NAIFA

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

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September 10, 2008

Florence Harmon
Acting Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File Number S7-14-08 – Indexed Annuities and Certain Other Insurance Contracts

Dear Ms. Harmon:

On behalf of the National Association of Insurance and Financial Advisors ("NAIFA"), the largest member association for insurance agents and advisors, I would like to thank you for the opportunity to comment on proposed Rule 151A, which purports to bring indexed annuities ("IAs") – and potentially other forms of annuity and insurance contracts – within the reach of federal securities laws and the scope of the Securities and Exchange Commission's ("Commission") regulation.

Founded in 1890 as the National Association of Life Underwriters, NAIFA is comprised of 770 state and local associations representing the business interests of 225,000 members and their employees. Members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members. NAIFA's website can be accessed at www.naifa.org.

Relying on well-founded federal court decisions and comprehensive state regulatory structures presently in place, NAIFA concludes that IAs should not be considered securities and requests that the Commission withdraw proposed Rule 151A. Federal district and appellate courts, and even the U.S. Supreme Court, have provided clear guidance confirming that IAs do not fit the definition of "security" and should remain outside the Commission's purview. Moreover, IAs are currently subject to comprehensive and thorough supervision by state insurance regulators. Regulatory models adopted by the National Association of Insurance Commissioners ("NAIC"), which have been promulgated in many states, sufficiently address the concerns raised by the Commission in supporting proposed Rule 151A, including concerns regarding disclosure and suitability. As discussed in detail below, NAIFA is committed to working towards having every state adopt <u>and</u> vigorously enforce these model regulations.

NAIFA strongly opposes unsuitable sales and unscrupulous marketing practices that may be used in offering IAs to the public, and supports levying strong sanctions against issuers and producers who engage in such conduct. NAIFA members work hand-in-hand with insurance regulators at the NAIC and in state governments to protect consumers from the bad behavior of the small number of individuals who sell these products in an inappropriate manner. Having said that, NAIFA believes that concerns about disclosure, suitability, and marketing practices are not the criteria that should be applied when considering whether IAs should be subject to federal securities laws and regulations. That question is better left to the reasoned analyses of federal courts who have explored the issue, and the language of the Commission's current regulations that detail what types of annuity contracts are beyond the Commission's jurisdiction.

I. Indexed Annuities are not Securities

<u>A. Relevant Case Law Demonstrates that the Federal Securities Laws Should Not Apply to Indexed Annuities</u>

Proposed Rule 151A is overreaching. The Commission's commentary accompanying the proposed rule suggests a misunderstanding of the nature of IAs. In considering whether IAs should be subject to federal securities regulation, the Commission should not be guided by speculative conclusions about potential investment risks, the need for additional investor protection, or apparent confusion regarding the obligations of IA issuers and sellers under federal securities law. Instead, the Commission's position should be grounded in a clear analysis of whether IAs fit within the framework of investment products that lawfully come within the purview of federal securities laws. NAIFA proposes that the Commission look to *Malone v. Addison Ins. Marketing*, 225 F.Supp.2d 743 (W.D. Ky. 2002), the only legal decision that has squarely addressed the question now confronted. The Commission's commentary discusses *Malone* only in a footnote, attempting to distinguish it as a decision that incorrectly applied the Rule 151 safe harbor test to the IA at issue in that case. The Commission otherwise ignores the federal district court's legal analysis of the question directly at issue here.

A decision to enact Rule 151A and regulate IAs under the federal securities laws should hinge on whether IAs actually fit the definition of "security" found in the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77a *et seq.*, and the Securities Exchange Act of 1934 ("Exchange Act"), U.S.C. §§ 78a *et seq*. *Malone* demonstrates that this analysis should be controlled by two factors: 1) the broad exemption found in Section 3(a)(8) of the Securities Act that places certain investment contracts outside that statute's scope[1]; and 2) Supreme Court decisions that have since restricted section 3(a)(8)'s sweeping

[1] Section 3(a)(8) indicates that the Securities Act will not apply to "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."

exclusion. An examination of these two points demonstrates that IAs should remain outside the Commission's authority.

