



Aviva USA 699 Walnut Street Des Moines IA 50309-3929 Tel 515 362 3600 www.avivausa.com

**VIA E-MAIL**

November 17, 2008

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

Re: **File Number S7-14-08, Supplemental Comment Letter  
Indexed Annuities and Certain Other Insurance Contracts  
Proposed Rules, Release Nos. 33-8933; 34-58022**

Dear Ms. Harmon:

Aviva USA Corporation (“Aviva” or “we”),<sup>1</sup> a major issuer of indexed insurance products in the United States and a member of Aviva plc, the fifth largest insurance group worldwide, appreciates the opportunity to provide additional comments during the re-opened comment period on the U.S. Securities and Exchange Commission’s (the “Commission”) proposed Rule 151A under the Securities Act of 1933 (the “1933 Act”).<sup>2</sup> According to the Proposing Release, Rule 151A “would prospectively define certain indexed annuities as not being ‘annuity contracts’ or ‘optional annuity contracts’ under this insurance exemption<sup>3</sup> if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.”<sup>4</sup>

As we stated in our comment letter dated September 10, 2008 (the “September Letter”) (a letter which we reaffirm and incorporate by reference into this letter),<sup>5</sup> we commend the Commission

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<sup>1</sup> Aviva issues indexed products through its direct wholly owned subsidiaries, Aviva Life and Annuity Company, American Investors Life Insurance Company, Inc., and Aviva Life and Annuity Company of New York. We are an Iowa corporation and an indirect, wholly owned subsidiary of Aviva plc, a public limited company incorporated under the laws of England and Wales. Aviva plc is the ultimate holding company of Aviva and had consolidated assets under management of approximately \$724.6 billion as of December 31, 2007.

<sup>2</sup> Release Nos. 33-8933, 34-58022, 73 Fed. Reg. 37,752 (Jun. 25, 2008) (the “Proposing Release”).

<sup>3</sup> Section 3(a)(8) exempts certain annuity and other contracts from the 1933 Act.

<sup>4</sup> Proposing Release at 37,752.

<sup>5</sup> We have attached a copy of the September Letter as Appendix A.

for its interest in protecting consumers, and have long been an ardent supporter of rational regulatory efforts to ensure that indexed annuities are sold in an environment in which the interests of consumers are protected. However, we continue to oppose proposed Rule 151A as it is currently drafted, and believe indexed annuities are fixed insurance products, not securities.

Further, if proposed Rule 151A is adopted as proposed, we continue to believe the legal test used to determine the statutory exemption set forth in Section 3(a)(8) of the 1933 Act would be dramatically altered, and would not be supported by current judicial precedent and Commission interpretations of Section 3(a)(8). This would not only essentially change the securities status of indexed annuities but also would create significant uncertainty regarding the securities status of other fixed annuities, and would potentially heighten litigation and enforcement risks for insurers.

In addition, if proposed Rule 151A is adopted without the Commission undertaking certain other regulatory reforms, an unlevel playing field between registered indexed annuities and variable annuities would be created that would hinder, rather than promote, competition in the marketplace. Although Rule 12h-7,<sup>6</sup> the proposed exemption from the reporting requirements of the Securities Exchange Act of 1934 (the "1934 Act") also set forth in the Proposing Release, would partially address some of these competitive disadvantages, it alone is not sufficient to produce a regulatory regime for registered indexed annuities reasonably comparable to that existing for variable annuities. Any differences that exist should be grounded only in sound policy justification. Consequently, we respectfully reiterate our request that the Commission adopt a comprehensive regulatory package of reforms to address various issues relating to regulatory consistency before, or concurrent with, the effectiveness of any rule that would require the registration of indexed annuities.

Finally, we continue to recognize that there has been uncertainty in the marketplace concerning the status of indexed annuities under the federal securities laws since their introduction in the mid-1990's, and we welcome a rule that would provide clear, objective guidance to insurers as to the status of indexed annuities. We suggest that an amendment to Rule 151 under the 1933 Act would, as a practical matter, better serve the Commission's objectives and provide insurers with the certainty they need.

We divide this letter into three sections as follows:

- Under "Proposed Rule 151A Is A Dramatic Departure From Rule 151 And Existing Precedent And Is Fundamentally Flawed," we provide additional information to support our argument that indexed annuities are fixed insurance products, not securities.

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<sup>6</sup> *Id.* at 37,762. Proposed Rule 12h-7 would exempt insurance companies that issue indexed annuities from periodic reporting requirements provided certain conditions were met.

- Under “Proposed Rule 151A Is Severely Anti-Competitive,” we provide additional information about the unlevel playing field that would be created between indexed annuities and variable annuities unless the Commission adopts before or concurrent with the effectiveness of proposed Rule 151A a comprehensive regulatory package to ensure that any registered indexed annuities are not competitively disadvantaged.
- Under “An Amendment to Rule 151 Would Better Serve the Commission’s Objectives And Avoid Any Of The Challenges of Proposed Rule 151A,” we provide the outlines of an alternative rulemaking proposal.

### **I. Proposed Rule 151A Is A Dramatic Departure From Rule 151 And Existing Precedent And Is Fundamentally Flawed**

As we discussed in our September Letter, proposed Rule 151A, by only focusing on the purported investment risk and volatility assumed by a contract owner for positive interest, fails to recognize that the robust contractual guarantees typically provided by insurers largely remove any investment risk that an indexed annuity contract owner may have. As such, we continue to believe that proposed Rule 151A is fundamentally inconsistent with judicial precedent and with prior Commission interpretations in which the investment risks of the insurer and the contract owner are weighed against each other and considered as one factor in a “facts and circumstances” test. Proposed Rule 151A, therefore, is flawed.

Among the robust contractual guarantees we provide is that once interest is credited to an indexed annuity, it is “locked in” and cannot be taken away by subsequent poor equity market performance. This guarantee is especially important in these economic times.<sup>7</sup> This significant contractual guarantee differentiates indexed annuities from securities, including variable annuities, and serves to limit any purported investment risk that an indexed annuity contract owner may have. The guarantee shifts investment risk to an insurer because, as we discussed in our September Letter, no matter how the market and the hedging instruments that the insurer uses to manage its risk perform, the insurer must provide the guarantee. Proposed Rule 151A fails to consider this important investment risk that an insurer assumes on its indexed annuities.

Further, in addition to the arguments set forth in our September Letter, we submit that indexed annuities, as shown by the operation of Aviva’s contracts, support our argument that proposed Rule 151A is flawed. These insurance contracts neither receive the full market gains nor suffer the market losses to which a participant in the market would be subject. Despite this, the Commission is proposing that indexed annuities be regulated as securities if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

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<sup>7</sup> We note that many insurers provide similar contractual guarantees on their indexed annuities.

Shown below are three charts. Each chart shows the performance of actual or hypothetical Aviva indexed annuity contracts (based on contracts that may have been issued using then current rates) as compared to the Standard & Poor's 500 Composite Price Index (the "S&P 500").<sup>8</sup> In addition, the first chart also compares the performance of an Aviva indexed annuity contract with that of a hypothetical traditional fixed annuity contract.

### **Chart A**

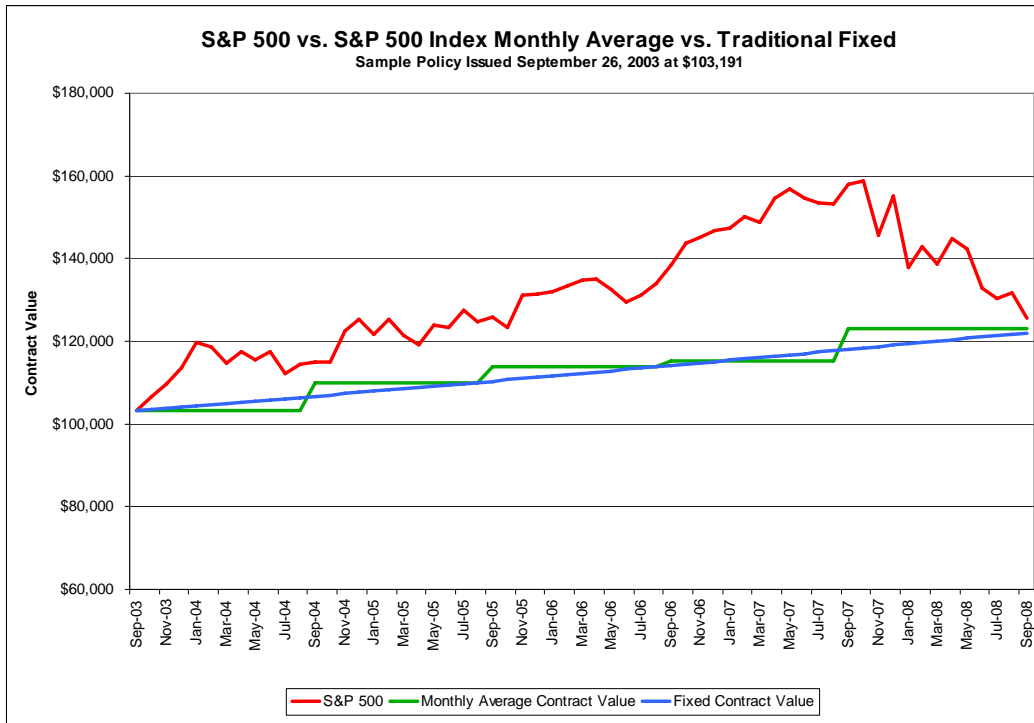
This chart shows the operation of an actual Aviva indexed annuity contract issued in September 2003 and its performance through 2008.<sup>9</sup> Interest, if any, is based in part on the performance of the S&P 500, and is credited annually to the contract using the monthly average of the index. The annual interest credited on the hypothetical traditional fixed annuity is 3.42%, which, like all annuities, would be tax deferred.<sup>10</sup> The chart depicts the performance of the S&P 500, the contract's account value and the traditional fixed contract's value ("Fixed Contract Value").

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<sup>8</sup> All S&P 500 numbers in the charts utilize closing values and exclude dividends.

<sup>9</sup> Actual indexed interest credited was 6.65% on the first contract anniversary, 3.38% on the second anniversary, 1.41% on the third anniversary, 6.63% on the fourth anniversary and 0.00% on the fifth anniversary. We credit interest, if any, on a monthly average crediting strategy by using the performance of the S&P 500 over a one-year period calculated by taking the value of the S&P 500 on the same day of each month during the year and dividing by 12, subject to a cap and a spread. No withdrawals have been taken on the annuity. Past performance is not a guarantee of future results.

<sup>10</sup> Aviva believes that the 3.42 % rate is a reasonable estimate of what traditional fixed annuities averaged over the time period shown.



As shown above, the value of the indexed annuity contract only correlates to a limited extent with the performance of the S&P 500. When comparing the performance of the hypothetical traditional fixed annuity, the indexed annuity contract and S&P 500, the performance of the contract more closely tracks the performance of the traditional fixed annuity contract than an investment in the S&P 500.

**Chart B**

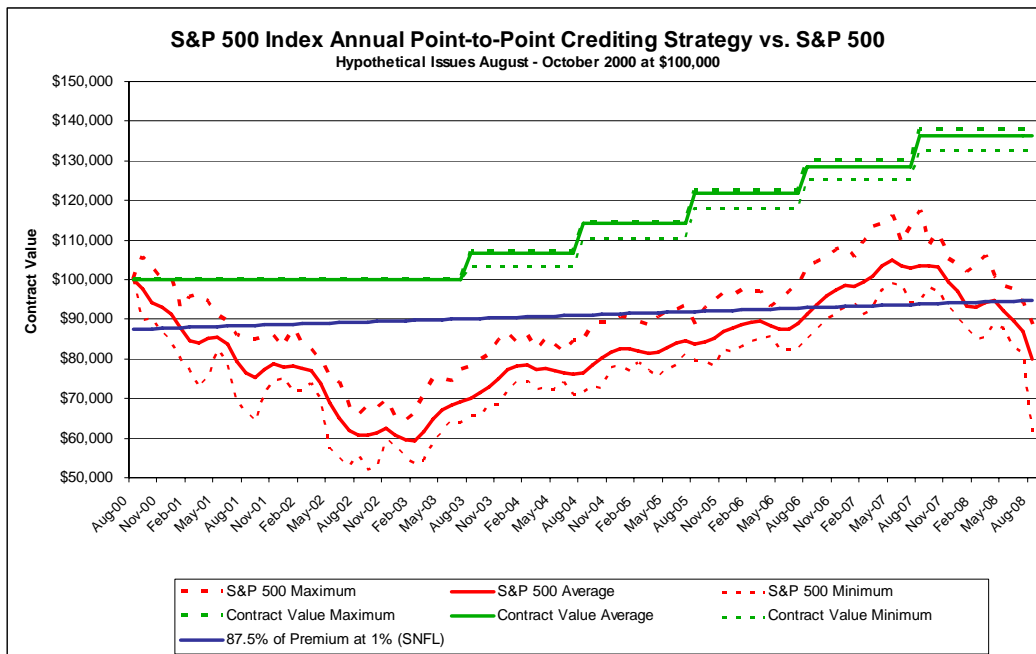
Chart B shows the hypothetical performance of certain Aviva indexed annuity contracts issued during August – October 2000 and their performance through 2008.<sup>11</sup> Interest, if any, is based in

<sup>11</sup> For contract account values, we assumed the issuance of a contract each business day through the 28<sup>th</sup> of each month during the August – October time frame with \$100,000 premium deposited into each contract. We used the actual caps that were in effect for each contract year in the graph, actual S&P 500 values and assumed a one year point-to-point interest crediting methodology. Because interest crediting is done on a point-to-point basis, and index periods differ based on contract issue date, performance varies.

