NATIONAL WESTERN
LIFE INSURANCE COMPANY

JAMES P. PAYNE
SENIOR VICE PRESIDENT–SECRETARY

September 10, 2008

VIA E-MAIL

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

Re: File Number S7-14-08
Indexed Annuities and Certain Other Insurance Contracts
Proposed Rule, Release Nos. 33-8933, 34-58022

Dear Ms. Harmon:

National Western Life Insurance Company (the "Company", "National Western" or "we") is a stock life insurance company domiciled in the State of Colorado and a major writer of indexed annuity contracts in the United States.[1] National Western has been in the business of writing fixed indexed annuity contracts for over 11 years and currently offers indexed annuity contracts in 49 states and the District of Columbia.

National Western appreciates the opportunity to offer its comments in response to the request by the Securities and Exchange Commission ("Commission" or "SEC") in Release No. 33-8933 (the "Proposing Release")[2] for comments on proposed rule 151A that would deem certain annuity contracts for state law purposes as not an "annuity contract" or "optional annuity contract" under Section 3(a)(8) of the Securities Act of 1933 (the "1933 Act"). As noted in the Proposing Release, proposed rule 151A "is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index."[3]

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1 National Western is a publicly-held insurance company that, as of December 31, 2007 had approximately $7 billion in assets.

2 See Indexed Annuities and Certain Other Insurance Contracts, Rel. Nos. 33-8933, 34-58022 (June 25, 2008).

3 Id. at 1.

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National Western has been a staunch supporter of strong and effective regulation of disclosure, suitability and sales practice standards for fixed indexed annuity contracts since the Company first commenced writing fixed indexed annuity contracts in August 1997 and has adopted stringent standards, discussed below, in those areas to govern the offer and sale of the Company's fixed indexed annuity contracts. National Western maintains that a regulatory framework that embodies robust customer protections is vital to the protection of purchasers of fixed indexed annuity contracts and is in the best interests of all concerned parties, including writers of fixed indexed annuity contracts. We believe, however, that those customer protection goals have been and continue to be most effectively met through the regulation of fixed indexed annuity contracts by the insurance department of each state, not through duplicative, unnecessary and expensive regulation by the SEC and the Financial Industry Regulatory Authority ("FINRA") that proposed rule 151A would require.

In summary, National Western believes that proposed rule 151A is fundamentally flawed and strongly opposes adoption of the rule by the SEC. In National Western's view, proposed rule 151A is an unworkable, ill-conceived rule that is arbitrary, capricious and inconsistent with Congressional intent to preserve for the states the regulation of insurance that is embodied in Section 3(a)(8) of the 1933 Act. Proposed rule 151A is also fundamentally in conflict with and not supported by judicial precedent and SEC interpretations. Moreover, the proposed rule would impose high unnecessary costs on both purchasers of fixed indexed annuity contracts and insurance company writers of fixed indexed annuity contracts, some of which the SEC and its staff have failed to identify or fully account for in the Proposing Release.

Notwithstanding the dramatic and far reaching effects that proposed rule 151A would have on the entire fixed indexed annuity industry, including tens of thousands of state-licensed agents that distribute the products, the SEC has proposed rule 151A with virtually no warning and no prior consultation with the life insurance industry. National Western advocates a more inclusive and cooperative approach to the regulation of fixed indexed annuity contracts as a more rational approach to regulation, an approach that state insurance departments have followed through coordination with the National Association of Insurance Commissioners ("NAIC"), writers of fixed indexed annuity contracts, industry groups and other interested parties.

Because proposed rule 151A represents a dramatic departure from the Congressional intent to preserve for the states the regulation of insurance, is unsupported by relevant legal precedent, and would result in severe adverse consequences for both purchasers of fixed indexed annuity contracts and the fixed indexed annuity industry, the first section of this letter provides National Western's legal analysis and critique of proposed rule 151A. The second section identifies significant costs associated with regulation under proposed rule 151A that were not identified or fully accounted for by the SEC and its staff in the Proposing Release. The third section challenges the implication

in the Proposing Release that securities regulations are more effective than state insurance regulation in regulating fixed indexed annuities.

I. Proposed Rule 151A Is Fundamentally in Conflict With and Not Supported By U.S. Supreme Court Precedent Interpreting the Section 3(a)(8) Exclusion and, As Such, Is Fatally Flawed

Proposed rule 151A broadly defines a class of fixed annuity contracts that would **no longer** be able to rely on the exclusion from SEC registration found in Section 3(a)(8) of the 1933 Act. An insurance company that issues fixed indexed annuity contracts would bear the continual burden of making ongoing determinations regarding whether its annuity contracts fall within or outside the definition of "not" an annuity under the proposed rule. Absent some other exemption, a fixed annuity contract that, pursuant to the insurer's determination, meets that definition in proposed rule 151A would be required to be registered as a security.

Under proposed rule 151A, a fixed indexed annuity contract would be subject to registration if it satisfies a two-prong test:

- Amounts payable by the issuer under the contract are calculated, in whole or in part, by reference to the performance of a security,[4] including a group or index of securities; and
- Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.[5]

This two-prong test in proposed rule 151A mistakenly focuses exclusively upon the likelihood of "excess" indexed interest being paid and does not permit consideration of the risk of loss to the consumer. Nor does the proposed rule take into account the significant guarantees and risk of loss borne by the insurance company that writes the contract.

A. *The Rule 151A Proposing Release Mistakenly States That a Fixed Indexed Annuity Purchaser Assumes Investment Risk Comparable to a Variable Annuity or Mutual Fund Purchaser, and In So Doing Misconstrues and Misapplies Relevant Precedent*

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[4] Security would have the same meaning it has in Section 2(a)(1) of the 1933 Act. Proposing Release at 32.

