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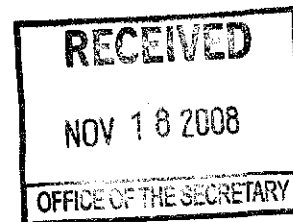
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04928-00001

**VIA COURIER**

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



Re: *Supplemental Comment on Proposed Rule 151A*  
*Release Number 33-8933 (File Number S7-14-08)*

Dear Ms. Harmon:

On behalf of the Coalition for Indexed Products, I am submitting the enclosed supplemental comments regarding the Securities and Exchange Commission's Proposed Rule 151A, which was published for comment on July 1, 2008.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Eugene Scalia".

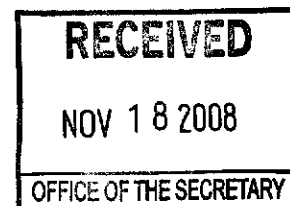
Eugene Scalia

ES/djd

**Supplemental Comments  
of the  
Coalition for Indexed Products  
Regarding Proposed Rule 151A**

Release Number 33-8933 (File Number S7-14-08)

November 17, 2008



## Supplemental Comments of the Coalition for Indexed Products Regarding Proposed Rule 151A

The Coalition for Indexed Products (the "Coalition") hereby requests that the Commission consider these supplemental comments on Proposed Rule 151A under the Securities Act of 1933 (the "Proposed Rule"). The Coalition previously submitted comments on September 10, 2008. *See* Comment of the Coalition for Indexed Products (Sept. 10, 2008) ("Coalition Comment"). The Coalition Comment demonstrated that the plain meaning and purpose of the Securities Act of 1933 (the "Act" or "'33 Act"), Supreme Court precedent, and lower court decisions all make clear that fixed indexed annuities ("FIAs") as characteristically structured are within Section 3(a)(8)'s exemption for "annuity contracts." Coalition Comment at 6-14. The Coalition Comment also showed that the Proposing Release misconstrues the meaning of investment risk and improperly claims benefits from the Proposed Rule because it fails to consider the extensive state regulatory and enforcement system that governs FIAs. Coalition Comment at 14-29 and Addendum at 1-6.<sup>1</sup>

The comments that have been submitted regarding proposed Rule 151A are overwhelmingly opposed to the adoption of the Proposed Rule. However, certain companies, trade groups, regulators, and individuals have expressed some level of support for the Proposed Rule. The Coalition believes that some of these commenters have introduced into the record legal and factual errors that should be corrected to enable the Commission to make a properly informed decision regarding the Proposed Rule. We submit these supplemental comments to address the most significant of those errors.

Because it is one of the lengthiest and most extensive comments in support of the Proposed Rule, and because it was authored by a state securities regulatory organization quoted in the Proposing Release, we will focus primarily on the comment letter of the North American Securities Administrators Association ("NASAA"). *See* Comment of Karen Tyler, NASAA President and North Dakota Securities Commissioner (Sept. 10, 2008) ("NASAA Comment").<sup>2</sup> The NASAA Comment errs in numerous important aspects, by: (1) introducing a new "adequacy of state regulation" test that is nowhere to be found in Section 3(a)(8) or decisions interpreting it; (2) minimizing and mischaracterizing the risk allocation analysis central to the Supreme Court's Section 3(a)(8) decisions; and (3) making factual and legal errors with regard to

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<sup>1</sup> In this comment, the term "fixed indexed annuities," or "FIAs," is used to refer to these products as customarily structured and described at pages 2-5 of the Coalition's September 10 comment letter.

<sup>2</sup> NASAA has little basis on which to comment on FIAs, which have been regulated exclusively by state insurance regulators. Given NASAA's limited background in FIA regulations, it is surprising that the Commission has quoted undocumented assertions from NASAA in the Proposing Release for Rule 151A, while not consulting with or taking into consideration the views of the 50 state insurance administrators.

the marketing of FIAs. The NASAA Comment also completely mischaracterizes the scope and effectiveness of the state insurance regulatory system—comments submitted in the rulemaking by state regulators, on the other hand, demonstrate that the state regulatory and enforcement system is robust and effective in providing meaningful information to potential purchasers, and meaningful penalties for violators. Ultimately, the effect of the NASAA Comment is not to strengthen the case for the Proposed Rule, but rather to show that adopting the rule requires radical departures from the principles laid down by the Supreme Court for interpreting and applying Section 3(a)(8).

\* \* \*

FIAs are annuity contracts within the meaning of Section 3(a)(8). The Commission should reaffirm that and withdraw its proposed rule, rejecting the invitation of NASAA and others to use “novel” interpretations of the Act to regulate products already so closely supervised by the states. That this is the right course for the Commission has only become more clear in the weeks since the Coalition’s initial Comment: The plummeting financial markets have been a bracing reminder of the *real* meaning of investment risk, as purchasers of variable annuities and mutual funds have experienced sometimes devastating losses while holders of fixed indexed annuities have experienced no loss and have had their interest credits from the markets’ prior up-years locked in. (See the charts at Exhibit B.) And respectfully, the current crisis will require the Commission to focus on its core mission—it can ill-afford, and there is no need, to undertake to regulate congressionally-exempted annuity products that a legion of state insurance regulators have said they are continuing their comprehensive efforts to address.

**I. The NASAA Comment Demonstrates That Defining Fixed Indexed Annuities As “Securities” Requires Misreading Every Prong Of The Test Applied By The Courts Under Section 3(a)(8).**

The NASAA Comment misreads each of the three parts of the legal test customarily employed under Section 3(a)(8) to distinguish annuities from securities. It thereby confirms that the Commission cannot adopt the Proposed Rule consistent with the text of the Act and the decisions of the Supreme Court.

*A. The “Adequacy” Of State Regulation Is Not A Factor In The Legal Analysis Of Whether An FIA Is An Annuity Contract Under Section 3(a)(8).*

Section 3(a)(8) applies to an annuity contract “issued by a corporation 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.” In its comment letter, NASAA attempts to transform the Act’s requirement of state supervision into a full-blown assessment of the “adequacy” of the state regulatory system. NASAA Comment at 5-6. NASAA’s approach is factually mistaken—FIAs *are* comprehensively regulated by the states—see Coalition Comment at 20-28—and neither the statutory text nor the caselaw supports an “adequacy” test. The statute merely requires that an annuity contract be “subject to the supervision” of a state insurance commissioner (or similar entity or official). NASAA cites the Supreme Court’s *United Benefit* decision for the proposition

that “the Supreme Court . . . confirmed that the inadequacy of state insurance regulation is an important factor to consider when applying the Section 3(a)(8) exemption” (Comment at 5-6). But *United Benefit* actually specifically **rejected** a weighing of state regulation in the analysis: “The argument that the existence of adequate state regulation was the basis for the exemption . . . was conclusively rejected . . . in *VALIC* . . .” *SEC v. United Benefit Insurance Co.*, 387 U.S. 202, 209, 210 (1967) (citation omitted). The Coalition is aware of no Section 3(a)(8) opinion in which a court purported to assess the sufficiency of state annuity regulation to determine whether the contracts at issue were annuities or securities for the purpose of the Act. See, e.g., *SEC v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65 (1959) (“*VALIC*”); *United Benefit*, 387 U.S. 202; *Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561 (7th Cir. 1991) (“*AIAP*”); *Otto v. Variable Annuity Life Insurance Co.*, 814 F.2d 1127 (7th Cir. 1986), *rev’d on rehearing* 814 F.2d 1140 (7th Cir. 1987); *Malone v. Addison Insurance Marketing*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

NASAA also misconstrues Justice Brennan’s concurring opinion in *VALIC* to support its “adequacy of state regulation” test. Contrary to NASAA’s suggestion at page 6, Justice Brennan did **not** pose the question whether state regulation was adequate, but instead inquired whether state regulation was meant by Congress to cover a particular type of product. See *VALIC*, 359 U.S. at 76. In doing so, he was concentrating on the “annuity contract” clause of Section 3(a)(8), not the “supervision” clause. Nowhere does Justice Brennan’s opinion, or any other judicial opinion, suggest that the Commission is granted the authority by Section 3(a)(8) to sit in judgment of the effectiveness of state regulatory systems and to “define” annuities as securities when it believes the states have fallen short. NASAA’s suggestions to the contrary only underscore the incompatibility of the regulatory approach NASAA champions with the deference to state insurance regulation embodied in Section 3(a)(8), the McCarran-Ferguson Act, and elsewhere in the U.S. Code. *Accord* NASAA Comment at 19 (advocating “a concurrent approach to the regulation of these investments”).

Finally, it is telling that NASAA appears to base its reasoning on a pair of court decisions that did not involve Section 3(a)(8) at all. See NASAA Comment at 6-7 (citing *Marine Bank v. Weaver*, 455 U.S. 551 (1982), which held that certificates of deposit were not subject to the Act, and *Reves v. Ernst & Young*, 494 U.S. 56 (1990), concerning promissory notes). These cases are inapposite because they did not involve Section 3(a)(8)’s unambiguous provision that the products addressed there—annuities—are not subject to SEC regulation if the issuing company is regulated by a state insurance agency. That is the case with FIAs.