For an indexed annual point-to-point crediting strategy, we calculate indexed-linked credits based on the percentage change in the S&P 500 index price for each one-year period, subject to a cap. We declare the cap at the beginning of each term period.

We therefore show the minimum and maximum values along with the average to highlight the range of values for such contracts and the S&P 500. We have assumed no withdrawals or surrenders and 100% allocation to the point-to-point crediting strategy. Withdraws and surrenders may be subject to withdrawal charges and limited market value adjustments.

part on the performance of the S&P 500, and is credited annually. The minimum shown is the current National Association of Insurance Commissioners (“NAIC”) Standard Nonforfeiture Law that requires an insurer to credit 87.5% of premiums at a rate of interest that is the lesser of 3% and an amount based on a formula where the resulting interest rate is not less than 1% per year. The chart shows the range of performance of the S&P 500, the range of performance of the contracts, and the NAIC Standard Nonforfeiture Law at the lowest possible interest rate, *i.e.*, 1% per year. We note that during the period shown, the interest rate used in NAIC Standard Nonforfeiture Law may have been higher.

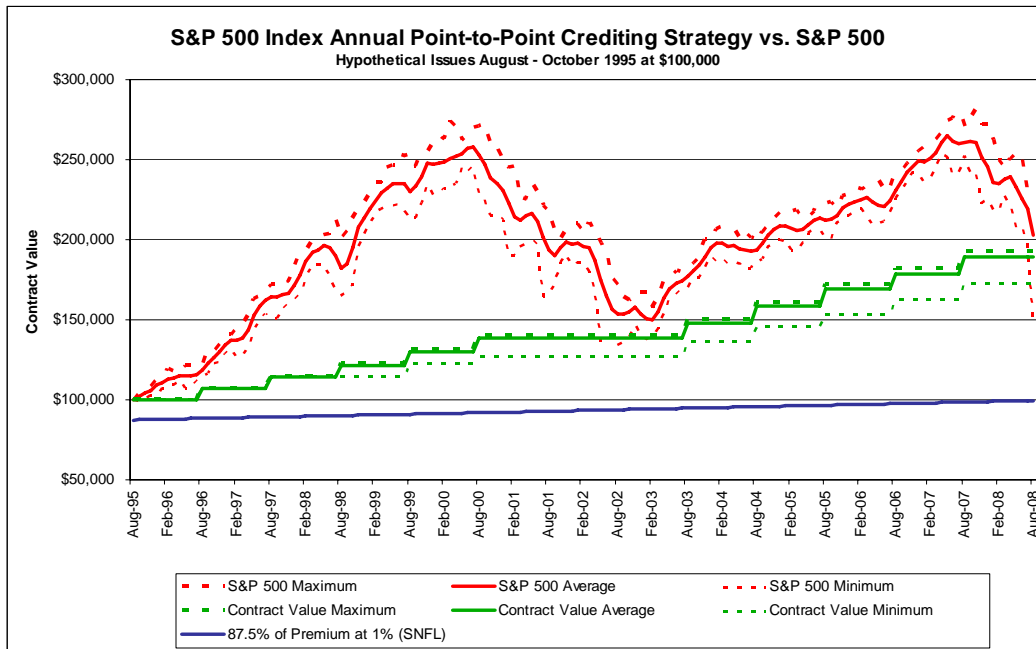


Given the volatility of the S&P 500, Chart B highlights how the guarantees provided by the contract can be very significant. Most notably, the contract owner receives the benefit of (i) the “lock-in” of previously credited interest, which protects the account value from downturns in the S&P 500, and (ii) the NAIC Standard Nonforfeiture Law, which even at the lowest possible interest rate of 1% provides a significant guarantee because in a period of market downturns, the guarantee may provide better performance than an investment in the S&P 500.

**Chart C**

To further illustrate the guarantees discussed in Chart B above over different market conditions, the chart below shows the hypothetical performance of Aviva indexed annuity contracts issued during the August – October 1995 timeframe and their performance through 2008.<sup>12</sup>

<sup>12</sup> For the time period between 1995 and 1999, our indexed annuity contracts did not have caps. For better comparison, however, we assumed 7% cap rates for that time period based on our good faith estimates. From 2000



During the period shown above, the S&P 500 experienced both significant declines and increases. The performance of the hypothetical indexed annuity contracts, however, remained consistent and predictable; the performance of the indexed annuity was either equal to or less than the performance of the S&P 500 when the index went up, and was zero when the S&P 500 went down. The contracts neither participated in the significant gains which the S&P 500 enjoyed nor did the contracts participate in the S&P 500's significant losses. The zero floor on interest credited to the contract and the guarantee that interest once credited is "locked in" and cannot be taken away by subsequent market downturns protected contract owners during S&P 500 downturns. In addition, the interest crediting mechanism provided contract owners with the ability to receive higher interest crediting rates during periods of time that the S&P 500 increased than they would have received on a traditional fixed annuity.

Proposed Rule 151A, by only focusing on one factor to determine the security status of an indexed annuity, the possibility for excess interest, ignores the important guarantees an insurer provides. As shown in the charts above, the performance pattern of an indexed annuity is more similar to that of a fixed annuity than an investment in the S&P 500. In addition, the charts illustrate how the guarantees provided by the contract shift the vast majority of the investment risk to the insurer.

on, we used actual cap rates in effect for each year for the point-to-point crediting strategy. For all time periods in the chart, we used the actual S&P 500 values. Although we assumed that the NAIC Standard Nonforfeiture Law in effect during the time period shown was 87.5% of premiums credited with interest of 1% annually, the actual rates credited during the time period may have been higher.

As noted in our September Letter, the U.S. Solicitor General with significant assistance from the Commission<sup>13</sup> recognized that the protection of the federal securities laws is not needed:

if, inter alia, the insurance company assumes a sufficient share of the investment risk, which reduces the risk to the participant, who is also protected by state regulation of the insurance company. Even though the participant bears some degree of risk, the annuity contract may qualify under the “annuity contract” exemption.<sup>14</sup>

As the charts above illustrate, the guarantees embedded into an indexed annuity shift the vast majority of the investment risk to the insurer. These include:

- the “locking in” of previously credited interest;
- the zero floor on interest credits;
- the compliance with NAIC Standard Nonforfeiture Law;
- the declaring in advance of the indexed crediting factors (cap rate, participation rate, spreads, etc.); and
- the guaranteeing of the indexed crediting factors regardless of the performance of the insurer’s general account investments.

These guarantees all have the effect of shifting significant investment risk to the insurer. For the contract owner, the crediting of interest based in part on the performance of an index merely provides the potential to receive higher interest crediting rates than a traditional fixed annuity.

## **II. Proposed Rule 151A Is Severely Anti-Competitive**

As we discussed in our September Letter, the Commission should not adopt proposed Rule 151A, or a similar proposal, unless the regulatory framework has been fundamentally reformed to more fully encompass indexed annuities to ensure that indexed annuities are not competitively disadvantaged. The 1933 Act regulatory framework is ill-suited for the continuous offering of indexed annuities, and the general S-1 registration form, in its current state, obscures the disclosure that is material to indexed annuity contract owners.<sup>15</sup> The 1933 Act corporate financing regulatory structure simply was not developed with indexed annuities in mind; that

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<sup>13</sup> Brief for the United States as Amicus Curiae, *Variable Annuity Life Ins. Co. v. Otto*, 486 U.S. 1026 (April 1988) (no. 87-600) (the “Brief”).

<sup>14</sup> Brief at 7 citing *VALIC* and *United Benefit* (“*VALIC I* and *United Benefit* do not suggest that an issuer must assume *all* investment risk under a contract in order for the contract to come within the exemption”).

<sup>15</sup> Insurers that are not well known seasoned issuers will have to register an indexed annuity on Form S-1. Issuers that meet certain requirements (such as filing reports under the 1934 Act for 12 calendar months immediately preceding the filing of the registration statement) may use Form S-3 for the registration of securities under the 1933 Act, provided the securities are offered in any transaction specified in the form (the “Transaction Requirement”).



structure was developed for debt and equity offerings by corporations with little or no reporting history and where the success of the offering depended upon the performance of the issuer's business.

By contrast, the Commission has developed a well-reasoned approach to variable annuity regulation under the federal securities laws. This approach includes registration forms and exemptive rules that take into account the unique nature of an insurance product offering.

In our September Letter, we provided a number of examples in which variable annuities enjoy regulatory advantages over indexed annuities. We also suggested a number of reforms that the Commission should undertake to "level the playing field." We set forth below additional information about some of the costs that insurers that issue indexed annuities would have to incur should indexed annuities be subject to the current regulatory structure.

As we have noted, variable annuity insurers would have a regulatory advantage over indexed annuity insurers because variable annuity insurers are able to register their insurance products on a registration form, Form N-4, which is tailored to address variable annuities and the disclosures that are most relevant to a variable annuity contract owner. By contrast, an insurer that is not a "well known seasoned issuer" must register an indexed annuity on Form S-1. Form S-1 is ill-suited for indexed annuities. The form, by focusing more on disclosure about the insurance company and less on the indexed annuity contract being offered, masks the product information that is most material to an indexed annuity contract owner.

We analyzed the external monetary costs alone that an insurer would incur to register an indexed annuity on Form S-1.<sup>16</sup> Simply to prepare and file the registrations statements with the SEC, we estimate that the external costs would be approximately \$350,000 per registration statement for the first few years.<sup>17</sup> Excluded are the significant costs associated with preparing financial statements and the annual expenses to maintain compliance with the federal securities laws and other rules associated with a registered offering.<sup>18</sup>

Many insurers that issue indexed annuities do not have audited financial statements prepared in accordance with generally accepted accounting principals ("GAAP") that would be required in order to register on Form S-1; instead, these insurers have audited financial statements prepared

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<sup>16</sup> These costs are limited to external costs to be expended by the insurer and exclude significant costs such as (i) the significant loss of personnel hours that would otherwise be devoted to other company projects, and (ii) the costs to individual insurance agents and insurance agencies to alter their business model, including costs associated with obtaining necessary licenses, training and updating their marketing and other materials.

<sup>17</sup> The costs associated with this would admittedly decrease over time as an insurer's expertise and efficiency increases.

<sup>18</sup> These costs include auditing and legal fees, costs associated with an increased head count and the related infrastructure and support needs, increased mailing costs and ongoing training and licensing fees. These costs may vary and would be dependent upon a variety of factors including sales volumes, the number of agents selling the products and the number of products that have been registered.

in accordance with statutory accounting principles (“SAP”).<sup>19</sup> If an indexed annuity were permitted to register on Form N-4, it is possible that the insurer could use SAP financial statements.<sup>20</sup>

We have developed an analysis of the major tasks and costs an insurer would have to undertake to develop and provide audited GAAP financial statements including the preparation of the management discussion and analysis. In order to initially develop the historical GAAP financials required by Regulation S-X and S-1, we estimate that it would take a team of individuals internal to the insurer, plus an external auditing team, a significant amount of time to develop GAAP financial statements. These costs alone would be at least several million dollars. An insurer that registered a variable annuity on Form N-4 may not have to incur these costs.

In addition, an insurer will have to spend several million dollars to build the infrastructure necessary to support a registered contract. These costs include expenses to upgrade technology, consulting fees, training expenses for employees, and infrastructure costs.

The estimated S-1 registration costs provided above do not include the additional printing and mailing costs (as compared to insurers that register a variable annuity on Form N-4) that would be incurred by insurers that register indexed annuities on Form S-1. These extra costs would include the printing and mailing costs relating to the added prospectus length because of inclusion of the management discussion and analysis and the inclusion of financial statements in the prospectus. They also would include the extra printing and mailing costs incurred because of the inability of indexed annuity insurers to use written sales material that would qualify as an omitting prospectus pursuant to Rule 482 under the 1933 Act.<sup>21</sup> None of these additional costs are costs that insurers that register variable annuities on Form N-4 would incur.

The above illustrates the significant burden that complying with proposed Rule 151A would impose on indexed annuity issuers and that the estimated S-1 registration costs far exceed the cost of approximately \$206,250 per registered product that the Commission estimated in the Proposing Release.<sup>22</sup>

In summary, throughout the Proposing Release, the Commission compared indexed annuities to variable annuities. Consistent with the approach taken in the Proposing Release, the

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<sup>19</sup> As we discussed in our September Letter, we believe that GAAP financial statements will be of limited utility to an indexed annuity contract owner. Further, because of the more conservative assumptions used in SAP financial statements such as the balance sheet (a financial statement highly relevant to the indexed annuity contract owner), SAP financial statements may prove to be more useful to an indexed annuity contract owner than GAAP financial statements.

