

August 29, 2008

Ms. Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

**Re: Request for Extension of Time to
Comment on Proposed Rule 151A
Release Number 33-8933 (File Number S7-14-08)**

Dear Ms. Harmon:

These preliminary comments are made on behalf of Genesis Financial Products, Inc. in support of its request for an extension of the comment period for proposed Rule 151A (Release Number 33-8933, File No. S7-14-08).

As background, we are an actuarial and product development firm with a long history of equity-indexed annuity (EIA) product development. We have worked on both registered and nonregistered EIA's. As actuaries and product developers we maintain a strong working knowledge of the interplay of state and federal regulation of insurance products, and in particular on the existing securities regulation regime for insurance products.

In our experience, the majority of well-designed EIA's provide strong enough guarantees so that they are legitimately exempt from registration under §3(a)(8) of the Securities Act of 1933 and Rule 151 under the Act. However, in some cases where weaker guarantees are offered, registration under the Securities Act, although not under the Investment Company Act of 1940, may be warranted (see for example Valley Forge Life Insurance Company, SEC No-Action Letter January 30, 1997).

Proposed Rule 151A would lump these unlike cases together, leading to inequitable treatment.

The Commission issued a concept release with respect to EIA's on August 20th, 1997 - over a decade ago - and apparently decided at that time that no en masse registration of EIA's was required. It has taken no substantive action until now.

Proposed Rule 151A upsets this equilibrium by proposing to overturn the de facto framework for analyzing the securities status of annuities on which the industry has relied in the interval (see, e.g., the NAIP's January 5th, 1998 submission to the SEC at <http://www.sec.gov/rules/concept/s72297/boros1.htm>).

Our understanding is that the SEC has proposed Rule 151A with the objectives of protecting and informing prospective annuity purchasers. While we fully support this objective, we believe that state insurance regulators have the matters of disclosure and consumer protection well in hand (see e.g. the NAIC's comment letter of August 14, 2008 to the Commission), and that proposed Rule 151A will not further these objectives.

Furthermore, our view is that Rule 151A, in its current form, is so flawed that it would be arbitrary, capricious, and an abuse of discretion by the Commission to adopt it.

Many commenters, including members of Congress, the American Academy of Actuaries, the American Council of Life Insurers, the National Association for Fixed Annuities, the Committee of Annuity Insurers, and the National Association of Insurance Commissioners, have requested an extension of the comment period (currently slated to end Sept. 10, 2008) for the proposed rule.

Despite the fact that we also require more time to develop a full analysis, we have reached some preliminary conclusions that we believe may be useful to the Commission and to commenters in general. One key conclusion is that a 90-day (or longer) extension of the comment period is warranted, on the following grounds:

- 1) The proposed rule is extremely far-reaching and will require more time to analyze thoroughly.
- 2) The proposing release contains a number of statements that we find problematic, such that commenters will be better able to make fully-informed comments given more background.
- 3) The proposed securities status test fails to provide any comfort regarding nonregistration status, and may therefore be very difficult to apply without damaging the economic interests of consumers, carriers, and distributors.
- 4) There are a number of flaws in the structure and application of the proposed securities status test. Some of these flaws may not be apparent at first glance. We believe that commenters aware of these flaws will be better able to make fully-informed comments.

We briefly explore these points in turn.

The Proposal is Extremely Far-Reaching

The proposal is extremely far-reaching, in that it not only proposes to classify the vast majority of EIA products as securities requiring registration, but may also have unintended effects on other insurance products such as traditional general account annuities, market-value-adjusted annuities, interest-indexed annuities, participating insurance, and equity-indexed universal life (EIUL).

Issuers and purchasers of all of these products have a natural interest in ensuring that any additional regulation to which they are subjected will actually achieve public policy goals, since they are already subject to a comprehensive system of state insurance regulation governing product design, financial solvency, and agent licensing and sales practices.

