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NASAA

By Email: rule-comment@sec.gov

September 10, 2008

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

Re: File Number S7-14-08—Comments on the SEC's Proposed Rule That Would Subject Certain Equity-Indexed Annuities to Regulation Under the Federal Securities Laws

Dear Ms. Harmon:

On behalf of the North American Securities Administrators Association (NASAA),[1] I am submitting this comment letter on the SEC's proposed rule that would subject equity-indexed annuities (EIAs) to regulation under the federal securities laws. *See* 73 Fed. Reg. 37,752 (July 1, 2008) (release of proposed Rule 151A). NASAA appreciates the opportunity to express its views on this matter of vital importance to our nation's investors.

OVERVIEW

NASAA strongly supports the SEC's proposed rule. EIAs are extremely complex investment products that have often been used as instruments of fraud and abuse. For years, they have taken an especially heavy toll on our nation's most vulnerable investors, our senior citizens. The proposed rule will enable the SEC to address these abuses with the regulatory tools available under the federal securities laws, ranging from mandatory registration and disclosure requirements to strong suitability standards and antifraud remedies. We commend the SEC and Chairman Cox in particular for taking this important step, and we urge the SEC to adopt the

[1] NASAA is the association of all state, provincial, and territorial securities regulators in North America. Its membership consists of the securities regulators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. Their core mission is protecting investors from fraud and abuse in the offer and sale of securities. Organized in 1919, NASAA is the oldest international organization devoted to investor protection.

proposed rule expeditiously so that the investing public can benefit from the protections it will afford.

Regulating EIAs as securities is clearly appropriate from the standpoint of legal and economic analysis. Contrary to insurance industry claims, EIAs impose significant risks upon investors, including fluctuations in the applicable equity index and potential loss of principal. In addition, issuers and agents routinely market EIAs as investments, not insurance products. For these reasons, EIAs are not the type of annuity that Congress intended to exempt from regulation under the federal securities laws. *See* Section 3(a)(8) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(8).

The investor protection rationale for the rule is even more compelling than its legal and economic underpinnings. The sales abuses associated with EIAs have been thoroughly documented over the years in regulatory warnings, governmental enforcement actions, private lawsuits, and media accounts, including the recent investigation featured on "Dateline NBC." State securities regulators have witnessed the same trend. The plain fact is that EIAs are often sold through deceptive marketing tactics and often to senior citizens for whom they are clearly unsuitable. Statistics compiled by the NASAA indicate that variable or equity-indexed annuities were involved a third of all cases in which senior citizens were subjected to securities fraud or abuse.

Without question, the single most effective way to address these abuses is to regulate EIAs as securities. Licensing standards under the securities laws will help ensure that agents have the requisite knowledge and character to sell these complex investment products. Those licensing requirements will also help ensure that agents are subject to appropriate supervision. Mandatory registration of EIAs as securities will vastly increase the amount of information available to investors concerning the features, risks, and costs associated with EIAs. Perhaps most important, the strong antifraud provisions and suitability standards that have been a part of securities regulation for decades will deter abuses in the sale of EIAs and provide more effective remedies for those who have already been victimized.

The proposed rule is not only an appropriate and necessary exercise of the SEC's rulemaking authority, but also a fair one. The rule is strictly prospective, and it gives issuers and agents a full year in which to achieve compliance. In addition, under appropriate conditions, it excuses issuers from certain reporting obligations imposed by the Securities Exchange Act of 1934.

Finally, none of the arguments being advanced against the rule are valid. State insurance laws alone cannot protect the public from the abuses associated with EIAs. The safeguards they provide are no substitute for the investor protections contained in the federal securities laws. Attempts to disparage the rule as part of a regulatory "turf" battle are also wrong. Critics who level that charge ignore the fact that the rule will not interfere with the continued regulation of EIAs by state insurance commissioners. The rule expressly provides that it will only apply to EIAs that are "subject to regulation under the insurance laws." *See* § 230.151A (a). Nor will the rule impose unreasonable burdens on industry. It will simply require compliance with the same regulatory standards that have applied to issuers for the past 75 years. In short, the rule will provide much needed protections for investors without unfairly burdening industry.

In the balance of this letter, we offer a more detailed analysis of the legal and economic justifications for the proposed rule, the abuses associated with EIAs, and the unique protections that securities regulation will provide. In addition, we review some of the basic misconceptions being advanced by those who oppose the regulation of EIAs as securities. Finally, we address several of the specific questions on which the SEC has invited comment in its proposing release. While we suggest a few changes in the rule that could enhance its effectiveness, we also affirm our view that even if adopted "as is," the rule will dramatically advance the cause of investor protection.

DR. CRAIG MCCANN'S REPORT

Along with our comment letter, we are submitting a report from Dr. Craig McCann, one of the nation's leading experts on EIAs. *See An Economic Analysis of Equity-Indexed Annuities*, Prepared by Craig J. McCann, PhD, CFA, Securities Litigation & Consulting Group, Inc. (Sept. 10, 2008) ("McCann Report") (accompanying comment letter). Dr. McCann's analysis supports the regulation of EIAs as securities on two levels. First, Dr. McCann demonstrates that investors assume all of the investment risk associated with EIAs, while the issuers assume none of that risk. He explains that issuers achieve this result through product design features that limit returns, risk-free hedging strategies, and the discretion to alter investors' returns during the long surrender periods typically associated with EIAs. As stated in the report:

> Whatever happens to the bond portfolio and whatever happens in the stock market, America Equity is protected because the full risks on the stock and bond market are passed on to the unsophisticated investors who buy equity-indexed annuities. Even if American Equity gets the risk transfer wrong, they are only going to be slightly wrong and only for a short time. With investors locked into long surrender periods, American Equity can use its virtually unfettered discretion to retroactively impose onto investors whatever small interest rate or stock market-based loss it might otherwise have borne.

McCann Report at 18. Dr. McCann elsewhere concludes that "[t]he investment risks to which investors are exposed are virtually identical to the risks of investing in mutual funds and variable annuities." *Id.* at 3. Under this analysis, EIAs clearly satisfy one of the established legal tests for determining whether an annuity should be regulated as a security—whether purchasers bear investment risk.

Second, Dr. McCann's analysis demonstrates the acute need for complete, accurate, and mandatory disclosure of the features, risks, and costs associated with EIAs. He explains that without such detailed disclosure, investors cannot compare the real investment returns of an EIA to the returns derived from other products, nor can they quantify the true value of the collateral features accompanying an EIA. As Dr. McCann explains, the typical EIA is a poor choice for investors on both counts:

> The [disclosure] proposed by the SEC is needed because issuers of existing equity-indexed annuities obfuscate the investment risks to which investors are exposed by repackaging what is actually a simple underlying investment with a layer of virtually worthless bells and whistles. . . . The net effect of the various equity-indexed annuities' gimmicks is to provide returns *below* those of treasury securities while exposing investors to stock market risk.

Id. at 5, 22 (emphasis added). Unless EIAs are regulated as securities in accordance with the proposed rule, investors will not have access to adequate disclosure about these investments, and they will continue to fall prey to the aggressive and misleading sales tactics often employed in the marketing of EIAs.

REGULATING EIA'S AS SECURITIES IS APPROPRIATE ON BOTH LEGAL AND ECONOMIC GROUNDS

I. EIAs Are Securities

There is no genuine dispute that EIAs are investment contracts under the *Howey* test. They involve the investment of money in a common enterprise with the expectation of profit to come predominantly from the efforts of others. *See, e.g., SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Courts and commentators alike treat this issue as a given. *See, e.g., Holding v. Cook*, 521 F. Supp. 2d 832, 836 (C.D. Ill. Oct. 9, 2007) (implicitly finding that EIAs fall under the broad definition of a security "that includes investment contracts," and also rejecting the contention that EIAs are entitled to the 1933 Act exemption as a matter of law); *see also* Jonathan Coleman, *Equity Indexed Annuities: "Securities" or Exempt Insurance Products Under the Federal Securities Laws?*, 34 No. 2 SEC. REG. L. J. 1, 3 (2006) ("Coleman Article") (application of *Howey* indicates that EIAs should be considered securities).

The Supreme Court certainly holds this view with respect to variable annuities. *See SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 211 (1967) ("We find it equally clear that the accumulation provisions [of the variable annuity at issue] constitute an 'investment contract' with the terms of Section 2 of the Securities Act"); *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 74 (1959) (*"VALIC")* (Brennan, J., concurring) ("Except for these exclusions [including Section 3(a)(8)], there is little doubt that these [variable annuity] contracts . . . would be subject to the Federal Acts"); *Luzerne County Retirement Board v. Makowski*, No. 3:CV-03-1803, 2007 WL 4211445, at *37-38 (M.D. Pa. Nov. 27, 2007) (applying the elements of *Howey* to variable annuities).

For purposes of an investment contract analysis, there is no meaningful distinction between EIAs and variable annuities. Indeed, when the Supreme Court first addressed the status of annuities under the 1933 Act, it indicated that the term security "is broad enough to include *any* 'annuity' contract." *Id.* at 67 (emphasis added); *see also Associates in Adolescent Psychiatry S.C. v. Home Life Insurance Co.*, 941 F.2d 561, 565 (7th Cir. 1991) (almost all annuity products "are securities, broadly understood, because they entail entrusting money to the hands of others in pursuit of appreciation"), *cert. denied*, 502 U.S. 1099 (1992).

II. <u>EIAs Are Not Entitled to the Exemption from Regulation Found in Section 3(a)(8) of the Securities Act</u>

The real challenge facing regulators has been determining whether EIAs fall within the class of annuity contracts that are entitled to an *exemption* from regulation under the Securities Act of 1933. In Section 3 of the Act, Congress listed various "classes of securities" that were exempted from coverage. Among the exemptions is one for "any . . . annuity contract . . . issued by a corporation subject to the supervision of the insurance commissioner . . . of any state." 15 U.S.C. § 77c(a)(8).

The federal courts have developed a number of tests that govern whether a hybrid insurance product is entitled to this exemption from regulation as a security. The tests focus on three core questions: (1) whether the product is subject to adequate regulation under state insurance law; (2) whether the product imposes investment risks on purchasers; and (3) whether the product is marketed as an investment. These are essentially the same elements that the SEC used to establish a safe harbor for annuities in 1986, although Rule 151 casts them in more narrow terms. *See* 17 C.F.R. § 230.151. If a product fails to meet any one of these tests, then it fails to qualify for the exemption. EIAs do not pass muster under *any* of these three criteria, and they accordingly cannot benefit from the exemption.

First, they are not subject to adequate regulation under state insurance law. State insurance laws do not protect investors from the dangers associated with the modern day EIA, a product that bears little resemblance to the relatively basic insurance contract that Congress had in mind when it created the exemption from regulation under the 1933 Act.

Second, EIAs pose significant investment risks to the buyer. These hazards include the economic *risk of loss of initial principal* arising from design features such as low guarantees, modest rates of return, and heavy surrender charges. EIAs also impose *performance risk* on investors, in that returns depend upon the performance of the equity markets as measured by various stock market indices. EIAs present yet a third type of risk: *complexity risk* arising from the incomprehensible bundle of features, terms, and conditions that issuers have designed into these products. As a result of this complexity, investors—and the sales agents who promote EIAs—are often unable to quantify the risks they face and to determine if an EIA is in fact a suitable investment.

Finally, EIAs are marketed primarily as investments, not as insurance products. For decades, the Supreme Court and other federal courts have regarded the way in which an investment is promoted as one of the key determinants in assessing the true nature of the offering. *See, e.g., SEC v. C.M. Joiner Leasing Corp.,* 320 U.S. 344, 353 (1943) (in the enforcement of the securities laws, it is appropriate that offerings be "judged as what they were represented to be").

In the following three subsections, we apply the foregoing tests to EIAs. The analysis confirms that these investment products are not entitled to the exemption from regulation found in Section 3(a)(8) of the 1933 Act. The SEC has correctly concluded that EIAs can and should be regulated under the federal securities laws.

A. EIAs Are Not Subject to Adequate Regulation Under Insurance Law

In order for an annuity of any kind to be exempt from regulation as a security, Section 3(a)(8) expressly requires that it be issued by a corporation subject to regulation by a state insurance commissioner. This threshold element in the 1933 Act exemption is more than a simple, mechanical test about whether the issuer of an annuity operates under the auspices of a state insurance commissioner. Rather, the correct application of this element requires a searching analysis of whether the annuity in question is subject to meaningful regulation under state insurance law. Justice Brennan made this clear in his concurrence in *VALIC.*

> [I]f a brand-new form of investment arrangement emerges which is labeled "insurance" or "annuity" by its promoters, the functional distinction that Congress set up in [the 1933 exemption] must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners. In that inquiry, an analysis of the regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed become relevant.

VALIC, 359 U.S. at 76 (Brennan, J., concurring).