<sup>20</sup> See Item 22 of Form N-4.

<sup>21</sup> See September Letter at 20.

<sup>22</sup> See Proposing Release at 37,770.

Commission should not regulate indexed annuities until it has provided indexed annuities with a well-reasoned regulatory framework similar to what it provides for variable annuities. Without such a regulatory framework, insurers that issue indexed annuities will incur significant costs and will be at an unfair competitive disadvantage to insurers that issue variable annuities.

### **III. An Amendment to Rule 151 Would Better Serve the Commission's Objectives And Avoid Any Of The Challenges of Proposed Rule 151A**

As we discussed in our September Letter, states have adopted robust suitability and disclosure regulations relating to indexed annuity sales and also have required specialized training for indexed annuity agents. Given this important work, we continue to believe that the Commission should consider whether an amendment to Rule 151 would better serve the Commission's objectives than proposed Rule 151A and the amendment would be more in line with judicial precedent. An amendment to Rule 151:

- could provide greater certainty as to the status of indexed annuities under the federal securities laws – insurers would not have to re-evaluate the securities status of their products every three years and either register or issue unregistered indexed annuity contracts;
- would not put indexed annuities at an unfair competitive disadvantage;
- would not be overbroad in reach as is proposed Rule 151A; and
- would be more useful to the consumer and insurer.

Further, an amended Rule 151 would be more consistent with the Commission's goals to provide "greater clarity with regard to the status of indexed annuities under the federal securities laws, . . . as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws."<sup>23</sup>

Rule 151 could be amended to deem an indexed annuity where interest was credited retroactively to not shift investment risk to a contract owner (and thus not be a security) as long as the conditions of amended Rule 151 were met. Such an amendment could address investment risks that the insurer would have to bear in order for the investment risk not to shift to the contract owner and the marketing of the contract, including heightened suitability requirements and agent training requirements.

Specifically, the Commission could amend Rule 151 to require indexed annuity insurers relying on the rule to comply with investment risk requirements that were more tailored to indexed annuities. Under the amended rule, the insurer, for the life of the contract, could have to:

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<sup>23</sup> Proposing Release at 37,753.

- guarantee any formula that credits interest based in part on the performance of an index (the “indexed crediting formula”) and credit earnings, if any, based on that formula;
- declare the current indexed crediting factors used in the indexed crediting formula in advance of the start of any term and guarantee that those factors would remain in place for at least one year for current contract owners;
- guarantee the minimum and/or maximum for each indexed crediting factor, as appropriate;
- guarantee that the insurer would not credit “negative interest” to the contract – in other words, all interest crediting provisions would have a zero floor;
- guarantee that the contract complies with NAIC Standard Nonforfeiture Laws and that in no event, will the insurer provide the contract owner with less than 87.5% of premiums at 2.25% annual interest for the life of the contract at surrender -- this would mean that a single premium contract owner could be guaranteed to receive the return of his or her premium in six contract years;
- guarantee that any interest, once credited, would be available for withdrawal or surrender (less any applicable surrender charge); and
- guarantee certain contract liquidity features, such as requiring an insurer permit a contract owner to withdraw up to 10% of account value each year without the imposition of a withdrawal charge.

In addition, the amended Rule 151 could require that indexed annuity insurers relying on the rule to provide each contract owner with a simplified disclosure document, similar to the certificate of disclosure required by the NAIC Annuity Disclosure Model Regulation. Specifically, each contract owner would have to receive at the point of sale a disclosure document written in plain-English that could provide the following:

- a general description of the indexed annuity, including any optional riders;
- disclosure concerning the interest crediting formula, including any caps, participation rates and spreads, and disclosure stating that any cap, participation rate, and/or spread could change for future interest crediting terms subject to contractually guaranteed minimum or maximum rates;
- clear disclosure about any fees and charges associated with the indexed annuity;
- disclosure about the commission that would be paid for the sale of the indexed annuity contract;
- a discussion of the liquidity features of the contract, including “free withdrawal” provisions;
- a discussion of the death benefit;
- a discussion of the tax status of the contract; and
- a discussion of the annuitization options.

Further, the amended Rule 151 could provide that an indexed annuity insurer satisfy specific marketing requirements to rely on the rule. To that end, the amended Rule 151 could require that

insurers take specified actions to ensure that an indexed annuity contract is marketed primarily as insurance, and also could include sales suitability and agent training requirements.

The requirements for marketing materials could include the following:

- a requirement that all marketing materials be approved in advance by the insurer;
- a requirement that all marketing materials include certain disclosures such as the identity of the insurer, disclosure that the annuity is not investment in the market and that it is not a security, and a statement that because of the surrender charges, the annuity may not be suitable as a short term investment.

The suitability and agent training requirements could include the following:

- a requirement that the insurance producer, or insurer if there is no producer, have a reasonable basis to believe the annuity is suitable for the prospective contract owner;
- a requirement that the insurer review the suitability of each transaction, and that the prospective contract owner complete a suitability questionnaire that addresses issues such as the prospective owner's liquidity needs and income;
- a requirement that the insurer have written policies and procedures in place to monitor suitability;
- a requirement that the insurer have heightened suitability procedures for sales to seniors;
- a requirement that if an insurer delegates the suitability review to a third party, that (i) the delegation be made by a written agreement, (ii) the third party permit the insurer to inspect its suitability review procedures, and (iii) the third party provide an annual written certification that its suitability procedures comply with the written delegation;
- a requirement that any insurance producer satisfy training requirements regarding indexed annuities and suitability in general and specific training about the product at issue; and
- a requirement that the insurer adopt written conduct rules designed to address the insurer's business and method of distribution and that each insurance producer certify annually that he or she has read and agrees to comply with such rules.

We respectfully submit that such an amendment to Rule 151 would accomplish the Commission's objectives and provide a level of certainty to insurers because the rule would specify those components that would always satisfy Section 3(a)(8) (unlike proposed Rule 151A where an insurer must determine every three years whether or not the annuity is a security). Importantly, an amended Rule 151 would provide the Commission with a level of assurance that insurers that relied on the amended rule were assuming sufficient investment risk as well as taking steps to ensure their products are not marketed as securities.

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Florence E. Harmon  
U.S. Securities and Exchange Commission  
November 17, 2008  
Page 14

Once again, we appreciate the opportunity to provide supplemental comments on proposed Rule 151A. We continue to believe, however, that the proposed rule is not supported by current judicial interpretations and Commission precedent interpreting Section 3(a)(8). In addition, if Rule 151A is adopted as proposed, variable annuities would enjoy an unfair regulatory advantage over registered indexed annuities unless the Commission were to undertake certain regulatory reforms in advance of or concurrent with the rule's effectiveness. Finally, we respectfully submit that an amendment to Rule 151 would better serve the Commission's objectives and provide insurers with the certainty they need.

If you have any questions or comments on this letter, please feel free to call me at 515.362.3657.

Sincerely,



Michael H. Miller  
Executive Vice President  
General Counsel and Secretary

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

Andrew J. Donahue, Director  
Susan Nash, Associate Director  
William J. Kotapish, Assistant Director  
Keith E. Carpenter, Senior Special Counsel  
Michael L. Kosoff, Attorney  
Division of Investment Management

# APPENDIX A



Aviva USA 699 Walnut Street Des Moines IA 50309-3929 Tel 515 362 3600 www.avivausa.com

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We commend the Commission for its interest in protecting consumers, and have long been an ardent supporter of rational regulatory efforts to ensure that indexed annuities are sold in an environment in which the interests of the consumer are protected. However, we oppose proposed Rule 151A as it is currently drafted, and believe indexed annuities are insurance products, not securities.

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<sup>4</sup> Proposing Release at 37,752.



Further, if Rule 151A is adopted as proposed, we believe the legal test used to determine the statutory exemption set forth in Section 3(a)(8) of the 1933 Act would be dramatically altered, and would not be supported by current judicial interpretations and Commission precedent interpreting Section 3(a)(8). This would not only essentially change the securities status of indexed products but also would create significant uncertainty regarding the securities status of other fixed products, and would potentially heighten litigation and enforcement risks for insurers.

In addition, if proposed Rule 151A is adopted without the Commission undertaking certain other regulatory reforms, an unlevel playing field between registered indexed annuities and variable annuities would be created that would hinder, rather than promote, competition in the marketplace. Although Rule 12h-7,<sup>5</sup> the proposed exemption from the reporting requirements of the Securities Act of 1934 (the “1934 Act”) also set forth in the Proposing Release, would partially address some of these competitive disadvantages, it alone is not sufficient to produce a regulatory regime for registered indexed annuities reasonably comparable to that existing for variable annuities, so that any differences that exist are grounded only in sound policy justification. Consequently, we respectfully request that the Commission adopt a comprehensive regulatory package of reforms to address various issues relating to regulatory consistency before, or concurrent with, the effectiveness of any rule that would require the registration of indexed annuities.

Finally, we recognize that there has been uncertainty in the marketplace concerning the status of indexed annuities under the federal securities laws since their introduction in the mid-1990’s, and we welcome a rule that would provide clear, objective guidance to insurers as to the securities status of indexed annuities. We suggest that a new safe harbor rule or an amendment to Rule 151 under the 1933 Act would, as a practical matter, better serve the Commission’s objectives and provide insurers with the certainty they need.

We divide this letter into six sections as follows:

- Under “Background,” we discuss proposed Rule 151A.
- Under “Proposed Rule 151A Is A Dramatic Departure From Rule 151 And Existing Precedent And Is Fundamentally Flawed,” we discuss how (i) proposed Rule 151A’s singular focus on the purported investment risk assumed by the contract owner for positive interest fails to recognize the robust guarantees provided by insurers, (ii) proposed Rule 151A’s “more likely than not” determination, which requires an insurer to ignore bona fide surrender charges, is flawed, (iii) proposed Rule 151A provides little or no certainty for an insurer that determines that an annuity is not a security, and (iv) the Commission’s analysis under proposed Rule 151A is overly broad and calls into question all products outside of Rule 151’s safe harbor.

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<sup>5</sup> *Id.* at 37,762. Proposed Rule 12h-7 would exempt insurance companies that issue indexed annuities from periodic reporting requirements provided certain conditions were met.

- Under “Proposed Rule 151A Is Severely Anti-Competitive,” we discuss (i) the fundamental regulatory reforms that the Commission must adopt before or concurrent with the effectiveness of proposed Rule 151A to ensure that indexed annuities are not competitively disadvantaged, (ii) that the Commission should delay the effectiveness of proposed Rule 151A by at least 24 months from the date it is adopted in order to enact those fundamental regulatory reforms, (iii) how proposed Rule 151A will hinder, not promote competition, and (iv) how the Commission will create an “unlevel playing field” with bank indexed products because of proposed Rule 151A.
- Under “The Current State Insurance Regulatory Structure Provides Important Protections to Investors that the Commission Failed To Consider,” we discuss the robust suitability, disclosure, and replacement regulations provided under state insurance laws.
- Under “A New Safe Harbor Rule or An Amendment to Rule 151 Would Better Serve the Commission’s Objectives And Avoid Any Of The Challenges Of Proposed Rule 151A,” we discuss the alternative concepts that the Commission could use to accomplish its goals of providing certainty for insurers and protections to consumers.
- Under “Conclusion,” we request that the Commission re-open the comment period to provide commentators with sufficient time to provide more thoughtful comments on proposed Rule 151A.

## **I. Background**

Proposed Rule 151A would define a class of annuities that would not be an “annuity contract” or an “optional annuity contract” for purposes of the Section 3(a)(8) exemption. An insurer would have to determine whether an annuity is within the scope of the proposed rule.

Specifically, under proposed Rule 151A, an annuity contract would be subject to registration if:

- (1) 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; and
- (2) amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.<sup>6</sup>

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<sup>6</sup> Proposed Rule 151A would apply to annuity contracts subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia, and that is subject to regulation under the insurance laws of that jurisdiction as an annuity.

Proposed Rule 151A specifically excludes any contract whose value varies according to the investment experience of a separate account.<sup>7</sup> No other contracts, however, are specifically excluded from proposed Rule 151A, and no other factors are deemed relevant in making the determination of the securities status of annuity.<sup>8</sup>

As discussed below, we believe that proposed Rule 151A's approach departs from and is not supported by existing legal precedent and Rule 151. Further, we believe that there are better approaches the Commission could take to accomplish its goals of providing greater certainty for insurers.

