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October 6, 2008

Via E-Mail

Ms. Florence E. Harmon
Acting Secretary
United States Securities and Exchange
Commission
100 F Street, N.E.
Washington, D.C. 20549
rule-comments@sec.gov

Re: Supplemental Comment regarding Release Nos. 33-8,933 and 34-58,022, "Indexed Annuities and Certain other Insurance Contracts" (File No. S7-14-08)

Dear Ms. Harmon:

We are counsel to American Equity Investment Life Holding Company ("American Equity" or the "Company"). On September 10, 2008, American Equity submitted a comment to the Securities and Exchange Commission (the "SEC" or "Commission") that explained the Company's legal and factual reasons for opposing a proposed rule relating to fixed indexed annuities ("FIAs") that would be codified as 17 C.F.R. § 230.151A ("Proposed Rule 151A").[1] Also on September 10, 2008, the North American Securities Administrators Association, Inc. ("NASAA") filed a comment on Proposed Rule 151A (the "NASAA Comment"). The NASAA Comment—one of the few that supports Proposed Rule 151A—is riddled with legal and factual errors and misrepresentations. Of particular concern to American Equity is that the NASAA Comment and its "expert" report are replete with errors that relate specifically to the Company

[1] American Equity refers to its comment submitted on September 10, 2008, which is publicly available at http://sec.gov/comments/s7-14-08/s71408-1801.pdf, as the "September 10 Comment."

and its products. The report, entitled "An Economic Analysis of Equity-Indexed Annuities" (the "McCann Report"), by a Dr. Craig J. McCann, is economically unsound and based on demonstrably false premises. And because many of McCann's contentions relate specifically to American Equity, the Company is in a unique position to rebut his misrepresentations and correct the record.[2]

In this supplemental comment, American Equity first addresses the defects in the McCann Report, on which the NASAA Comment heavily relies. American Equity then addresses some of the more significant errors in the NASAA Comment itself, including its flawed legal analysis of Section 3(a)(8) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77c(a)(8), and failure to prove its assertion that FIAs "are often used to perpetrate fraud and abuse."

I. The McCann Report is irrelevant and flawed.

Although NASAA proclaims that McCann is "one of the nation's leading experts on [FIAs]" (NASAA Comment at 3), there is no basis for this designation (and neither the NASAA Comment nor the McCann Report provide one). Indeed, as the report makes clear by way of omission, McCann has not been recognized by scholars as an authority on FIAs (or on the insurance industry) or even published any peer reviewed articles about FIAs (or on the insurance industry). McCann's sole qualification appears to be that he often testifies on behalf of plaintiffs' lawyers in litigation related to FIAs. *See, e.g., Yokoyama v. Midland Nat'l. Life Ins. Co.*, 243 F.R.D. 400, 410 & n.17 (D. Haw. 2007) (noting that plaintiff proffered McCann as a purported expert and observing that "the court has reservations about the methodology employed by Dr. McCann in modeling damages").

Most importantly, it is evident that the McCann Report is rife with mischaracterizations of FIAs and flawed legal theories, and largely ignores the established legal test for determining whether an annuity is entitled to the Section 3(a)(8) exemption. The McCann Report in no way supports adopting Proposed Rule 151A.

A. McCann fails to recognize that FIA purchasers are protected against any declines in a referenced index.

McCann's most perplexing assertions are that "[t]he investment risks to which equity-indexed annuity investors are exposed are virtually identical to the risks of investing in mutual funds and variable annuities," and that "the full risks o[f] the stock and bond market are passed on" to purchasers of FIAs. (McCann Report at 3, 5, 18.) McCann thus overlooks perhaps the

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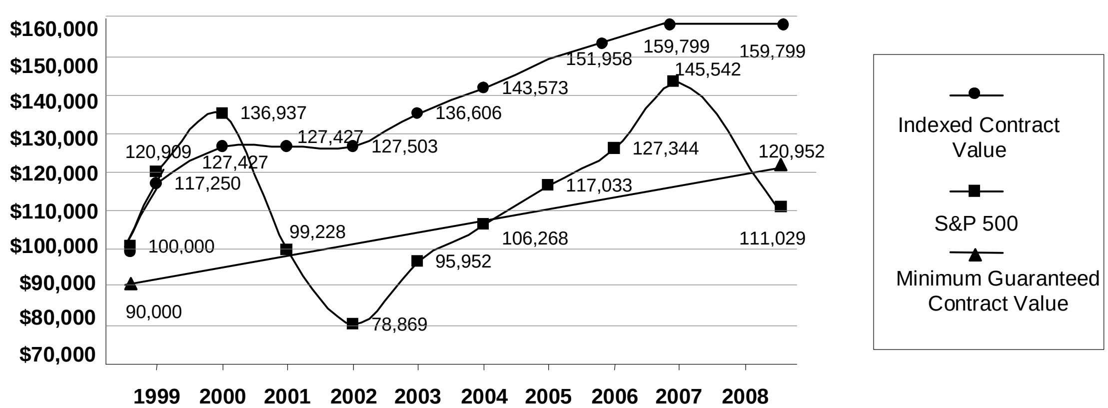
2 Moreover, the body of the NASAA Comment is virtually identical in substance to the letter dated February 22, 2008, that NASAA sent to Chairman Christopher Cox (the "NASAA February 22 Letter"). In its September 10 Comment, American Equity refuted several significant defects in the NASAA February 22 Letter and pointed out that the letter appears to have been a significant contributing factor to the deeply flawed release announcing Proposed Rule 151A. *See* September 10 Comment at 16-17; *see also* Release Nos. 33-8,933 and 34-58,022, 73 Fed. Reg. 37,752 (July 1, 2008) (the "Release").