Justice Brennan went on to argue that the exemption in Section 3(a)(8) does not apply to variable annuities because state insurance laws do not address the new forms of risk inherent in the modern day annuity. *Id.* at 73-93. He observed that annuities have assumed investment characteristics far different from those typical of the insurance and annuity policies that Congress was content to exempt from regulation in the 1933 Act. *Id.* at 91. As a result of this evolution, state insurance laws, with their singular focus on issuer solvency, have "become less and less meaningful." *Id.* at 85. By comparison, explained Brennan, the securities laws provide a host of necessary protections to investors, with an overriding emphasis on disclosure: "[T]he 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." *Id.* at 77. In the words of Justice Brennan, "there is no adequate substitute for [these protections] in the traditional regulatory controls administered by state insurance departments." *Id.* at 85-86. In *United Benefit*, the Supreme Court again confirmed that the inadequacy of state insurance regulation is an important factor to consider when applying the Section 3(a)(8) exemption. 387 U.S. at 210.

Since the *VALIC* decision in 1959, the Supreme Court has again and again looked to the adequacy of alternative regulatory safeguards in determining if an investment should be treated as a security. The Supreme Court followed this approach in *Marine Bank v. Weaver*¸ 455 U.S. 551 (1982), where it held that certificates of deposit were not subject to regulation under the securities laws: "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." *Id.* 559. Central to the Court's decision was the nearly absolute guaranty against loss provided by FDIC insurance on certificates of deposit, in addition to the reserve, reporting, and inspection requirements found in the banking laws. *Id.* at 558. The Supreme Court applied the same principle again in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), where it held that promissory notes were securities, in part because they were uncollateralized, uninsured, and unregulated under any other "substantial" or "comprehensive" statutory scheme. *Id.* at 69.

These decisions have established an important principle in federal securities law: if an investment product is the subject of meaningful consumer protections under an alternative regulatory regime, then there is correspondingly less need for the application of the federal securities laws. Conversely, where those protections are absent or insufficient, regulation under the securities laws is all the more necessary and appropriate.

Under this test, EIAs should be—indeed must be—regulated as securities. Justice Brennan's critique of state insurance regulation with respect to variable annuities also applies to EIAs, notwithstanding variations in the two types of products. The last 50 years have proven the point. It is widely understood that state insurance regulation was designed to promote the safety and soundness of issuers, not the protection of investors at the point of sale. Accordingly, insurance laws do not protect investors adequately from the sales practice abuses that are often associated with investment products like EIAs. For example, given the enormous complexity of EIAs, it is essential that they be subject to the strongest possible disclosure requirements. As Justice Brennan explained, however, insurance regulation is not a disclosure regime. Only the securities laws mandate a level of disclosure that is commensurate with the complexities and risks that EIAs present.

Justice Brennan's fundamental point about insurance regulation extends not only to disclosure but to other areas as well, including suitability, enforcement, and even licensing. EIAs have long surrender periods that make them especially inappropriate for many senior citizens. Nevertheless, elderly investors are prime targets for the sale of EIAs. An important regulatory antidote for this type of abuse is a strong suitability standard, yet many state insurance laws and regulations contain no such standard. On the other hand, the securities laws at both the state and federal level have for decades incorporated robust suitability requirements targeting precisely this form of abuse, which is so often associated with EIAs.

EIAs also call for the application of strong enforcement remedies. Extraordinarily high commissions on the sale of EIAs have proven to be, for many agents, an irresistible incentive to commit fraud and other sales abuses. Strong punitive measures are essential for addressing this problem. However, because state insurance laws and regulations focus on issuer solvency rather than consumer protection, they contain relatively weak enforcement remedies. They simply do not provide an adequate deterrent against abusive sales practices. The securities laws, on the other hand, incorporate strong enforcement measures that securities regulators have applied unflinchingly for decades. They include potentially heavy fines, rescission and restitution, license revocation, and in appropriate cases, criminal penalties.

Even the insurance licensing system has been questioned as inadequate to meet the challenges presented by EIAs. As FINRA has noted, "the fact that an associated person holds a license as an insurance agent may not adequately qualify him to understand the features of an EIA or the extent to which an EIA meets the needs of a particular customer." *See* FINRA Notice to Members 05-50, Equity-Indexed Annuities, at 5 (Aug. 2005).

Nor are EIAs endowed with any other safeguards, such as FDIC insurance or collaterization, that could mitigate the risk of loss and confusion they present to investors. The SEC has long recognized the importance of these considerations in applying the exemption. In its 1997 concept release, it invited comment about the nature of the state insurance provisions that apply to EIAs and the impact of those provisions on the "need" for federal securities regulation of EIAs. *See* Equity Index Insurance Products, Securities Act Release No. 33-7438, 1997 WL 473102, at *7 (Aug. 20, 1997). For all of these reasons, EIAs fail to satisfy the basic, threshold requirement for exemption from regulation as a security under Section 3(a)(8).

B. EIAs Pose Significant Investment Risks to the Buyer

Risk has never been an essential element in the definition of a security under federal law. *See SEC v. Edwards*, 540 U.S. 389, 394-95, 396-97 (2004) (supposedly fixed and guaranteed returns do not prevent an investment contract from being a security under federal law); *SEC v. W.J. Howey Co.,* 328 U.S. at 301 (for purposes of investment contract analysis, "it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value"). Nevertheless, for purposes of applying the Section 3(a)(8) exemption, the Supreme Court has established that the allocation of investment risk between the issuer and the investor is one factor to consider when distinguishing annuities that are entitled to the exemption from those that are not. The test has proven to be cumbersome, as courts have struggled to determine precisely what type of risk and what magnitude of risk the investor may be forced to bear before the exemption is lost to an issuer. In the words of one court, "How much risk is too much? The [Supreme] Court's opinions do not say, and the parties to our case debate the question vigorously." *See Associates in Adolescent Psychiatry*, 941 F. 2d at 566; *see also Otto v. Variable Life Insurance Co.,* 814 F.2d 1127, 1142 (7th Cir. 1986) (reversing earlier decision and finding that annuities were *non*-exempt, based solely on revelation that issuer reserved right to adjust excess interest at any time and thus imposed sufficient quantum of risk on investor), *cert. denied*, 486 U.S. 1026 (1988).

The risk test has also received more attention from courts and commentators than it deserves. It is in fact only one of several tests that govern the application of the Section 3(a)(8) exemption. Moreover, it is not the most important consideration. The Supreme Court's decision in *United Benefit* serves as a reminder on this point. The Court held that the variable annuity at issue failed to qualify for the exemption, even though the issuer's guarantee of cash value based on net premiums "reduce[d] substantially the investment risk of the contract holder." 387 U.S. at 211. The Court declared that "the assumption of an investment risk [by the issuer] cannot by itself create an insurance provision," and it relied instead on the *marketing* of the annuity as an investment to hold that it fell outside the exemption. *Id.*

Setting aside these concerns about the validity of *any* risk-based test, EIAs subject investors to a variety of investment risks that foreclose application of the exemption. For example, EIA purchasers typically face the risk that they will lose some portion of their initial investment.

Academic articles, investor alerts, and the SEC's own releases are replete with cautionary statements that EIAs *can* lose money. This may result either from "guarantees" of principal that are less than 100%, or from heavy surrender charges and loss of excess interest that are exacted when an investor cancels an EIA before maturity. As the SEC's current Investor Alert explains:

> **Can you lose money buying an equity-indexed annuity?**
>
> You can lose money buying an equity-indexed annuity, especially if you need to cancel your annuity early. Even with a guarantee, you can still lose money if your guarantee is based on an amount that's less than the full amount of your purchase payments. In many cases, it will take several years for an equity-indexed annuity's minimum guarantee to "break even."
>
> You may also have to pay a significant surrender charge and tax penalties if you cancel early. In addition, in some cases, insurance companies may not credit you with index-linked interest if you do not hold your contract to maturity.

SEC Investor Alert, "Equity-Indexed Annuities," at 1;[2] *see also* FINRA Investor Alert, "Equity-Indexed Annuities—A Complex Choice," at 3 ("FINRA Investor Alert") ("Is it possible to lose money in an EIA? Yes.");[3] Coleman Article, at 2 ("In addition, EIAs—like stocks and other speculative investments—can lose money, particularly in the event the holder is forced to cancel the annuity contract early."); *cf.* 1997 Release No. 33-7438, at *3 ("The guaranteed minimum return for a single premium product typically is *90% of premium* accumulated at a 3% annual rate of interest . . . ") (emphasis added). Although one lower court has suggested that losses attributable to early cancellation of an EIA are irrelevant to "investment risk," we have found no basis for that distinction in law, economics, or common sense, and the district court offered no authority for its position. *See Malone v. Addison Marketing, Inc.,* 225 F. Supp. 2d 743, 753 (W.D. Ky. 2002).[4]

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[2] *Available at* http://sec.gov/investor/pubs/equityidxannuity.htm.

[3] *Available at* http://www.finra.org/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/Equity-IndexedAnnuities-AComplexChoice/index/htm.

[4] The *Malone* case was poorly decided. Applying Section 3(a)(8) as well as Rule 151, the district court held that a 73 year old widow from Kentucky, along with other putative class members, had no claim under the federal securities laws against a group of brokers and insurance agents who collaborated in a fraudulent scheme to sell equity-indexed annuities and other products. The court downplayed or ignored a number of risks facing the plaintiffs, including the risk that any "guaranteed" interest returns were contingent upon a ten-year holding period and the risk that poor performance by the S & P 500 index would limit the plaintiff's gains. The court also took a narrow view of the marketing techniques used to sell the EIAs. It focused almost exclusively on written materials, rather than oral communications, and it gave controlling weight to two documents bearing the plaintiff's signature that were evidently designed as acknowledgement forms, not marketing materials. *Malone*, 225 F. Supp. 2d at 753-54. The

In addition, investors bear the risk of fluctuations in the stock market index used to calculate the amount of "excess interest" they will earn. Depending upon the performance of the index, investors may receive no excess interest whatsoever. This form of investment risk is made worse through an elaborate combination of low participation rates and caps on index-linked returns that stifle the potential for upside gain on the typical EIA. *See* 1997 Release No. 33-7438, at *5. The relevant case law as well as the SEC's safe harbor rule confirm that exposing investors to this type of market risk can void the exemption, quite apart from whether return of principal is guaranteed. Under Rule 151, for example, excess interest *may not* fluctuate in tandem with the market or at the whim of the issuer, but must instead be credited at a specified, minimum rate that is not modified more than once a year. *See* 17 C.F.R. § 230.151(b)(3).

To the extent that a given EIA has a "market value adjustment" feature, investors who need access to their money before the end of the guarantee period must assume the additional risk of interest rate fluctuations. The value of the investor's payment is subject to variation depending upon whether prevailing interest rates have risen or fallen relative to the investor's contract rate.

In addition to economic risks linked to potential loss of principal, uncertain market performance, and interest rate changes, investors who buy EIAs face yet another form of investment risk: complexity risk arising from the baffling array of features that issuers have incorporated into these products. When the investor and the salesman do not understand the product and its costs and benefits, it becomes virtually impossible for either of them to assess the merits of the investment relative to other financial products.

Although this type of risk is perhaps novel in the context of analyzing EIAs, it is nevertheless very real. Regulators, courts, and commentators routinely emphasize the complexity of EIAs as one of the most serious dangers facing any investor contemplating a purchase. For example, FINRA's Investor Alert on EIAs is entitled "Equity-Indexed Annuities—A Complex Choice," and it opens with these disturbing observations:

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court's analysis conflicts with the SEC's early statement of policy regarding the marketing element of Section 3(a)(8):

> All the circumstances, including the sales literature prepared by the issuer and oral and written representations to be made by the authorized salespersons, must be considered carefully in determining whether a particular insurance or annuity contract qualifies for the exemption under Section 3(a)(8).

General Statement of Policy Regarding Exemptive Provisions Relating to Annuity and Insurance Contracts, Securities Act Release No. 33-6051, 44 Fed. Reg. 21,628, at 21,628 (Apr. 5, 1979). Although the court in *Malone* was satisfied that the requirements of Section 3(a)(8) and Rule 151 had been met, an apparent victim of fraud in the sale of EIAs was left without recourse under the federal securities laws. The case thus highlights the need for a new and stronger approach to the regulation of EIAs, in the form of the proposed rule.

> EIAs are anything but easy to understand. One of the most confusing features of an EIA is the method used to calculate the gain in the index to which the annuity is linked. To make matters worse, there is not one, but several different indexing methods. Because of the variety and complexity of the methods used to credit interest, investors will find it difficult to compare one EIA to another.

FINRA Investor Alert, at 1; *see also* NTM 05-50, at 2 ("[B]ecause of the product's complexity, some associated persons might have difficulty understanding all of the features of the product and determining the extent to which those features meet the needs of the customer"); Mary L. Schapiro, Vice Chairman, NASD, Remarks at the NASD Spring Securities Conference, at 3 (May 25, 2005) ("Moreover, equity-indexed annuities are very complicated products that do not provide the liquidity that some older investors may need").[5]

Some courts have even entertained claims that the sale of EIAs to senior citizens constitutes an inherently unfair and deceptive scheme under state law, due in large part to their complexity. In *Yokoyama v. Midland National Life Insurance Co.*, the plaintiffs alleged a variety of fraudulent practices in the sale of EIAs, with a special focus on their daunting complexity:

> Plaintiffs argue that Defendant has built into each contract a complex web of surrender periods, surrender charges, interest adjustments and caps and spreads on the index increases which are so poorly disclosed that the consumer cannot see where his or her funds have gone and cannot compare his or her investment to other investments.

Civ. No. 05-00303 JMS-KSC, 2007 WL 1830858, at *2 (D. Haw. Feb. 13, 2007) (failing to certify class on other grounds).

