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September 10, 2008

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Attention: Ms. Florence E. Harmon
Acting Secretary

Re: Comments on Commission's Securities Act Release No. 8933 and Securities Exchange Act Release No. 58022 (June 25, 2008), File S7-14-08

Dear Commissioners:

We are writing on behalf of the National Association for Fixed Annuities ("NAFA").[1] NAFA appreciates this opportunity to submit its comment on Rule 151A ("Proposed Rule 151A") under the Securities Act of 1933 ("1933 Act")[2] that the Commission has proposed[3] ("Commission's Proposal").

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1 This firm has represented the industry association, the National Association for Fixed Annuities ("NAFA") on matters related to fixed index annuities. The firm has also had a partner on NAFA's Board of Directors since NAFA's organization. The Commission published its so-called "concept release" on fixed index annuities in 1997, Equity Index Insurance Products, Securities Act Release No. 7438 (Aug. 20, 1997) [hereinafter Commission's Concept Release]. This firm submitted a comment letter on behalf of NAFA and met with the Commission staff on behalf of one of the first life insurance companies issuing fixed index annuities. This firm also was responsible for drafting NAFA's White Paper on fixed index annuities, entitled "White Paper on Fixed Indexed Insurance Products Including 'Fixed Indexed Annuities' and Other Fixed Indexed Insurance Products" (2007), that the Commission cites a number of times in its proposing release. Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 8933, Securities Exchange Act Release No. 58,022, at 9 n.4 (proposed June 25, 2008) [hereinafter Commission's Proposing Release].

Moreover, this firm continues to represent individual insurers that are among the principal companies issuing fixed index annuities. We represent such insurers in federal and state regulatory matters, as well as litigation.

2 All references in this letter to sections and rules in this letter are to sections of, and rules under, the 1933 Act, unless otherwise specified.

3 Commission's Proposing Release, *supra* note 1.

As the Commission knows, NAFA is an organization created to provide training and education to foster better understanding of fixed annuities, including declared-rate, index and immediate annuities. It is the only independent, non-profit organization dedicated exclusively to the education and promotion of these products.

NAFA represents life insurance companies ("insurers"), distributors and other organizations involved with the creation and marketing of fixed annuities. NAFA membership represents over 96% of all insurers that primarily offer fixed annuity products – declared rate, index and immediate. In addition, NAFA's marketing company and agent membership represents more than 90% of fixed annuity production through the independent marketing channel.

NAFA supports efforts to enhance the interests of the public in general and of purchasers of annuities, including fixed index annuities, in particular. It is in the interest of insurers and producers that rogue sales persons and inappropriate sales practices be eliminated in connection with fixed index products, just as the same is true in connection with all insurance products and, indeed, all financial products.

At the same time, NAFA, with all due respect for the Commission, firmly believes that state insurance regulators are better positioned than the Commission to achieve these public interest objectives while promoting efficiency, competition and capital formation. Accordingly, again with all due respect, NAFA opposes the Commission's Proposed Rule 151A. The Proposed Rule:

- contravenes Congressional intent,
- overlooks or ignores Supreme Court standards,
- contradicts a directly applicable decision of a federal district court,
- contradicts Commission positions, and
- fails to meet requirements for Commission rulemaking.

As a result, the Proposed Rule is flawed and arguably invalid. NAFA believes that a court would vacate[4] the Proposed Rule.

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[4] The courts, in the last few years, have struck down several rules that the Commission had adopted. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006).

NAFA urges the Commission to withdraw its Proposal, rely on current and developing state insurance law and initiatives, and reinvigorate its traditional liaison with state insurance regulators. This letter sets out the legal rationale for NAFA's position.

The SEC did not grant the request of NAFA and others to extend the comment deadline beyond September 10, 2008.

I. EXECUTIVE SUMMARY[5]

NAFA respectfully submits the following.

Proposed Rule 151A is flawed, and arguably invalid.

The Commission's Proposing Release makes many statements that seem to justify Proposed Rule 151A on the grounds that fixed index annuities are subject to selling abuses[6] and offerees need protections under the federal securities laws.[7] However, we respectfully submit that the Commission's Proposing Release does not provide an adequate basis for the Commission's conclusion that registration under the 1933 Act is either correct under applicable law and precedent or the most efficient and effective answer to the problem the Commission perceives.

The Commission cites no data, and refers to no authority, providing an objective foundation for the Commission's professed concern about selling abuses. The Commission specifies no information about consumer complaints or enforcement actions that provide justification for the Commission's Proposal. The Commission points to no hard empirical evidence that state insurance regulators have not moved against perpetrators of any selling abuses. Any support for the Proposal appears to be merely anecdotal.

Furthermore, the Proposal is not precipitated by the design or operation of fixed index annuities, but rather by what the Commission perceives to be abuses in selling the annuities, especially to seniors. In other words, the Commission is requiring registration of fixed index annuities as securities in order that the products be offered and sold by registered broker-dealers under the Securities Exchange Act of 1934.

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5 This section of our letter summarizes points discussed in greater detail in the balance of our letter. The summary is generally in the same order as the points discussed.

For readability, we placed citations in this section principally for court decisions. However, we referred to other sections, where the citations can be found.

6 The Commission's Proposing Release, *supra* note 1, at 8, refers to "abusive sales practices" and annuity provisions "unsuitable for seniors and others." Page 15 refers to "concerns about potentially abusive sales practices." Page 16 refers to "abusive sales practices and securities fraud" and "products involved in senior investment fraud." Page 17 refers to "potentially misleading sales materials and potential suitability issues." Page 32 refers to "abusive sales practices." Page 33 refers to "abusive sales practices and the recommendation of unsuitable transactions."

7 The Commission's Proposing Release, *supra* note 1, at 6, states as follows:

> With respect to these [fixed index] annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections.

We respectfully submit that the Commission's Proposal reflects an improper analysis of the federal securities laws and a roundabout, expensive and, therefore, inefficient, approach for the Commission to take. As discussed herein, we believe there are more direct, more economical and ultimately more effective approaches that the Commission should take, such as the following:

- continue its traditional and legally sound approach of recognizing that fixed index annuities are not securities;
- continue to recognize and rely on current state insurance law and developing NAIC and individual state initiatives; and
- create a Commission liaison, not only with the North American Securities Administrators Association ("NASAA"), but with the NAIC and/or industry groups including NAFA.[8]

To begin with, fixed index annuities, as a product class, are not securities under three different Supreme Court[9] standards, namely that any risk that the owner assumes:

- is not a substantial "investment risk," where the insurer guarantees principal, a minimum rate of interest and credited interest and, therefore, does not shift to the owner the degree of "investment risk" that evidences a security under the Supreme Court's standard pronounced in *VALIC* and *United Benefit*;[10]
- is not an "investment risk" that reflects the entrepreneurial or managerial efforts of others and, therefore, is not the kind of risk that evidences a security under the Supreme Court's standard pronounced in *Howey*;[11] and
- is not a risk of loss, because the owner's investment is protected by state insurance regulation – including product, marketing and solvency regulation – and, therefore,

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8 *See* the discussion in VI.A.3., *infra*.

9 References to the Supreme Court mean the United States Supreme Court.

10 The Supreme Court pronounced its standard in *SEC v. Variable Annuity Life Insurance Co*. (*VALIC*), 359 U.S. 65, 71 (1959) and *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 210 (1967).

11 SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

is not the kind of risk that evidences a security under the Supreme Court's standard pronounced in *Weaver*.[12]

We emphasize that, in connection with the bullet immediately above, the Supreme Court, in *Weaver*, has pronounced that a financial product is not a security where the owner is protected against loss by the existence of a regulatory scheme other than the federal securities laws. The Commission, as explained in IV.C., below, filed an amicus brief in the *Weaver* case urging the Supreme Court to so hold. The Commission stated that a financial product is not a security where governmental regulation and supervision of the insurance industry eliminates the risk of loss. The Commission, citing *VALIC* and later *United Benefit*, urged the following position (with emphasis added) of the Supreme Court:

> In *contrast* to the federal securities laws, which through disclosure of material facts enable investors to make an "informed choice" among investments, including an *assessment of the risk involved,* the regulation of the banking industry, like that of the *insurance industry*, emphasizes *pervasive governmental supervision* to *substantially eliminate the risk of loss*.[13]

The Commission similarly has told the Supreme Court, in the context of state insurance law regulation, as follows:

> The relevant purpose of the securities laws is to ensure that investors in securities are fully and accurately informed about the issuer and the investment's relevant features, including its risks. This protection is not needed if, *inter alia*, the insurance company *assumes a sufficient share of the investment risk*, which reduces the risk to the participant, who is *protected by state regulation* of the insurance company.[14]

So, the Commission has twice told the Supreme Court that 1933 Act registration and disclosure of financial products is not necessary or appropriate where governmental regulation – such as that provided by state insurance law – substantially eliminates the owner's risk of loss. It

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[12] Marine Bank v. Weaver, 455 U.S. 551 (1982).

[13] Brief for the United States as Amicus Curiae Supporting Writ of Certiorari at 11, Marine Bank v. Weaver, 455 U.S. 551 (1982) (No. 80-1562), 1981 WL 390025 [hereinafter Commission's Weaver Brief] (emphasis added). The names of staff members of the Commission appear on the brief.

[14] Brief for the United States as Amicus Curiae Supporting Writ of Certiorari at 7, Variable Annuity Life Ins. Co. v. Otto, 486 U.S. 1026 (1988) (No. 87-600) [hereinafter Commission's VALIC v. Otto Brief] (citing *Weaver*, 455 U.S. 551) (emphasis added). The names of staff members of the Commission appear on the brief.

follows that the Commission's rationale for its Proposal directly contradicts this Commission statement communicated to the Supreme Court.

The inescapable starting point is that:

- fixed index annuities guarantee principal (less charges), a minimum rate of interest and credited interest;
- these guarantees are backed by an insurer's general account;
- state insurance law requires that an insurer meet product and marketing requirements regarding these guarantees and deal with consumer complaints, as well as set aside reserves for these guarantees, in order to protect the insurer's ability to pay the guaranteed amounts;
- state insurance regulation protects the solvency of insurers; and
- state guaranty fund associations protect against owner loss of investment.

These are indisputable hallmarks of traditional fixed annuities. And these are hallmarks of fixed *index* annuities. These hallmarks distinguish traditional annuities and fixed index annuities from all other financial products, such as mutual funds, variable annuities and open brokerage accounts.[15]

The Commission's proposal fails to recognize the nature and extent of existing regulation of fixed index annuities under state insurance law, including regulation of the insurers that issue, and the producers that market, such products, as well as ongoing state level initiatives to enhance regulatory oversight of fixed index annuities. We submit that a better understanding of the existing and developing state insurance law regulatory scheme will demonstrate that:

- Rule 151A is unnecessary, because the asserted benefits of Rule 151A are already being met by state insurance regulation; and
- fixed index annuities are issued by regulated insurers that are subject to a comprehensive set of regulations; accordingly, owners of fixed index annuities do not bear a risk of loss that the Supreme Court determined in *Weaver* to be necessary to characterize a financial instrument as a security.

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[15] The Commission indicates otherwise: "Thus these purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and [sic] variable annuities, and open brokerage accounts." Commission's Proposing Release, *supra* note 1, at 5.

The Commission's Proposing Release gives short shrift to the comprehensive regulatory scheme under state insurance law. Specifically, although the Commission's Proposing Release identifies Rule 151A's consumer protections through federal disclosure and sales practices protections as the most important benefits to consumers, the Commission's Proposing Release makes no reference whatsoever to the many and varied aspects of state insurance regulation addressing these very topics. Instead, the Commission's Proposing Release simply notes that "[s]tate insurance regulation is focused on insurance company solvency and the adequacy of insurers' reserves, with the ultimate purpose of ensuring that insurance companies are financially secure enough to meet their contractual obligations."[16]

While it is true that a primary focus of state insurance regulation is solvency based, it is equally true that state insurance regulation has other primary points of focus, including consumer protections through state regulatory oversight over market practices of insurers and insurance producers. As noted in the very same chapter of the treatise that the Commission's Proposing Release cites for the assertion that state insurance regulation is focused on solvency, the treatise also discusses, in equivalent detail, state insurance regulation's focus on (i) the organization and licensing of insurers, (ii) the regulation of the form and content of insurance policy and contract forms, and (iii) the regulation of insurers' and producers' market practices.[17] Within the realm of market practice regulation, regulators pay particular attention to unfair trade practices (including unfair sales practices such as false advertising, churning, twisting, etc.), disclosure, suitability and supervision, illustrations, producer licensing, education and training, and consumer complaints.[18]

The Commission, as explained in II.A., below, has taken the position that fixed index annuities are not securities since 1986, or for more than two decades. The Commission stated in 1986 that fixed annuities with index features that met the requisite conditions could rely on the "safe harbor" of Rule 151 under Section 3(a)(8). And the Commission stated in 1997 that fixed index annuities had the hallmarks of traditional annuities under Section 3(a)(8) and did not require that fixed index annuities be registered as securities.

As explained in II.B., below, the Commission's long-standing position, but not the Commission's Proposal, is consistent with the intent of Congress. Congress did not intend the definition of "security" in Section 2(a)(1) to include insurance and annuities. Furthermore,

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16 *Id.* at 48.

17 KENNETH BLACK, JR. & HAROLD D. SKIPPER, LIFE & HEALTH INSURANCE 949-55 (13th ed. 2000) [hereinafter BLACK & SKIPPER].

18 *See generally id.* at 953-55, 277-303.

Congress intended Section 3(a)(8) to be a means of assuring that insurance and annuities would not be deemed to be a security.

The Commission's long-standing position, but not the Commission's Proposal, is also consistent with the Supreme Court's standard under Section 3(a)(8). In essence, the Supreme Court has said that annuities qualify under Section 3(a)(8) where insurers bear a substantial "investment risk. " Insurers, under fixed index annuities, bear the requisite risk, because they guarantee principal (less charges), a minimum rate of interest and credited interest.

The Commission's Proposal, as explained in III., below, is not consistent with the Supreme Court's standard under Section 3(a)(8) to the extent that:

- the Commission misapplies the Supreme Court's standard by not focusing on the substance of the "investment risk" assumed by the insurer, but instead characterizing the opportunity for gains in excess of these substantial guarantees as an "investment risk" assumed by the owner;

- the Commission fails to identify the source of the new, unprecedented standard or explain why the new standard is necessary or appropriate and how the new standard is consistent with the Supreme Court's standard pronounced in *VALIC* and *United Benefit*;

- the Commission's Proposal fails to reflect the Supreme Court's definition of "investment risk" as risk of loss, which is not the case here where the insurer guarantees the principal (less charges), a minimum interest rate and credited interest;

- the Commission's Proposal misapplies the functional analysis set out in Justice Brennan's concurring opinion in the Supreme Court's *VALIC* decision by failing to recognize that the insurer's guarantee of principal (less charges), a minimum interest rate and credited interest obviate the need for disclosure to the purchaser under the 1933 Act;

- the Commission's Proposal ignores or overlooks a federal court decision[19] that finds fixed index annuities not to be securities under the Supreme Court's standard for Section 3(a)(8) and fails to explain why the Commission disagrees with the court; and

[19] Malone v. Addison Ins. Mktg., Inc., 225 F. Supp. 2d 743 (W.D. Ky. 2002). The Commission's Proposing Release mentions, in a footnote, the district court's finding under Rule 151, but fails to address the court's separate finding under Section 3(a)(8). Commission's Proposing Release, *supra* note 1, at 21 n.38.

- the Commission's Proposal would require or encourage registration of other insurance and annuity products that clearly fall outside Section 3(a)(8) under the Supreme Court's standards.

The Commission's Proposal, as explained in IV., below, is not consistent with the Supreme Court's standards for determining whether a financial product is a security to the extent that:

- the Commission's Proposal fails to reflect the Supreme Court's standard in *Howey* that a financial product is not a security where the owner does not assume a risk that reflects the entrepreneurial or managerial efforts of others and where there is no common enterprise, as is true with fixed index annuities; and

- the Commission's Proposal fails to reflect the Supreme Court's standard in *Weaver* that a financial product is not a security where the owner is protected against loss by a governmental regulatory scheme, as is true with fixed index annuities.

The Commission's Proposal, as demonstrated in V., below, fails to take into account comprehensive state insurance law in general and NAIC and state initiatives regarding regulation of fixed index annuities in particular.

The Commission's Proposal, as explained in VI., below, does not meet the requisite standards that the Commission is required to meet in rulemaking, to the extent that the Proposal:

- fails to present a rigorous analysis, as Congress requires, of whether Proposed Rule 151A would promote *efficiency*;

- fails to promote efficiency, as Congress requires, in terms of insurers' doing business and the Commission's discharging its mandate;

- fails to promote efficiency, as Congress requires, because Proposed Rule 151A seeks to remedy certain selling practices[20] by the indirect requirement of 1933 Act registration rather than the more efficient alternative of relying on state insurance regulation of the marketing of fixed annuities;

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[20] The Commission held an open meeting, on June 25, 2008, during which it voted to publish the Commission's Proposing Release, *supra* note 1. During the meeting, the Commission showed a clip from NBC's Dateline about selling abuses involving seniors. Christopher Cox, Chairman, SEC, Statement at Opening Meeting on Equity-Indexed Annuities, Washington, D.C. (June 25, 2008) [hereinafter Open Meeting on Equity-Indexed Annuities] (transcript on file with the author).

- fails to promote efficiency, as Congress requires, because the Proposal relies on a liaison with state *securities* regulators to the exclusion of state *insurance* regulators;

- fails to promote efficiency, as Congress requires, because the Proposal does not implement the recommendations of the 2006 NASD Investor Fraud Study that the Commission endorsed;

- fails to present a rigorous analysis, as Congress requires, whether Proposed Rule 151A would promote *competition*;

- fails to promote competition, as Congress requires, by requiring fixed index annuities, but not declared-rate and other types of fixed annuities, to register under the 1933 Act;

- fails to promote competition, as Congress requires, between fixed index annuities and like financial products and, not, as the Commission states, unlike financial products such as mutual funds, variable annuities and open brokerage accounts;

- fails to present a rigorous analysis, as Congress requires, whether Proposed Rule 151A will promote *capital formation*;

- fails to promote capital formation, as Congress requires, by not considering the impact of the Commission's Proposal in increasing capital formation; and

- fails to promote capital formation, as Congress requires, by imposing unnecessary and unrelated regulatory costs which tend to decrease the sale of fixed index annuities.

An industry has grown up in reliance on the Commission's long-standing position that fixed index annuities, as a product class, are not securities. So, the Commission's abrupt and unexplained reversal of its more than two-decade-long position is puzzling and unexpected.

The Commission's reversal departs from the Commission's long-standing inaction position on fixed index annuities. The Commission's reversal also departs from the traditional analysis, pronounced by the Supreme Court and followed by the other courts and the Commission, for determining whether insurance and annuities are securities. The Commission's reversal also contradicts other standards pronounced by the Supreme Court for determining whether financial products are securities. So, the Commission's Proposal raises serious and far-reaching legal, operational and business issues for the industry.

The Commission should continue with the tried and true approach that it has developed to implement the principles pronounced by the Supreme Court, rather than pursue its proposed approach that we believe is materially flawed and, arguably, invalid.

The Commission's traditional approach is more likely than not to enable the Commission to meet its Congressional mandate to:

- protect investors and the public,
- promote efficiency,
- promote competition and
- promote capital formation.[21]

NAFA's recommendation is that the Commission:

- withdraw its Proposal to adopt Rule 151A;
- continue its traditional and legally sound approach of recognizing that fixed index annuities are not securities;
- continue to recognize and rely on current state insurance law and developing NAIC and individual state initiatives;[22] and
- continue the Commission's traditional policy[23] of having a liaison with state insurance regulators and reinvigorate that liaison with the NAIC and/or industry groups, including NAFA, regarding fixed index annuities.

In short, the Commission's Proposal fails to comply with Congressional requirements for rulemaking. But more importantly, the Commission's Proposal fails to follow the standards, intended by Congress and pronounced by the Supreme Court, that govern the status of insurance and annuity products regulated under state insurance law.

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21 Commission's Proposing Release, *supra* note 1, at 81.

22 *See* V., *infra*.

23 *See* VI.A.3., *infra*.

II. FIXED INDEX ANNUITIES ARE ANNUITIES AND NOT SECURITIES BASED ON THE INTENT OF CONGRESS

A. The Commission's Proposal Is Flawed, Because It Reverses the Commission's Long-Standing Position that Fixed Index Annuities Are Annuities under Section 3(a)(8) and Not Securities

The Commission has been stating that fixed index annuities can qualify as annuities and not securities since 1986 – more than two decades ago.[24]

The Commission first stated, in 1986, that fixed index annuities can qualify as annuities and not securities under the "safe harbor" afforded by Rule 151. The Commission then stated, in 1997, that fixed index annuities had the hallmark guarantees of traditional annuities under Section 3(a)(8) and did not call for their registration as securities.

1. The Commission's Proposal Abandons the Commission's Long-Standing Position that Certain Fixed Index Annuities Can Rely on Rule 151

The Commission *currently* permits certain fixed index annuities to rely on Rule 151 and has so permitted since the Commission adopted Rule 151 in 1986. In adopting Rule 151, the Commission addressed fixed index annuities and "determined that it would be appropriate to extend the rule to permit insurers to make limited use of *index* features in determining the excess interest rate."[25]

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[24] However, the Commission's Proposing Release, *supra* note 1, at 7-8, could give the misleading impression that index features, and the Commission's awareness of them, did not arise before the mid-1990s:

> Beginning in the mid-1990s, the life insurance industry introduced a new type of annuity, referred to as an "equity-indexed annuity," or, more recently, "fixed indexed annuity."

The Commission's Proposing Release, *supra* note 1, at 21 n.38, refers to use of an "indexing formula" prior to 1986, but does so obliquely in a footnote.

The fact is that, since the 1980s, a variety of combination fixed and variable annuities, as well as stand-alone fixed annuities, have included fixed index account options that set excess interest by reference to prevailing published interest rates and Treasury securities.

[25] Definition of Annuity Contract or Optional Contract, Securities Act Release No. 6645 (May 29, 1986) [hereinafter Commission's Rule 151 Adopting Release] (emphasis added; footnotes omitted). The full Commission stated, at 29-30, as follows:

> After reviewing the comments, the Commission has determined that it would be appropriate to extend the rule to permit insurers to make limited use of *index* features in determining the excess interest rate, so long as the excess rate is not modified more frequently than once per year. The insurer, therefore, would be permitted to specify an *index* to which it will refer, no more often

In publishing its "concept release"[26] on fixed index annuities eleven years later, the Commission confirmed that certain fixed index annuities could rely on Rule 151. The Commission said that, in adopting Rule 151, the Commission extended the Rule's coverage "to permit insurers to make limited use of index features in determining the excess interest rate."[27] Furthermore, in 1997, the Commission asked for and received comments from the industry regarding whether an "indexed-based return determined retrospectively by reference to a formula that is established prospectively" should affect the status of fixed indexed annuities as securities or insurance.[28]

Now, however, the Commission proposes to abandon its own long-standing position under Rule 151, and radically shift direction to require virtually all fixed index annuities to be

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> than annually, to determine the excess rate that it will guarantee under the contract for the next 12-month or longer period. Once determined, the rate of excess interest credited to a particular purchase payment or to the value accumulated under the contract must remain in effect for at least the one-year time period established by the rule. Thus, while the rate of interest calculated under a particular *index* or formula may fluctuate upward or downward on a daily basis, the excess interest rate actually credited may not fluctuate more than once per year. The Commission is concerned that *index* feature contracts that adjust the rate of return actually credited on a more frequent basis operate less like a traditional annuity and more like a security and that they shift to the contractowner all of the investment risk regarding fluctuations in that rate.

26 Commission's Concept Release, *supra* note 1.

27 The full Commission statement is as follows:

> In adopting Rule 151, the Commission extended the rule's coverage to permit insurers to make limited use of index features in determining the excess interest rate, so long as the excess rate is not modified more frequently than annually. Specifically, the insurer could specify an index to which it would refer, no more often than annually, to determine the excess rate that it would guarantee under the contract for the next 12-month or longer period. In addition, an insurer could not change the terms of the index feature used for calculating the excess rate more frequently than once per year.

Id. at 18 (emphasis added; footnote omitted). We respectfully submit that Rule 151 and the above statement can be read to permit reliance on the Rule by an index annuity that prospectively sets the index used to determine excess interest retrospectively.

28 The full Commission statement is as follows:

> How does the use of an indexed-based return determined retrospectively by reference to a formula that is established prospectively affect the status of these contracts as securities or insurance?

Id.

registered,[29] including those that it had previously stated would be exempt from registration by reason of Rule 151.

2. <u>The Commission's Proposal Abandons the Commission's Long-Standing Position that Certain Fixed Index Annuities Can Rely on Section 3(a)(8)</u>

As explained in 1., immediately above, the Commission, since 1986, has permitted fixed index annuities to rely on Rule 151. In 1997, the Commission raised questions and asked for detailed information regarding the status of fixed index annuities under Rule 151 and Section 3(a)(8). After raising its questions and receiving information, the Commission made no pronouncement, and took no action, that prevented fixed index annuities from continuing to rely on Section 3(a)(8).

The Commission based its position on the fact that fixed index annuities have the hallmarks of traditional fixed annuities. The Commission expressly characterized the guarantees under fixed index annuities as "the guarantees of principal and minimum return offered in traditional fixed annuities."[30]

Indeed the Commission, in 1997, confirmed its position,[31] adopted in 1986, that a fixed index annuity could rely on Section 3(a)(8) based on the principles reflected in Rule 151 and judicial precedent construing Section 3(a)(8).

Subsequently, a federal district court found[32] fixed index annuities not to be securities under Section 3(a)(8), based on the Supreme Court's standards pronounced in *VALIC* and *United Benefit*. Pursuant to the Commission's statements in 1986 and 1997, this federal court decision in 2002 became judicial precedent construing Section 3(a)(8).

It is significant to note that the Commission did not attempt to join in the case and file a brief stating its view of the status issue raised in the case. Moreover, the Commission did not

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[29] Technically, the 1933 Act requires the registration of *offerings* of securities. However, for readability, this letter refers to registration of *securities*.

[30] Commission's Concept Release, *supra* note 1, at 3.

[31] The Commission stated in its Concept Release, *supra* note 1, at 17, as follows:

> In situations when the Rule 151 safe harbor is not applicable, the status of a contract may be analyzed by reference to the principles discussed [sic] in Rule 151 and the accompanying releases and to judicial precedents construing Section 3(a)(8).

See infra note 118.

[32] *Malone*, 225 F. Supp. 2d 743. *See* discussion of the case under III.H., *infra*.

pronounce any view of the decision at the time the court handed down the decision. Indeed, the Commission did not pronounce any view of the decision until the Commission published its Proposing Release. So, the Commission did not state its view of the decision until six years after the decision.

Even then, the Commission states a view on only a portion of the court's findings. The Commission states its disagreement with the court's decision that the fixed index annuities qualify as non-securities under Rule 151. The Commission does not state its view of the court's decision that the fixed index annuities also qualify as non-securities under Section 3(a)(8).

B. The Commission's Long-Standing Position that Fixed Index Annuities Are Not Securities Is Consistent with the Intent of Congress, but the Commission's Proposal Is Not

Congress did not define the term "security" in Section 2(a)(1) to include insurance or annuities. We discuss this point in 1., below.

Even if a financial product specified in Section 2(a)(1) could somehow be deemed to include insurance or annuities, Section 3(a)(8) would exclude the insurance or annuity product. Congress intended Section 3(a)(8) as a fail-safe to assure that insurance or annuities would not be deemed to be a security within the meaning of Section 2(a)(1). We discuss this point in 2., below.

1. Congress Did Not Intend the Definition of "Security" To Include Insurance or Annuities

Fixed indexed annuities are not securities within the meaning of Section 2(a)(1).

The statutory preamble to Section 2(a)(1) states that the definition of "security" applies "unless the context otherwise requires." The legislative history of the 1933 Act shows that Congress did not consider insurance and annuities to be securities, and that the unique characteristics of insurance and annuities place them in a different context from the products specified in Section 2(a)(1). It follows that there is no need to address each financial product specified in Section 2(a)(1) and analyze whether fixed index annuities constitute such an instrument.

Nevertheless, we address one aspect of Section 2(a)(1), lest it be misread. A fixed index annuity is not an "interest," referred to in Section 2(a)(1), "based on the value" of an "index of securities." Section 2(a)(1) expressly limits any such interest to "any put, call, straddle, option, or privilege *on* any security, certificate of deposit, or group or index of securities."[33] The

[33] 15 U.S.C. § 77b(a)(1) (emphasis added).

legislative history makes clear that the parenthetical reference in Section 2(a)(1) to "any interest therein or based on the value thereof" refers back to solely the instruments specified above.[34] The legislative history also makes clear that when Congress amended Section 2(a)(1) to add the reference to "index of securities," it did so with the intent of clarifying the status of options as separate securities.[35]

By expressly limiting the applicability of Section 2(a)(1) to these specified index products, Section 2(a)(1) can be read to *exclude* other index products such as fixed index annuities.

2. Congress Intended Section 3(a)(8) To Be a Means of Assuring that Insurance and Annuities Would Not Be Deemed To Be a Security

a. Section 3(a)(8) Is "Supererogation"

As discussed in 1., immediately above, Congress did not intend insurance and annuities to be deemed to be securities.

However, even if an instrument specified in Section 2(a)(1) could somehow be deemed to include insurance or annuities, Section 3(a)(8) would exclude the insurance or annuity product. Congress intended Section 3(a)(8) as a fail-safe to assure that insurance or annuities would not be deemed to be a security within the meaning of Section 2(a)(1).

The legislative history of Section 3(a)(8) makes clear the intent of Congress not to categorize as "securities" insurance policies and annuity contracts issued by insurers already subject to regulatory supervision by a state or other governmental authority. The late, eminent Harvard Law School Professor Louis Loss,[36] in his treatise, characterized the Section 3(a)(8)

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[34] The syntax of the House Report statement makes this clear:

> In addition, this Section is further amended to include in the definition of "security," any put, call, straddle, option or privilege "on any group or index of securities (including any interest thereon or based on the value thereof)," on certificates of deposit and, when traded on a national securities exchange, or foreign currency.

H.R. REP. NO. 97-626(I), *reprinted in* 1982 U.S.C.C.A.N. 2780, 2790 (1982).

[35] *See id.* (stating that "this change clarifies for the purpose of the Securities Act that an option is a separate security"); *see also* Wolf v. Banco Nacional de Mexico, S.A., 739 F.2d 1458 (9th Cir. 1984) (stating that the purpose of the 1982 amendment to Section 2(a)(1) was to "expressly include various types of options within the definition of 'security' and to make clear the exclusive jurisdiction of the Securities and Exchange Commission over them").