Malone's first factor is quickly addressed: IAs meet the requirements of section 3(a)(8). There is no dispute that the typical IA is: 1) an annuity contract; and 2) issued by an insurance company that is subject to regulation and supervision by a state insurance commissioner.

The second factor – controlling Supreme Court precedents that have clarified what kinds of annuities are not entitled to section 3(a)(8)'s protections – unquestionably affirms that IAs should remain outside the reach of federal securities laws. *Malone*'s analysis relies heavily upon the distinction that the Court has drawn between variable annuities and fixed annuities in *SEC v. Variable Life Insur. Co.* ("*VALIC*"), 359 U.S. 65 (1959) and *SEC v. United Benefit Life Insur. Co.* ("*United Benefit*"), 387 U.S. 202 (1967). Discussing *VALIC*'s decision to classify variable annuities as subject to federal securities laws, *Malone* notes that the holder of a variable annuity assumes a much greater risk than the holder of a fixed annuity, who is provided with a guaranteed contract value. *VALIC* concluded that the issuer of a variable annuity does not provide a fixed return, and therefore assumes no true risk in the insurance context. By contrast, a fixed annuity – which is exempt from federal securities laws under section 3(a)(8) – guarantees that some portion of the benefits available under the annuity contract will be payable in fixed amounts. *Malone*, 225 F.Supp.2d at 749 (citing 359 U.S. at 72).

Malone found that central to the analysis in *United Benefit* was the fact that the insurer only promised to serve as an investment agency and did not promise the policy holder a fixed amount of savings plus interest. *United Benefit* explained that where there is a fixing of benefits stipulated at the outset of a conventional annuity contract, the critical issue from an investment standpoint is the planning problem shouldered by the insurer who has to make financial decisions to back the guarantee. The Court concluded that in a fixed annuity, the annuitant has no direct interest in the fund, and the insurer has a dollar target to meet. Thus, with a fixed annuity, the insurer is acting like a savings institution with state regulation adjusting to that role. *Malone*, 225 F.Supp.2d at 749-750 (citing 387 U.S. at 208).

Malone also draws on appellate court decisions that provide additional guidance on the distinction between fixed and variable annuities. In *Lander v. Hartford Life and Ins. Co.*, 251 F.3d 101 (2d Cir. 2001), the Second Circuit emphasized the extent to which a payout made by a variable annuity was entirely dependent on the success of the investment securities selected by the annuitant in holding that variable annuity contracts were "covered securities" under the Securities Litigation Uniform Standards Act of 1998. By contrast, the value of an IA is not entirely dependent upon the results achieved by the underlying investment to which the contract is tied.

Another example is found in *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1986), where the Seventh Circuit found that the insurance product at issue was a fixed annuity because the company selling the product was required to pay a guaranteed rate of interest on all fixed annuity contributions during the first ten years of the contract.

Malone uses this Supreme Court and Circuit Court authority to find three reasons why the IAs at issue in that case were like a fixed annuity instead of a variable annuity, and therefore not subject to the federal securities law claims raised by the plaintiff:

- The investment contracts at issue guaranteed the plaintiff a minimum 3 percent return, irrespective of the performance of the S&P 500 index to which the IA was tied. Even though the plaintiff's return could have been greater than 3 percent based on performance of the S&P 500, the 3 percent return guarantee meant that the issuer, not the purchaser, assumed the investment risk. This characteristic satisfies the concerns raised in *VALIC*.

- The payments received by the plaintiff were not directly dependent on the performance of the investments made with her money. In contrast to what happens with a variable annuity, the payments received by the plaintiff were not a function of a personalized portfolio and her principal was not held in an independent account. This feature satisfies the concerns raised in *United Benefit*.