In his original 2006 article on EIAs, Dr. McCann offered this assessment of the opaque nature of EIAs: "No registered rep, insurance broker, or retail investor, and precious few finance PhDs, could understand these products." *See* Craig McCann and Dengpan Luao, *An Overview of Equity Indexed Annuities*, SECS. LITIG. AND CONS. GRP., at 13 (2006) ("McCann Article").[6]

There is no doubt that this form of risk, arising from the inherent complexity of the product, is foisted upon investors, not assumed by issuers. Furthermore, there is no reason why such risk should be ignored for purposes of distinguishing insurance products from investments for purposes of the Section 3(a)(8) exemption. The concept of "investment risk" should be understood and applied broadly, in keeping with the remedial purposes of the securities laws. The best and perhaps sole remedy for the baffling complexity of the typical EIA is the disclosure regime mandated under the securities laws, which include strong sanctions for non-compliance. As Justice Brennan argued in *VALIC,* Congress did not foresee the evolution of such complex annuities in 1933, and the rationale for exempting them from securities regulation under Section 3(a)(8) no longer exists.

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[5] *Available at* http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P014261.
[6] *Available at* http://www.slcg.com/research.php?c=1b&i=18) (emphasis added).

C. EIAs Are Marketed Primarily as Investments, Not as Insurance Products

Long before the advent of either variable or equity-indexed annuities, the Supreme Court established that the dominant factor in identifying whether a financial product should be regulated as a security under federal law is the manner in which it is marketed or promoted. The classic formulation of the test is found in *Joiner*, where the Supreme Court held that leasehold interests in land, coupled with oil drilling rights, were securities under the 1933 Act:

> Novel, uncommon, or irregular devices, whatever they appear to be, are also reached [by the definition] if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security.'

SEC v. C.M. Joiner Corp., 320 U.S. 344, 351 (1943). The Court rejected the argument that the underlying asset associated with the offering defines its true nature, and it emphasized that the test focuses instead on the way the offering is promoted:

> In applying acts of this general purpose, the courts have not been guided by the nature of the assets back of a particular document of offering. The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be.

Id. at 352-53.

Years later, in *Reves*, the Court again applied essentially the same marketing test as a key element in determining whether *notes* are securities, and it expressly declared that investors' perceptions of an offering will override conflicting economic analysis:

> Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.

Reves v. Ernst & Young, 494 U.S. at 66. As an example of the factors that shape investor expectations, the Court identified use of the word "investment" in advertisements promoting the product, and the absence of any "countervailing factors that would have led a reasonable person to question this characterization." *Id.* at 70.

Finally, in *United Benefit*, the Court addressed the status of variable annuities under the Section 3(a)(8) exemption. Although the Court acknowledged that risk transfer was a factor to consider, it assigned considerably more weight to the marketing of the annuity than to the degree of investment risk assumed by the issuer. *SEC v. United Benefit Life Ins. Co.*, 387 U.S. at 211. The Court adopted the *Joiner* approach, quoted above, and further elaborated upon the marketing test by noting that annuities compete for market share with other investments such as mutual funds, which are undoubtedly securities:

> Flexible Fund arrangements . . . are considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of "growth" through sound investment management.
>
> Contracts such as [these] offer important competition to mutual funds . . . and are pitched to the same consumer interest in growth through professionally managed investment. It seems eminently fair that a purchaser of such a plan be afforded the same advantages of disclosure which inure to a mutual fund purchaser . . . .

Id. In its own pronouncements, the SEC has consistently and correctly identified marketing as "highly relevant" in determining the proper treatment of annuities under federal law, citing to *United Benefit. See* Definition of Annuity Contract or Optional Annuity Contract, Securities Act Release No. 33-6645, 1986 WL 93108 (F.R.), at *20,260 (June 4, 1986) (squarely rejecting arguments that the Supreme Court has never established marketing as an essential element of a Section 3(a)(8) analysis).

Few courts have had the occasion to address the precise issue of whether EIAs qualify for the Section 3(a)(8) exemption, but those that have done so acknowledge the importance of the marketing test. *See Holding v. Cook*, 521 F. Supp. 2d at 838 (in fraud action involving EIAs, court cited need to develop factual record on the issue of how the EIA was marketed before deciding whether it was a security, given the potentially critical role of that element).

Measured by these tests that the Supreme Court has established, EIAs leave little doubt about their status as securities under federal law. Scholars, regulators, and aggrieved private plaintiffs all agree that EIAs are marketed primarily as investments, not as insurance products. Experts on the subject, for example, have forthrightly declared that "EIAs are merely another type of financial product, marketed and sold as investments," Coleman Article, at 6, and that they are "touted as excellent investments for investors wanting to participate in market returns without bearing market risk," McCann Article at 9.

Regulatory warnings and pronouncements confirm that EIAs are typically portrayed as investments. For example, FINRA's NTM 05-50 voices a pointed concern "about the manner in which associated persons are marketing and selling unregistered EIAs, and the absence of adequate supervision of these sales practices." NTM 05-50, at 2. The Notice reviews a sampling of advertisements typically used to promote EIAs. Those ads confirm that promoters consistently use "investment" terminology (adorned with frequent exclamation marks) in their promotional materials, and clearly emphasize the profit potential from EIAs, not the "stability and security" that insurance offers. *Cf. United Benefit*, 387 U.S. at 211. Here are some examples from the NTM:

- "The market goes up—you gain!"
- "A Win/Win Investment Vehicle!"
- "upside potential and no market downside risk"

Id.. The Notice furthermore cautions that "all recommendations to liquidate or surrender a registered security" for purposes of funding the purchase of an unregistered EIA must be "suitable," *id.* at 5, reflecting the fact that EIAs compete with other securities for investor funds and are therefore properly viewed as the same type of financial product.

The report issued last fall by the SEC, FINRA, and NASAA on the regulatory sweeps of "free lunch seminars" squarely supports this conclusion. *See* SEC, NASAA, AND FINRA, PROTECTING SENIOR INVESTORS: REPORT OF EXAMINATIONS OF SECURITIES FIRMS PROVIDING "FREE LUNCH" SALES SEMINARS (Sept. 2007).[7] The report states that the primary goal of the seminars is to "obtain new customers and sell investment products." *Id.* at 4. It furthermore ranks EIAs third among the items most commonly discussed at the seminars, along with other types of securities such as variable annuities, mutual funds, and speculative oil and gas investments. *Id.* at 4. State securities regulators also find this pattern significant: "In many cases, the salesperson recommends that the senior sell securities they currently own and use the proceeds to purchase indexed or variable annuities, products that are often flagrantly unsuitable for seniors." Joe Borg, President, NASAA, Remarks at the 2007 Senior Summit (Sept. 10, 2007).[8]

Regulatory enforcement actions provide further evidence that EIAs are promoted and perceived as securities. Hawaii, Massachusetts, and Minnesota are among the states that have filed cases involving the sale of EIAs. Their actions illustrate not only the fraud and abuse all too often associated with EIAs, but also the marketing of these products as investments. Two recurrent themes appear in these cases. First, unscrupulous salesmen consistently induce investors to liquidate securities portfolios in order to buy high commission EIAs, confirming that EIAs are interchangeable with securities. Second, sales pitches often lead investors to believe that through EIAs, they are actually investing in traditional securities such as mutual funds. For example, in *In re Teruya,* the respondents used fraudulent sales tactics to persuade senior citizens to replace existing securities investments with unsuitable equity-indexed annuities. *See* Preliminary Order to Cease and Desist and Notice of Right to Hearing, No. SEU-2001-095 (Haw. Dept. of Comm. and Cons. Affs. Sept. 7, 2007). Moreover, some investors were led to believe that they were investing in an S&P 500 index *fund*, not an annuity. *Id.* at 8. The SEC brought its own injunctive action based on the same facts. *See* Complaint, *SEC v. Senior Resources of Hawaii, Inc.*, No. CV07-00467 (D. Haw. Sept. 7, 2007).

In *In re Investors Capital Corp.*, the respondents engaged in a fraudulent campaign to sell EIAs to senior citizens, who often "liquidated, transferred, or exchanged a security to purchase an equity-indexed annuity." *See* Administrative Complaint, No. E-2005-0190, at 32 (Mass. Div. of Secs. Nov. 16, 2005). Salesmen also invoked the advantages of the stock market, "without the downside risk." *Id.* at 35; *see also Minnesota v. Allianz Life Insurance Co.*, Complaint, No. 27-

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[7] *Available at* http://sec.gov/spotlight/seniors/freelunchreport.pdf.
[8] *Available at* http://www.nasaa.org/NASAA_Newsroom/Speeches/7179.cfm.

CV-07-581 (D. Minn. Jan. 9, 2007) (alleging widespread pattern of abuse in sale of EIAs to senior citizens, who were persuaded to liquidate mutual funds and variable annuities to purchase EIAs).

Lawsuits filed by private plaintiffs provide yet further evidence that EIAs are marketed as investment products. Although the reported decisions deal primarily with issues such as class certification, they also support the view that EIAs are sold by promoters and perceived by investors as securities. *See, e.g., Mooney v. Allianz Life Ins. Co.*, No. 06-545, 2007 WL 128841, at *2-3 (D. Minn. Jan. 12, 2007) (alleging systematic fraud in sale of EIAs, and describing sales pitches that spoke in terms of potential "grow[th]" from linkage to S&P 500 index); *Yokoyama v. Midland National Life Ins. Co.,* 243 F.R.D. 400, 402-04 (D. Haw. 2007) (describing EIAs, which were sold in a fraudulent scheme, in terms of "investments," "invested premium," and "earning[s]" on premiums").[9]

The SEC has rightly suggested that, given the nature of EIAs, it may be inherently impossible to avoid marketing them as investments: "The Commission is concerned that the nature of equity index insurance products may make it particularly difficult to market these products without primary emphasis on their investment aspects." 1997 SEC Release No. 33-7438, at *8-9. Even those who seek to limit the regulation of annuities as securities have been forced to acknowledge this fundamental truth. In 1986, virtually all commentators challenged the emphasis on marketing in the SEC's proposed safe harbor rule. *See* 1986 Release No. 33-6645, at *20,260. In their opposition to the marketing test, however, they were forced to concede the core issue: "[A]nnuities have always had a large investment component, and . . . therefore, it would be unfair to insurers and the public *not* to market these products as . . . investments." *Id.* (emphasis added). The same could be said of EIAs, and for this reason, they should be regulated as investments under the federal securities laws.

All of these sources provide convincing evidence that EIAs are marketed primarily as investments, not insurance products. This warrants a finding that they are securities and that they fall outside the exemption from regulation in Section 3(a)(8).

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[9] A few cases have addressed the nature of EIAs outside the context of federal securities law, and those decisions reflect the same point: EIAs are viewed fundamentally as investments, not insurance products. *See In re Simpson*, 366 B.R. 64, 73 (B.R. App. Panel 9th Cir. 2007) (holding that an EIA is an investment, not insurance, under California law, because "instead of creating an immediate estate for the benefit of others, the annuitant [reduces] the annuitant's immediate estate in favor of future contingent income"); *cf. Nationsbank v. Variable Annuity Life Ins. Co.,* 513 U.S. 251, 814-15 (1995) (holding that annuities are investments, not insurance products, under federal banking law).

EIAS ARE OFTEN USED TO PERPETRATE FRAUD AND ABUSE

Underlying the foregoing legal analysis is perhaps the single most important point about EIAs: they are often used to defraud investors. All available evidence, ranging from the daily news clips to the investor alerts issued by federal and state regulators, clearly show that EIAs are being deployed as instruments of fraud and abuse. They have enticing features that make them attractive to our large and vulnerable population of senior citizens. EIAs are so complex, however, that most investors cannot look behind the sales pitch and assess the meager benefits, high costs, and significant risks they actually entail. Instead, baffled by the intricacies of EIAs, mentally exhausted investors often rely too heavily on the advice of salesmen. Those salesmen, in turn, receive such generous commissions from EIAs that they cannot resist selling them, regardless of how unsuitable they may be for investors. As Dr. McCann explained in his original critique of EIAs:

> [E]quity-indexed annuities' complexity makes it virtually impossible even for brokers and agents to properly evaluate the annuities. Salesmen can readily determine, though, that commissions paid for selling equity-indexed annuities—as high as 10% or 12%—are much higher than commissions paid on mutual funds and variable annuities. . . . The net result of equity-indexed annuities' complex formulas and hidden costs is that *they survive as the most confiscatory investments sold to retail investors*.

See McCann Article, at 13 (emphasis added).[10]

This combination of factors has proven to be particularly injurious to our senior citizens. The elderly are all too often the victims of fraud through the sale of variable and equity-indexed annuities. At the SEC's first Senior Summit in July 2006, then-NASAA President Patty Struck shared state enforcement statistics indicating that "unregistered securities, variable annuities, and equity-indexed annuities are the most pervasive financial products involved in senior investment fraud." *See* Patricia D. Struck, President, NASAA, Statement at SEC Seniors Summit, at 2 (July 17, 2006).[11] Those statistics further show that in some states, over half of all senior fraud cases involve variable or equity-indexed annuities. *Id.*

Additional support for this undeniable trend is found in the enforcement actions and private actions discussed elsewhere in this comment letter. Unfortunately, many additional cases could be cited. *See, e.g., Strube v. American Equity Investment Life Insurance Co.*, 226 F.R.D. 668 (D. Fla. 2005) (describing systematic fraud in the sale of EIAs to 23,000 elderly citizens), *cert. denied*, 127 S. Ct. 208 (2006). The threat has grown significantly in recent years. EIAs are relatively new products, but their sales volume has increased sharply, from $14 billion in 2003 to an estimated $25 billion in 2005. *See* Coleman Article, at 2.