central feature of FIAs: *an FIA purchaser is protected against any decline in the relevant stock or bond index*, as opposed to the unlimited losses one could suffer from a direct investment in the stock or bond market. As American Equity explained in its September 10 Comment, the value of an American Equity FIA is exposed to absolutely no risk of loss of principal due to index volatility because the credited interest rate never can be negative—regardless of whether the referenced index declines in value. (*See* September 10 Comment at 9.) As an additional protection against loss from declines in the referenced index, credited interest based on appreciation of the index is locked-in each year and is not forfeited, even if the index goes down.[3]

The major stock market losses over the past year demonstrate the substantial security of FIAs as compared with mutual funds or other direct investments in the stock or bond market. Many investors in the stock market and bond market (including those in mutual funds and variable annuities) have lost a substantial portion of their investments. On the other hand, as the following chart indicates, a purchaser of an American Equity FIA has been exposed to absolutely no loss of principal or credited interest due to this volatility. Further, regardless of how the stock and bond markets perform, an FIA holder is guaranteed to receive a minimum interest rate over the life of the FIA:



As the chart shows, FIAs never lose value—even in a down market.[4] If the S&P 500 index (or other referenced index) declines, the index-based credit from prior years remains intact.

3 Index-based interest credit is annually locked-in because the beginning value for appreciation of the referenced index is reset on each contract anniversary, and that reset level becomes the benchmark against which appreciation over the next year is measured. For example, if the customer selects the S&P 500 as the interest crediting reference for his or her FIA in year one, and the index appreciates eight percent in that year, the customer's FIA will be credited with interest based on that appreciation. If the customer selects the S&P 500 as the interest crediting reference for his or her FIA in year two, and the index declines in that year, the contract simply will be credited with zero index appreciation for year two (although the purchaser still is guaranteed the minimum guaranteed interest rate over the life of the contract). The appreciation from year one would be unaffected, *i.e.*, the year-one increase is locked in. (*See* September 10 Comment at 9.) By contrast, in a mutual fund or other direct investment in the stock or bond market, any loss of value is borne by the investor.

4 The chart illustrates over a ten-year time period the account values of an American Equity FIA for a customer who made a $100,000 premium payment, as compared against the performance of the S&P 500 index over that

(cont'd)

Moreover, because the beginning value of the index is reset annually, FIA purchasers receive the benefit of an eventual stock market rebound without suffering any of the losses that investors in, for example, a mutual fund, would have to recoup before returning to positive growth.[5]

McCann is simply wrong in declaring that FIAs are merely "equity-participation securities" to which "[i]nsurance companies add trivial insurance benefits, disadvantageous tax treatment and exorbitant costs." (McCann Report at 4.) McCann does not provide a comparison between equity participation securities and FIAs, and does not explain why the insurance benefits of FIAs are allegedly "trivial" or the tax treatment of FIAs is supposedly "disadvantageous." McCann thus lacks any basis to argue that Proposed Rule 151A is necessary because this "superficial repackaging exposes investors who purchase [FIAs] to the same risks as investors who purchase stocks, bonds, and mutual funds." (McCann Report at 5.) In fact, the insurance against risk of loss—insurance that McCann calls "trivial"—is a critically important feature of FIAs, which distinguishes them from "stocks, bonds, and mutual funds."

B. McCann's description of American Equity's 10-K is materially misleading.

McCann purports to use a recent American Equity Form 10-K to demonstrate the underlying economics of FIAs. (*See* McCann Report at 17-22 ("American Equity's Form 10-K Tells a Story").) McCann's presentation of American Equity's business and products, however, is fundamentally flawed and is based on material distortions of what American Equity actually said in its Form 10-K.

1. American Equity does not tell Wall Street that FIAs are a "low-risk business," and American Equity in fact bears substantial risks in connection with FIA sales.