- Even though the plaintiff's return could have been over and above the guaranteed return depending on the performance of the S&P 500, the court did not find this argument conclusive for demonstrating that the contracts at issue were securities. The fact remained that the issuer bore as much or more of the risk than the plaintiff, since it could take a loss if it could not surpass the indexed rate in its own investments. Important to the court was that the plaintiff's risk was not that she would lose the value of her initial investment. A risk that had she chose a different contract her money might have been worth more than that guaranteed under the contracts at issue is not the kind of risk that determines whether a security exists. Ultimately, the court found that because the issuer assumed a much greater risk, the plaintiff's investment was more like insurance and less like an investment.[2]

The rationale adopted by the court in *Malone* to conclude that the IAs at issue there were not securities should be applied here. The hallmark of an IA is that it offers a specified minimum guaranteed return. Moreover, monies paid by purchasers for IAs are not invested directly in the stock market. Instead, purchasers are offered a specified percentage of how much the index gains over a period of time, and a guaranteed minimum return if the index to which the product is linked declines. The Commission's commentary acknowledges as much, indicating that "[i]ndexed annuities generally provide a guaranteed minimum value, which serves as a floor on the amount paid upon

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[2] *Malone* went on to find that the IAs at issue there also satisfied the requirements of the Rule 151 safe harbor. While the Commission's commentary challenges that finding, *see* 73 FR 37752-01 n.38, it is not critical to the analysis of whether IAs are securities. *See Malone*, 225 F.Supp.2d at 751 (indicating that the court could have concluded that the IAs were not securities without engaging in a Rule 151 analysis).

withdrawal, as a death benefit, or in determining the amount of annuity payments." 73 FR 37754.

The guaranteed floor feature of IAs belies the Commission's effort to link IAs with products historically regulated under federal securities laws. The Commission states, "[i]ndividuals who purchase such indexed annuities assume many of the same risks and rewards that investors assume when investing their money in mutual funds, variable annuities and other securities." *Id.* at 37752. Unlike those products, however, IAs ensure purchasers that they will be entitled to, at the very least, a certain guaranteed return. Mutual funds, variable annuities, and other securities cannot offer such assurances, presenting consumers with potential investment outcomes that range from the purchased security losing all of its value to realizing significant returns. While purchasers of IAs have the potential for higher than guaranteed returns depending on the performance of the index to which the IA is tied, such a risk is not the same – and thus does not warrant the same protections – as that found for an investment product that could potentially lose all of its value. Moreover, as indicated in the *United Benefit* analysis, the insurer – not the IA purchaser – must make investment decisions and shoulder the responsibility for meeting the guarantee.

B. IAs Fit Within Rule 151's Safe Harbor

As also demonstrated in *Malone*, IAs should be exempt from regulation under the federal securities laws as they fit within Rule 151's safe harbor, 17 C.F.R. §230.151, which provides certain types of annuities an exemption from federal securities laws. An annuity meets Rule 151's requirements as long as: 1) its issuer is subject to state insurance regulation; 2) its issuer assumes the investment risk as prescribed by the rule; and 3) it is not marketed primarily as an investment. IAs available in today's market exhibit all of these characteristics.

First, as noted above, and as acknowledged by the Commission's commentary, IA issuers are entities that are currently regulated under state insurance law.

Second, assumption of the investment risk associated with IAs lies with issuers, not purchasers of IAs. These products meet the all of the requirements set out by Rule 151 for demonstrating that the issuer assumes the investment risks. IAs feature the following characteristics: 1) guarantee the purchaser virtually the entire principal amount of purchase payments and interest, less deductions for sales, administrative costs, and other expenses; 2) credit a specified rate of interest to net purchase payments and interest credited to the account; and 3) guarantee that the rate of interest to be credited to the account in excess of the specified interest rate promised by the account will not be modified more than once per year. *See* 17 C.F.R. §230.151(b). As discussed above, the Commission proposes to lump IAs in with other products historically regulated as securities (*e.g.* mutual funds, variable annuities), claiming that IAs present similar investment risks. However, that conclusion is fundamentally flawed. Unlike those other products, the value of an IA will not fall beneath a guaranteed point if the index to which it is tied sinks in value. The issuer, not the IA owner, bears the risk of any such downturn.