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[10] *Available at* http://www.slcg.com/research.php?c=1b&i=18) (emphasis added).
[11] *Available at* http://www.nasaa.org/Issues_Answers/Legislative_Activity/Testimony/4999.cfm.

In NASAA's view, adopting the proposed rule and shielding investors from the predatory sale of EIAs is one of the most important steps that the SEC can take to advance the cause of investor protection. It is an essential complement to the other important initiatives that the SEC has pursued over the last two years in an effort to reduce the financial exploitation of senior citizens. As noted in recent remarks from SEC Chairman Christopher Cox before the Practicing Law Institute, the SEC has joined with other regulators in a series of steps aimed at protecting the nation's seniors from investment fraud: strengthening investor education programs, conducting joint exams of "free lunch" seminars, and bringing dozens of enforcement actions against those who target seniors. *See* Christopher Cox, Chairman, SEC, Remarks to the "SEC Speaks in 2008" Program of the Practicing Law Institute, at 7 (Feb. 8, 2008).[12]

While all of these steps are important components of an overall investor protection strategy, none can have the impact of a declaration by the SEC that an entire class of investments widely used to exploit seniors shall henceforth be subject to the broad array of protections available under the federal securities acts. Those protections include rigorous disclosure and suitability standards; testing and licensing requirements for agents; and tough sanctions that can overcome the lure of high commissions. All of these measures are sorely needed with respect to EIAs.

THE PROPOSED RULE IS AN APPROPRIATE AND FAIR EXERCISE OF THE SEC'S REGULATORY AUTHORITY

The SEC certainly has the power to remove the uncertainty surrounding the status of EIAs by defining certain types of EIAs as beyond the scope of the 1933 Act exemption. *See, e.g.,* 15 U.S.C. § 77s(a) (conferring general authority upon the SEC to make rules and define terms). In the context of annuity regulation, the SEC has already entertained and rejected the argument that it lacks the authority to define the meaning of the word "annuity" as it appears in Section 3(a)(8). *See* "Annuity Contracts" and "Optional Annuity Contracts," Securities Act Release No. 33-6050, 1979 WL 169946, at *2 (Apr. 5, 1979) (asserting that the agency has authority to address the scope of the annuity exemption either through a rule or through an interpretive release).

Along with the authority to make rules and interpret the statutory language comes the authority to change those rules and interpretations. Congress explicitly conferred this power in the basic rulemaking provision of the 1933 Act, when it granted the SEC authority to "amend" and "rescind" its rules and regulations. *See* 15 U.S.C. § 77s(a). Even adherence to a regulatory stance over a significant period of time does not prevent the SEC or any other administrative agency from altering its position in furtherance of the public interest. The SEC explained the point this way in 1972 when it decided to bring certain corporate reorganizations under the registration provisions of the 1933 Act:

> The Commission recognizes that the "no-sale" concept has been in existence in one form or another for a long period of time. Certain persons who commented . . . have cited this as a reason for retaining the present Rule 133 and others have asserted that the Commission lacks the power to revise the rule. The Commission

[12] *Available at* http://sec.gov/news/speech/2008/spch020808cc.htm.

> does not agree with these comments. Administrative agencies as well as courts from time to time change their interpretation of statutory provisions in light of reexamination, new considerations, or changing conditions which indicate that earlier interpretations are no longer in keeping with the statutory objectives.

Notice of Adoption of Rules 145 and 153A, Prospective Rescission of rule 133, Amendment of Form S-14 under the Securities Act of 1933, and Amendment of Rules 14A-2, 14A-6, and 14C-5 under the Securities Exchange Act of 1934, Exchange Act Release No. 9804, 1972 WL 121530, at *3 (Oct. 6, 1972). In a comment that could easily be made about the status of EIAs, the SEC went on to explain that its decision to change the applicable rule was "based upon a number of factors, including the observation that Rule 133 has enabled large amounts of securities to be distributed to the public without the protections afforded by the Act's registration provisions." *Id.* The SEC is rightly committed to the proposition that rules and interpretations can and should evolve when necessary to ensure that the interests of investors are protected.

Finally, there are no practical consequences or market repercussions that suggest the SEC should stay its hand. The proposed rule incorporates reasonable provisions designed to afford the industry with a fair opportunity to conform its behavior to the new requirements, prospectively applied. While industry will have to bear the costs of complying with the registration, licensing, and antifraud provisions of the securities laws, those costs are outweighed by the benefits to investors. The SEC has previously made clear, in the context of interpreting the Section 3(a)(8) exemption, that cost considerations cannot "overrid[e] the strong public policy of requiring registration and full disclosure of the nature and terms of a proposed securities offering." 1979 Release No. 33-6050, at *2. Justice Brennan made the same point nearly 50 years when the Supreme Court first held that variable annuities must conform to the federal securities laws. Faced with the argument that the Court's decision would not only burden issuers, but would put them out of business, Justice Brennan made this observation:

> But in the final analysis, it is not decisive of the issues here that a holding that these contracts are subject to the Federal [Securities] Acts might require some modification in the business of issuing them. *Since these contracts are in fact covered by the Acts, there can be no reason why their issuers should be able to carry on the investment business in a way in which Congress has forbidden.*

See VALIC, 359 U.S. at 93 (Brennan, J., concurring) (emphasis added).

ARGUMENTS AGAINST THE RULE LACK MERIT

The SEC has received hundreds of comment letters on proposed Rule 151A, many of them expressing opposition. A common theme is that the sale of EIAs is already "highly regulated" by state insurance commissioners, and that the rule would therefore impose an unnecessary layer of regulation on industry. The centerpiece of this argument is the claim that approximately 35 insurance commissioners have recently adopted a version of the model suitability rule for annuities, developed by the National Association of Insurance Commissioners ("NAIC").

Insurance laws and regulations do not focus primarily on protecting the investing public from marketing abuses. They were designed instead to protect the safety and soundness of insurance companies. NASAA recognizes that insurance regulators in many states are considering, and in some instances adopting, new rules aimed at enhancing consumer protections. This is a positive trend. However, these developments hardly show that regulation of EIAs as securities is unnecessary or unwarranted. The fact is that state insurance regulation falls short in terms of both regulatory standards and enforcement philosophy. More important, perhaps, is this fundamental truth: regardless of how consumer-oriented insurance regulation may become, the application of federal securities law to the offer and sale of securities such as EIAs will always be necessary and appropriate in order to protect investors. A dual system of state and federal regulation has worked admirably in the securities field, and given the complexities, risks, and documented abuses associated with EIAs, it is clear that a concurrent approach to the regulation of these investments is essential.

With respect to codes of conduct, state insurance laws do not incorporate the strong disclosure, suitability, or antifraud standards that are found in the federal securities laws. For example, there is no counterpart in the insurance laws to the detailed disclosures that issuers are required to make in the securities registration process. As Dr. McCann makes clear in his report, without that level of transparency, investors and their financial advisers find it nearly impossible to understand the significant risks, high costs, and meager benefits of the typical EIA.

The insurance suitability standard touted in numerous comment letters is (1) inapplicable in many states, (2) weaker than the securities law counterpart, and to our knowledge, (3) not vigorously enforced. The history of the model suitability rule promulgated by the NAIC is instructive. The NAIC adopted the first version of the rule in 2003, but it was severely limited in scope, applying only to investors over the age of 65. After receiving widespread criticism for taking such a grudging approach to investor protection, the NAIC in 2006 adopted a revised version without the age restriction. However, even as it stands, the NAIC's model rule is weaker than the suitability rule that has applied in the securities field for decades. For example, in the NAIC model, the core prohibition against unsuitable sales applies for the most part only to insurance agents, not issuers. Moreover, it permits issuers to delegate a great deal of their supervisory responsibilities.

With respect to enforcement philosophy, insurance regulation has never been marked by a particularly aggressive, pro-consumer approach. In general, insurance departments have focused their resources on overseeing the solvency of insurance companies. This function, vital though it may be, offers little protection against the abusive sales practices that our nation's investors routinely face.

The comment letters opposing the SEC's proposed rule actually reflect these regulatory shortcomings. Those letters offer no data to support the notion that insurance commissioners vigorously enforce consumer protection standards. Instead, the letters highlight the speedy complaint resolution procedures that are available to aggrieved investors. This model of consumer protection is a minimalist one, under which regulators essentially facilitate dispute resolution, if and when investors realize they have been victimized—a realization that may never come to an elderly investor pressured into an incomprehensible EIA with a 15 year maturity period. Without the threat of aggressive enforcement as a deterrent, however, complex investment products like EIAs, marketed by highly motivated sales agents, simply cannot be effectively regulated. Application of the securities laws, along with a strong enforcement philosophy, is essential.

Enforcement actions taken by other regulators reinforce the point. The SEC and a number of state securities regulators have pursued actions alleging misconduct in the sale of EIAs, even where those regulators lacked explicit statutory authority to regulate EIAs directly. Examples include the enforcement actions discussed above. Attorneys general have also recognized the need to take aggressive enforcement action against issuers engaged in the misleading sale of EIAs. *See* Press Release, Office of Attorney General Lori Swanson, Minnesota Attorney General Lori Swanson Settles American Equity Case and Sues AmerUs/American Investors Over Unsuitable Annuities (February 7, 2008) (describing a series of actions against the nation's leading issuers of EIAs, alleging unsuitable and misleading sales of EIAs to thousands of elderly investors). It appears that state insurance commissioners, on the other hand, have brought relatively few enforcement actions involving the sale of EIAs, even though they have been primarily responsible for the regulation of EIAs since these investments were first introduced 15 years ago.

CLARIFICATIONS AND CHANGES THAT WOULD ENHANCE THE RULE

The SEC's proposed rule is an appropriate and effective approach to the regulation of EIAs under the federal securities laws. Nevertheless, the SEC may wish to consider the following changes that would enhance the clarity and breadth of the rule.

<u>Clarify the prospective application of the rule.</u> The SEC's release explains that the new rule will apply "only to indexed annuities that are *issued* on or after the effective date of our final rule." *See* Release, at 7 (emphasis added). Does "issued" in this context mean "sold" to an individual investor, or does it mean designed by the insurance company and released into the marketplace? Under the latter meaning, the rule would arguably permit the continued, unregulated sale of any EIAs that were first marketed prior to the effective date of the final rule. This result would clearly be at odds with the purposes of the rule. To eliminate any possibility that the rule could be interpreted in this fashion, clarification is warranted.

<u>Expand the scope of the rule to encompass other indexed products.</u> The SEC's release requests comment as to what contracts should be covered by the definition, and it specifically asks whether the proposed definition should apply to forms of insurance other than annuities. *See* Release, at 30. NASAA believes that to the extent any other insurance products impose investment risks upon purchasers, or are marketed as investments, then it would be appropriate to subject them as well to regulation under the federal securities laws. Examples of other insurance products warranting such treatment include equity-indexed life insurance and equity-indexed universal life insurance.

Simplify and broaden the test for defining annuities covered by the rule. At the heart of the proposed rule is this test: the rule will apply to indexed annuities if "amounts payable by the issuer are more likely than not to exceed the amounts guaranteed under the contract." § 230.151A(a)(2). This provision raises concerns. For example, it calls for a prediction based upon certain assumptions and methodologies. It may therefore allow issuers to circumvent the rule depending upon which assumptions and methodologies they choose to apply. In his report, Dr. McCann assuages these concerns by observing with confidence that under this predictive test, "all existing equity-indexed annuities I am aware of would unambiguously be covered by the proposed rule." *See* McCann Report, at 5.

Nevertheless, NASAA believes that it would be advantageous to simplify and broaden the scope of the rule. For example, the rule could incorporate just the *first* test set forth in section 230.151A(a)(1), without adding the "more likely than not" standard. With this modification, the rule would simply apply to any annuities where the "amounts payable by the issuer under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities."

Some observers undoubtedly would criticize this approach, arguing that it would cover annuities regardless of how much risk they transfer to investors. This broader approach is, however, both legally defensible and beneficial to investors. It has the virtue of simplicity, clarity, and ease of application. It also would thwart industry attempts to evade the rule through economic sleight of hand. And insofar as EIAs transfer at least some risk to investors and are marketed as investments, then under current law, they may legitimately be regulated as securities. A less drastic but still helpful modification to the rule could be made by requiring only that there be "a significant possibility" that amounts payable will exceed amounts guaranteed.

Modify the provisions governing the issuers required determinations. NASAA suggests that three changes be made in the provisions governing an issuer's determination as to whether amounts payable are more likely than not to exceed amounts guaranteed under the contract. First, we see no rationale for making the issuer's determination "conclusive." Second, the types of acceptable assumptions and methodologies could be specified in more objective terms. For example, rather than requiring those assumptions and methodologies to be "reasonable," the rule could also require that they adhere to accepted standards of economic and actuarial analysis. Finally, the rule should make clear that the analysis underlying the issuer's determination be preserved in written form and made available upon request to the SEC.