[5] Proposing Release at 93-94.

In the Proposing Release, the SEC attempts to justify proposed rule 151A by citing the two Supreme Court cases that addressed the status of annuity contracts under Section 3(a)(8) of the 1933 Act, S.E.C. v. Variable Annuity Life Ins. Co. ("VALIC")[6] and S.E.C. v. United Benefit Life Ins. Co. ("United Benefit").[7] Unfortunately, the SEC fails to acknowledge in the Proposing Release that the annuity contracts at issue in VALIC and United Benefit are variable annuities, and as such, are fundamentally different from the fixed indexed annuity contracts the SEC proposes to regulate. The annuity contracts in both VALIC and United Benefit essentially passed-through the full investment risk of the insurer's general or separate account to the contract owner, because the contract owner receives ". . . only a *pro rata* share of what the portfolio of equity interests reflects – which may be a lot, a little, or nothing."[8]

The variable annuity contracts in VALIC and United Benefit have virtually nothing in common with fixed indexed annuity contracts. National Western's contracts, like other fixed indexed annuity contracts, are fixed annuities that refer to an external equity index to credit interest. Such fixed indexed annuities guarantee minimum values that equal or exceed the requirements of applicable state non-forfeiture law, credit only positive rates of indexed interest on an annual basis, and guarantee the amounts of indexed interest previously credited, adding such interest to the basis on which subsequent interest is credited. Under National Western's fixed indexed annuity contracts, a contract owner's principal and previously credited interest are guaranteed and can not be diminished by any negative performance of the external index. This is in direct contrast to a variable annuity contract under which a contract owner's principal is at risk and is subject to a full pass-through of the investment experience of an underlying portfolio of mutual fund securities, whether positive or negative.

Fixed indexed annuity contracts are also distinct from the variable annuity contract analyzed in United Benefit. The United Benefit contract attempted to provide some minimum guarantees that were not present in the variable annuity in VALIC, by guaranteeing that the surrender values in year one would not be less than fifty percent of premium grading up to 100% of premium in year ten. The Supreme Court dismissed the guaranteed minimum values as "insignificant," noting that "[t]he record shows that United Benefit set its guarantee by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so that it would not have become operable under any prior conditions."[9] By contrast, state non-forfeiture laws

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6 S.E.C. v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

7 S.E.C. v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

8 VALIC at 71.

9 United Benefit, 387 U.S. at 209 and n. 12. The Court also noted that the United Benefit contract required "special modifications of state law," and that the guaranteed minimum at maturity was "significantly less than that guaranteed by the same premiums in a conventional deferred annuity contract." Id. at 209. Neither of which is the case with respect to fixed indexed annuity contracts.

applicable to all fixed annuities guarantee that a contract owner will receive no less than 87.5% of premiums if the contract is surrendered in the first year. State non-forfeiture laws also require that interest be added to that amount at a rate between 1.0% and 3.0% for life of the contract.[10] The guarantees under state non-forfeiture law are dramatically more substantial than the guarantee under the variable annuity contract in United Benefit and have not been established by state insurance regulators so that the guarantee would never become operable, but rather represent the level of minimum guarantees that state regulators have determined is appropriately in the public interest to protect both the individual customer from risk of loss and the insured public from insurer solvency – a distinction that is unrecognized in the Proposing Release.

In the Proposing Release, the SEC attempts to equate fixed indexed annuity contracts with registered securities by noting that the annuity contracts "are similar in many ways to mutual funds, variable annuities, and other securities,"[11] and that fixed indexed annuity contract owners would assume "many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities."[12] This is a mistaken view. What the SEC does not address is that the predominant risk borne by purchasers of mutual funds, variable annuities, and other securities is a risk of loss of the principal amount of their investment, a risk recognized by the Supreme Court in VALIC and United Benefit. By not recognizing that consumers of fixed indexed annuity contracts are not at risk of losing their premium plus interest due to negative market performance, yet are protected by state non-forfeiture laws which include minimum interest crediting guarantees, the SEC fundamentally misconstrues the product it proposes to regulate and thus its application of judicial precedent to the product is fundamentally flawed.

B. *The SEC's Failure to Consider the Investment Risk Borne by the Insurance Company Is Inconsistent with Judicial Precedent and Prior SEC Interpretations*

Proposed rule 151A focuses its test for securities status exclusively upon the potential fluctuation in annual interest rates above the minimum interest guarantee – the only risk borne by the purchaser of an indexed annuity contract. Proposed rule 151A completely ignores the investment risk borne by insurance companies that underwrite

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[10] The minimum annual rate of interest is the lesser of (i) 3% per year and (ii) the five-year Constant Maturity Treasury Rate reported by the Federal Reserve, reduced by 1.25%, but not less than 1%. See NAIC Standard Nonforfeiture Law for Individual Deferred Annuities, NAIC Model Laws, Regulations and Guidelines 805-1 (2007).

[11] Proposing Release at 27.

[12] Id. at 32.

fixed indexed annuity contracts. Insurance companies bear substantial investment risk associated with their general account investments where fixed indexed annuity premiums are held, including, but not limited to, disintermediation, interest rate risk, reinvestment risk, counterparty or credit risk, and the risk that returns from general account investments will not be sufficient to meet contractual guarantees. Issuers of fixed indexed annuity contracts assume these risks when they unconditionally agree to pay contract owners principal, credited with positive interest in accordance with the terms of the contracts, subject to minimum nonforfeiture guarantees. By ignoring the insurer's investment risks, the SEC has taken a position that clearly is at odds with the Supreme Court decisions in VALIC and United Benefit.