The proposal may also have the unintended effect of restricting access to annuity products guaranteeing principal and providing other insurance benefits. For this to occur at a time when so many boomers are reaching retirement age, and the securities markets that provide no guarantees are undergoing great uncertainty, would be extremely unfortunate and could impede the achievement of retirement goals for many people. This would be inconsistent with the SEC's mission.

Given the length of time that has elapsed since the Commission published its concept release on equity-indexed annuities, and given the existence of a de facto industry standard framework on which carriers have relied on for more than a decade, it clearly makes sense to take time to consult with the industry to ensure that the correct regulatory action is taken, if indeed any is required at all.

In this regard it may be worthwhile to note that the NAIC has developed a model regulation governing suitability of annuity transactions that has already been adopted by a majority of the states, and has also undertaken a variety of other disclosure initiatives. It seems clear that to the extent that proposed Rule 151A's purpose is to mandate additional disclosure, it will achieve marginal gains at best.

There are Problematic Statements in the Proposing Release

There are a number of problematic statements in the proposing release that we believe will be more understandable if supplied with additional context. Although we do not provide an exhaustive list here (for reasons of space, among other things) we believe that the following examples may be helpful. Page references are to the proposing release.

"Indexed annuities are attractive to purchasers because they promise to offer market-related gains". (P. 5) This is a true but incomplete statement. A more complete statement would be that EIA's provide a unique combination of guarantees and growth potential.

Many EIA purchasers would not be comfortable allocating the same dollar amount to stocks, mutual funds, or variable annuities, precisely because of the guarantees offered by EIA's. Lumping EIA's in with stocks and mutual funds because of the potential for growth seems to misconstrue the concept of investment risk. Behavioral finance research (and simple introspection) shows that the pain of a loss in value is felt more keenly than the pleasure of an equal dollar gain - under some measures, two to three times as keenly. Losses are the investment risk that purchasers seek to avoid - not gains.

In addition, the guarantees provide the potential purchaser with the knowledge of the minimum benefit that they will receive, and a solid basis for deciding whether that amount will be sufficient.

"...claims that rapid sales growth has been fueled by the payment of outside commissions that are funded by high surrender charges imposed over long periods...", (P. 8) Interestingly, the proposed rule does not address this claimed abuse, while recent actions by state insurance departments and attorneys-general do. Registration on an S-1 form does not in any way limit surrender charges, although state insurance law does.

"The United Benefit insurer guaranteed that the cash value of its variable annuity contract would never be less than 50% of purchase payments made, and that, after ten years, the value would be no less than 100% of payments", (P. 19) This is not correct - the values were 50% and 100% of net premiums (i.e. premiums after deduction of a front-end load, characteristic of the annuity products of the time), so that principal was never fully guaranteed.

According to the case as actually reported, the long-term guarantee provided by the "Flexible Fund" contract found to be a security was 100% of net premiums. As shown by the guaranteed values in footnote 10 of the United Benefit decision, even by year 30 the guaranteed value of the "Flexible Fund" contract was less than the sum of the premiums paid, while for the company's standard deferred annuity (used as a comparison, nonsecurity policy), the guaranteed value exceeded the premiums paid by over 50%.

Clearly a contract that never breaks even on a guaranteed basis cannot be viewed as providing safety of principal and can reasonably be viewed as a security. However, such a contract would not pass muster under today's state nonforfeiture laws. Most if not all of the nonregistered EIA designs currently available in the marketplace do provide safety of principal by the end of the surrender charge period.

"Indexed annuities are not entitled to rely on the safe harbor of Rule 151 because they fail to satisfy the requirement that the insurer guarantee that the rate of any interest to be credited in excess of the guaranteed minimum rate will not be modified more frequently than once per year." (P. 21) We are aware that correctly construing law and regulation can sometimes require interpretation. However, we would note that interpretation is not always uniform and that this statement, if taken literally, is not accurate.