CONCLUSION

Millions of investors across the country, many of them senior citizens, need protection from the fraud and abuse that is taking place in the sale of EIAs. Although these products are securities, they remain largely unregulated under federal securities law by virtue of the Section 3(a)(8) exemption. That exemption, however, was never intended to apply to financial products like EIAs, since they are marketed primarily as investments, they pose substantial risks to consumers, and they are not subject to adequate regulation under the insurance laws. The SEC's proposed rule closes this regulatory gap. We commend the SEC for taking this step, and we urge that the proposed rule be adopted for the benefit of all investors, especially our senior citizens.

Thank you for the opportunity to comment on this important rule proposal. If you have any questions about NASAA's comments, please feel free to contact me, at 701-328-4702, or Stephen Hall, NASAA's Deputy General Counsel, at 202-737-0900.

Sincerely,

Karen Tyler
NASAA President and North Dakota Securities Commissioner

Accompanying Document: Report of Dr. Craig McCann

An Economic Analysis of Equity-Indexed Annuities

September 10, 2008

Submitted to the North American Securities Administrators Association (NASAA)

Prepared by Craig J. McCann, PhD, CFA
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An Economic Analysis of Equity-Indexed Annuities

Executive Summary

The Securities and Exchange Commission has proposed to clarify an exemption from the federal securities laws to exclude from the exemption equity-indexed annuities that expose investors to stock market risk.

Equity-indexed annuities are complex contracts that pay investors part of the capital appreciation in a stock index and provide illusory but superficially appealing benefits including minimum value guarantees.

Equity-indexed annuities' issuers obfuscate investment risks by repackaging what is actually a simple underlying investment in securities and in the process deny investors the protections federal securities laws provide other investors.

A direct consequence of the lack of SEC oversight is that investors in equity-indexed annuities cannot determine the true costs they incur when purchasing equity-indexed annuities relative to alternative investments such as stocks, bonds and mutual funds. Investors are also exposed to an inadequately regulated, highly incentivized and frequently unscrupulous sales force as a result of the lack of effective SEC oversight.

The SEC's Rule Proposal is an important step towards providing truthful, complete disclosure and protection from sales practice abuses to investors who are currently investing $25 billion per year in unregistered securities.

SECURITIES LITIGATION & CONSULTING GROUP

I. Introduction

A. Rule Proposal

On June 25, 2008 the Securities and Exchange Commission issued a rule proposal that would clarify the annuity contract exemption from the federal securities laws to exclude equity-indexed annuity contracts whose payoffs are more likely than not to exceed the amounts guaranteed under the contract.[1] All existing equity-indexed annuities would meet this criterion and so the rule would require that they all be registered under the Federal securities laws. The rule would therefore provide investors who purchase equity-indexed annuities with the full protections provided to investors who purchase economically equivalent investments.

B. Equity-Indexed Annuities

Equity-indexed annuities are contracts offered by insurance companies that pay investors part of the capital appreciation in a stock index and guarantee a minimum return if the contract is held to maturity. Since their introduction in the U.S. in 1995, sales of equity-indexed annuities have grown dramatically. Although good data is not available, commentators have estimated that $25 billion in equity-indexed annuities were sold in 2007.[2] Sales have increased because equity-indexed annuities limit downside risk, offer some participation in stock market gains and generate extraordinary commissions to salesmen and profits to issuers. Despite the growth in sales, merits of equity indexed annuities have remained obscured by their complexity and abusive sales practices targeting the least sophisticated and most vulnerable investors have flourished.

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[1] Securities and Exchange Commission *Indexed Annuities and Certain Other Insurance Contracts*, SEC Release Nos. 33-8933, 34-58022, File No. S7-14-08 ("SEC Rule Proposal")

[2] See http://www.indexannuity.org

C. Securities Litigation and Consulting Group, Inc.

Securities Litigation and Consulting Group, Inc. ("SLCG") is a financial economics consulting firm based in the Virginia suburbs outside of Washington, DC founded in 2000. SLCG's employees hold PhDs in finance, economics, mathematics and statistics. SLCG circulated a preliminary working paper which described the stylized features of equity-indexed annuities and explained how they can be modeled and evaluated in January 2006.

II. Rule Proposal

A. Clarification of Regulation

Annuity contracts which meaningfully transfer risks from investors to issuers are exempt from federal securities laws. The SEC rule proposal would clarify the definition of an annuity contract for determining this exemption to exclude from the exemption contracts issued by insurance companies which expose investors to significant investment risks. Existing equity-indexed annuities superficially appear to protect investors from these investment risks but, in fact, do not. The investment risks to which investors are exposed are virtually identical to the risks of investing in mutual funds and variable annuities.[3]

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[3] "Individuals who purchase indexed annuities are exposed to a significant investment risk – i.e., the volatility of the underlying securities index. …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." SEC Rule Proposal, page 5.

"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". SEC Rule Proposal, page 6.

"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. The value of such an indexed annuity reflects the benefits and risks inherent in the securities market, and the contract's value depends upon the trajectory of that same market. Thus, the purchaser obtains an instrument that, by its very terms, depends on market volatility and risk." SEC Rule Proposal, page 26.

Equity-indexed annuities are quite similar to equity-participation securities, which are traded on the American Stock Exchange under various brand names. Equity-participation securities guarantee that investors will receive the initial face value of the security plus part of the increase in the value of a stock or stock index. The payoffs to equity-participation securities can be determined using participation rates, caps or annuals spreads just like equity-indexed annuities. Insurance companies add trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to equity-participation securities, mix in complex, arbitrary return calculations and sell the resulting contracts as equity-indexed annuities. The repackaging of equity-participation securities as equity-indexed annuities and aggressive anti-regulatory position taken by issuers has heretofore exempted equity-indexed annuities from effective securities regulation.

B. Coverage Criterion

The rule proposal would apply to any annuity contract whose payoffs to investors vary significantly with stock market returns.[4] Although the rule proposal is not definitive on the point in time at which the payoffs' sensitivity to stock market returns should be assessed, the end of the surrender period is reasonable as proper product design would not include surrender periods which were intended to extend beyond the expected term of an investment.[5] In what follows, I assess the impact of the proposed rule's

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[4] "When 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 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." SEC Rule Proposal, page 6.

[5] Surrender periods designed into EIA products could extend beyond when investors are expected to receive payoffs from contracts but such a design should raise serious consumer and investor protection questions and is ignored in this paper.

coverage criterion if applied at the end of surrender periods. All existing equity-indexed annuities I am aware of would unambiguously be covered by the proposed rule.

C. Need for Regulation

Federal securities laws protect investors by requiring full and fair disclosure of all material facts by issuers and non-abusive sales practices by brokers and agents. The clarification proposed by the SEC is needed because issuers of existing equity-indexed annuities obfuscate the investment risks to which investors are exposed by repackaging what is actually a simple underlying investment with a layer of virtually worthless bells and whistles.[6] This superficial repackaging exposes investors who purchase equity-indexed annuities to the same risks as investors who purchase stocks, bonds and mutual funds while denying them the full protections of federal laws afforded other investors.[7]

A direct consequence of the lack of SEC oversight is that investors in equity-indexed annuities cannot determine the true costs they incur when purchasing these investments and cannot effectively compare equity-indexed annuities to alternative investments such as stocks, bonds and mutual funds. Equity-indexed annuities' unregistered status also severely limits the recourse available to victims of sales practice abuses.

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[6] For example, consistent with issuers' underlying investment portfolios, academics model equity-indexed annuities as equivalent to portfolios of low risk bonds and call options on stock indexes. *See* Zvi Bodie and Dwight B. Crane, *The Design and Production of New Retirement Savings Products*, Harvard Business School Working Paper #98-070 January 28, 2008. Issuers obscure the simple economics of this investment by making it superficially extraordinarily complicated.

[7] "The Federal interest in providing investors with disclosure, antifraud, and sales practice protections arises when individuals are offered indexed annuities that expose them to securities investment risk. 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. However, a fundamental difference between these securities and indexed annuities is that – with few exceptions – indexed annuities historically have not been registered as securities. As a result, most purchasers of indexed annuities have not received the benefits of federally mandated disclosure and sales practice protections." SEC Rule Proposal, page 6.

If federal securities regulation is necessary to protect investors who purchase stocks, bonds, mutual funds and variable annuities then such regulation is also necessary to protect investors who purchase equity-indexed annuities. The interpretive loophole through which equity-indexed annuities have heretofore evaded effective disclosure requirements and sales practice abuse prohibitions explains the growth in equity-indexed annuities which neither the target audience - nor the sales force - can adequately evaluate.

III. Equity-Indexed Annuities

Equity-indexed annuities' notional (as opposed to real, spendable) account values are determined by a set of features including stock market returns, term to maturity, crediting method, participation rate, caps, spreads, bonus credits, guaranteed premium base and minimum rates of return applied to the evolution of a stock index over the life of the investment. Payoffs before the end of quite lengthy surrender periods depend on the substantial surrender charges applied to interim accumulated account values. In addition to the characteristics that define payoffs, the contracts have features which include provisions for modest withdrawals without paying surrender charges, death payments, annuitization options and guaranteed minimum values.

A. Account Value or Accumulation Value: Company Scrip, Not Cash.

An equity-indexed annuity contract has a notional value – as opposed to a cash value – called an *account value* or *accumulation value*. This notional value changes once a year on the contract purchase date's anniversary as that contract year's returns are credited to the previous anniversary's scrip value. If the investor wants to realize value from an equity-indexed annuity they are likely to receive substantially less than this notional value because of the application of surrender charges described below.

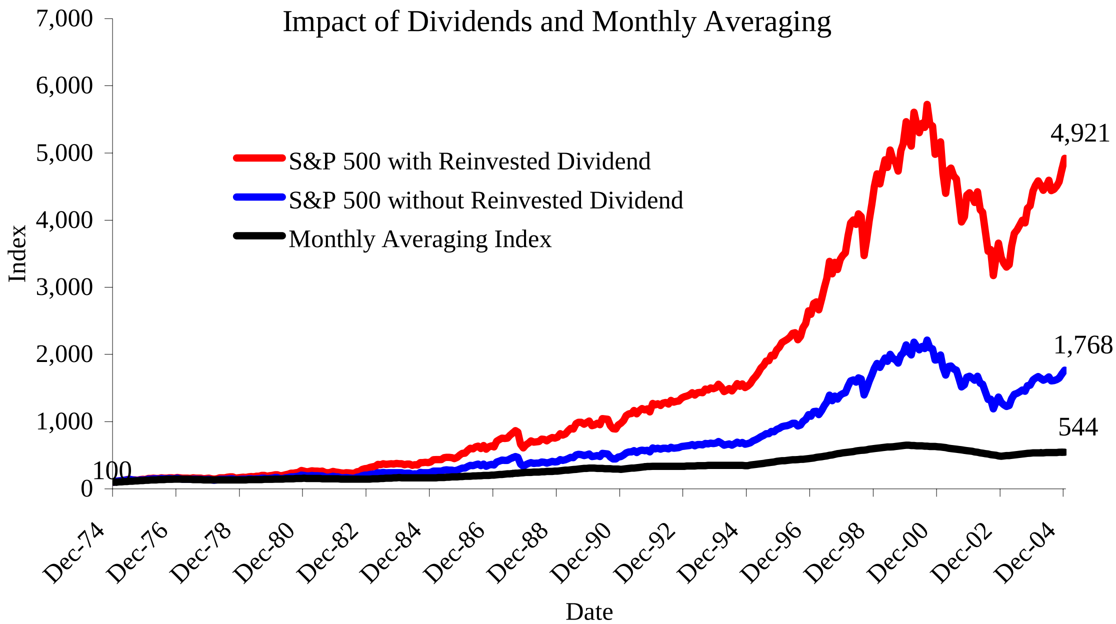
The account or accumulation value is economically quite similar to scrip which has been used infamously in lieu of cash wages in some industries and can only be spent at company stores at inflated prices. In what follows, I will refer to equity-indexed annuities' account or accumulation value as *scrip* value to differentiate it from the cash value which could be realized by investors.

B. Stock Index

Equity-indexed annuities credit investors with a return based on the change in the level of a stock price index. Most equity-indexed annuities are linked to the level of the S&P 500 Index; a few equity-indexed annuities are linked to other indices. The indexes used are price appreciation indexes and so changes in the level of the indexes do not include the dividends investors would receive if they owned the underlying stocks or stock mutual funds. Dividends have historically accounted for 20% of the returns investors have earned in the S&P 500 stocks and so exclusion of dividends causes the changes in the S&P 500 Index level used in equity-linked annuities to significantly understate the returns earned by investors in the S&P 500.

Figure 1 illustrates the impact of excluding dividends from the calculation of stock index returns from 1975 to 2004. On December 31, 1974 the S&P 500 closed at 68.56. The top line shows the value of the S&P 500 over time with reinvested dividends. The second line from the top shows the level of the S&P 500 index excluding dividends. Excluding dividends reduces the return over the 30 year period by 64%.