Both VALIC and United Benefit require that the investment risk borne by the insurance company under a fixed annuity contract be taken into account in determining the status of the contract as a security. In VALIC, the Court noted that ". . .we conclude that the concept of 'insurance' involves some investment risk-taking on the part of the company"[13] and that ". . . the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense."[14] From the Court's statements, it is clear that guarantees of principal and interest are critical to its determination of whether an insurance company that underwrites an annuity contract can rely on the Section 3(a)(8) exemption under the 1933 Act. Proposed rule 151A, however, focuses exclusively upon the likelihood of indexed interest exceeding guaranteed minimums under the fixed indexed annuity contract, and ignores altogether the guarantees of principal and interest provided by the insurance company. As such, the proposed rule effectively eviscerates the Supreme Court analysis in VALIC and United Benefit and undermines the validity of the Proposing Release's analytic foundation.

The approach the SEC has taken in connection with proposed rule 151A is also inconsistent with the earlier approach it took in connection with the existing safe harbor rule under Section 3(a)(8), rule 151 under the 1933 Act. Under rule 151, the SEC specifically conditioned reliance on the safe harbor upon the insurance company's assumption of sufficient investment risk through guarantees of principal and interest under the annuity contract.[15]

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[13] VALIC, 359 U.S. at 71.

[14] Id.

[15] See Rule 151. Under paragraph (b)(2) of rule 151, to be deemed to have assumed sufficient investment risk for purposes of the safe harbor, the insurer must guarantee for the life of the contract the principal amount of purchase payments and interest credited thereto and credit net purchase payments and interest credited thereto with a specified rate of interest at least equal to the minimum rate required to be credited by the nonforfeiture law in the jurisdiction in which the contract is issued (or if no such law is applicable, the rate required for individual annuity contracts by the NAIC Standard Nonforfeiture Law).

The proposing release for rule 151, in particular, discussed the importance of the insurer's assumption of investment risk and linked its discussion back to the U.S. Supreme Court precedent. The SEC noted in that proposing release that "VALIC and United Benefit emphasize that Congress intended section 3(a)(8) to be available to annuity contracts under which the insurer assumes the investment risk. Although these cases, particularly United Benefit, do not require the insurer to assume all investment risk for a contract to be insurance under section 3(a)(8), they make clear that the degree of investment risk assumed by the insurer is the critical factor [emphasis added]."[16] Later, in the release adopting rule 151, in declining a request from a commentator to remove the minimum interest requirement from then proposed rule 151, the SEC cited VALIC to reaffirm the importance of an insurance company's assumption of investment risk through guarantees of principal and interest in determining the availability of the Section 3(a)(8) exemption.

> The Commission is adopting paragraph (b)(2)(ii) [on insurer's assumption of sufficient investment risk] as proposed. It would be inappropriate, particularly in light of clear judicial precedent, to eliminate this provision of the proposal. The Supreme Court in VALIC unambiguously concluded that absent some element of a fixed return, i.e., "[s]ome investment risk-taking on the part of the company," an annuity contract is outside the scope of section 3(a)(8). As stated in the proposing release, paragraphs (b)(2)(i) and (ii) of the rule's investment risk test work in tandem to ensure that a contract relying on the rule includes a guarantee by the insurer that at least some portion of the benefits will be paid in a fixed amount.[17]

The SEC's decision in the Proposing Release not to consider the investment risk borne by insurance companies when it guarantees principal and interest under fixed indexed annuity contracts is contrary to the analysis in both the VALIC and United Benefit cases, to the SEC's own prior interpretation of those cases as noted in the Proposing and Adopting Releases for rule 151, and to rule 151 itself. Rather, the SEC has profferred a de novo test for determining the securities status of a fixed annuity that radically departs from case law and the recognized tenets of Section 3(a)(8) analysis embodied in the SEC's own adopted proposals.

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[16] Definition of Annuity Contract or Option Annuity Contract, Rel. 33-6558 [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,710 at 87,160 (Nov. 21, 1984) ("Rule 151 Proposing Release") at 4.

[17] Definition of Annuity Contract or Option Annuity Contract, Rel. 33-6645 [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,004 at 88,130 (May 29, 1986) ("Rule 151 Adopting Release") at 8.

C. *The Sole Focus of the "More Likely Than Not" Test in Proposed Rule 151A on the Likelihood of "Excess" Interest Is Inconsistent with Section 3(a)(8) Precedent and Unnecessarily Biased*

The "more likely than not" test in proposed rule 151A focuses solely on a single factor: the likelihood that interest in excess of the guaranteed minimum will be paid to contract owners. No other factors are considered under the proposed rule, including guarantees of principal, minimum levels of interest, previously credited interest, credited interest based on the performance of an index and terms of the contract, a death benefit and annuity purchase rates. The singular focus on the likelihood of the payment of excess interest to contract owners is, as noted above, inconsistent with precedent under Section 3(a)(8). Judicial interpretations of Section 3(a)(8) require an evaluation of not only the risk of loss borne by the contract owner, but also a weighing of the investment risk borne by the contract owner against the investment risk borne by the insurance company.[18]

Historically, the SEC itself has followed a more general facts and circumstances test for analyzing investment risk in determining the availability of the Section 3(a)(8) exemption, not a myopic test such as that set forth under proposed rule 151A. In the 1984 Rule 151 Proposing Release, the SEC explained the necessity of assessing investment risk under a more complex facts and circumstances analysis noting that:

