function in substantially the same manner; that is, providing workers and retirees with insurance that guarantees their retirement savings will not be reduced by short term swings in the bond market or the actions of other plan participants. Retirement plan benefit payments are made to the plan participants first from the underlying assets owned by the plan and, if these assets are depleted, then from the insurance company's assets.

Importance of Synthetic GICs to the Retirement Savings of Millions of Americans

The continued availability of stable value products is critically important to the retirement industry, as these products are the largest conservative investment in DC plans. According to the Stable Value Investment Association, there are over $540 billion in stable value products held by DC plans. Stable value insurance wrap contracts make it possible for many of these stable value products to exist. The SVIA estimates that insurer-issued synthetic GICs represented approximately 26.7 percent of stable value assets in 2010.[2] The wrap providers guarantee payments to plan participants of their stable value balance. This guarantee of benefit responsiveness enables the plan to report the contract value on participant statements, regardless of daily changes in the market value of the underlying bonds.

More importantly, these wrap contracts make it possible for DC plan participants to receive returns approximating an intermediate term bond fund without being subject to the principal risk of owning the actual bonds. An alternative investment sometimes offered to plan participants is a money market fund. We estimate that the average difference in yield between the average stable value fund and the average money market fund was 2.99 percent, as of June 30, 2011.[3] Without stable value wrap contracts, this higher return would not have been possible and millions of participants would have received greatly reduced returns.

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[2] SVIA calculation based upon the SVIA 15th Annual Stable Value Investment & Policy Survey covering assets as of December 31, 2010; SVIA-LIMRA Stable Value Sales and Assets Survey for the First and Second Half of 2010.

[3] As of June 30, 2011, the SVIA Survey reported returns of 3.01 percent (available at www.stablevalue.org) and iMoneyNet. All Taxable Money Fund reported returns of 0.02 percent (available at www.iMoneyNet.com).

From 1989 to 2009, stable value products provided an average annual return of 6.1 percent—higher than that of intermediate term bond funds (5.6 percent) and money market funds (3.9 percent).[4] The returns for the first two alternatives were well above the average inflation rate of 3.0 percent during the same period.[5]

Comprehensive Regulation of Insurance Companies and Insurance Products

We agree with and join the comments of the SVIA, ACLI and CAI regarding the adequacy of existing regulation of synthetic GICs issued by state-regulated insurance companies. As detailed by these commenters and our responses below to the Commissions' questions, insurance companies, and insurance products are subject to comprehensive, appropriate and successful regulation under state law. Regulation of insurance companies reaches nearly every aspect of their operations and finances, with the fundamental objectives of protecting policyholders and ensuring that companies maintain sufficient assets to satisfy all obligations under insurance contracts.

It is clear that the intent of Congress in enacting the provisions in Dodd-Frank relative to swaps was driven by the apparent lack of regulation and oversight of the derivatives markets, and notably swaps, and the capacity of such instruments for magnifying and extending risks throughout the financial system. That is not the case with respect to insurance company-issued synthetic GIC contracts; in fact the opposite is true. It is inconceivable that Congress intended to preempt the existing extensive regulatory oversight of insurance contracts. It is also clear that Congress, while unable to give full consideration to the stable value market at the tail end of the Dodd-Frank Act legislative process (which led it to direct the Commissions to conduct the present study), did not proceed based on any presumption or general belief that the insurance industry was in need of further regulation regarding stable value contracts.

Consequences of Classifying Synthetic GICS as Swaps

If synthetic GIC contracts are determined to be swaps, the preemption provisions of the Dodd-Frank Act section 722(b) make it clear that state insurance regulation would be preempted. It is highly likely that state insurance departments would then be forced to preclude insurance companies under their jurisdiction from writing such contracts, since the regulators would no longer have any authority to regulate insurance companies with respect to synthetic GICs. This would create massive unintended negative results for DC retirement plans and the insurance industry by significantly reducing the capacity available in the market for wrap contracts and in all likelihood significantly increasing the price at which such contracts could be replaced (if at all). The effect on retirement savings would thus be decreasing returns to plan participants or even reducing the availability of stable value investment options to DC plans. These wholly negative consequences would not be offset by any positive result, such as closure of a regulatory gap or reduction of any systemic or other risks intended to be addressed by the Dodd-Frank Act.