Figure 1
Impact of Dividends and Monthly Averaging



C. Term to Maturity

One-tier equity-indexed annuities pay out after the end of lengthy surrender charge periods without additional penalties. That is, after the end of the surrender period the scrip value equals the cash surrender value. It is common to refer to the end of the surrender charge period as the maturity of the contract.[8] The equity-indexed annuity payout is a function of the general level of price appreciation in the stock market at, or shortly before, the contract is wholly or partially liquidated. Other things equal, equity-indexed annuities with longer surrender periods provide less value to investors than annuities with shorter maturities.

Unlike one-tier annuities, the cash surrender value of a two-tier equity-indexed annuity never equals the scrip value. Two-tier annuities require that investors annuitize at disadvantageous rates of return over long periods of time to apply the scrip value. If investors don't annuitize a two-tier equity-indexed annuity they suffer significant losses even if they have held the investment for many years. For instance, the Allianz MasterDex 10 annuity is a two-tier equity-indexed annuity that offers a 10% premium credit that it is forfeited unless the contract is held for at least 5 years and is then annuitized for at least 10 years at what must then certainly be disadvantageous annuitization rates.

D. Crediting Method: How Changes in the Stock Index are Measured

There are two general formulas - called indexing methods - used to calculate changes in the index level. The *point-to-point method* measures the increase in the index level between two points in time without incorporating dividends, calculated at regular intervals, usually the contract's anniversary dates. This point-to-point increase in the index level is then reduced through one or more gimmicks and the resulting credit is applied to the previous contract anniversary's scrip value. The change in the scrip value from year to year cannot be negative. That is, the scrip value will stay constant rather

[8] Maturity is sometimes a defined term in the contracts specifying a date in the future well beyond when any investor will still be alive.

than decline if the credit calculated according to the contract's formula is negative. This is sometimes described as a *reset* or *ratchet* feature. Some point-to-point indexed annuities have a look-back feature, rather than an annual ratchet, whereupon if the index level is lower at the end of the contract than it was on some earlier reset date, the crediting feature will record an increase that is greater than under the simple point-to-point method, everything else held constant.

The *averaging method* calculates the difference in the index level from a starting date – either the contract purchase date or a subsequent anniversary – to the daily or month-end average value over some subsequent period.[9] In its most common form, the averaging method calculates the difference between the index level at the beginning of a contract year and the average monthly anniversary date closing levels during the contract year. As with the point-to-point method, the percentage difference in the month-end average level during the contract year from the level at the beginning of the year is reduced by one or more gimmicks and the resulting credit, if positive, is applied to the prior anniversary's scrip value.

Yet more complicated monthly averaging equity-index annuities include a look-back feature which yields the highest average month-end index level over sub-periods starting from the initial investment. For example, Sun Life's Keyport MultiPoint annuity is a monthly averaging equity-indexed annuity with look back to high water mark. It uses the highest average monthly index level from the purchased date to each anniversary to calculate index changes.

The Keyport annuity's value at maturity can be written as:

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[9] Some equity-indexed annuities average daily index values instead of monthly index values. Our discussion and examples focus on the monthly averaging method. Daily averaging makes evaluation computationally only slightly more difficult than for monthly averaging and doesn't change any qualitative conclusion.

Eq. 1) $$V_T = V_o \times \max\left[1+\alpha\left(\frac{\max(I_0, \frac{\sum_{n=1}^{12} I_n}{12}, \frac{\sum_{n=1}^{2\times12} I_n}{12}, \frac{\sum_{n=1}^{3\times12} I_n}{12}, \ldots, \frac{\sum_{n=1}^{T\times12} I_n}{12}) - I_0}{I_0}\right), \beta(1+\gamma)^T\right]$$

Where,

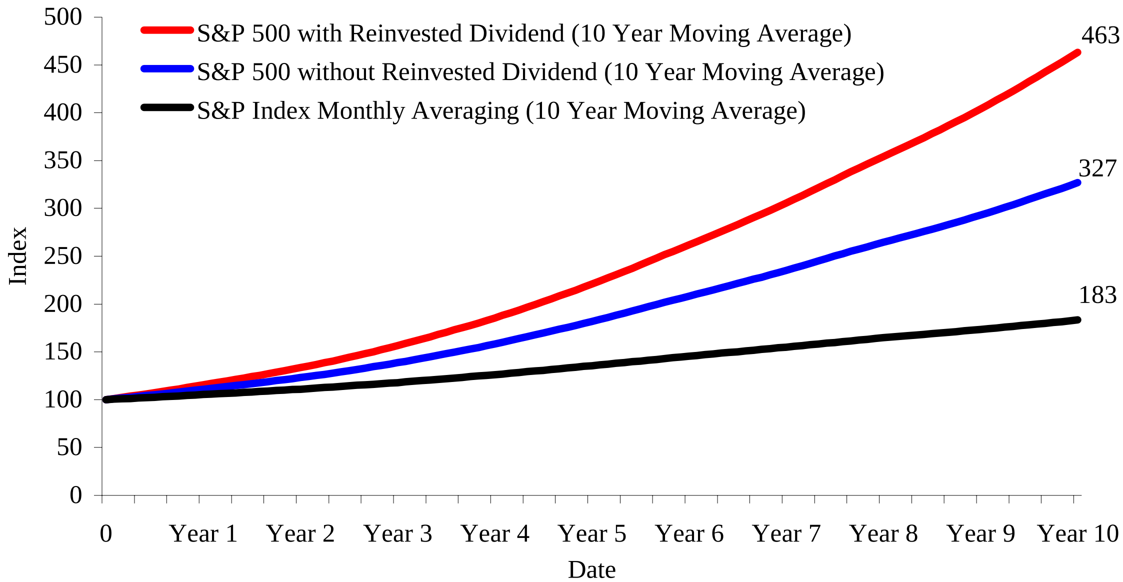
V_T = value of annuity at maturity,
V_0 = premium paid at initial purchase,
α = participation rate,
$AI_t = \frac{\sum_{n=1}^{t\times12} I_n}{12}$, is the arithmetic mean of monthly index level from the start of the term to the t^{th} anniversary.
I_0, I_n = index level at purchase date and at n^{th} month, respectively,
β = fraction of initial premium earning guaranteed return,
γ = guaranteed return, and
T = initial term to maturity in years.

A Sun Life Keyport MultiPoint contract was sold to an elderly widow on December 12, 2003 for $50,126 after she had been convinced by a salesman to liquidate substantially all of her meager liquid assets which had previously been invested in mutual funds. This contract’s crediting formula is virtually impenetrable and could not be effectively evaluated by the customer or the salesman. Without effective annual expense ratio disclosure, the only way to determine what the annual cost of the Sun Life Keyport MultiPoint contract – or any other equity-indexed annuity – is to value the contract. The level of sophistication required to value the annuity described by Eq. 1 is staggering. As we will see below, this complexity is a façade laid over the top of a simple investment for which a simple, informative, investor-friendly annual expense disclosure could be made.

Advocates for equity-indexed annuities claim that the monthly average return method makes the resulting calculated index level changes less volatile and that this reduced volatility allows the industry to offer investors a higher participation rate on annuities which use monthly averaging. Such statements are misleading since the volatility relevant to the cost of the guaranteed minimum return is the volatility of the underlying stock index. Instead, monthly averaging systematically understates the increase in the level of the index compared to point-to-point indexing. The expected index change with monthly averaging will be roughly half the expected change calculated by the traditional point-to-point method. Thus, with the monthly averaging method insurance companies can claim to pay 100% participation of the calculated index level change while only paying 50% of the actual change in the index level. The lowest line in Figure 1 above shows the value of the S&P 500 Index calculated by applying the monthly averaging with annual reset method. Monthly averaging further reduced the change in the price level of the index by 70% over 30 years.

The impact of monthly averaging is not a phenomenon of the time period covered. I constructed 241 10-year periods by rolling 10 years of data forward one month at a time from 1975 to 2004. The first months' returns, second months' returns and so on were then averaged across the 241 periods. The impact of dividends and monthly averaging on these average returns is illustrated in Figure 2. Excluding dividends reduces the average return over 10-year periods by 29%. Monthly averaging reduces the change in the level of the index by a further 44%. Unsophisticated investors might believe that they will get 100% of the increase from 100 to 463 when in fact they receive only 23% of this increase.

Figure 2
Impact of Dividends and Monthly Averaging (10 Year Moving Average)



E. Participation Rate: The Fraction of the Index Change Credited

A fraction, called the participation rate, of the change in the stock index calculated according to one of the methods described above is used in determining the additional return, if any, over and above the guaranteed minimum return an investor will receive. Participation rates vary significantly, and are easy but misleading to compare; a higher participation rate may not mean higher payouts to investors. Other things held constant, the higher the participation rate an equity-indexed annuity pays, the more valuable it is. However with equity-indexed annuities all else is seldom held constant; a 100% participation rate in a monthly averaging equity-indexed annuity is comparable to a 50% participation rate in a point-to-point equity-indexed annuity.

F. Spreads or Index Margins and Caps

The gross credit calculated by multiplying the index change by the participation rate is then sometimes further reduced by an amount called a spread or an index margin that can be as great as 3% or 4%.

The index-based additional return credited to an investor may be further limited by a monthly, annual or lifetime cap. For example, the increase in a contract's index value under the point-to-point method with annual resets might be capped at 8% meaning that the contract's index value will increase by only 8% in years when the index level increases by more than 20% or 30%. The effect of caps is dramatic because the average long run return to stocks is heavily influenced by years with unusually high returns. For example, the annualized price appreciation in the S&P 500 from 1975 to 2004 was 10.0%. If the yearly increase is capped at 14%, the resulting series has an annualized appreciation of only 5.5%. The index-based returns credited to an investor's contract are dramatically reduced as a result of the application of spreads and caps. The impact of caps and spreads is not readily apparent and two contracts linked to the same index, with the same indexing method and the same participation rate can have significantly different net returns.

G. Bonus Credits

Bonus premium credits are offered on some equity-indexed annuities. The bonuses are sold as a free "kicker", available to offset surrender charges on existing variable annuities and equity-indexed annuities or contingent deferred sales charges on mutual funds. These credits are superficially appealing but are illusory. Other features of the bonus annuities negate the premium credits as the premium credits are fully offset by higher surrender charges, longer surrender periods and larger pricing spreads. For example, Allianz has offered both the PremierDex and the PremierDex 5 distinguished primarily by a 5% premium bonus. The PremierDex 5 has a 15% surrender charge instead of a 10% surrender charge and its surrender period lasts 10 years instead of 7 years.

H. Surrender Charge Schedules

Equity-indexed annuities have surrender charges which usually decline over a period of years. The average surrender period is 10 years but some annuities, such as the Bonus Gold annuity issued by American Equity have surrender charges which last for 17 years. The surrender charges are frequently 10% or 12% but can be as high as 25%. The Bonus Gold's surrender charge in the first year is 20%; even after 10 years the Bonus Gold's surrender charge remains 12.5%.

I. Market Value Adjustments (MVA) or Interest Adjustment (IA)

In addition to the surrender charges many equity-indexed annuity charge investors a disguised surrender charge in the form of the Market Value Adjustment or Interest Adjustment. Equation 2) is an example of a typical MVA

Eq. 2) $$\text{Market Value Adjustment} = \left[\frac{(1 + i_0 - .005)}{(1 + i_i)}\right]^T$$

where

i_0 is the current interest rate on the fixed option when the annuity is purchased,
i_1 is the current interest rate on the fixed option when the annuity is surrendered,
T is the remaining whole and partial years remaining to end of surrender period.

The equity-indexed annuity's scrip value is multiplied by the Market Value Adjustment factor before the surrender charge is applied to determine the amount an investor receives if they surrender an annuity. Table 1 illustrates the impact of various changes in interest rates after 1 year of the Interest Adjustment on an annuity with 10-year surrender period and an initial interest rate of 4%.

Table 1
Market Value or Interest Adjustment Factors
Impose Additional Surrender Charges

	Change In Interest Rates						
	-1.5%	-1.0%	-0.5%	0.0%	+0.5%	+1.0%	+1.5%
Interest Adjustment	9.1%	4.5%	0.0%	-4.2%	-8.3%	-12.1%	-15.8%
Bond Price Change	12.0%	7.8%	3.8%	0.0%	-3.7%	-7.2%	-10.5%
Additional Surrender Charge	-2.9%	-3.4%	-3.8%	-4.2%	-4.6%	-5.0%	-5.3%

The Market Value Adjustment causes the cash value of an equity-indexed annuity to fluctuate like the price of a bond but with a significant bias. If interest rates are unchanged and the contract is surrendered after one year, the investor will pay a 4.2% penalty in addition to the explicit surrender charge as a result of the Market Value Adjustment. In contrast, the value of a 4.0% coupon bond issued at par one year earlier with nine years remaining would be unchanged if the yield remained at 4%. The 4.2% penalty is the additional surrender charge if interest rates are unchanged.

The Market Value Adjustment is applied to the entire scrip value, not just the portion allocated to a fixed interest option. The Market Value Adjustment introduces substantial interest rate risk into equity-indexed annuities and adds a hidden surrender charge that starts out at over 4% and declines along with the disclosed surrender charge over the surrender period.

J. Guaranteed Cash Surrender Value

Equity-indexed annuities guarantee that investors will receive a minimum rate of return – typically from 1% to 3% on between 75% and 100% of the initial investment. Due to steep upfront loads and surrender charges, the guaranteed cash value is substantially less than the original investment for many years after a purchase. The guaranteed rate of return is typically much less than the risk free rate of return offered on US Treasury securities with the same maturity as the annuity. On some contracts, no interest is credited unless the annuity is held to maturity.