> Determining the status under the [1933] Act of any guaranteed investment contract involves certain factual and legal questions, *e.g.*, whether the insurer or the contractowner is assuming the investment risk under the contract. . . . Since under a guaranteed investment contract the insurer and the contractowner may *share* the investment risk to varying degrees, depending on the facts and circumstances involved, this type of contract cannot always readily

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[18] See, e.g., VALIC, 359 U.S. at 71 ("The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company"); Olpin v. Ideal Nat'l Ins. Co., 419 F.2d 1250, 1262 (10th Cir. 1969) (insurer bore sufficient investment risk when it was obligated to pay an amount that could be mathematically calculated, and given the insurer's unconditional obligation to pay). See also the SEC's Amicus Brief filed in the case of Otto v. Variable Annuity Life Insurance Co., 814 F.2d 1127 (7th Cir. 1986), rev'd on rehearing, 814 F.2d 1140 (1987), modified (1987), cert. denied, 486 U.S. 1026 (1988) in which the SEC argued that an annuity qualified for Section 3(a)(8) if "the insurance company assumes a sufficient share of the investment risk, which reduces the risk to the participant, who is also protected by state regulation of the insurance company. Even though the participant bears some degree of risk, the contract may qualify under the 'annuity contract' exemption." Brief for the United States as Amicus Curiae, Variable Life Annuity Insurance Co. v. Otto, 486 U.S. 1026 (May 23, 1988) (denying certiorari) at 7.

> be characterized either as "insurance" or as a "security" for purposes of section 3(a)(8).[19]

As judicial precedent requires and SEC interpretations proscribe, the test for assessing the availability of the Section 3(a)(8) exemption must involve a facts and circumstances analysis of how investment risk is shared. Such an analysis should not be ignored, as the SEC now appears to advocate under proposed rule 151A.

The proposed "more likely than not" test not only lacks balance, it also lacks any semblance of proportionality. There is no weighing of the risk of loss of an amount of excess interest against the amounts of contractually guaranteed interest and principal under the test. Conceivably under the proposed rule 151A test, if indexed interest were presumed to be credited more than half of the time under the contract, no matter how small the amount, even if a scintilla of indexed interest were presumed to be credited, the fixed indexed annuity contract would be a security under the test.

In addition, the treatment of surrender charges under the "more likely than not" test skews the test in such a way as to assure that any fixed indexed annuity contract with a surrender charge must register as a security, thus eliminating the Section 3(a)(8) exemption for such products. Under paragraph (b)(1) of proposed rule 151A, an insurance company can not take surrender charges into account in determining amounts payable under a fixed index annuity contract, but must take surrender charges into account in determining amounts guaranteed under the contract. Proposed rule 151A requires that surrender charges reduce the amounts guaranteed but not the amounts payable. The effect of this imbalanced treatment of surrender charges is that regardless of the likelihood of indexed interest being included in amounts payable under a fixed annuity contract, if the contract has a surrender charge, it will very likely fail the "more likely than not" test solely because of the surrender charge.

In the Proposing Release, the SEC attempts to justify its decision not to take surrender charges into account in determining amounts payable under a fixed index annuity contract ". . . in order to eliminate the differential impact that such charges would have on the determination depending on the assumptions made about contract holding periods."[20] National Western is puzzled by the SEC's rationale since the duration of the contract holding period would clearly have a comparable effect on "amounts payable" and "amounts guaranteed" under a fixed indexed annuity contract. The justification offered by the SEC for the disparate treatment of surrender charges under the "more likely than not" test is wholly lacking in foundation.

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19 Rule 151 Proposing Release at 2.

20 Proposing Release at 40.

Furthermore, the incorporation of surrender charges into an investment risk analysis under Section 3(a)(8) is unprecedented, and for that matter, completely contrary to the SEC's own treatment of surrender charges in any Section 3(a)(8) analysis. In the Rule 151 Adopting Release, the SEC specifically modified then proposed rule 151 to alleviate commentators' concerns that the section of the rule requiring the guarantees of purchase payments and previously credited interest would not allow for the deduction of surrender charges.[21] In so doing, the SEC expressed its view that ". . . a contingent deferred sales load ("CDSL") is simply a sales load that is deducted upon partial or full redemption and that is contingent on the number of years the contact has been in effect. A CDSL normally does not shift additional investment risk to the contractowner . . ."[22] Given the absence of any judicial support for treating surrender charges as a component of investment risk under Section 3(a)(8) and given that prior SEC interpretations are to the contrary, it is both puzzling and disturbing that the SEC would incorporate surrender charges in the investment risk test under proposed rule 151A, and do so in a manner that prejudices the test in such a substantial way.

D. *Proposed Rule 151A Ignores Factors that the Courts and the SEC Have Historically Recognized as Significant in Determining the Availability of the Section 3(a)(8) Exemption*

Courts have viewed marketing as a significant and sometimes determinative factor in a Section 3(a)(8) analysis.[23] In United Benefit, as noted above, the Supreme Court determined that the "Flexible Fund Annuity" did not qualify for the Section 3(a)(8) exemption. In finding that the accumulation phase of that variable annuity constituted an investment contract, and therefore was a security requiring registration, the United Benefit Court quoted its decision in S.E.C. v. Joiner Leasing Corp. noting:

> 'The test ... is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate

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21 Rule 151 Adopting Release at 7.

22 Id. at n. 20 (emphasis added).

23 See, e.g., United Benefit, 387 U.S. at 211 (annuity at issue was a security if its appealed to the purchaser "not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management"); Grainger, 547 F.2d at 306 (a court should look beyond the four corners of the insurance contract and consider advertising and promotional efforts in making a Section 3(a)(8) determination).