## **II. Proposed Rule 151A Is A Dramatic Departure From Rule 151 And Existing Precedent And Is Fundamentally Flawed**

- A. *Proposed Rule 151A's focus on the purported investment risk to the investor for positive interest is fundamentally inconsistent with judicial precedent and prior Commission interpretations and is flawed.*

Proposed Rule 151A, by only focusing on the purported investment risk (and volatility) assumed by a contract owner for positive interest, fails to recognize that the robust contractual guarantees provided by insurers largely remove any investment risk that an indexed annuity contract owner may have. As such, proposed Rule 151A is fundamentally inconsistent with judicial precedent and with prior Commission interpretations in which the investment risks of the insurer and the contract owner are weighed against each other and considered as one factor in a "facts and circumstances" test. Rule 151A, therefore, is flawed.

In the Proposing Release, the Commission discusses the two Supreme Court cases that address investment risk under Section 3(a)(8), *S.E.C. v. Variable Annuity Life Insurance Co. of America* ("VALIC")<sup>9</sup> or *S.E.C. v. United Benefit Life Insurance Co.* ("*United Benefit*").<sup>10</sup> However, in so doing, the Commission fails to note that neither of those two cases stand for the proposition that the status of an annuity under the federal securities laws is based solely on the likelihood that the purchaser receives positive interest. Rather, those cases stand for the proposition that a product that is fundamentally a variable annuity is a security where the insurer's guarantee is non-existent, *de minimus*, or deceptive. Security-status resulted because the insurer had little or no investment risk when weighed against the investment risk assumed by the contract owner. The

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<sup>7</sup> Proposing Release at 37,758.

<sup>8</sup> According to the Proposing Release, the status under the 1933 Act of "any annuity, other than an annuity that is determined under proposed rule 151A to not be an 'annuity contract' or 'optional annuity contract,' would continue to be determined by reference to the investment risk and marketing tests articulated in existing case law under section 3(a)(8), and, to the extent applicable, the Commission's safe harbor rule 151." Proposing Release at 37,762.

<sup>9</sup> 359 U.S. 65 (1959).

<sup>10</sup> 387 U.S. 202 (1967).

investment risk of the insurer, as well as the mortality risks the insurer assumes and the marketing of the product, were considered by the Supreme Court when determining the securities status of an annuity contract.

The Supreme Court held in *VALIC* that the annuity contract at issue, a variable annuity, was not an “annuity” within the meaning of Section 3(a)(8) because the entire investment risk was borne by the annuitant, not the insurance company. Premiums collected under the VALIC contract were invested in common stocks and other equities, while benefits payable under the VALIC contract varied with the success of investment portfolio in equities – an interest which the Court characterized as having “a ceiling but no floor.”<sup>11</sup> The Court noted that “insurance” typically involves the company’s guarantee that at least some fraction of the benefits will be payable in fixed amounts. Absent some guarantee of fixed income, a variable annuity places all investment risks on the annuitant and none on the insurance company, thus failing the test of “insurance.”<sup>12</sup>

In an attempt to provide the investment risk assumption the Supreme Court found lacking in *VALIC*, the insurance company in *United Benefit* guaranteed that the value of a deferred (essentially variable) annuity contract after ten years would never be less than the aggregate net premiums paid under the contract. United Benefit’s contract was a deferred annuity with a “pay-in” period during which the annuitant’s net premiums were placed in a separate account, composed primarily of common stocks. The value of the net premiums varied according to the investment experience of the separate account. At maturity, the purchaser could convert the value of his or her interest to a fixed annuity or elect to receive the greater of (a) his or her interest in the separate account or (b) aggregate premiums.

The Supreme Court in *United Benefit* concluded that the variable “pay-in” phase did not qualify for the Section 3(a)(8) exemption. The Supreme Court noted that during the “pay-in” period, “[i]nstead of promising to the policyholder an accumulation to a fixed amount of savings at interest, the insurer promise[d] to serve as an investment agency and allow the policyholder to share in its investment experience.”<sup>13</sup> United Benefit merely promised to return, at a minimum, net premiums paid, an “amount [that] is substantially less than that guaranteed by the same premiums in a conventional deferred annuity contract.”<sup>14</sup> United Benefit’s investment risk was minimal because United Benefit set the guarantee low enough so that the guarantee would have never been operable in the prior fifty years.<sup>15</sup> The Supreme Court found that while the guarantee

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<sup>11</sup> 359 U.S. at 72.

<sup>12</sup> *Id.* at 71. Further, the mortality risk assumed by the insurer was not sufficient “investment risk” for the VALIC’s annuity contract to qualify for the Section 3(a)(8) exemption.

<sup>13</sup> 387 U.S. at 208.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 209 n.12 (“The record shows that United set its guarantee by analyzing the performance of common stocks during the first half of the 20<sup>th</sup> century and adjusting the guarantee so that it would not have become operable under any prior conditions.”)

“reduce[d] substantially the [contractholder’s] investment risk,” “the assumption of an investment risk cannot by itself create an insurance provision.”<sup>16</sup> In addition, the Supreme Court noted that the United Benefit contract required special modifications in state law,<sup>17</sup> and used a sales kit that touted the possibility of investment return and the experience of United Benefit’s management in professional investing.<sup>18</sup>

In contrast to the lack of investment risk borne by the insurers that issued the variable annuities in *VALIC* and *United Benefit*, the investment risk borne by an insurer that issues indexed annuities is significant. Unlike variable annuities, all insurers that issue indexed annuities, at the very least, must provide state nonforfeiture minimum guarantees. Such guarantees are substantially in excess of the guarantee provided in *United Benefit*, and require that the contract owner receive 87.5% of premium if the contract is surrendered in year one (compared to 50% of net premiums guaranteed by the insurer in *United Benefit* if the contract was surrendered in year one), and 87.5% of premium accumulated at between 1% and 3% interest for the life of the contract (compared to 100% of net premiums returned after 10 years).<sup>19</sup>

State nonforfeiture laws are the standard guarantee for all individual deferred annuity contracts, whether fixed or indexed, and represent a level of minimum guarantees that state regulators have determined is appropriately in the public interest to protect both the individual consumer from forfeiture and the insured public from insurer insolvency. Indeed, the Commission recognized the importance of state regulation of insurer solvency when it determined that the Commission could rely on state regulation in proposing Rule 12h-7.

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<sup>16</sup> *Id.* at 211 (emphasis added).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 211 n.15.

<sup>19</sup> The NAIC standard nonforfeiture law for individual deferred annuities provides that interest rates calculated in accordance with the model law must be credited to at least 87.5% of gross premiums decreased by the sum of (i) any prior withdrawals accumulated at rates of interest indicated by the model law, (ii) an annual contract charge of \$50, accumulated at rates of interest specified in the model law, (iii) any premium tax paid by the company for the contract, accumulated at rates of interest specified in the model law, and (iv) any indebtedness. The interest that must be credited is the lesser of 3% per annum and:

- (a) the five-year Constant Maturity Treasury Rate reported by the Federal Reserve no longer than 15 months before the contract issue date or the date of redetermination;
- (b) reduced by 125 basis points (225 basis points for an equity index annuity – this reduction must reflect the value of the equity index benefit, and the insurer must demonstrate by actuarial memo that the market value of the benefit does not exceed the present value of the additional 100 basis point reduction);
- (c) where the resulting interest rate is not less than 1%; and
- (d) the interest rate shall apply for an initial period and may be redetermined for additional periods.

National Association of Insurance Commissions, NAIC Model Laws, Regulations and Guidelines 805-1 (2007) (adopted in some form by every state except Florida and Mississippi from 2003 to 2005).

Further, virtually all indexed annuity insurers provide guarantees in addition to those required by state nonforfeiture laws and in addition to what would be required for an annuity to qualify for the Rule 151 safe harbor. Such guarantees may include a significant cash surrender value guarantee, such as a guarantee that the owner will receive the return of 100% of his or her premiums paid less prior withdrawals at any time while the contract is in force, and a guarantee of minimum crediting rates for a fixed crediting strategy and minimum caps and participation rates for an indexed crediting strategy for the life of the contract. By providing the guarantees, the insurer is obligated to provide the benefits regardless of the performance of the insurer's general account investments that support the guarantees. **This is particularly evident in today's environment where the insurer has assumed all credit risk and default risk in its general account. The contract owner has been insulated from losses associated with equities, mortgage losses, and other credit defaults.**

In addition, state insurance regulation provides other significant protections to indexed contract owners. Importantly, indexed annuity contract owners receive the protections of comprehensive state "guaranty fund" laws that are similar to FDIC insurance. The guaranty fund coverage does not generally apply to insurance products issued through separate accounts.<sup>20</sup>

As the Supreme Court recognized in *VALIC*, variable annuities, by their nature, place all the investment risk on the annuitant/owner. The investment return of a variable annuity contract owner will vary directly with market conditions and account value can be lost if the market declines.

By contrast, with an indexed annuity, the use of an external index in accordance with a predetermined fixed formula contradicts the notion that Aviva is serving as an investment agency or supplying investment advice. There simply is no pass-through of the company's general account investment performance under Aviva's indexed annuity contracts: the company credits positive interest to an indexed crediting strategy based, in part, on the performance of an external index. The only "risk" an Aviva contract owner may have with respect to index performance is that no additional interest will be credited to account value if the index performs poorly in the future. Proposed Rule 151A fails to recognize this key distinction between a variable annuity and an indexed annuity. Throughout the Proposing Release, the Commission assumes that a purchaser of a variable annuity and a purchaser of indexed annuity have similar investment risks. Equating the risk of loss of principal with the risk that positive interest will not be credited is incorrect and simply without basis.

Rule 151 requires an insurer to consider the investment risks assumed by the insurer and by the contract owner, as well as the marketing of the contract, in making its determination about the

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<sup>20</sup> However, guaranty fund coverage will apply to certain guaranteed features, such as guaranteed minimum withdrawal benefits, provided in variable annuities.

status of an annuity contract under the federal securities laws.<sup>21</sup> These requirements were emphasized by the Commission in an *amicus curiae* brief submitted to the Supreme Court in *Otto v. Variable Annuity Life Ins. Co* (“*Otto*”).<sup>22</sup> At the Supreme Court’s request, the U.S. Solicitor General (with significant assistance from the Commission; the Commission’s general counsel, solicitor and three other Commission staff members are listed on the Brief) filed an *amicus curiae* brief in *Otto* supporting the grant of certiorari.<sup>23</sup> The court in *Otto* examined an annuity contract under which the insurer guaranteed a fixed rate of 3.5% to 4.0% with the possibility of excess interest also being credited. This excess interest could be changed at any time at the insurer’s discretion and was as high as 14.5%. The Brief stated that whether the fixed annuity was an “annuity contract” within the meaning of Section 3(a)(8) should be answered by reference to *VALIC* and *United Benefit*. Under those authorities, as well as prior Commission announcements, the Brief stated that it is recognized that investment risk of the insurer is a critical factor to consider in determining investment risk, but it is only one of the interrelated factors for judging whether a contract is within Section 3(a)(8).<sup>24</sup> Importantly, the Brief recognized that the protection of the federal securities laws is not needed:

if, inter alia, the insurance company assumes a sufficient share of the investment risk, which reduces the risk to the participant, who is also protected by state regulation of the insurance company. Even though the participant bears some degree of risk, the annuity contract may qualify under the “annuity contract” exemption.<sup>25</sup>

While the Brief recognized that *Otto* assumed the risk that no excess interest would be credited, with regard to the investment risk criterion of Section 3(a)(8), the Brief concluded that *VALIC*, by guaranteeing the return of principal and minimum accrued interest, did assume sufficient

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<sup>21</sup> Rule 151 sets forth four factors to be considered in establishing whether an insurer is assuming sufficient investment risk. Each of the four factors must be satisfied for an annuity contract to shift sufficient investment risk to the insurer. Among those factors are that the insurer guarantee for the life of the contract, the principal amount of premiums and interest credited thereto (less deductions, without regard to timing, for sales, administrative or other expenses or charges) and that the insurer credit net premiums and interest credited thereto with a specified rate of interest for the life of the contract, such interest must at least equal the minimum rate of interest required by the relevant state nonforfeiture law. Rule 151, consistent with judicial interpretations of Section 3(a)(8), mandates consideration of investment risk allocation under the terms of the contract. Under Rule 151, the insurer is not required to assume all the investment risk under the contract. Rather, the insurer must limit the shifting of investment risk to the contract owner so that the investment risk the insurer assumes is sufficient to qualify the contract for the Section 3(a)(8) exclusion.

<sup>22</sup> 814 F.2d 1127 (7<sup>th</sup> Cir. 1986), *rev’d on rehearing*, 814 F.2d 1140 (1987), *modified* (1987), *cert. denied*, 486 U.S. 1026 (1988).

<sup>23</sup> Brief for the United States as Amicus Curiae, *Variable Annuity Life Ins. Co. v. Otto*, 486 U.S. 1026 (April 1988) (no. 87-600) (the “Brief”).

<sup>24</sup> Brief at 6, 9.

<sup>25</sup> Brief at 7 *citing* *VALIC* and *United Benefit* (“*VALIC I* and *United Benefit* do not suggest that an issuer must assume *all* investment risk under a contract in order for the contract to come within the exemption”).

investment risk under the contract for it to meet the investment risk criterion of Section 3(a)(8). The ability of the insurer to change the excess interest rate at its sole discretion did not automatically take the contract out of Section 3(a)(8).