[36] The Commission's library, in Washington, D.C., is named after Professor Loss.

exemption as "supererogation,"[37] consistent with statements made in a report of the House of Representatives, as follows:

> Paragraph (8) [of Section 3(a)] makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.[38]

Congress recognized that, as a fundamental matter, insurance policies and "like contracts" are not to be viewed as "securities," offered for "investment purposes," and enacted Section 3(a)(8) to make any "misinterpretation impossible."[39]

b. <u>Section 3(a)(8), Although Labeled an "Exemption," Has Been Deemed To Be an Exclusion</u>

The Commission and the courts have confirmed that Congress did not intend insurance and annuities to be regulated under the 1933 Act.

The Commission and the courts have done so by deeming Section 3(a)(8) to be an "exclusion" from all of the provisions of the 1933 Act rather than a more limited "exemption" from the registration provisions of the 1933 Act.

Indeed, the Commission made this point in its Proposing Release.[40]

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[37] 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 242 (4th ed. 2001).

[38] H.R. REP. NO. 73-85, at 15 (1933).

[39] *Id.* It follows that, even if Rule 151A was adopted as proposed, an annuity that this rule precludes from reliance on Section 3(a)(8) could nevertheless fall outside the definition of a security, based on the proposition that Section 3(a)(8) is supererogatory. Surprisingly, the Commission's Proposal seems not to recognize this important fact; and this is another of the Proposal's material deficiencies.

[40] The Commission stated as follows:

> The Commission has previously stated its view that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from the registration but not the antifraud provisions. Securities Act Release No. 6558 (Nov. 21, 1984) [49 Fed. Reg. 46,750, 46,753 (Nov. 28, 1984)]. *See also* Tcherepnin v. Knight, 389 U.S. 332, 342

c. Congress, in Effect, Has Barred the Commission from Interfering with State Insurance Regulation

There is still further evidence that Congress did not intend insurance and annuities to be subject to federal regulation.

Congress has promulgated a statutory mandate[41] that no act of Congress, unless the act concerns insurance, shall be construed to invalidate, impair or supersede state insurance law. Therefore, the Commission, in construing the 1933 Act to apply to fixed index annuities, must ascertain that its Proposal does not invalidate, impair or supersede state insurance law.

Accordingly, it appears that the Commission, in making its Proposal, is bound to ascertain that the proposed Rule 151A does not invalidate, impair or supersede state insurance law. However, the Commission has made no effort to analyze and evaluate what impact Proposed Rule 151A would have on existing state insurance law.

III. FIXED INDEX ANNUITIES ARE NOT SECURITIES BASED ON THE SUPREME COURT'S STANDARD PRONOUNCED IN *VALIC* AND *UNITED BENEFIT*

A. The Commission's Proposal Is Flawed, Because the Commission's Long-Standing Position that Fixed Index Annuities Are Not Securities Is Consistent with the Supreme Court's Standard, but the Proposal Is Not

The Commission's traditional approach – grounded in the U.S. Supreme Court's decisions in the *VALIC*[42] and *United Benefit*[43] decisions – has been to deem that insurers bear the requisite level of substantial investment risk where an annuity guarantees:

> n.30 (1967) (Congress specifically stated that "insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act," (*quoting* H.R. REP. NO. 73-85, at 15 (1933)).

Commission's Proposing Release, *supra* note 1, at 17 n.27.

41 The McCarran-Ferguson Act, 15 U.S.C. § 1012(b) (2007), declares that:

> [n]o Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance.

The Supreme Court referred to the McCarran-Ferguson Act in its *VALIC* decision. *VALIC*, 359 U.S. at 68.

42 *VALIC*, 359 U.S. 65.

- an amount equal to purchase payments made by an owner (less charges),
- a guaranteed minimum rate of interest paid for the life of the contract, and
- any credited minimum or excess interest.

We respectfully submit that the Commission's Proposal applies the Supreme Court's standard beyond the intent of Congress and beyond the contemplation of the Supreme Court. The Supreme Court's opinion in *VALIC* and *United Benefit* was in the context of *variable* annuities, not fixed annuities such as the fixed index annuities involved here.

The Supreme Court in *VALIC* took abundant care to limit the scope of its opinion regarding insurance and annuity products. It did not give a carte blanche to apply the standard, developed in the context of variable annuities, to fixed annuities.

Indeed, the Supreme Court stated at the outset of its opinion in *VALIC* as follows:

> We start with reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of "insurance," they speak with the authority of a long tradition.[44]

The Supreme Court contrasted "fixed annuities" with variable annuities that the Court said involved "new features."[45] The Court identified these new features as investment of premiums in common stock and benefits that vary with the success of the investment policy. These "new features" that the Court identified are not features of fixed index annuities. It follows that fixed index annuities should be treated like fixed annuities rather than variable annuities. As the Supreme Court said:

> While all the States regulate "annuities" under their "insurance" laws, traditionally and customarily they have been fixed annuities, offering the annuitant specified and definite amounts beginning with a certain year of his or

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[43] *United Benefit*, 387 U.S. 202.

[44] *VALIC*, 359 U.S. at 69.

[45] *Id.*

> her life. The standards for investment of funds underlying these annuities have been conservative.[46]

The Supreme Court also took great care to limit the scope and effect of its opinion to the variable products before it, as follows:

> We realize that life insurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we *would not undertake to freeze the concepts of "insurance" or "annuity" into the mold they fitted when these Federal Acts were passed*.[47]

We respectfully submit that the Commission's Proposal exceeds the authority that the Commission can derive from *VALIC* and *United Benefit* for applying the Supreme Court's standard to fixed index annuities, as distinguished from variable annuities.

B. The Commission Misapplies the Supreme Court's Standard by Focusing on Investment Risk Assumed by the Purchaser Rather than Weighing Investment Risk Assumed by the Insurer as well as the Purchaser

The Supreme Court pronounced the chief standard to be whether the insurer shifts a "substantial" "investment risk" to the owner. An insurer has not been deemed to shift such a risk to the owner where the insurer guarantees:

- a principal amount equal to the amount of purchase payments (less charges),
- interest credited at a minimum interest rate for the term of the contract, and
- any previously credited interest rate.

The Commission proposes a new and different standard of whether it is "more likely than not" that the insurer will pay an owner more than the guaranteed amount. This standard does not derive from, and is inconsistent with, the Supreme Court's pronouncements.

The Commission takes an approach that is at odds with the approach that the Commission took in the "safe harbor" of Rule 151 under Section 3(a)(8). In that Rule, the Commission provided that an annuity could rely on the "safe harbor" if the insurer guaranteed principal, a minimum interest rate and previously credited interest. The rationale has been that an insurer

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46 *Id.*

47 *Id.* at 71 (emphasis added).

assumes a sufficiently substantial investment risk in guaranteeing principal, a minimum interest rate and previously credited interest. This is because the owner assumes only the less significant risk that the insurer will declare, for the following year, no excess rate of interest or a rate of excess interest than is different (higher or lower) from that declared for the past year.

The Commission proposes a radically different approach. The Commission fragments or separates the excess interest element from the insurer's guarantee of the purchase payments, a minimum interest rate and credited interest. The proposed approach focuses on the investment risk posed by the former without weighing the floor[48] on that risk guaranteed by the latter.

The Commission's approach is not in line with Supreme Court precedent or with the Commission's previously stated approach.[49] The Commission identifies the investment risk *solely* in terms of the owner's risk (if it can be characterized as a "risk") of not being credited with interest greater than the guarantee under a fixed index annuity and ignores the *diminution* of investment risk provided by the guarantee of principal, a minimum interest rate and previously credited interest.[50] This unprecedented approach necessarily leads to a misapplication of the standard for when federal securities laws should apply. The "'true underwriting of risks'[51] and

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[48] *Id.* at 71-74 (describing a floor that a guarantee provides as a factor in assessing the insurer's investment risk) (footnote omitted). The Court stated:

> The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risk on the annuitant, none on the company. . . . The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities – an interest that has a ceiling but no floor.

[49] *Id.* at 71 ("But we conclude that the concept of insurance involves some investment risk-taking on the part of the company."). The Commission's Proposing Release, *supra* note 1, at 18, states: "With regard to investment risk, beginning with *SEC v. Variable Annuity Life Ins. Co.*, the Court has considered whether the risk is borne by the purchaser (tending to indicate that the product is not an exempt 'annuity contract') or by the insurer (tending to indicate that the product falls within the Section 3(a)(8) exemption."). The Commission's Proposing Release, *supra* note 1, at 17-18, states: "Under [*VALIC* and *United Benefit*], factors that are important to a determination of an annuity's status under Section 3(a)(8) include (1) the allocation of investment risk *between* insurer and purchaser." (emphasis added).

[50] *VALIC*, 359 U.S. at 71 (describing the definition of insurance as including "a guarantee that at least some fraction of the benefits will be payable in fixed amounts"); *United Benefit*, 387 U.S. at 207-08 (stating that one consideration among others was "that a company must bear a substantial part of the investment risk associated with the contract in order to qualify its products as insurance").

[51] The Commission's Proposing Release, *supra* note 1, at 24, states: "According to the U.S. Supreme Court, Congress intended to include in the insurance exemption only those policies and contracts that include a 'true underwriting of risks' and 'investment risk-taking' by the *insurer*." (emphasis added); *VALIC*, 359 U.S. at 73 ("There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.").

'investment risk-taking' *by the insurer*"[52] cannot be adequately assessed if the Commission ignores the insurer's role in the allocation of investment risk.

Indeed, the Commission appears to dismiss the guarantee of principal, a minimum interest rate and credited interest in assessing the allocation of investment risk between the insurer and owner. First, the Commission says that the degree to which the contracts are insured "may be too small" to qualify the annuity as insurance.[53] The Commission goes on to say that the annuity protections "may not adequately" transfer the investment risk from the purchaser to the insurer.[54] Second, the Commission seems to fragment the current excess interest, on the one hand, from the principal, guaranteed minimum interest rate and credited interest on the other hand. Then, the Commission concludes that the owner assumes the principal investment risk as to that fragmented portion of a fixed index annuity.[55]

These assertions of the Commission are unsupported by thorough analysis and are contradictory to the Supreme Court's analysis and the Commission's own view as recent as in 1997.[56] While the Commission does concede that fixed index annuities reduce risk, the Commission surprisingly notes, citing no support, that they "do not eliminate" a purchaser's exposure to investment risk.[57] This rationale is totally inconsistent with the approach that the

52 *VALIC*, 359 U.S. at 71 (stating that insurance "involves some risk-taking on the part of the insurer") (emphasis added).

53 The Commission's Proposing Release, *supra* note 1, at 26, states: "These contracts may to some degree be insured, but that degree may be too small to make the indexed annuity a contract of insurance."

54 *Id.* "Thus the protections provided by indexed annuities may not adequately transfer investment risk from the purchaser to the insurer when amounts payable by an insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract."

55 The Commission's Proposing Release, *supra* note 1, at 6, states as follows:

> The individual [owner] underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the equity-linked returns under the contract.

56 The Supreme Court, in *United Benefit*, 387 U.S. at 211 n.5, stated that while the assumption of investment risk by itself cannot create an insurance provision, "the guarantee of cash value based on net premiums reduces substantially the investment risk of the contract holder." The Commission's Concept Release, *supra* note 1, at 3, states: "Equity indexed annuities are designed to appeal to *risk averse* consumers who desire to participate in market increases, *without sacrificing the guarantees of principal and minimum return* offered in traditional fixed annuities." (emphasis added).

57 The Commission's Proposing Release, *supra* note 1, at 26, states: "These provisions reduce – but do *not* eliminate – a purchaser's exposure to investment risk under the contract." (emphasis in original.)

Commission took in Rule 151 and in establishing the principle that fixed index annuities can qualify under Rule 151.

Although the Commission tacitly acknowledges an insurer's investment risk related to offering guarantees of principal and minimum interest, the Commission does not acknowledge an insurer's investment risk in paying excess interest. When an insurer declares an excess interest rate formula, the insurer promises to pay the owner an amount based on the future performance of a selected index. If the insurer is unable to earn that amount through investment of its own assets, the insurer must pay the difference. Thus, the insurer bears investment risk not only with respect to the principal and guaranteed minimum interest payments, but also with respect to excess interest payments.

The Commission, in the past, has recognized that insurers enter into *hedging* transactions in order to protect against the investment risks assumed in making guarantees under fixed index annuities.[58] But the Proposing Release fails to acknowledge this fact. The Commission fails to relate insurers' hedging transactions to the substantial investment risk that insurers assume in guaranteeing principal (less charges), guaranteed minimum interest and credited interest. The Commission's failure to make this link casts material doubt on the validity of the Commission's Proposal and its consistency with the Supreme Court's standards under *VALIC* and *United Benefit* and the Commission's implementation of that standard.

Similarly, the Commission's Proposing Release acknowledges state insurance law protection of an insurer's solvency.[59] However, the Commission fails to link the prospect of insolvency to the substantial risk that insurers assume in guaranteeing principal (less charges), guaranteed minimum interest and credited interest.

C. <u>The Commission Misapplies the Supreme Court's Standard by Overstating Purchasers' Investment Risk with Respect to Excess Interest</u>

Even if the Commission had considered insurers' investment risk, the Commission's analysis is flawed due to its overstatement of purchasers' investment risk related to excess interest. The Commission states in the Proposing Release:

> [W]hen the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, the majority of the investment risk for the fluctuating, equity-linked portion of the return is borne by the individual purchaser, not the insurer. The individual

[58] Commission's Concept Release, *supra* note 1, at 9, 16.

[59] Commission's Proposing Release, *supra* note 1, at 19.

> underwrites the effect of the underlying index's performance on his or her contract investment and assumes *the majority* of the investment risk for the equity-linked returns under the contract.[60]

The Commission's position that an excess interest benefit under an index annuity transfers predominant investment risk to the purchaser is at odds with the facts, relevant court decisions, and statements by the Commission itself.

In *Malone*, the district court found that an index annuity that offered opportunities for excess interest did not transfer predominant investment risk to the purchaser. The district court in *Malone* stated:

> Plaintiff's risk was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have been worth more than 134 percent at the end of the ten-year contract period. That type of risk-that she could have gotten a better deal but for the pressure she encountered to enter into this particular contract – is *not the type of risk central to determining whether a security exists*…Because the Defendants assumed a much greater risk, Plaintiff's Investment seems a lot more like insurance and less like an investment for the Plaintiff.[61]

The Commission itself has stated in an amicus brief to the Supreme Court that the potential for excess interest under a fixed annuity contract did not transfer predominant investment risk to the purchaser.[62] In addition, the Commission has taken the position that for purposes of Section 3(a)(8), investment risk is the risk of loss, not the risk of varying positive returns. For example, in the Commission's release adopting Rule 151 in 1986, the Commission stated that although market value adjustment products could not rely on Rule 151, certain market value adjustment products, such as products that pay excess interest but where the marked value adjustments do not invade principal, could qualify for the Section 3(a)(8) exemption.[63]

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60 *Id.* at 25 (emphasis added).

61 *Malone*, 225 F. Supp. 2d at 751 (emphasis added).

62 The Commission argued, "[a]t least where, as here, a state-regulated insurer assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the investment-risk criterion is satisfied." Commission's VALIC v. Otto Brief, *supra* note 14, at 8-9.

63 The Commission stated:

> The degree to which any given MVA feature affects investment risk, and, therefore, the status of the contract, would depend on, among other things, the terms of the feature. In this regard, *an*

Even assuming that the excess interest element of fixed index annuities subjects purchasers to investment risk, the Commission overstates that investment risk in the Proposing Release. Unlike purchasers of mutual funds or variable annuities, the account value of a fixed index annuity does not "fluctuate" (contrary to the Commission's assertions).[64] If the index declines in value, the purchaser bears no risk because the issuer guarantees both a minimum crediting rate and previously credited interest. If the index increases in value, the purchaser will receive excess interest depending on a pre-set formula. Once that interest is credited, it cannot be lost, regardless of how the index performs in subsequent crediting periods. This is a crucial distinction between fixed index annuities and mutual funds or variable annuities. With a mutual fund or variable annuity, the positive performance of an investment in one period can be wiped out by negative performance in subsequent crediting periods. This is the risk of market fluctuation of which the Supreme Court was considering when analyzing variable annuities in *VALIC* and *United Benefit*.[65]

The only risk that a purchaser of a fixed index annuity can be said to bear is that the excess interest rate in one period may be higher than the excess interest rate earned in another period. But this risk is really only the abstract risk that the purchaser could have earned higher amounts by purchasing an alternative investment, a risk that the Supreme Court has said is not relevant in determining the existence of a security.[66] Moreover, it is identical to the risk assumed under any traditional fixed annuity, namely that the insurer may declare lower or higher excess interest in different periods. In fact, reference to an index that is not within the insurer's control may result in greater risk to the insurer than under traditional fixed annuities.

> *MVA feature that invaded principal* would be more problematic under a section 3(a)(8) analysis than one that merely requires forfeiture of a small portion of previously credited excess interest.

Commission's Rule 151 Adopting Release, supra note 25, at 15 (emphasis added).

64 *See* Commission's Proposing Release, *supra* note 1, at 25 ("By purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns.").

65 *VALIC*, 359 U.S. at 71 ("The holder [of a variable annuity] gets only a pro rata share of what the portfolio of equity interest reflects – which may be a lot, a little, or nothing."); *and United Benefit*, 387 U.S. at 208 ("The 'Flexible Fund' program completely reverses the role of the insurer during the accumulation period. Instead of promising to the policyholder an accumulation to a fixed amount of savings at interest, the insurer promises to serve as an investment agency and allow the policyholder to share in its investment experience.").

66 *VALIC,* 359 U.S. at 71 (noting that "it is no answer to say that the risk of declining returns in times of depression is the reciprocal of the fixed-dollar annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low"). *See also Malone*, 225 F. Supp. 2d at 751 (citing *VALIC*, 359 U.S. at 71).

D. <u>The Commission Misapplies the Supreme Court's Marketing Test as Applicable to Fixed Index Annuities</u>

The Commission states in the Proposing Release:

> Marketing is another significant factor in determining whether a state-regulated insurance company is entitled to the Securities Act "annuity contract" exemption. In *United Benefit*, the U.S. Supreme Court, in holding an annuity to be outside the scope of Section 3(a)(8), found significant the fact that the contract was "considered to appeal to the purchaser not on the usual basis of stability and security but on the prospect of 'growth' *through sound investment management*."[67]

The Commission fails to recognize that, unlike variable annuities that were the subject of the Supreme Court's review in *United Benefit*, fixed index annuities are *not* marketed on the prospect of growth *through sound investment management*. Excess interest applied under fixed index annuities depends on the performance of an external index, not on the wisdom of an insurer's investment policy. This distinction is not only important, it is central to the Supreme Court's finding that the variable annuities (which, among other things, provide no minimum guaranteed interest) in *VALIC* and *United Benefit* were securities.[68] The Commission provides

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[67] Commission's Proposing Release, *supra* note 1, at 19 (citing *United Benefit*, 387 U.S. at 211) (emphasis added).

[68] The Supreme Court noted in *VALIC*, 359 U.S. at 70, that, "[t]he holder of a variable annuity cannot look forward to a fixed monthly or yearly amount in his advancing years. It may be greater or less, depending on the wisdom of the investment policy." Similarly, Justice Brennan stated in his concurring opinion in *VALIC*, 359 U.S. at 78 (emphasis added), as follows:

> [O]ne of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company not become a direct sharer in the company's investment experience; that his investment in the policy or contract be sufficiently protected to prevent this. But the situation changes where the coin of the company's obligation is not money but is rather the *present condition of its investment portfolio*. To this extent, the historic functions of state insurance regulation become meaningless. Prescribed limitations on investment and examination of solvency and reserves become perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio. But beyond controlling corporate solvency and the adequacy of reserves, and maintaining observance of the legal list of investments, the state plans of regulation do not go in regulating *investment policy*. Where the nature of the obligation assumed is such, the federally protected interests in disclosure to the investor of *the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used* become obvious and real.

The Supreme Court noted in *United Benefit*, 387 U.S. at 211 n.15 (emphasis added), that, "United's primary advertisement for the 'Flexible Fund' was headed 'New Opportunity for Financial Growth.' United's sales aid kit included displays emphasizing the possibility of investment return and *the experience of United's management in professional investing*."

no further support or analysis regarding how or why fixed index annuities should fail the marketing test.

The Commission's total absence of analysis of the marketing test as it applies to fixed index annuities provides further evidence of the Commission's overreaching. This absence is particularly noticeable given the monopolizing focus on sales practices during the Commission's open meeting that dealt with commercial television reporting of individual abuses rather than legal principles.[69]

Courts that have considered the marketing test under Rule 151 have determined that fixed index annuities and other fixed insurance contracts may satisfy the marketing test for purposes of the Section 3(a)(8) exclusion.[70] We respectfully submit that if this analysis was properly applied to fixed index annuities, such products would generally qualify for the exclusion under Section 3(a)(8).

E. The Commission Ignores Other Important Differences Between Fixed Index Annuities and Variable Annuities that the Supreme Court Has Noted as Central in Distinguishing Insurance from a Security

As noted above, issuers of fixed index annuities bear substantial investment risk, and fixed index annuities are marketed on the basis of "stability and security." These are the hallmarks of insurance and annuities.

But fixed index annuities also have other fundamental characteristics (noted as relevant by the courts and the Commission) that make them more like fixed annuities, and less like variable annuities – more like insurance, and less like an investment.

First, payments under fixed index annuities are not dependent on the performance of investments made with their money, and purchasers do not share in the investment experience of the issuer. Second, the investment guarantees offered under fixed index annuities do not involve pooling of investment risks among policyholders in a separate account. These elemental features of fixed index annuities further distinguish such products as insurance, and not investment products.

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69 *See supra* note 20.

70 *Malone*, 225 F. Supp. 2d 743; Berent v. Kemper Corp., 780 F. Supp. 431 (E.D. Mich. 1991), *aff'd* 973 F.2d 1291 (6th Cir. 1992); *and* Assocs. in Adolescent Psychiatry v. Home Life Ins. Co. of New York, 729 F. Supp. 1162 (N.D. Ill. 1989), *aff'd* 941 F.2d 561 (7th Cir. 1991).

1. <u>Payments Do Not Depend on Investments Made with Purchasers' Money, and Purchasers Do Not Share in the Investment Experience of the Company</u>

The excess interest paid under fixed index annuities depends on the performance of an external benchmark, not on the performance of the assets contributed by the purchaser. Numerous courts, including the Supreme Court, have noted this as a significant factor distinguishing fixed and variable insurance products.

For example, courts have noted that state (not federal) regulation is appropriate when investors' returns are shielded from the *investment experience* of the insurer.

- In *VALIC*, Justice Brennan explained that under a traditional fixed life insurance or annuity policy, "the investors could not be said, in any meaningful sense, to be a sharer in the *investment experience* of the company. In fact, one of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company not become a direct sharer in the company's *investment experience*; that his investment in the policy or contract be sufficiently protected to prevent this."[71]

- In *Malone*, the district court distinguished the index annuity at issue from variable annuities as follows: "Plaintiff's benefit payments from American Equity were not directly dependent on the performance of investments made with *her* money. That is to say, as a structural matter, Plaintiff's contract did not operate like a variable annuity: her payments were not a function of a personalized portfolio and her principal was not held in an independent account. Had Plaintiff participated in a variable annuity, she would have retained control over the investment of her account."[72]

By contrast, the Supreme Court has found a security to exist under variable annuities that serve as a conduit for purchasers to invest their money on an equity basis and share in the insurer's investment experience.

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71 *VALIC*, 359 U.S. at 78 (Brennan, J., concurring).

72 *Malone*, 225 F. Supp. 2d at 750-51 (citing the Investment Company Act of 1940, requiring that variable annuity policies must be registered as investment companies) (emphasis added).

- In *VALIC*, Justice Brennan stated in his concurring opinion, "where the investor is asked to put *his* money in a scheme for managing it on an equity basis, it is evident that the [1940] Act's controls become vital."[73]

- In *United Benefit*, the Supreme Court noted that, "[t]he 'Flexible Fund' program completely reverses the role of the insurer during the accumulation period. Instead of promising to the policyholder an accumulation to a fixed amount of savings at interest, the insurer promises to serve as an investment agency and allow the policyholder to share in *its* investment experience."[74]

The fact that excess interest credited under fixed index annuities depends not on the investment performance achieved by the insurer with the purchaser's money, but rather on the investment performance of an external index eliminates the need for federal protections under the Supreme Court's standards.

2. <u>There Is No Pooling of Investment Risks Among Owners in a Separate Account</u>

The courts and the Commission also have distinguished fixed and variable insurance products by reference to the fact that under variable products, policyholders' money is pooled in a segregated account, whereas fixed insurance products do not involve pooling of risks.

- In *United Benefit*, the Supreme Court explained that, "[i]n a conventional annuity where a fixed amount of benefits is stipulated it is essential that the premiums both cover expenses and produce a fund sufficient to support the promised benefits… There is some shifting of risk from policyholder to insurer, but *no pooling of risks* among policyholders. In other words, the insurer is acting, in a role similar to that of a savings institution, and *state regulation is adjusted to this role*. The policyholder has no direct interest in the fund and the insurer has a dollar target to meet."[75]

- In *VALIC*, the Supreme Court noted that, "the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only *a*

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[73] *VALIC*, 359 U.S. at 80 (Brennan, J., concurring) (emphasis added).

[74] *United Benefit*, 387 U.S. at 208 (emphasis added).

[75] *Id.* at 207-08 (emphasis added).

> *pro rata share* of what the portfolio of equity interests reflects – which may be a lot, a little, or nothing."[76]

- In *Malone*, the district court found that a fixed index annuity was not a security, noting that, "at no point does Plaintiff's complaint allege that her premiums were maintained in *separate accounts* or that, for some reason, they should have been – the keystone characteristic of all variable annuity contracts."[77]

- In its amicus brief in *Otto v. VALIC*, the Commission took the position that VALIC assumed substantial investment risk under the Contract because, among other things, account values did not vary "according to the investment experience of a *separate account*."[78]

Because the returns under fixed index annuities are not limited to a pro rata share of a dedicated pool of purchasers' money, and account values do not fluctuate according to the investment experience of a separate account, fixed index annuities are more like traditional fixed annuities, and less like variable annuities.

It bears repeating that the Commission's failure to analyze these fundamental characteristics of fixed index annuities, and their substantial similarities to traditional fixed insurance casts material doubt on the validity of the Commission's Proposal and its consistency with the Supreme Court's standard under *VALIC* and *United Benefit*.

F. <u>The Commission Fails to Identify the Source of the New, Unprecedented Standard or Explain Why the New Standard Is Necessary or Appropriate and How the New Standard Is Consistent with the Supreme Court's Standard in *VALIC* and *United Benefit*</u>

The Commission's proposed new standard for testing insurance products under Section 3(a)(8), as described in the Release, is inconsistent with the principles pronounced by the Supreme Court, other courts and the Commission itself. If the Commission believes its proposed standard to be consistent with the principles pronounced by the Supreme Court, the Commission

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[76] *VALIC,* 359 U.S. at 71 (emphasis added).

[77] *Malone*, 225 F. Supp. 2d at 750 (emphasis added).

[78] Commission's VALIC v. Otto Brief, *supra* note 14, at 7 (emphasis added).

does not explain its basis for that view.[79] Moreover, the Commission does not disclose the source of the proposed standard.[80]

The basis on which the Commission proposes Rule 151A appears to suffer from similar infirmities to those cited by the D.C. Circuit Court of Appeals in vacating the Commission's so-called "Hedge Fund Rule."[81]

1. <u>Courts Have Struck Down the Approach that the Commission Follows Here</u>

Proposed Rule 151A seeks to subject fixed index annuities to 1933 Act registration, notwithstanding that for many years these annuities, as a product class, have generally not been regarded as being subject to such registration. This parallels the so-called "Hedge Fund Rule," which sought to subject hedge fund advisers to registration under the Investment Advisers Act of 1940 ("Advisers Act"), notwithstanding that they had historically not been regarded as subject to such registration.

Both rules seek to define the meaning of specific words in a statutory exclusion: in the case of Proposed Rule 151A, the words "annuity" or "optional annuity" in the Section 3(a)(8) exclusion, and, in the case of the Hedge Fund Rule, the word "clients" in the Section 203(b)(3) exclusion from Advisers Act registration.

Both rules employ a very similar approach to accomplish their objective. Proposed Rule 151A would provide that, if a fixed index annuity has certain characteristics specified in the Rule, it will not be an annuity or optional annuity and therefore will be subject to 1933 Act registration. The Hedge Fund Rule, similarly, would have provided that, if a hedge fund had certain characteristics specified in the rule, its limited partners would be clients of the hedge fund's adviser, thus subjecting the adviser to Advisers Act registration.

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[79] The Commission's Proposing Release, *supra* note 1, at 23-26, does quote the Supreme Court, but does not *link* these quotes to the nature of fixed indexed annuities. We respectfully submit that the Commission's quotations of Supreme Court statement do not support the Commission's Proposed Rule 151A.

[80] The Commission's proposed standard may have been adopted from a linguistic approach taken in legal opinions, particularly opinions regarding the federal tax laws, to articulate the degree of expectation that courts would arrive at the same conclusion as the person giving the opinion. 31 C.F.R. pt. 10 (as amended by T.D. 9165, 2005-1 C.B. 357).

[81] *Goldstein*, 451 F.3d 873.

2. A Court Has Announced Standard for Valid Commission Rulemaking

The court in *Goldstein*, of course, did not foreclose all attempts by the Commission to adopt rules defining statutory terms that are susceptible of different meanings. The court stated:

> If Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose *any* one of those meanings. As always, the "words of the statute should be read in context, the statute's place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account" to determine whether Congress has foreclosed the agency's interpretation.[82]

The court, however, did not believe that the Commission had adequately explained how the interpretation embodied in the Hedge Fund Rule "fit" with the statutory language and conformed to the statutory purposes.[83] In particular, the court criticized the Commission for "painting with such a broad brush" that it failed adequately to justify its interpretation.[84]

Goldstein doubtless leaves the Commission considerable leeway to adopt an interpretation after an analysis to assure that the interpretation conforms to the statutory language and purposes. The court does, however, require that such an analysis be performed with a certain degree of rigor and be based on statutory purposes and not merely the Commission's own preferences (regardless how wise or laudable those preferences might be).[85]

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[82] *Id.* at 878 (footnote omitted).

[83] *Id.* at 880-81.

[84] *Id*. at 883.

[85] *See* CBS Corp. v. FCC, 535 F.3d 167 (3d Cir. 2008) (emphasis added), stating:

> Like *any agency*, the FCC may change its policies without judicial second-guessing. But it cannot change a well established course of action without supplying notice of and a *reasoned explanation for its policy departure*.