*B. NASAA’s Attempt To Minimize And Redefine “Investment Risk” Underscores That FIAs Place Ample Investment Risk On The Insurer, As That Term Is Commonly Understood And Has Been Used By The Supreme Court.*

Fixed indexed annuities place substantial investment risk on insurers (see Coalition Comment at 4, 11), and the allocation of investment risk between insurer and insured has been central to both Supreme Court decisions applying Section 3(a)(8). See *VALIC*, 359 U.S. at 70-73; *United Benefit*, 387 U.S. at 209. It is striking, therefore, that when it comes to this part of the Section 3(a)(8) analysis, NASAA begins by openly challenging the governing caselaw and suggesting that it be ignored. Investment risk “has received more attention from courts and commentators than it deserves,” NASAA objects at page 8, presumably including in this

statement decisions of the Supreme Court that are binding on lower courts and the Commission. The “test has proven to be cumbersome,” NASAA explains, and purports to address the investment risk inquiry only after grudgingly “[s]etting aside [its] concerns about the validity of any risk-based test.” *Id.* (emphasis in original).<sup>3</sup>

As the Proposing Release acknowledges, however, the allocation of risk has been a central determinant of whether an annuity contract is insurance and thus eligible for the exemption. Proposing Release at 37,752; *see also VALIC*, 359 U.S. at 72-73 (stating that risk is “the one earmark of insurance as it has commonly been conceived of in popular understanding and usage”). Even NASAA’s retained expert admits the importance of investment risk to the Section 3(a)(8) analysis. *See* Statement of Craig J. McCann, Ph.D. at 3, attached to NASAA Comment (“Annuity contracts which meaningfully transfer risks from investors to issuers are exempt from federal securities laws.”).<sup>4</sup> NASAA’s challenge to this established principle of Supreme Court law suggests that NASAA itself recognizes that, under a Section 3(a)(8) analysis as traditionally applied, FIAs are indeed annuities.<sup>5</sup>

Even when purporting to address investment risk in its comment, NASAA attempts—unsuccessfully—to redefine the term in a manner that conflicts with the term itself and with its historical use. NASAA asserts that loss of principal through the operation of a fully disclosed and pre-set withdrawal charge is a form of investment risk. *Id.* at 8-9. It argues that the purchaser of an FIA bears the risk of fluctuations in the stock market index associated with the

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<sup>3</sup> The NASAA Comment also effectively urges the Commission to disregard Section 3(a)(8) by suggesting that the Commission eliminate the proposal’s “more likely than not” test and include all FIAs simply on the basis of their indexing feature. NASAA Comment at 21; *see also, e.g.*, Comment of William A. Jacobson, Esq., on behalf of the Cornell Securities Law Clinic, at 4-5 (Sept. 10, 2008) (expressing support for the rule but also stating that the Commission should only consider FIAs’ indexing features). But this proposal is even further removed from applicable Section 3(a)(8) precedent as it would completely ignore the allocation of risk.

<sup>4</sup> McCann’s analysis of risk and valuation for index annuities has been the subject of extensive criticism. *See, e.g.*, Exhibit A at 30, 43, 47-48, 59-78 (excerpts of presentation of Dr. David F. Babbel.) In addition, a judge overseeing an FIA case in which McCann serves as plaintiffs’ expert has appointed an independent expert economist to assess McCann’s methodologies. *Negrete v. Fidelity and Guar. Life Ins. Co.*, No. 05-6837, Amended Order Appointing Rule 706 Expert Witness at 2-3 (C.D. Cal. May 23, 2008).

<sup>5</sup> Indeed, every single case analyzing whether a contract meets Section 3(a)(8) has balanced the investment risks assumed by the purchaser and insurer. *See, e.g.*, *VALIC*, 359 U.S. at 70-73; *United Benefit*, 387 U.S. at 209; *AIAP*, 941 F.2d at 566-68; *Otto*, 814 F.2d at 1140-41; *Malone*, 225 F. Supp. 2d at 750-51; *see also, e.g.*, *Olpin v. Ideal Nat’l Ins. Co.*, 419 F.2d 1250, 1261-63 (10th Cir. 1969) (considering risks to insurer and purchaser in connection with endorsement to life insurance); *Berent v. Kemper Corp.*, 780 F. Supp. 431, 442-43 (E.D. Mich. 1991) (single premium life insurance policy), *aff’d*, 973 F.2d 1291 (6th Cir. 1992); *Dryden v. Sun Life Assurance Co. of Canada*, 737 F. Supp. 1058, 1062-63 (S.D. Ind. 1989) (whole life insurance policies with dividend feature); *see also* Coalition Comment at 8-13.

contract and that, depending on the performance of the index, the purchaser could receive “no excess interest whatsoever.” NASAA Comment at 10. And after incorrectly identifying the purported risks of FIAs, NASAA urges the Commission to rely on a concept of “complexity risk” that has no support in Section 3(a)(8) law and which NASAA itself admits is a “type of risk [that] is perhaps novel in the context of analyzing [FIA]s.” NASAA Comment at 10.

Each element of NASAA’s risk argument misses the mark, further confirming that the Commission would need to ignore established law and irrefutable factual evidence to adopt the Proposed Rule. Charges for early withdrawal are just that—charges—not investment “risk” under the annuity contract value itself. See *Malone*, 225 F. Supp. 2d at 751. The imposition of those charges is triggered only by events described in the contract, not by any external events in financial markets. NASAA states that “[t]he *Malone* case was poorly decided,” and there is “no basis for [the proposition that an early withdrawal charge is not investment risk] in law, economics, or common sense.” NASAA Comment at 9 & n.4. Judge Easterbrook, however, in his decision exempting the Flexible Fund under Section 3(a)(8), stated directly that withdrawal charges do “nothing to throw *investment* risk on the investor.” *AIAP*, 941 F.2d at 567 (emphasis in original). The Commission itself has stated that a withdrawal charge “is simply a sales load that is deducted upon [withdrawal] [and] normally does not shift additional investment risk to the contract owner.” Definition of Annuity Contract or Optional Annuity Contract, Release No. 33-6645, 51 Fed. Reg. 20,254, 20,257 n.20. Under NASAA’s view, transaction fees for purchasing stocks, mutual funds, permanent life insurance, real estate, or declared rate annuities would also have to be considered investment risk, yet those fees—including withdrawal charges—are simply administrative costs, not investment risk.

NASAA also misconstrues the structure of FIAs and obscures the fact that FIAs place substantial investment risk on the insurer. Premiums from FIAs are deposited in the insurer’s “general account,” with the insurer bearing the risk that changing interest rates and credit conditions will affect the value of the account and, potentially, affect the insurer’s ability to satisfy insureds’ guaranteed payments. See Coalition Comment at 4. The NASAA Comment states that “[t]he value of the investor’s payment is subject to variation depending upon whether prevailing interest rates have risen . . . .” NASAA Comment at 10. In fact, from the day of issue FIA purchasers are assured that in the absence of early withdrawal they will receive their principal plus interest. The likelihood that they will receive *additional* financial returns is not “investment risk” as the term is commonly understood. See Coalition Comment at 14-16 and Addendum at 1-6; and see *Malone*, 225 F. Supp. 2d at 751 (the possibility of receiving extra payments on a guaranteed contract is not “risk” under Section 3(a)(8)).

Finally, NASAA’s admittedly bashful introduction of the notion of “complexity risk” (a “type of risk [that] is perhaps novel,” it acknowledges) further illustrates the complete departure from existing Section 3(a)(8) law that evidently is deemed necessary by one of the Proposed Rule’s principal advocates. NASAA’s concept of “complexity risk” bears no resemblance to the concept of risk discussed in *VALIC*, *United Benefit*, or any other cases interpreting Section 3(a)(8). The only purported authority cited by NASAA is a federal district court in which, NASAA states, the court “entertained claims” that FIAs are complex. See *id.* at 11 (citing *Yokoyama v. Midland National Life*, 2007 WL 1830858 (D. Haw. Feb. 13, 2007)). However, the court said nothing with regard to the legal question of whether FIAs are annuities or securities

under the Act or how the alleged complexity of FIAs would factor into an investment risk analysis.<sup>6</sup>

NASAA's treatment of "investment risk" is deeply flawed and cannot support the Proposed Rule.

C. *NASAA Misconstrues The "Marketing" Component Of Section 3(a)(8) Analysis, And Inaccurately Characterizes The Marketing Of FIAs.*

As NASAA, the Coalition, and other commenters have pointed out, the Court in *United Benefit* held that the variable annuities in that case were securities based in part on how they were marketed, stating that the contracts were "considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management." *United Benefit*, 387 U.S. at 211 (emphasis added), cited in NASAA Comment at 13 and Comment of William A. Jacobson, Esq., on behalf of the Cornell Securities Law Clinic, at 4 (Sept. 10, 2008). Because the test set forth in the Proposed Rule fails to allow for consideration of how FIAs are marketed, it conflicts with Section 3(a)(8) jurisprudence. Coalition Comment at 18-19.

While NASAA correctly recognizes that a product's marketing is an element of the Section 3(a)(8) analysis, it again misconstrues the Supreme Court's decisions in order to extend the securities laws to reach FIAs when, properly construed, they would not. NASAA suggests that simply identifying the investment aspects of a product is enough to place it outside the annuity exemption of Section 3(a)(8). NASAA Comment at 12-15. All annuity contracts have investment characteristics, however (Coalition Comment at 7, 18 n.14); mentioning this feature cannot establish that a product is *not* an annuity. Instead, courts have inquired whether a company has promoted its *investment management expertise*, not the fact of investment itself. In *United Benefit*, for example, the Court emphasized that the company was marketing products based on "the experience of United's management in professional investing." 387 U.S. at 211 n.15. Similarly, Justice Brennan's concurrence in *VALIC* emphasized that with annuities the purchaser is not "a direct sharer in the company's investment experience," whereas when "the coin of the company's obligation is . . . the present condition of its investment portfolio," "the

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<sup>6</sup> NASAA's expert also makes numerous inaccurate statements with respect to FIAs, such as when he attempts to argue that FIAs have no real cash value. See McCann Statement at 6. McCann posits that "[a]n equity-indexed annuity contract has a notional value—as opposed to a cash value—called an account value or accumulation value" and states that he "will refer to equity-indexed annuities' account or accumulation value as scrip value to differentiate it from the cash value which could be realized by investors." *Id.* These statements, however, confuse the two basic financial concepts of hedging and annuity contracts. "Contract values" or "account values" of annuities are deposit liabilities just like banks carry for savings accounts and CDs. There is nothing "notional" about them. The term "notional" is a hedging term—one buys a derivative based upon the notional value of the hedged instrument. It has no application to fixed-indexed annuities.



federally protected interests” underlying the securities laws are triggered. *VALIC*, 359 U.S. at 78. The Commission itself, in promulgating Rule 151, noted that “a marketing approach that fairly and accurately describes both the insurance and investment features of a particular contract . . . would undoubtedly ‘pass’ [Rule 151’s] marketing test.” Release No. 33-6645, 51 Fed. Reg. at 20,261. NASAA’s re-characterization of the marketing prong to bar virtually any mention of “investment” is unsustainable.