McCann alleges that "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." (McCann Report at 17.) This is simply false—American Equity's financial disclosures discuss the risks and uncertainties of the business at length. *See*, *e.g.*, American Equity Investment Life Holding Co., Annual Report (Form 10-K), at 13-20 (Mar. 14, 2008)

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same period. The chart is based on actual credited rates from September 30, 1998, through September 30, 2008, for American Equity's Index-1 product, utilizing the S&P 500 annual monthly average crediting strategy over the life of the contract. If the policyholder surrendered the FIA at any time during the period illustrated in the graph, the policyholder would have been entitled to receive the greater of the index contract value minus applicable surrender charges or the minimum guaranteed contract value.

5 For example, if the S&P 500 index declines 30% this year, an FIA simply will be credited with zero index-based interest, *but will lose no money* (and in fact still is guaranteed the minimum guaranteed interest rate over the life of the contract). Additionally, if over the next year the S&P 500 appreciates 10%, the FIA will be credited with interest based on that appreciation. Thus, unlike an investor in an S&P 500 mutual fund, who will have to wait until the index appreciates 30% before potentially returning to positive growth, the purchaser of an FIA immediately can accumulate additional index-based interest.

(hereinafter, "American Equity Form 10-K") ("General economic conditions, including changing interest rates and market volatility, affect both the risks and returns on both our products and our investment portfolio."). American Equity's Form 10-K repeatedly emphasizes its business risks, including, for example, that "[s]ubstantial and sustained increases and decreases in market interest rates can materially and adversely affect the profitability of our products, our ability to earn predictable returns, the fair value of our investments and the reported value of stockholders' equity." *Id.* at 14.[6]

Moreover, contrary to McCann's assertion, American Equity informs Wall Street that its investment risks are significant. In particular, American Equity bears the risk that the investment performance of the Company's general account (in which all customers' premiums are combined) could fall short of the amounts necessary to meet its guarantees to policyholders of principal and interest and other contractual benefits—benefits the Company must provide regardless of whether general account assets perform as expected and whether losses are incurred on those assets. *See* American Equity Form 10-K at 6, 14-15.[7] These risks include:

- credit quality and default related to fixed maturity and other debt securities ("We are subject to the risk that the issuers of our fixed maturity securities and other debt securities (other than our U.S. agency securities), and borrowers on our commercial mortgages, will default on principal and interest payments, particularly if a major downturn in economic activity occurs.");[8]
- credit quality and default related to derivative instruments (if "counterparties fail to honor their obligations under the derivative instruments, we will have failed to provide for crediting to policyholders related to the appreciation in the applicable indices");
- interest rate fluctuations ("Interest rate risk is our primary market risk exposure.");
- premature asset sales ("we may be required to sell certain of our investments at a time that their fair value is less than the carrying value of these securities"); and
- reinvestment risk ("80% of our fixed income securities have call features and are subject to redemption . . . [w]e have reinvestment risk related to these redemptions to the extent

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6 The explanation to Wall Street that McCann posits, of the allegedly "simple" business of FIAs, also is at odds with McCann's assertion that FIAs are so complex that "'precious few finance PhDs could understand these products.'" (NASAA Comment at 11 (quoting Craig McCann and Dengpan Luao, *An Overview of Equity Indexed Annuities*, Securities Litigation & Consulting Group, Working Paper, at 13 (2006)).)

7 As explained in more detail in American Equity's September 10 Comment, American Equity provides policyholders with the stated guaranteed interest regardless of whether general account assets perform as expected and whether losses are incurred on those assets. The stated guaranteed interest is the greater of the value calculated from a minimum guaranteed interest rate or the value from interest, compounded annually, at a rate selected by the policyholder which may be either fixed rate or a rate calculated with reference to the appreciation of a particular equity or fixed income index, by a formula set prospectively. (*See* September 10 Comment at 8-13.)

8 The events of recent weeks demonstrate that counter-party risks, including risks of default, are very real, and are not hypothetical as McCann suggests.

> we cannot reinvest . . . in assets with credit quality and yield characteristics similar to . . . the redeemed bonds").

American Equity Form 10-K, at 14, 15. These risks often materialize, which causes American Equity to regularly realize losses on individual assets. *See e.g., id.* at F-22 to F-24 (note 3 to audited consolidated financial statements). Moreover, these risks are disclosed in American Equity's Form 10-K because the Company's *shareholders*, not its policyholders, bear the risk that losses from general account investments will erode American Equity's stockholders' equity and/or common share value.

2. American Equity does not utilize index-based interest crediting parameters to eliminate its investment risk, and an investment spread is not an expense ratio.