However, proposed Rule 151A, unlike Rule 151 and the Commission's reasoning in the Brief,<sup>26</sup> only focuses on one factor, excess interest (*i.e.*, if the amount payable, which includes excess interest, is more likely than not to exceed the guaranteed amount more than half the time), in determining the status of an indexed annuity under the federal securities laws. No other facts or circumstances, even guarantees that are in excess of the guarantees required by state nonforfeiture laws, are considered under proposed Rule 151A. This flawed analysis could lead to the determination that an indexed annuity is a security even though the insurer provides robust guarantees that exceed minimum state nonforfeiture requirements. For example, under proposed Rule 151A, an indexed annuity in which 100% of the purchase payments were guaranteed to receive interest at 3.0% per year would be a security if the amount payable more than half the time included .10% of excess interest tied to an index (for a total of 3.10% per year). As the Commission recognized in the proposing release for Rule 151 and its reasoning in the Brief, and as is consistent with *VALIC* and *United Benefit*, it is not necessary for the insurer to assume all the investment risk under an annuity contract. Rather, it is the degree of the investment risk the insurer assumes that is important.<sup>27</sup> By so limiting the investment risk analysis to only the amount of positive interest that may be credited, proposed Rule 151A fails to consider other critical investment risks that an insurer assumes, the mortality risks the insurer assumes, and the marketing of the product and thereby, is not supported by *VALIC*, *United Benefit*, or prior Commission interpretations. Consequently, proposed Rule 151A is flawed. The important guarantees and risks the insurer assumes make indexed annuities insurance products within the meaning of Section 3(a)(8), not securities.

*B. The "more likely than not" determination, which requires an insurer to ignore bona fide surrender charges, is unprecedented and flawed.*

The practical consequence of proposed Rule 151A(b)(1)(a)'s "more likely than not" determination is that in most, if not all, circumstances, an indexed annuity that has surrender charges will fail the test and be deemed a security because the amounts payable will exceed the amounts guaranteed by at least the amount of the surrender charges. This is because, in making the "more likely than not" determination, the proposed rule requires an insurer to determine the

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<sup>26</sup> Definition of Annuity Contract or Optional Annuity Contract, Securities Act Release No. 6645, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,004 (May 29, 1986) at 88,130 ("Release 6645") ("[t]he presence or absence of a mortality risk assumption may be an appropriate factor to consider in a general facts and circumstances analysis under section 3(a)(8)").

<sup>27</sup> Definition of Annuity Contract or Optional Annuity Contract, Securities Act Release No. 6558, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,710 at 87,160 (Nov. 21, 1984) ("[a]lthough these cases, particularly *United Benefit*, do not require the insurer to assume *all* investment risk for a contract to be insurance under section 3(a)(8), they make clear that the degree of investment risk assumed by the insurer is the critical factor").



amounts payable under an indexed annuity contract without reference to any charges that are imposed at the time of payment. However, such charges are to be taken into account in determining the amounts guaranteed under the contract. In other words, proposed Rule 151A requires insurers to consider surrender charges in determining minimum guaranteed amounts, but not in determining cash value.

In attempting to justify such disparate treatment, the Commission states that it is proposing such methodology “in order to eliminate the differential impact that such charges would have on the determination depending on the assumptions made about contract holding periods.”<sup>28</sup> However, the “differential impact” of holding periods is equally applicable to the determination of the amounts guaranteed. There is no precedent supporting the likelihood of *bona fide* charges, including surrender charges, being imposed as an appropriate factor to consider in determining the securities status of an insurance product. *Bona fide* charges established by the terms of a contract are expenses not risks.

In neither *VALIC* nor *United Benefit* did the Supreme Court find, or even consider, that the likelihood of the imposition of *bona fide* charges, including surrender charges, as an appropriate factor to consider in determining the securities status of what was fundamentally a variable annuity.

Further, the Commission’s approach under proposed Rule 151A is the direct opposite of the approach taken by the Commission with Rule 151’s investment risk analysis. Rule 151(b)(2) specifically permits insurers to deduct sales, administrative or other expenses or charges in determining the principal amount plus interest the insurer must guarantee for the life of the contract in order for the annuity to satisfy Rule 151’s investment risk test. Such charges, the Commission believed, would “not result in expense structures that transfer additional investment risk from the insurer to a contractowner.”<sup>29</sup>

By mandating the comparison with and without surrender charges to determine the status of the product under the federal securities laws, the Commission in effect is regulating product design. Indexed annuities that reflect surrender charges in guaranteed minimum values will automatically be deemed to have amounts payable that exceed amounts guaranteed. This regulation of charges is neither consistent with Rule 151 nor with the National Securities Market Improvement Act of 1996 (“NSMIA”).<sup>30</sup> As part of NSMIA, Congress amended the Investment Company Act of 1940 (the “1940 Act”) to substitute a more general “reasonableness” standard for the then existing statutory limits on the amount, type, and timing of the fees assessed in

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<sup>28</sup> Proposing Release at 37,761.

<sup>29</sup> Release 6645 at 88,132. Also, the Commission stated that “a contingent deferred sales load (“CSDL”) is simply a sales load that is deducted upon partial or full redemption and that is contingent on the number of years the contract has been in effect. A CDSL normally does not shift additional investment risk to the contractowner. . .” *Id.* at n.20.

<sup>30</sup> National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, §205, 110 Stat. 3416 (1996).

variable insurance contracts. By so requiring the consideration of surrender charges on the amounts payable side of the equation, but not on the amounts guaranteed side, the Commission is deviating from the more flexible regulation of insurance product charges that Congress mandated with NSMIA. As such, proposed Rule 151A will stymie innovation and competitiveness in the marketplace -- thus defeating two of NSMIA's goals.

In addition, the more likely than not determination may lead to illogical results. An insurer may be able to design a product that makes no sense other than to avoid proposed Rule 151A. For example:

- Indexed Annuity A guarantees 2% interest plus 100% of the increase in the index in excess of 25% for the upcoming year; and
- Indexed Annuity B guarantees 3.5% interest plus 12% of the increase in the index in excess of 3.25% for the upcoming year.

Therefore, under Indexed Annuity A because it is unlikely that an indexed annuity would have indexed returns in excess of 25% per year, Indexed Annuity A would not be deemed to be a security since the amount payable has less than a 50% chance of exceeding the guaranteed amount. However, Indexed Annuity B would be deemed to be a security because it is more likely than not that the index would return more than 3.25% per year. The insurer's guarantee under Indexed Annuity A is less than the insurer's guarantee under Indexed Annuity B, but the likelihood of paying indexed interest in Indexed Annuity A is less certain than Indexed Annuity B. This result is illogical and without precedent.

*C. Proposed Rule 151A provides little or no certainty for an insurer that determines an annuity is not a security.*

Under proposed Rule 151A, an insurer relies on its determination that an annuity is not a security at its own risk. By design, proposed Rule 151A is principles-based and vague.

The Commission provides that in making the "more likely than not determination," an insurer will need to make "assumptions about (i) insurer behavior, (ii) purchaser behavior, and (iii) market behavior, and will need to assign probabilities to various behaviors."<sup>31</sup> The Commission believes that insurers should be able to make such determinations because they "routinely undertake such analyses for purposes of pricing and hedging their contracts,"<sup>32</sup> and "should generally be guided by both history and their own expectations about the future,"<sup>33</sup> in determining whether assumptions are reasonable.

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<sup>31</sup> Proposing Release at 37,760.

<sup>32</sup> *Id.* [citations omitted].

<sup>33</sup> *Id.* at 37760.

However, actuaries may reasonably differ on how the determination under proposed Rule 151A is to be made. In fact, the Commission recognizes that “a range of methodologies and assumptions may be reasonable and that a reasonable methodology or assumption utilized by one insurer may differ from a reasonable assumption or methodology selected by another insurer.”<sup>34</sup> The Commission states that in determining whether an insurer’s methodology is reasonable, “it would be appropriate to look to methods commonly used for valuing and hedging similar products in insurance and derivatives markets.”<sup>35</sup> Contrary to the Commission’s assertions, however, insurers do not currently perform the testing in the manner contemplated by the Proposing Release. Further, there is no Actuarial Standard of Practice to provide guidance on how an actuary should make the “more likely than not” determination.<sup>36</sup>

The Commission states that it believes it is important “to provide reasonable certainty to insurers with respect to the application of the proposed rule and to preclude an insurer’s determination from being second guessed, in litigation or otherwise, in light of actual events that may differ from assumptions that were reasonable when made.”<sup>37</sup> To that end, proposed Rule 151A purports to provide general guidance stating that an insurer’s determination regarding the “more likely than not” determination would be conclusive if the insurer’s methodology and the economic, actuarial, and other assumptions used are reasonable; the computations made by the insurer in support of the determination are materially accurate; and the determination is made not more than six months before the date on which the contract is first offered and not more than three years before the date on which the particular contract is issued.

However, any challenge to the reasonableness of an annuity’s status under proposed Rule 151A will be made after the fact with the benefit of hindsight. Thus, proving a “more likely than not” determination was reasonable when made will be difficult. For example, what may have been reasonable five years ago based on assumed future behaviors of markets and purchasers, may no longer appear reasonable today given the benefit of observing actual behaviors of markets and purchasers. In addition, the valuing and hedging methods the Commission states that insurers are to use in making the “more likely than not” determination were not developed to withstand enforcement and litigation challenges; rather such methods were developed only for internal valuing and hedging purposes. Unsubstantiated policy statements by the Commission may prove to be little or no comfort for an insurer when faced with enforcement and litigation risks posed by reliance on a vague rule.

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<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> The American Academy of Actuaries develops Actuarial Standards of Practice to provide uniform guidance to actuaries.

<sup>37</sup> Proposing Release at 37,760.

In addition, as noted above, in order for a “more likely than not” determination to be conclusive, proposed Rule 151A requires an insurer to assess the securities status of an annuity before it is issued and every three years thereafter. Therefore, it would be possible for an annuity to be exempted from registration one year but be required to register the next or registered as a security one year and exempted from registration the next. As a result, the “redetermination” itself will lead to many practical difficulties and to heightened litigation and enforcement risks for an insurer.

Unless the Commission provides significant regulatory reforms/relief before the effectiveness of Rule 151A (as discussed in Section III below), the “redetermination” required by proposed Rule 151A will amplify the compliance, litigation and enforcement issues for an insurer. For example, compliance issues under Section 5 of the 1933 Act raised by the “redetermination” include the following:

- (i) if an insurer determines after the third year of selling the indexed annuity that was not registered to then register the index annuity under the 1993 Act, will the insurer have to stop selling the “unregistered” version of the product before the registered version is declared effective?
- (ii) further, in such circumstances, will there be a waiting period before an insurer may file the registered version of the product because the insurer has “conditioned” the market by sales of the unregistered product?

The Proposing Release provides no guidance on how an insurer should address these practical concerns.

*D. Proposed Rule 151A is overly broad in scope, and calls into question the securities status of all products that are outside Rule 151.*

Proposed Rule 151A is overly broad in scope. Proposed Rule 151A(a)(1) reaches all contracts 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.” This reach, depending on the interpretation of “by reference to,” may extend proposed Rule 151A’s reach beyond indexed annuities (the product the Commission intended to reach by the rule),<sup>38</sup> to include:

- annuities and guaranteed investment contracts with MVA formulae tied to a security (e.g., U.S. Treasuries);
- retail and institutional products where interest is determined by express reference to Treasuries or bond indices;

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<sup>38</sup> See Proposing Release at 37,752.

- discretionary excess interest products insofar as the yield or total return of the general account portfolio (or segment thereof) is a factor in setting current interest rates; and
- participating policies insofar as dividends payable are derived in part from investment experience.

As a result of the expansiveness of proposed Rule 151A, serious questions may be raised about the securities status of all products potentially within the scope of proposed Rule 151A(a)(1). This is particularly the case where the product is outside the Rule 151 safe harbor but within Section 3(a)(8). Issuers of those products could face dire consequences, including potentially being exposed to heightened litigation and enforcement risks.

Further, the broad scope of proposed Rule 151A may lead courts to reexamine how they make determinations of the securities status of an insurance product under Section 3(a)(8). Courts may find it difficult to apply the seemingly conflicting principles of both proposed Rule 151A (that defines an annuity not to be an annuity contract) and Rule 151 (that provides certainty on what is an annuity) to a product that does not clearly fit within either rule. As a result, courts may interpret Rule 151 as the outer limits of Section 3(a)(8).<sup>39</sup> Such result would be contrary to the clear intentions of the Commission as set forth in Rule 151's adopting release. In that release, the Commission stated that Rule 151, as a safe harbor, "does not attempt to identify the outer limits of section 3(a)(8) beyond which a contract, though denominated 'insurance,' is a security subject to federal regulation."<sup>40</sup>

The Proposing Release asks whether proposed Rule 151A should apply to indexed life insurance products.<sup>41</sup> We strongly oppose applying proposed Rule 151A in its current form to indexed life insurance.