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[4] Calculated by Prudential based upon annualizing the monthly returns found in Dr. David Babbel and Dr. Miguel A. Herce, "Stable Value Funds: Performance to Date," The Wharton School, January 2011. Additional summarization provided by Dr. Babbel and Dr. Herce, February 2011.

[5] Bureau of Labor Statistics, "Consumer Price Index Data from 1913 to 2009."

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Request for Comment – Questions from the Commissions

Below Prudential provides answers to selected questions to assist the Commission staff in their analysis of synthetic GICs under the study.

What characteristics, if any, distinguish SVCs from swaps?

Many characteristics distinguish synthetic GICs from transactions historically known as swaps. Key differences include:

- <u>Synthetic GICs are not tradable or assignable.</u> By their terms, synthetic GICs cannot be assigned or transferred, thus there is no secondary market for exchanging such contracts. The contracts are individually underwritten and negotiated specific to each retirement plan or fund that wants a stable value investment option to be available for plan participants and retirees.

- <u>Synthetic GICs do not permit immediate contract value payments.</u> The insurer cannot be forced by the contract holder to make an immediate contract value payment. Since there are no such automatic or unilateral immediate payment triggers synthetic GICs cannot be used to arbitrage or speculate.

- <u>Synthetic GICs are inherently collateralized.</u> Synthetic GICs are supported by an underlying portfolio of diversified high-quality fixed income securities. This portfolio must be exhausted and remaining benefit payments to be paid to plan participants before the insurer has any payment obligation under the synthetic GICs. Not only are synthetic GICs inherently collateralized, but the ratio of market value to contract value typically ranges from 96 to 104 percent. In other words, the insurance company's obligations typically are supported by a portfolio that is over collateralized (in the case of a 104 percent ratio the value of the underlying portfolio is 104 percent of the insurance company's total contract liability) or substantially collateralized (in the case of a 96 percent ratio the value of the portfolio is equal to 96 percent of the insurer's total contractual liability). *Exposure to the insurer, therefore, is at most a small fraction of the contract value.* As a result, synthetic GICs involve no leverage and cannot be used for speculation.

- <u>Synthetic GICs are not market referenced.</u> Synthetic GICs are generally valued at contract value for the purposes of identifying the benefits payable, based on the guarantee of principal and credited interest under the insurance contract. There is no truly relevant market value reference for synthetic GICs since the contracts are not tradable or assignable.

- <u>Synthetic GICs are not standardized.</u> Synthetic GICs could not be cleared through a clearinghouse because they are not uniform or standardized. The contracts are issued following an extensive underwriting and due diligence process, and are tailored to meet the objectives of a specific DC retirement plan or fund based on the unique factors and characteristics present.

Are the proposed rules and the interpretive guidance set forth in the Product Definitions Proposing Release useful, appropriate, and sufficient for persons to consider when evaluating whether SVCs fall within the definition of a swap? If not, why not? Would SVCs satisfy the test for insurance provided in the Product Definitions Proposing Release? Why or why not? Is additional guidance necessary with regard to SVCs in this context? If so, what further guidance would be appropriate? Please explain.

Stable value contracts generally—and synthetic GIC contracts specifically—would not satisfy the insurance test described in the proposed rules or interpretive guidance set forth in the Proposing Release, and therefore neither the rules nor the guidance are useful, appropriate, or sufficient in applying the definition of swap to SVCs.

To distinguish insurance products from swaps, the Proposing Release provides two separate parts: (1) proposed rules; and (2) interpretive guidance.

The proposed rules include a "product" test and an "issuer" test. Unfortunately, the product test of the proposed rules is very narrow and would not include many annuity and retirement products, including most SVCs. More specifically, the product test requires, in part, that a beneficiary have an "insurable interest" in the underlying product, that the insurable interest exist throughout the term, that a loss occurs (and is proved), and any payment be limited to the value of the insurable interest. Under state insurance law, insurable interest requirements apply to insurance products that have the potential to create a conflict of interest, such as life insurance and property insurance. These rules prevent "wagering" on the loss of life or property by limiting persons eligible to purchase these forms of insurance to those with a close relationship to the person or property insured. In most jurisdictions, insurable interest rules do not apply to forms of insurance that do not raise these conflicts or concerns, including annuity contracts and SVCs. Therefore, the vast majority of SVCs will not satisfy the product test under the proposed rules, because no insurable interest is required or established.