Most if not all EIA's credit indexed interest over full-year periods (other than perhaps for "stub years", e.g. payment of an indexed death benefit if the owner dies partway through a contract year). The de facto industry-standard analysis framework alluded to above extends the reasoning of Rule 151 in a natural way

into a broader §3(a)(8) framework, and as such does not contemplate determining the credited interest rate more frequently than annually, other than for "stub years".

It is obvious that if indexed interest is only credited annually, and no interest rate is calculated or reported at sub-year intervals, then the rate of interest cannot have been modified more frequently than once per year. In that case the literal requirements of Rule 151 would be satisfied.

"Indexed annuities are attractive to purchasers precisely because they provide participation in the securities markets." (P. 27) This appears to us to be another incomplete and in fact inaccurate statement. The insurer may participate in the securities or futures markets but the purchaser does not. EIA's appeal to safety-conscious purchasers much more than would a mutual fund or a stock, and do not allow purchasers to select securities, and so don't provide participation in the securities markets per se. As pointed out above, a more complete statement would be that EIA's provide a unique combination of guarantees and growth potential.

These and other problematic statements in the proposing release demonstrate that close reading and careful consideration are required before commenters can provide the Commission with a full analysis of the proposed rule.

The Proposed Test Provides No Comfort Regarding Nonregistration Status

We repeat the gist of the test here for convenience. Given an appropriately defined issuer (carrier) and annuity contract, registration is required if:

- 1) Amounts payable by the issuer under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities; and
- 2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

Surprisingly, this proposed registration test does not provide any certainty with respect to the nonregistered status of an indexed annuity not meeting the test. It is an "if" test, not an "if and only if" test. Stated more directly, the proposed test can force registration but provide no comfort regarding nonregistration, as is made explicit at page 46 of the proposing release.

We believe that this is a severe flaw in the proposed test. In the absence of clarity, consumers, carriers, and distributors will be unable to determine the securities status of proposed transactions and will suffer substantial uncertainty and potential economic losses as a result.

The SEC is legally required to consider whether its rulemaking actions will promote the goals of efficiency, competition, and capital formation. Our view is that if the SEC is to meet this legal requirement a clear test for registration vs. nonregistration status must be in place, since creating regulatory uncertainty cannot reasonably be said to promote any of these goals.

We suggest that the de facto industry standard framework for securities analysis of annuity contracts would be a reasonable starting point for a test providing greater certainty.

Other Flaws in the Proposed Registration Test

There are a number of additional flaws or logical difficulties with the proposed registration test. The following list is not meant to be exhaustive.

Additional Flaw #1: Equating Outperformance with Risk

The first flaw in the proposed test is purely conceptual. The proposed test equates two distinct concepts in its attempt to define which annuities are securities requiring registration:

- the possibility of outperformance of guarantees, and
- investment risk sufficient to require securities registration.

In short, the test equates outperformance with risk.

As stated above, this is an odd combination. Most people intuitively view "risk" as "risk of loss", not "risk of gain". Although variance has often been conflated with risk in the finance literature, this is purely for mathematical tractability, and no-one takes seriously the notion that an annuity owner will object to interest being credited at a higher rate. Losses are the investment risk that purchasers seek to avoid - not gains.

It's also the case that under this test any indexed product could avoid the time and expense of registration merely by sufficiently reducing the amount of indexed interest credited. For the SEC to encourage lower returns to prospective annuity purchasers as a consumer protection measure seems strange.

Additional Flaw #2: Counterintuitive Product Classifications under The Proposed Test

It is possible for indexed annuity products that seem intuitively riskier to pass the test, while products that seem intuitively safer fail. This can happen in multiple ways. We provide a couple of quick sketches of hypothetical product designs displaying these features.

The Hypothetical "Compound Index" Annuity - There is a simple recipe, under the proposed test, for making an EIA not requiring registration out of one that does.