> that promoters' offerings be judged as being what they were represented to be.'[24]

Rule 151 explicitly contains a requirement that a fixed annuity "is not marketed primarily as an investment."[25] Likewise, in the Proposing Release, the SEC itself acknowledges marketing as a significant factor in a Section 3(a)(8) analysis.[26] Yet the two-pronged test of proposed rule 151A fails to consider marketing as a factor to be given any weight in determining the securities status of an indexed annuity. This oversight in the proposed rule ignores the substantial resources that fixed indexed annuity writers, such as National Western, have dedicated to ensuring that their fixed indexed annuities are not marketed primarily as investments.

Courts and the SEC have also viewed the assumption of mortality risk as a relevant factor to consider in any Section 3(a)(8) analysis.[27] Although the SEC determined not to include a mortality risk assumption requirement as an element of rule 151, in the Rule 151 Adopting Release, the SEC noted that:

> However, the Commission is not concluding by this action that consideration of mortality risk assumption has no place in a section 3(a)(8) analysis of annuity contracts outside the 'safe harbor.' The presence or absence of a mortality risk assumption may be an appropriate factor to consider in a general facts and circumstances analysis under section 3(a)(8).[28]

Proposed rule 151A, unlike rule 151, is not a safe harbor, and if adopted, would act to exclude fixed indexed annuity contracts that fail its test from the Section 3(a)(8) exemption. Because the proposed rule is conclusive of an annuity contract's status under Section 3(a)(8), the proposed rule should take into account all factors that are relevant in assessing a contract's eligibility for the Section 3(a)(8) exemption. Otherwise, proposed rule 151A would likely require the registration of the types of contracts that courts, in attempting to discern Congress' intent in enacting Section 3(a)(8), would have excluded

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[24] United Benefit, 387 U.S. at 211 (quoting S.E.C. v. Joiner Leasing Corp., 320 U.S. 344, 352-3 (1943)).

[25] Rule 151(a)(3).

[26] Proposing Release at 19 ("Marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to the Securities Act 'annuity contract' exemption.").

[27] See, e.g., VALIC, 359 U.S. at 71 (the insurer's assumption of mortality risk under an annuity contract "gives [the annuity] an aspect of insurance"); Dryden v. Sun Life Assurance Co. of Canada, 737 F. Supp. 1058 (S.D. Ind. 1989), aff'd without opinion, 909 F. 2d 1486 (7th Cir. 1990) (insurer's obligation to pay the fixed sum death benefit caused it to bear the risk of poor performance of its investments).

[28] Rule 151 Adopting Release at 4.

from SEC regulation as insurance. For these reasons, National Western believes that proposed rule 151A is fatally flawed and should not be adopted by the Commission.

E. *The Test in Proposed Rule 151A Is Unworkable and Requires Insurers to Make Subjective Determinations that Will Increase Uncertainty*

Proposed rule 151A would permit a fixed indexed annuity to avoid securities status only if the insurer determines, in accordance with paragraph (b) of the rule, that the amount payable under the contract more likely than not would not exceed the amounts guaranteed under the contract.[29] According to the Proposing Release, the insurer bears the burden of proving that the Section 3(a)(8) exemption applies and "would – if challenged in litigation – be required to provide that its methodology and its economic, actuarial, and other assumptions [used in making the determination] were reasonable, and that the computations were materially accurate."[30]

An insurer must make the determination that a fixed annuity is outside the rule by analyzing "expected outcomes under various scenarios involving different facts and circumstances."[31] Such determination may not be made more than three years prior to the date on which the contract is issued and must be made at least six months before a contract is issued. In other words, under the proposed rule, an insurer would be required to prove repeatedly that a particular product continues to remain outside the rule if the product continues to rely on Section 3(a)(8).[32]

The Proposed Release gives little decisive interpretative guidance on how the industry should determine when an annuity falls within or without the proposed rule's "more likely than not" test, other than to say that a determination is conclusive[33] so long as the insurer's methodology and assumptions are reasonable, the insurer's computations are materially accurate, and the determination is sufficiently current. The Proposing Release uses only generalized terminology in describing the actual determination that the insurer must make, stating that the insurer will need to make assumptions in several areas, including "assumptions about (i) insurer behavior, (ii) purchaser behavior, and (iii)

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29 As noted above, surrender charges can not be deducted from amounts payable, but must be deducted from amounts guaranteed. See Proposed Rule 151A (b)(1).

30 Proposing Release at 36. ("As with all exemptions from registration and prospectus delivery requirements of the Securities Act, the party claiming the benefit of the exemption – in this case, the insurer – bears the burden of proving that the exemption applies." Id. (footnote omitted)).

31 Id. at 33.

32 The Proposing Release does not address whether or when the insurer must stop sales of an unregistered annuity as soon as it determines that the annuity falls within rule 151A's perilous harbor.

33 See Proposing Release at 35.

market behavior, and will need to assign probabilities to various potential behaviors."[34] These assumptions should generally "be guided by both history and [an insurer's] own expectations about the future".[35] There is absolutely no basis in caselaw, or Commission interpretations, or industry practice for this test, yet the Commission expects insurers to interpret and rely on their conclusions under a test that the Commission itself has difficulty explaining.

Regarding the reasonableness of an insurer's methodology, the Commission notes that "it would be appropriate to look to methods commonly used for valuing and hedging similar products in insurance and derivative markets."[36] However, the Commission recognizes that there may be a "range of methodologies and assumptions" that are reasonable, so that reasonable methodologies and assumptions "may differ" from one insurer to another. Such statements give insurers no authoritative guidance on the range and kinds of methodologies and assumptions that the Commission would find "reasonable."[37]

National Western is very concerned that the probabilities and calculations that under the proposed rule are supposed to form the basis of the insurer's determination must be based on the insurer's own assumptions about future outcomes of the market and customer behavior, rather than by looking toward some kind of objective criteria. While the Commission states that it would look to the methodology an insurer commonly uses for valuing and hedging similar products, National Western finds such guidance ambiguous. To the extent its actuaries perform economic and actuarial methodologies, such calculations have not been designed using the vague factors the Commission identifies in the Proposing Release.