G. The Commission's Proposal Misapplies the Functional Analysis Set Out in Justice Brennan's Concurring Opinion in *VALIC* by Failing to Recognize that the Insurer's Guarantee of Principal, Minimum Interest Rate and Credited Interest Obviate the Need for Disclosure to the Purchaser Under the 1933 Act

The Commission relies heavily[86] on Justice Brennan's concurring opinion in *VALIC* [87] to support the proposition that fixed index annuities should be regulated under federal securities law instead of state insurance law. Justice Brennan applied a functional analysis[88] that turns on the degree of investment risk[89] assumed by an insurer and the owner, the method by which owners' returns are achieved,[90] and the regulatory scheme that Congress intended to regulate that product.[91] Essentially, Justice Brennan says that where an owner bears a substantial investment

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[86] Commission's Proposing Release, *supra* note 1, at 19.

[87] *VALIC*, 359 U.S. at 73. Mr. Justice Stewart joined the concurrence.

[88] *Id.* at 74 (Brennan, J., concurring) ("[Securities Act § 3(a)(8) was] to take effect where the issuer of the policy or contract was subject to the supervision of the state 'insurance commissioner, bank commissioner, or any agency or officer performing like *functions*' (Securities Act § 3(a)(8)) or where a company classifiable as an 'insurance company' was 'subject to supervision by the insurance commissioner or a similar official or agency of a State.'") (emphasis added).

[89] *VALIC*, 359 U.S. at 90-91 (Brennan, J., concurring) ("The prevention of insolvency and the maintenance of 'sound' financial condition in terms of fixed-dollar obligations is precisely what traditional state regulation is aimed at. The protection of share interests in a fluctuating, managed fund has received the attention of specific federal legislation. Both are '*investment risks'* in a sense, but they differ vastly in kind and lend themselves to different regulatory schemes.") (emphasis added).

[90] *VALIC*, 359 U.S. at 77-78 (Brennan, J., concurring) ("In fact, one of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company *not become a direct sharer in the company's investment experience*; that his investment in the policy or contract be sufficiently protected to prevent this…[B]eyond controlling corporate solvency and the adequacy of reserves, and maintaining observance of the legal list of investments, the state plans of regulation do not go in regulating *investment policy*. Where the nature of the obligation assumed is such, the federally protected interests in disclosure to the investor of *the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used* become obvious and real .… The traditional state insurance department regulation of contract terms, reserves, solvency, and permissible investments simply *does not touch the points of definition of investment policy and investment technique, and control over investment policy changes and over the interests of the men who shape the policies of investment and furnish investment advice that the 1940 Federal Act provides*. These controls may be largely irrelevant to traditional banks and insurance companies, which Congress clearly exempted; they were not investing heavily in equity securities and holding out the possibilities of capital gains through fund management; but *where the investor is asked to put his money in a scheme for managing it on an equity basis*, it is evident that the Federal Act's controls become vital.") (emphasis added).

[91] *VALIC*, 359 U.S. at 91 (Brennan, J., concurring) (stating that different investment risks lend themselves to different regulatory schemes).

risk, disclosure is needed to appraise the risk. Where risk is borne by an insurer, a purchaser does not need disclosure.

Through selective quotations, the Commission gives the appearance that Justice Brennan's functional analysis favors federal regulation of fixed index annuities. However, a fair reading of the concurring opinion and an application of its analysis to fixed index annuities indicates that Justice Brennan's approach favors state regulation over federal regulation.[92]

The Commission cites to Justice Brennan's concurring opinion as support for the Commission's argument that state insurance laws are inadequate and disclosure is required when a purchaser is not "sufficiently protected."[93] The Commission then summarily concludes that purchasers of index annuities are not sufficiently protected if they are more likely than not to receive excess interest. But Justice Brennan's concurring opinion does not support the Commission's conclusion. Justice Brennan's argument for federal disclosure was carefully limited to circumstances where (i) the insurer assumes no investment risk (when the insurer's obligation under the contract is simply to pay the current value of its investment portfolio), and (ii) "the investor is asked to put his money in a scheme for managing it on an equity basis" (noting that "state plans of regulation do not go [into] regulating investment policy").[94] And

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[92] For example, the Commission states in the Proposing Release, *supra* note 1, at 27 (citing *VALIC*, 359 U.S. at 91 (Brennan, J., concurring)):

> Indexed annuities are similar in many ways to mutual funds, variable annuities, and other securities. Although these contracts contain certain features that are typical of insurance contracts, they also may contain "to a very substantial degree elements of investment contracts."

We respectfully note that Justice Brennan's statements in *VALIC* involved his analysis of a variable annuity which offered no guaranteed fixed return, and no downside risk protection feature. Therefore, Justice Brennan's quoted language does not support the Commission's argument relating to fixed index annuities.

[93] Specifically, the Commission argues in the Commission's Proposing Release *supra* note 1, at 19 (emphasis added):

> In analyzing investment risk, Justice Brennan's concurring opinion in *VALIC* applied a functional analysis to determine whether a new form of investment arrangement that emerges and is labeled "annuity" by its promoters is the sort of arrangement that Congress was willing to leave exclusively to the state insurance commissioners. In that inquiry, the purposes of the federal securities laws and state insurance laws are important. *Justice Brennan* noted, in particular, that the emphasis in the Securities Act is on disclosure and that the philosophy of the Act is that *"full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved."* Where an investor's investment in an annuity is sufficiently protected by the insurer, state insurance law regulation of insurer solvency and the adequacy of reserves are relevant. Where the investor's investment is *not sufficiently protected*, the disclosure protections of the Securities Act assume importance.

[94] Justice Brennan makes this point clear in the paragraphs that follow the language quoted by the Commission. Justice Brennan explained in *VALIC*, 359 U.S. at 77-78 (Brennan, J., concurring) (emphasis added):

Justice Brennan also says that state regulation (not federal) is appropriate where a purchaser is protected from the investment risk of the insurance company.[95]

The guaranteed minimum value offered in fixed index annuities shields owners from downturns in the market and, as a result, risk of loss. This type of guarantee was simply not present in *VALIC*.[96] But, in addition, the entire panoply of state insurance law, including product regulation and marketing regulation, as well as solvency regulation, protects owners.[97] Under Justice Brennan's approach, where a guaranteed minimum value (such as that characteristic of fixed index annuities, but absent in *VALIC*) obviates the need for appraisal of risk,[98] and where the owner's return does not depend on the insurer's investment experience or a manager's investment policy, disclosure no longer serves as a valid reason for applying federal securities law over state insurance law.

> [O]ne of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company *not become a direct sharer in the company's investment experience*; that his investment in the policy or contract be sufficiently protected to prevent this. But the situation changes where the coin of the company's obligation is not money but is rather the present condition of its investment portfolio. To this extent, the historic functions of state insurance regulation become meaningless. Prescribed limitations on investment and examination of solvency and reserves become perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio. But beyond controlling corporate solvency and the adequacy of reserves, and maintaining observance of the legal list of investments, *the state plans of regulation do not go in regulating investment policy. Where the nature of the obligation assumed is such, the federally protected interests in disclosure to the investor of the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used become obvious and real.* The contract between the investor and the organization no longer squares with the sort of contract in regard to which Congress in 1933 thought its 'disclosure' statute was unnecessary.

[95] *VALIC*, 359 U.S. at 77-78 (Brennan, J., concurring) ("This congressional division of regulatory functions is rational and purposeful in the case of a traditional life insurance or annuity policy, where the obligations of the company were 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. In fact, one of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company not become a direct sharer in the company's investment experience; that his investment in the policy or contract be sufficiently protected to prevent this.").

[96] *Weaver*, 455 U.S. 551 (finding a product to not be a security under the federal securities laws where the purchaser is "virtually guaranteed payment in full"). *See* the discussion of *Weaver* under IV.C., *infra*.

[97] The Commission's Proposing Release, *supra* note 1, at 19, erroneously focuses on state insurance law protection of "insurer solvency and the adequacy of reserves," without recognizing the importance of product regulation and marketing regulation.

[98] *Id.*

The insurer's minimum guarantees or fixed dollar obligations under fixed annuities are, according to Justice Brennan, precisely what the state law was designed to protect.[99] This lends strong support to the notion that state insurance law should govern these products, not federal securities laws.[100] The Commission's reliance on Justice Brennan's concurring opinion in VALIC is more severely undercut by the fact that the Commission itself has described fixed index annuities as risk adverse due to their guarantees.[101] Applying this description to Justice Brennan's functional approach makes it clear that fixed index annuities, like traditional insurance products, commit the insurer to fixed obligations. This feature provides the purchaser with sufficient guarantees so as to be protected against sharing in the investment experience of the insurer.[102] This would, according to Justice Brennan's own functional standard, bring fixed index annuities within the basic premise of state insurance regulation.[103]

The Commission also misquotes Justice Brennan in the Proposing Release when it states:

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[99] *VALIC*, 359 U.S. at 90-91 (Brennan, J., concurring) ("The prevention of insolvency and the maintenance of 'sound' financial condition in terms of fixed-dollar obligations is precisely what traditional state regulation is aimed at.").

[100] Justice Brennan's functional analysis employs an inquiry into Congressional intent when drafting the federal securities laws. Applying that same procedure to fixed index annuities supports the argument that state insurance laws should govern as the intent of Congress in this instance is clear. *See* 1 LOSS & SELIGMAN, *supra* note 37, at 242.

> § 3(a)(8) seems on its face to create a negative implication that insurance policies *are* securities, which are exempt from the registration requirements but are subject to the antifraud provisions. Nevertheless, the Commission early took the position that insurance or endowment policies or annuity contracts issued by regularly constituted insurance companies were not intended to be securities, and that in effect § 3(a)(8) is supererogation.

This undoubtedly carries out the legislative intention, for the House Report (*see supra* note 38 and accompanying text) states that the purpose of the exemption makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act.

[101] Commission's Concept Release, *supra* note 1, at 3. ("Equity indexed annuities are designed to appeal to risk averse consumers who desire to participate in market increases, without sacrificing the guarantees of principal and minimum return offered in traditional fixed annuities."). *See also VALIC*, 359 U.S. at 91 n.30 ("Of course, the primary investment aim of the traditional insurer is preservation of dollar capital with income.").

[102] *VALIC*, 359 U.S. at 77-78 (Brennan, J., concurring) ("In fact, one of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company not become a direct sharer in the company's investment experience; that his investment in the policy or contract be sufficiently protected to prevent this.").

[103] *Id.* (Brennan, J., concurring).

> Indexed annuities are attractive to purchasers precisely because they offer participation in the securities markets. Thus, individuals who purchase such indexed annuities are "*vitally interested in the investment experience*."[104]

What Justice Brennan actually said was that during the payout phase of a variable annuity, the investor is "vitally interested in the investment experience *of the company*" (referring to the underlying trust company), because the annuity payments depend on the current value of the annuity units.[105] Justice Brennan noted that annuity units are measured similarly to interests in a trust company. Presumably, the Commission omits the words "of the company" because, unlike variable annuities and mutual funds, money used to purchase a fixed index annuity is *not* invested in an investment portfolio that determines the value of the owner's policy, and fixed index annuity owners do *not* depend on the investment experience of a pool of assets similar to a mutual fund or trust company. These distinctions detract from the Commission's argument, and are omitted from the Proposing Release. The Commission's analysis in the Proposing Release appears to be tailored to fit a pre-ordained result. We respectfully submit that this analysis would not survive judicial scrutiny.

H. The Commission's Proposal Ignores or Overlooks a Federal Court Decision that Finds Fixed Index Annuities Not To Be Securities Under the Supreme Court's Standard for Section 3(a)(8) and Fails To Explain Why the Commission Disagrees with the Court

A federal district court ("Court") has found a fixed indexed annuity to be insurance and not securities separately under both Rule 151[106] and Section 3(a)(8)[107] based on an analysis of principles that the Supreme Court has pronounced.

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[104] Commission's Proposing Release, *supra* note 1 at 27 (citing *VALIC*, 359 U.S. at 89 (Brennan, J., concurring) (emphasis added)).

[105] Specifically, Justice Brennan explained in *VALIC*, 359 U.S. at 89 (Brennan, J., concurring) (emphasis added):

> [T]he individual [pay-out phase] payment is still a payment measured basically in the same way as one's interest in an investment trust is measured. And in a very real sense the investor is more *vitally interested in the investment experience of the company* at this period than he ever was in the pay-in period, and in a way more vitally than any holder of an open-end investment company certificate, or share in a publicly traded closed-end company ever is: he has become completely 'locked in.'

[106] *Malone*, 225 F. Supp. 2d at 751-52.

[107] *Id.* at 751. The Court said:

> [T]he Court finds [the fixed index annuities] are more like 'fixed annuities' and therefore are excluded from the definition of 'security' under the Supreme Court's opinions in *VALIC* and *United Benefit*.

The Commission's Proposing Release acknowledges the decision, but does so at the end of a long footnote.[108] And the Commission acknowledges only the finding under Rule 151 and not the primary finding under Section 3(a)(8).[109] Under these circumstances, we believe that the Commission gives insufficient weight to the Court's analysis and decision under Section 3(a)(8) on which the decision is based. The decision undercuts the Commission's approach of requiring virtually all offerings of fixed index annuities to be registered under the 1933 Act.

The case involved the status of a fixed index annuity under the federal securities laws.[110] The fixed index annuity involved in the case was a single-premium deferred annuity issued by the American Equity Investment Life Insurance Company. The Company guaranteed plaintiff a minimum return of 100% of her premium plus a guaranteed rate of interest of 3% interest annually, and an excess interest rate derived from the performance of the S&P 500 Index.

The Court reviewed, in some detail, the principles that the Supreme Court laid down in its *VALIC* and *United Benefit* decisions[111] and subsequent circuit court decisions in "drawing the line between fixed and variable annuities."

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[108] Commission's Proposing Release, *supra* note 1, at 21 n.38.

[109] *Id*. The Court in *Malone*, 225 F. Supp. 2d at 751 (emphasis added), stated, after finding that the contracts were not securities under Section 3(a)(8):

> *The Court could end its inquiry here.* However, the Security [sic] and Exchange Commission Rule 151 Safe Harbor also merits discussion because it guarantees certain types of annuities an exemption from federal securities law.

[110] The Court granted a motion to dismiss on the grounds that the fixed index annuities at issue "are exempt from the federal securities laws both under Section 3(a)(8) and Rule 151," so that "there is no legal basis for Plaintiff's complaints under the Securities Exchange Act of 1934" "to recover for the harm caused to her and members of her class by the corporations' fraudulent sale of living trusts and other investments."

The plaintiff was a 73-year old widow. She brought a class action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. She alleged the fraudulent sale of living trusts and other investments including the fixed index annuity.

The Court, as a technical matter, determined that there was no legal basis for plaintiff's complaints under the Securities Exchange Act of 1934 and granted defendants' motion to dismiss.

The Court based its determination on a finding that Section 10(b) and Rule 10b-5 applied in connection with transactions in *securities* and that no securities were involved in the transactions underlying the plaintiff's complaints. First, the Court determined that the plaintiff did not *sell* securities, because she merely transferred authority to "make investments" to an entity and "was not the actual purchaser or seller of securities." Then, the Court determined that the plaintiff did not *buy* securities, because the fixed index annuity was not a security under either Section 3(a)(8) and Rule 151. The court made *separate* findings regarding Section 3(a)(8) and Rule 151.

[111] The Court said:

The Court found that the Contracts were excluded from the definition of "security" under *VALIC* and *United Benefit*, as follows:

- the owner received a guaranteed minimum rate of interest, even "in the event the S&P 500 [sic] performed poorly . . . Consequently, American Equity assumed the investment risk and not [owner]" who received payment regardless of how poorly the market performed;[112]

- the owner's "benefit payments" from the insurer "were not directly dependent on the performance of investments made with her money," that is, "her payments were not a function of a personalized portfolio and her principal was not held in an independent account";[113]

- the owner had no risk that "she would lose the value of her initial investment";[114] and

- the owner did bear "an element of risk and uncertainty" to the extent that "her return over and above the guarantee depended on the performance of the S&P 500 Index," but the insurer "actually bore as much or more of the risk than Plaintiff," because if the insurer "was unable to surpass this indexed rate in its own investment of the Plaintiff's premium, then it was the loser."[115]

The Court concluded that "[f]or all these reasons . . . the contracts are more like 'fixed annuities' and therefore are excluded from the definition of 'security' under the Supreme Court's opinions in *VALIC* and *United Benefit*."[116]

The decision conflicts with the Commission's Proposal to adopt Rule 151A. The Court, consistent with the Supreme Court's standard and the provisions of Rule 151, assessed the

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> In making its determination, the Court has carefully considered the general principles set out by the Supreme Court.

Malone, 225 F. Supp. 2d at 748 (specifically referencing *VALIC* and *United Benefit*).

112 *Id.* at 750.

113 *Id.*

114 *Id.* at 751.

115 *Id.*

116 *Id.*

investment risk that the insurer and owner each assumed (including risks related to the receipt of fluctuating excess interest), weighed them against each other, determined that the insurer assumed "as much or more"[117] of the investment risk than the owner, and determined the fixed index annuity to be insurance and not a security.

We respectfully suggest that the Commission's Proposing Release does not give the Court's decision the weight it warrants. The Proposing Release dismisses the Court's finding under Rule 151, but totally elides the Court's separate analysis and finding that the fixed index annuity qualifies as a non-security under Section 3(a)(8).

Even if the Court was mistaken in its finding that the fixed index annuity fell within Rule 151, the product, as a legal matter, can be analyzed separately under Section 3(a)(8). The Commission has so declared.[118] We respectfully suggest that the Commission's failure to address the Court's analysis and decision under Section 3(a)(8) is a substantial flaw of the Commission's Proposing Release and Proposed Rule 151A.

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[117] *Id.*

[118] As the Commission has said:

> In this regard, insurers offering life insurance contracts are in the same position as those who seek to offer annuity contracts in direct reliance upon section 3(a)(8). The securities law status of a life insurance contract may be analyzed by reference to the principles discussed in rule 151 and accompanying releases and by reference to relevant judicial interpretation of section 3(a)(8).

Commission's Rule 151 Adopting Release, *supra* note 25, at 5 n.4.

As the Commission has further said:

> Any insurer that is unable, or chooses not, to rely on rule 151 may still look to the rule and accompanying releases for interpretive guidance. The rationale underlying the conditions set forth in the rule is relevant to any section 3(a)(8) determination.

Id. at 36-37 (footnote omitted).

As the Commission has also said:

> In situations when the Rule 151 safe harbor is not applicable, the status of a contract may be analyzed by reference to the principles discussed in Rule 151 and the accompanying releases and to judicial precedents construing Section 3(a)(8).

Commission's Concept Release, *supra* note 1, at 12.

I. <u>The Commission Ignores Its Own Amicus Brief in *Otto v. VALIC*</u>

In *Otto v. Variable Annuity Life Insurance Co.*,[119] the Seventh Circuit originally determined that VALIC's annuity contract that offered a guaranteed minimum rate of return of 4% for the first ten contract years and 3.5% thereafter was excluded from the definition of security under Section 3(a)(8). Upon rehearing,[120] the court reversed its opinion and determined that VALIC's absolute right to change the excess interest component at any time shifted the investment risk to the purchasers and the contract did not comply with all conditions of Rule 151.

The Commission, through the Department of Justice, filed an amicus brief in support of VALIC's petition for writ of certiorari before the Supreme Court, and stated that the Seventh Circuit's reasoning was "unclear" and its legal analysis was "wrong."[121] The Commission argued that Rule 151 did not define the outer limits of Section 3(a)(8), and that the security status of VALIC's contract should be answered by reference to the Supreme Court's decisions in *VALIC* and *United Benefit* in addition to Rule 151.

The Commission took the position that VALIC assumed substantial investment risk under the Contract because: (i) it guaranteed return of principal; (ii) it guaranteed an interest rate of 3½% or 4% on principal and accrued interest; (iii) it guaranteed the payment of all monies credited to the account (principal, interest, and excess interest) prior to surrender; and (iv) account values did not vary according to the investment experience of a separate account.[122] The Commission argued, "[a]t least where, as here, a state-regulated insurer assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the investment-risk criterion is satisfied."[123]

These statements in the Commission's amicus brief are contrary to the position the Commission now takes in the Proposing Release.

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[119] Otto v. Variable Annuity Life Ins. Co., 814 F.2d 1127 (7th Cir. 1986).

[120] After the original opinion was issued, VALIC informed the court that it reserved the right at any time to alter the excess interest paid on all contributions.

[121] Commission's VALIC v. Otto Brief, *supra* note 14, at 5-6.

[122] *Id.* at 7-8.

[123] *Id.* at 8-9. The Commission did not reach a conclusion regarding the annuity's status under the federal securities laws because the record was unclear as to VALIC's marketing strategy and its assumption of mortality risk.

J. <u>The Commission's Proposal Would Require or Encourage 1933 Act Registration of Other Insurance and Annuity Products that Could Fall Outside Section 3(a)(8) Under the Supreme Court's Standard</u>

Proposed Rule 151A would require or encourage 1933 Act registration of products that the Commission apparently does not intend to be registered. We discuss examples of such products below. Rule 151A also would provide competitive advantages to issuers of fixed declared-rate products competing with fixed index annuities.

We respectfully submit that the Commission either (i) has not given adequate consideration of the factors of efficiency and competition as required by Section 2(b) or (ii) having given adequate consideration, has not adequately articulated those considerations.

1. <u>Market Value Adjustment Product Registration Would Be Required Under Rule 151A</u>

The Commission's Proposing Release indicates that the scope of Proposed Rule 151A is very broad. The Rule would require registration under the 1933 Act of a contract under which any payout amount was calculated by reference to securities performance.[124]

It follows that Proposed Rule 151A is likely to require many offerings of products with a market value adjustment to be registered. As the Commission has recognized, market value adjustment ("MVA") formulas reflect the performance of securities.[125] In times of decreasing interest rates, MVA formulas typically result in additional payments to surrendering owners. Therefore, Proposed Rule 151A could be deemed to require 1933 Act registration at any time when the issuer considered it "more likely than not" that prevailing interest rates would decrease.

This result seems to conflict with the Commission's long-standing position that an MVA feature does not necessarily require registration. The Commission has stated that whether or not a product with an MVA feature is required to be registered under the 1933 Act depends on – not

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[124] The Commission's Proposing Release, *supra* note 1, at 31 states as follows:

> The rule would apply whenever any amounts payable under the contract under any circumstances, including full or partial surrender, annuitization, or death, are calculated, in whole or in part, by reference to the performance of a security or securities.

[125] The Commission has defined an MVA feature as follows:

> Under an MVA feature, the insurer adjusts the proceeds a contractowner receives upon an early surrender (*i.e.*, a surrender made before the end of a period of guaranteed discretionary excess interest) to reflect *changes in the market value of* its portfolio securities supporting the contract.

Commission's Rule 151 Adopting Release, *supra* note 25, at 11-12 n.14 (emphasis added).

the MVA per se – but rather on the *degree* to which the MVA invades previously credited interest and principal.[126]

We believe the result of Proposed Rule 151A described above would have adverse consequences in terms of efficiency and competition. Section 2(b) requires the Commission to consider that result and explain the justification for that result.

2. Other Life Insurance Products

The Commission indicates that it is at least considering having Proposed Rule 151A apply to life insurance. The Commission's Proposing Release, *supra* note 1, at 30, asks for comment on the question: "Should the proposed definition apply to forms of insurance other than annuities such as life insurance . . .?"

Such an extension of Proposed Rule 151A likely would require forms of traditional life insurance to be registered as securities. An example would be participating – or par – life insurance policies. Par policies have not been considered to be securities.[127] However, par life insurance policies would, in the words of Proposed Rule 151A, involve "[a]mounts payable by the issuer under the contract [that] are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities."

NAFA believes that such an extension would contravene Congressional intent, ignore Supreme Court standards, contradict Commission positions and fail to meet requirements for Commission rulemaking.

IV. FIXED INDEX ANNUITIES ARE NOT SECURITIES UNDER THE SUPREME COURT'S STANDARDS PRONOUNCED IN *HOWEY* AND *WEAVER*

We discuss the Commission's proposal under the Supreme Court's standard in *Howey* under A. and B., below, and the Supreme Court's standard in *Weaver* under C., below.

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126 The Commission has stated as follows:

> The degree to which any MVA feature affects investment risk and, therefore, the status of the contract, would depend on, among other things, the terms of the feature. In this regard, an MVA feature that invaded principal would be more problematic under a section 3(a)(8) analysis than one that merely requires forfeiture of a small portion of previously credited excess interest.

Id. at 14-15 (footnote providing example omitted).

127 *See* Dryden v. Sun Life Assurance Co., 737 F. Supp. 1058, 1062 (S.D. Ind. 1989).

In this regard, the Supreme Court's holdings in *VALIC* and *United Benefit* (as well as most of the other authorities as to the federal securities law status of insurance products) depended, ultimately, upon an application of *Howey* and its progeny. The fact that fixed index annuities are not securities under *Howey*, therefore, is well-nigh dispositive of the question. We respectfully submit that *Weaver* also carries great weight in this regard.

A. <u>The Commission's Proposal Fails to Reflect the Supreme Court's Standard in *Howey* that a Financial Product Is Not a Security Where the Owner Does Not Assume a Risk that Reflects the Entrepreneurial or Managerial Efforts of Others, as Is True with Fixed Index Annuities</u>

Any risk that the owner may be deemed to assume, where the interest rate credited is derived from securities market indexes, is not an "investment risk" that evidences a security.

The Supreme Court has held that "an investment contract . . . means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[128] The Supreme Court has further said that the touchstone of a security is "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the *entrepreneurial* or *managerial* efforts of others."[129]

The risk to the owner that a securities market index may increase or decrease is not the kind of risk that the Supreme Court has identified as the indicium of a security. To begin with, the return produced by a securities market index is not a result of, in the Supreme Court's words, "the efforts of the promoter or a third party."[130] Moreover, the owner does not buy a fixed index annuity with, again in the Supreme Court's words, the "expectation of profits to be derived from the *entrepreneurial* or *managerial* efforts of others."[131]

A fixed index annuity differs from a variable annuity or variable life insurance policy. The owner of a fixed index annuity is not dependent upon money managers who exercise investment discretion in buying, holding and selling a portfolio of securities held in an insurer's *separate* account. And a fixed index annuity differs from a declared-rate annuity. The owner of a fixed index annuity is not dependent upon money managers who exercise investment discretion

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128 *Howey,* 328 U.S. at 298-99.

129 United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (emphasis added).

130 *Howey*, 328 U.S. at 298-99.

131 *Forman*, 421 U.S. at 832 (emphasis added).

in buying, holding and selling a portfolio of securities held in an insurer's *general* account, where investment return is a factor in the insurer's determination of the interest rate to declare.

In contrast, the return based on a securities market index is the mathematical result of the mechanical functioning of an impersonal measuring methodology,[132] not the efforts of any human being. An insurer's mere selection of recognized indices does not rise to the level of "effort" that *Howey* contemplates. The Commission appears to have overlooked the fact that federal courts have found no securities to be involved where profits were dependent upon the fluctuations of certain markets that are analogous to indexes of securities markets.[133] So, whatever the risk that an owner may assume under a fixed index annuity, it is not an "investment risk" that the Supreme Court and other courts have associated with a security.

Furthermore, the risk to the owner that a securities market index may increase or decrease is not the result of an "investment" decision by the owner. A fixed index annuity provides, in advance, for the identity of the indexes and the methodology for deriving an interest rate from the indexes. The owner, to this extent, has no choice or other element of discretion in connection with the indexes from which the owner's rate of interest is derived. To the extent that the owner makes no investment choice regarding the indexes and methodology provided in a given fixed index annuity, the owner cannot be said to assume an "investment risk" that the Supreme Court and other courts have pronounced as the indicium of a security.

B. <u>The Commission's Proposal Fails to Reflect the Supreme Court's Standard in *Howey* that a Financial Product Is Not a Security Where There is No Common Enterprise, as Is True with Fixed Index Annuities</u>

The Supreme Court has held that "an investment contract…means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[134]

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[132] As the Commission recognizes in its Proposing Release, *supra* note 1, at 10, "an indexed annuity specifies all aspects of the formula for computing return in advance of the period for which return is to be credited" and "the computation is performed pursuant to a mathematical formula that is guaranteed in advance of the crediting periods." The Commission, however, fails to explain how these features meet the Supreme Court's Howey test.

[133] SEC v. Belmont Reid & Co., Inc., 794 F.2d 1388, 1391 (9th Cir. 1986) (holding that the "efforts of the promoter or third party" prong of the Howey test was not satisfied where the investor's profits were "dependent upon the fluctuations of the gold market, not the managerial efforts of [the company"]); Noa v. Key Futures, Inc., 638 F.2d 77 (9th Cir. 1980) (*per curium*) (holding that the sale of silver was not an investment contract because "the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of [the third party]").

[134] *Howey*, 328 U.S. at 298-299.

In interpreting the "common enterprise" element, courts are divided on whether the element requires that (i) investors' funds must be pooled such that investors share pro rata in the profits and risks of the enterprise (horizontal commonality),[135] (ii) the success of the investment be linked to the efforts of the promoter (broad vertical commonality),[136] or (iii) there is interdependence or mutuality of interest in the success of the investor and the fortunes of the promoter (narrow vertical commonality).[137]

Fixed index annuities involve neither horizontal commonality nor vertical commonality. Fixed index annuities do not involve horizontal commonality, because, unlike mutual funds or variable annuity investments, purchasers of fixed index annuities do not receive a pro rata share of pooled assets. Fixed index annuities also do not involve vertical commonality, because the amount of the excess interest depends on the performance of an external index, over which the insurer exercises no management control, and the fixed index annuity owner and the insurer do not share a mutuality of interest in the returns of the index.

Because fixed index annuities do not involve a common enterprise, they are not securities under the *Howey* test.

C. <u>The Commission's Proposal Fails To Reflect the Supreme Court's Standard in *Weaver* that a Financial Product Is Not a Security Where the Owner Is Protected Against Loss by a Governmental Regulatory Scheme, as Is True with Fixed Index Annuities</u>

1. <u>The Commission's Proposal Contradicts a Previous Commission Position Urged on, and Accepted by, the Supreme Court</u>

The Supreme Court has pronounced in *Weaver*[138] that a financial product is not a security where the owner is protected against loss by the existence of a regulatory scheme other than the

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[135] The Third, Sixth, and Seventh Circuits require horizontal commonality. *See, e.g.*, Salcer v. Merrill Lynch, Pierce, Fenner and Smith Inc., 682 F.2d 459 (3d Cir. 1982); Cooper v. King, 114 F.3d 1186 (6th Cir. 1997); SEC v. Lauer, 52 F.3d 667 (7th Cir. 1995).

[136] SEC v. R.G. Reynolds Enters., Inc., 952 F.2d 1125 (9th Cir. 1991); Westchester Corp. v. Peat, Marwick, Mitchell & Co., 626 F.2d 1212 (5th Cir. 1980).