This guarantee can be easily misunderstood to be the equivalent in value to that of the US Treasury but it is in fact only as good as the credit quality of the insurance company issuing the annuity. While Standard and Poors rates Jackson National Life and Jefferson Pilot AAA, it rates RBC Insurance A- and American Equity Investment Life only BBB+. State guarantee funds provide some protection but they are severely limited and the credit quality of state guarantee funds is not as good as that of the US Treasury.

IV. Other Features

A. Penalty free withdrawal

Issuers of equity-indexed annuities and their sales force touts claimed penalty-free annual withdrawals - whether pursuant to the 10% annual allowance or to a nursing home or terminal illness-rider. It is false and misleading to refer to these withdrawal options as penalty-free since investors typically forgo index-related returns for the partial year already passed whenever they die or surrender a portion of their account value. Since this partial return cannot be negative, losing this partial year return is clearly a penalty. Also, investors who purchase registered securities have substantially higher risk-adjusted expected returns and greater liquidity. It is false and misleading for issuers to tout their withdrawal features as valuable benefits without disclosing that these features are only beneficial to the extent they allow investors to avoid the draconian illiquidity and ongoing, annual expropriation of investors' wealth.

B. Death benefit

Most equity indexed annuity contracts waive surrender charges upon death. This "benefit" cannot be added to the value of future maturity payoffs without also deducting the expected harm caused by steep, long-lasting surrender charges. The death payment provision accrues only to investors' beneficiaries and does not mitigate the illiquidity burden on investors.

The death payment provisions can be valued by projecting the expected excess of the equity-indexed annuity's scrip value over the values of alternative portfolios of stocks and bonds, weighting these expected excesses, if any, by the probability of death in that year and discounting the result to the present. I have performed this analysis and determined that the value of the death benefit is less than 10 basis points per year – a small amount in comparison to the 275 to 300 basis points implied annual cost of equity-indexed annuities.

C. Annuitization Options

Equity indexed annuities typically provide contractual rights to annuitize but often only at annuitization rates as low as 1%. This right would be valuable if the future interest rates were reasonably likely to be less than the rates specified for annuitization. The Federal Reserve Board reports the lowest observed daily 5-year and 10-year constant maturity Treasury yield since the start of this data in 1962 are 2.08% and 3.13%. Thus, the probability that the annuitization option provided by equity indexed annuities with a 1% annuitization guarantee would be in the money is essentially zero.[10]

The annuitization provisions of some equity-indexed annuities are even less valuable. Some specify annuitization interest rates ranging from 1% to 3% but investors have no right to annuitize until the end of a 14-year surrender period or, in some cases, age 115. Seniors who purchase such annuities thus have no right to receive the guaranteed annuitization rates until a date that approximates or exceeds their life expectancy. Those who do survive long enough to obtain the specified rate will receive the benefit for only a short time and - as illustrated in the Federal Reserve Board data - any rare benefit realized is likely to be small.

V. Underlying Economics

A. American Equity's Form 10-K Tells a Story[11]

American Equity's status as a publicly traded company and its focus entirely on the business of issuing equity-indexed annuities allows us a revealing glimpse into the underlying economics of the equity-indexed annuities industry. American Equity tells the Securities and Exchange Commission, stock market investors and Wall Street analysts that issuing equity indexed annuities is a simple, low-risk business.

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[10] Even if prevailing interest rates were to approach such unprecedented levels, the increased value of the bond-related component of a diversified alternative investment would more than offset the value of the specified annuitization rate.

[11] The following section is based on American Equity's Form 10-K filings with the Securities and Exchange Commission and its transcribed conference calls with analysts.

American Equity pays big commissions to motivate aggressive sales practices. The assets gathered – largely from unsophisticated senior citizens – are invested in bond portfolios and a small amount is set aside and invested in stock index options. Whatever happens to the bond portfolio and whatever happens in the stock market American Equity is protected because the full risks on the stock and bond market are passed on to the unsophisticated investors who buy equity-indexed annuities. Even if American Equity gets the risk transfer wrong they are only going to be slightly wrong and only for a short time. With investors locked into long surrender periods, American Equity can use its virtually unfettered discretion to retroactively impose whatever small interest rate or stock market-based loss it might otherwise have borne onto investors.

American Equity refers to the fraction of investor's purchase payments it will take for itself to recoup the commissions it has paid, cover its other costs and achieve its desired profits as its "investment spread." American Equity subtracts this investment spread from the expected return on its bond portfolio to determine the returns it will credit to investors. American Equity refers to the returns it intends to credit to investor as the "cost of money." For example, if the expected return on the bond portfolio is 6.5% and American Equity decides to take a 3% investment spread to recoup commissions, cover its costs and generate profits, it will credited 3.5% on average to investors.

If an investor chooses the fixed option within an equity-indexed annuity, American Equity credits the investor the 3.5% cost-of-money in our previous example as an interest rate fixed for one year. American Equity resets the fixed rate offered from time to time in response to changes in the expected yield on the bond portfolio so that, whatever the yield on the bond portfolio, American Equity will get the pricing spread 3.0% in our example to cover its costs and make a virtually riskless profit.

If an investor chooses an indexed option, American Equity will credit the investor with the payoffs from options that can be purchased with the 3.5% cost-of-money which would otherwise have been credited as a fixed interest rate. That is, American Equity determines how much it is willing to spend on options and then adjusts the participation rates, caps and asset fees to align the credits it might have to give investors under the index options with the payoffs from the options which can be purchased with the interest that it would otherwise credit to the fixed account. On average and over time, the credits to investors who chose the index option will be less than the cost of the options and therefore less than the fixed interest credited to investors who choose the fixed rate option.

The expected return on portfolios of corporate bonds varies a little but the bond portfolio American Equity invests customer premium dollars in had an average net annual investment return of 6.34% from the beginning of 2002 through the end of 2007. American Equity has passed this 6.34% per year return on to purchasers of its equity indexed annuities after deducting an average annual pricing spread of 2.81% to cover the commissions it pays agents and cover its other costs and to generate profits. See Table 2.

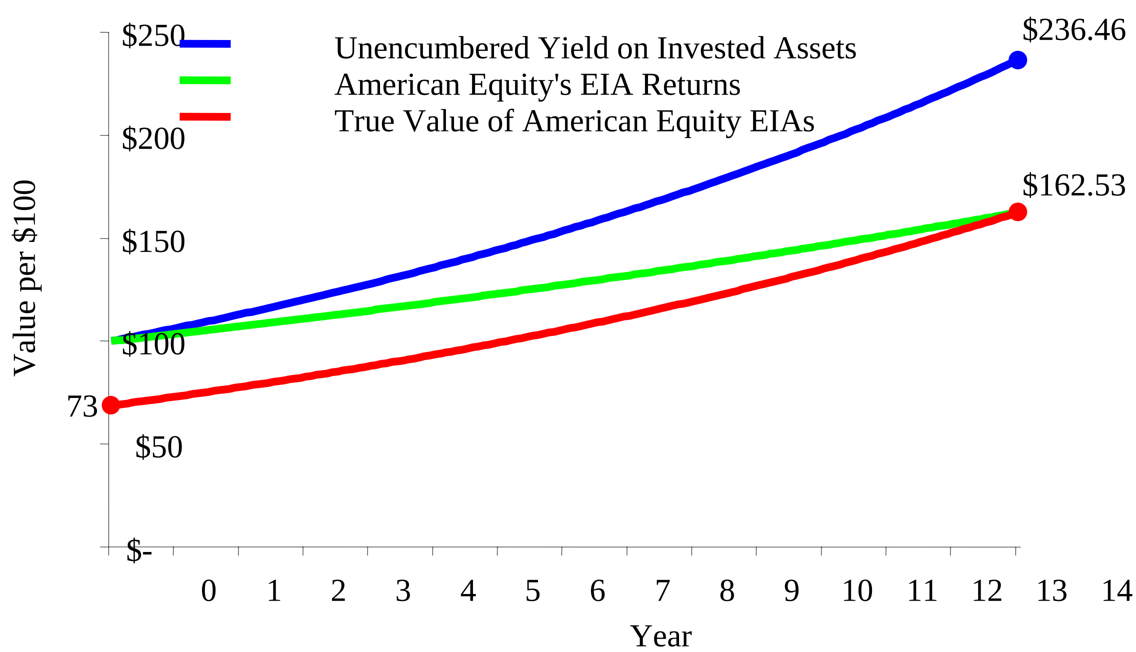
Table 2
American Equity Charges Expense Ratios
Between 2.6% and 2.9% on Equity-Indexed Annuities

	2002	2003	2004	2005	2006	2007	Average '02-'07
Yield on Invested Assets (Gross Returns)	6.91%	6.43%	6.28%	6.18%	6.14%	6.11%	6.34%
Investment Spread (Expense Ratio)	2.72%	2.97%	2.91%	2.80%	2.86%	2.60%	2.81%
Cost of Money (Net Returns)	4.19%	3.46%	3.37%	3.38%	3.28%	3.51%	3.53%

Thus investors in American Equity's equity-indexed annuities over time are certain to receive the return on a bond portfolio less a pricing spread of 2.6% to 3.0%. American Equity provides this information to sophisticated Wall Street analysts but refuses to provide this simple, revealing truth to unsophisticated investors.

Figure 3 illustrates the impact of American Equity's costly equity-indexed annuities. $100 will grow to $236.46 in 14 years at the 6.34% average yield to the portfolio of bonds American Equity invests the money it receives from purchasers of equity indexed annuities. After American Equity deducts its 2.81% annual expense ratio, the same $100 will only grow to $162.53 in 14 years. It only takes $68.73 – not $100 – to grow to $162.53 at the yields on the investments American Equity buys with its customers' money. Thus, American Equity only needs to invest $68.73 on average for each $100 a customer gives American Equity. This allows American Equity to pay commissions as high as 16%, incur overhead and still make a substantial profit.

Figure 3
American Equity's Form 10-Ks
Implies Its EIAs Worth Less Than $0.70 Per $1.



American Equity's investment spreads are not compensation for bearing interest rate risk, credit risk or stock market risk. American Equity is able to pass on virtually all such risks to investors since - as it tells Wall Street – it can alter the fixed rate and the index credit parameters which determine its cost of money (i.e., returns to equity-indexed annuities investors) over time to efficiently manage its pricing spread (i.e., shift all investment risk to its customers). The interest rate risks and credit risks in the bond portfolio are borne by purchasers of American Equity's equity-indexed annuities whether they choose the fixed rate option or the indexed option. Stock market risk is borne by purchasers who choose indexed options since the stock market risk in American Equity's promised payments is funded by the options purchased with the returns investors would otherwise earn if they had chosen the fixed account option.

American Equity "investment spreads" are annual expense ratios as that term is used in the investment management industry. Just like the annual expense ratios in a mutual fund levied by fund companies, the investment spread is a charge levied by American Equity to pay for commissions, overhead and profit.

Fundamentally, on a risk-adjusted basis, American Equity over the past six years has been investing the proceeds from the sales of its equity-indexed annuities into a bond portfolio and then deducting a 2.81% annual expense ratio before passing the returns on to investors. This process is not meaningfully different from what mutual fund companies do with the proceeds from the sale of mutual fund units except that American Equity and the other equity-indexed annuities issuers deduct ten times as much from the gross returns of the investment portfolio before passing the returns on to retail investors. Table 3 summarizes the disclosures American Equity makes to Wall Street in its Form 10-K about what it charges retail investors but which it will not make to the unsophisticated investors its highly-incentivized sales force targets.

Table 3
American Equity Average Expense Ratio is 2.81%

	Average'02-'07
Yield on Invested Assets (Gross Returns)	6.34%
Investment Spread (Expense Ratio)	2.81%
Cost of Money (Net Returns)	3.53%

Broad bond market portfolios that provide investors with the same gross returns as American Equity earns on its bond portfolio are widely available to investors. These funds are highly liquid, completely transparent and provide investors the same downside protection at less than 1/10th of the cost of American Equity's equity-indexed annuities. For instance, Vanguard's Total Bond Market Fund has gross returns which are similar to American Equity's bond portfolio, but passes its returns to investors with only about 0.20% in annual charges rather than the 2.81% American Equity charges investors.[12]

B. The net effect of equity-indexed annuities' gimmicks is to provide returns below those of Treasury securities while exposing investors to stock market risk

The complex crediting methods, participation rates, caps, and spreads presented to potential purchasers mask simple underlying economics. The spurious nature of equity-indexed annuities' complex crediting methods can be illustrated with the Bonus Select equity-indexed annuity issued by American Investors Life.

The Bonus Select has at least four superficially different crediting methods. The 1-year Point-to-Point ("1YP2P") method credits investors' account values with the percentage increase in the S&P 500 index on each contract anniversary subject to a 6.5% annual cap. The 2-year Point-to-Point ("2YP2P") method credits investors' account values with the percentage increase in the S&P 500 index at every second contract anniversary subject to a 13.0% bi-annual cap on the two-year credit. The 1-year Monthly Cap crediting method adds up the 12 monthly changes in the S&P 500 index during a contract year, subject to a 2.35% monthly cap. The 1-year Average S&P Index Up Strategy credits a fraction of the percentage difference in the average of the 12 monthly anniversary S&P 500 index levels and the index level at the start of the year less an index margin or spread.