In addition, proposed rule 151A requires that the computations supporting the determination be documented and be "materially accurate," yet the Commission gives no guidance on how the determination must be documented or on how insurers are to obtain a sufficient level of assurance (whether provided by third parties or senior company officers) to support such calculations. In addition, the Commission gives no projections of the costs to insurers of obtaining such assurances.

National Western believes that the proposed rule is a significant departure from sound and time-tested industry practice and strongly urges the Commission not to adopt the test identified in (b) of the proposed rule.

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34 Id. at 37 (emphasis added).

35 Id. at 38 (emphasis added).

36 Id. at 37.

37 Id.

II. The SEC Significantly Underestimates the Costs that Proposed Rule 151A Would Impose on the Insurance Industry

National Western is extremely concerned that the conclusive approach the SEC has chosen to follow under proposed rule 151A in defining a category of annuity contracts as securities will stifle competition in the fixed indexed annuity industry and have other severe adverse effects. If adopted, proposed rule 151A will cause purchasers of fixed indexed annuity contracts to bear unnecessary increased costs, and will add to the regulatory burdens of the fixed indexed annuity industry at a time when many in the United States are struggling to find affordable answers to their retirement funding needs. Some of those costs, which the SEC in the Proposing Release failed to identify and fully address, are discussed below.

Registration and Related Costs. The Proposing Release notes that "Insurers will incur costs associated with preparing and filing registration statements for indexed annuities that are outside the insurance exemption as a result of proposed rule 151A."[38] The Proposing Release then notes that such costs include "the costs of preparing and reviewing disclosure, filing documents, and retaining records."[39] There is no discussion in the Proposing Release, however, of what those costs would entail. One very substantial cost for any filer of a Form S-1 registration statement is the due diligence review undertaken to verify disclosure in the registration statement. Such reviews typically entail onsite reviews of company operations and records, production, review and analysis of officer and director questionnaires and interviews of relevant company officers and other personnel, which are most often performed by outside counsel.

There is no indication that the SEC considered the cost to insurers of having to prepare financial statements in accordance with SEC requirements, including U.S. Generally Accepted Accounting Principals, or GAAP. There is also no indication that the SEC took into account the cost that the insurance company itself would incur when entering into distribution arrangements with broker-dealers. And there is no indication that the SEC considered the limitations that current SEC rules impose on the ability of fixed annuity writers to advertise their products.[40] In general, all those costs are

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38 Id. at 76.

39 Id.

40 Rule 482 under the 1933 Act is a flexible rule that permits investment companies registered under the Investment Company Act of 1940, including variable annuity separate accounts and mutual funds, to advertise their products in advance of delivery of the statutory prospectus and to include information the substance of which is not included in the statutory Section 10(a) prospectus. However, 1933 Act registration of fixed annuities does not permit the use of Rule 482 advertisements in advance of the delivery of the statutory prospectus similar to what is permitted for mutual funds and variable annuity contracts.

substantial and even more so for companies that have never prepared a registration statement for filing with the SEC, worked through the SEC registration process or had a security distributed by registered representatives of a broker-dealer.

"More Likely Than Not" Test. As noted above, the Proposing Release notes that "[i]nsurers may incur costs in performing the analysis necessary to determine whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts guaranteed under the contract"[41] and that the determination involves analyzing "expected outcomes under various scenarios involving different facts and circumstances."[42] The Proposing Release concludes that because insurers routinely undertake such analysis in pricing and hedging their fixed indexed annuity contracts the cost of undertaking the analysis for purposes of proposed rule 151A may not be significant.[43] National Western disagrees. National Western does not undertake these kinds of tests and frankly does not know what kind of tests the Commission had in mind.

In addition, because the SEC fails to give any specific guidance in the Proposing Release regarding the methodology and assumptions that insurance companies should employ under a proposed rule 151A analysis, companies like National Western will be subject to second guessing of their analysis and determinations with the benefit of hindsight and to significantly increased risk of litigation resulting from such uncertainty. In the Proposing Release, the SEC has not made any attempt to identify and quantify in any concrete way those increased risks and costs for insurers.

Scope of the Rule. Under proposed rule 151A, an annuity for state law purposes would not be an annuity under Section 3(a)(8) if the amounts payable by the insurance company under an annuity are "calculated in whole or in part by reference to the performance of a security, including a group or index of securities."[44] The Proposing Release states that the rule intends to "define the class of contracts that is subject to scrutiny broadly,"[45] so that proposed rule 151A would, by its terms, "apply to indexed annuities but also to other annuities where amounts payable are calculated by reference to a single security or any group of securities."[46]

The intended reach of proposed rule 151A, then, is extremely broad and could have significant detrimental consequences for all fixed annuity writers. Not only indexed

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41 Proposing Release at 75.

42 Id.

43 Id.

44 Id. at 46.

45 Id. at 31.

46 Id. at 32.

annuities, but also unregistered market value adjusted annuities and other contracts that currently rely on Section 3(a)(8) and calculate contract values and credit interest by taking into account the performance of specific securities, groups of securities or securities indices would come under the proposed rule. If the Commission or the courts ultimately determine that the phrase "calculated, in whole or in part, by reference to the performance of a security" is to be determined very broadly, then even discretionary excess interest contracts that currently qualify for Rule 151 could get swept into proposed rule 151A. The costs such a broad interpretation of the rule would impose on the fixed annuity industry, as well as consumers in general, is not addressed in the Proposing Release and should be addressed by the Commission before any such rule is adopted.