[137] Hocking v. Dubois, 885 F.2d 1449 (9th Cir. 1989); Great Lakes Chem. Corp. v. Monsanto Co., 96 F. Supp. 2d 376 (D. Del. 2000); Copeland v. Hill, 680 F. Supp. 466 (D. Mass. 1988).

[138] *Weaver*, 455 U.S. 551.

federal securities laws. The Commission filed an amicus brief[139] in the case, urging the Supreme Court to so hold.

Both the Supreme Court and the Commission stated the principle that a financial product is not a security where governmental regulation and supervision of the insurance industry virtually eliminates the risk of loss. The Supreme Court[140] indicated its awareness of *United Benefit*,[141] and the Commission cited *VALIC* in urging its position on the Supreme Court.

Both the Supreme Court and the Commission, as quoted below, said that "risk of loss" includes *both* the owner's:

- risk of insolvency and
- investment risk[142] wholly apart from the insolvency risk.

NAFA respectfully submits that the Commission overlooked or ignored this long-standing position that the Commission successfully urged on the Supreme Court. Consequently, the Commission's Proposal is inconsistent with this position and the standard that the Supreme Court pronounced. NAFA does not believe that the Commission's Proposal can stand, because it contradicts the position that the Commission has taken before the Supreme Court and the pronouncements of the Supreme Court and other courts that reflect the Commission's position.

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139 Nominally, the brief was for the United States specifying the Commission, as well as the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and the Department of Justice. Commission's Weaver Brief, *supra* note 13.

140 *Weaver*, 455 U.S. at 556.

141 Commission's Weaver Brief, *supra* note 13. The Commission also cited *United Benefit* in its Brief. *Id*. at 27.

142 Investment risk is concerned with primarily risk of loss, not the possibility of gain. Michael M Pompian, CFA, CPA, author of *Behavioral Finance and Wealth Management: How to Build Optimal Portfolios That Account for Investor Biases*, discusses the "loss aversion bias" developed as part of the prospect theory of Daniel Kahneman and Amos Tversky, at 208-210. In *Prospect Theory: An Analysis of Decision under Risk*, 47 ECONOMETRICS 263-291 (1979), Kahneman and Tversky observe that people generally feel a stronger impulse to avoid losses than to acquire gains. Mr. Pompian specifically notes that a number of studies on loss aversion have contributed to a rule of thumb that "[p]sychologically, the possibility of a loss is on average twice as powerful a motivator as the possibility of making a gain of equal magnitude."

2. <u>The Supreme Court Has Held that a Financial Product Is Not a Security Where Governmental Regulation Protects the Owner Against Loss</u>

The Supreme Court, in *Weaver*, held that a bank certificate of deposit ("CD")[143] was not a "security."[144]

The rationale was that the owner had no risk of loss under the CD, because the owner was protected against loss by a regulatory system that served as an alternative to the federal securities laws. The Supreme Court stated:

> It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws. We therefore hold that the certificate of deposit purchased by the Weavers is not a security.[145]

The Supreme Court's approach was to ascertain the existence of an alternative regulatory scheme – in this case, the federal banking laws[146] – to ascertain the nature and breadth of the

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[143] The status of bank products as securities is relevant to the status of fixed index annuities. This is because, among other things, Section 3(a)(8) refers to annuities issued by banks subject to supervision under banking laws.

[144] *Id.* The case arose under the antifraud provisions of the Securities Exchange Act of 1934 and involved the definition of "security" under that Act. However, the Supreme Court stated that "[w]e have consistently held that the definition of 'security' in the 1934 Act is essentially the same as the definition of 'security' in § 2(1) [sic] of the Securities Act of 1933." *Forman*, 421 U.S. at 847 n.12. *Weaver*, 455 U.S. at 1123. It follows that the *Weaver* decision is relevant to a determination that a financial product is a security under the 1933 Act.

[145] *Weaver*, 455 U.S. at 558 (footnote omitted).

[146] The Commission's Weaver Brief, *supra* note 13, at 11, asserts that state *insurance* law could suffice as a substitute for the federal securities laws. Similarly, federal courts have found that federal law is not required for the Weaver standard and that *state* law and even foreign law can suffice as an alternative regulatory scheme. Tafflin v. Levitt, 865 F.2d 595 (4th Cir. 1989) (no security, because the Maryland Savings-Share Insurance Corporation creates a comprehensive regulatory and insurance system that adequately reduced the risk, thereby satisfying the Weaver standard); West v. Multibanco Comermex, S.A., 807 F.2d 820 (9th Cir. 1987) (no security, because the Mexican banking scheme adequately reduced the risk to the investor); Wolf v. Banco Nacional de Mexico, S.A., 739 F.2d 1458 (9th Cir. 1984) (no security where "Mexico thoroughly regulates its banks and . . . no Mexican bank has become insolvent in fifty years"); *contra* In re Calozza Litigation, No. C94-1566Z, 1995 WL 370991 (W.D. Wash. April 20, 1995) (security, where state insurance laws cannot sufficiently reduce the risk of the instrument so the protections of the federal securities laws become unnecessary); Bradford v. Moench, 809 F. Supp. 1473 (D. Utah 1992) (a court under the jurisdiction of the Tenth Circuit); Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485 (10th Cir. 1990) ("state regulation of the transaction should not be a factor governing application of the remedial federal securities laws"). The Commission has told the Supreme Court that state insurance law can be an adequate regulatory alternative for the federal securities laws, as discussed under 3., *infra*.

scheme's coverage. The Supreme Court looked to protections both while an issuer is solvent and when an issuer becomes insolvent.[147] The Supreme Court said that the issuer of the CD

> is subject to the comprehensive set of regulations governing the banking industry. Deposits in federally regulated banks are protected by the reserve, reporting, and inspection requirements of the federal banking laws. Advertising relating to the interest paid on deposits is also regulated. In *addition*, deposits are insured by the Federal Deposit Insurance Corporation.[148]

The Supreme Court has confirmed its *Weaver* standard in the *Reves* case.[149] The Supreme Court in *Reves* found that notes were securities, where, in contrast to *Weaver*, there was no governmental regulatory scheme that provided protections in lieu of the federal securities laws. The Supreme Court, in *Reves*, found that the owner was not protected, because, among other things, without federal securities regulation, "the notes here would escape federal regulation entirely."[150]

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[147] The Supreme Court, in reversing the Court of Appeals, referred to protection against, among other things, an issuer's insolvency, as follows:

> The Court of Appeals failed to give appropriate weight to the important fact that the purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary longterm [sic] debt obligation assumes the risk of the borrower's insolvency.

Weaver, 455 U.S. at 559.

[148] *Id.* at 558 (distinguishing between insolvency risk and investment risk) (emphasis added; footnote omitted).

[149] Reves v. Ernst & Young, 494 U.S. 56 (1990). An agricultural cooperative, in order to raise money to support its business operations, sold promissory notes payable on demand by the holder. The cooperative sent newsletters stating that it had over 11 million dollars in assets, so any investment would be safe and secure. However, the cooperative did not place any liens on their property after selling a note. Therefore, the notes were uncollateralized and uninsured. Despite the cooperative's assurances, the cooperative filed for bankruptcy. At the time, the cooperative had sold notes owing 10 million dollars to over 1,600 individuals. After the cooperative filed for bankruptcy, the note holders filed suit against the firm that had audited the cooperative's financial statements. The firm's argument was that the notes were not securities as defined under the Securities Exchange Act of 1934.

[150] *Id.* at 68. The Supreme Court's complete statement is:

> Finally, we find no risk-reducing factor to suggest that these instruments are not in fact securities. The notes are uncollateralized and uninsured. Moreover, unlike the certificates of deposit in *Marine Bank*, *supra* at 455 U.S. 557-558 [*i.e.*, *Weaver*], which were insured by the Federal Deposit Insurance Corporation and subject to substantial regulation under the federal banking laws, and unlike the pension plan in *Teamsters v. Daniel*, 439 U.S. 551, 439 U.S. 569-570 (1979), which was comprehensively regulated under the Employee Retirement Income Security Act of 1974, 88 Stat. 829, 29 U.S.C. s 1001 *et. seq.*, the notes here would escape federal regulation entirely if the Acts were held not to apply.

The Supreme Court expressly recognized that the Commission, as *amicus curiae*, had filed a brief in the *Weaver* case and specifically stated the Commission's conclusion that the Weaver CD was not a security.[151] The Commission's Weaver Brief is on all fours with the Supreme Court's holding, but sets out a fuller and more detailed analysis, as discussed immediately below.

3. <u>The Commission's *Weaver* Brief Sets Out the Position that a Financial Product Is Not a Security Where Governmental Regulation, Like State Insurance Regulation, Protects an Owner Against Loss</u>

The Commission explained that the *Weaver* case was important to the Commission, because it was "concerned that the term 'security' not be construed in a way that would call into question the applicability of the securities laws in other contexts."[152] The Commission assured the Supreme Court that its "position" was "consistent with Congressional intent in enacting the federal securities and banking laws."[153]

The Commission went on to state the standard that a financial product should not be deemed to be a security where governmental regulation and supervision substantially eliminate the owner's "risk of loss."[154] The Commission spoke of "risk of loss" in terms of a financial product's "principal and interest."[155] The Commission identified the "risk of loss" as involving the risk of an insurer's insolvency and the more likely day-to-day investment risk that an owner bears even where, as in most cases, the issuer does not become insolvent.

The Commission pointed out the day-to-day protection against investment risk as follows:

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[151] The Supreme Court stated:

> In addition, the Court of Appeals noted that the Securities and Exchange Commission had taken the position that certificates of deposit are securities. However, the SEC has filed a brief as *amicus curiae* in this case, jointly with the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency, which argues that the Weavers' certificate of deposit is not a security.

Weaver, 455 U.S. at 557 n.6.

[152] Commission's Weaver Brief, *supra* note 13, at 2.

[153] *Id.*

[154] *Id*. at 11.

[155] The Commission's Weaver Brief, *supra* note 13, at 14, referred to "a comprehensive scheme of federal regulation that substantially eliminates the risk of non-payment of principal and interest."

> Under the federal bank regulatory scheme [which the Commission equates with regulation of the insurance industry] *almost all phases of the business* of national, state member, and insured state non-member banks are regulated.[156]

The Commission referred to the breadth of protection against investment risk as follows:

> The regulation [of banking, which the Commission equates with the regulation of the insurance industry] extends to all major steps in the establishment and development of a national bank, including not only entry into the business, changes in status, consolidations, reorganizations, but also the most intensive *supervision of operations* through regular examinations.[157]

The Commission cited, as support for its position, the functional analysis laid out by Justice Brennan in his concurring opinion in *VALIC*.[158] The Commission contrasted the roles of federal securities law regulation, on the one hand, and alternative governmental regulatory schemes like state insurance regulation, on the other hand. The Commission indicated that disclosure of material facts was appropriate where offerees had to make an informed investment decision in order to assess an investment risk. But the Commission also indicated that such disclosure was *not* necessary where a governmental regulatory scheme, like the federal banking laws or the state insurance laws, substantially eliminates the risk of loss under the financial instrument.

Specifically, the Commission stated:

> In contrast to the federal securities laws, which through disclosure of material facts enable investors to make an "informed choice" among investments, including an assessment of the risk involved, the regulation of the banking industry, like that of the insurance industry, emphasizes pervasive governmental supervision to substantially eliminate the risk of loss. See *SEC*

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156 *Id.* at 11 (emphasis added).

157 *Id.* at 11 n.14 (quoting K. DAVIS, ADMINISTRATIVE LAW TREATISE § 4.04 at 247 (1958)) (emphasis added). The Commission, at the same page, cited the Supreme Court as stating: "Banking is one of the longest regulated and most closely supervised of public callings." Fahey v. Mallonee, 332 U.S. 245, 250 (1947). The Commission specifically referred to protection for owners against "unfair or deceptive acts or practices" and in rectifying "any 'unsafe or unsound' practice or any violation of 'law, rule, or regulation' through a 'cease and desist order' that may, by 'mandatory' terms or otherwise, require the bank to 'take affirmative action to correct the conditions resulting from any such violation or practice.'" Commission's Weaver Brief, *supra* note 13, at 15.

158 *VALIC*, 359 U.S. at 73. We discuss Justice Brennan's concurring opinion under III.G., *supra*.

> *v. Variable Annuity Life Insurance Company*, 359 U.S. 65, 77 (1959)(Bennan, J. concurring).[159]

The Commission's Proposing Release fails to recognize this statement, much less attempt to explain how the Commission's Proposal is consistent with this statement.

4. The Commission's Brief Sets Out the Position that Redundant Regulation of Financial Products that Serves No Substantial Public Benefit Should Be Avoided

The Commission also emphasized that "redundant regulation that provides no substantial public benefit should be avoided."[160]

The Commission noted that if the Supreme Court found the CD to be a security, the antifraud provisions under the Securities Exchange Act of 1934 would "bring into play the investigative and enforcement authority of the SEC, including its authority to subpoena records, take testimony, and commence enforcement actions seeking disclosure and other injunctive relief."[161]

The Commission spoke out *against* duplicative regulation of financial products, pointing out that application of the federal securities laws "would mean that an industry that already is subject to pervasive regulation to protect depositors would be subject to regulation under another federal scheme."[162]

5. The Supreme Court, as Urged by the Commission, Has Pronounced that an Owner of a Financial Product Bears No Risk of Loss, Even Where an Owner's Investment Is Not Fully Guaranteed

The Supreme Court pronounced that an owner of a financial product bears no risk of loss, even where a governmental regulation scheme guarantees less than 100 percent of the owner's investment. The Supreme Court has emphasized that it is the comprehensiveness of governmental regulation on a normal day-to-day basis,[163] and not simply the amount of any

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159 Commission's Weaver Brief, *supra* note 13, at 11.

160 *Id.* at 25.

161 *Id.*

162 *Id.*

163 The Supreme Court stated as follows:

governmental monetary guarantee in the case of insolvency, that causes an owner of a financial product to bear no risk of loss.

In *Weaver*, the owner held a $50,000 CD[164] that the Federal Deposit Insurance Corporation insured for $40,000.[165] The Supreme Court said that the owner "is virtually guaranteed in full."[166]

The Commission had urged this position on the Supreme Court. The Commission's Brief argued that the owner of a financial product did not bear a risk of loss even where the governmental monetary guarantee was less than 100%. The Commission pronounced that there was no need for 1933 Act disclosure, including disclosure of the investment risk involved, where governmental regulation "substantially"[167] eliminates the owner's risk of loss.

Other courts have followed the principle, pronounced by the Supreme Court at the Commission's urging, that an owner of a financial product bears no risk of loss, even where governmental regulation guarantees less than 100 percent of the owner's investment. A federal district court, in finding that an owner did not bear a risk of loss, has said that there should not be "undue reliance on the existence, or absence, of FDIC insurance."[168] Indeed, another federal

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> Deposits in federally regulated banks are protected by the reserve, reporting, and inspection requirements of the federal banking laws [and] advertising relating to the interest paid on deposits is also regulated.

Weaver, 455 U.S. at 558.

[164] *Id*. at 551.

[165] *Id*. at 553.

[166] *Id*.

[167] The Commission stated:

> In contrast to the federal securities laws, which through disclosure of material facts enable investors to make an "informed choice" among investments, including an assessment of the risk involved, the regulation of the banking industry, like that of the insurance industry, emphasizes pervasive government supervision to *substantially* eliminate the risk of loss.

Commission's Weaver Brief, *supra* note 13, at 11 (emphasis added).

[168] State Farm Bank v. Burke, 445 F. Supp. 2d 207 (D. Conn. 2006). The court said, at 220:

> Further, while the defendant argues that the absence of full FDIC insurance for jumbo CDs compels a determination that such CDs may constitute securities under the Supreme Court's definition in *Marine Bank* [*i.e.*, Weaver] . . . defendant places undue reliance on the existence, or absence, of FDIC insurance.

court found that an owner did not bear a risk of loss, even where state banking regulation was administered in a way that failed to assure that the owner would "ever be paid in full."[169] Both courts referred to the Supreme Court's pronouncement in *Weaver* that it is the existence of a comprehensive regulatory and insurance system governing the issuer, and not solely the protections that apply in the case of insolvency, that causes a financial product not to be a security.[170]

6. <u>The Commission's Proposal Contradicts Commission Statements Made to the Supreme Court and Otherwise</u>

We have been unable to reconcile the Commission's Proposal with the position that the Commission urged on the Supreme Court in *Weaver* and that became the Supreme Court standard. As explained above, the Supreme Court pronounced that, in order for a financial instrument to be a security, the owner must risk loss, and the owner does not risk loss where a governmental regulatory scheme substantially protects the owner, not only during an issuer's insolvency, but also during the more usual situation of the issuer's solvency.

Fixed index annuities are regulated under the full panoply of state insurance law which includes product regulation, marketing regulation and solvency regulation.[171]

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[169] Tafflin v. Levitt, 865 F.2d 595 (4th Cir. 1989). The court said, at 599:

> We recognize of course that in the case of Old Court an others, the Maryland system viewed in hindsight was ineffective. Whether the holders of Old Court's certificates of deposit will ever be paid in full is problematic even though Maryland has required the accumulation of interest thereon to be reduced. But we do not think that *Marine Bank* [*i.e.*, Weaver] depends upon the effectiveness of the regulatory scheme as it may have been administered.

[170] The court, in *Tafflin*, 865 F.2d at 598-599, said:

> We read *Marine Bank* [*i.e.*, Weaver] to hold that the existence of a comprehensive regulatory and insurance system governing the issuer removes certificates of deposit issued by it from the general definition of "securities" contained in the Act.

The court in *State Farm Bank*, 455 F.Supp. at 220, said:

> Thus, while the existence of FDIC insurance was a factor in the Supreme Court's definition of "security," it was not determinative, and partial FDIC insurance is sufficient to exempt a CD from the definition of "security" pursuant to the Supreme Court's decision in *Marine Bank* [*i.e.*, Weaver].

[171] As with other insurance products, fixed index annuities and the issuing insurers, as well as the sales force that sells the annuities, are regulated under the full panoply of state insurance laws and regulations, described under V., *infra*.

Fixed index annuities are backed by state guaranty fund associations.[172] These guaranty fund associations back fixed guarantees under life insurance company products and stand ready to protect owners if insurers fail.

Under these circumstances, statements made in the Commission's Proposing Release to support the Commission's Proposal contradict the Commission's earlier statements made to the Supreme Court, and otherwise. These Commission statements include, for example:

- "Indexed annuities are similar in many ways to mutual funds, variable annuities and other securities." [173]

  Elsewhere, the Commission has said otherwise. The Commission has told[174] the Supreme Court that state insurance law protects owners [of insurance products] against risk of loss in terms of both insolvency risk and investment risk. There is no set of laws that similarly protect owners of mutual funds, variable annuities (to the extent of variable features) and other securities.

- "We believe that individuals who purchase indexed annuities that are more likely than not to provide payments that vary with the performance of securities are exposed to significant investment risks."[175]

  Elsewhere, the Commission has said otherwise. The Commission has told[176] the Supreme Court that owners of financial products bear no risk of loss – and, therefore, do not own securities – where governmental regulatory schemes – including state insurance law – substantially guarantee owners against loss of principal and interest.[177] The Commission's statement about the investment risks of fixed index annuities contradict the Commission's statement to the Supreme Court.

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172 Every state has enacted a guaranty fund law, which requires the payment of the present value of benefits under fixed index annuities. As a condition to obtaining and maintaining a license in each state, insurers are required to become members of the state guaranty fund association in each state in which they seek to do business. We discuss these points in detail under V., *infra*.

173 Commission's Proposing Release, *supra* note 1, at 27.

174 Commission's Weaver Brief, *supra* note 13, at 11.

175 Commission's Proposing Release, *supra* note 1, at 27-28.

176 Commission's Weaver Brief, *supra* note 13, at 11.

177 *See id*.

- "Individuals 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." [178]

  Elsewhere, the Commission has said otherwise. The Commission has said that consumers purchasing fixed index annuities seem to be "seeking to lock in prior gains from stock market investments while retaining some exposure to the market."[179] Therefore, the Commission's reference to the "same risks and rewards contradicts the Commission's statement in its Concept Release regarding fixed index annuities.

- "Indexed annuities are attractive to purchasers because they promise to offer market-related gains. Thus, these purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts."[180]

  Elsewhere, the Commission has said otherwise. The Commission has said that fixed index annuities are "designed to appeal to risk averse consumers who desire to participate in market increases, without sacrificing the guarantees of principal and minimum return offered in traditional fixed annuities."[181] These are not the same reasons that investors buy mutual funds, variable annuities and open brokerage accounts.

- "There is a strong federal interest in providing investors with disclosure, antifraud, and sales practice protections when they are purchasing annuities that are likely to expose them to market volatility and risk." [182]

  Elsewhere, the Commission has said otherwise. The Commission has told the Supreme Court that, where governmental regulatory schemes – including state insurance law – provides for pervasive regulation, redundant regulation that provides no substantial public benefit should be avoided.[183] The Commission's

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[178] Commission's Proposing Release, *supra* note 1, at 6.

[179] Commission's Concept Release, *supra* note 1, at 3.

[180] Commission's Proposing Release, *supra* note 1, at 5.

[181] Commission's Concept Release, *supra* note 1, at 3.

[182] Commission's Proposing Release, *supra* note 1, at 27.

[183] Commission's Weaver Brief, *supra* note 13, at 11.

statement that there is a strong federal interest in providing disclosure contradicts the Commission's statement to the Supreme Court.

- "The presence of protection against loss does not, in itself, transform a security into an insurance or annuity contract."[184]

  Elsewhere, the Commission has said otherwise. The Commission has told the Supreme Court that a financial product is not a security where pervasive governmental supervision substantially eliminates risk of loss.[185] The Commission's statement about protection against loss not transforming a security into an annuity contradicts the Commission's statement to the Supreme Court.

We do not believe that the Commission's stated rationale for its Proposal is consistent with the Commission's statements to the Supreme Court in *Weaver* and the standard that the Supreme Court pronounced in *Weaver.* We respectfully submit that the Commission has an obligation to come forward and articulate the reconciliation. In the absence of such a reconciliation, we believe that the Commission's Proposal is flawed and, arguably, invalid.

V. THE COMMISSION'S PROPOSAL FAILS TO RECOGNIZE THE NATURE AND EXTENT OF EXISTING REGULATION OF FIXED INDEX ANNUITIES UNDER STATE INSURANCE LAW AND CURRENT INITIATIVES TO ENHANCE REGULATORY OVERSIGHT AT THE STATE LEVEL

The Commission's proposal fails to recognize the nature and extent of existing regulation of fixed index annuities under state insurance law, including regulation of the insurers that issue and the producers that market such products, as well as ongoing state level initiatives to enhance regulatory oversight of fixed index annuities. We submit that a better understanding of the existing and developing state insurance law regulatory scheme will demonstrate that:

- Rule 151A is unnecessary – the asserted benefits of Rule 151A are already being met by state insurance regulation; and

- Fixed index annuities are issued by regulated insurance companies which are subject to a comprehensive set of regulations; accordingly, owners of fixed index annuities do not bear a risk of loss that the Supreme Court determined in *Weaver* to be necessary to characterize a financial instrument as a security.

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184 Commission's Proposing Release, *supra* note 1, at 27 n.52.

185 Commission's Weaver Brief, *supra* note 13, at 11.

These two points are discussed, respectively, in Parts V.A. and V.B. below.

A. <u>Rule 151A is Unnecessary – The Asserted Benefits of Rule 151A are Already Being Met by State Insurance Regulation</u>

The Proposing Release gives short shrift to the comprehensive regulatory scheme under state insurance law. Specifically, although the Proposing Release identifies Rule 151A's consumer protections through federal disclosure and sales practices protections as the most important benefits to consumers, the Proposing Release makes no reference whatsoever to the many and varied aspects of state insurance regulation addressing these very topics. Instead, the Proposing Release simply notes that "[s]tate insurance regulation is focused on insurance company solvency and the adequacy of insurers' reserves, with the ultimate purpose of ensuring that insurance companies are financially secure enough to meet their contractual obligations."[186]

While it is true that a primary focus of state insurance regulation is solvency based, it is equally true that state insurance regulation has other primary points of focus, including consumer protections through state regulatory oversight over market practices of insurers and insurance producers. As noted in the very same chapter of the treatise that the Proposing Release cites for the assertion that state insurance regulation is focused on solvency, the treatise also discusses in equivalent detail state insurance regulation's focus on (i) the organization and licensing of insurers, (ii) the regulation of the form and content of insurance policy and contract forms, and (iii) the regulation of insurers' and producers' market practices.[187] Within the realm of market practice regulation, regulators pay particular attention to unfair trade practices (including unfair sales practices such as false advertising, churning, twisting, etc.), disclosure, suitability and supervision, illustrations, producer licensing and training, and consumer complaints.[188]

As will be demonstrated below, Rule 151A does not provide disclosure and sales practice protections that are not currently available to consumers. Indeed, existing laws and current initiatives by the respective states are at least as protective of consumer rights, and in many instances are more protective than would be the case under federal regulation of fixed index annuities. Solely for purposes of brevity, the discussion below will be based primarily on the laws of seven states having the largest level of fixed index annuity sales, which NAFA estimates accounted for more than half of fixed index annuity sales by dollar volume in 2007 (such states, collectively, the "Principal States").[189] The laws of the Principal States are generally

[186] Commission's Proposing Release, *supra* note 1, at 48.

[187] BLACK & SKIPPER, *supra* note 17, at 949-55.

[188] *See generally id.* at 953-55, 277-303.

[189] The seven Principal States are: Arizona, California, Florida, Illinois, New York, Pennsylvania, and Texas.

representative of those of the other states and the District of Columbia. The discussion below also highlights certain other states' laws as well as relevant "Model Laws" and "Model Regulations" published by the National Association of Insurance Commissioners ("NAIC").

1. Proposed Rule 151A Asserts Benefits to Consumers that are Currently Available Under State Insurance Law

As stated in the Proposing Release's "Executive Summary," the primary driver of proposed Rule 151A is the perceived need for a federal consumer protection scheme, primarily through enhanced point-of-sale disclosure as well as through federal sales practice protections:

> As a result [of the fact "that – with few exceptions – index annuities have not been registered as securities"], most purchasers of index annuities have not received the benefits of federally mandated disclosure and sales practice protections.
>
> . . . With respect to these annuities [i.e., the class of index annuities outside the scope of Section 3(a)(8)], investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections.[190]

The Proposing Release contains a "Cost/Benefit Analysis" that elaborates on the full and fair disclosure and sales practices protections to be afforded by Proposed Rule 151A as well as the Proposed Rule's other expected benefits.[191] For ease of analysis, we have grouped the Commission's asserted benefits into four categories:

- Sales Practice Protection;
- Full and Fair Disclosure;
- Consumer Protection and Enforcement;
- Regulatory Efficiency.[192]

As discussed below, state insurance affords equivalent, or greater, benefits to consumers.

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[190] Commission's Proposing Release, *supra* note 1, at 6 (Executive Summary).

[191] *Id.* at 68-74.

[192] The "Benefit" subheadings in the Proposing Release are: Disclosures, Sales Practice Protections, Regulatory Certainty, Enhanced Competition, and Relief from Reporting Obligations. *Id.*

2. State Insurance Law Provides Equivalent, or Greater, Benefits and Other Protections to Consumers

The Proposing Release's benefits analysis wholly ignores the panoply of benefits afforded consumers under the existing state insurance law regulatory scheme. These benefits essentially mirror, and in some aspects exceed, the proposed benefits of Rule 151A. Moreover, state insurance regulation is dynamic and continually evolving to address developments in the insurance industry and marketplace. As fixed index annuities have achieved greater marketplace acceptance in recent years, coupled with the emergence of certain recognized sales practice issues, state regulatory authorities and the NAIC (as well as the insurance industry itself) have undertaken a number of initiatives to more rigorously control sales practices and to enhance disclosure to consumers of fixed annuity products.

The discussion below will compare the four categories of asserted benefits identified above with corresponding aspects of state insurance law that provide similar or greater benefits.

a. State Insurance Law Provides Consumers with Similar, and in Certain Respects Greater, Sales Practice Protection Benefits

The Commission has outlined the "sales practice protection" benefits to be derived from Proposed Rule 151A at pages 71 and 72 of the Proposing Release. There, the Commission asserts that Rule 151A would require persons effecting transactions to be registered as broker-dealers or to become associated persons through a networking arrangement, thereby making broker-dealer sales practice protections applicable to transactions in registered fixed index annuities. Asserted benefits to consumers would be: (i) registered representatives would be obligated to make only recommendations that are suitable; (ii) such registered representatives would be subjected to supervision by a broker-dealer; (iii) both the selling broker-dealers and their registered representatives would be subject to FINRA oversight; and (iv) the broker-dealers would be required to comply with books and records, supervisor and other compliance requirements as well as be subject to the Commission's inspection and enforcement powers.[193] The suitability and supervision benefits are discussed immediately below, while FINRA oversight and broker-dealer recordkeeping and other compliance requirements are discussed in Part V.A.2.c., below.

State insurance laws impose suitability and supervision requirements that are substantially similar to those under the federal securities laws. State insurance law also imposes rigorous producer licensing requirements, including requirements as to education and background checks. Moreover, state insurance law provides a number of other important sales practices protections to consumers, including protections specifically targeted to senior

[193] *Id.* at 71-72.

populations. While it is true that Rule 151A is not specifically focused on sales to seniors, it is also apparent that the Commission was influenced by fixed index annuity sales in the senior market.[194] For the most part, sales practice concerns involving seniors have been predicated on suitability issues (which are discussed in subpart (i) immediately below), although other senior sales issues also exist (which are discussed in subpart (ii) relating to other sales practice protections).

Accordingly, the primary effect of Rule 151A would not be to provide sales practice protections that are currently unavailable to consumers, but instead would be to overlay the federal regulatory scheme on top of an existing, more-comprehensive state insurance law regulatory scheme.

(i) State Insurance Law Imposes Robust Suitability and Supervision Requirements

Suitability in the sale of annuities is an important feature of state insurance law. Generally, state suitability laws require producers (or insurers when no producer is involved) to make a suitability determination in accordance with statutory standards. State suitability laws also require insurers to supervise and exercise oversight over producers acting on their behalf.

The laws of Arizona and Florida are illustrative of state suitability requirements. For example, the Arizona Insurance Code imposes the following suitability requirements on producers (or insurers when no producer is involved):

> A. In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or a series of insurance transactions, the insurance producer, or the insurer if no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to the consumer's investments and other insurance products and as to the consumer's financial situation and needs.
>
> B. Before the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer if no producer is involved, shall make reasonable efforts to obtain information concerning:
>
> 1. The consumer's financial status.
>
> 2. The consumer's tax status.

[194] *See* the discussion in VI.A.2., *infra*.