Further, most IAs meet the requirement that they are not marketed primarily as investments. While the Commission's commentary focuses on the notion that IAs are promoted as investment vehicles and are attractive to purchasers because of the potential returns associated with IAs, not all IAs are subject to this concern. As was important in *United Benefit* and *Malone*, IAs are promoted as vehicles of "stability and security" over the prospect of growth. Moreover, to the extent that certain IAs are marketed as investments and touted for their potential gains, they should not be viewed as being generally representative of all IA offerings, and in turn subject an entire class of annuity contracts to federal securities regulation because of their unique marketing. If the Commission seeks to regulate such contracts, they should be removed from the general class of IAs on a case-by-case basis.

II. Indexed Annuities Are Currently Subject to Comprehensive Regulation by State Insurance Regulators

A. Current State Regulation

Subjecting IAs to federal regulation is wholly unnecessary. While the Commission's commentary accurately states that most IA purchasers have not received the benefits of federally-mandated disclosure and sales practice protections, it completely ignores the thorough and comprehensive regulation of these contracts that currently exists under state law. Using models promulgated by the NAIC, a number of states have adopted regulatory schemes prohibiting misleading and inappropriate sales practices and mandating certain disclosure and suitability requirements, which afford IA purchasers significant protection. Even apart from these measures, each state department of insurance provides significant regulatory protections for any IA purchaser. For example, sales materials produced by issuers must be filed with the state in which the issuer is located, and a complete review of any product must be completed before a state permits its sale within the state.

B. NAIC Model Regulations

The NAIC's model regulations addressing disclosure and suitability requirements provide clear guidance on how states should be regulating IAs and other annuities. The NAIC's Annuity Disclosure Model Regulation provides standards for the disclosure of information about annuity contracts in an effort to protect consumers and promote consumer education. This model regulation requires that anyone who applies for an annuity contract receive a disclosure document that describes the benefits of the annuity and emphasizes its long-term nature. It also requires that purchasers receive a Buyer's Guide to promote consumer education about how fixed and indexed annuities work. More than twenty states have enacted the disclosure model or related legislation.

The NAIC's Suitability in Annuity Transactions Model Regulation sets forth standards and procedures concerning recommendations to consumers that result in transactions involving annuity products. This model has been adopted in 35 states. It requires that the insurance needs and financial objectives of consumers are appropriately addressed at the time of the transaction, placing an affirmative duty on insurers and insurance producers to have reasonable grounds for believing that the recommendation made to a consumer in connection with the purchase or exchange of an annuity is suitable given the consumer's disclosed investments and financial status.

C. Current State Regulatory Efforts to Enhance and Strengthen Consumer Protections for Indexed Annuity Purchasers

Earlier this year, the NAIC charged two separate working groups to commence work aimed at improving the regulation of annuity sales in order to further protect annuity consumers from unsuitable sales and marketing practices, and to review and consider enhancements to the Annuity Disclosure Model Regulation to better inform annuity consumers about the products purchased and how they work.

In addition, the state insurance departments of New Hampshire, Iowa, Missouri, Illinois, Oregon, Ohio, and Pennsylvania have asked the Insurance Marketplace Standards Association ("IMSA") to conduct a review of annuity supervision and monitoring practices currently employed by IMSA qualified companies. The IMSA report identifies certain supervision and monitoring practices employed by IMSA qualified companies, which represent 50% of the annuity marketplace based on premium volume. The report, which is scheduled to be completed in September 2008, is designed to identify a range of annuity suitability supervision and monitoring practices that may be employed by NAIC working groups charged with strengthening the suitability model's protections.