When read literally, proposed Rule 151A only operates to define what is an "annuity" for purposes of Section 3(a)(8). Although the Proposing Release expressly provides that proposed Rule 151A does not apply to contracts "that are regulated under state insurance law as life insurance, health insurance, or any form of insurance other than an annuity,"<sup>42</sup> proposed Rule 151A advances a new analytical framework that may need to be considered by insurers in determining whether an indexed life insurance product qualifies for the exemption under Section 3(a)(8). Proposed Rule 151A will have a collateral impact on indexed life insurance as insurers and their legal counsel may feel it prudent to analyze their products under the rule as a defensive measure, even though the products are expressly excluded from the rule.

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<sup>39</sup> We note that some courts have already interpreted Rule 151 as defining the boundaries of Section 3(a)(8). *See, e.g., Berent v. Kemper Corp.*, 780 F. Supp. 431 (E.D. Mich. 1991), *aff'd*, 973 F.2d 1291 (6<sup>th</sup> Cir. 1992) (determining that single premium life insurance policies were not securities).

<sup>40</sup> Release 6645 at 88,129.

<sup>41</sup> Proposing Release at 37,758.

<sup>42</sup> *Id.*

The Commission has not addressed indexed life insurance or examined the product as it has with indexed annuities. Indexed annuities and indexed life insurance contracts are fundamentally different products that serve fundamentally different consumer needs. In fact, the only feature they share is the calculation of indexed interest. The indexed interest credited under a universal life product is only one of several factors that drives product performance, whereas it is a primary factor impacting annuity product performance. In a universal life product the interplay of interest crediting, cost of insurance charges, premium patterns and loads and other unit based expenses all combine to impact product performance.

Moreover, where applicable, indexed life insurance products, unlike variable life insurance products, are subject to the NAIC's Life Insurance Illustrations Model Regulation, which sets forth a comprehensive set of requirements relating to consumer disclosure and protection which are the same objectives the Commission has stated for the proposed Rule 151A.<sup>43</sup> In short, applying the proposed Rule 151A to indexed life presents a number of challenges that have not been fully considered or addressed in the proposed rule. If the Commission believes that further regulation of indexed life is necessary, it should be studied as part of a separate rule or proposal.

For all the reasons discussed above, it would be inappropriate to apply proposed Rule 151A to indexed life insurance products, whether intentionally or not. **Moreover, if proposed Rule 151A is adopted in any form, the Commission must make clear that the rule and the analytic framework of the "more likely than not" test do not and are not in any way intended to apply to indexed life insurance.**

At a minimum, fundamental regulatory reforms similar to those outlined in Section III below would be necessary before any rule is adopted to ensure that indexed life products are not competitively disadvantaged.

### **III. Proposed Rule 151A Is Severely Anti-Competitive**

- A. *The Commission should not adopt proposed Rule 151A unless the regulatory framework has been significantly overhauled and modernized to ensure that indexed annuities are not competitively disadvantaged.*

The Commission should not adopt proposed Rule 151A, or a similar proposal, unless the regulatory framework has been fundamentally reformed to more fully encompass indexed annuities to ensure that indexed annuities are not competitively disadvantaged. Currently, subjecting indexed annuities to the 1933 Act regulatory structure would be the equivalent of

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<sup>43</sup> 40 states have either adopted the NAIC Life Insurance Illustration Model Regulation has been adopted in 40 states or some related regulation.

Purchasers will lose the valuable consumer protections provided by the NAIC's Life Insurance Illustration Model Regulation if insurers are required to register indexed life insurance contracts with the Commission.

putting the proverbial “square peg into a round hole.” The 1933 Act regulatory framework is ill-suited for the continuous offering of indexed annuities, and the general Form S-1 registration form in its current state obscures the disclosure that is material to indexed annuity contract owners.<sup>44</sup> The 1933 Act corporate financing regulatory structure simply was not developed with indexed annuities in mind; that structure was developed for debt and equity offerings by corporations with little or no reporting history and where the success of the offering depended upon the performance of the issuer’s business.

By contrast, the Commission has developed a well-reasoned approach to variable annuity regulation under the federal securities laws. This approach includes registration forms and exemptive rules that take into account the issues unique to variable annuities.

The Commission’s proposed Rule 12h-7 that would exempt insurance product issuers from the periodic reporting requirements of the 1934 Act is an important first step to ensure a level playing field between indexed annuities and variable annuities. However, many of the other advantages offered to variable annuities should be extended to indexed annuities. The well-established regulatory framework for variable annuities already provides a different registration statement, financial statements, disclosures, and advertising/marketing requirements than those applicable to traditional offerings of debt and equity securities. The rationale for these differences should apply with equal force to indexed annuities.

Set forth below are the advantages variable annuities would enjoy over indexed annuities under the current regulatory framework and regulatory reforms the Commission should undertake to level the playing field.

*Relevant Focused Disclosure*

- **Variable Annuity Regulatory Framework:** Ability to register on Form N-4, a registration form developed for variable annuities.

**Necessary Regulatory Reform:** A registration form specifically developed for indexed annuities, an amendment to Form S-1 to more tailor the form for indexed annuities, or an amendment to Form N-4 to permit indexed annuities to register on Form N-4.<sup>45</sup>

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<sup>44</sup> Insurers that are well known seasoned issuers will have to register an indexed annuity on Form S-1. Certain S-1 issuers that meet the registration requirements specified in the form (such as filing reports under the 1934 Act for 12 calendar months immediately preceding the filing of the registration statement) may use Form S-3 for the registration of securities under the 1933 Act, provided the securities are offered in any transaction specified in the form (the Transaction Requirement).

<sup>45</sup> Any new registration statement for indexed annuities should focus on disclosure of the following: benefits and risks associated with the contract -- this disclosure would include a discussion of the guarantees provided by the insurer; interest crediting provisions; charges; withdrawals/surrenders; rider disclosure; death benefit; annuitization; free-look rights; and taxation.

**Discussion:** If any rule is adopted that would require indexed annuities to register, an insurer that is not a “well-known seasoned issuer” must register an indexed annuity on Form S-1. Form S-1 is a two-part registration form that contains a prospectus, including financial statements, that is provided to the investor, and a Part II that contains exhibits and other information that is not provided to the investor.

Form S-1 is ill-suited for indexed annuities and obscures information that is most material to an indexed annuity contract owner. The prospectus for a registration statement on Form S-1 focuses on the insurance company, not on the indexed annuity contract being offered. Unlike a conventional debt and equity offering where the success of the offering depends on the business prospects of the company, an insurance contract is issued by a state regulated entity where, because of the insurance regulatory protections, information about the insurer is not as relevant to the purchaser. Form S-1 requires the insurer to meet all applicable requirements of Regulation S-K.<sup>46</sup>

By contrast, Form N-4 focuses disclosure on information about product features and charges, information highly relevant to an owner. Form N-4 is a three-part registration statement form in which (i) a prospectus containing all essential information about the product and registrant to help the investor make his or her investment decision is provided to the investor; (ii) a statement of additional information containing information

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Financial statements should not be included in the prospectus.

<sup>46</sup> The requirements of Regulation S-K include:

- Item 101 of Regulation S-K:- A discussion of the general development of the insurer’s business over the previous five years, a detailed narrative description of the insurer’s business “done and intended to be done,” and financial information about the issuer’s business segments and geographic areas;
- Item 102 of Regulation S-K:- A description of the location and general character of principal plants, mines and other materially important properties of the insurer and its subsidiaries;
- Item 301 of Regulation S-K: Selected financial data of the issuer for at least the last five fiscal years;
- Item 303 of Regulation S-K: Management’s discussion and analysis (“MD&A”) of its financial condition and results of operations (including liquidity, capital resources, and reported income). The MD&A generally must address the three-year period covered by audited general account financial statements required to be included in a prospectus;
- Item 305 of Regulation S-K: Quantitative and qualitative disclosure about market risk;
- Items 401 and 402 of Regulation S-K: Detailed disclosure regarding the directors and executive officers of the insurance company, including their background, involvement in legal proceedings, transactions with the insurance company, and extensive disclosure on executive compensation.
- Item 403 of Regulation S-K: Disclosure regarding security ownership of beneficial owners and management;
- Item 404 of Regulation S-K: Disclosure regarding certain relationships and related transactions; and
- Items 504 – 508 of Regulation S-K: Information about the use of proceeds, determination of offering price, dilution, selling security holders, and plan of distribution.

In addition, Item 11(e) of Form S-1 requires placement of the financial statements in the prospectus.



that may be of interest to some investors, including financial statements, is provided to the investor upon request, and (iii) a Part C containing an exhibit list and other information which is not provided to the investor. The extensive and burdensome company disclosures required by Form S-1 are not required by Form N-4.

### *Financial Statements*

- **Variable Annuity Regulatory Framework:** Ability for insurers to use, under certain circumstances, financial statements prepared in accordance with statutory accounting principles (“SAP”).

**Necessary Regulatory Reform:** Ability to use financial statements prepared in accordance with SAP.

**Discussion:** Form N-4 permits an insurer to file audited financial statements prepared in accordance with statutory requirements if the insurer would not otherwise have to prepare financial statements in accordance with generally accepted accounting principles (“GAAP”).<sup>47</sup> Preparing audited financial statements in accordance with GAAP is an expensive and time consuming process. If any rule is adopted that would require indexed annuities to register, many insurers that issue indexed annuities would not have to prepare audited financial statements in accordance with GAAP except to file a registration statement on Form S-1. Those insurers not only will have to prepare audited financial statements in accordance with GAAP for current periods, but also will have to create audited historical financial statements prepared in accordance with GAAP. This alone will significantly increase the costs to an insurer of preparing audited financial statements in accordance with GAAP.

Further, audited financial statements prepared in accordance with SAP may prove to be more valuable to an indexed annuity contract owner. As the Commission noted in the Proposing Release, state insurance departments and the financial statements they require are focused on the solvency of the insurer.<sup>48</sup> Therefore, for example, the balance sheet, a financial statement highly relevant to an indexed annuity contract owner as it relates to an insurer’s claims-paying ability, is prepared using more conservative assumptions under SAP than it is under GAAP.

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<sup>47</sup> However, an insurer must prepare financial statements in accordance with GAAP if the insurer prepares financial information in accordance with GAAP for use by its parent, in any report under Sections 13(a) and 15(d) of the 1934 Act, or any registration statement filed under the 1933 Act.

In addition, Rule 7-02(b) of Regulation S-X permits mutual life insurance companies and their wholly owned stock insurance subsidiaries to use financial statements prepared in accordance with SAP.

<sup>48</sup> See Proposing Release at 37,762-63.

- **Variable Annuity Regulatory Framework:** Ability to provide financial statements upon request to owners.

**Necessary Regulatory Reform:** A registration statement tailored for indexed annuities, or amendments to Form S-1 or Form N-4.

**Discussion:** The financial statements for a variable annuity are included in the Statement of Additional Information filed on Form N-4. The Statement of Additional Information is only provided to an owner upon request. By contrast, Form S-1 requires that financial statements be included in the prospectus.<sup>49</sup> This is costly for an insurer, particularly for an insurer that is not a well known seasoned issuer. If any rule is adopted that would require indexed annuities to register, an insurer that is not a well known seasoned issuer must precede or accompany a free writing prospectus with a statutory prospectus. Further, as discussed above, the financial statements for a contract owner are not as relevant as they would be for an investor in a corporate debt or equity offering where the prospects for the offering's success depend on the offeror's business prospects.

- **Variable Annuity Regulatory Framework:** Ability to file less financial information than is required for an issuer that files on Form S-1 or Form S-3.

**Necessary Regulatory Reform:** Ability to file the same amount of financial information as does a depositor of a variable annuity separate account.

**Discussion:** Form N-4 waives certain Regulation S-X requirements. Among those requirements is the requirement to provide interim financial statements. See Form N-4, Item 23, Instruction 3.

Further, an insurer that issues a variable insurance product does not have to provide selected financial data for the past five fiscal years in the prospectus as required by Form S-1 and Item 301 of Regulation S-K.

By contrast, a registrant on Form S-1 must provide financial statements that meet all applicable Regulation S-X requirements, and provide the selected financial data required by Item 301 of Regulation S-K.

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<sup>49</sup> In some cases, companies that file periodic reports under the 1934 Act might be able to incorporate the financial statements by reference to those reports. However, this option is not available to insurers that are not well known seasoned issuers, and proposed Rule 12h-7, by itself, would not relieve insurers from the requirement of including financial statements in the prospectus.

*Marketing/Advertising*

- **Variable Annuity Regulatory Framework:** Issue written sales material that qualifies as an omitting prospectus pursuant to Rule 482 under the 1933 Act and that does not have to be preceded or accompanied by a statutory prospectus.

**Necessary Regulatory Reform:** An amendment to the federal securities laws, either to Rule 482 or otherwise, to permit indexed annuities to be marketed in manner similar to variable annuities.