There also is no merit to McCann's argument that "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." (McCann Report at 20.) FIAs are among the many types of annuities that permit the insurer to adjust certain features of the contract to reflect changing economic and business environments. For example, traditional fixed rate annuities permit the issuer to adjust rates annually, subject to guaranteed minimums, to reflect, among other factors, changes in the economy, general account asset yields, and costs of providing annuity benefits. Similarly, FIA contracts permit the insurer, also subject to guaranteed minimums, to annually adjust participation rates, caps, and other crediting features of the index-based interest component to reflect changes in the economic environment or cost of options. These adjustments may affect the amount of annual interest credited to an FIA policyholder, but they do not represent a pass-through of all of American Equity's general account investment risks to the purchaser. As explained *supra*, an FIA purchaser's annual index-based interest credit is locked-in and the credited interest rate never can be negative, regardless of whether the referenced index declines in value. As such, the policyholder bears no risk of losing principal or credited interest as a result of such crediting parameter adjustments.[9]

In addition, the contractual guarantee of minimum cap and participation rates limits the degree to which American Equity can adjust annual interest credits and adds to the risks borne by the Company. *See* American Equity Form 10-K at 14 ("In general, our ability to lower crediting rates is subject to a minimum crediting rate filed with *and approved by state regulators*.")

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[9] Crediting parameters are therefore irrelevant to the Section 3(a)(8) analysis, which focuses not on whether a specified level of gain will be achieved but whether there is a risk of loss. *See, e.g., Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d 743, 751 (W.D. Ky. 2002) ("Plaintiff's risk was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have been worth more . . . . That type of risk . . . is not the type of risk central to determining whether a security exists."); *see also* September 10 Comment at 8. Because crediting parameters cannot cause the purchaser's principal or credited interest to decline in value, and the purchaser is guaranteed to receive a certain return on his or her principal, McCann's conclusions regarding any transfer of risk do not affect the analysis of investment risk that a purchaser assumes for purposes of Section 3(a)(8).

(emphasis added). Any changes are further limited by "competition and other factors, including the potential for increases in surrender and withdrawals." *Id.* Moreover, although McCann claims that American Equity can *retroactively* pass along investment risks (*see* McCann Report at 20), any change to crediting features is annually disclosed to the purchaser *in advance* of the purchaser's selection of a referenced index and crediting methods. (*See, e.g.*, "American Equity Investment Life Insurance Co., American Equity's Gold Standard for a Secure Retirement: Bonus Gold," (Index-1-07), at 4-5, *available at* http://annuitybrokers.com/i/u/982487/i/AEL_Bonus_Gold_Client_Brochure.pdf (last visited September 26, 2008).)

Furthermore, there are no crediting parameters that apply to the minimum guaranteed interest rate that policyholders receive. McCann fails to explain how American Equity could transfer the substantial risk that the returns from its general account investments will not exceed the minimum guaranteed interest rate. The simple fact is that American Equity carries the risk, not policyholders.

McCann next argues that the "investment spread" referenced in American Equity's Form 10-K really is an annual expense ratio "charge levied by American Equity to pay for commissions, overhead and profit." (McCann Report at 21.) According to McCann, this investment spread "is not meaningfully different from what mutual fund companies do." (*Id.*) This is simply not true. The investment spread is merely the difference between the cost of interest and other annuity benefits American Equity provides to policyholders, and the return of the Company's general account investments.[10] Unlike variable annuities and mutual funds, American Equity charges no loads or annual fees to consumer account balances for the costs of sale, investment management, or otherwise managing its annuity business. Rather, like other insurance products to which spread management is important (including many life insurance policies, traditional fixed annuities, and health policies), American Equity seeks to earn an "investment spread" on its general account investments. Such a spread is not equivalent to an expense ratio that a mutual fund charges because American Equity must provide to policyholders certain stated guaranteed interest and benefits regardless of the performance of its general account investments. American Equity entirely bears the risk that it will not earn a spread or that the spread will be inadequate. As a further example, there is no distinction between the "spread" insurance companies seek to earn and the spread that banks seek to earn on their assets with respect to interest credited to depositors.[11]

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10 *See* American Equity Investment Life Holding Company, Annual Report (Form 10-K), at 26-27 (March 14, 2008). The cost of money does not include all of American Equity's costs of operating, such as amortizing deferred sales commissions or overhead costs. *Id.* (*See also* McCann Report at 18 (noting that the investment spread does not include commissions or other American Equity expenses).) Further, the general account includes assets related to American Equity's life insurance business, and thus the investment spread is not limited solely to the cost of money and return of invested premiums of FIAs.

11 McCann's contention that the investment spread is an annual expense ratio also fails because interest credits are not the sole benefit to policyholders of the FIA. In addition to safety of premium and the potential to earn a better return than other safe money alternatives, many consumers purchase FIAs for other insurance features of the product, such as a guaranteed income stream for life, tax deferral benefits, avoidance of probate, annual

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3. There is no merit to McCann's allegation that FIAs do not benefit consumers.

McCann next argues that FIAs are almost never appropriate because, he claims, any investor could emulate American Equity's general account investment portfolio by purchasing bond mutual funds, and thus avoid the crediting parameters that FIAs impose. (McCann Report at 21-22.) This comparison is inapt because bond mutual funds expose the purchaser to interest rate risk and credit default risk (in addition to charging annual fees regardless of whether the value of the bond fund appreciates in value), which is hardly comparable to a principal-protected insurance product such as an FIA.