Take an existing EIA requires registration under the proposed test and assume (for the sake of simplicity here) that there is only one date at which indexed interest is to be credited. The probability P that indexed interest will exceed the guarantee is greater than or equal to 50% (since we're assuming registration is required under the test) but will in general be less than 100% (since indexed interest that always exceeds the guarantee ends up effectively defining a new, higher, guarantee).

We then select a second uncorrelated index and pick an economic event with a probability of 50% or less of occurring. For example, if the first index is the S&P 500, then the second index might be the Barclays U.S. Government Inflation-Linked Bond Index (assuming for sake of argument that the return on inflation-linked bonds is independent of the S&P 500). The economic event might be that the value of the second index on the crediting date is less than the value of the second index on the annuity issue date.

Then we construct the new EIA as follows:

- 1) Double the excess of the indexed interest credit over the guarantees compared with the original EIA, and
- 2) On the crediting date, if the event E occurs, make the doubled indexed credit to the annuity: if not, not.

This approach makes the new EIA intuitively riskier, in that "more things have to go right" for the indexed interest to be credited. However, it makes it more likely than not that no indexed interest will be credited, since P less than 1 implies that half of P is less than one-half. Therefore the new intuitively riskier EIA would not require registration under the test.

The Hypothetical "One Guarantee" Annuity - Typical single premium EIA's have a dual guarantee structure, in which (to oversimplify slightly) the cash value available to the owner is the greater of two quantities:

- 1) The premium, together with indexed interest to date credited according to the crediting formula, less a surrender charge, and
- 2) A percentage of premium (often 90%), accumulated at a nonforfeiture interest rate (often in the 2-3% range).

This dual guarantee structure is usually adopted because it ensures compliance with state individual annuity nonforfeiture laws and with the principles underlying the SEC's existing Rule 151.

Under the de facto industry standard analysis framework, the surrender charge, percentage of premium, and nonforfeiture accumulation rate are usually set to comply with state law and to achieve a cash value equal to premium within six to eight years after issue on a guaranteed basis.

However, many states do not apply their individual annuity nonforfeiture laws to group annuity products. This implies that a group annuity product could remove item two in the "greater of" test without falling afoul of state law, or Rule 151 either, if we assume for the moment that Rule 151 is inapplicable to EIA's as stated in the proposing release for Rule 151A. We then have an annuity for which the cash value is just the premium, together with indexed interest to date credited according to the crediting formula, less a surrender charge.

Such a product would not require registration under the test proposed in Rule 151A, since, so long as it credits indexed interest according to its crediting formula, it manifestly has credited what it guaranteed to credit - no more, no less. The index and the crediting formula together define the only guarantee provided.

Additional Flaw #3: Detrimental Effects of the More Likely Than Not Computation

The proposed rule places a new requirement on actuaries to perform "more likely than not" computations to determine the securities status of an annuity product. The results of these computations will depend on actuarial assumptions with respect to mortality, persistency, and index changes.

It is not clear whether the SEC has fully considered the likely effect of normal variations in these assumptions. It is entirely possible that two actuaries, both performing a "more likely than not" test, could obtain different answers (i.e. a greater than 50% probability of crediting indexed interest greater than the guarantees vs. a less than 50% probability) for very similar products. We can provide examples of this phenomenon on request.

We therefore believe that adoption of the test as proposed could easily lead to a situation in which virtually identical products would have different registration status, potentially causing economic harm and confusion in the marketplace. More specifically:

- 1) A specific form of contract from a given carrier could require registration at one time, and not at a second time, based entirely on determinations external to the form of the contract and difficult for the purchaser to understand, and
- 2) Two contract forms, virtually identical and issued on the same day, could have different registration requirements if issued by different carriers.

Clearly there is no precedent for either of these situations in any existing method of determining registration status. Neither of these situations would be conducive to achieving the SEC's goals of promoting efficiency, competition, and capital formation.

Conclusion

In view of our preliminary analysis as described above, we respectfully request that the comment period for the proposed rule be extended to December 9, 2008 or later.

Sincerely,

Richard C. Payne

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