Anti-Competitive Effects. The Proposing Release states that "Proposed rule 151A may result in enhanced competition among indexed annuities and other competing financial products, such as mutual funds and variable annuities"[47] and attributes such enhanced competition to enhanced disclosure resulting from proposed rule 151A that would lead to "more informed investment decisions by potential investors."[48] National Western disagrees with the basic premise upon which the SEC's conclusory statement rests – that the implementation of proposed rule 151A and resulting SEC regulation of fixed indexed annuity contracts would lead to enhanced disclosure.

The Proposing Release notes that if proposed rule 151A were adopted fixed indexed annuity contracts "that register under the Securities Act would generally register on Form S-1."[49] Form S-1 is the "catch-all" form for registration under the 1933 Act that operating companies and other issuers of securities use to register their securities when no other registration statement form has been prescribed by the SEC. The focus of Form S-1 is on providing detailed disclosure of the operations, business and financial condition of the issuer – here the insurance company – and directors and officers of the insurance company, including their background, involvement in legal proceedings, transactions with the company, and significant details on executive compensation. Form S-1 does not focus on the fixed indexed annuity contract being offered. In that regard, the disclosure in a Form S-1 registration statement is extremely ill-suited and of limited use to purchasers of fixed indexed annuity contracts. Although the SEC has adopted tailored registration forms for variable annuity contracts and variable life insurance policies, the SEC has not adopted nor at this time is the SEC prepared to propose a registration form for fixed indexed annuity contracts. Thus, the prospectus that would be used to offer registered fixed indexed annuities, unlike the current disclosure now used by National Western to offer its indexed annuities, would be cluttered with extraneous, irrelevant information about the insurance company, lengthy and incomprehensible – clearly not an

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47 Id. at 72.

48 Id.

49 Id. at 61.

improvement over what the Company currently uses pursuant to state insurance department disclosure requirements.

The Proposing Release notes that in 2007 there were a total of 322 indexed annuity contracts in the market,[50] however, the Proposing Release identifies only three instances where an insurance company elected to register its fixed indexed annuity contract with the SEC,[51] representing less than one percent of available fixed indexed annuity contracts. Also, the Proposing Release does not identify and National Western is not aware of any division or office at the SEC charged with responsibility for developing disclosure standards for fixed indexed annuity contracts and is not aware that any such standards have ever been developed, much less published by the SEC or its staff. The lack of SEC staff experience in assessing disclosure and establishing standards of disclosure for fixed indexed annuity contracts stands in stark contrast to the experience and efforts undertaken by state insurance departments and the NAIC, as discussed in section III of this letter. For the reasons noted, as well as the absence of any prior efforts on the part of the SEC to regulate fixed indexed annuity contracts, it is presumptuous, inconsistent with history and lacking in any basis for the SEC to assert in the Proposing Release that SEC regulation would enhance disclosure related to fixed indexed annuity contracts and that proposed rule 151A would thereby enhance competition.

The Proposing Release does acknowledge that there "could be costs associated with diminished competition" as a result of the adoption of proposed rule 151A; specifically that some insurance companies would cease writing fixed indexed annuity contracts rather than register the contracts with the SEC.[52] The Proposing Release then notes that "[a]ny reduction in competition must be considered in conjunction with the potential enhancements to competition . . ." As noted above, the SEC's assertion that proposed rule 151A would enhance competition is highly suspect.

In National Western's opinion, the most likely scenario is that proposed rule 151A will significantly diminish competition. If adopted, proposed rule 151A effectively would require all fixed indexed annuity contracts to be registered with the SEC and sold by registered representatives of broker-dealers. Proposed rule 151A would require such agents to become associated with a broker-dealer and licensed to sell securities. Instead of incurring the time and expense of obtaining a securities license, insurance agents may choose not to sell fixed indexed annuity contracts and sell only other fixed insurance contracts, thereby reducing available distribution channels for fixed indexed annuity contracts. Proposed rule 151A incorrectly assumes that all broker-dealer channels would

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50 Id. at 19.

51 Id. at 14 n.17.

52 Id. at 79.

be immediately available to fixed indexed annuity writers, when this would not be the case. The Proposing Release fails to identify and quantify these costs.

In addition, as noted above, registration of fixed indexed annuity contracts with the SEC would impose substantial costs on insurance companies, costs that some insurance companies because of their cost structure, lines of business and required profit margin may be unable to absorb. Proposed rule 151A, by raising the costs of writing fixed indexed annuity contracts and reducing distribution channels, likely could make writing fixed indexed annuity contracts prohibitively expensive and unprofitable for some insurance companies, most likely causing smaller insurance companies to exit the market. That would have the negative effect of causing the market for fixed indexed annuity contracts to contract and overall competition to diminish, at a time when Americans are looking for affordable retirement solutions.

Collateral Costs. The Proposing Release does not acknowledge the collateral costs of proposed rule 151A. For example, an exodus of insurance companies from the fixed indexed annuity market would result in a loss of revenue for those companies that exit the market which may not be readily replaced. The loss of revenue would inevitably lead to layoffs as companies reduce expenses to remain profitable. The loss of jobs would not only affect employees who were laid off, but also have adverse effects for nearby communities. Similar effects may be experienced by the companies' third party service providers and their communities.