For some risk-minimizing individuals, including (among many others) senior citizens, the guarantees of an insurance product like an FIA are far preferable to the potential for loss of principal inherent in investing in the stock or bond market through mutual funds. Although McCann argues that American Equity FIA purchasers would be better off investing in "[b]road bond market portfolios that provide investors with the same gross returns as American Equity earns on its bond portfolio" (*See* McCann Report at 21), these products, including fixed maturity securities and options, can and do risk the purchaser's principal. There is no dispute that long-term investments in certain securities *may* provide the potential for higher returns than FIAs, but with that higher potential return comes higher risk—up to and including complete loss of principal. Such investments, like Vanguard's Total Bond Market Fund (to use McCann's example), may not be suitable for risk-minimizing investors who desire preservation of principal.[12] McCann's conclusion that the risks of FIAs are "virtually identical to the risks of investing in mutual funds and variable annuities" (McCann Report at 3, 5) entirely discounts the fact that FIAs insure against the loss of value, whereas mutual funds do not.

Moreover, the allegedly "superior investments" that McCann advocates do not offer the other insurance benefits of FIAs. Although many consumers purchase FIAs for the safety of premium and the potential to earn a better return than other safe money alternatives, many consumers purchase FIAs at least partially (if not primarily) for the other insurance features of the product. (*See supra*, n.11.) In wholly conclusory fashion, McCann dismisses these benefits as "virtually worthless bells and whistles" (McCann Report at 5), but ignores that many consumers highly value these aspects of the product, evidenced by their purchasing decisions and use of the products over the past 12 years. Although the events that trigger some of these insurance benefits may occur rarely, the current financial crisis demonstrates that the unexpected can happen, and

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penalty-free withdrawals, enhanced penalty-free withdrawals upon nursing home confinement or terminal illness, and/or death benefits. Therefore, policyholders receive many benefits that the investment spread does not measure with respect to an individual purchaser.

12 Although McCann asserts that a bond portfolio "provide[s] investors *the same downside protection* at less than 1/10th of the cost of American Equity's [FIAs]" (McCann Report at 22 (emphasis added)), he fails to explain what the downside protection of bonds is. In fact, there is none, because if the value of the assets of Vanguard's Total Bond Market Fund decline or disappear, then the value of the customer's investment declines or disappears. Not so with an American Equity FIA.

many consumers highly value the safety and security of insurance against such events. If American Equity operated just like a mutual fund company, it would not be able to meet its insurance promises to its FIA policyholders.

4. McCann's argument that additional disclosures to consumers are necessary is flawed.

McCann contends that federal disclosure requirements are necessary but does not identify even a single disclosure that American Equity makes to customers, and therefore completely fails to explain how American Equity's disclosures are allegedly inadequate. In fact, as explained in the September 10 Comment, state insurance laws require substantial disclosures in connection with FIA sales. Under these laws, American Equity makes extensive disclosures to consumers at the point of sale and *in every sale* obtains the signed acknowledgment of the purchaser and sales agent that the disclosures were made.[13]

II. NASAA's legal and factual analysis are flawed and contrary to established precedent.

In addition to the wholly unreliable analysis set forth in the McCann Report, NASAA presents a deeply flawed legal analysis of whether FIAs are exempt from the securities laws under Section 3(a)(8).

A. NASAA's "adequate state regulation" test appears nowhere in *VALIC* and *United Benefit*.[14]

NASAA asserts that a "basic threshold requirement" for the Section 3(a)(8) exemption is that the product must be "subject to adequate regulation under state insurance law." (*Id.* at 5, 8.) The only state regulation requirement contained in Section 3(a)(8), however, is that the "annuity contract" be "subject to the supervision of the insurance commissioner, bank commissioner, or

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13 McCann's argument that the disclosure regime of the federal securities laws is necessary to protect consumers fails for other reasons as well. For example, McCann devotes a significant portion of his report to making FIAs appear as complicated as possible, even including a dense half-page algorithm that McCann contends is necessary to understand how FIAs operate. McCann fails to explain why a purchaser would need to understand a lengthy valuation algorithm to understand the features, benefits, and costs of FIA policies, however. Nor does McCann explain how such a valuation formula transforms FIAs into securities. Indeed, there is no distinction between such aspects of FIAs and the many aspects of any annuity (including those that undisputedly are exempt from the securities laws) that are designed by actuaries. *See* Kenneth Black, Jr. & Harold D. Skipper, Jr., *Life & Health Insurance* 713 (13th ed.) (2000) (describing actuarial calculations related to annuities). Although actuaries design annuities, a purchaser doesn't need a degree in actuarial science to purchase one. There simply is nothing remarkable about FIAs having *some* complex features, particularly given that they are true "annuity contracts." Nor does McCann explain how the federal disclosure requirements would require the disclosure of this additional information that McCann contends is so important to policyholders.

