Northwestern Mutual®

Michael J. Mazza
Assistant General Counsel and
Assistant Secretary

720 East Wisconsin Avenue
Milwaukee, WI 53202-4797
414 665 2052 office
414 625 2052 fax
michaelmazza@northwesternmutual.com

September 10, 2008

VIA E-MAIL

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: **File Number S7-14-08**
Indexed Annuities and Certain Other Insurance Contracts
Proposed Rules File Nos. 33-8933; 34-58022

Dear Ms. Harmon:

The Northwestern Mutual Life Insurance Company (the "Company") appreciates the opportunity to comment on Proposed Rule 151A under the Securities Act of 1933 and Proposed Rule 12h-7 under the Securities Exchange Act of 1934 (the "Proposed Rules") regarding indexed annuities and certain other insurance contracts.[1] The Proposed Rules would, among other things, define the terms "annuity contract" and "optional annuity contract" under the Securities Act of 1933 (the "Securities Act") and, under certain conditions, exempt insurance companies from filing reports under the Securities Exchange Act of 1934 (the "Exchange Act") with respect to indexed annuities and other securities that are registered under the Securities Act.

I. Introduction

The Company, as a mutual company, exists for the benefit of its policy owners and clients. Begun in 1857, the Company presently leads the U.S. in total individual life insurance dividends paid to policy owners and, as of the end of 2007, had over 306,000 annuity contracts worth $14.8 billion. We, along with other issuers of fixed and variable annuities, benefit from a sales environment that favors investing customers, and thus generally share the Commission's concerns about the inappropriate sales practices referenced in the Release. We also agree with the Commission that the benefits to customers who may purchase certain non-variable insurance contracts outweigh the burdens of Exchange Act reporting by issuers of such contracts, and thus generally support the adoption of a rule providing an exemption from the requirements of Sections 13 and 15(d) of the Exchange Act for insurance companies that issue SEC-registered non-variable insurance contracts.

[1] See Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 33-8933, Securities Exchange Act Release No. 34-58022 (June 25, 2008), 73 Fed. Reg. 37,751 (July 1, 2008) (the "Release").

Nevertheless, the Company has serious reservations about several elements contained in the present version of the Proposed Rules. Specifically, the two-part test in Proposed Rule 151A for whether an annuity contract would be subject to registration under the Securities Act

- dramatically departs from established precedent,
- downplays the significance of state law guarantees, state regulation, and the risks assumed by insurers subject to such state laws,
- threatens to require registration of products clearly within the statutory definition of insurance and products involving neither the contractual attributes of, nor the problematic sales practices sometimes associated with, indexed annuities, and
- raises a number of serious practical problems for annuity issuers.

II. Specific Comments on the Proposed Rules

Proposed Rule 151A has a two-part definition of an annuity that is not an "annuity contract" under Section 3(a)(8) of the Securities Act. Under Proposed Rule 151A, an annuity would be subject to registration 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 [as that term is defined in Section 2(a)(1) of the Securities Act], 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.

Both parts of this two-part test are problematic.

A. The Broad Definition in Proposed Rule 151A Contradicts Precedent and Downplays Risks Assumed by Insurers Subject to State Laws

By attempting to pull indexed annuities into the definition of "securities" by narrowing the exclusion for "annuities" under Section 3(a)(8) of the Securities Act, the Release has dramatically altered the regulatory landscape that has been constructed over time through statute, case law, and rulemaking. Such precedent has established a more developed and nuanced understanding of "investment risk" than the truncated analysis presented in the Release.

For instance, the Release relies on two seminal United States Supreme Court cases interpreting Section 3(a)(8) of the Securities Act for its interpretation of "investment risk."[2] But the Release's focus on these cases is curious for at least two reasons. First, contracts at issue in *VALIC* and *United Benefit* were *variable* annuities, where it was clear that the individual investor, and not the insurance company, bore the risk of poor investment performance. Such contracts are fundamentally different from contracts Proposed Rule 151A appears to define as

---

[2] *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) ("*VALIC*"); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) ("*United Benefit*"). *See* Release at 37755.

securities – *e.g.*, fixed annuities with minimum guaranteed values required under state non-forfeiture laws, where the insurance company bears a substantial and meaningful risk of poor investment performance. Second, the "investment risk" analysis in both *VALIC* and *United Benefit* was significantly broader than that which is contained in the release. And it has been this more thorough analysis of "investment risk" that has guided regulators and issuers for over forty years.