Increased Costs to Consumers. Proposed rule 151A would result in increased costs for owners of fixed indexed annuity contracts. For insurance companies able and willing to register their fixed indexed annuity contracts with the SEC, increased costs associated with the offer and sale of a registered security would be reflected in the terms of the contract, such as the principal and interest guarantees, indexing formula and other features, resulting in less favorable terms for contract owners. With respect to those companies that choose to exit the fixed indexed annuity contract market, in particular smaller companies, their departure would reduce price competition in the market. In either case, the clear result would appear to be that the costs associated with owning a fixed indexed annuity contract would increase.

III. The SEC Mistakenly Assumes that Securities Regulations Are More Effective than State Insurance Regulations in Protecting Consumers, Including Seniors

State insurance departments have regulated fixed indexed annuity contracts since their inception, more than 13 years ago, and together with the National Association of Insurance Commissioners ("NAIC"), have developed and are continually enhancing disclosure, suitability and sales practice standards for fixed indexed annuity contracts. Based on the discussion of state insurance regulation in Proposing Release, National Western believes that the SEC and its staff have significantly underestimated both the scope and depth of state insurance department regulation of fixed indexed annuity

contracts. In addition, as noted above, the SEC or its staff is devoid of experience in regulating fixed indexed annuity contracts, has not developed disclosure or other standards to govern these contracts, and lacks at this time the experience and expertise necessary for the competent regulation of these increasingly important retirement savings instruments.

The Proposing Release recognizes and gives deference to the state insurance regulatory role in protecting insurer solvency under our federal system of regulation.[53] That solvency regulation is particularly relevant and important for all fixed annuities, including indexed annuities, where state non-forfeiture laws provide consumers with financial protections and the assets supporting the annuity contract are maintained in the insurer's general account and not in insulated separate accounts. However, in the Proposing Release, the Commission has failed to take into account the nature and extent of state insurance disclosure and sales practices regulation of indexed annuity products.

State insurance regulators have been devoting considerable resources in recent years to strengthening sales and disclosure practices relating to annuities. Many states have adopted NAIC model regulations that address suitability and disclosure requirements, including the Suitability in Annuity Transactions Model Regulation.[54] In November 2004, when only four states had adopted the NAIC suitability model, National Western created a suitability questionnaire and required all of its producers in *all* states to use the form in any deferred annuity sale to an individual over the age of 65. In addition, beginning in May 2008, National Western expanded these requirements to all deferred annuity sales for applicants of *all ages*. It is National Western's policy not to issue an annuity policy unless the suitability questionnaire is properly completed.

The NAIC's Annuity Disclosure Model Regulation or comparable regulations, which have been adopted in 22 states, are complied with on a 50-state basis by many indexed annuity writers. For instance, National Western has a very detailed, consumer-oriented disclosure brochure that it requires its producers to review with the applicants in every deferred annuity sale. The disclosure brochure must be reviewed and signed at the time of sale, and despite the fact that a signature is not required under the law, it is National Western's policy not to issue an annuity policy until it receives the signed copy

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[53] See Proposing Release at 52 ("A key basis for the proposed exemption [in proposed rule 12h-7] is that investors are already entitled to the financial condition protections of state law and that, under our federal system of regulation, Exchange Act reporting may be unnecessary.").

[54] The NAIC Suitability in Annuity Transactions Model Regulation is a robust regulatory scheme, establishing standards and procedures governing recommendations made to consumers that result in annuity transactions, to ensure "that insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed." The regulation imposes on insurers and insurance producers the requirement for maintaining written procedures and conducting periodic reviews that are reasonably designed to assist in detecting and preventing violations of the model act. The model suitability regulation or comparable regulations have now been adopted in more than 33 states.

of the disclosure signature page. Many argue that such state-mandated simplified disclosure practices are at least as effective as, if not more so than, SEC prospectuses, which are criticized as too complex and lengthy.

Consumers of annuity products are also protected by replacement laws across the country, including regulations based on a model law adopted in 2000 by the NAIC. Adopted in twenty three states, including Texas, this model regulation requires insurers to develop systems of supervision, control, monitoring, and recordkeeping, and to provide consumers with plain-English notices and signed disclosure documents, if a replacement or financed purchase transaction occurs. Almost all of the remaining states have other replacement laws in place, all with the primary purpose of providing the consumer with full disclosure regarding a replacement transaction.

State insurance departments are also stepping up inspection and enforcement activities regarding index annuities, conducting examinations of insurers domiciled in their state, as well as those doing business in the state. The scope of market conduct exams is wide-ranging and is focused increasingly on on-site exams of product suitability. The corrective measures and amount of fines imposed on insurers may be significant. Annuity writers are subject to state unfair trade practice statutes which prohibit the misrepresentation of product terms and conditions, and are within the jurisdiction of their state attorney generals, several of whom have brought high profile enforcement cases alleging unsuitable sales and replacements of fixed and indexed annuities to seniors.

In sum, state insurance regulators are actively engaged in regulating fixed indexed annuities, devoting considerable resources to improved monitoring and rooting out unsuitable sales practices, while providing consumers with readable, clear, and accurate disclosure about fixed indexed annuities. These efforts stand in sharp contrast to the lack of SEC staff experience in assessing disclosure and establishing standards of disclosure for fixed indexed annuity contracts and the Commission's inattention to developing a disclosure form and advertising regulations that would permit registered indexed annuities to compete on equal footing with registered variable annuities.

IV. Conclusion

For the reasons stated above, National Western respectfully requests that the Commission not adopt rule 151A.

Sincerely,

James P. Payne
Senior Vice President - Secretary
National Western Life Insurance Company

cc: The Honorable Christopher Cox
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
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