The interpretive guidance also includes a "product" test and an "issuer" test. The product test in the interpretive guidance provides the following list of products: "surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and annuity products the income on which is subject to tax treatment under section 72 of the Internal Revenue Code." The Proposing Release does not provide any explanation as to why only these products and not others are listed, nor does the release explain why only certain annuities (those subject to certain tax treatment) are included, while others are not (those subject to different tax treatment).

Synthetic GIC contracts issued by insurance companies typically are issued on group annuity contract forms. Therefore, under the proposed interpretive guidance, SVCs would be recognized as insurance, and not swaps, only if they are subject to taxation under section 72 of the Internal Revenue Code (the "Code"). Code section 72 does not "define" what is or is not an annuity contract. Instead, Code section 72 requires that an annuity contract meet very technical requirements to receive a specified federal income tax treatment, including the deferral of any income recognition on the "inside build-up." However, there are several categories of annuities (including Synthetic GIC contracts) that do not need to (and typically do not) meet the requirements of section 72. SVCs generally are held by tax exempt trusts funding qualified retirement plans. Because the plan itself provides for tax deferral, it is unnecessary for the SVCs to address the

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complex and technical requirements of section 72. Accordingly, many SVCs will not satisfy the product test of the interpretive guidance, because such products are annuities that are not subject to section 72 of the Code.

We strongly support the comments on the Proposing Release submitted by the Committee of Annuity Insurers and the American Council of Life Insurers. In part, these comments recommend that annuity contracts subject to state insurance regulation be excluded from the definition of swap (and security-based swap), without regard to tax treatment under section 72 of the Code. The comments also recommend that the Commissions clarify and confirm that insurance products that fall within section 3(a)(8) of the Securities Act of 1933 (i.e., non-securities), or that are insurance products that are also securities, whether or not registered under the Securities Act, are excluded from the definitions of swap (and security-based swap). With these changes and clarifications, the proposed insurance product test would encompass synthetic GIC contracts subject to state insurance regulation, and therefore would be appropriate for determining SVCs that should fall outside of the definition of swap (and security-based swap).

Do SVC providers pose systemic risk concerns? Are there concerns with entities that may be systemically important institutions providing SVCs? What are the consequences for SVFs, employee benefit/retirement plans, and the financial system should an SVC provider fail?

We are unable to construct an argument or analysis that would suggest, much less demonstrate, how synthetic GICs could pose a systemic risk to the U.S. or global financial system. Nor are we aware of any that were offered by any experts, regulators, or other parties during the Dodd-Frank Act legislative process or subsequently.

There are no systemic risk concerns, or concerns with insurance companies providing SVCs because (1) the investors own and control the underlying bond portfolio, and accordingly the exposure of investors to the issuing insurance companies is limited to the difference between the contract value and the market value of the underlying investments; (2) insurance companies are subject to extensive transparent statutory financial reporting requirements which include the synthetic GIC business lines; (3) the insurance guarantees are largely hedged by the underlying bond portfolios; (4) the risks associated with the guarantees provided by the insurance companies are required to be regularly examined by actuaries who certify as to the results, and appropriate reserves held to pay potential liabilities; (5) synthetic GICs are core insurance company activities fully reported on the company balance sheet, reported to regulators and rating agencies, not a sideline business carried on outside of a regulated company or through little-known business units; (6) there are no cross defaults or tie-ins with other financial institutions; and (7) insurance companies hold significant capital in excess of required reserves as an additional cushion to further ensure that they have the assets needed to satisfy contractual obligations.

In considering the potential for systemic risk, it is instructive to consider the relative magnitude of risk being underwritten through synthetic GICs compared to the overall insurance liabilities of the issuing insurance company. Prudential Retirement is one of the leading underwriters of synthetic GICs with $35 billion worth of contract values as of June 30, 2011. As noted earlier, typically 96 to 104 percent of this contract liability is hedged or inherently collateralized by the underlying bond portfolios. This hedging or collateralization status is included in the reserve analysis required to be completed under existing insurance regulation. To put this business into perspective, as of

December 31, 2010, Prudential Financial had $3.25 trillion in life insurance worldwide in force. Thus, the synthetic GIC business represents a very small percentage of the contingent insurance contract liabilities managed by large and diverse insurance companies like Prudential.