**Discussion:** If any rule is adopted that would require indexed annuities to register, insurers that issue indexed annuities would be prohibited from using Rule 482 omitting prospectuses. Rule 482 allows information about variable annuities to be easily and cost effectively disseminated through the mail and the media without having to be preceded or accompanied by a prospectus.

An insurer that issues an indexed annuity would be required to use a “free writing prospectus” to deliver written marketing materials,<sup>50</sup> and if that insurer is not a “well-known seasoned issuer,” as defined by Rule 405 under the 1933 Act, the free writing prospectus must be preceded or accompanied by the delivery of a preliminary or final statutory prospectus.

The 1933 Act marketing structure to which insurers that are not well known seasoned issuers would be subject was developed for registrants with little or no reporting history and whose offerings depended upon the financial/business prospects of the company. In the release adopting the Securities Offerings Reforms, the Commission recognized that use of a free writing prospectus by issuers that are not well known seasoned issuers may not be feasible unless the free writing prospectuses are in electronic form and contain a hyperlink to the statutory prospectus.<sup>51</sup> The Commission stated that this was the appropriate result to assure that an investor receives a balanced disclosure document of an issuer with little or no reporting history.<sup>52</sup> These articulated policy reasons for limiting the use of free writing prospectuses seem inappropriate and unnecessary for regulated insurance product offerings.

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<sup>50</sup> Rule 405 pursuant to the 1933 Act defines a “free writing prospectus,” in part, as “any written communication . . . that constitutes an offer to sell or a solicitation of an offer to buy the securities relating to a registered offering . . . and is made by means other than” a Section 10(a) prospectus or a red herring prospectus.

<sup>51</sup> Securities Act Rel. No. 8591, 70 Fed. Reg. 44,722, 44,747 (Jul. 19, 2005)

<sup>52</sup> *Id.* at 44,747-48.

In addition, all free writing prospectuses prepared by or on behalf of, or used or referred to by, the issuer or by other offering participants must be filed on EDGAR. By contrast, Rule 482 advertisements do not have to be filed on EDGAR.

The inability of indexed annuity insurers to easily and cost effectively disseminate product information in a similar manner puts indexed annuity insurers at a significant competitive disadvantage, particularly if indexed annuity insurers must compete for shelf space at broker-dealers and for time and attention of registered representatives. Unfortunately, even in a registered representative environment, product selections presented to a consumer often hinge on an “easy to do business” factor.

### *Registration and Filing Fees*

- **Variable Annuity Framework:** Recognizing the continuous nature of an investment company offering, Section 24(f) of the 1940 Act permits investment companies to register an unlimited number of securities and pay filing fees in arrears net of redemptions.

**Necessary Regulatory Reform:** Indexed annuity offerings are continuous offerings. Insurers that register indexed annuities should be able to register an unlimited number of securities and pay filing fees in arrears net of redemptions.

**Discussion:** If any rule is adopted that would require indexed annuities to register, an insurer under the current regulatory framework would register the product of Form S-1 or Form S-3. Forms S-1 and S-3 require that an insurer determine the number of securities to be registered up-front and pay a filing fee on those securities. Under Rule 415(a)(2) pursuant to the 1933 Act, the amount of the registration fee must cover the amount of the security that the insurer reasonably expects to offer and sell within two years from the initial effective date of the registration statement.

If the amount of prepaid registration fees is about to be exhausted and the issuer wishes to continue to offer the indexed annuity, the issuer would have to register additional securities on a new registration statement pursuant to Rule 413 of the 1933 Act. Under Rule 429(a) of the 1933 Act, when the new registration statement is filed to register additional shares for the same indexed annuity, the registrant may combine the prospectuses of the new registration statement and previous registration statements that still have unsold securities. The SEC will assign a new 1933 Act registration number to the registration statement containing the combined prospectuses; however, the facing sheet must continue to list the previous 1933 Act numbers of the prospectuses combined in the registration statement. A new registration statement must be filed every three years.<sup>53</sup>

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<sup>53</sup> See Rule 415 pursuant to the 1933 Act.

Rule 462(b) of the 1933 Act provides a limited ability to become effective immediately upon filing with the SEC where the new registration statement registers additional securities in an amount and at a price that together represent no more than 20 percent of the maximum offering price set forth for each class of securities in the “Calculation of Registration Fee” table contained in such earlier registration statement.

Because the 1933 Act regulatory framework was not developed with continuous offerings in mind, the registration filing fee process would be cumbersome and costly for an indexed annuity insurer. An indexed annuity issuer would be required to develop systems to monitor the number of securities sold and be prepared to file new registration statements to continue to sell a security that has been registered. Insurers that issue variable annuities do not have to go through such complexities simply to pay a filing fee and register securities.

#### *Automatic Effectiveness of Post-Effective Amendments*

- **Variable Annuity Framework:** Ability to file a post-effective amendment to a registration statement and have that amendment go effective automatically pursuant to Rule 485(b) under the 1933 Act if that amendment does no more than update financial statements and make other non-material changes.

**Necessary Regulatory Reform:** An insurer should be able to file a post-effective amendment to a registration statement and have that amendment go effective automatically if that amendment does no more than update financial statements and make other non-material changes.

**Discussion:** If any rule is adopted that would require indexed annuities to register, many insurers that register indexed annuities will not be well known seasoned issuers. The Commission has not adopted a procedure whereby a post-effective amendment may go effective automatically except for issuers that qualify as “well-known seasoned issuers.” This means that there will be delay in updating a registration statements while the staff reviews any update and decides whether to declare it effective. Variable annuities, in similar situations, are not subject to such delays.

In addition, if proposed Rule 12h-7 under the 1934 Act is not adopted, an issuer of an indexed annuity will be subject to full range of the 1934 Act’s periodic reporting requirements and to significant Sarbanes-Oxley provisions.<sup>54</sup>

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<sup>54</sup> In addition, indexed annuities are subject to the FINRA’s corporate financing rule, Rule 2710. That rule requires that before participating in a public offering of securities, certain documents must be filed with FINRA. Rule 2710 also contains detailed limitations on compensation that can be paid for the distribution of securities, and other limitations on public offerings. Variable annuities are not subject to the corporate financing rule. We realize that FINRA is not part of the Commission, but urge the Commission to work with FINRA to level the playing field between variable annuities and indexed annuities.

Although Rule 151A, as proposed, is prospective in nature, the proposed rule will raise Section 5 compliance concerns. Insurers will have to address the Section 5 compliance concerns discussed in Section II above as they decide how to register any indexed annuity that they are currently selling. The Commission must provide insurer's guidance as to how they should address those Section 5 compliance concerns.

Throughout the Proposing Release, the Commission compares indexed annuities to variable annuities. Consistent with the approach taken the Proposing Release, the Commission should not adopt proposed Rule 151A until it has provided indexed annuities with a well-reasoned regulatory framework similar to what it provides for variable annuities. We commend the Commission for beginning to develop a well-reasoned approach to indexed annuity regulation with proposed Rule 12h-7 under the 1934 Act. However, the Commission must go significantly farther and address the necessary regulatory reforms set forth above.

*B. Creating an unlevel playing field is not consistent with NSMIA.*

Creating an unlevel playing field between variable annuities and indexed annuities simply is not consistent with NSMIA. The purpose of NSMIA is to promote efficiency and capital formation in the financial markets, as well as to protect investors and provide more effective and less burdensome regulation.<sup>55</sup> To further such goals, Congress amended Section 2(b) of the 1933 Act to require that the Commission consider, in part, whether a rulemaking will "promote efficiency, competition, and capital formation."

The Commission's arguments set forth in the Proposing Release about how proposed Rule 151A may, in fact, enhance competition between variable annuities and indexed annuities are flawed. The Commission recognizes that proposed Rule 151A may cause some insurers to stop issuing indexed annuities, thus reducing competition, but states that the loss of competition will be balanced by the potential increase in competition among indexed annuities and other financial products and by the protections that investors will gain under the federal securities laws. Nowhere in the Proposing Release, however, does the Commission recognize the unlevel playing field that will be created between variable annuities and indexed annuities, nor does the Commission recognize that investors may actually lose important state insurance regulatory protections (discussed in Section IV below).<sup>56</sup> Further, Rule 151A, if adopted as proposed, will significantly lessen the competition between indexed annuities and traditional fixed insurance products due to the increased regulatory costs associated with issuing indexed annuities.

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<sup>55</sup> See *Conference Report to Accompany H.R. 3005*, H.R. Rep. No. 104-864, (1996).

<sup>56</sup> State insurance laws may exclude products registered with the Commission from their regulations. See n. 65 *infra*.

- C. The Commission should level the playing field between indexed annuities and variable annuities by delaying the effectiveness of proposed Rule 151A or any rule requiring the registration of indexed annuities by at least 24 months after the rule's adoption in order to enact fundamental regulatory reforms.*

As discussed above, in the absence of fundamental regulatory reforms, the regulatory advantages that variable annuities will have over indexed products are significant. Not only do variable annuities enjoy a greater speed to market advantage because of a better defined regulatory structure, variable annuities enjoy greater marketing and advertising advantages. However, there are alternative concepts that could level the playing field between variable annuities and indexed annuities.

At a minimum, we believe that the effective date of proposed Rule 151A or any rule requiring the registration of indexed annuities should be delayed at least 24 months after the rule's adoption in order to give the Commission sufficient time to accomplish the significant overhaul the regulatory structure that would be necessary to encompass indexed annuities. This delay also would provide insurers with time to, among other things, train and prepare its distribution network, develop new registered products, develop regulatory and compliance procedures for registered products, and revise their administrative systems for registered products. We note that one of the questions posed in the Proposing Release specifically addressed whether indexed annuities should register on Form N-4. We strongly support having indexed annuities register on Form N-4 or a form specifically designed for indexed annuities.

Another alternative concept that the Commission has is to consider a new safe harbor rule or amending Rule 151. As discussed in Section V below, this alternative concept would provide insurers with greater certainty. With such certainty, insurers then would be better able to work within the regulatory structure to create innovative products. Thus, NSMIA's goal of encouraging innovation would be met.

- D. Proposed Rule 151A will hinder, not promote competition.*

The Commission believes that proposed Rule 151A may increase competition because of the greater clarity the rule would provide investors and because of the greater ability of investors to make informed decisions.<sup>57</sup> Recent experience, however, suggests otherwise.

In 2005, the National Association of Securities Dealers, Inc. ("NASD") now the Financial Industry Regulatory Authority, Inc. ("FINRA"), issued Notice to Members 05-50 ("NTM 05-50"). In that notice, the NASD discussed its concerns about the status of indexed annuities under

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<sup>57</sup> Proposing Release at 37,771.

the federal securities laws. Citing such concerns, the NASD encouraged member firms to supervise indexed annuity transactions as though they were securities transactions. The consequences of NTM 05-50 were perhaps both intended and unintended. NTM 05-50 had the intended result of causing certain broker-dealers to restrict their registered representatives' ability to sell indexed annuities. However, NTM 05-50 had perhaps the unintended result of decreasing competition for indexed annuity sales because fewer firms would sell indexed annuities and consequently fewer prospective purchasers would be offered an indexed annuity.

Proposed Rule 151A effectively would require that all indexed annuities be sold by registered representatives of broker-dealers. This would be represent a dramatic turn of events for the indexed annuity industry. Currently, most indexed annuities are sold by insurance agents who are not registered representatives. Proposed Rule 151A would require such insurance agents to become securities licensed and to associate with a broker-dealer. Becoming licensed can be a time consuming and costly process for an insurance agent.<sup>58</sup> Although insurers may assist agents in becoming licensed, many agents may, in lieu of becoming licensed, opt not to sell indexed annuities and instead exclusively sell traditional fixed-rate insurance products. This result would have a ripple effect on insurers and consumers.

Because selling an indexed annuity would become more difficult under proposed Rule 151A, many insurers for which indexed annuity sales represent a smaller percentage of their total revenues may determine to abandon offering indexed annuities altogether, and as recognized by the Commission, lose revenue.<sup>59</sup> If this were the case, the market for indexed annuities may contract, not expand, and competition may decrease.

Further, the Commission suggests that broker-dealers that are reluctant to sell indexed annuities currently because of the uncertain securities status of the products, may become willing to sell indexed annuities after proposed Rule 151A becomes effective.<sup>60</sup> In theory, the Commission may be correct in its assumptions. However, it is also true that broker-dealers have limited shelf space for insurance products. Broker-dealers may determine that their efforts are better spent marketing other products, particularly, as discussed above, if there are fewer insurers that offer indexed annuities. There is no guarantee that a broker-dealer may approve the sale of indexed

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<sup>58</sup> We note that there are three ways in which agents may become registered: (i) an insurance agent may become licensed and associate with a broker-dealer on his own, (ii) a field marketing organization that has an agency agreement with an insurer may decide to register as a broker-dealer and develop the regulatory and compliance structure that is required by such registration, and (iii) a field marketing organization that has an agency agreement with an insurer may have individuals become licensed and then enter into a networking agreement with a broker-dealer. Various costs are associated with each option including the costs of becoming licensed, the costs of evaluating existing relations with wholesalers and others, travel costs and negotiation costs. For a field marketing organization, these costs could be significant. These costs were grossly underestimated by the Commission in the Proposing Release.