> 3. The consumer's investment objectives.
>
> 4. Other information considered to be reasonable by the insurance producer, or the insurer if no producer is involved, in making a recommendation to the consumer.
>
> C. Except as provided under subsection D, an insurance producer, or the insurer if no producer is involved, does not have any obligation to a consumer under subsection A related to any recommendation if a consumer either:
>
> 1. Refuses to provide relevant information that is requested by the insurer or insurance producer.
>
> 2. Decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer.
>
> 3. Fails to provide complete or accurate information.
>
> D. An insurer's or insurance producer's recommendation shall be reasonable under all of the circumstances actually known to the insurer or insurance producer at the time of the recommendation.[195]

The current Florida Insurance Code has identical statutory language to the Arizona Insurance Code (quoted above), except that Florida makes its suitability laws expressly applicable to senior consumers, who are defined as any persons 65 years of age or older.[196] In addition, the Florida

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[195] ARIZ. REV. STAT. ANN. § 20-1243.03 (2006). This statute is based on the NAIC's SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION (Model 275) § 1. As to the other Principal States, *see* FLA. STAT. § 627.4554(4) (2004) (substantially similar to Arizona except that suitability law pertains to consumers aged 65 and over; the Florida Statute also has been modified to require producers to make reasonable efforts to obtain substantial additional information as well as complete a suitability form adopted by Florida's Office of Insurance Regulation); ILL. ADMIN. CODE tit. 50, § 3120.50 (2007) (substantially similar to Arizona); TEX. INS. CODE ANN. § 1115.051 (substantially similar to Arizona). In addition, the remaining three Principal States have pending legislation to add suitability requirements to their respective insurance codes. *See* Cal. Senate Bill 573 (9/22/2007) (proposing new section 784.54 of the California Insurance Code, which is substantially similar to Arizona, but which also requires the producer to make reasonable efforts to obtain information concerning the consumer's liquid net worth); NY Assembly Bill I-AB 10002 (2/20/08) (proposing new Section 2137 of the New York Insurance Code, which requires any "advisor" to a senior to have reasonable grounds for believing the sale is suitable for that senior, with suitability to be determined by obtaining certain statutorily prescribed information from the senior that is more comprehensive than the information required under Arizona law); Pa. Senate Bill No. 1307 (3/13/08) (proposing new section 401-B et seq. of the Pennsylvania Insurance Code, which is substantially similar to Arizona).

[196] FLA. STAT. §§ 627.4554(3)(c) & (4)(a)-(d) (and in the event of a joint purchase by more than one party, a purchaser is considered to be a senior consumer if any of the purchasers is age 65 or older).

Legislature recently amended the Florida Insurance Code (effective January 1, 2009) to substantially increase the types of information a producer (or an insurer if no producer is involved) must gather for suitability purposes to include, at a minimum, the following:

> 1. Personal information, including the age and sex of the parties to the annuity and the ages and number of any dependents;
> 2. Tax status of the consumer;
> 3. Investment objectives of the consumer;
> 4. The source of the funds to be used to purchase the annuity;
> 5. The applicant's annual income;
> 6. Intended use of the annuity;
> 7. The applicant's existing assets, including investment holdings;
> 8. The applicant's liquid net worth and liquidity needs;
> 9. The applicant's financial situation and needs;
> 10. The applicant's risk tolerance; and
> 11. Such other information used or considered to be relevant by the insurance agent or insurer in making recommendations to the consumer regarding the purchase or exchange of an annuity contract. This information shall be collected on a form adopted by rule by the department and completed and signed by the applicant and agent . . . .[197]

Also, effective January 1, 2009, the Florida Insurance Code will impose the following additional suitability requirements on producers:

> (d) In addition to the information required by paragraph (b), before the execution of a replacement or exchange of an annuity contract resulting from a recommendation, the insurance agent shall also provide, on a form adopted by rule by the department, information concerning differences between each existing annuity contract and the annuity contract being recommended in order

[197] *Id.* § 627.4554(4)(b) (effective January 1, 2009).

> to determine the suitability of the recommendation and its benefit to the consumer. A true and correct executed copy of this form shall be provided by the agent to the insurer, or the third party that has contracted with such insurer pursuant to subparagraph (f)3., within 10 days after execution of the form, and shall be provided to the consumer no later than the date of delivery of the contract or contracts. The information shall include, at a minimum:
>
> 1. A comparison of the benefits, terms, and limitations between the annuity contracts.
>
> 2. A comparison of any fees and charges between the annuity contracts.
>
> 3. A written basis for the recommended exchange, including the overall advantages and disadvantages to the consumer if the recommendation is followed.
>
> 4. Such other information used or considered to be relevant by the insurance agent or the insurer in making recommendations to the consumer regarding the replacement or exchange of an annuity contract.
>
> (e) Prior to the execution of a purchase or exchange of an annuity contract resulting from a recommendation, an agent shall also disclose to the consumer that such purchase or exchange may have tax consequences and that the applicant should contact his or her tax advisor for more information.[198]

The Arizona Insurance Code also imposes the following statutory requirements on insurers to supervise the suitability practices of producers, with such supervision to include the following:

> A. An insurer shall either assure that a system to supervise recommendations that is reasonably designed to achieve compliance with this article is established and maintained by complying with subsections C, D and E, or establish and maintain such a system. Such a system includes:
>
> 1. Maintaining written procedures.
>
> 2. Conducting periodic reviews of records that are reasonably designed to assist in detecting and preventing violations of this article.

[198] *Id.* § 627.4554(4)(d) & (e) (effective January 1, 2009).

. . .

> C. An insurer may contract with a third party, including a managing general agent or business entity, to establish and maintain a system of supervision as required by subsection A with respect to insurance producers under contract with or employed by the third party.
>
> D. An insurer shall make reasonable inquiry to assure that the third party contracting under subsection C is performing the functions required under subsection A and shall take such action as is reasonable under the circumstances to enforce the contractual obligation to perform the functions. An insurer may comply with the obligation to make reasonable inquiry by doing both of the following:
>
> 1. Annually obtaining a certification from a third party senior manager who has responsibility for the delegated functions that the manager has a reasonable basis to represent, and does represent, that the third party is performing the required functions.[199]
>
> 2. Based on reasonable selection criteria, periodically select third parties contracting under subsection C for a review to determine if the third parties are performing the required functions. The insurer shall perform those procedures to conduct the review that are reasonable under the circumstances. . . .[200]

Again, the Florida Insurance Code contains identical requirements to those of Arizona Insurance Code.[201]

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[199] Under Arizona law: "A person shall not provide a certification under subsection D, paragraph 1 unless both of the following apply: 1. The person is a senior manager with responsibility for the delegated functions [and] 2. The person has a reasonable basis for making the certification." ARIZ. REV. STAT. ANN. § 20-1243.04(H).

[200] *Id.* § 20-1243.04. As to an insurer's supervisory duties under the laws of the other Principal States, *see* FLA. STAT. § 627.4554(4) (substantially similar to Arizona); ILL. ADMIN. CODE tit. 50, § 3120.50 (substantially similar to Arizona); TEX. INS. CODE ANN. § 1115.051 (substantially similar to Arizona); Cal. Senate Bill 573, § 785.54 (proposed statute is substantially similar to Arizona); Pa. Senate Bill No. 1307 (proposed statute is substantially similar to Arizona). The proposed statute in New York does not require insurer supervision of advisors, but does require that consumers receive a 30-day free-look right (60 days when the annuity sale occurs in the consumer's home). NY Assembly Bill I-AB 10002 (2/20/08).

[201] FLA. STAT. § 627.4554(4)(d).

Most states' laws require insurers to maintain "records of the information collected from the consumer and other information used in making the recommendations that were the basis for insurance transactions for at least five years or until the next regular examination by the insurance regulatory authority of its state of domicile, whichever is later, after the insurance transaction is completed by the insurer" and explicitly empower the respective insurance departments to order insurers and producers to take corrective action in the event of a violation of such suitability laws.[202]

In addition to the existing suitability legislation and/or regulations in the respective states, the majority of which are modeled on the NAIC's Suitability in Annuity Transactions Model Regulation (2003), efforts are underway at the NAIC to update the Model Regulation. In June 2008, the NAIC adopted a charge for the Suitability of Annuity Sales (A) Working Group to "review and consider changes to the Suitability in Annuity Transactions Model Regulation to improve the regulation of annuity sales and to provide insurers uniform guidance in developing agent training, supervision and monitoring standards in order to better protect annuity consumers from unsuitable sales and abusive sales and marketing practices."[203] The Working Group has been actively working on this project, and it has also been proactive in obtaining input from the individual states, some of which are currently engaged in enhancing their own suitability requirements.[204]

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[202] ARIZ. REV. STAT. § 20-1243.05-.06. In addition to the power to order insurers and producers to take corrective action, Arizona law (as well as the laws of all other states) grants broad enforcement powers and remedies to the Director for violations of any provision of Arizona's insurance laws. *See* the discussion under V.A.2.c, *infra*. As to the recordkeeping requirement and enforcement powers in the other Principal States, *see* FLA. STAT. § 627.4554(5)-(6) (substantially similar to Arizona); ILL. ADMIN. CODE tit. 50, § 3120.60-.70 (substantially similar to Arizona); TEX. INS. CODE ANN. § 1115.055, .101 & .102(a) (substantially similar to Arizona, but adding additional sanction powers); Cal. Senate Bill 573, § 785.55-.56) (proposed statute is substantially similar to Arizona); Pa. Senate Bill No. 1307 (proposed statute is substantially similar to Arizona). The proposed statute in New York does not require insurer supervision of advisors, but does require that consumers receive a 30-day free-look right (60 days when the annuity sale occurs in the consumer's home). NY Assembly Bill I-AB 10002 (2/20/08)

[203] According to the NAIC:

> This review is prompted, in part, by a letter sent to the NAIC from the Chairman of the Senate Special Committee on Aging, Herb Kohl (D-WI). The letter was sent to the NAIC as a follow-up to a hearing held by the Special Committee in September 2007 on the use of senior designations in the sale of annuities to seniors. In his letter, Chairman Kohl requested that the NAIC conduct a comprehensive review of its suitability standards and, as appropriate, strengthen those standards to address the use of senior designations in connection with the sale of investment products, including annuities, in order to ensure the suitability of annuity sales to seniors.

available at http://www.naic.org/documents/committees_models_suitability.doc.

[204] For example, the Wisconsin Commissioner announced the creation of a special committee ("The Annuity Sales Supervision Advisory Committee") to analyze the annuity sales marketplace for the period of August 1, 2007

State insurance law also provides contract purchasers with "free look" rights, which complement state law suitability protections by affording consumers an additional period of time within which to consider the advisability of their purchase, to contact the insurer or the producer for more information, and to return the contract for a full refund if they ultimately decide the contract is not right for them. California has statutory free look protections that are typical of what the respective states require. Specifically, under California law:

> Every policy of individual life insurance[205] which is initially delivered or issued for delivery in this state on and after January 1, 1990, shall have printed thereon or attached thereto a notice stating that, after receipt of the policy by the owner, the policy may be returned by the owner for cancellation by delivering it or mailing it to the insurer or to the agent through whom it was purchased. The period of time set forth by the insurer for return of the policy by the insured shall be clearly stated on the notice and this period shall be not less than 10 days nor more than 30 days. . . . The account value and policy fee shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy.[206]

California, like many other states, provides for even more expansive free look rights when annuity contracts are sold to seniors (defined as age 60 and over in this statute):

> (a) . . . every individual annuity contract that is initially delivered or issued for delivery to a senior citizen in this state on and after July 1, 2004, shall have printed thereon or attached thereto a notice stating that, after receipt of the policy by the owner, the policy may be returned by the owner for cancellation by delivering it or mailing it to the insurer or agent from whom it was

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through April 30, 2009. The committee's charge is to make recommendations to better protect Wisconsin annuity consumers from unsuitable and abusive sales in the market place. Press Release, Wis. Comm'r of Ins., Annuity Sales Committee Appointed (Aug. 1, 2007). The Alabama Insurance Commission has also recently created an "Annuities Task Force," which will work jointly on investigations of annuity sales, particularly as they apply to the suitability of the products sold to Alabama consumers. Press Release, Ala. Dep't of Ins., State Agencies Create Alabama Annuities Task Force (Apr. 16, 2008).

[205] California law provides that "Life insurance includes insurance upon the lives of persons or appertaining thereto, and the granting, purchasing, or disposing of annuities." CAL. INS. CODE § 101.

[206] CAL. INS. CODE § 10127.9 (West 2008). *See* ARIZ. INS. CODE § 20-1233; FLA. STAT. § 626.99(4)(a); 215 ILL. COMP. STAT. ANN. 5/226(1)(h) (West 2008); N.Y. INS. LAW § 3219(a)(9) (McKinney 2008); 40 PA. STAT. ANN. § 510d(a)(1); *see generally* http://www.tdi.state.tx.us/pubs/consumer/cb078A8.html (Texas Insurance Department website notice stating that "[a]lmost all annuities sold in Texas come with a 10-day 'free look' period, and replacement annuities provide a 30-day free look provision. During this period, you can cancel the contract for any reason and get a full refund. Use this time to reread the contract and make sure it meets your financial needs.").

> purchased. The period of time set forth by the insurer for return of the policy by the owner shall be clearly stated on the notice and this period shall be not less than 30 days. . . .
>
> (c) . . . every individual annuity contract, other than variable contracts and modified guaranteed contracts, subject to this section, that is delivered or issued for delivery in this state shall have the following notice either printed on the cover page or policy jacket in 12-point bold print with one inch of space on all sides or printed on a sticker that is affixed to the cover page or policy jacket:
>
> **"IMPORTANT**
>
> YOU HAVE PURCHASED A LIFE INSURANCE POLICY OR ANNUITY CONTRACT. CAREFULLY REVIEW IT FOR LIMITATIONS.
>
> THIS POLICY MAY BE RETURNED WITHIN 30 DAYS FROM THE DATE YOU RECEIVED IT FOR A FULL REFUND BY RETURNING IT TO THE INSURANCE COMPANY OR AGENT WHO SOLD YOU THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE."[207]

In addition, California and other states have additional free look rights under their respective replacement laws.[208]

State insurance regulation includes state insurance department oversight over insurers' suitability practices through periodic market conduct examinations as well as targeted examinations as the regulators deem necessary.[209] To assist state examiners in performing these examinations, the NAIC publishes a "Market Regulation Handbook." This two-volume set identifies specific areas of inquiry and examination procedures, and the Handbook is updated annually to keep pace with developments in the marketplace. Chapter 19 of the Handbook ("Conducting the Life and Annuity Examination") covers a number of subtopics, one of which is "Marketing and Sales" and identifies twelve "Standards" against which an insurer's regulatory

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[207] CAL. INS. CODE § 10127.9. *See also, e.g.,* ARIZ. INS. CODE § 20-1233.

[208] *See* the discussion of Replacement Laws under V.A.2.a., *infra*.

[209] *See, e.g.,* ARIZ. ADMIN. CODE § R20-6-1701 (2008); CAL. INS. CODE § 730; FLA. STAT. § 624.316; 215 ILL. COMP. STAT. 5/132.3; N.Y. INS. LAW § 309; 40 PA. STAT. ANN. § 323.3; TEX. INS. CODE ANN. §401.052.

compliance on Marketing and Sales are to be measured. Two of these Standards specifically address suitability with regard to (i) the insurer's oversight over producers' suitability practices (Standard 9), and (ii) the insurer's own suitability compliance (Standard 10).

Standard 9 provides as follows: "Insurer rules pertaining to producer requirements in connection with regard to [sic] suitability in annuity transactions are in compliance with applicable statutes, rules and regulations," and sets forth specific examination procedures that include:

- Examine for effectiveness the insurer's system of verifying that, prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer obtained information concerning:
  - The consumer's financial status;
  - The consumer's tax status;
  - The consumer's investment objectives; and
  - Such other information used or considered to be reasonable by the insurance producer, in making recommendations to the consumer.
- Examine for effectiveness the insurer's system of recording or monitoring whether an insurance producer proceeded with a sale that either may have violated the insurer's suitability procedures.
- Examine for effectiveness the insurer's system for review or oversight of sales transactions subject to a suitability requirement in cases where no suitability analysis was performed because the consumer:
  - Refused to provide relevant information requested by the insurance producer;
  - Decided to enter into an insurance transaction that was not based on a recommendation of the insurance producer; or
  - Failed to provide complete or accurate information.
- Review completed annuity transactions and compare the information obtained by the insurance producer to the type of product purchased to determine if the insurance producer had reasonable grounds for believing that the product was suitable on the basis of the facts disclosed by the consumer as to his or her

> investments and other insurance products and as to his or her financial situation and needs.[210]

Standard 10 provides as follows: "Insurer rules pertaining to requirements in connection with suitability in annuity transactions are in compliance with applicable statutes, rules and regulations," and sets forth specific examination procedures that include:

- Determine if the insurer has advised its producers of its suitability policy.
- Determine if the insurer has the capacity to produce data required by the suitability regulation.
- Review policy files to determine that the insurer is retaining required records for required time frames.
- Examine insurer's procedures for verifying producer supervision and compliance with requirements on suitability.
- Examine for effectiveness the insurer or third-party contractor's system of verifying that when recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions, the insurance producer, or the insurer where no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his/her investments and other insurance products and as to his/her financial situation and needs. . . .
- Determine if the insurer or third-party contractor is the supervising party. Verify that a system is established and maintained to supervise recommendations that are reasonably designed to achieve compliance. The system should at a minimum include maintaining written procedures and conducting periodic reviews of its records that are reasonably designed to assist in detecting and preventing violations. . . .[211]

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[210] 2 NAIC MARKET REGULATION HANDBOOK 428-29 (2008).

[211] *Id.* at 431-32. The Handbook also contains detailed examination procedures for instances in which the insurer is using a third-party contractor for suitability review, including provisions relating to the insurer's oversight over any such third-party contractor.

- Review insurer records of corrective action taken in mitigation of apparent violations of suitability standards for sales directly by the insurer and by any insurance procedures who are acting as agents for the entity. . . .[212]

Finally, concurrent with the NAIC's efforts to update the Suitability in Annuity Transactions Model Regulation, the NAIC's Market Regulation and Consumer Affairs (D) Committee has developed, and will soon be presenting to state regulators, an education seminar on annuity "Sales, Suitability and Supervision." The NAIC has been coordinating with FINRA on suitability issues, and senior representatives from FINRA will be among the faculty along with personnel from state insurance and securities departments.[213]

As demonstrated above, there is robust suitability regulation at the state level, including point-of-sale suitability review by producers, supervision by insurers, and regulatory oversight by state insurance regulators. Accordingly, any benefits to be derived from subjecting fixed index annuity sales to federal suitability requirements are, at most, marginal.

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[212] *Id.* at 431-432.

[213] A description of the course content appears on the webpage for the NAIC's Market Regulation and Consumer Affairs (D) Committee, *available at* http://www.naic.org/committees_d.htm., as follows:

> Regulator Only: NAIC Sales, Suitability and Supervision Education Seminar September 24-25, 2008
>
> Suitability and supervision of annuity sales and practices is a key priority of the NAIC and its Life Insurance and Annuities (A) Committee. Join us following the Fall National Meeting in Washington, D.C. for a 1 1/2 day regulator training session to learn more about the activities of this committee and emerging issues in this area, including supervision and monitoring of marketing and sales practices of annuities for seniors, agent training, senior designations, and disclosure requirements.
>
> If you are a state or federal regulator, don't miss this chance to learn more about the many aspects of suitability regulation from both the insurance regulator's and securities regulator's perspective. Insurance commissioners, state securities regulators and senior representatives from FINRA will provide a comprehensive picture of the regulatory treatment of annuities products. The course is eligible for CLE credits.

More generally, the NAIC has created an "Insurance Regulator Professional Designation Program" in response to requests by regulators for a structured professional development path based on the NAIC curriculum. *See* http://www.naic.org/education_designation.htm. This Program's mission is "to provide professional growth opportunities for state insurance regulators at all levels, and to promote improving regulators' knowledge, skills and best practices in the areas of consumer protection, insurer solvency and market conduct regulation." *See* http://www.naic.org/documents/education_designation_policies.pdf.

(ii) State Insurance Law Imposes Significant Other Sales Practices Protections

In addition to sales practice protections relating to suitability and licensing of insurance producers, state insurance law contains an array of other sales practice regulations designed to benefit consumers. Four of the more important protections with regard to the sale of fixed index annuities are (i) laws relating to sales to seniors, (ii) replacement laws, (iii) unfair trade practices laws, and (iv) advertising laws. Also discuss below is an important industry initiative to promote ethical sales practices.

Senior Sales

In recent years, there has been substantial publicity regarding abusive sales practices with respect to senior sales, including fixed index annuities. Likewise, state regulators have been proactive in taking measures to protect the interests of seniors. In addition to the measures being taken by the states as described below, state efforts on suitability (as discussed above) are driving factors in ensuring that sales to seniors are proper. Below are examples from the Principal States of the types of regulatory activity states have been taking in recent years in connection with sales of annuities to seniors:

Arizona – In October 2005, the Arizona Department of Insurance published a consumer alert entitled "10 Things You Should Know About Buying Fixed Deferred Annuities." This was followed in April 2008 by a Department press release entitled "Annuities: Assess Before You Invest," which was accompanied by "Consumer Guide: Annuities for Seniors."[214]

California – Since 1990, the California Insurance Code has contained a series of statutory protections for seniors under an Article of the Insurance Code entitled "Senior Insurance."[215] In June 2006, the Department published a 27 page pamphlet entitled "What Seniors Need to Know About Annuities." The Department has also issued numerous press releases (e.g., October 5, 2007 release entitled "Insurance Commissioner Poizner Announces Senior Issues Task Force, Warns Seniors to Be on the Lookout for Insurance Scams") and has published a "Senior Insurance Bill of Rights" outlining various provisions of California law designed to protect seniors.

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[214] "10 Things You Should Know About Buying Fixed Deferred Annuities," "Annuities: Assess Before You Invest," "Consumer Guide: Annuities for Seniors," Arizona Department of Insurance, *available at* http://www.id.state.az.us/consumerlifehealth.html.

[215] CAL. INS. CODE §§ 785-789.10. Separate statutory sections within this sequence include, among other things: "Conduct of insurers and agents," "Standards for solicitation to senior citizens," "Advertisements: misleading or deceptive practices," and "Unnecessary replacement policies prohibited."

Florida – Florida has published a 38 page consumer brochure entitled "Life Insurance and Annuities – a guide for consumers." In addition, Florida adopted comprehensive legislation on June 30, 2008 to "enhance protections for senior Floridians who are considering the purchase of annuities" and "to give Florida the enforcement power it needs to better protect our vulnerable senior population." Among other things, this law identifies unlawful use of designations implying that a producer is certified or qualified to provide specialized financial advice to seniors, and imposes additional suitability and replacement requirements for annuity sales to seniors.[216] Florida also maintains an "Equity Indexed Annuity Alert" webpage on its Office of Insurance Regulation's website.[217]

Illinois – Illinois regularly issues "News for Seniors" educational publications covering a broad spectrum of issues pertinent to seniors, including publications on topics such as insurance programs, elder abuse, and fraud awareness.[218]

New York – In 2007, New York formed the "New York State Insurance Department Elder Protection Unit," which provides support and protection for the elderly in dealing with insurance and related concerns. Among other things, the Unit will set standards for insurers, agents and brokers in the sale and servicing of insurance products for senior citizens, and when warranted, recommend disciplinary action in the form of monetary fines or revocation of licenses.[219] On May 21, 2008, New York published a Consumer Alert entitled "Consumer Alert: Seniors Beware – Question Credentials of 'Senior Specialist' – Beware of 'Free Lunch' Seminars." A recent New York Insurance Department "Regulatory Agenda" also identifies a number of proposed regulations under development, including a proposal to add a new part to 11 NYCRR to set forth annuity sales standards and procedures to prohibit the sale of unsuitable annuities.[220]

Pennsylvania – Since July 2003, Pennsylvania has published "A Consumer's Guide to Annuities," which among other things, outlines abusive practices consumers should beware of. The Pennsylvania Insurance Department has also created a webpage for

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216 S.B. 2082, 2008 Leg. (June 30, 2008).

217 *See* http://www.fldfs.com/Consumers/annuity_alert.htm.

218 *See* http://www.state.il.us/aging/1news_pubs/news.htm.

219 Press Release, N.Y. Ins. Dep't, Insurance Department Establishes Elder Protection Unit (Sept. 12, 2007), *available at* http://www.ins.state.ny.us/press/2007/p0709121.htm.

220 New York Insurance Department Regulatory Agenda (June 5, 2008) (emphasis on items 27, 36, 37 & 38), *available at* http://www.ins.state.ny.us/r_misc/agenda08jun.pdf.

"Older Pennsylvanians"[221] with links to various other webpages within and outside the Department, including to Consumer Alerts published by the Department (such as an alert entitled "Annuities and Deceptive Sales Practices").

Texas – The Texas Insurance Department has published a series of Consumer Alerts and other publications directed to seniors. Recent publications include a Consumer Alert entitled "Seniors Urged to be Careful with Personal Information," a March 2008 paper entitled "Insurance Fraud" (which among other things, includes a section about "Fraud Against Seniors"), and a May 2008 paper entitled "Understanding Annuities."[222]

These are just a sampling of the state based initiatives pending throughout the United States. In addition, senior based initiatives are underway at the NAIC. In June 2008, the NAIC adopted a Model Bulletin and Consumer Alert to help protect seniors from unscrupulous, abusive sales practices and fraud.[223] The Alert and Bulletin are intended to be used by state insurance departments as a template for bulletins to be issued in their own states.[224] The Model Bulletin cautions insurers and producers against the improper use of senior designations, stating:

- Producers who misrepresent their level of expertise in marketing and sales activities will be subject to penalties under state law.

- Insurers that allow their producers to use misleading designations will also be subject to penalty under state law.[225]

The NAIC then followed this Bulletin with the development of a Model Regulation regarding the use of misleading designations in the sale of insurance. This Model Regulation has been drafted by the NAIC's Life Insurance & Annuities (A) Committee and is modeled after the North American Securities Administrators Association ("NASAA") *"Model Rule on the Use of*

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221 *Available at* http://www.ins.state.pa.us/ins/cwp/view.asp?A=1339&Q=548425.

222 "Seniors Urged to be Careful with Personal Information," "Insurance Fraud," "Understanding Annuities," Texas Department of Insurance, *available at* http://www.tdi.state.tx.us/consumer/documents/cpmseniorinfoalert.pdf and http://www.tdi.state.tx.us/pubs/tdipubs1.html.

223 The NAIC's press release announcing the Model Bulletin and Consumer Alert are available at http://www.naic.org/Releases/2008_docs/senior_sales.htm.

224 For example, this Consumer Alert can be directly accessed from the Pennsylvania Insurance Department's "Older Pennsylvanians" webpage, *available at* http://www.ins.state.pa.us/ins/cwp/view.asp?A=1339&Q=548425.

225 NAIC Seniors Consumer Alert and Bulletin, *available at* http://www.naic.org/documents/committees_bulletins_senior_designations.pdf.

Senior-Specific Certifications and Professional Designations.[226] The Model Regulation is intended to be presented to the NAIC for formal adoption at the NAIC's Fall National Meeting in September 2008.[227]

Replacement Laws

Sales of annuity contracts may involve one annuity contract being exchanged for a new annuity contract, with the account value under the old contract being used to fund all or a portion of the cost of the new contract. To protect consumers against churning, twisting, and other abusive practices that may arise, almost all states have adopted replacement laws. These laws are generally patterned on the NAIC's "Life Insurance and Annuities Replacement Model Regulation," the stated purpose of which is to "regulate the activities of insurers and producers with respect to replacement transactions and to protect the interests of annuity purchasers by assuring that purchasers receive information with which a decision can be made in his or her best interests, reduce the opportunity for misrepresentation and incomplete disclosure, and establish penalties for failure to comply with the replacement requirements."[228]

Each of the Principal States' replacement laws is based on this Model Regulation (other than New York's, which is similar in substance) and imposes the following requirements on insurers and producers involved in replacement transactions:

- At point-of-sale, producers must ascertain whether the applicant has an existing insurance policy or annuity contract, and if so, whether that policy or contract will be replaced. State mandated disclosure documents and replacement forms must be delivered and/or completed.[229]

- Insurers using producers must maintain a system for supervision and control of producers to ensure compliance with the replacement law requirements, including among other things: (i) methods of informing producers of the insurer's replacement requirements to incorporate those requirements into training manuals; (ii) a system to provide each insurance producer with a written statement of the insurer's position on the acceptability of replacements to guide the insurance

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[226] NASAA's Model Rule is available at http://www.nasaa.org/content/Files/Senior_Model_Rule_Adopted.pdf.

[227] An earlier draft (dated July 15, 2008) of the Model Regulation to be presented to the NAIC for formal adoption is available at http://www.naic.org/documents/committees_a_senior_designations.doc.

[228] NAIC LIFE INSURANCE AND ANNUITIES REPLACEMENT MODEL REGULATION (MODEL LAW 631) § 1.

[229] These forms are usually based on sample forms contained in the NAIC Model Regulation. *See id.* at Appendix A, Appendix B & Appendix C.

producer as to the appropriateness of a replacement transaction; (iii) a system to review the appropriateness of each replacement transaction for compliance with the insurer's replacement policy; and (iv) a procedure to detect replacement transactions that have not been reported as such by the applicant or insurance producer. State law also requires insurers to: (v) have the capacity to monitor each producer's replacements for that insurer and be able to produce, on request, and make available to the insurance department for each insurance producer, information and records regarding annuity contract replacements as a percentage of the producer's total annual annuity contract sales and the number of transactions that are unreported replacements of existing policies or contracts detected by the insurer's monitoring system; (vi) comply with statutory records retention requirements; and (vii) ascertain that the sales material and illustrations used in the replacement meet the requirements of the state's replacement law and are complete and accurate for the proposed contract.

- After the insurer who will be issuing the replacement contract receives the application and replacement forms from the producer, the insurer must, among other things: (i) verify that it has received all required forms and that the forms comply with the state's replacement law; (ii) notify any existing insurer that may be affected by the proposed replacement and, within five days of any request from the existing insurer, mail that insurer a copy of available disclosure documents for the proposed contract; and (iii) provide the contract owner a thirty-day free look notice.

- The existing insurer must provide certain notices to the contract owner and is subject to record retention requirements. Likewise, post-issuance, the new insurer is also subject to post-issuance notice to contract owner and record retention requirements.[230]

These laws also provide specific penalties for violation of the replacement law and authorize the insurance commissioner to adopt related rules. Replacement transactions are a specific point of focus in market conduct examinations,[231] and are also regularly the subject of state insurance department or attorney general enforcement actions (see discussion in Part V.A.2.c. below).