14 *SEC v. Variable Annuity Life Ins. Co. ("VALIC")*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia." 15 U.S.C. § 77c(a)(8). A "meaningful state regulation analysis" is absent from the requirements set forth in *United Benefit*, and in fact was rejected by the Supreme Court. 387 U.S. at 210 (noting that the *VALIC* dissent took the position that "that the existence of adequate state regulation" of variable annuities should be a basis for the Section 3(a)(8) exemption, but that the majority "conclusively rejected" such a holding) (quoting *Prudential Ins. Co. v. SEC*, 326 F.2d 383, 388 (3d Cir. 1964)); *see also* 73 Fed. Reg. 37,752, 55 (Release acknowledging that the relevant Supreme Court test relates to allocation of risk and the manner in which the annuity is marketed).

Moreover, NASAA ignores the fact that a significant aim of state insurance law is to provide insurance consumers with substantive protections against abusive sales practices. NASAA summarily dismisses state insurance consumer protection laws as inadequate but does not provide a single citation or example to support its bare assertion.[15] As American Equity explained in its September 10 Comment, which analyzed state insurance regulations in-depth, states actively and effectively regulate the sale of FIAs.[16]

B. NASAA's proposed risk test is contrary to law.

NASAA next argues that an FIA is a security if it "imposes investment risks on purchasers." (NASAA Comment at 5.) This formulation ignores that *allocation* of risk is the principal factor in determining whether an annuity meets the Section 3(a)(8) exemption, rather than simply whether a purchaser bears *any* risk. *See Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.* ("*AAP*"), 941 F.2d 561, 566 (7th Cir. 1991) ("No annuity transfers all of the risk to the seller. . . . Section 3(a)(8) therefore necessarily exempts annuities that leave purchasers with some investment risk.").

Regardless, NASAA proposes *eliminating any measurement of risk from Proposed Rule 151A*, and urges the SEC to eliminate the "more likely than not test" from Proposed Rule 151A.

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15 NASAA also argues that FIAs should be regulated as securities because FIAs are not "endowed with any other safeguards, such as FDIC insurance or collateralization, 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." (NASAA Comment at 8.) But *no annuities* offer FDIC insurance; that does not mean that all annuities are securities. Regardless, every state has an insolvency guaranty law, which generally establishes a fund to indemnify losses suffered by policyholders of insolvent insurers. *See* Black and Skipper at 962-63; *see also* 73 Fed. Reg. 37,752, 56.

16 NASAA even contradicts itself in attacking state insurance regulations. *Compare e.g.*, NASAA Comment at 19 ("insurance regulation has never been marked by a particularly aggressive, pro-consumer approach") *with id.* at 20 (describing the Minnesota attorney general's "aggressive enforcement action" involving FIA sales). NASAA argues that state regulation is inadequate because state attorneys general, rather than state insurance departments, filed the enforcement actions that NASAA cites. There is no logic to this contention, however, because a state attorney general is the chief legal officer of a state and is charged with enforcing the state's laws. At bottom, these state enforcement actions demonstrate that state laws adequately protect purchasers of FIAs and that states aggressively enforce such laws.

(*See* NASAA Comment at 21 ("[T]he 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.'").) Even NASAA concedes that this would altogether eliminate risk allocation from Proposed Rule 151A: "[s]ome observers undoubtedly would criticize this approach, arguing that it would cover annuities regardless of how much risk they transfer to investors." (*Id.*) NASAA nonetheless proclaims its standard "legally defensible"—without any explanation of how this standard is compatible with the Securities Act or the Supreme Court's contrary rulings, which recognize allocation of risk as a central factor. *See VALIC*, 359 U.S. at 71; *United Benefit*, 387 U.S. at 208.

NASAA next shifts its focus to surrender charges, arguing that purchasers of FIAs assume investment risk because surrender charges can cause an FIA purchaser to lose money. (NASAA Comment at 8-9.) Courts have long since rejected this view. *See, e.g., AAP*, 941 F.2d at 567 (holding that withdrawal penalties do "nothing to throw investment risk on the investor."); *Malone*, 225 F. Supp. 2d at 753 (rejecting plaintiff's argument that surrender charges cause the policyholder to assume investment risk).[17]

Failing that, NASAA argues that so-called "complexity risk"—the risk that purchasers do not fully understand the FIA product—transforms FIAs from insurance into securities. (NASAA Comment at 5, 9-12.) Even NASAA acknowledges that "complexity risk" is a "novel" concept (NASAA cites to no authority for this test, which appears nowhere in the law), but argues that "there is no reason why such risk should be ignored for purposes of distinguishing insurance products from investments" under Section 3(a)(8)). (*Id.* at 10.) But the SEC is not free to invent new law, and there is no basis in law or logic to support the argument that the complexity of an insurance product bears on whether the product is a security.[18]

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17 NASAA argues that *Malone* was "poorly decided" but fails to engage in meaningful analysis of specific errors in the court's legal reasoning. (*See* NASAA Comment at 9 n.4.) Moreover, NASAA emphasizes the *effect* of the decision on the plaintiff, which is of course irrelevant to whether the decision was legally correct. (*Id.* at 10 n.4.) The fact that Malone did not have a *federal securities law* remedy for her claims did not mean Malone was left without means of legal redress. Indeed, Malone continued to litigate claims in state court. *Cf. Malone*, 225 F. Supp. 2d at 754 (declining to exercise supplemental jurisdiction over Malone's state-law claims).