The NASAA Comment errs factually in claiming that FIAs characteristically are marketed primarily as investments: “Scholars, regulators, and aggrieved private plaintiffs all agree that [FIA]s are marketed primarily as investments.” NASAA Comment at 13. This is mere assertion, not evidence, whereas the marketing materials submitted for the rulemaking record by the Coalition show descriptions of FIAs that are careful to emphasize the guarantee of principal, minimum interest, and other features that further financial stability and security; the materials also explain the interest crediting feature and that it is not a means of participating in the stock market. *See* Coalition Comment at 19 and Exhibit C thereto. The fact that the materials mention the indexed-component of the product as a feature that distinguishes FIAs from other annuities the purchaser may be considering hardly indicates that an FIA is not an annuity.

*D. The NASAA Comment Misconstrues Other Caselaw.*

The NASAA Comment cites a number of cases arising outside of Section 3(a)(8) for the proposition that if the insurance exemption were not in the Act, then FIAs would be securities. NASAA Comment at 4. NASAA’s point is unclear: It is precisely to avoid such results that statutory exemptions are written. The cases NASAA cites are inapt in any event. *SEC v. W.J. Howey Co.* is cited for the proposition that FIAs are investment contracts. 328 U.S. 293 (1946), cited in NASAA Comment at 4. But *Howey* involved land sales contracts and did not even mention the word annuity or Section 3(a)(8), NASAA provides no explanation of how *Howey* sheds light on Section 3(a)(8). Similarly, the NASAA Comment states at page 8 that “[r]isk has never been an essential element in the definition,” and cites for support *SEC v. Edwards*, 540 U.S. 389 (2004), a case that did not discuss Section 3(a)(8) and involved the purchase and lease of pay phones. These cases add no insight as to the proper meaning of Section 3(a)(8).

NASAA also mischaracterizes the Section 3(a)(8) cases that it does cite. A Seventh Circuit case is cited for the proposition that “there is no meaningful distinction between [FIA]s and variable annuities.” NASAA Comment at 4 (citing *Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 565 (7th Cir. 1991) (“*AIAP*”). But as the Coalition noted in its previous comment, *AIAP* was a case in which Judge Easterbrook and the Seventh Circuit held that a “Flexible Annuity” with characteristics similar to fixed indexed annuities fell *within* the Section 3(a)(8) exemption. *See* Coalition Comment at 12; *see also* NASAA Comment at 8 (citing language from *AIAP* for the proposition that the investment risk test is “cumbersome,”

even though *AIAP* employed the risk test to hold the Flexible Fund exempt from securities regulation).<sup>7</sup>

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In advocating a markedly different approach toward each aspect of the Section 3(a)(8) test applied by the courts, NASAA states at one point that the rationale for Section 3(a)(8) “no longer exists.” NASAA Comment at 11. That may be NASAA’s view, but it assuredly is no basis for disregarding Section 3(a)(8) as written and as interpreted by the Supreme Court. That one of the Proposed Rule’s leading proponents sees such sharp distinctions between regulation of FIAs on the one hand and traditional Section 3(a)(8) analysis on the other should give the Commission considerable hesitation before adopting a rule that treats FIAs as securities.

## II. State Regulation of FIAs Is Robust.

The NASAA Comment claims that extensive fraud involving FIAs and the inadequacy of state regulation require the SEC to intervene. Not only is that not the legal question before the Commission, it is factually inaccurate.

NASAA asserts that “*variable or equity-indexed annuities* were involved in a third of all cases in which senior citizens were subject to securities fraud or abuse.” NASAA Comment at 2 (emphasis added). As support for this charge, NASAA cites its own former president’s statement making the same claim. NASAA Comment at 16; *see also* Proposing Release at 37,755 (citing NASAA president’s statement). But NASAA has yet to respond to requests by Coalition members that it provide information that supports this “statistic.” And as one Coalition member explained in a separate comment to the Proposed Rule, there is no indication how many of these purported cases of fraud involving “unregistered securities, variable annuities, and equity-indexed annuities” actually concerned *FIAs*, as opposed to the other products mentioned. *See* Comment of American Equity Investment Life Holding Company, at 14-15 (Sept. 10, 2008); *see also* Coalition Comment at 26 n.21.

Any reliance on the SEC, FINRA, and NASAA joint examination of free lunch seminars is similarly misplaced. *See* Coalition Comment at 26 n.21; *see also* NASAA Comment at 14 (relying on free lunch report); Proposing Release at 37,755 (same). The report examined *broker-dealers’* compliance with the *securities laws* in seminar sales. It did not examine independent insurance agents, who are the principal sellers of fixed indexed annuities. Within the report,

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<sup>7</sup> The NASAA Comment mischaracterizes another Section 3(a)(8) case for “implicitly finding that [FIA]s fall under the broad definition of a security.” NASAA Comment at 4 (citing *Holding v. Cook*, 521 F. Supp. 2d 832, 836 (C.D. Ill. 2007)). In fact, *Holding* merely stated that whether FIAs “are ‘annuities’ or ‘securities’ for purposes of the federal securities laws is complicated and resists generalization” and “[d]epending on the mix of features, an equity-indexed annuity may or may not be a security.” 521 F. Supp. 2d at 837. The court did not decide whether the FIAs were annuities, stating instead that the issue was “better left to a developed factual record after adequate time for discovery.” *Id.* at 839 (citing *AIAP*, 941 F.2d at 561).

moreover, fixed indexed annuities are mentioned only three times, with the report's dominant focus being on mutual funds, real estate investment trusts, variable annuities, private placements of speculative securities—such as oil and gas interests—and reverse mortgages. The report simply did not demonstrate that FIAs presented a particular problem or were even extensively offered at “free lunch” events. The NASAA Comment does not address these deficiencies in the report. At most, the joint examination reveals there are occasional problems with practices that the Commission *already* regulates—the marketing of variable annuities and mutual funds. That hardly is a basis for the Commission to expand its jurisdiction to regulate other products.

Similarly, NASAA cites court filings as supposed support for the proposition that FIAs “are often used to perpetrate fraud and abuse” (NASAA Comment at 16), but the citations are to court complaints and unsubstantiated allegations. *See, e.g.*, NASAA Comment at 16 (citing *Strube v. American Equity Investment Life Insurance Co.*, 226 F.R.D. 688 (M.D. Fla. 2005), as “describing systematic fraud in the sale of [FIA]s,” although the court only was repeating the plaintiff’s unsubstantiated allegations); *id.* at 11 (asserting that the *Yokoyama* court “entertained claims” regarding the deceptive nature of FIAs when in fact the court simply described plaintiff’s allegations in the context of *denying* class certification). Allegations of fraud are not evidence that fraud occurred, and indeed, statistics maintained by the State of Maryland, for instance, show that “[c]omplaints about equity indexed annuities represent less than 1/2 of 1% of the complaints received by the MIA’s Life and Health Unit.” Comment of Ralph Tyler on behalf of the Maryland Insurance Administration, at 7 (Sept. 9, 2008) (“Maryland Comment”).

NASAA is likewise unable to support its assertions that state insurance regulation is inadequate or ineffective. It questions the effectiveness of the disclosure and suitability requirements of state insurance laws, asserting that commenters opposing the Proposed Rule “offer no data to support the notion that insurance commissioners vigorously enforce consumer protection standards.” *Id.* at 16, 19.<sup>8</sup> In fact, the Coalition Comment demonstrated that the state regulatory and enforcement system is robust and effective in providing meaningful information to potential purchasers, and meaningful penalties for violators. Coalition Comment at 21-27. The submissions of regulators themselves confirm this. *See, e.g.*, Comment of Jim Mumford, on behalf of the Iowa Insurance Division (Sept. 10, 2008) (“Iowa Comment”) (outlining extensive state regulation of FIAs and arguing that the Proposed Rule will have a chilling effect on the efforts of companies and state regulators); Comment of Sandy Praeger, Insurance Commissioner, NAIC President, et al. (Sept. 10, 2008) (“NAIC Comment”) (same); Maryland Comment (detailing Maryland’s regulatory framework applicable to FIAs); Comment of Sandy Praeger, Kansas Insurance Commissioner, NAIC President, et al. (Aug. 14, 2008) (“As insurance products, indexed annuities are subject to the state insurance non-forfeiture laws, investment laws, financial regulation laws, advertising laws, replacement laws and guaranty fund laws

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<sup>8</sup> The NASAA Comment relies on Justice Brennan’s statement from the middle of last century that “insurance regulation is not a disclosure regime.” NASAA Comment at 7. State insurance regulators require substantial disclosures today. *See* Coalition Comment at 21-24 (detailing extensive state disclosure laws).

among others. They are different from variable annuities in very material ways and are subject to greater scrutiny under state laws.”).

The NAIC Comment, for example, states that 43 states have adopted the NAIC Life Insurance and Annuities Replacement Model Regulation or something similar, at least 33 states have adopted the NAIC Suitability in Annuity Transactions Model Regulation or related legislation, and 22 states have adopted the NAIC Annuity Disclosure Model Regulation or related legislation. NAIC Comment at 1-2.<sup>9</sup> The NAIC Comment also demonstrates that states are committed to further improving their regulatory systems, as evidenced by the working groups currently meeting to address NAIC’s model disclosure and suitability regulations. *Id.* at 3. NASAA ignores this widespread coordination among states in their regulatory practices and the fact that many companies adopt model rules on a nationwide basis, even in states where they are not required. *See* Coalition Comment at 20.

Comments submitted by Iowa and other jurisdictions refute NASAA’s statements regarding state suitability laws. The Iowa Insurance Division regulates insurance *and* securities, is thus a member of NASAA, and wrote specifically because it was “troubled with the misinformation that NASAA has provided the SEC” in previous filings. Iowa Comment at 1. (“[I]n the first quarter of 2008 [Iowa and its insurance carriers] have issued approximately 44% of the premium received on indexed annuities.”). The Iowa Comment states:

NASAA also has said that the FINRA requirements on suitability are stronger than the NAIC Suitability Model and that is also very inaccurate. The NAIC Model is based on FINRA’s Rule 2310 but covers variable and fixed annuities, individual and group, no matter what distribution system is used, and places the ultimate responsibility on the carrier issuing the policy. It can’t get much broader than that.