There is no indication that during the Dodd-Frank Act legislative process, Congress was concerned in any manner with any assumed systemic or other risks related to the insurance products issued by state regulated insurance companies, including synthetic GICs.

If, despite this comprehensive regulatory structure, a particular insurer's financial condition were to deteriorate and the insurer deemed to be at risk by its insurance regulator, insurance laws provides for the supervision and, if necessary, orderly rehabilitation or liquidation of the life insurance company by the insurance commissioner. In an insolvency proceeding, the assets in the general account of the insurance company are made available to satisfy payment of policy claims, such as a contract value payment required by a synthetic GIC, ahead of general creditors.

In the unlikely event that an insurance company failure were to occur and the market value of the assets was insufficient to satisfy the contract value payment to SVF investors, the risk of contagion to financial system would be minimal because any such failure would be highly specific to the insurance company at risk, and its synthetic GIC purchasers, and would not extend to other financial institutions.

What financial and regulatory protections currently exist that are designed to ensure that SVC providers can meet their obligations to investors, and what are the sources of such protections? Does the level of protection vary depending on the SVC provider? How effective are any such measures?

As detailed extensively by multiple commenters in response to various rulemaking initiatives under the Dodd-Frank Act, the state based regulation of insurance is comprehensive and reaches nearly every aspect of the insurer's finances, operations, products, and marketing.[6] The dominant purpose of insurance regulation has always been to safeguard the solvency of insurance companies and protect policyholders, and therefore financial condition is the subject of extensive regulation. Areas subject to detailed insurance regulation include reserves, asset valuation, investments, expenses, surplus levels, dividends, and rehabilitation/liquidation.

To ensure that insurance departments have the information necessary to conclude that insurance companies are in compliance with legal requirements concerning financial condition, insurers are required to prepare and deliver detailed annual statements to the insurance department in each state in which it is licensed to do business. These annual statements are prepared using

6 See, e.g., ACLI's August 30, 2010 comment letter regarding obligations of brokers, dealers and investment advisers available at http://sec.gov/comments/4-606/4606-2669.pdf (explains the extensive regulatory network governing the sale of insurance products); ACLI's September 20, 2010 comment letter regarding Core Definitions in Title VII of Dodd-Frank Act, at Appendix B, available at http://sec.gov/comments/s7-16-10/s71610-62.pdf> (outlines regulation of insurance company investments). Uniformity in state insurance laws has been achieved through the work of the National Association of Insurance Commissioners (NAIC), to which each U.S. insurance commissioner belongs. The NAIC develops Model Acts that commissioners present to their legislatures for adoption. See, for example, Model Acts governing insurer investments (Model 280), capital requirements (Model 312), insurance holding company systems (Model 440), insurance liability valuation and reserves (Models 805, 806, 808, 820), unfair trade practices (Model 880), examinations (Model 390) advertising (Model 570), and producer licensing (Model 218).

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conservative statutory accounting rules and include additional exhibits, schedules and interrogatories designed to gather information about operations and trends beyond current financial data. Insurers are also subject to rigorous financial examinations by insurance regulators.

All states have adopted model laws governing assumptions used to determine insurance policy reserves. Generally, following these standards, insurers must determine and hold reserves sufficient for the insurer to meet all insurance contract liabilities when they fall due.

The combination of conservative limits on insurer investments, strict requirements for reserves and capital, and financial reporting and examinations provide a strong and historically successful framework for protecting insurance company solvency.

This highly regulated environment contrasts sharply with that of the largely unregulated swap market that Title VII of the Dodd-Frank Act was designed to address.

Conclusion

Prudential Financial believes strongly that synthetic GICs and other insurance company-issued SVCs are a key component to stable value investments, which are critical to helping millions of Americans save and plan for a secure retirement. These contracts are inherently different than derivatives or swaps and have a proven record of success under an already extensive regulatory regime. As currently used by plan sponsors and fiduciaries and extensively regulated primarily by insurance departments, SVCs do not pose systemic economic risk. Accordingly, Prudential Financial requests that the Commissions appropriately classify these contracts as insurance products, not swaps, or, to the extent that they are considered swaps, exempt them from the swap definition without subjection to additional regulation.

Again, we appreciate the opportunity to provide Prudential's perspective and market experience on this important topic.

Sincerely,