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[230] *See* ARIZ. REV. STAT. ANN. § 20-1241 et seq.; CAL. INS. CODE § 10509 et seq.; FLA. ADMIN. CODE ANN. r. 69O-151.001 et seq. (2008); ILL. ADMIN. CODE tit. 50, § 917.20 et seq.; N.Y. COMP. CODES R. & REGS. tit. 11, § 51.1 et seq. (2008) (Regulation 60); 31 PA. CODE § 81.1 et seq. (2008); TEX. INS. CODE ANN. § 1114.001 et seq.; Cal. Senate Bill 573, § 785.54 (proposed statute); Pa. Senate Bill No. 1307 (proposed statute).

[231] *See* 2 NAIC MARKET REGULATION HANDBOOK 416-18 (2008) (Marketing and Sales Standards 2 & 3, specifically relating to replacements).

Unfair Insurance Trade Practices Laws

Every state has laws specifically directed to unfair insurance trade practices. Most of these laws are patterned after the NAIC's Unfair Trade Practices Act, which defines and prohibits fifteen categories of unfair insurance trade practices, including (i) misrepresentations and false advertising, (ii) false information, (iii) unfair discrimination, and (iv) unfair financial planning practices.[232] Specific categories of prohibited conduct may vary between the states (with some states identifying additional categories of prohibited unfair insurance trade practices), but most if not all states' laws contain the core prohibitions against misrepresentations and false advertising, false information, and unfair discrimination. Thus, in California, for example, insurers and producers are subject to sanctions for violating, among other things, the following statutory prohibitions:

- "Making, issuing, circulating, or causing to be made, issued or circulated, any estimate, illustration, circular, or statement misrepresenting the terms of any policy issued or to be issued or the benefits or advantages promised . . . or making any misrepresentation to any policyholder insured in any company for the purpose of inducing or tending to induce the policyholder to lapse, forfeit, or surrender his or her insurance."

- "Making or disseminating or causing to be made or disseminated before the public in this state, in any newspaper or other publication, or any advertising device, or by public outcry or proclamation, or in any other manner or means whatsoever, any statement containing any assertion, representation or statement with respect to the business of insurance or with respect to any person in the conduct of his or her insurance business, which is untrue, deceptive or misleading, and which is known, or which by the exercise of reasonable care should be known, to be untrue, deceptive or misleading."

- "Making or permitting any unfair discrimination between individuals of the same class and equal expectation of life in the rates charged for any contract of life insurance or of life annuity or in the dividends or other benefits payable thereon, or in any other of the terms and conditions of the contract."[233]

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[232] NAIC UNFAIR TRADE PRACTICES ACT (MODEL 880) § 4.

[233] CAL. INS. CODE §§ 790.03 (a), (b) & (d). *See* ARIZ. REV. STAT. §§ 20-443.01, 20-444 & 20-448.01; FLA. STAT. § 626.9541; 215 ILL. COMP. STAT. 5/421; N.Y. INS. LAW § 2402, 2403; 40 PA. STAT. ANN. § 1171.5; TEX. INS. CODE ANN. § 541.001 *et seq*.

Unfair insurance trade practice violations, as well as specific advertising regulations promulgated pursuant to state unfair insurance trade practices laws (discussed immediately below), are also a common area of enforcement activity by state insurance regulators. See discussion in Part V.A.2.c. below.

Annuity Advertising Laws

Another set of state insurance law protections, usually promulgated pursuant to a state's unfair insurance trade practices act (and/or pursuant to an insurance commissioner's general rulemaking authority) are regulations specifically relating to advertising of annuities. These regulations are usually patterned after the NAIC's "Advertisements of Life Insurance and Annuities Model Regulation."[234] As an example, California's Life Insurance Advertisements Regulation, which applies to both life insurance policies and annuity contracts, is adopted pursuant to the Insurance Commissioner's authority under California's "Unfair Practices" law,[235] is patterned on the NAIC's Model Regulation, and is illustrative of the types of specific advertising regulations that a majority of the states have adopted (above and beyond the general prohibitions all states have against misleading and false advertising under their unfair insurance trade practices laws).

The stated purpose of California's advertising regulation is "to set forth minimum standards and guidelines to assure a full and truthful disclosure to the public of all material and relevant information in the advertising of life insurance policies and annuity contracts."[236] This regulation broadly defines the term "Advertisement" to include:

> material designed to create public interest in life insurance or annuities or in an insurer, or to induce the public to purchase, increase, modify, reinstate or retain a policy, including: . . . descriptive literature and sales aids of all kinds issued

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[234] NAIC ADVERTISEMENTS OF LIFE INSURANCE AND ANNUITIES MODEL REGULATION (MODEL LAW 570) § 1 *et. seq*.

[235] CAL. CODE REGS. tit. 10, § 2547 ("These regulations are promulgated pursuant to the authority granted to the Insurance Commissioner under the provisions of Section 790.10 of the Insurance Code.").

[236] CAL. CODE REGS. tit. 10, § 2547.1. *See* FLA. ADMIN. CODE ANN. r. 69O-150.101; ILL. ADMIN. CODE tit. 50, § 909.10; N.Y. COMP. CODES R. & REGS. tit. 11, § 219.1; 28 TEX. ADMIN. CODE § 21.101; *see also* NAIC ADVERTISEMENTS OF LIFE INSURANCE AND ANNUITIES MODEL REGULATION (MODEL LAW 570) § 1.

> by an insurer or agent, including but not limited to circulars, leaflets, booklets, depictions, illustrations and form letters . . . .[237]

Substantive requirements with respect to annuity advertisements under California's advertising regulation include:

- "Every insurer shall establish and at all times maintain a system of control over the content, form and method of dissemination of all advertisements of its policies. All such advertisements, regardless of by whom written, created, designed or presented, shall be the responsibility of the insurer."[238]

- "Advertisements shall be truthful and not misleading in fact or by implication. The form and content of an advertisement of a policy shall be sufficiently complete and clear so as to avoid deception. It shall not have the capacity or tendency to mislead or deceive. Whether an advertisement has the capacity or tendency to mislead or deceive shall be determined by the Insurance Commissioner from the overall impression that the advertisement may be reasonably expected to create upon a person of average education or intelligence within the segment of the public to which it is directed." In addition, "The information required to be disclosed by these regulations shall not be minimized, rendered obscure or presented in an ambiguous fashion or intermingled with the text of the advertisement so as to be confusing or misleading. . . . No advertisement shall omit material information or use words, phrases, statements, references or illustrations if such omission or such use has the capacity, tendency or effect of misleading or deceiving purchasers or prospective purchasers as to the nature or extent of any policy benefit payable, loss covered, premium payable or state or federal tax consequences. The fact that the policy offered is made available to a prospective insured for inspection prior to consummation of the sale, or an offer is made to refund the premium if the purchaser is not satisfied, does not remedy misleading statements."[239]

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[237] CAL. CODE REGS. tit. 10, § 2547.2(c). *See* FLA. ADMIN. CODE ANN. r. 69O-150.103; ILL. ADMIN. CODE tit. 50, § 909.20; N.Y. COMP. CODES R. & REGS. tit. 11, § 219.3; 31 PA. CODE § 51.1; 28 TEX. ADMIN. CODE § 21.101; *see also* NAIC ADVERTISEMENTS OF LIFE INSURANCE AND ANNUITIES MODEL REGULATION (MODEL LAW 570) § 2.

[238] CAL. CODE REGS. tit. 10, § 2547.3(b). *See* ARIZ. ADMIN. CODE § R20-6-201.01; FLA. ADMIN. CODE ANN. r. 69O-150.102; ILL. ADMIN. CODE tit. 50, § 909.30; N.Y. COMP. CODES R. & REGS. tit. 11, § 219.2; 31 PA. CODE § 51.3; 28 TEX. ADMIN. CODE § 21.122; *see also* NAIC ADVERTISEMENTS OF LIFE INSURANCE AND ANNUITIES MODEL REGULATION (MODEL LAW 570) § 3.

[239] CAL. CODE REGS. tit. 10, §§ 2547.4-.5. *See* ARIZ. ADMIN. CODE § R20-6-202(C); FLA. ADMIN. CODE ANN. r. 69O-150.104-.105; ILL. ADMIN. CODE tit. 50, § 909.40-.50; N.Y. COMP. CODES R. & REGS. tit. 11, § 219.4; 31 PA.

- "Each insurer shall maintain at its home or principal office a complete file containing a specimen copy of every printed, published or prepared advertisement of its individual policies and specimen copies of typical printed, published or prepared advertisements of its blanket, franchise and group policies, hereafter disseminated in this State with a notation indicating the manner and extent of distribution and the form number of any policy advertised. Such file shall be subject to inspection by this Department. All such advertisements shall be maintained in said file for a period of either four years or until the filing of the next regular report on examination of the insurer, whichever is the longer period of time." In addition, "Each insurer subject to the provisions of these regulations shall file with this Department with its Annual Statement a certificate of compliance executed by an authorized officer of the insurer wherein it is stated that, to the best of his knowledge, information and belief, the advertisements which were disseminated by or on behalf of the insurer in this State during the preceding statement year, or during the portion of such year when these regulations were in effect, complied or were made to comply in all respects with the provisions of these regulations and the insurance laws of this State as interpreted by these regulations."[240]

Through these annuity-specific advertising regulations and the broader Unfair Trade Practices Act prohibitions on false and misleading advertising, state regulators have significant authority to regulate and enforce insurers' and producers' sales practices with respect to advertising and marketing of fixed index annuities.

Industry Initiatives

In addition to state laws designed to prohibit unfair trade practices generally, and misleading or incomplete advertising specifically, complementary industry-based initiatives also regulate the insurance marketplace under state insurance laws. For example, in 1996, the Insurance Marketplace Standards Association ("IMSA") was formed to strengthen consumer trust and confidence in the life insurance, long-term care insurance and annuity products industry. IMSA is a voluntary, non-profit organization whose members[241] commit to maintain

CODE § 51.21-.22; 28 TEX. ADMIN. CODE § 21.103; *see also* NAIC ADVERTISEMENTS OF LIFE INSURANCE AND ANNUITIES MODEL REGULATION (MODEL LAW 570) §§ 4-5.

[240] CAL. CODE REGS. tit. 10, § 2547.9. *See* ARIZ. ADMIN. CODE § R20-6-201.01; FLA. ADMIN. CODE ANN. r. 69O-150.119; ILL. ADMIN. CODE tit. 50, § 909.90; N.Y. COMP. CODES R. & REGS. tit. 11, § 219.5; 31 PA. CODE § 51.4; 28 TEX. ADMIN. CODE § 21.116; *see also* NAIC ADVERTISEMENTS OF LIFE INSURANCE AND ANNUITIES MODEL REGULATION (MODEL LAW 570) § 9.

[241] "Members" are insurance companies who have applied for IMSA membership and have successfully met IMSA's qualification requirements. IMSA qualification is a two-step process:

high ethical standards and to be fair, honest and open in the way they advertise, sell and service their individually sold products.[242] Each IMSA member commits itself to the following standards in all matters affecting the sale of individually-sold life, annuity, and long-term care products:

1. To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.

2. To provide competent and customer-focused sales and service.

3. To engage in active and fair competition.

4. To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.

5. To provide for fair and expeditious handling of customer complaints and disputes.

> Step 1. The company conducts a self-assessment by comparing its current policies and procedures to IMSA standards (found within the Elements of Compliance chapter of the IMSA Assessment Handbook). In order to comply with IMSA standards, the company may establish new policies and procedures and/or make modifications to current policies and procedures, as appropriate. Once the company concludes that it can demonstrate compliance with IMSA standards, it moves to the next stage.
>
> Step 2. A Qualified Independent Assessor, selected from a list of IMSA-approved Qualified Independent Assessors, reviews the company's self-assessment evidence and performs an independent assessment to evaluate whether there is a reasonable basis for the company's determination that it has complied with IMSA standards.
>
> Satisfactory conclusion of the two-step assessment process will allow IMSA, upon the company's completion of the application process, to confer membership in IMSA for a period of three years. However, if the company experiences i) material organizational changes, ii) acquisitions and/or iii) market conduct problems or adverse regulatory activity during the membership period, these events may require additional interim assessments. During the three-year membership period, members are encouraged to review, modify and improve their market conduct practices consistent with IMSA's "continuous improvement" concept. At the end of the three-year period, members must repeat both the self and independent assessments to renew their IMSA qualification.
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> Companies seeking membership may become "individual" or "fleet" members. "Individual" denotes a single company seeking membership whereas "fleet" signifies a holding company or group of related companies.

IMSA Membership Process, http://www.imsaethics.org/Content/MembershipProcess_42.aspx.

[242] *See generally* IMSA website, http://www.imsaethics.org/.

6. To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles of Ethical Market Conduct. [243]

In addition, IMSA has published Consumer Guides for various products, including annuities. The IMSA Consumer Guide for Annuities discusses the various types of annuities (including fixed index annuities) and product features that are available, provides tips to follow when considering the purchase of an annuity, and provides links to the following other sources of information about annuities: AARP, the federal government's Consumer Information Center, the NAIC, and the ACLI.[244]

(iii) State Insurance Law Contains a Comprehensive Producer Licensing Scheme

The Proposing Release's asserted benefits of having sales made through licensed broker-dealers are also duplicative of protections already existing under state insurance law. Producer licensing and oversight have been important features of state insurance regulation for decades. Each of the states has comprehensive producer licensing laws, with significant uniformity between the states due to the efforts of the NAIC (as mandated by certain provisions of the Gramm-Leach-Bliley Act (the "GLBA")). Among other things, the NAIC has promulgated a Producer Licensing Model Act (the "PLMA").[245]

For example, Florida's producer licensing laws are based on the PLMA, and are illustrative of the laws existing throughout the country. Under such laws, individuals and entities are prohibited from selling, soliciting, or negotiating insurance without a license.[246] These statutes contain specific requirements for persons seeking a license as well as for those who have achieved licensure, including, for example, the following requirements:

- Each individual applicant must pass a written examination that tests the knowledge of the individual concerning the lines of authority for which application is made as

[243] *See* IMSA website "FAQ's," http://www.imsaethics.org/Content/FAQs_47.aspx.

[244] IMSA's "A Consumer's Guide to Annuities" is available at http://www.imsaethics.org/util/showdoc.aspx?doc=4.

[245] NAIC PRODUCER LICENSING MODEL ACT (MODEL LAW 218) § 1 *et seq*.

[246] FLA. STAT. § 626.112(1)(a). *See* ARIZ. REV. STAT. ANN. § 20-282; CAL. INS. CODE § 1631; 215 ILL. COMP. STAT. 5/500-15; N.Y. INS. LAW § 2102 (basing licensing requirements on solicitation of insurance); 40 PA. STAT. ANN. § 310.3; TEX. INS. CODE ANN. § 4001.101; *see also* NAIC PRODUCER LICENSING MODEL ACT (MODEL LAW 218) § 3.

well as the duties and responsibilities of an insurance producer under applicable insurance laws and regulations.[247]

- Applications shall be made upon prescribed forms, and each applicant is required to provide "such other or additional information as the department may deem proper to enable it to determine the character, experience, ability, and other qualifications of the applicant," including fingerprint cards."[248]

Some individual states have gone beyond these requirements. For example, California requires eight hours of annuity training prior to selling annuities and an additional four hours of continuing annuity education every two years[249] and in Florida, effective January 1, 2009, specific training in suitability will be required as part of its licensing regimen.[250]

The respective states also impose ongoing requirements upon licensed producers, including requirements that producers maintain records and make them available for Insurance Department inspection,[251] and license renewal requirements.[252] The majority of states also subject producers to continuing education as part of the license renewal process.[253]

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247 FLA. STAT. § 626.221. *See* ARIZ. REV. STAT. ANN. § 20-284; CAL. INS. CODE §1666; 215 ILL. COMP. STAT. 5/500-25; N.Y. INS. LAW § 2103(f)(1); 40 PA. STAT. ANN. §310.4; TEX. INS. CODE ANN. § 4001.105; *see also* NAIC PRODUCER LICENSING MODEL ACT (MODEL LAW 218) §5

248 FLA. STAT. §§ 626.161-.171. *See* ARIZ. REV. STAT. ANN. § 20-285; CAL. INS. CODE § 1668; 215 ILL. COMP. STAT. 5/500-30; N.Y. INS. LAW § 2103(f); 40 PA. STAT. ANN. § 310.6; TEX. INS. CODE ANN. § 4001.105; *see also* NAIC PRODUCER LICENSING MODEL ACT (MODEL LAW 218) § 6.

249 CAL. INS. CODE § 1749.8.

250 On June 30, 2008, Florida adopted a number of changes to the Florida Insurance Code to "enhance protections for senior Floridians who are considering the purchase of annuities." Press Release, Fla. Office of Ins. Regulation (July 1, 2008), *available at* http://www.floir.com/pressreleases/viewmediarelease.aspx?id=2959. Those changes include the addition of the following requirement to Section 626.2815 of the Florida Insurance Code: "Any person who holds a license to solicit or sell life insurance in this state must complete a minimum of 3 hours in continuing education, approved by the department, on the subject of suitability in annuity and life insurance transactions."

251 FLA. STAT. § 626.561. *See* ARIZ. REV. STAT. ANN. § 20-290; CAL. INS. CODE § 1727; ILL. ADMIN. CODE tit. 50, § 3113.50; N.Y. COMP. CODES R. & REGS. tit. 11, § 20.4; 28 TEX. ADMIN. CODE § 19.1013.

252 FLA. STAT. § 626.381. *See* ARIZ. REV. STAT. ANN. § 20-289; CAL. INS. CODE § 1718; 215 ILL. COMP. STAT. 5/500-35; N.Y. INS. LAW § 2103(j)(2); 40 PA. STAT. ANN. § 310.8; TEX. INS. CODE ANN. § 4003.001-.004; *see also* NAIC PRODUCER LICENSING MODEL ACT (MODEL LAW 218) § 7.

253 *See* ARIZ. REV. STAT. ANN. § 20-2902; CAL. INS. CODE § 1749.33; FLA. ADMIN. CODE ANN. r. 69O-228.220; ILL. ADMIN. CODE tit. 50, § 3119.45; N.Y. INS. LAW § 2132; 31 PA. CODE § 39.8; TEX. INS. CODE ANN. § 4004.053.

To further assist the states in the administration of their respective licensing programs, the NAIC is in the process of publishing a "State Licensing Handbook." This Handbook is currently under active development, and it is anticipated that the final version of the Handbook will be approved by the NAIC and published before year-end.[254]

Finally, producer licensing is one of the topics that state market conduct examiners focus upon when performing market conduct examinations. The Market Regulation Handbook contains an entire section on Producer Licensing standards,[255] and in addition to outlining Standards and associated review procedures relating to verifying that all producers are properly licensed and appointed, the Market Regulation Handbook addresses terminations of producers, including insurer compliance with termination notices to the states.[256] The respective states are also very active in policing against unlicensed persons engaged in the sale, solicitation, or negotiation of insurance as well as abusive sales practices by such persons. See discussion in Part V.A.2.c. below.

Thus, there is robust producer licensing regulation at the state level, including education, testing and background requirements for producers, appointment and termination requirements for insurers, and regulatory oversight by state insurance regulators. Accordingly, any benefits from requiring sales of fixed index annuities through broker-dealers are, at most, marginal in light of existing state regulation.

b. State Insurance Regulation Provides Consumers with Similar, and in Certain Respects Greater, Disclosure Benefits

The Commission has outlined the "disclosure" benefits to be derived from Rule 151A at pages 69 through 71 of the Proposing Release. There, the Commission asserts that Rule 151A would extend the benefits of full and fair disclosure under the federal securities laws to purchasers of fixed index annuities. According to the Proposing Release, without federally mandated disclosures, investors face significant obstacles in making informed investment decisions and that "[e]xtending the federal securities disclosure regime to such index annuities

[254] An NAIC memorandum dated August 8, 2008 outlining the status of the handbook is available at http://www.naic.org/documents/committees_d_plwg_080811_memo_SPLHIII.pdf. The latest draft (8/8/08) of the Handbook is available at http://www.naic.org/documents/committees_d_plwg_080811_SLH_draftIII.pdf.

[255] 1 NAIC MARKET REGULATION HANDBOOK 256-66 (2008).

[256] 1 NAIC MARKET REGULATION HANDBOOK 261-62 (2008). Importantly, license terminations are reported into a central "National Insurance Producer Registry" ("NIPR") database, which is accessible by all state regulators. *See id.* at 262.

that impose securities investment risk should help to provide investors with the information they need."[257] According to the Proposing Release, required disclosures would include:

- Information about costs, such as surrender charges;
- Method of computing index return, e.g. applicable index, method for determining change in index, caps, participation rates, spreads;
- Minimum guarantees, as well as guarantees (or lack thereof) with respect to the method for computing index return; and
- Benefits (lump sum, as well as annuity and death benefits).[258]

The specific types of disclosures referenced in the Proposing Release are already mandated under state insurance law through requirements relating to: (i) policy content (e.g., charges and other deductions must be specified in the contract), (ii) contract readability, (iii) "Buyers Guides" or other disclosures that must be made in connection with the sale of annuities, and (iv) prohibitions against misrepresentations and omissions. In addition, state law provides for regulatory oversight and enforcement of the foregoing requirements. Thus, the primary effect of Rule 151A would not be to provide disclosures or protections against misleading and/or incomplete disclosures that are currently unavailable to consumers, but instead would be to overlay the federal enforcement scheme on top of an existing state insurance law enforcement scheme.

(i) State Insurance Law Requires Full and Fair Disclosure

The specific types of disclosures referenced in the Proposing Release are already mandated under state insurance law through requirements relating to policy content (*e.g.*, charges and other deductions must be specified in the contract; readability, etc.) and under advertising, disclosure, and/or "Buyer's Guides" requirements.

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257 Commission's Proposing Release, *supra* note 1, at 69-70.

258 *Id.* at 70. The Proposing Release also goes on to state that: (i) by having disclosure publicly available through EDGAR, investors would have an "enhance[d] ability to compare various index annuities and also to compare index annuities with mutual funds, variable annuities, and other securities and financial products"; and (ii) lack of registration would also signal to investors an insurer's determination that investors would not receive more than guaranteed amounts at least half the time. *Id.* at 70-71.

Contract Content Requirements

The insurance laws of every state require the filing of policy and contract forms with the state insurance regulator. The statutory requirements for forms filings under Arizona law are, in substance, typical of what the respective states require:

> Any life or disability insurance policy form, life or disability insurance application form where written application is required and is to be made a part of the policy and printed rider or endorsement form, shall not be delivered or issued for delivery in this state by a life or disability insurer unless it has been filed with and approved by the director.[259]
>
> A. The director shall disapprove any form of policy, application, rider or endorsement or withdraw any previous approval thereof only:
>
> 1. If it is in any respect in violation of or does not comply with this title.
>
> 2. If it contains or incorporates by reference any inconsistent, ambiguous or misleading clauses, or exceptions and conditions which deceptively affect the risk purported to be assumed in the general coverage of the contract.
>
> 3. If it has any title, heading or other indication of its provisions which is misleading.
>
> 4. If the purchase of such policy is being solicited by false, deceptive or misleading advertising matter, sales material or representations. . . .[260]

All of the Principal States require that all annuity contracts contain certain specific provisions, such as provisions regarding "free-look" periods,[261] grace periods, incontestability, an "entire contract" clause and the like.[262] In addition, these states impose readability requirements.[263]

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[259] ARIZ. REV. STAT. ANN. § 20-1110. *See* CAL. INS. CODE § 10168.93; FLA. STAT. § 627.410; 215 ILL. COMP. STAT. 5/143; N.Y. INS. LAW § 3201; 40 PA. STAT. ANN. § 477b; TEX. INS. CODE ANN. § 1701.051.

[260] ARIZ. REV. STAT. ANN. § 20-1111. *See* FLA. STAT. § 627.411; 215 ILL. COMP. STAT. 5/143; N.Y. INS. LAW § 3201; TEX. INS. CODE ANN. § 1701.055.

[261] State insurance law free look requirements are discussed under V.A.2.a., *supra*.

Most states require insurers to submit product specific filing checklists with their contract filings. These checklists detail specific requirements a product filing must meet, and often require the insurer to certify that the contract meets all such requirements. For example, Arizona is typical, with its "Review Requirement Checklist" for "Annuities" identifying numerous applicable provisions of the Arizona Insurance Code and Insurance Regulations. Arizona's checklist also identifies certain unpublished requirements of the Department, including a number of specific unpublished requirements relating to "Equity Indexed Policies," such as requirements that the index must be approved by the Arizona Department of Insurance, any index change must be approved by the Department, and that the Department must be provided with an explanation as to how the insurer will support the product if the index gains exceed those of the insurer's general account.[264]

In addition, some states publish detailed filing guidelines in addition to their checklists. For example, New York's guidelines for Fixed Deferred Annuity Contracts are 27 pages long and include the following specific contract requirements:

- The current and the guaranteed minimum interest rates must appear in the contract.
- The guaranteed maximum expense charges and surrender charges, including the withdrawal charge and market-value adjustment, if applicable, must be specified.
- The contract must describe the guaranteed benefits, with sufficient detail to determine such benefits, including (i) Minimum Paid-Up Annuity Benefit (The mortality and interest basis for guaranteed purchase rates used in the minimum

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[262] ARIZ. REV. STAT. ANN. §§ 20-1218 *et seq.* *See* CAL. INS. CODE § 10113 *et seq.*; FLA. STAT. § 627.464 *et seq.*; 215 ILL. COMP. STAT. 5/226; N.Y. INS. LAW § 3219; 40 PA. STAT. ANN. §510a; TEX. INS. CODE ANN. § 1101.001 *et. seq.*

[263] ARIZ. REV. STAT. ANN. §§ 20-1110.01 (authorizing Director to enact readability regulations) and ARIZ. ADMIN. CODE § R20-6-213 (readability regulations). *See* FLA. STAT. § 627.4145; N.Y. INS. LAW § 3102; 31 PA. CODE § 89b.11; 28 TEX. ADMIN. CODE § 3.6.

[264] Arizona Review Requirements Checklist for Annuities, available on the Department's website at http://www.id.state.az.us/insforms.html#section_six. *See also* Florida Individual Non-Variable Annuity Checklist, *available at* http://floir.com/pdf/OIR-B2-1352.pdf; Illinois Equity Indexed Annuities Checklist, *available at* http://www.idfpr.com/doi/LAH_HMO_IS3_Checklists/Equity_indexed_annuities.htm; New York Individual Fixed Deferred Annuity Contracts Checklist, *available at* http://www.ins.state.ny.us/acrobat/ifdach3.pdf; Pennsylvania Individual Flexible/Single/Fixed Premium Deferred Fixed Annuity, *available at* http://www.ins.state.pa.us/ins/lib/ins/rates/checklists/Ind_Flex_Deferred_Fixed_Annuity_092006.xls; Texas Individual and Deferred Group Annuity Checklist, *available at* http://www.tdi.state.tx.us/forms/lhlifehealth/lhl321iligda1.pdf; Texas Equity Indexed Annuity Checklist, *available at* http://www.tdi.state.tx.us/forms/lhlifehealth/lhl318ileina.pdf.

> paid-up annuity benefit must be stated in the policy.); (ii) Cash Surrender Benefit; and (iii) Death Benefit. The contract must also specify the times at which guaranteed benefits are payable and provide sufficient information to determine the amounts of such benefits.[265]

Moreover, some states are also beginning to provide supplemental specific guidance for index annuity filings, with New York's supplemental guidance including the following contract content requirements:

- The product must comply with all the usual nonforfeiture requirements associated with the particular product.

- The equity-index is readily available from published sources and is identified in the policy.

- There may be no loss of value in the product solely based on changes in the equity-index.

- The contract must describe how the equity-index is used to determine the equity-index accumulation amount, including any limitation on the portion of the change in the equity-index that is reflected in the equity-index accumulation amount.

- If there are limitations on the portion of a positive change in the equity-index that is reflected in the product value then such limitations must either be: (i) guaranteed for the entire period of the equity-index is in effect; or (ii) subject to periodic change where such change: (a) occurs no more frequently than annually; (b) is subject to minimums stated in the product for the entire period of time that the equity-index is in effect; and (c) any limitations that allow for increases in the portion of the product's value based on the equity-index accumulation amount above the stated minimums in the contract are considered additional amounts within the meaning of section four thousand two hundred thirty-two of the Insurance Law and are subject to all conditions and requirements thereto.[266]

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[265] New York's "Individual Fixed Deferred Annuity" filing guidelines, *available at* http://www.ins.state.ny.us/acrobat/ifdaout3.pdf (last updated 4/30/02). *See also* New York's "Individual Fixed Deferred Annuity Contracts Checklist," *available at* http://www.ins.state.ny.us/acrobat/ifdach3.pdf (last updated 4/30/02).

[266] *See, e.g.,* the New York Insurance Department's "Guidance on Equity Index Products, *available at* http://www.ins.state.ny.us/acrobat/20071031.pdf (October, 31, 2007).

The NAIC has developed an ambitious "speed-to-market" initiative for product filings and approvals, which is managed by the NAIC and the Interstate Insurance Product Regulation Commission ("IIPRC" and sometimes colloquially referred to as the "Interstate Compact" or the "Compact").[267] The Compact allows an insurer to file a policy form with the IIPRC, and upon approval of that form, the insurer is authorized to offer that product in all Compact states (currently 33 states). As part of the Compact process, the NAIC establishes substantive guidelines, on a product by product (contract standards) and feature by feature (feature standards) basis, that must be met as a condition to submitting a product for approval through the IIPRC (or, in the case of a feature standard, if that type of feature is included within the contract filing). These guidelines are based upon similar guidelines used by the respective states.

The contract language and disclosure requirements that must be followed for submissions through the Interstate Compact include the types of disclosures summarized above for New York, and thus mirror the types of disclosure benefits to consumers that the Proposing

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[267] Following is a recent IIPRC press release summarizing the status of the speed-to-market initiative, *available at* http://www.insurancecompact.org/releases/100th_product_mileston.htm.

> WASHINGTON, D.C. (Aug. 20, 2008) — The Interstate Insurance Product Regulation Commission (IIPRC) hit a milestone earlier this month, when it approved its 100th life insurance product.
>
> As a successful state-based initiative to modernize insurance product regulation, the IIPRC reviews and approves products using its new national standards and speed-to-market, centralized processes for the 33 members of the Insurance Compact.
>
> Representing more than one-half of premium volume across the country, the IIPRC provides a uniform regulatory platform that allows insurers to get new products to the market quickly, while continuing to uphold strong consumer protections through state-based regulation. With operations launched little more than one year ago, the IIPRC has already hit a significant milestone by approving 100 life insurance products.
>
> "The states are proactively responding to the changing financial marketplace by instituting new and modern regulatory mechanisms that promote a vibrant insurance sector, while continuing to ensure that consumers are protected," said IIPRC Management Committee Chair and West Virginia Insurance Commissioner Jane Cline. "This is only the beginning. As we promulgate more national standards, filings through the IIPRC's streamlined process will surely increase."
>
> With a team of highly experienced professionals, the IIPRC reviews asset-type insurance products, including life, annuity, disability-income and long-term care insurance products. Using one set of standards, products are reviewed and approved for sale in less than 60 days.
>
> "The Compacting states are providing the state-of-the art electronic filing platform for insurers to make one filing for approval that is valid in all member jurisdictions," said Oklahoma Insurance Commissioner Kim Holland, who chairs the IIPRC Communications Committee. "By getting more sound and cost-effective products to the market nationally, we are ensuring that consumers have choice and protection in our markets. We hope these efforts will make the IIPRC an insurer's filing venue of choice."