*Id.* at 3. The Iowa Comment details the extensive steps it has taken to raise the standards of conduct for FIA carriers. *See* Iowa Comment at 1-2.

The Maryland Comment also reflects a robust state regulatory program, providing a two-page bullet-point summary of Maryland laws applicable to FIAs, and stating:

The Commission should take particular note of Maryland’s suitability regulation (COMAR 31.09.12). By its terms, this regulation ‘applies to each recommendation to purchase or exchange an annuity made to a consumer by an insurance producer, or an insurer where no insurance producer is involved, that results in the purchase or exchange recommended.’ The regulation imposes explicit duties on insurers and producers to ‘have reasonable grounds for believing that the recommendation is suitable for the consumer. . . .’

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<sup>9</sup> Six states are currently considering the NAIC Suitability in Annuity Transactions Model Regulation.

The Maryland regulatory regime is as robust as it is comprehensive. Maryland's insurance regulatory structure demonstrates that any assertion that states do not currently regulate indexed annuities is false.

Maryland Comment at 4-5, 6.

Like its assertion that *all* scholars agree that FIAs are marketed as investments, NASAA's claim that *no data* point to effective state regulatory programs is patently incorrect and unreliable. The rulemaking record reflects that state regulation is substantial and enacting the Proposed Rule would only harm consumers by inserting an unnecessary layer of regulation into the market for FIAs. In the words of the Iowa Insurance Division, the Proposed Rule "will have a chilling effect on [State regulation] as companies have to comply with a new regulator in this area while still meeting the new requirements imposed by states." Iowa Comment at 2-3.

The potential repercussions of adopting Rule 151A and the unnecessary limitations it could place on the ability of consumers to use FIAs would come at a time when FIAs are demonstrating their resilience in a troubled market. Purchasers of FIAs have not experienced the recent downturn in the market because the guarantee features of the FIAs mean that FIA holders will not share in market losses. Gains received by FIA holders in previous years have been locked in. FIAs are proving a wise approach for consumers who wish to place their money in relatively safe instruments and have more comfort that they will avoid the worst effects of the current market turmoil. *See* Exhibit B.

### Conclusion

For all the reasons set forth above, the Coalition for Indexed Products respectfully requests that the Commission decline to adopt Proposed Rule 151A, and instead affirm that fixed indexed annuities are annuities, not securities. These products should be left to state regulation, as Congress intended and as state insurance commissioners not only stand ready to do, but *are* doing. Duplicative SEC regulation would needlessly constrict the availability of FIAs and raise their cost at the very time they are providing shelter from market turbulence, and would needlessly divert the Commission's resources into an entire new area at a time when the demands on the Commission's core mission have never been greater.

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# Un-Supermodels and the FIA

*Ibbotson Associates / IFID Centre Conference*

*Guaranteed Living Income Benefit Insurance Products*

David F. Babbel  
Professor of Insurance and Finance  
The Wharton School of Business  
University of Pennsylvania  
and Senior Advisor to CRA Intl

**November 11, 2008**



## 2. Recent Historical Evidence

This section looks at the performance of two representative annuities, compared to alternative investments. Annuities are issued each year starting on 1/1/95 (1995 is when the first FIA was issued in the US). We assume no mortality and no surrender and just look at the value of the annuities and alternative investments at the end of the surrender charge period or as of 10/31/08, whichever comes first.

It is important to note that the comparison is done in terms of the annuities' maturity payoff value and does not include the additional benefits of mortality risk and penalty-free withdrawals.

## **2. Recent Historical Evidence**

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**We compare the performance of two fixed indexed annuities to various alternatives:**

- **Vanguard's S&P 500 Total Return Fund**
- **The S&P Index used in calculating the FIAs' crediting rates**
- **An un-rebalanced benchmark portfolio comprised of:**
  - **50% Vanguard's S&P 500 Total Return Fund**
  - **50% Vanguard's Total Bond Market Fund**
- **A Money Market Index (Merrill Lynch 91-day T-bill Index minus 20 bps per year)**
- **We use actual returns to calculate the value of the annuity and alternatives just described, over the annuity's term or as of October 31, 2008**



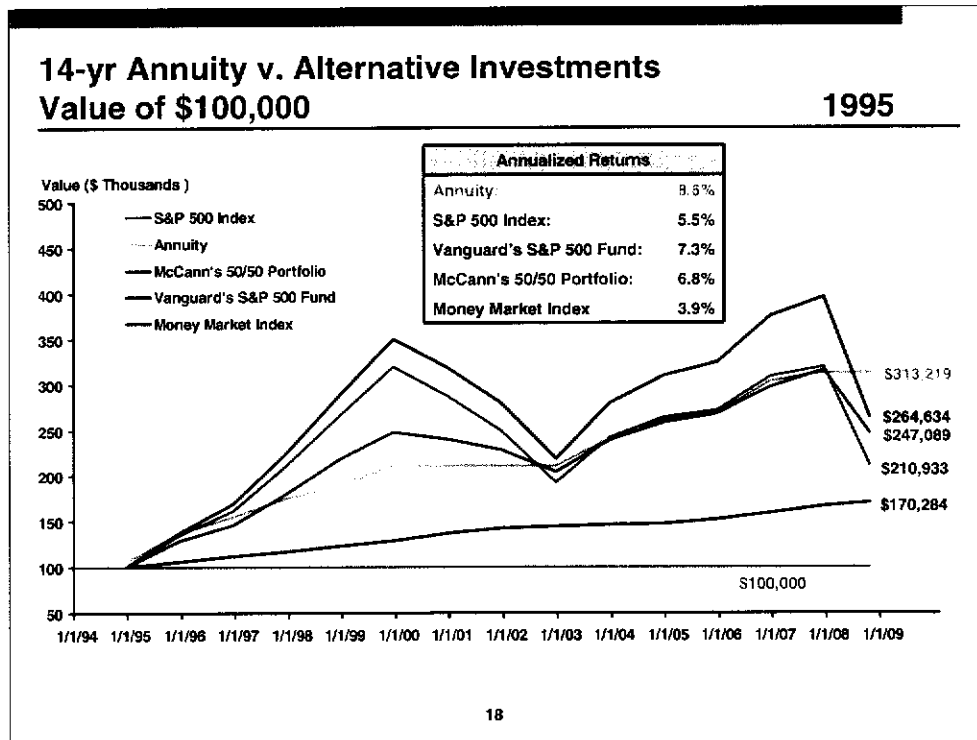
## 2. Recent Historical Evidence

- **We first consider a monthly point-to-point, 14-year annuity**  
We consider policies issued on the first day of each year starting on 1/1/95 and calculate the account values as of the end of the surrender charge period or October 31, 2008, whichever comes first.
- **We also consider a monthly point-to-point, 9-year annuity, with similar issue dates**
- **Some annuities would still be in force as of 10/31/08, but we can calculate their account values**
- **These annuities are similar to some analyzed by Dr. McCann and have the following actual terms:**

Policy Name	Term	Monthly Cap	Annual Floor	Bonus
Annuity No. 1	14 yrs.	3.50%	0%	6%
Annuity No. 2	9 yrs.	4.25%	0%	3%

17

The two annuities considered in this section are representative among the FIAs in the FIA litigation. They have actual parameters and surrender charge periods of 14 and 9 years. The choice of 1/1/95 is because FIAs were first issued in the US in 1995.

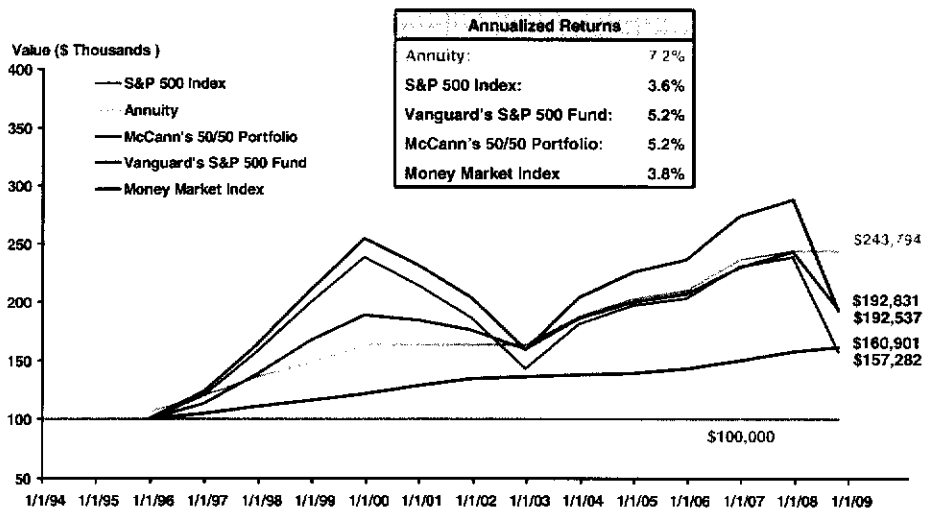


Note that none of the 14-year annuities would have been out for more than 14 years. This one, issued on 1/1/95, will reach 14 years on 1/1/09. However, we can compare the account value as of 10/31/08 with the value of alternative investments over the same period.

Although the crediting rate for the 2008 calendar year has not yet been determined, it is a safe bet to assume that the PtP formula will credit 0% for the 2008 year and so, on this annuity and all other 14-year annuities, we have kept the annuity value constant for the 1/1/08 – 10/31/08 period.