18 In support of its argument that FIA purchasers bear "complexity risk," NASAA cites to the statement of McCann: "No registered rep, insurance broker, or retail investor, and precious few finance PhDs could understand these products." (NASAA Comment at 11 (quoting C. McCann and D. Luao, *An Overview of Equity Indexed Annuities*, Securities Litigation and Consulting Group, at 13 (2006)).) Of course, this statement is fundamentally incompatible with NASAA's other argument that "[t]he best and perhaps sole remedy for the baffling complexity of the typical [FIA]" is disclosure as a security under federal law. (NASAA Comment at 11.) The federal disclosure regime would not help consumers if no "registered rep., insurance broker, or retail investor" (or anyone with less than a doctorate degree) can understand FIAs in the first place.

C. NASAA's "marketing" arguments also fail.

NASAA next argues that the allocation of risk pales in importance next to the marketing of FIAs, which NASAA asserts is the most important aspect of the Section 3(a)(8) analysis.[19]

Contrary to NASAA's position, the Supreme Court's "marketing" test is far broader than whether FIAs are "marketed primarily as investments, not as insurance products." (NASAA Comment at 13.) The relevant inquiry is whether an annuity "appeal[s] to the purchaser not on the usual basis of stability and security but on the prospect of 'growth' through sound investment management." *United Benefit*, 387 U.S. at 211; *see also Otto v. VALIC*, 814 F.2d 1127, 1132 (7th Cir. 1986), *rev'd on rehearing on other grounds* 814 F.2d 1140 (7th Cir. 1987). NASAA's singular focus on whether FIAs are marketed as investments thus fails for two reasons. First, the issue is how the annuity "appeals" to a consumer. Marketing may constitute *evidence* of how an annuity appeals to consumers, but it is not the sole factor in an FIA's appeal. *United Benefit*, 387 U.S. at 210-111; *see also AAP*, 941 F.2d at 565. Second, NASAA conflates the issue of whether FIAs appeal to purchasers as *investments* with whether they appeal on the basis of "sound investment management." This distinction is important because all insurance contracts are investments to some degree. *See VALIC*, 359 U.S. at 75 (Brennan, J., concurring) (stating that, with respect to Section 3(a)(8), "the point must have been that there then was a form of 'investment' known as insurance (including 'annuity contracts') which did not present very squarely the sort of problems that the Securities Act and the Investment Company Act were devised to deal with . . . ."); *see also AAP*, 941 F.2d at 565 ("The Securities Act of 1933 partitions *investments* between the world of securities regulation and insurance regulation via § 3(a)(8) . . . .") (emphasis added). That an FIA could be deemed an "investment" is irrelevant to whether it qualifies for the Section 3(a)(8) exemption.

Legal defects aside, NASAA also fails to offer competent evidence that FIAs are "typically portrayed as investments" or "promoted and perceived as securities." (NASAA Comment at 13-14.)[20] NASAA proclaims that "[s]cholars, regulators, and aggrieved private plaintiffs" allegedly "all agree that [FIAs] are marketed primarily as investments, not as insurance products." (*Id.* at 13.) But NASAA's support consists only of statements made in two articles (with no basis in the articles themselves, or any explanation of how the authors came to

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[19] NASAA's argument 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" (NASAA Comment at 12) calls into question the validity of Proposed Rule 151A, which is based entirely on risk. 73 Fed. Reg. 37,752 ("the proposed definition would hinge upon a familiar concept: the allocation of risk."). Although NASAA both incorrectly emphasizes the relevant "marketing" inquiry and questions "the validity of *any* risk based test" (NASAA Comment at 8), NASAA's argument nevertheless exposes a flaw in Proposed Rule 151A—the rule would not take into account an important aspect of the Supreme Court's test for whether an annuity meets the Section 3(a)(8) exemption.