Release asserts will result from Rule 151A. Of particular relevance to the proposed Rule 151A are contract standards the IIPRC adopted on May 30, 2008 for Individual Deferred Non-Variable Annuity Contracts as well as feature specific standards for fixed index annuities. The IIPRC's "Individual Deferred Non-Variable Annuity Contract Standards" impose an array of substantive requirements, such as disclosure of all charges and contract readability requirements.[268] The IIPRC's standards for "Index-Linked Crediting Feature For Deferred Non-Variable Annuities" also contain substantive requirements for fixed index annuities, such as disclosure of which elements are guaranteed and which may be changed at the insurer's discretion.[269] Other related feature standards are currently under development by the NAIC, such as for bonuses paid in connection with the sale of deferred annuities.

<u>Annuity Advertising and Buyers Guide Content Requirements</u>

In addition to the requirements under state insurance law that annuity contracts contain certain provisions and that such contracts must be readable, a growing number of states are also requiring that Buyer's Guides or other disclosure materials be delivered to consumers at point of sale. For example, under Arizona's "Annuity Disclosure" statute, if an application for an annuity is taken in a face-to-face meeting, then at or prior to the taking of the application, the applicant must be given both a disclosure document and a buyer's guide in a form prescribed by the Director.[270] Arizona law requires, at a minimum, the following information in the disclosure document:

> 3. A description of the contract and its benefits, emphasizing its long-term nature and including examples where appropriate.
>
> 4. The guaranteed, nonguaranteed and determinable elements of the contract, their limitations, if any, and an explanation of how they operate.
>
> 5. An explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed.

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[268] The IIPRC's "Individual Deferred Non-Variable Annuity Contract Standards" are available at http://www.insurancecompact.org/rulemaking_records/080530_ind_def_nonvar.pdf.

[269] The IIPRC's standards for "Index-Linked Crediting Feature For Deferred Non-Variable Annuities" are available at http://www.insurancecompact.org/rulemaking_records/080530_index_linked_crediting.pdf.

[270] ARIZ. REV. STAT. ANN. § 20-1242.02.A. (and prescribing alternative delivery procedures for other than face-to-face meetings, such as direct solicitations and internet transactions). *See* CAL. INS. CODE § 10509.975.; FLA. STAT. § 626.99; N.Y. INS. LAW § 3209.

> 6. The periodic income options both on a guaranteed and nonguaranteed basis.
>
> 7. Any value reductions caused by withdrawals from or surrender of the contract.
>
> 8. How values in the contract can be accessed.
>
> 9. The death benefit, if available, and how it will be calculated.
>
> 10. A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract. . . .
>
> 12. The specific dollar amount or percentage charges. Fees shall be listed with an explanation of how they apply.
>
> 13. Information about the current guaranteed rate for new contracts that contains a clear notice that the rate is subject to change.[271]

For the Buyer's Guide, the Director requires the use of the form developed by the NAIC under its Annuity Disclosure Model Regulation.[272] The Buyer's Guide included as an appendix to the NAIC Model Regulation generically explains the different types of annuities available, certain important features consumers should focus on (*e.g.*, amounts to be credited and types of charges that may be deducted, contract benefits, and other features), items to consider in determining whether a fixed deferred annuity is right for the consumer, and questions the consumer should ask of the agent or insurer.[273]

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[271] ARIZ. REV. STAT. ANN. § 20-1242.02.G. *See* N.Y. INS. LAW § 3209(d).

[272] ARIZ. ADMIN. CODE § R20-6-212.01 ("For the purpose of meeting the requirements of A.R.S. Section 20-1242.02 regarding a Buyer's Guide: Annuity Disclosure Model Regulation, Appendix - Buyer's Guide to Fixed Deferred Annuities, Volume II, pp. 245-6 through 245-13, 1999, with attached Appendix I - Equity-Indexed Annuities, Volume II, pp. 245-14 through 245-20, 1999."). There is a current initiative underway within the NAIC to amend this Model Regulation. Specifically, in June 2006, an NAIC working group was formed to draft an amendment to the Model Regulation, which amendment would substantially rewrite the "Buyer's Guide" to present more detailed explanations and comparisons of the various types of annuity contracts available in today's marketplace (including fixed index annuities), including explanations of their unique features. The NAIC working group's latest published draft of the amended Buyer's Guide update (draft dated July 15, 2008) is available on the NAIC's website at http://www.naic.org/documents/committees_a_appendixA.doc.

[273] NAIC ANNUITY DISCLOSURE MODEL REGULATION (MODEL LAW 245) at Appendix A.

Iowa, the state of domicile of insurers writing a significant volume of fixed index annuities, has also been one of the leading states in seeking to improve fixed index annuity disclosures (as well as other initiatives relating to fixed annuity products[274]). In early 2008, the Iowa Insurance Department, in conjunction with the ACLI, agreed to participate in a joint initiative designed to ensure that consumers receive adequate information before they purchase fixed index and non-index annuity contracts. The standards for the information are based on the communication of accurate and proper information in a consumer-friendly format. This initiative is also designed to guide insurers preparing the disclosures required by the NAIC's Annuity Disclosure Model Regulation to prepare and disclose information in a more uniform manner, which will assist consumers when comparing fixed annuity products. [275]

(ii) State Insurance Law Includes Strong Oversight Mechanisms to Ensure Full and Fair Disclosure Requirements

State insurance law provides for regulatory oversight over the contract and other disclosure requirements outlined immediately above, as well as the prohibitions against misleading or incomplete disclosures under state laws relating to unfair trade practices and life insurance and annuity advertising (see Parts V.A.2.a.(ii) and V.A.2.b.(i), above). As noted above, some of the oversight is exerted at the point contracts are developed through product content and approval requirements. However, state insurance regulators also review insurers' advertising and disclosure documents during market conduct examinations.

The NAIC's Market Regulation Handbook contains two "Marketing and Sales" Standards of particular relevance to disclosure made in connection with fixed index annuities (Standard 1 and Standard 11).

Standard 1, which requires that "All advertising and sales materials are in compliance with applicable statutes, rules and regulations," recommends, among other things, the following examination procedures:

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[274] In addition to annuity disclosure initiatives, Iowa has been at the forefront of other related disclosure and sales practice consumer protection efforts, including efforts to set limitations on illustrations used in the sales of fixed annuity products (Iowa Ins. Dep't Bulletin 07-05, *available at* http://www.iid.state.ia.us/docs/bull0807.pdf) and to curtail the improper use of certain designations and titles targeting senior purchasers (Iowa Ins. Dep't Bulletin 07-05, *available at* http://www.iid.state.ia.us/docs/bull0705.pdf).

[275] *See* Press Release, Iowa Ins. Dep't (Feb. 4, 2008), http://www.iid.state.ia.us/docs/press020408.pdf (announcing the initiative); *and* Iowa Ins. Dep't Bulletin 08-01, *available at* http://www.iid.state.ia.us/docs/bull0801.pdf (relating to Iowa's disclosure pilot program). An important part of the disclosure initiative is the use of disclosure "templates" prepared by the ACLI for fixed index annuities available at http://www.iid.state.ia.us/news_media/aclisampleindexedannuitydisclosure.pdf and for fixed non-index annuities available at http://www.iid.state.ia.us/news_media/aclisamplefixedannuitydisclosure.pdf.

- Review advertising materials in conjunction with the appropriate policy form.

- Materials should *not*:

  - Misrepresent policy benefits, advantages or conditions by failing to disclose limitations, exclusions, or use terms or expressions that are misleading or ambiguous;

  - Make unfair or incomplete comparisons with other policies;

  - Make false, deceptive or misleading statements or representations with respect to any person, company or organization in the conduct of insurance business;

  - Omit material information or use words, phrases, statements, references or illustrations, if such omissions or such use has the capacity, tendency or effect of misleading or deceiving purchasers or prospective purchasers as to the nature or extent of any policy payable, loss covered, premium payable, or state or federal tax consequences; and

  - Offer a policy that utilizes a reduced initial premium rate in a manner that overemphasizes the availability and the amount of the reduced initial premium. When an insurer charges an initial premium that differs in amount from the amount of the renewal premium payable on the same mode, all references to the reduced initial premium should be followed by an asterisk or other appropriate symbol which refers the reader to that specific portion of the advertisement which contains the full rate schedule for the policy benefit advertised.

- Review advertising carefully for use of the term "guarantee." Verify that the scope and duration of any guarantee is accurately described. Determine that the regulated entity has accurately portrayed non-guaranteed elements. Verify that complete information is provided regarding the scope and duration of guarantees.

- Review advertising carefully for use of the term "bonus." Review the functioning of any such bonus payments and verify that the information provided is accurate in describing the amount and the conditions for payment, retention or recoupment of the bonus.

- Review advertising carefully for explanations of surrender periods and charges. Review the functioning of any such surrender charge and, in particular, how the charge is calculated in death claims. Verify that the information provided regarding the amount of the charge and the conditions for assessment are accurate.

Index products

- For advertising for interest-sensitive products, review explanations of the crediting methods and terms. Review the functioning of the crediting methods to determine that the explanations are understandable and accurate. Verify that accurate information is provided regarding the options available to the consumer and the methods by which the consumer is to exercise the options.

- Review the methods used by the regulated entity, annually or otherwise, to convey ongoing information about policy/contract values and options available to the consumer to change interest-crediting methods or exercise other policy/contract features in future terms.[276]

Standard 11, which requires that "The insurer has procedures in place to educate and monitor insurance producers and to provide full disclosure to consumers regarding all sales of products involving fixed-index annuity products, and all sales are in compliance with applicable statutes, rules and regulations," recommends the following examination procedures:

- Examine procedures for verifying producer compliance with established policies and procedures; and

- Review commission structure and note any differences between index and non-index annuity products. If it appears that the difference may be significant enough to provide incentive to a producer to recommend one product over another regardless of suitability, perform further analysis to test that hypothesis.[277]

Thus, there are ample features of state insurance law designed to provide consumers with the same full and fair disclosure benefits as are asserted in the Proposing Release to be a primary benefit of Rule 151A. Moreover, as discussed immediately below, not only do those protections exist on paper, but there is also robust enforcement activity at the state level.

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[276] 2 NAIC MARKET REGULATION HANDBOOK 411-15 (2008).

[277] *Id.* at 434.

c. <u>State Insurance Regulation Provides Consumers with Similar Consumer Protection and Enforcement Benefits</u>

The Proposing Release has identified certain consumer protection and enforcement benefits to be derived from the sales practices protections and disclosure benefits discussed above:

- In the discussion of Rule 151A's disclosure benefits, the Proposing Release notes at page 70 that: "The potential liability for materially false and misleading statements and omissions under the federal securities laws would provide additional encouragement for accurate, relevant, and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell them."

- In the discussion of Rule 151A's sales practice protection benefits, the Proposing Release notes at pages 71 and 72 that: "Both the selling broker-dealer and its registered representatives would be subject to the oversight of FINRA. The registered broker-dealers would also . . . be subject to the Commission's general inspections and, where warranted, enforcement powers."

As discussed below, state insurance laws provide substantially equivalent consumer protection and enforcement benefits as those outlined above. State insurance regulation provides these benefits through market surveillance, examinations, complaint handling requirements, and enforcement powers. Potential penalties and remedies under state insurance law include cease and desist orders, equitable remedies (e.g., restitution), monetary fines, criminal sanctions, and the suspension and/or revocation of an insurer's or producer's license. Moreover, the respective state insurance regulators have been increasingly aggressive in recent years in addressing perceived abusive practices relating to fixed index annuities.

(i) Insurance Regulators Have Broad Examination and Enforcement Powers

The Insurance Commissioners and the Insurance Departments of all states have very broad powers to enforce the insurance laws of their respective states. Illustrative of the types of laws on the books of the respective states are the following provisions of the California Insurance Code, which give the California Insurance Commissioner broad examination powers and a wide pallet of remedies when faced with an insurer's or producer's violation of California's insurance laws. As to the power to examine and investigate, the California Insurance Code provides that:

> The commissioner shall have power to examine and investigate into the affairs of every person engaged in the business of insurance in the State in order to determine whether such person has been or is engaged in any unfair method of

> competition or in any unfair or deceptive act or practice prohibited by Section 790.03 or determined pursuant to this article to be an unfair method of competition or an unfair or deceptive practice in the business of insurance. . . .[278]

The California Insurance Commissioner also has express statutory authority to enforce California's insurance laws as follows:

- The commissioner may suspend an insurer's certificate of authority whenever he finds, after proper hearing following notice, that such insurer engages in, among other things: (a) conducting its business fraudulently, or (b) not carrying out its contracts in good faith. In certain circumstances, the Commissioner may permit an insurer to pay monetary penalties in lieu of a suspension of the insurer's certificate of authority.

- The commissioner may revoke an insurer's certificate of authority if any insurer (as well as certain affiliates and officers or directors of such insurers or affiliates) has been convicted on, or pleaded guilty or nolo contendere to, an indictment or information in any jurisdiction charging a felony for theft or larceny, mail fraud, or violation of any corporate securities statute or any insurance statute.

- The commissioner may suspend or revoke a producer's license if, among other things, the producer has shown incompetency or untrustworthiness in the conduct of any business, or has by commission of a wrongful act or practice in the course of any business exposed the public or those dealing with him to the danger of loss; has knowingly misrepresented the terms or effect of an insurance policy or contract; or has failed to perform a duty expressly enjoined upon him by a provision of this code or has committed an act expressly forbidden by such a provision.

- Any person who engages in any unfair method of competition or any unfair or deceptive act or practice defined in Section 790.03 is liable to the state for a civil penalty to be fixed by the commissioner, not to exceed five thousand dollars ($5,000) for each act, or, if the act or practice was willful, a civil penalty not to

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[278] CAL. INS. CODE §790.04. *See also* ARIZ. REV. STAT. ANN. § 20-142; FLA. STAT. §624.316; 215 ILL. COMP. STAT. 5/132.3; N.Y. INS. LAW § 309; 40 PA. STAT. ANN. § 323.3; TEX. INS. CODE ANN. § 401.051. The California Insurance Commissioner also has broad authority to conduct financial examinations of insurers, including as follows: "The commissioner, whenever he or she deems necessary . . . shall examine the business and affairs of the insurer. . . . For purposes of completing an examination of any company under this article, the commissioner may examine or investigate any person, or the business of any person, insofar as the examination or investigation is, in the discretion of the commissioner, necessary or material to the examination of the company." CAL. INS. CODE § 730(a) & (c).

> exceed ten thousand dollars ($10,000) for each act. The commissioner also may issue a cease and desist order with respect to such conduct.[279]

In addition, there are numerous provisions of state law that provide remedies for specific statutory violations.[280]

(ii) State Insurance Complaint Handling Laws Serve as an Additional Enforcement Mechanism

The insurance laws of every state provide procedures relating to consumers complaints against insurers and producers. Ultimately, these procedures are designed to achieve (i) prompt resolution of consumer complaints or provide a predicate for state insurance department intervention, and (ii) provide a more global oversight mechanism for insurance regulators to monitor and take appropriate action against instances or patterns of wrongful conduct. Illinois provides a typical example of the complaint handling and monitoring procedures employed by the respective states.

- State insurance complaint laws address two categories of complaints by consumers: those directed to insurers or producers, and those directed to insurance departments regarding insurers' or producers' conduct.

- In the former situation, state laws require insurers to respond in a manner designed to promote a speedy and justified resolution of the complaint, which if successful would obviate the need for regulatory intervention. In addition, those laws require that insurers maintain certain complaint records.[281]

- In addition, complaints may be made directly to the state insurance department, in which event a series of regulatory requirements attach to the disposition and monitoring of such complaints. Under Illinois law:

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[279] CAL. INS. CODE §§ 704, 704.5, 704.7, 790.035, 790.05, 1668 & 1668.1. *See also* ARIZ. REV. STAT. ANN. §§ 20-152, 20-220, 20-456 & 20-295; FLA. STAT. §§ 624.310, 624.418, 626.621 & 626.9581; 215 ILL. COMP. STAT. 5/132.3, 5/407.2, 5/427, 5/431 & 5/500-70; N.Y. INS. LAW §§ 309, 2110 & 2404; 40 PA. STAT. ANN. §§ 46, 477b, 324.13 & 1171.11; TEX. INS. CODE ANN. §§ 82.051, 86.001, 401.051, 541.110 & 801.102.

[280] For example, California's replacement laws (as well as the replacement laws of other states) empower the Insurance Commissioner to order restitutions for violations of those laws. CAL. INS. CODE § 10509.9; *see generally* V.A.2.a., *supra*.

[281] ILL. ADMIN CODE tit. 50, § 926.50 (requiring insurers to maintain records of complaints received from consumers or the Department for seven years from the time the complaint was closed).

- When the Department receives a complaint against an insurer or producer (referred to under Illinois law as the "respondent," the Department notifies the respondent and specifies when the respondent must report back to the Department (usually within 21 days)

- The Respondent's report must explain all actions taken or not taken and which were the basis for the complaint, and include documents supporting the respondent's position or that responds to information requested by the Department

- Upon receipt of the respondent's report, a Department analyst will evaluate the material submitted and advise the complainant of the action taken and disposition of the complaint; or pursue further investigation with the respondent or complainant; or refer the complaint file to the appropriate Division within the Department of Insurance for further regulatory action.[282]

From a practical perspective, this complaint process is one of the most important and effective consumer protection mechanisms under state law, as it often leads to the prompt resolution of complaints without the need for formal enforcement actions. For example, all states advertise that consumers may file complaints, and provide toll free phone numbers and website links for complaint filing.[283] In fact, some states, like California, statutorily mandate that the Department maintain "(1) A toll-free telephone number published in telephone books throughout the state, dedicated to the handling of complaints and inquiries [, and make] (2) Public service announcements to inform consumers of the toll-free telephone number and how to register a complaint or make an inquiry to the department."[284] The NAIC also provides a website link for consumers, with any complaints filed with the NAIC referred to the affected states.[285] These outreach efforts yield a substantial number of complaints; for example, the Consumer Services

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[282] ILL. ADMIN CODE tit. 50, § 926.40.

[283] *See*

http://www.id.state.az.us/consumerassistance.html (Arizona);
http://www.insurance.ca.gov/contact-us/0200-file-complaint/index.cfm (California);
http://servicepoint.fldfs.com/eservice_enu/start.swe?SWECmd=Start (Florida);
http://www.idfpr.com/DOI/Complaints/Complaints.asp (Illinois);
http://www.ins.state.ny.us/consindx.htm#how (New York);
http://www.ins.state.pa.us/ins/lib/ins/consumer/COMPLAINT_FORM.pdf (Pennsylvania);
http://www.tdi.state.tx.us/consumer/complfrm.html (Texas).

[284] CAL. INS. CODE § 12921.1(a)(1)-(2).

[285] *See* http://www.naic.org/cis/helpComplaint.do#file_complaint (NAIC consumer complaint instructions).

Bureau of the New York Insurance Department responded to 60,000 complaints from consumers and providers in one year, and also responded to approximately 500,000 telephone inquiries for information.[286]

In addition to potentially taking enforcement action if a particular consumer's complaint cannot adequately be resolved, another important aspect of state regulation of complaints is more globally oriented: to identify the volume of complaints against an insurer or producer as well as any trends or patterns. This is accomplished through the market conduct examination process (either through routine or specifically targeted examinations), with the NAIC Market Regulation Handbook containing the following four "Complaint Handling" examination Standards:

- All complaints are recorded in the required format on the regulated entity's complaint register.
- The regulated entity has adequate complaint handling procedures in place and communicates such procedures to policyholders.
- The regulated entity takes adequate steps to finalize and dispose of the complaint in accordance with applicable statutes, rules and regulations and contract language.
- The time frame within which the regulated entity responds to complaints is in accordance with applicable statutes, rules and regulations.[287]

State law also contains provisions mandating that state regulators act upon their examination findings. For example, the California Insurance Code requires that:

> The commissioner shall ascertain patterns of complaints by insurer, geographic area, insurance line, type of violation, and any other valid basis the commissioner may deem appropriate for further investigation, and periodically evaluate the complaint patterns to determine additional audit, investigative, or enforcement actions which may be taken by the commissioner . . . . For the purposes of this subdivision, complaints mean those written complaints received by the commissioner under subdivision (a), and written complaints received by the

[286] New York Circular Letter 1999-19 (June 10, 1999), *available at* http://www.ins.state.ny.us/circltr/1999/cl99_19.htm.

[287] 1 NAIC MARKET REGULATION HANDBOOK 240-47(2008).

> commissioner from any other sources, alleging misconduct or unlawful acts by insurers or production agencies.[288]

Thus, abusive practices that surface through consumer complaints may ultimately become the subject of regulatory enforcement activity.

(iii) State Insurance Regulators Regularly Exercise their Enforcement Powers Against Insurers and Producers

Not only do state insurance regulators have the authority to enforce their laws, they (or the state attorney general) have been aggressive in taking enforcement actions for violations of their insurance laws. Because of the Comment deadline, NAFA has not had sufficient time to compile complete reports showing the volume and breadth of enforcement activity by the respective states. Accordingly, NAFA directs the Commission's attention to the respective state insurance department websites for information about their enforcement activity.[289] NAFA also stands ready to provide the Commission with a report on state enforcement actions if the Commission so requests.

Given that state insurance Commissioners have broad powers and duties to enforce their laws and, in fact, proactively do so, particularly with regard to fixed index annuities, the primary effect of Rule 151A would not be to provide consumer protection and enforcement protections that are currently unavailable to consumers, but instead would be to overlay the federal regulatory enforcement scheme on top of an existing, comprehensive state insurance law enforcement scheme.

d. <u>State Insurance Regulation Provides Consumers with Similar, and in Certain Respects Greater, Regulatory Efficiency Benefits</u>

The Proposing Release has identified regulatory certainty as a benefit of Rule 151A. Specifically, the Proposing Release asserts at page 72 that the Rule would afford insurance

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288 CAL. INS. CODE § 12921.4(b).

289 As to the Principal States, *see* http://www.id.state.az.us/newsletter.html (Arizona's "Insurance Regulator" quarterly newsletter that, among other things, identifies disciplinary actions against insurers and agents); http://www.insurance.ca.gov/0300-fraud/ (California Insurance Department "Enforcement Branch" webpage); http://www.floir.com/market_conduct/is_market_conduct_index.aspx (Florida Office of Insurance Regulation "Market Investigations" webpage); http://www.idfpr.com/DOI/Main/news_links.asp (Illinois Division of Insurance links to "Illinois Regulator" newsletters, which identify disciplinary actions against insurers and agents, and Press Releases); http://www.ins.state.ny.us/das.htm (New York Department of Insurance "Disciplinary Actions" webpage); http://www.ins.state.pa.us/ins/cwp/view.asp?a=1337&Q=543749&insNav=| (Pennsylvania Insurance Department "Bureau of Enforcement" webpage); http://www.tdi.state.tx.us/commish/actions.html (Texas Department of Insurance "Enforcement Efforts" webpage).

companies issuing fixed index annuities, distributors who sell them, and purchasers who buy them greater regulatory certainty as to the applicability of the federal securities laws. Presumably, this regulatory certainty would result from each party's knowledge as to what its rights and obligations are. However, as discussed above, from a consumer perspective, even if consumers know their rights under the federal securities laws, there is little, if any, substantive difference in the bundle of rights under the federal securities laws from those already existing rights under state insurance law (other than the right to bring securities based claims).

B. State Insurance Regulation Eliminates the Risk of Loss to Owners of Fixed Index Annuities that Is a Necessary Condition to Characterizing Them as Securities

The Commission's Proposal fails to recognize the nature and extent of state insurance law regulation of fixed index annuity contracts, as well as state insurance law regulation of the insurers that issue those contracts and the producers that market those contracts. We respectfully submit that the comprehensive state insurance law regulatory scheme protects owners of fixed index annuities from the risk of loss the Supreme Court determined in *Weaver* to be necessary to characterize a financial instrument as a security.

There are three principal facets of the state insurance regulatory scheme that protect contract holders from risk of loss under fixed index annuities:

- Provisions of law relating to contract design and state law oversight, which place the entire risk of "investment loss" on the insurer;
- Provisions of law designed to ensure that insurers operate in a manner that minimizes the possibility that they will be unable to meet their contract obligations, as well as provisions of law providing for regulatory oversight of insurers' solvency; and
- In the event an insurer becomes insolvent, provisions of law as well as regulatory responses designed to ensure that contract holders receive all that they are contractually entitled to.

Each of these facets of state insurance regulation are discussed in, respectively, Parts V.B.1, 2 and 3, below.

1. State Insurance Regulation of the Terms of Fixed Index Annuities Eliminates Risk of Loss at the Contract Level

State insurance regulatory involvement commences at the design of the product. State insurance laws and regulations mandate specific required terms be included in every fixed index annuity contract. These provisions are designed to protect the policyholder by minimizing any advantage the insurer may have due to greater knowledge of insurance. While the exact language of the provisions is not usually stipulated, the terms must be at least as favorable as the statute and must be written in plain English. Examples of these are nonforfeiture provisions, incontestablity clauses, and entire contract clauses, which are described below.

a. State Nonforfeiture Provisions

The Principal States as well as virtually every other state require fixed indexed annuity policies to contain nonforfeiture provisions to protect the policyholder's contributions to the policy. Nonforfeiture provisions generally must state the mortality table and interest rate used and the method of calculating the nonforfeiture values available to the policyholder. The nonforfeiture laws also set out when the nonforfeiture values must be available and the required minimums. Annuities specifically must stipulate the minimum paid-up annuity benefits, the amounts to be paid in the event of partial or full surrenders of the contract, the minimum number of times for such surrenders after issuance of the contract and contain a statement that any paid-up annuity, cash surrender or death benefits that may be available under the contract are not less than the minimum benefits required by any statute of the state in which the contract is delivered.[290]

b. Incontestability Clauses

Incontestability clauses are statements required to be in fixed index annuities that provide that the insurer can not contest the validity of the annuity once the policy has been in place for a certain period of time, usually two years.[291] Such clauses operate as a statute of limitations and require the insurer to do any investigations into the application and policy circumstances within the allotted time period.

c. Entire Contract Clauses

Entire contract clauses are another mechanism to protect both the policyholder and the insurer by providing that the policy constitutes the entire agreement between the parties.[292] The application is usually made part of the contract by attaching it to the policy.

[290] *See* ARIZ. REV. STAT. ANN. § 20-1232; CAL. INS. CODE § 10168.1; 215 ILL. COMP. STAT. 5/229.4a; N.Y. INS. LAW § 4223; 40 PA. STAT. ANN. § 510b; TEX. INS. CODE ANN. § 1107.003.

[291] *See* ARIZ. REV. STAT. ANN. § 20-1220; CAL. INS. CODE § 10113; FLA. STAT. § 627.466; 215 ILL. COMP. STAT. 5/226(b); N.Y. INS. LAW § 3219(a)(2); 40 PA. STAT. ANN. § 510a(b).

[292] *See* ARIZ. REV. STAT. ANN. § 20-1205; CAL. INS. CODE § 10113.5; FLA. STAT. § 627.467; 215 ILL. COMP. STAT. 5/226(c); N.Y. INS. LAW § 3219(a)(3); 40 PA. STAT. ANN. § 510a(c).

Moreover, under state insurance laws, a fixed index annuity may not be delivered or issued for delivery in a state until it has been filed with and approved by the commissioner of insurance of that state.[293] Thus, fixed index annuities are subject to prior review by, and in many cases state insurance law mandated prior approval by, state insurance regulators. Forms are generally required to be filed within a certain period of time before use and the commissioner must then approve or disapprove of the form within an allotted amount of time.[294] To be approved, a form must be in compliance with all the laws of the state and contain all of the statutorily mandated provisions, including for example, the nonforfeiture, incontestability, and entire contract clauses discussed above. Each form filing must be accompanied by a certification stating that the filing complies with all of the laws of the state. In addition to the form, many states require the insurer to file an actuarial memorandum demonstrating the product's compliance with the applicable laws.[295]

Due to the mandated filing, state insurance regulators ensure that fixed index annuities comply with state insurance laws and regulations. Moreover, state insurance laws grant insurance regulators authority to disapprove or withdraw approval of a filing if the insurance regulatory authority determines the filing is false, encourages misrepresentation, is unjust, unfair, inequitable, ambiguous, misleading, inconsistent, deceptive, contrary to law or to the public policy of the state, or contains exceptions and conditions that unreasonably or deceptively affect the risk purported to be assumed in the general coverage of the policy.[296]

Finally, when state insurance regulators conduct mandated periodic market conduct examinations of insurers, one area that state insurance regulators are required to examine is whether the insurer and any producers are selling products that have not been approved by the insurance department of each state in which the product is being sold. "Underwriting and Rating" Standard 5 of the General Examination Standards of the NAIC Market Regulation Handbook states "[a]ll forms, including contracts, riders, endorsement forms and certificates are

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[293] *See* ARIZ. REV. STAT. ANN. § 20-1110; CAL. INS. CODE § 10168.93; FLA. STAT. § 627.410; 215 ILL. COMP. STAT. 5/143; N.Y. INS. LAW § 3201; 40 PA. STAT. ANN. § 477b; TEX. INS. CODE ANN. §1701.051.

[294] *See id.*

[295] *See*, *e.g.*, Illinois Department of Insurance, Annuity Filing Checklist, *available at* http://www.idfpr.com/DOI/Regulatory_Filings/Checklist/AnnuityFilingChecklistforCompanies.pdf; Pennsylvania Insurance Department, Individual Flexible/Single/Fixed Premium Deferred Fixed Annuity (General Account/Separate Account) (With or Without Bonus, Equity Indexed, Market Value Adjustment), *available at* http://www.ins.state.pa.us/ins/lib/ins/rates/checklists/Ind_Flex_Deferred_Fixed_Annuity_092006.xls; Texas Department of Insurance, Equity Indexed Annuities Checklist, *available at* http://www.tdi.state.tx.us/forms/lhlifehealth/lhl318ileina.pdf.

[296] *See*, *e.g.*, ARIZ. REV. STAT. ANN. § 20-1111; FLA. STAT. § 627.411; 215 ILL. COMP. STAT. 5/143(1); N.Y. INS. LAW § 3201(c).

filed with the Department of Insurance, if applicable."[297] Review procedures for this Standard include determining if forms have been filed and approved.[298] This mechanism provides an additional measure of protection that fixed index annuities sold comply with state insurance laws and regulations.