# 14-yr Annuity v. Alternative Investments Value of \$100,000

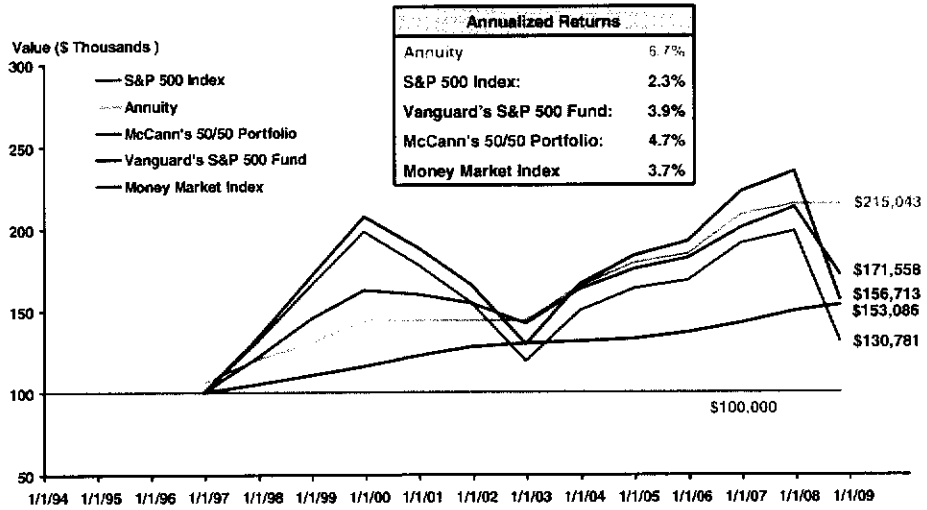
1996



# 14-yr Annuity v. Alternative Investments

## Value of \$100,000

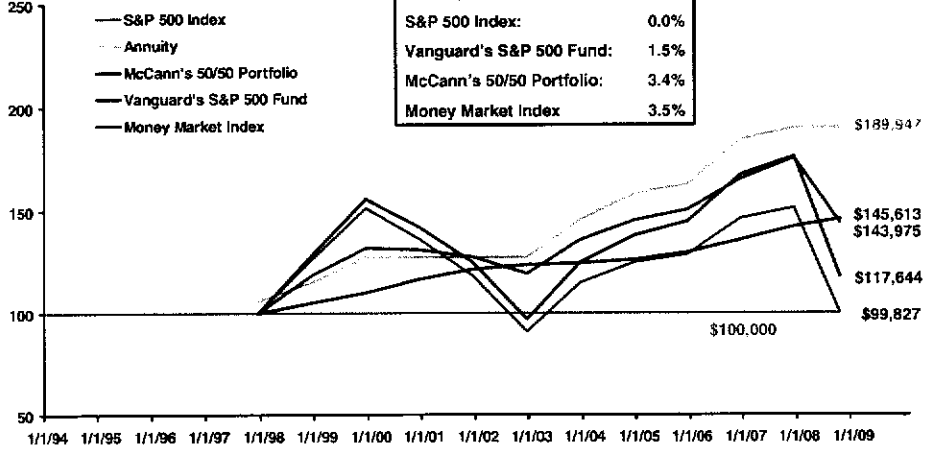
1997

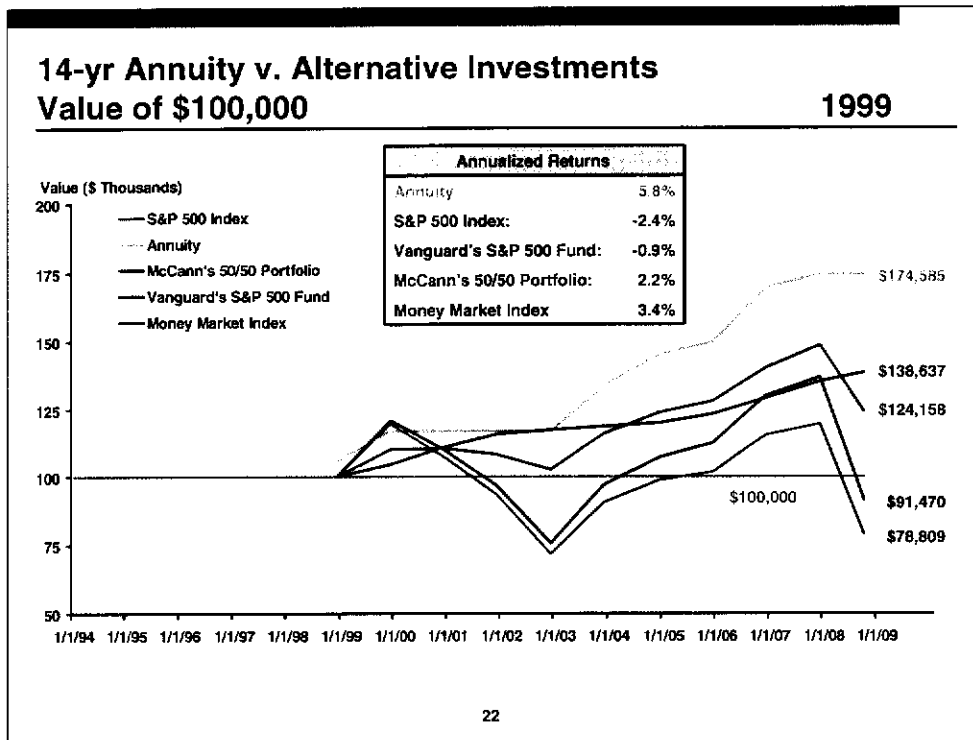


# 14-yr Annuity v. Alternative Investments Value of \$100,000

1998

Value (\$ Thousands)





A key thing to note about this slide is that even if monthly returns are close to being uncorrelated in the long run, they can be significantly correlated over periods of months or even years. This short-term correlation is very favorable to FIAs both when the market is going down (positive effect of a floor) and when the market is going up (relative insignificance of the cap).

During the 2000-2002 crash, negative monthly returns in one month were followed by negative monthly returns in subsequent months. This makes the floor of zero return very valuable for an FIA.

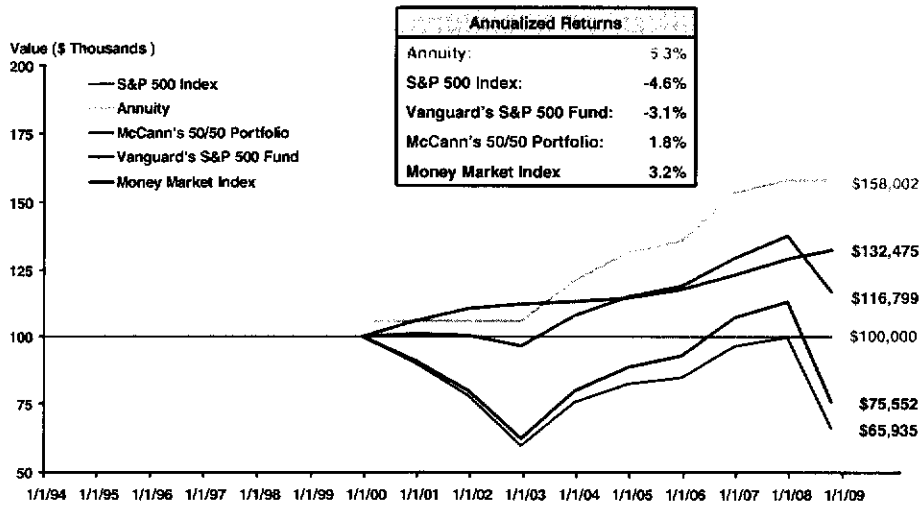
During the 2003-2007 run up, positive monthly returns in one month were followed by positive monthly returns in subsequent months. This makes the monthly cap, even if it is binding in a few months, not as effective in limiting the size of the crediting rate.

So in this slide we see the annuity value line flat while the market tanks in 2000-2002 month after month, and then we see the annuity value line growing at almost the same rate as the market steadily does well in 2003-2007.

# 14-yr Annuity v. Alternative Investments

## Value of \$100,000

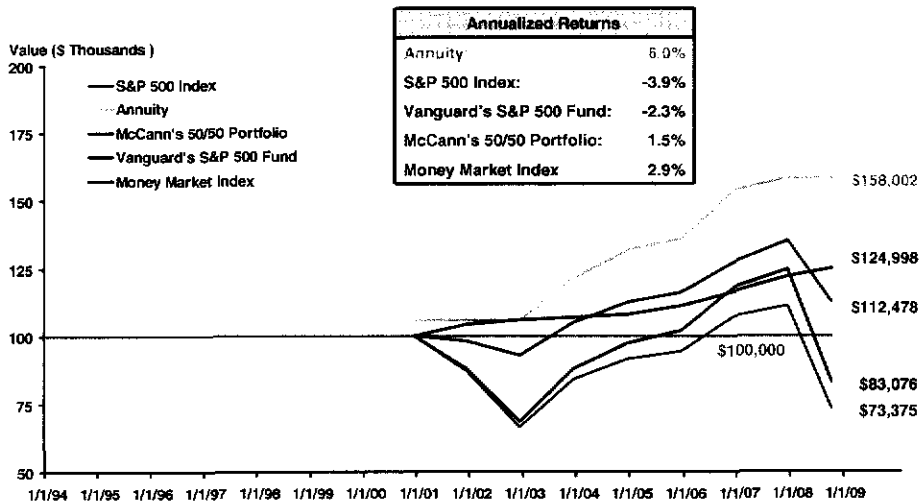
2000



# 14-yr Annuity v. Alternative Investments

## Value of \$100,000

2001

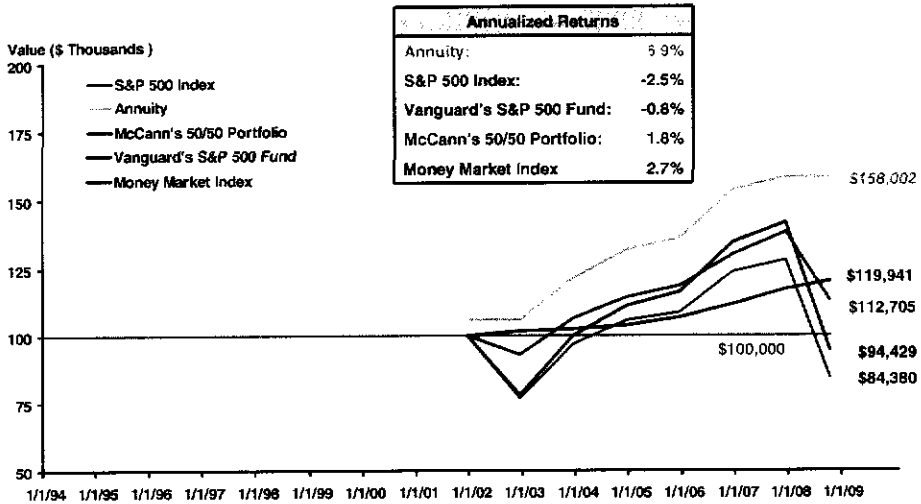


Annualized Returns	
Annuity	6.0%
S&P 500 Index:	-3.9%
Vanguard's S&P 500 Fund:	-2.3%
McCann's 50/50 Portfolio:	1.5%
Money Market Index	2.9%