NAIFA believes that time, resources, and energy should be invested in strengthening an already widespread, uniform regulatory scheme rather than implementing a completely new regulatory structure at the federal level. While NAIFA acknowledges that not every state has adopted the suitability and disclosure models, NAIFA is committed to working with the NAIC and the states to promote the adoption of these models across the United States, and to find ways to enhance the state regulatory structure to address the concerns that the Commission and others have raised about the marketing and sale of IAs. In addition, in order to address concerns about contract terms and provisions that may make particular products inherently unsuitable for any consumer, NAIFA also recommends that a state regulatory body be designated to develop standards for IA product design that would be implemented by state insurance regulators and used to prevent inappropriate IA products from reaching the marketplace.

III. The Need for Additional Regulation Has Not Been Demonstrated

Although the Commission seeks to further protect potential purchasers of IAs with its proposed Rule 151A and limit the harms that poorly designed products and unscrupulous sellers of IAs present, the reality is that the need for Commission action is not readily apparent. Concerns and complaints about IAs seem limited, by comparison, when considering similar issues for variable annuities and other securities, which are already under the Commission's jurisdiction. A March 2008 NAIC Customer Information Source report indicates that between 2005 and 2007, the NAIC received annually, on average, 207,646 complaints. About one percent of those complaints related to annuities, and only about one-tenth of one percent related specifically to IAs. This data suggests that IA products have many satisfied customers. Indeed, Advantage Compendium, an annuity analyst firm, has indicated that the IA industry experiences one complaint for every $109 million of premium received. With such positive results, proposed Rule 151A may be a solution that is in search of a problem.

Further, even in circumstances where complaints over IAs arise, the dispute resolution mechanisms put in place under state regulatory schemes are proven tools that should not be overhauled by a new federal system that jeopardizes the efficiencies regulators and consumers can now expect. Under current state schemes, consumers receive rapid responses from state insurance departments when filing complaints. In most cases, agents and companies must provide written responses within 10 business days of an insurance department inquiry, and purchaser complaints are routinely resolved in 30 days. By contrast, the Commission's complaint resolution process is much slower, more complex, and more costly for consumers, potentially including the cost of legal representation and the delays of litigation.

IV. Additional Considerations

NAIFA is also concerned by the breadth of the language included in Proposed Rule 151A. Although the Commission's commentary speaks only in terms of regulating IAs, the proposed rule is not as clear, and could be interpreted to have a much broader reach. NAIFA requests that if the Commission intends to enact this proposal, additional language be included in the rule making clear that it reaches only indexed annuities, and could not be interpreted to reach other annuity and insurance products that are not contemplated by the Commission's commentary.

As indicated at the outset of these comments, NAIFA shares the Commission's concerns about inappropriate marketing practices and sales of IAs to consumers, and is strongly opposed to unscrupulous sales practices as well as the sale and purchase of unsuitable IA products. Part of the concern about ensuring adequate protection from these dangers for purchasers rests with the design of IA products. As an alternative to the Commission's proposal, NAIFA recommended earlier in our comments that a regulatory body or task force at the state level should be designated to develop standards for IA product design that would be implemented by state insurance regulators and used to prevent inappropriate IA products from reaching the marketplace. Such a proposal would undoubtedly enhance consumer protections while maintaining many of the strengths of the currently regulatory schemes for IAs that are already in place. Coupled with the application of the NAIC disclosure and suitability models and state consumer protection laws in this arena to weed out unsuitable IA products, properly educate consumers, and appropriately punish issuers and producers who violate the law, states could continue to be the primary regulatory force over IAs.

Thank you again for allowing NAIFA the opportunity to provide our feedback on this proposal. Please let us know if we can be of assistance to you as this process moves forward.

Sincerely,

/s/ Gary A. Sanders

Gary A. Sanders
Senior Counsel, Law and Government Relations