<sup>59</sup> Proposing Release at 37,770.

<sup>60</sup> *Id.* at 37,769.



annuities. In fact, insurers may have to offer broker-dealers costly incentives to encourage the sale of indexed annuities. Such incentives may skew sales of indexed annuities towards products that offer broker-dealers shelf space payments and other incentives; such products may or may not offer contract owners the most favorable terms.

*E. Proposed Rule 151A may create an unlevel playing field between indexed annuities and bank indexed products.*

The Commission believes proposed Rule 151A may increase competition among mutual funds, variable annuities, and indexed annuities.<sup>61</sup> The proposed rule, however, may have the opposite effect with regard to competition between indexed annuities and bank indexed products, such as indexed certificates of deposits.

By its terms, proposed Rule 151A(a) limits its reach to contracts that are subject to regulation under the insurance laws of that jurisdiction as an annuity. Bank products are not regulated as annuities under state insurance laws. Thus, bank indexed products, even though they may subject an investor to many of the same “risks” as an indexed annuity, may be issued without incurring the time and expense of registering with the Commission. This squarely gives bank indexed products a competitive advantage over indexed annuities.<sup>62</sup>

#### **IV. The Current State Insurance Regulatory Structure Provides Important Protections To Investors That The Commission Failed To Consider**

The Commission has stated that there is a federal interest in providing investors “with disclosure, antifraud, and sales practice protections” when they are offered indexed annuities which may expose them to securities risk.<sup>63</sup> While the Commission recognizes the importance of state insurance departments in protecting insurer solvency, and in fact relies on state insurance regulation in proposing Rule 12h-7 under the 1934 Act, the Commission fails to recognize the important safeguards under the current state insurance regulatory structure to which indexed annuities are subject.

State insurance regulation is broader and far more comprehensive than just solvency regulation. In most states, there are significant regulations covering the following areas:

- suitability review;

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<sup>61</sup> Proposing Release at 37,769.

<sup>62</sup> We recognize, however, that a certificate of deposit purchased from a federally regulated bank is not a security for purposes of Section 10(b) of the 1934 Act. *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (holding because holders of certificates of deposit are abundantly protected under federal banking laws, it is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws).

<sup>63</sup> Proposing Release at 37,752.

- “free-look” periods;
- annuity disclosure requirements;
- advertising;
- unfair trade practices;
- replacements;
- market conduct review of insurers;
- levels of consumer guarantees in annuities;
- agent licensing and training;
- insurance agent penalties for violations of sales rules;
- non-forfeiture laws;
- guarantee fund laws; and
- policy form requirements.

Those requirements and others apply to fixed annuities, including indexed annuity contracts.

Further, states have been on the forefront of investor protection issues as they relate to fixed annuities, including indexed annuities. Many states have adopted National Association of Insurance Commissioners (“NAIC”) model regulations that address disclosure, suitability, and replacement issues. Among the model regulations adopted by states are the:

- NAIC Suitability in Annuity Transactions Model Regulation (adopted by the NAIC in 2003);<sup>64</sup>
- NAIC Annuity Disclosure Model Regulation (adopted by the NAIC in 1998); and
- NAIC Insurance and Annuity Replacement Model Regulation (current version adopted by the NAIC in 1998).

The NAIC Suitability in Annuity Transactions Model Regulation regulates the suitability of annuity sales, and in fact, is modeled after NASD Rule 2310, but goes beyond the requirements of that rule by imposing duties on the insurer. The NAIC’s model suitability regulation requires that the insurer or producer have reasonable grounds for believing that the sale is suitable for the contract owner. To that end, the insurer or producer must make reasonable efforts to obtain information concerning the consumer’s financial status, tax status, investment objectives, and other reasonable information. Further, the model suitability regulation requires that there be a system in place to supervise the suitability recommendations made to consumers: such system must include written procedures and periodic compliance reviews. The NAIC Life Insurance and Annuities (“A”) Committee has formed a working committee to enhance agent training, supervision and monitoring standards, and thus better protect consumers from unsuitable sales and abusive marketing practices.

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<sup>64</sup> The NAIC Suitability in Annuity Transactions Model Regulation was originally the Senior Protection in Annuity Transactions Model Regulation and applied to the suitability of annuity sales to purchasers over age 65. That model regulation was expanded in 2006 to become the Suitability in Annuity Transactions Model Regulation.

The NAIC Annuity Disclosure Model Regulation requires that a prospective indexed annuity contract owner receive a certificate of disclosure explaining the product features in a simplified format and a buyer's guide explaining the general features of indexed annuities. Both documents must be delivered at the point of sale. The certificate of disclosure requires, among other items, that the insurer concisely describe (i) the benefits and limitations of the contract, (ii) how interest is credited under the contract, (iii) any reductions in value caused by withdrawals or surrender of the contract, (iv) the guaranteed and nonguaranteed elections of periodic income options, (v) what the death benefit is and how the death benefit will be calculated, (vi) the specific dollar amount or percentage charges and fees with an explanation of how they apply, and (vii) the federal tax status of the contract.

The buyer's guide is written by the NAIC using "plain-English" principles. It discusses basic information about (i) an annuity, (ii) how interest is credited to an indexed annuity, (iii) how withdrawals are made and the charges that may be assessed as a result of a withdrawal, (iv) the benefits of an annuity and how contract values may vary, and (v) the important considerations a prospective contract owner should consider before investing. Many insurers, including Aviva, require both the agent and purchaser to sign the certificate of disclosure as a condition to issuing the contract.<sup>65</sup>

The certificate of disclosure may prove to be more useful to an indexed annuity contract owner than the cumbersome S-1 prospectus with its company disclosures that are largely irrelevant to an indexed annuity contract owner.

The Insurance and Annuity Replacement Model Regulation protects consumers by requiring insurers to develop systems of supervision, control, monitoring and recordkeeping.<sup>66</sup> It also requires insurers to provide consumers with plain-English notices and signed disclosure documents, if a replacement or financed purchase transaction occurs.

In addition to the Suitability in Annuity Transactions Model Regulation, the Annuity Disclosure Model Regulation and the Insurance and Annuity Model Regulation, the NAIC has undertaken other important initiatives. Among those initiatives is a model regulation relating to the use of senior designations by agents. If adopted by the NAIC, the Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities will specifically prohibit senior-specific certifications and designations unless certain criteria are met. This model regulation has been approved by the NAIC's "A" Committee, and is modeled after the North American Securities Administrators Association (NASAA) Model Rule on the Use of Senior-Specific Certifications and Professional Designations.

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<sup>65</sup> We note that consumers may lose this valuable disclosure regulation Rule 151A is adopted. Products registered with the Commission are excluded from the NAIC Annuity Disclosure Model Regulation.

<sup>66</sup> The NAIC Insurance and Annuity Replacement Model Regulation has been adopted in 45 states.

Individual states also have undertaken initiatives relating to the sale of indexed annuities. Importantly, Iowa, the domiciliary state of Aviva and many large indexed annuity issuers, has adopted the Iowa Indexed Product General Training Regulation. This regulation became effective on January 1, 2008,<sup>67</sup> and requires an agent to receive indexed product training approved by the Iowa Insurance Division before he or she can sell indexed products. The topics covered by the mandatory training course include a primer on indexed annuity contract provisions, the disadvantages and advantages of indexed annuities, differentiating the effects for consumers over age 65 versus those under age 65, suitability and marketing practices, special issues for senior consumers, and current indexed annuity product developments. Also, the NAIC as well as certain state insurance departments, such as Kansas, have issued investor alerts to seniors warning them of potential deceptive sales practices.<sup>68</sup>

We recognize the important work done by states in ensuring that indexed annuity sales are suitable and that disclosure concerning the indexed annuity is clear and concise. To that end, we, as well as most insurers, comply with the most stringent of NAIC model regulations relating to suitability, annuity disclosure, and replacements nationwide regardless of whether the model regulations have been adopted by the state in which the indexed annuity is sold. Further, we have developed enhanced guidelines for suitable sales to which all its agents must adhere and have enhanced our product disclosures to provide clear, “plain-English” guidance about the key features of its indexed annuities and the risks and benefits attendant by the purchase of the product.

**V. A New Safe Harbor Rule Or An Amendment To Rule 151 Would Better Serve The Commission’s Objectives And Avoid Any Of The Challenges Of Proposed Rule 151A**

As noted above, states have adopted robust suitability and disclosure regulations relating to indexed annuity sales and also have required specialized training for indexed annuity agents. Given this important work, the Commission should consider whether a new safe harbor rule or an amendment to Rule 151 would better serve the Commission’s objectives than proposed Rule 151A. A new safe harbor rule/amended Rule 151:

- could provide greater certainty as to status of indexed annuities under the federal securities laws;
- would not put indexed annuities at a competitive disadvantage;
- would not be overbroad in reach as is proposed Rule 151A; and

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<sup>67</sup> See Iowa Insurance Division Rules 191-15.80- 87.

<sup>68</sup> See, e.g., *NAIC Consumer Alert: Annuities and Senior Citizens – Senior Citizens Should Be Aware Of Deceptive Sales Practices When Purchasing Annuities*, available at [http://www.naic.org/documents/consumer\\_alert\\_annuities\\_senior\\_citizens.htm](http://www.naic.org/documents/consumer_alert_annuities_senior_citizens.htm).

- would be more useful to the consumer and insurer.

Further, the new safe harbor rule/amended Rule 151 would be more consistent with the goals of indexed annuity rulemaking, which according to Commission Chairman Cox, is to provide “clear guidance on separating the insurance component from the investment component to inform a determination of whether a particular product is primarily insurance or primarily an investment.”<sup>69</sup>

Because of the strides made in state insurance regulation on which the Commission could rely (and consistent with the approach taken by the Commission in proposing Rule 12h-7 under the 1934 Act), the new safe harbor rule/amended Rule 151 could deem an indexed annuity where interest was credited retroactively to not shift investment risk to a contract owner (and thus not be a security) as long as the conditions of the new safe harbor rule/amended Rule 151 were met. The new safe harbor rule/amended Rule 151 could focus on investment risk, disclosure and sales practices, and could provide objective standards an insurer could use to determine the securities status of an indexed annuity. Like Rule 151, which references the NAIC Standard Nonforfeiture Law,<sup>70</sup> the new safe harbor rule/amended Rule 151 would reference various NAIC model regulations. If an indexed annuity fails to have the required features and/or the insurer fails to follow the guidelines set forth in the rule, the product would be outside of the safe harbor and the insurer must determine the securities status of the indexed annuity based on its analysis of Section 3(a)(8) of the 1933 Act.

We understand that the Commission has been concerned with features of certain indexed annuities. Thus, it would be appropriate for the new safe harbor rule/amended Rule 151 to specify certain product components to ensure that the insurer bears sufficient investment risk. To that end, possible product components for a new safe harbor rule/amended Rule 151 could include:

- a guarantee that it would take no more than a certain number of years for the contract owner’s guaranteed minimum value to equal 100% of purchase payments;
- minimum guaranteed levels for the components of the interest crediting formulae;
- components within the index crediting formulae that cannot change more often than once every 12 months for a particular contract owner;
- a guarantee that indexed interest, once credited, is available for withdrawal; and
- a guarantee that no negative interest would be credited to an indexed crediting strategy.

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<sup>69</sup> SEC Chairman Christopher Cox, *Speech by SEC Chairman: Chairman’s Address to the North American Securities Administrators Association 2008 Public Policy Conference*, (Apr. 1, 2008) available at <http://www.sec.gov/news/speech/2008/spch040108cc.htm>.

<sup>70</sup> See Rule 151(c).

We submit that the new safe harbor rule/amended Rule 151 would accomplish the Commission's objectives and provide greater certainty for insurers because the rule will specify those components that will always satisfy Section 3(a)(8). As previously discussed, Rule 151A as proposed is vague, and will lead to inconsistent results as reasonable actuaries may disagree on how to make the "more likely than not" determination.

## **VI. Conclusion**

By our letter dated August 20, 2008, we requested a 90-day extension of time to file comments on proposed Rule 151A. We have devoted tremendous efforts to preparing this analysis of proposed Rule 151A in a very short comment period. Given the significance and broad reaching impact of this proposal, we respectfully request that the Commission re-open the comment period so additional analysis of proposed Rule 151A can be provided. Absent a re-opening of the comment period, we strongly encourage the Commission to consider a new safe harbor rule or amending Rule 151 as an alternative to an entirely new and unprecedented approach to security status determination as a more effective means to accomplish the stated objectives of proposed Rule 151A.

If you have any questions or comments on this letter, please feel free to call me at 515.362.3657.

Sincerely,



Michael H. Miller  
Executive Vice President  
General Counsel and Secretary

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

Andrew J. Donahue, Director  
Susan Nash, Associate Director  
William J. Kotapish, Assistant Director  
Keith E. Carpenter, Senior Special Counsel  
Division of Investment Management