Justice Douglas's majority opinion in *VALIC* described some of the features of this investment risk analysis in noting that "the concept of 'insurance' involves *some* investment risk-taking *on the part of the company*,"[3] and that "the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense. . . . For in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts"[4] (emphasis supplied). The majority opinion adds that when a company guarantees "an interest that has a ceiling but no floor,"[5] there has been "no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage."[6]

The Release refers to Justice Brennan's oft-quoted concurrence in *VALIC* for the proposition that the Securities Act emphasized disclosure so that investors can "intelligently appraise the risks involved,"[7] whereas state insurance regulation relates to "solvency and the adequacy of reserves."[8] On their face, these quotes may rightly suggest complementary areas of focus when it comes to the regulation of variable annuities;[9] but critical to Justice Brennan's analysis in *VALIC* was the realization that federal securities regulation is inapt "where the obligations of the company [are] measured in fixed-dollar terms and where the investor could not be said, in any meaningful sense, to be a sharer in the investment experience of the company."[10]

Thus, *VALIC* stands for the proposition that when considering whether an insurance contract falls into the definition of a "security" requiring registration, a fundamental component of the "investment risk" analysis applied involves an inquiry into the investment risks assumed by the *issuer* as well as the individual investor. Ignoring the floors set by state law and other

---

[3] *VALIC*, 359 U.S. at 71.
[4] *Id.*
[5] *Id.* at 72.
[6] *Id.* at 73.
[7] *Id.* at 77.
[8] *Id.*
[9] It is important to note that since *VALIC* was decided in 1959 – and particularly in the last ten years – state insurance regulation has focused increasingly on other forms of direct consumer protection beyond insurer solvency, including a wide range of areas such as annuity advertising and disclosure, annuity solicitation and replacement, annuity suitability, annuity non-forfeiture values, market conduct examinations, producer training and education, consumer complaints, anti-fraud and mandatory reporting, rights to examine, consumer privacy, retention of records, and financial transactions between producers and customers. Many of these model laws and regulations were not in place at the time of the *VALIC* decision.
[10] *VALIC*, 359 U.S. at 77.

guarantees assumed by the issuing company, as the Release does, is simply inconsistent with the Supreme Court's venerable interpretation of a 75-year old statute.

The other Supreme Court case cited in the Release, *United Benefit*, extended, but did not contradict, the investment risk analysis in *VALIC* described above. Reviewing a variable annuity contract with minimum guarantees absent from the *VALIC* contract (*i.e.*, a 50% surrender value "floor" in year one grading up to a full 100% of premium guarantee in year ten), the *United Benefit* court found such a guarantee to be "insignificant,"[11] noting that the issuing company had set the guarantee in light of historical performance "so that it would not have become operable under any prior conditions."[12] Contracts designed to satisfy state non-forfeiture law provide more significant guarantees than the type at issue in *United Benefit.* Further, it is difficult to understand how satisfying the non-forfeiture requirements enacted by fifty state legislatures is somehow insufficiently "meaningful" to qualify a product as insurance.

The Release's suggestion to the contrary[13] not only contradicts case law but the Commission's own Rule 151, which recognized the significance of state law guarantees by including compliance with applicable state non-forfeiture law in the list of factors qualifying an annuity for the "safe harbor" afforded by Rule 151. The "investment risk" analysis in the Release also appears to contradict the Commission's own analysis contained in the Adopting Release for Rule 151, where the Commission stated that "in light of clear judicial precedent," (including *VALIC*), it was "inappropriate" for the authors of Rule 151 to ignore an insurer's promise to "credit a specified rate of interest" in determining whether a contract fit within the Rule's "safe harbor" for satisfying Section 3(a)(8).[14]

Disregarding the significance of insurance companies' guarantees under state non-forfeiture law is also fundamentally unfair to insurance companies. For example, insurance companies typically invest in corporate securities and mortgage loans to support the guarantees offered in fixed annuities. The risk of these assets defaulting is borne by the insurance companies. Recent history contains painful examples of the realities of such risks – including the failure of annuity-issuer Baldwin-United in the 1980s to invest assets to enable it to perform on the guarantees contained in its annuities, the rash of asset defaults in 2000-2003, and the recent mortgage loan crises. In addition to credit risk, insurance companies subject to state non-forfeiture law bear the risk that the market value of assets may be insufficient to cover benefit payments because of a rise in interest rates. In such an interest rate environment, the market value of assets would decrease but the minimum non-forfeiture surrender value would not decline.