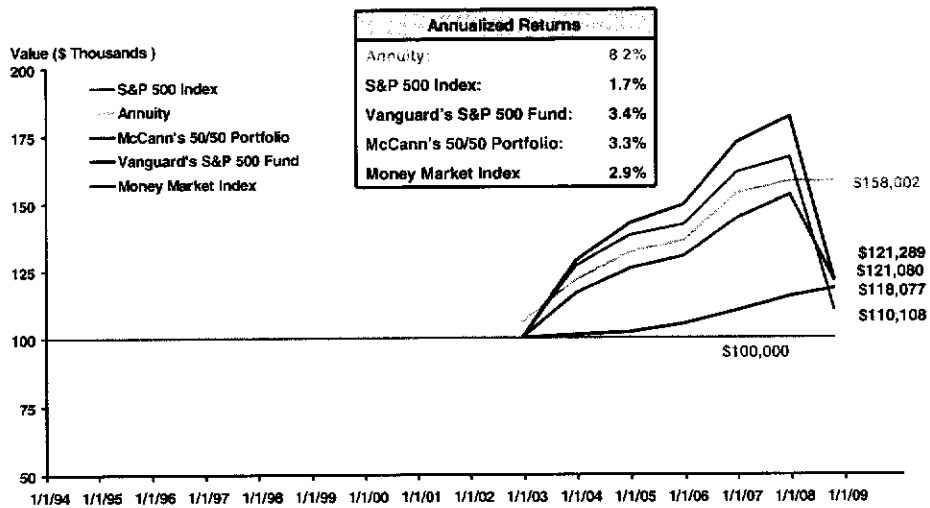
# 14-yr Annuity v. Alternative Investments Value of \$100,000

2002



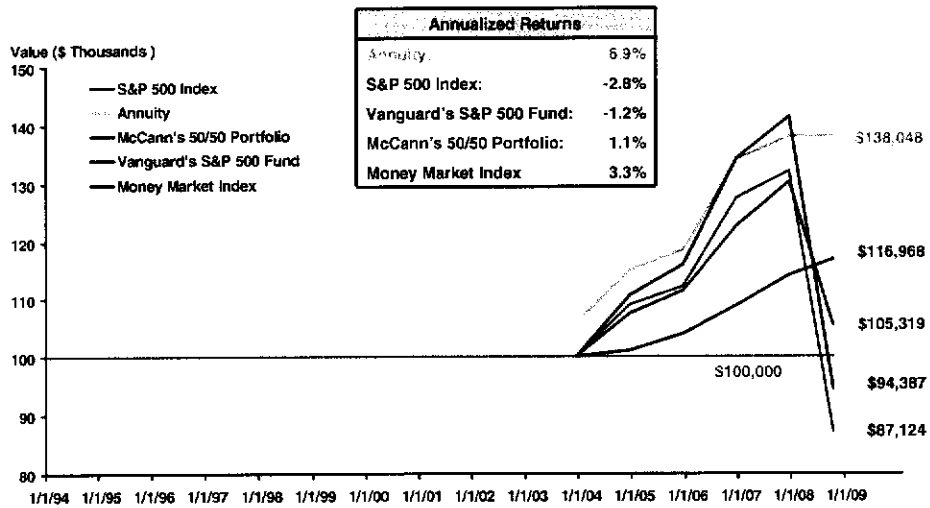
# 14-yr Annuity v. Alternative Investments Value of \$100,000

2003



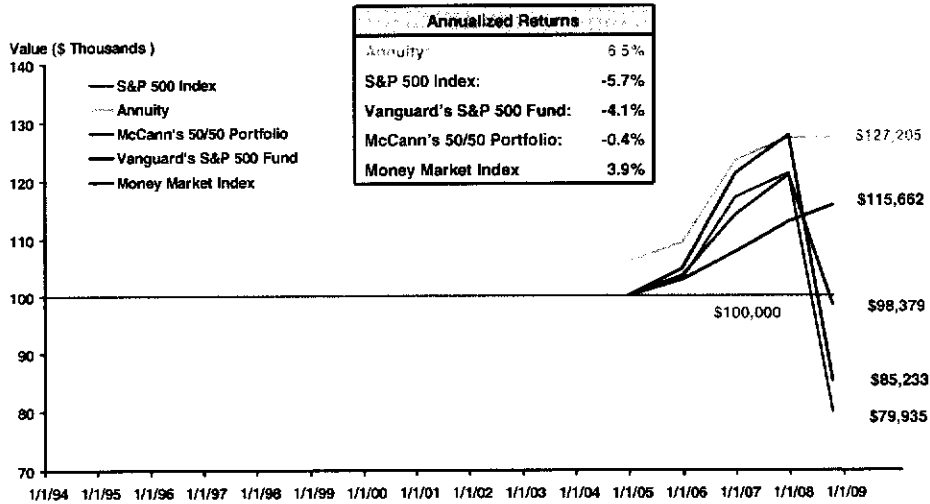
# 14-yr Annuity v. Alternative Investments Value of \$100,000

2004



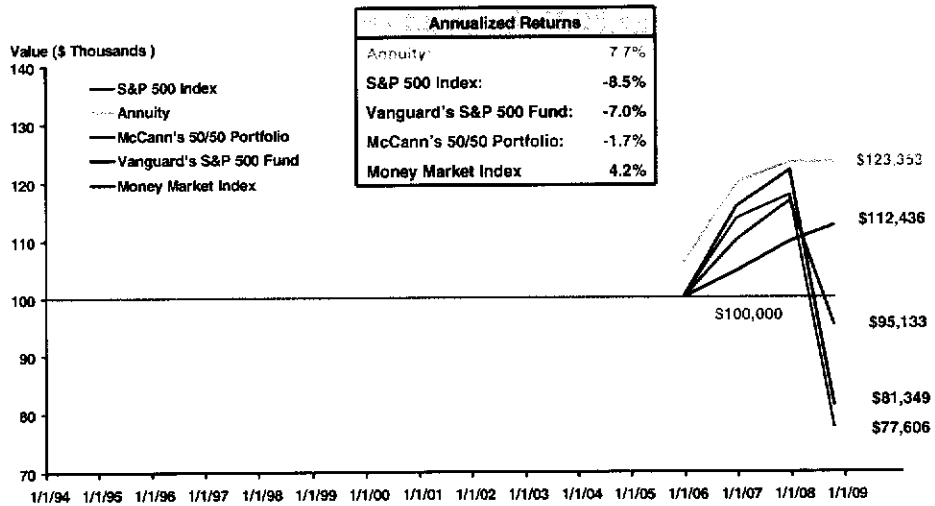
# 14-yr Annuity v. Alternative Investments Value of \$100,000