I summarize the results of these four superficially quite different crediting methods in Table 4. The four methods each reduce the 12.1% average stock market returns to within a very narrow range, i.e. from 4.6% to 4.9%.

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[12] *See* for example, Vanguard's 2003 prospectus for its Total Bond Market Fund at www.sec.gov/Archives/edgar/data/794105/000093247104000512/bondindex485b.txt.

Table 4
Bonus Select 1
Annualized Returns from 1990 to the Present

Crediting Method	Average Annual Return	Accumulation of $100 for 10 Years
Simple Securities		
S&P 500 with dividends	12.1%	$313.37
S&P 500 without dividends	9.8%	$254.70
10-Year Treasury Bonds	5.7%	$174.08
American Investors Life's Bonus Gold		
One Year, Point to Point	4.9%	$161.34
Two Year, Point to Point	4.9%	$161.34
Monthly Cap	4.7%	$158.29
S&P Index UP (monthly averaging)	4.6%	$156.79

$100 invested for 10 years at the average return on the S&P 500 since 1990 would grow to $313.37. Even excluding dividends, $100 invested in the S&P 500 for 10 years would grow to $254.70. In fact, despite the fact that purchasers of American Investors Life's equity-indexed annuities are exposed to substantial market risk, the likely returns are less than what would be earned on a portfolio of truly riskless Treasury securities. Since January 1, 1990 the average yield on 10-year treasury securities was 5.7% and so on average during this same period $100 invested in truly risk-free US treasury securities would have grown to $174.08. In contrast, the illiquid, complex, opaque Bonus Select would have grown to between $156.79 and $161.34 depending on which of the superficially different but in reality virtual identical crediting methods were chosen. Thus the equity-indexed annuities produce lower returns than US Treasury securities despite being illiquid and exposing investors to stock and bond market risk.

This is a recurring theme in equity-indexed annuities. There is an enormous amount of complexity designed into the product but ultimately the complexity is a smoke screen designed and managed to provide investors with substantially the same miniscule returns regardless of which index option is chosen. The resulting investor returns equal the returns on a bond portfolio less a 2.5% - 3.0% annual expense ratio.

C. Issuers' Discretion to Change Contract Parameters Significantly Further Reduces Their Annuities' Value

Issuers retain discretion to lower participation rates, caps and credited interest rates and to increase index margins in such a way as to significantly reduce the value of contracts ex post, limited only by relatively insubstantial contractual guarantees. This discretion has significant value to the issuers because it gives them the flexibility to set initial parameters without concern for long run profitability while guaranteeing that they will earn its desired profits in the aggregate. The issuers' extraordinary discretion imposes significant uncertainty and costs on investors.

The issuers' ability to change parameters is similar to - but much more extreme than - the ability an issuer of callable bonds has to reset the interest rate it pays to investors. If an issuer issued an 8% coupon bond when the current yield on its 10-year debt was 6%, the bond would sell for approximately $115. If the issuer could, at its discretion, redeem or call the 8% coupon bond after 1 year and thereafter pay 6% on newly issued debt, the 8% coupon bond would only be worth about $102. If investors had purchased the bond for $115 they would stand to lose more than 10% of their investment value upon exercise of that discretion to call the 8% bond. If the issuer could reduce the coupon rate on the 8% bond described above to 3% after the first year without having to redeem the bond for $100, the issuer could reduce the value of the bond investors paid $115 for at issuance to only $83. Issuers are able to accomplish exactly this sort of expropriation as a result of its discretion to alter contract parameters and the profits received.

As these examples illustrate, issuers of equity-indexed annuities have the ability to dramatically expropriate an investor's wealth after the investor is committed to a long-term, high-cost investment. I am not aware of any other product sold with this extraordinary feature for the obvious reason that no one would buy such a product except at a substantial discount which adequately reflected the risk of future discretionary adjustments undermining the value of the asset.

Even these examples don't capture the cost to investors of issuer's virtually unfettered discretion to change the parameters determining the value of the investor's asset. An investor in a callable $100 face value bond will typically receive more than $100 for a called bond. Unlike investors in callable bonds, investors in equity-indexed annuities cannot liquidate their annuities for face value or more in response to a change in the parameters which would substantially reduce the value of the annuity. Instead, investors must pay significant surrender charges to get out of poor investments made worse by issuers' extraordinary discretion.

The cost to investors of the issuers' ability to alter contract parameters is directly related to the difference between: (1) the value of contracts when issued if issuers had no such discretion; and (2) the value issuers will pay investors in order to achieve their profit goals. Thus, the more facially attractive an equity-indexed annuity appears at issuance in relation to market conditions or other investments without the discretionary adjustment options, the more costly is an issuers' ability to alter contract parameters thereby reducing that apparent value.[13]

VI. Valuations and Comparisons

Equity-indexed annuities can be valued using standard, scientific methodologies. Issuers have sophisticated internal models to control the liabilities they incur to investors to ensure the issuers a virtually risk free profit. These issuers know precisely the effective annual cost to investors of their equity-indexed annuities offerings. American Equity is the only issuer I am aware of that comes close to disclosing the annual costs but does so only in conference calls with Wall Street analysts and buried in the fine print of its Form 10-K and Form 10-Q filings with the SEC.

[13] This is directly analogous to the cost of the embedded call option in a callable bond. The greater the difference between the callable bond's coupon rate and the market yield on similar debt, the more costly the embedded option.

American Equity's SEC filings show that it sets the parameters used to determine investor's returns to achieve an investment spread ("investment spread" to American Equity, "expense ratio" to investors) of approximately 2.8% per year. Assuming American Equity's investments are efficient, a 2.80% spread per year over a 7-year term would imply a value at issuance of $0.82 per dollar paid by investors (irrespective of the other excessive internal costs), over a 10-year term would imply a value at issuance of $0.75 per dollar paid by investors and over a 14-year term would imply a value of $0.67 per dollar paid by investors.[14]

A balanced assessment of the costs and benefits of any equity indexed annuity requires a comparison of the annuity's likely returns on alternative investments under reasonable assumptions. Consider, as an example of such a comparison, an S&P 500 index annuity with point-to-point option with an index margin of 4% for the first year, a premium bonus of 11%, a minimum guaranteed interest of 2%, and a surrender period of 14 years purchased on September 29, 2004. I created a comparison of this annuity to a portfolio of Treasury bonds and a stock mutual fund. This would be a typical comparison a financial expert giving un-conflicted, objective investment advice would have created. The comparison portfolio consists of $7,000 (70% of the $10,000 assumed investment) invested in 14-year, zero-coupon Treasury bonds maturing on September 29, 2018 and $3,000 invested in a low cost S&P 500 Index fund.

The S&P 500 Index closed on September 29, 2004 at 1,114.80. On September 29, 2018 the $10,000 investment in the annuity will return the greater of $13,195 (i.e. 100% of $10,000 accumulated at 2% interest rate for 14 years) or an Accumulation Value calculated using the annual point-to-point method. The Accumulation Value depends not

[14] To accurately value any individual equity-indexed annuity at any point in time, one would need to apply an appropriate discount for the issuers' discretion, incentives and demonstrated behavior. Any such discount should reflect the valuation implied by issuers' managed average gross margins. Given American Equity's discretion, incentives and demonstrated behavior the true value of its products is undoubtedly considerably less than these values.

only on the level of the S&P 500 on September 29, 2018 but also on the path of annual index levels on the way to September 29, 2018. Our simulation results below take this path dependency into account.

On September 29, 2004, $7,000 would have purchased 14-year, zero-coupon Treasury bonds with a face value of approximately $13,326. The $7,000 Treasuries investment will therefore be worth approximately $13,326 on September 29, 2018 regardless of the level of the S&P500.[15] The remaining $3,000, from the $10,000 total initial investment, invested in the S&P 500 Index mutual fund will be worth more or less than $3,000 depending on the total return on the fund. I assume that the expected total annual return on the S&P 500 Index of companies is 12.5%. I assume that the stocks in the S&P 500 index have an average dividend yield of 2.5% and the fund has an annual expense ratio of 0.25%.

I performed a Monte Carlo simulation to generate likely future values of the annuity and of the Treasury bonds and stock mutual fund based on reasonable assumptions. Except in extremely rare cases, the annuity pays investors much less than a simple portfolio of risk-free Treasury bonds and large-cap stocks. In fact, 99.8% of the time the investor would be better off with the Treasury securities and stocks than with the equity-indexed annuity if we assume the 4% monthly cap during the first year was not increased during the rest of the term. That is, investors who were sold the annuity would be worse off 99.8% of the time, even if they held the annuity for 14 years and it performed exactly as designed.

Moreover the benefit from having bought the annuity in the extremely unlikely event that the market suffers catastrophic losses over a 14-year period is tiny compared to the cost of having bought the equity-indexed annuity the vast majority of the time. After 14 years, the expected value of the $10,000 invested in Treasury bonds and stocks on

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[15] The yield to maturity on 14-year zero-coupon Treasury bonds on September 29, 2004 was 4.65%.

September 29, 2018 is $28,442 and the expected value of the equity-indexed annuity is only $19,735. The $8,707 equity-index annuity shortfall can be broken down into a $8,725 expected cost for when the Treasuries and stock would have been worth more than the EIA (99.8% of the time)versus a $459 expected benefit when the annuity would have been better (0.2% of the time). The expected cost/benefit ratio is thus a staggering 9,485 to 1. That is, the investor pays $9,485 in costs for every $1 in benefit from the downside protection relative to the Treasuries and stock portfolio.

There is currently no disclosure of the effective cost of owning an equity-indexed annuity analogous to the annual expense ratio in a mutual fund or the annual expenses of a variable annuity. Such a disclosure is necessary for investors and salespeople to evaluate the financial ramifications of an investment in equity-indexed annuities and to understand the serious risks, limitations and expenses in the product.

According to the Investment Company Institute, in 2004 the average annual expense for stock mutual funds was 1.19%, for bond funds was 0.92% and for money market funds was 0.42%. In contrast, the expense ratios implied by the structure of equity-indexed annuities is between 2.7% and 3.0%. This cost is not disclosed in any materials I have reviewed (except American Equity's 10-Ks); I was only able to determine it after extensive analysis of the product including computer modeling.

VII. Specific Comments on the Proposed Rule

A. Should the proposed rule apply to other products?[16]

The proposed rule would provide federal investor protections to purchasers of equity indexed annuities that expose investors to stock market risk. Equity-indexed universal life (EUIL) contracts are growing in popularity and should be covered by the rule also. These contracts have the same relationship to equity-indexed annuities that variable universal life contracts have to variable annuities. In fact, the structure on a

[16] SEC Rule Proposal, page 29.

EUIL is virtually identical to that of an equity-indexed annuity. EUILs expose investors to stock market risk in exactly the same way equity-indexed annuities expose investors to stock market risk. Federal investor protections should be extended to purchasers of EUILs.

B. Should the proposed "more likely than not" test be modified?[17]

The proposed rule would exclude any equity-indexed annuity whose payoffs were “more likely than not” to exceed the minimum amounts guaranteed in the contracts from the annuities contracts. In our previous work, I determined that for all practical purposes the minimum guarantees in current equity-indexed annuities would never be binding. That is, despite their featured prominence in marketing and efforts to forestall effective regulation, issuers set minimum guarantees so low that the amounts paid at the end of surrender periods would exceed the minimum guarantees more than 99% of the time. As such most any threshold other than the “more likely than not” for the likelihood that the payouts would exceed the minimum guaranteed amounts would also be triggered.[18]

C. Should the issuers’ determination be conclusive? and Should the testing procedures be mandated?[19]

The Commission proposes to allow issuers to determine whether a particular contract’s payouts are “more likely than not” to exceed the minimum guarantees. Essentially 100% of the time, the payouts to current equity-indexed annuities will exceed the truly trivial minimum guaranteed amounts. Issuers routinely assess the likelihood that they will have to pay out the minimum guaranteed amounts using well established finance and actuarial models. Consistent with our findings, the issuers have determined that the probability that the minimum guarantees will be paid is 0%. Issuers will not be

[17] SEC Rule Proposal, page 34.
[18] The only way to design an equity indexed annuity that would not trigger such a test would be to increase the minimum guarantees dramatically or reduce the already dismal expected returns.
[19] SEC Rule Proposal, page 41.

able to excuse themselves from coverage of this rule in good faith. The only way issuers could determine that their equity-indexed annuities are not covered would be to adopt non-standard methodologies purely for the purpose of continuing to game the regulatory system.

VIII. Summary

Equity indexed annuities are products which survive in the market place only because of the lack of effective investor protection regulation.

To summarize:

- Existing equity-indexed annuities are too complex for the industry's sales force and its target investors to understand the investment.
- This complexity is designed into what is actually a quite simple investment product to allow the true cost of the product to be completely hidden.
- The high hidden costs in equity-indexed annuities are sufficient to pay extraordinary commissions to a sales force that is not disciplined by sales practice abuse deterrents found in the market for regulated securities.
- Unsophisticated investors will continue to be victimized by issuers of equity indexed annuities until truthful disclosure and the absence of sales practice abuses is assured.