[20] In any event, such an argument would fail with respect to American Equity FIAs. American Equity markets FIAs primarily on the basis of their insurance features and the Company's marketing materials emphasize that FIAs provide the safety and stability of traditional fixed-rate annuities. *See Malone*, 225 F. Supp. 2d at 753-54 (rejecting plaintiff's claim that American Equity marketed its FIA as an investment).

their conclusions) and general notices from the Financial Industry Regulatory Authority ("FINRA"). These FINRA notices (1) generalize the marketing of FIAs and (2) do no more than describe certain aspects of FIAs, but provide no basis to evaluate the marketing of these products as a whole. (*Id.* at 13-14.) NASAA also presents "proof" that unidentified salesmen convinced unidentified consumers to liquidate their investment portfolios to purchase unidentified FIAs. NASAA contends that this demonstrates that FIAs are marketed as investments, because FIAs allegedly "compete" for customer dollars with these investment portfolios. (*Id.* at 14.) It does not follow that competition between FIAs and the investments that NASAA describes means that FIAs are the same as those products. Investors in, for example, mutual funds, may become disenchanted with the potential or actual loss of their principal and seek to satisfy an entirely different type of financial need—the security of insurance against further loss of principal, a guaranteed lifetime income stream, or a death benefit. This is exactly the kind of competition that consumers need and competition among industries—or their regulators—is not a rationale for duplicative and unnecessary regulation.

D. NASAA provides no competent evidence that there is widespread fraud involving FIAs.

Finally, NASAA asserts that FIAs "are often used to perpetrate fraud and abuse." (NASAA Comment at 16.) NASAA provides no support for this categorical statement. As American Equity explained in its September 10 Comment, the available data actually indicate a low rate of complaints regarding FIAs, as there are fewer complaints concerning FIAs than traditional fixed annuities or variable annuities (which already are regulated as securities). (*See* September 10 Comment at 17-18.) NASAA's "evidence" of fraud, does not withstand scrutiny:

- NASAA argues that unidentified "daily news clips" and unnamed "investor alerts issued by federal and state regulators, clearly show that [FIAs] are being deployed as instruments of fraud and abuse." (*Id.* at 16.) It is unclear what "news clips" and "alerts" NASAA has in mind. Moreover, NASAA provides no statistics or studies to support this claim, and ignores the very low complaint history involving FIAs, typically in contrast to variable annuities. (*See* September 10 Comment at 14-18.)

- McCann contends that "[t]he net result of equity-indexed annuities' complex formulas and hidden costs is that they survive as the most confiscatory investments sold to retail investors." (NASAA Comment at 16 (quoting C. McCann and D. Luao, *An Overview of Equity Indexed Annuities*, Securities Litigation & consulting Group, Working Paper, at 13 (2006)) (emphasis omitted).) As explained *supra*, Section I, McCann fundamentally misunderstands the benefits and operation of FIAs, and his bare assertion is thus entitled to no weight.

- NASAA's former president, Patricia D. Struck, has claimed that FIAs "are often used to perpetrate fraud and abuse." (NASAA Comment at 16 (citing statement of Patricia D. Struck, Statement at SEC Seniors Summit (July 17, 2006), a*vailable at* http://www.nasaa.org/ Issues_Answers/ Legislative_Activity/Testimony/4999.cfm).) As American Equity explained in its September 10 Comment, Ms. Struck's claim suffers from multiple defects: (i) she has produced no statistics to support her assertion; (ii) there is no reasonable basis to conclude that there were appreciable levels of total complaints; and (iii) there is no indication of how many of the cases of fraud involving "unregistered securities, variable annuities, and equity-indexed annuities" that Ms. Struck referenced actually pertain to *FIAs*, as opposed to the other products she mentioned. In fact, Ms. Struck's statement is just as likely to support the opposite conclusion: that it is federally-regulated *variable* annuities that comprise the majority of complaints in the states at issue.

- NASAA's reliance on unsustained allegations of fraud by plaintiffs' lawyers is misplaced; untested allegations are not evidence. (*See, e.g.*, NASAA Comment at 16 (characterizing the *Strube* court's opinion as "describing systematic fraud in the sale of [FIAs]," although the court only was repeating the plaintiff's unsustained allegations); *id.* at 11 (asserting that the *Yokoyama* court "*entertained* claims that the sale of [FIAs] to senior citizens constitutes an inherently unfair and deceptive scheme under state law" (emphasis added), when in fact the court simply described plaintiff's *allegations* in the context of denying class certification).)

Conclusion

For the foregoing reasons, and for the reasons set forth in its September 10 Comment, American Equity respectfully requests that the Commission reject Proposed Rule 151A.

If you have any questions or would like additional information, please contact me.

Respectfully submitted,

/s/ Eric J. Gorman

Eric J. Gorman

cc: Honorable Christopher Cox, Chairman (via Federal Express)
Honorable Kathleen L. Casey, Commissioner (via Federal Express)
Honorable Elisse B. Walter, Commissioner (via Federal Express)
Honorable Luis A. Aguilar, Commissioner (via Federal Express)
Honorable Troy A. Paredes, Commissioner (via Federal Express)
Brian Cartwright, General Counsel, Office of the General Counsel (via Federal Express)