2. State Insurance Regulation of Insurance Companies Issuing Fixed Index Annuities Eliminates Insurer Solvency Related Risk of Loss

In order to transact business in a state, a life insurer must be licensed in the state. Most states insurance laws state that "no person shall act as an insurer and no insurer shall transact insurance … except as authorized."[299] In order to qualify for the authority to transact insurance, an insurer must be in compliance with all insurance provisions of the state and file with the insurance department certain information such as its corporate charter, articles of incorporation, bylaws, annual statement from the preceding year, and report of its last examination.[300]

Once an insurer is licensed, state insurance laws and regulations continue to regulate the operation of the insurer. Under each state's insurance laws, the insurance regulatory authority is granted broad supervisory and administrative powers not only for the initial licensing but also as to the maintenance of minimum financial standards and other established standards discussed below.

Licensure requires an insurer to meet rigorous financial standards such as reserving, which must be certified to by a life insurance actuary, financial statements audited by an independent certified public accountant, and strict investment standards as well as managerial character and trustworthy standards. The pervasiveness of "governmental supervision" of insurers extends to the accounting system insurers use. While operating companies use generally accepted accounting principles ("GAAP"), the insurance industry accounts for assets and liabilities and income and expenses using statutory accounting principles ("SAP"), which are considered much more conservative as to when income can be realized and the carrying values of certain assets and liabilities.

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[297] 1 NAIC MARKET REGULATION HANDBOOK 291 (2008).

[298] *Id.*

[299] *See, e.g.*, ARIZ. REV. STAT. ANN. § 20-206; CAL. INS. CODE § 700; FLA. STAT. § 624.401; 215 ILL. COMP. STAT. 5/24; N.Y. INS. LAW § 1101; 40 PA. STAT. ANN. § 46; TEX. INS. CODE ANN. § 801.051.

[300] *See, e.g.*, ARIZ. REV. STAT. ANN. § 20-215; CAL. INS. CODE § 707; FLA. STAT. § 624.413; N.Y. INS. LAW § 1102.

a. **Financial Solvency Regulation**

State insurance regulators are responsible for monitoring insurers' financial conditions and ensuring the individual companies' and overall industry's solvency. As part of this oversight, insurers are required to file annual financial statements with the insurance department.[301] These statements are generally required to be in the form adopted by the NAIC which requires, among other things, a report of an independent certified public accountant, the insurer's balance sheet, statement of operations, statement of cash flows, statement of changes in capital and surplus, and certain designated notes to the financial statements.[302] As part of the annual statements, the statutorily imposed policy reserves must be actuarially certified.[303] The reserves "shall not be less than the amount, estimated and consistent with the provisions of this title, necessary to assure payment of the insurer's unpaid policyholder and contract holder obligations."[304]

In addition to the financial statements, insurers must file annual Risk-Based Capital ("RBC") reports with the insurance department of their domicile state, the NAIC, and any other state where the insurer is authorized to do business if that state so requests.[305] RBC regulation is a "risk-based capital formula establishing target surplus amounts that are required above reserve requirements, which are intended to reflect the risk inherent in an insurer's contractual obligations and asset portfolio."[306] RBC regulation is predicated on the ratio of an insurer's "Total Adjusted Capital" to its "Authorized Control Level RBC", as those terms are defined in the state RBC provisions and calculated in accordance with the RBC Instructions. If, for example, an insurer's Total Adjusted Capital is three times as large as its Authorized Control Level RBC, the insurer is said to have a RBC ratio of 300%. These RBC ratios, and certain downward trends in the ratios, provide the triggers under the RBC laws for corrective action by the insurer and/or state insurance regulators.

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[301] *See* ARIZ. REV. STAT. ANN. § 20-223; CAL. INS. CODE § 900; FLA. STAT. § 624.424; 215 ILL. COMP. STAT. 5/136; N.Y. INS. LAW § 307; 40 PA. STAT. ANN. § 443; 28 TEX. ADMIN. CODE §7.70.

[302] NAIC ANNUAL FINANCIAL REPORTING MODEL REGULATION (MODEL LAW 205) § 5.

[303] *See* ARIZ. REV. STAT. ANN. § 20-696.02; CAL. INS. CODE § 10489.15; FLA. STAT. § 625.121(3)(a); 215 ILL. COMP. STAT. 5/223; N.Y. INS. LAW § 4217; 40 PA. STAT. ANN. § 71; TEX. INS. CODE ANN. § 425.054.

[304] *See*, *e.g.*, ARIZ. REV. STAT. ANN. § 20-516.

[305] *See* ARIZ. REV. STAT. ANN. § 20-488.01; CAL. INS. CODE § 739.2; FLA. STAT. § 624.4085; 215 ILL. COMP. STAT. 5/35A-10; N.Y. INS. LAW § 1322; 40 PA. STAT. ANN. § 221.2-A; 28 TEX. ADMIN. CODE §7.402.

[306] BLACK & SKIPPER, *supra* note 17, at 931-32.

Most states follow the NAIC Model's levels of increasingly aggressive regulatory intervention based upon an insurer's RBC ratio:

RBC Level	Trigger for Regulatory Intervention	Required Regulatory Action
Company Action Level	RBC ratio below 200% or RBC ratio below 250% with a negative trend (as specified in the RBC Instructions)	RBC Plan
Regulatory Action Level	RBC ratio below 150%	RBC Plan and regulatory exam and corrective action order
Authorized Control Level	RBC ratio below 100%	Insurer may be placed under regulatory control
Mandatory Control Level	RBC ratio below 70%	Insurer must be placed under regulatory control

If, for example, the RBC formula yields $100 million of Authorized Control Level RBC, then any insurer with less than $100 million of Total Adjusted Capital available to cover this amount of risk (i.e., an RBC ratio below 100%) is deemed to have insufficient capital relative to its RBC risks. An insurer with an RBC ratio below a 100% is deemed to pose a sufficient risk to its policyholders and the public under the Model Act so as to authorize the insurance commissioner to place the insurer under regulatory control.

As an additional early warning system, most states depend on the NAIC's Insurance Regulatory Information System ("IRIS") to flag insurers that may be in financial difficulty for additional review. IRIS uses 12 financial ratios to sort out insurers with potentially unusual results and then performs a more in-dept analysis of those insurers' annual statements to determine which insurers should be subjected to further review by their domicile state.

b. Holding Company Regulation

The states' Insurance Holding Company provisions contain additional means by which the insurance regulatory authority can ensure an insurer's liquidity. For certain transactions between members of a holding company, notice must be filed with the state insurance regulatory authority before the transaction is entered into and the terms and fees must be fair and reasonable, expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices, and the books of both of the parties to the transaction must accurately reflect the nature and details of the transaction.[307] The insurance commissioner generally has the power to disapprove of the transaction within an allotted amount of time before it is entered into. Additionally, the holding company provisions require that notice be filed with and subject to the disapproval of the insurance commissioner of any extraordinary dividends being paid to shareholders.[308]

c. <u>Additional Oversight</u>

Licensure also subjects insurers to examination by the department of insurance at least every five years or more frequently at the department's discretion.[309] Licensed insurers are required to give the department access to all books and papers related to the insurer's business. Examinations encompass the affairs, transactions, accounts, and records relating directly or indirectly to the insurer and the assets of the insurer's managing general agents and controlling or controlled person. Such examinations are generally conducted using the NAIC's Market Regulation Handbook. In addition to examining the insurer, the state insurance regulatory authority generally has the power to examine any person, or the business of that person, if the authority believes it necessary or material to the examination of the insurer.[310]

3. <u>State Insurance Guarantee Funds Eliminate Risk of Loss in the Event of Insurer Insolvency</u>

Fixed index annuities are backed by state guaranty fund associations. These guaranty fund associations back fixed guarantees under life insurance company products and stand ready to protect owners if insurers fail.

Every state has enacted a guaranty fund law, which requires the payment of the present value of benefits under fixed index annuities. As a condition to obtaining and maintaining a

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[307] *See* ARIZ. REV. STAT. ANN. § 20-481.12; CAL. INS. CODE § 1215.5; FLA. ADMIN. CODE ANN. § 69O-143.047; 215 ILL. COMP. STAT. 5/131.20; N.Y. INS. LAW § 1505; 40 PA. STAT. ANN. § 991.1405; TEX. INS. CODE ANN. § 823.101.

[308] *See* ARIZ. REV. STAT. ANN. § 20-481.19; CAL. INS. CODE § 1215.5; FLA. ADMIN. CODE ANN. § 69O-143.047; ILL. ADMIN. CODE tit. 50, § 855.30; 40 PA. STAT. ANN. § 991.1405; 28 TEX. ADMIN. CODE § 7.204.

[309] *See* ARIZ. ADMIN. CODE § R20-6-1701; CAL. INS. CODE § 730; FLA. STAT. § 624.316; 215 ILL. COMP. STAT. 5/132.3; N.Y. INS. LAW § 309; 40 PA. STAT. ANN. § 323.3; TEX. INS. CODE ANN. § 401.052.

[310] *See, e.g.*, CAL. INS. CODE § 730; TEX. INS. CODE ANN. § 401.054.

license in each state, insurers are required to become members of the state guaranty fund association in each state in which they seek to do business.

Individual state laws vary as to the amount of annuity benefits guaranteed. Some states follow the "Life and Health Insurance Guaranty Association Model Act," which authorizes the payment of up to $100,000 per individual of the present value of annuity benefits in the event of the insolvency of the life insurer that issued the annuities.[311] New York, the state with the largest guaranteed amount, guarantees individuals the present value of annuity benefits under the contracts they hold up to a maximum of $500,000.[312] The amounts guaranteed by other states vary, but every state's guaranty fund guarantees to pay individual fixed index annuity contract holders at least $100,000 of the present value of annuity benefits.[313]

The National Organization of Life and Health Insurance Guaranty Associations ("NOLHGA") is composed of guaranty fund associations from every state. NOLHGA assists its member associations in quickly and cost-effectively providing coverage to policyholders in the event of a multi-state life or health insurer insolvency.[314] Since its creation in 1983, NOLHGA states that it has assisted its member guaranty associations in guaranteeing more than $20.2 billion in coverage benefits for policyholders and annuitants of insolvent companies. In that time, the associations have provided protection for more than two million policyholders and worked on more than 60 multi-state insolvencies."[315]

VI. THE COMMISSION'S PROPOSAL FAILS TO MEET REQUISITE STANDARDS FOR RULEMAKING THAT CONGRESS MANDATES

Section 2(b)[316] requires that the Commission consider whether Proposed Rule 151A will promote:

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311 NAIC LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATION MODEL ACT (MODEL LAW 520) § 3.C.2(a)(iii).

312 N.Y. INS. LAW §§ 7708(a)(3) & (b)(3).

313 *See*, *e.g.*, Section 8.a.(2)(iii) of Chapter 508C of the Iowa Insurance Code, which guarantees up to $250,000 in present value of annuity benefits for individual annuity holders.

314 *See* National Organization of Life and Health Insurance Guarantee Associations, About Us, *available at* http://www.nolhga.com/aboutnolhga/main.cfm/location/whatisnolhga (Aug. 2008).

315 *Id.*

316 Section 2(b) provides as follows:

- efficiency,
- competition, and
- capital formation.

The legislative history of Section 2(b) shows that Congress intends for the Commission to engage in a "rigorous analysis."[317]

The Commission's Proposing Release does not set out a "rigorous analysis" of whether Proposed Rule 151A will promote efficiency, competition and capital formation.

The Commission principally addresses the Section 2(b) rulemaking requirements in a section of only three pages[318] of a 96-page release, plus a few statements elsewhere. Moreover, the Commission fails to make its analysis "in addition to the protection of investors," as Congress requires. In other words, the Commission makes its analysis in the context of the protection of investors, which is inconsistent with what Congress requires. Furthermore, the Commission does not discuss alternative approaches that, contrary to Proposed Rule 151A, would promote efficiency, competition and capital formation.

> *Consideration of Promotion of Efficiency, Competition, and Capital Formation*. Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

317 The legislative history of Section 2(b) states as follows:

> Section 106 requires the Commission to consider efficiency, competition, and capital formation when it engages in rulemaking or reviews SRO-proposed rules pursuant to the Securities Act, the Exchange Act, or the Investment Company Act under a "public interest" standard. The new section makes clear that matters relating to efficiency, competition, and capital formation are only part of the public interest determination, which also includes, among other things, consideration of the protection of investors. For 62 years, the foremost mission of the Commission has been investor protection, and this section does not alter the Commission's mission. In considering efficiency, competition, and capital formation, the Commission shall analyze the potential costs and benefits of any rulemaking initiative, including, whenever practicable, specific analysis of such costs and benefits. The Committee expects that the Commission will engage in *rigorous analysis* pursuant to this section.

H.R. REP. NO. 104-622, *reprinted in* 1996 U.S.C.C.A.N. 3877, 3901 (June 17, 1996).

318 Commission's Proposing Release, *supra* note 1, at 81-84.

A. <u>The Commission's Proposal Is Flawed, Because The Commission Fails To Engage in a Rigorous Analysis of Whether the Proposal Will Promote Efficiency</u>

1. <u>The Commission Fails To Consider the Impact of the Commission's Proposal on the Efficiency of the Industry and the Commission</u>

The Commission does briefly mention the promotion of efficiency. However, the Commission does so solely in the context of the protection of investors.[319]

The Congressional requirement is that the Commission consider the promotion of efficiency in a context "in addition" to the protection of investors. NAFA respectfully submits that the Commission is required to present a "rigorous analysis" of the promotion of efficiency of Proposed Rule 151A – not in terms of the protection of investors – but in terms of the Rule's impact on the industry and the Commission.

For example, significant questions arise for both the industry and the Commission regarding the efficiency of the proposed 1933 Act registration process.

The Commission raises – but does not analyze – a number of serious issues regarding the efficiency of the registration process. These issues include such questions as what products should register, what registration form should be used, and whether the Commission's registration forms should be modified.[320] Furthermore, the Commission does not consider the additional resources that it will need to process the registration and continuing effectiveness of what the Commission estimates to be 400 contracts.[321] These questions go to the core of the promotion of efficiency by Proposed Rule 151A. The Commission is required to give these and other questions about efficiency a rigorous analysis.

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[319] The Commission's Proposing Release, *supra* note 1, at 81-82, considers efficiency in terms of "benefits of the disclosure and sales practice protections" and how the protections "would enable investors to make more informed investment decisions, and investors would receive the benefits of the sales practice protections."

[320] *Id.* at 30.

[321] *See id.* at 64-66, 76, 80.

2. <u>The Commission's Proposal Fails To Promote Efficiency, Because It Seeks To Remedy Certain Selling Practices by the Indirect Requirement of Registration Under the 1933 Act Rather than the More Efficient Alternative of Relying on State Insurance Regulation of the Marketing of Fixed Annuities</u>

The Commission's Proposing Release makes a number of statements that seem to justify Proposed Rule 151A on the rationale that fixed index annuities are subject to selling abuses[322] and offerees need protections under the federal securities laws.[323] However, we respectfully submit that the Proposing Release does not provide an adequate basis for the Commission's conclusion that registration under the 1933 is the most efficient answer to the problem it perceives.

As we state under I., above, the Commission cites no data, and refers to no authority, providing an objective foundation for the Commission's professed concern about selling abuses. Moreover, the Commission specifies no information about consumer complaints or enforcement actions that provide justification for the Commission's Proposal. The Commission does not point to hard empirical evidence that state insurance regulators have not moved against perpetrators of any selling abuses. Any support for the Proposal appears to be merely anecdotal.

Furthermore, the Proposal is not precipitated by the design or operation of fixed index annuities, but rather by what the Commission perceives to be abuses in selling the annuities, especially to seniors. In short, it appears that the Commission is requiring registration of fixed index annuities as securities in order that the products be offered and sold by registered broker-dealers under the Securities Exchange Act of 1934.

This is a roundabout, expensive and, therefore, inefficient, approach for the Commission to take. There are more direct, economical and, therefore, efficient approaches that the Commission should take, such as the following:

- rely on current state insurance law and developing NAIC and individual state initiatives; and
- create a Commission liaison, not only with the NASAA, but with the NAIC and/or industry groups including NAFA.[324]

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[322] *See supra* note 6.

[323] *See supra* note 7.

[324] *See* the discussion in VI.A.3., *infra*.

In addition, the Commission could implement, and/or encourage FINRA to implement, the recommendations of the 2006 NASD Investor Fraud Study.[325]

The Commission's traditional position – but not its Proposal – is consistent with Congressional intent. The legislative history shows that Congress did not view insurance and annuity products that provide hallmark guarantees of principal and interest to be securities under Section 2(a)(1). And Congress adopted Section 3(a)(8), as supererogation, to assure that insurance and annuity products with hallmark guarantees are not deemed to be securities. The Commission – at least up to now – has respected this Congressional intent.

3. <u>The Commission's Proposal Fails To Promote Efficiency, Because the Proposal Relies on a Liaison with State Securities Regulators to the Exclusion of State Insurance Regulators</u>

The Commission's development of Rule 151A in coordination with state *securities* regulators is puzzling and troublesome.

To begin with, the Proposing Release states that the Commission, in developing Proposed Rule 151A, coordinated with NASAA.[326] However, generally speaking, fixed index annuities are regulated under state *insurance* law, rather than state *securities* laws. The Proposing Release does not explain why the Commission chose to coordinate exclusively with NASAA and not also with state insurance regulators through their national organization, the NAIC.

Moreover, prior to the Commission's open meeting to consider Rule 151A, the NAIC wrote a letter[327] to Chairman Cox outlining the efforts of the NAIC and individual states to

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[325] *See* the discussion of this point in VI.A.4., *infra.* The 2006 NASD Investor Fraud Study ("NASD Study") made clear that the answer to selling abuses is not solely financial education of the public. Consequently, the Commission's Proposal for registration, prospectuses and disclosure is not wholly consistent with the recommendations of the NASD Study. The NASD Study concluded that it was the personal characteristics of purchasers that caused them to purchase unsuitable investments and called for regulators to adjust their thinking and take steps in a different direction. We do not believe that either the Commission or FINRA has announced how it will proceed in implementing the NASD Study's recommendations.

[326] Commission's Proposing Release, *supra* note 1, at 16-17. Indeed, prior to the Commission's publication of its Proposing Release, Commission Chairman Christopher Cox delivered a speech before NASAA that announced the Commission's development of a rule to regulate fixed index annuities. Christopher Cox, Chairman, SEC, Address to the North American Securities Administrators Association, Washington, D.C. (Apr. 1, 2008).

[327] Letter from Sandy Praeger, Kansas Insurance Commissioner, NAIC President, Roger A. Sevigny, New Hampshire Insurance Commissioner, NAIC President Elect, Jane L. Cline, West Virginia Insurance Commissioner, NAIC Vice President, Susan E. Voss, Iowa Insurance Commissioner, NAIC Secretary-Treasurer, to Christopher Cox, Commission Chairman (May 14, 2008) (on file with author).

regulate fixed indexed annuities. The Proposing Release, however, ignores the NAIC's letter and the initiatives noted in the letter, and mischaracterizes state insurance regulation as essentially limited to protecting solvency.[328]

The Commission's approach is inconsistent with the Commission's traditional approach. Over the years, the Commission has consulted with state insurance regulators. The earliest reference we can point to dates back to 1976, where a Commissioner talked in terms of modifying SEC regulations in the light of state regulation.[329]

Ironically, the Commission, in proposing Rule 12h-7, takes the opposite approach regarding the rationale for exemption under Section 3(b) under the Securities Exchange Act of 1934. The Commission conditions the exemptive rule on state supervision and examination of insurers and their financial condition.[330]

We believe that the Commission's coordination of Rule 151A with state securities administrators rather than state insurance commissioners has adverse consequences in terms of efficiency and competition that Section 2(b) of the 1933 Act requires the Commission to consider and rigorously analyze.

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[328] Commission's Proposing Release, *supra* note 1, at 19, 48-49. We describe state insurance law in V., *supra*.

[329] Then Commissioner Philip A. Loomis explained the Commission's approach as follows:

> We are aware of the fact that we need better consultation with the insurance industry and more education for ourselves. . . . The Commission . . . has determined to take steps looking towards the creation of a variable equity insurance product advisory committee. We haven't gone very far with it as yet. We have to consult the director of the Office of Management and Budget, but we intend to do it. We don't intend this to be the kind of advisory committee which makes studies and files reports. Rather, we hope it will be a *continuing consultative body* with us on such questions as how variable life insurance and other equity insurance products work, revision of our existing forms where necessary, *modification of regulations in the light of state regulation* and any other information which leads us to feel that the *existing regulations are unnecessary, inappropriate or duplicative*, and further to consider whether and what type of legislative approach to some of these problems we might be able to agree upon.

Philip A. Loomis, Remarks under Caption "Fifteen Years of Federal Regulation of Variable Contracts," Proceedings of Conference on Variable Annuities and Variable Life Insurance (June 24-25, 1976), 32 Bus. Law 675, 695-696 (Special Issue Mar. 1977) (emphasis added).

[330] *E.g.*, Commission's Proposing Release, *supra* note 1, at 1. In proposing Rule 12h-7, the Commission recognized that most of the disclosures required in reports under the Securities Exchange Act of 1934 ("1934 Act Reports") are not of much relevance to purchasers of fixed index annuities. It is most ironic that a principal effect of Proposed Rule 151A would be to require 1933 Act registration. Although such registration would ensure availability to customers of information of the type required in 1934 Act reports, the fact that most such information is of little relevance to fixed index annuity purchasers underscores the inappropriateness and inefficiency of treating such annuities as securities.

4. <u>The Commission's Proposal Fails To Promote Efficiency, Because the Proposal Does Not Implement the Recommendations of the 2006 NASD Investor Fraud Study that the Commission Endorsed</u>

The Proposing Release is also puzzling and troublesome in referring to the Commission's Senior Summit,[331] but not to the NASD Study[332] made public, with notable focus, at the Summit.

The NASD Study found – counter to common perception – that "investment fraud victims" are:

- "more financially literate than non-victims";
- compared to the general population, more educated, have high levels of income, and are more often not married; and
- compared to non-victims, more optimistic, tend to have a personality that is more self-reliant and self-deterministic, and are more likely to rely on their own experience and knowledge to make financial decisions.

The NASD Study concluded that "traditional financial literacy education alone will not inoculate investors from being defrauded." The NASD Study made clear that factors other than the diversity and complexity of financial products contribute significantly to investment fraud.

So, according to the NASD Study, it's not enough simply to *educate* the public as to the characteristics and operation of financial products. What also must be addressed is what the NASD Study calls the "psychological profile of investors – the demographic and personality indicators."

We are not aware that either the Commission or FINRA has taken steps to implement the recommendations of the NASD Study. Certainly, the Commission's Proposing Release fails to even refer to the NASD Study. Indeed, the Commission has proposed an approach requiring disclosure that is at odds with the recommendations of the NASD Study.

The NASD Study can be read to say that disclosure required for products registered under the 1933 Act is *not* the answer – or, at least, not the complete answer – to selling abuses. It follows that Proposed Rule 151A does not appear to be the most efficient way for the Commission to take steps against selling abuses.

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331 Commission's Proposing Release, *supra* note 1, at 16-17.

332 NASD, Investor Fraud Study Final Report (May 12, 2006).

B. <u>The Commission's Proposal Is Flawed, Because the Commission Fails To Engage in a Rigorous Analysis of Whether the Proposal Will Promote Competition</u>

The Commission's Proposing Release addresses competition, as required by Section 2(b) of the 1933 Act. However, we respectfully submit that the Proposing Release does not indicate that the Commission gave a "rigorous analysis" of the factor of competition as required by Section 2(b) of the 1933 Act, for the reasons set out below.

1. <u>The Commission's Proposing Release Addresses Competition Without Sufficient Information</u>

As a threshold matter, the Commission's Proposing Release addresses competition without having the adequate empirical foundation. The Commission's Proposing Release makes numerous statements about the nature and degree of competition between fixed index annuities and other financial products, but cites no source of information.

Indeed, it appears that the Commission attempts to overcome an apparent lack of factual information regarding competition by simply acknowledging all possibilities, *i.e.*, that Rule 151A may *either* enhance *or* diminish competition or *both*. More specifically, the Proposing Release states that Rule 151A could lead to "increased competition" or to a "reduction in competition."[333] We read the Proposing Release as conceding that the Commission has not marshaled the requisite information to address the factor of competition in the rigorous analytical manner that Congress contemplated in adopting Section 2(b) of the 1933 Act.

2. <u>The Commission's Proposing Release Does Not Indicate that the Commission Considered Competition Between Fixed Index Annuities and Fixed Declared-Rate Annuities</u>

The Proposing Release speaks of competition between fixed index annuities, on the one hand, and mutual funds, variable annuities and open brokerage accounts, on the other hand.[334]

However, the Proposing Release does not speak of competition between fixed index annuities and declared-rate annuities. The Proposing Release refers to declared-rate annuities,[335] and recognizes that fixed index annuities have become an increasingly important business line for "some" insurers.[336] However, the Commission's Proposing Release stops short of

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[333] Commission's Proposing Release, *supra* note 1, at 82.

[334] *Id.* at 5.

[335] *Id.* at 20 n.35.

[336] *Id.* at 14.

considering the competition between insurers that issue fixed index annuities, but not declared-rate annuities.

The Proposing Release attempts to make a case for registration of fixed index annuities under the 1933 Act based on "the risk for the unknown, unspecified, and fluctuating securities-linked portion of the return" and "the risk of an uncertain and fluctuating financial instrument.[337]

However, the Commission has viewed declared-rate annuities in essentially the same terms. In the Commission's view, [338] an owner of a declared-rate annuity assumes an investment risk that, following a one-year period during which the insurer guaranteed a rate of excess interest, the insurer (i) will not declare any rate of excess interest, or (ii) will declare a rate of interest that is higher or lower than that for the previous year. The Commission has recognized that perhaps the most significant factor that the insurer considers in setting the rate of excess interest is the rate of return that the insurer expects to earn on its holdings of securities and other assets.

So, declared-rate annuities, like fixed index annuities, transfer to the owner a risk to the extent that the rate of excess interest for the following year is unknown, unspecified, uncertain and fluctuating. However, the Commission has traditionally considered this risk to be unsubstantial when viewed in the context of the investment risk that the insurer retains.

It follows that the Commission, in requiring 1933 Act registration for fixed index annuities and not for a declared-rate annuity, creates an unlevel, and therefore, unfair playing field to the advantage of issuers of a declared-rate annuity.

3. The Commission's Proposal Fails To Promote Competition by Inappropriately Focusing on Competition Between Fixed Index Annuities and Mutual Funds, Variable Annuities, and Open Brokerage Accounts

The Commission's Proposing Release speaks of competition between fixed index annuities on the one hand and mutual funds, variable annuities and open brokerage accounts, on the other hand. We respectfully submit that this is an inappropriate comparison because of the essential differences between the two product categories.

It goes without saying that mutual funds, variable annuities and open brokerage accounts do not have the floor guarantees that fixed index annuities have. We respectfully submit that the

[337] *Id*. at 25.

[338] Commission's VALIC v. Otto Brief, *supra* note 14, at 8.

Commission is required to have a less-strained rationale for subjecting fixed index annuities to the 1933 Act requirements to which mutual funds and variable annuities are subject.

C. The Commission's Proposal Is Flawed, Because the Commission Fails To Engage in a Rigorous Analysis of Whether the Proposal Will Promote Capital Formation

1. The Commission Fails To Consider the Impact of the Commission's Proposal in Increasing Capital Formation

The Commission's Proposing Release includes one sentence[339] considering whether Proposed Rule 151A will promote capital formation.

The Commission relies exclusively on a supposed increased efficiency to justify its assertion that Rule 151A will promote capital formation.[340] As stated above, the Commission's Proposal does not support the Commission's claim that Rule 151A will lead to increased efficiency. Therefore, the Commission's reliance on increased efficiency as the sole basis for claiming Rule 151A will promote capital formation also fails to meet the "rigorous analysis" standard required by Congress.[341]

When referring to the promotion of capital formation, the Commission states that increased market efficiency "could" promote capital formation. As stated above, the Commission provides no explanation as to how Rule 151A will promote efficiency. Therefore relying on increased efficiency as the sole basis for claiming Rule 151A will promote capital formation is hardly the rigorous analysis that Congress requires.

2. The Commission's Proposal Fails To Promote Capital Formation by Imposing Unnecessary and Unrelated Costs that Tend to Decrease the Sale of Fixed Index Annuities

The Commission does briefly consider[342] the promotion of capital formation. However, the Commission does so solely in the context of the protection of investors.[343]

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[339] Commission's Proposing Release, *supra* note 1, at 83.

[340] *Id*.

[341] *See supra* note 317.

[342] Commission's Proposing Release, *supra* note 1, at 83.

The Congressional requirement is that the Commission consider the promotion of capital formation in a context "in addition" to the protection of investors. NAFA respectfully submits that the Commission is required to present a "rigorous analysis" of the promotion of capital formation.

The Proposed Rule 151A would promote capital formation if the Rule would increase the sale of fixed index annuities. However, the Commission has not analyzed the impact of the Proposed Rule 151A to the point where it can determine whether or not the Rule will increase the sale of fixed index annuities. The Commission, on the one hand, states that Proposed Rule 151A "may enhance" the sale of fixed index annuities.[344] But the Commission states that "Proposed rule 151A might have some negative effects" in that there could "be fewer issuers of indexed annuities."[345] Obviously, the Proposed Rule 151A would not promote capital formation in the latter scenario.

This point goes to the core of the promotion of capital formation by the Proposed Rule 151A. Congress requires the Commission to give these and other questions about capital formation a rigorous analysis.

VII. CONCLUSION

NAFA appreciates the opportunity to submit these comments in firm opposition to Proposed Rule 151A.

NAFA respectfully submits that the Commission should:

- withdraw its Proposal to adopt Rule 151A;
- continue its traditional and legally sound approach of recognizing that fixed index annuities are not securities;
- continue to recognize and rely on current state insurance law and developing NAIC and individual state initiatives;[346] and

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[343] The Commission's Proposing Release, *supra* note 1, at 83, simply states that "enhanced investor protections under proposed rule 151A could promote capital formation by improving the flow of information between insurers that issue indexed annuities, the distributors of those annuities, and investors."

[344] *Id*. at 82.

[345] *Id.*

[346] *See* V., *supra*.

- continue the Commission's traditional policy[347] of having a liaison with state insurance regulators and reinvigorate that liaison with the NAIC and/or industry groups, including NAFA, regarding fixed index annuities.

If the Commission has any question or needs further information, please contact James F. Jorden at 202-965-8135, 305-347-6801, or jfj@jordenusa.com, or Gary O. Cohen at 202-965-8152 or goc@jordenusa.com.

Very truly yours,

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347 *See* VI.A.3., *supra*.