---

[11] *United Benefit*, 387 U.S. at 209.
[12] *Id.*
[13] *See* Release at 37757 (noting that contracts which "provide some protection against risk of loss" (including those with floors set by state non-forfeiture law) "may to some degree be insured, but that degree may be too small" to render the contract insurance).
[14] Securities Act Release No. 33-6645 (May 29, 1986).

B. Proposed Rule 151A Could Require Registration of Products Within §3(a)(8)

Departing from precedent by circumscribing established "investment risk" analysis would have the collateral effect of creating uncertainty over the status of a range of products that at present are widely considered to be well within the definition of "insurance" for purposes of Section 3(a)(8) of the Securities Act. There are many insurance products that have guaranteed floors consistent with significant state non-forfeiture law minimum guarantees but whose "ceilings" depend on the performance of the investments in the sponsoring insurance company's general account – which may or may not include a number of "securities." If Proposed Rule 151A, as currently drafted, would classify as a security any insurance product with returns that may have a "securities-linked portion," the Commission may be inundated with registrations for products that are clearly insurance without any appreciable benefit to citizens concerned about their financial security.

For instance, the literal language of part (1) of Proposed Rule 151A could be interpreted by some to require registration of products that established precedent has clearly defined as insurance. These include not only discretionary excess interest contracts, but any general account life insurance policy or annuity contract that may pay dividends which may in part reflect the performance of the sponsoring life company's general account and that are, under part (2) of the Proposed Rule, "more likely than not" to pay more than the guaranteed minimums. While it is difficult to believe that the Commission would intend to include fixed life insurance into the definition of "security," the language of the rule – as it stands at present – would not prevent such a classification in the future, either by the Commission or by courts.[15] It seems clear that these kinds of products pose no risk to investors that needs to mitigated by the creation of a new rule, registration with the Commission, and regulation of sales by FINRA. Thus, in response to the Staff's request for comment on the specific question of whether "the proposed definition [should] apply to forms of insurance other than annuities, such as life insurance,"[16] our answer – particularly with respect to fixed life insurance – is most certainly in the negative.

C. Proposed Rule 151A's "More Likely Than Not" Test is Unworkable

Part (2) of the two-part test in Proposed Rule 151A, by introducing a "principles-based" analysis to the definition of whether a certain contract is a security, raises a number of practical concerns for issuers – *e.g.*, What happens if *any* amount of non-guaranteed interest is paid? How would the actuarial opinion supporting the "more likely than not" determination be documented? Would regulators (or others, such as potential litigants) second-guess this determination in hindsight? And given the Commission's concern over promissory statements about future performance, how is an issuer to publicize contracts that by definition postulate a positive projection of future performance? Far from providing certainty for investors, regulators, and

[15] While subparagraph (c) of Proposed Rule 151A specifically excludes "any contract whose value varies according to the investment experience of a separate account," no other contracts are so expressly excluded.
[16] Release at 37758.

issuers, the Proposed Rule's test would appear likely simply to engender confusion and increase the risk of litigation against issuers of these valuable and important retirement income products.

III. Conclusion

As discussed above, we believe Proposed Rule 151A significantly departs from precedent, betrays an unfounded suspicion of the significance of state law guarantees, could require registration of products that clearly fall within the statutory exemption for insurance products, and places significant burdens on insurance companies issuing products that are uniquely situated to meet the financial security needs of Americans – many of whom can no longer rely solely on Social Security and traditional pension plans as their primary source of financial security in retirement. We urge the Commission to reconsider the assumptions on which the Release appears to be based.

Thank you for the opportunity to comment. If you have any questions, please contact me at (414) 665-2052.

Very truly yours,

/s/ Michael J. Mazza

Michael J. Mazza
Assistant General Counsel and Assistant Secretary

763457