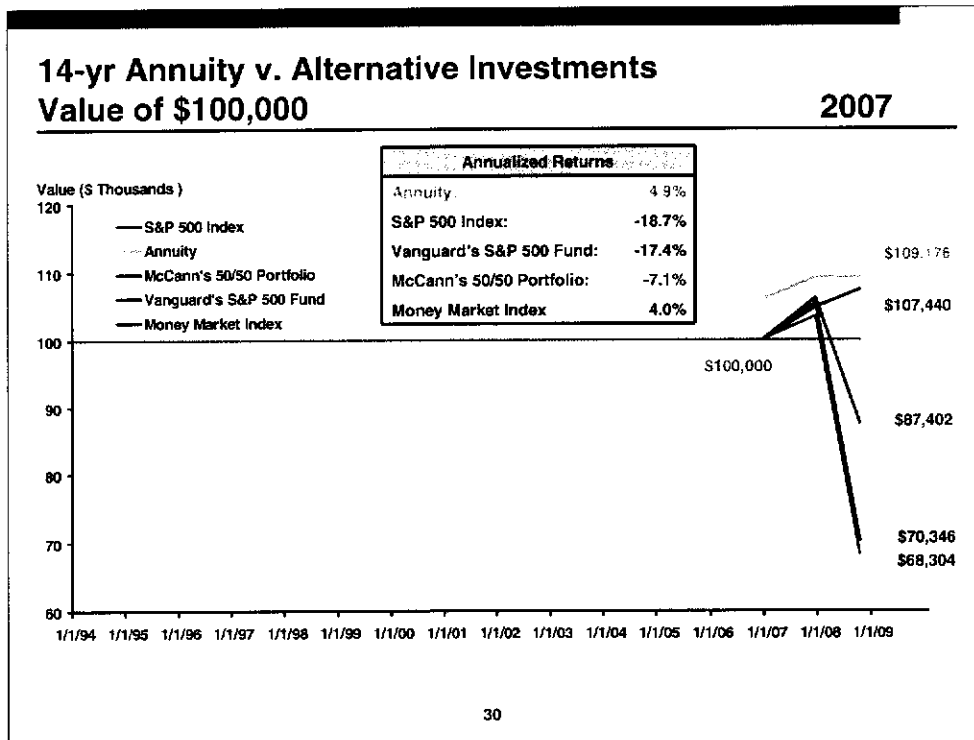
2005



# 14-yr Annuity v. Alternative Investments Value of \$100,000

2006



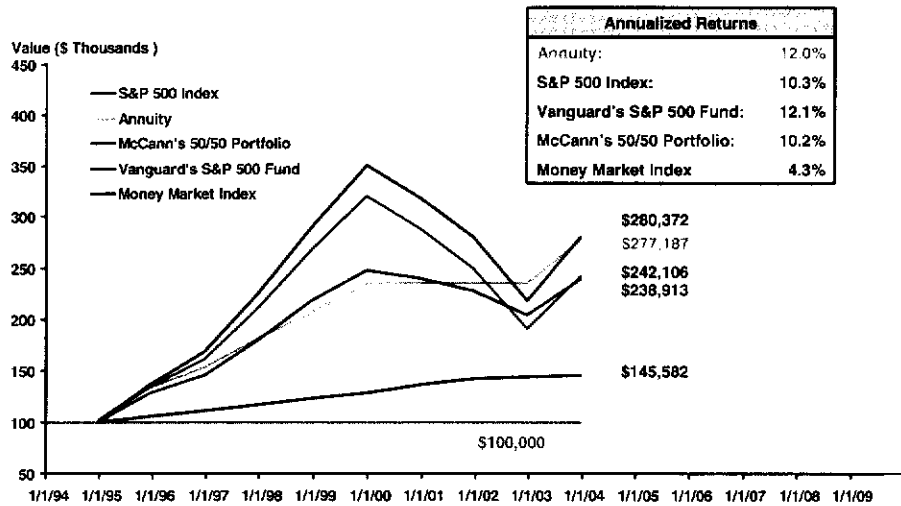


Note that each year for all 14 years that these policies have been issued, they outperformed McCann's 50/50 portfolio, in spite of his assertion that his portfolio would outperform annuities 98-99.8% of the time. Of course, we are using his measure of "performance" which focuses strictly on the maturity payoff value. This is an inadequate measure of performance because it ignores many valuable options associated with the annuity, and ignores consumer risk tolerance, health, mortality, tax status, and so forth. Including these factors would make the annuity performance even more highly valued.

Will this "superior performance" (using McCann's measure of performance) continue in the future? I have no idea... and neither does Dr. McCann, his assertions notwithstanding.

## 9-yr Annuity v. Alternative Investments Value of \$100,000

1995



Annualized Returns	
Annuity:	12.0%
S&P 500 Index:	10.3%
Vanguard's S&P 500 Fund:	12.1%
McCann's 50/50 Portfolio:	10.2%
Money Market Index	4.3%

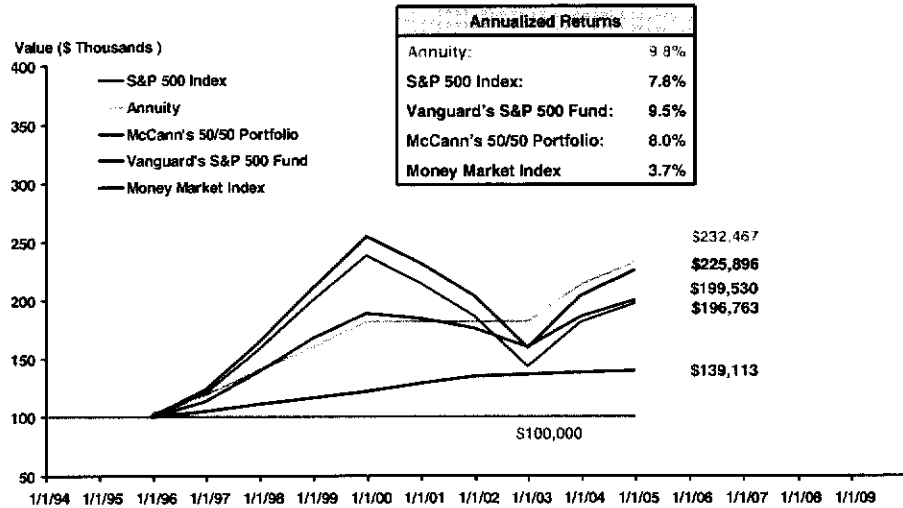
31

The series of 9-year annuities begins here. Note that many of them will have the end of their term before 10/31/08 and so they show complete value lines.

# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

1996

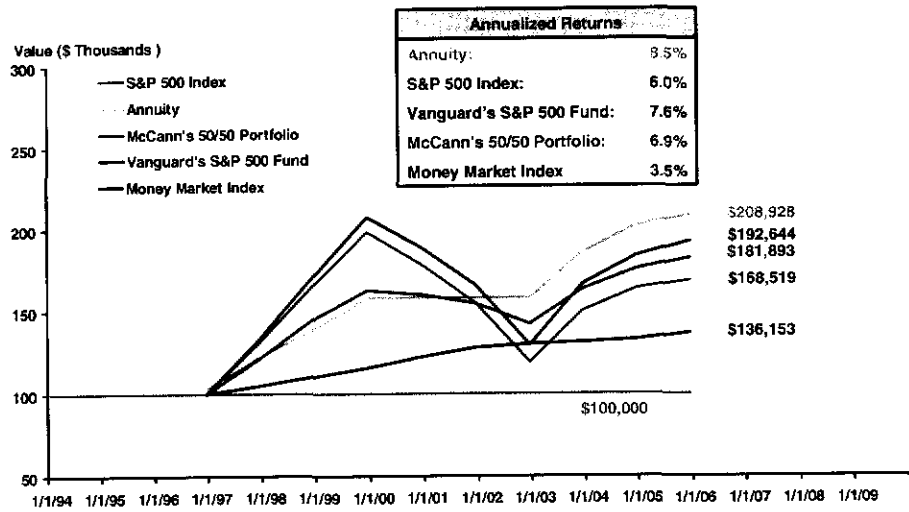




# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

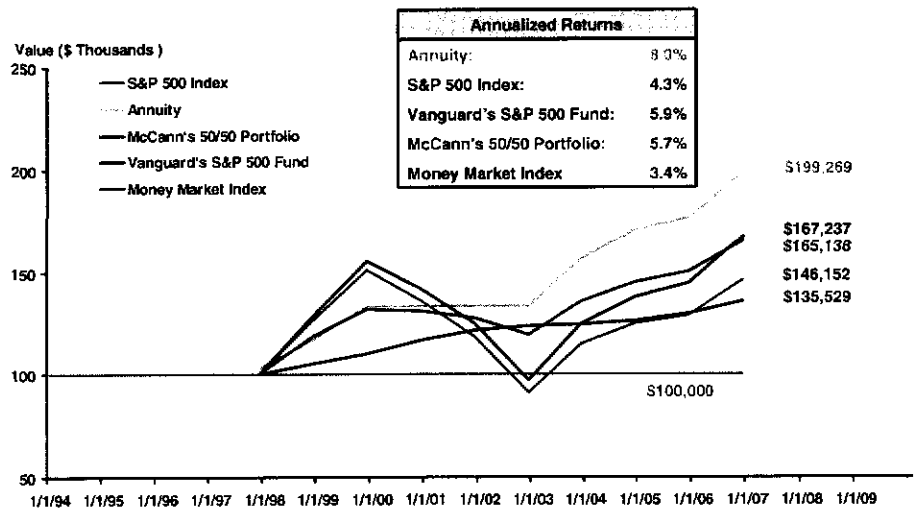
1997



# 9-yr Annuity v. Alternative Investments

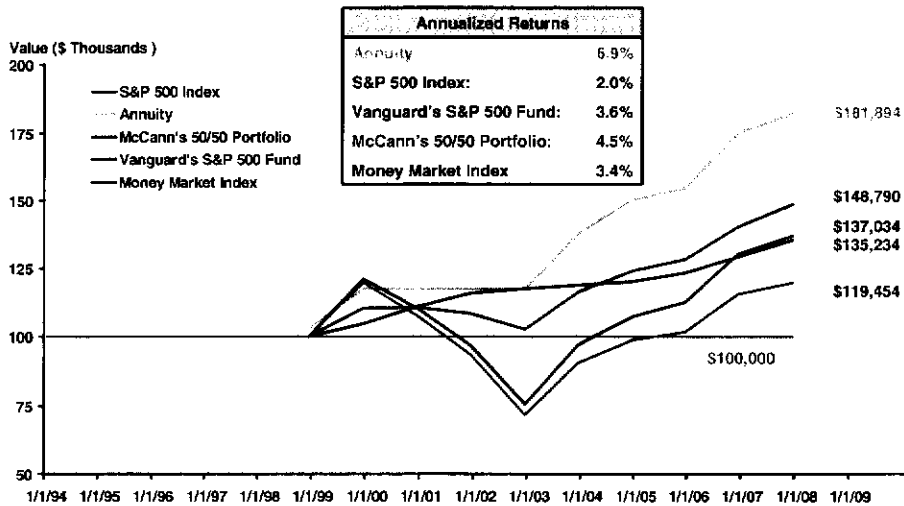
## Value of \$100,000

1998



# 9-yr Annuity v. Alternative Investments Value of \$100,000

1999



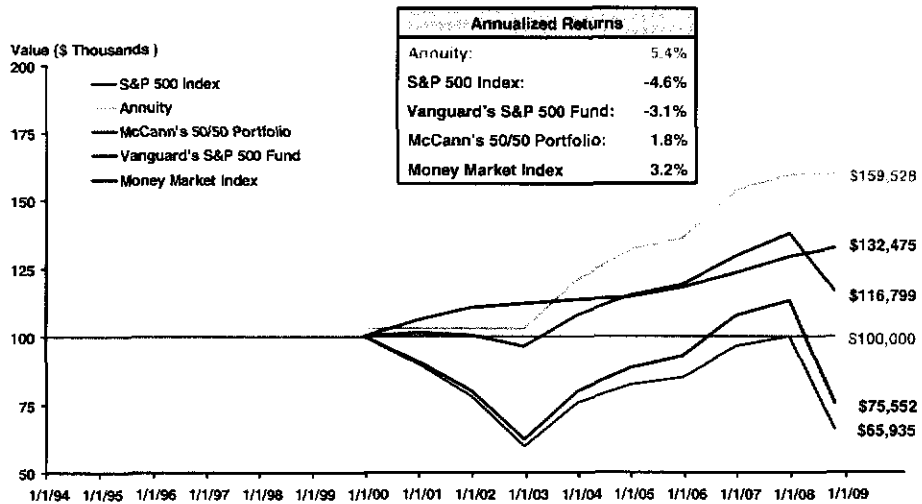
35

This is the last of the 9-year annuities with a full 9-year value line.

# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

2000



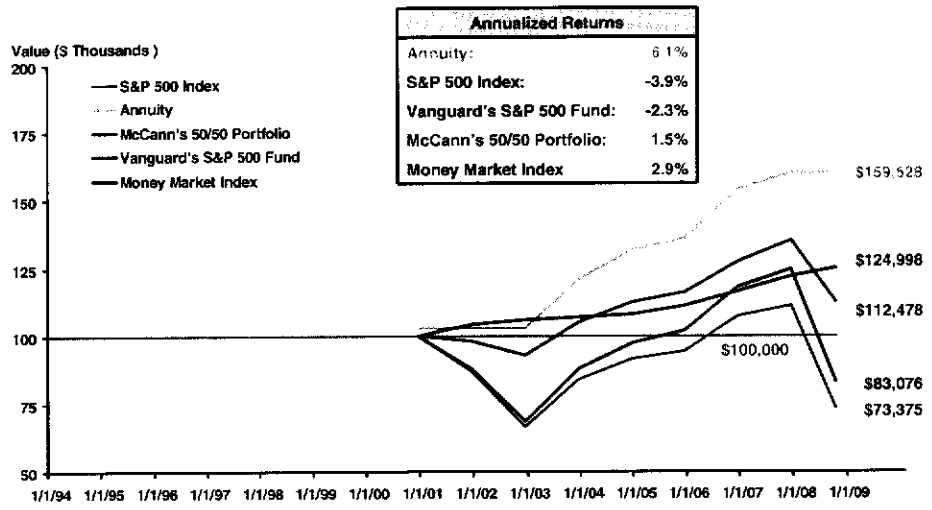
36

Here again we assume that the crediting rate for the 2008 anniversary year is going to be 0%, based on the S&P performance so far this year.

# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

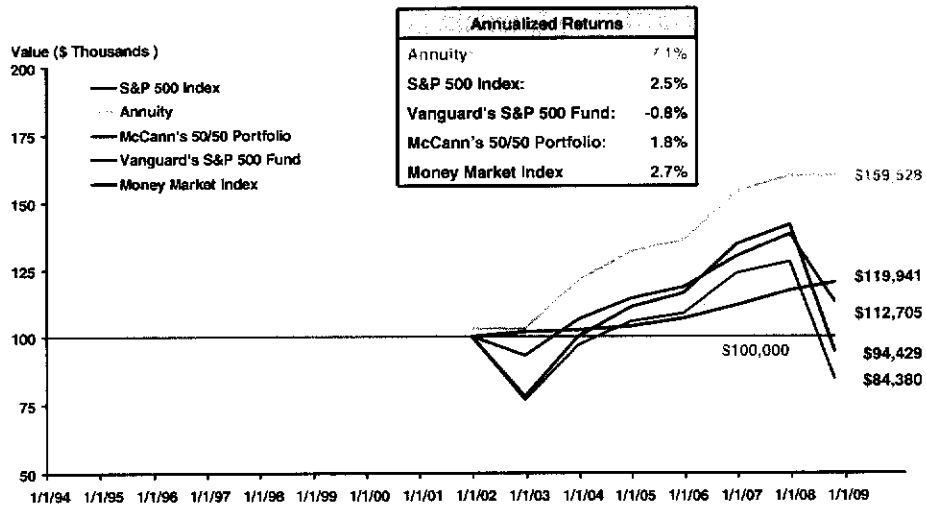
2001



# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

2002

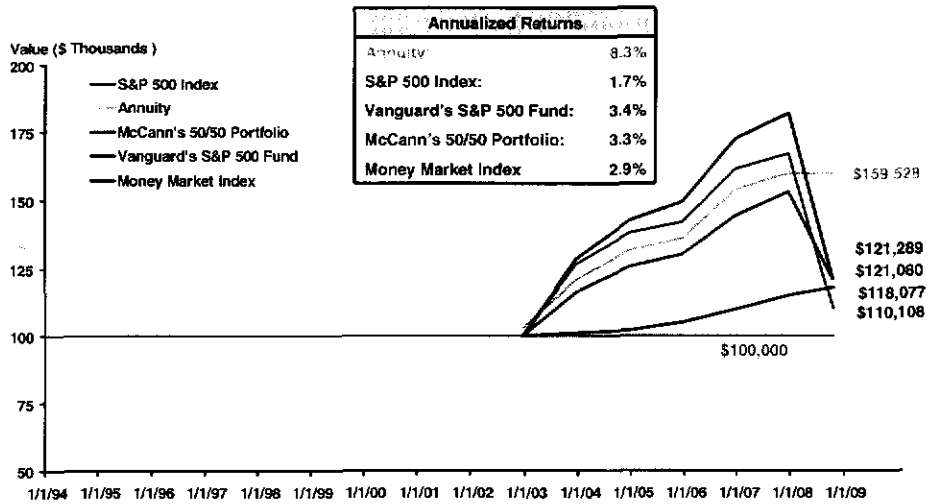


Annualized Returns	
Annuity	7.1%
S&P 500 Index	2.5%
Vanguard's S&P 500 Fund	-0.8%
McCann's 50/50 Portfolio	1.8%
Money Market Index	2.7%

# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

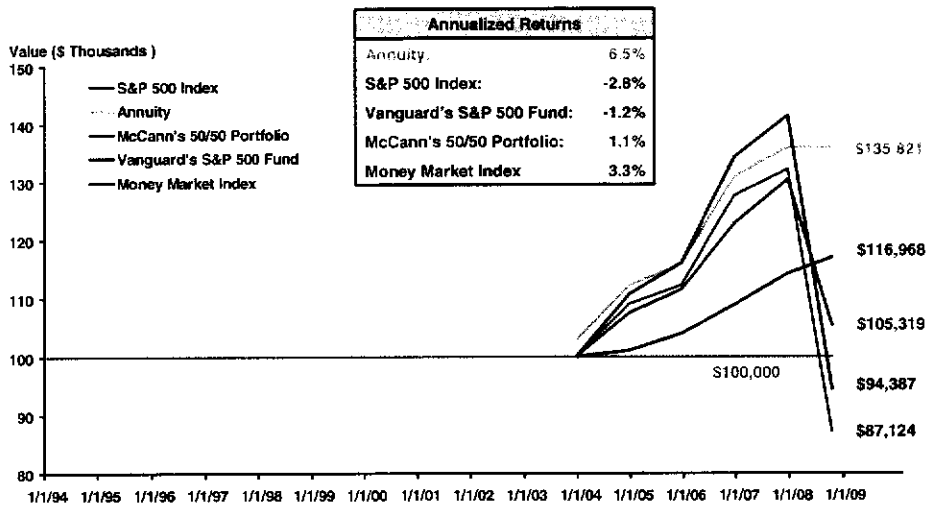
2003



# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

2004

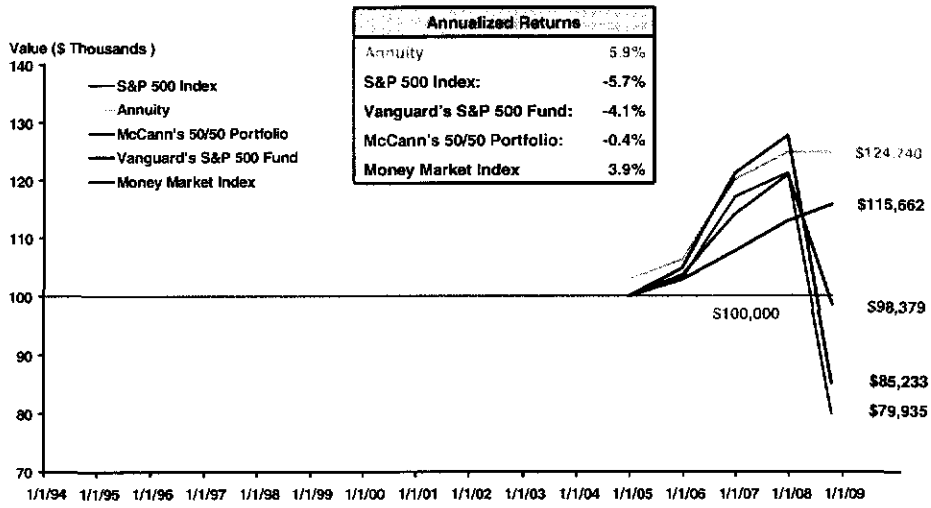




# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

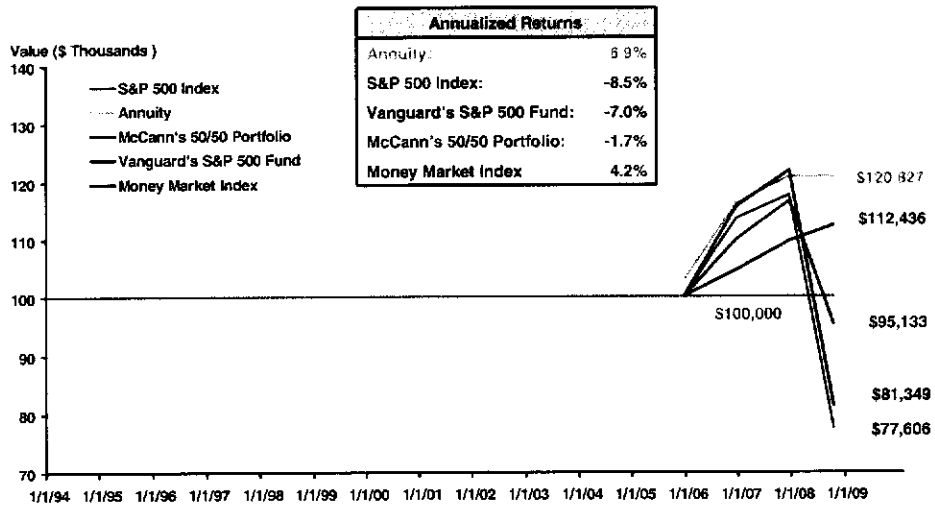
2005



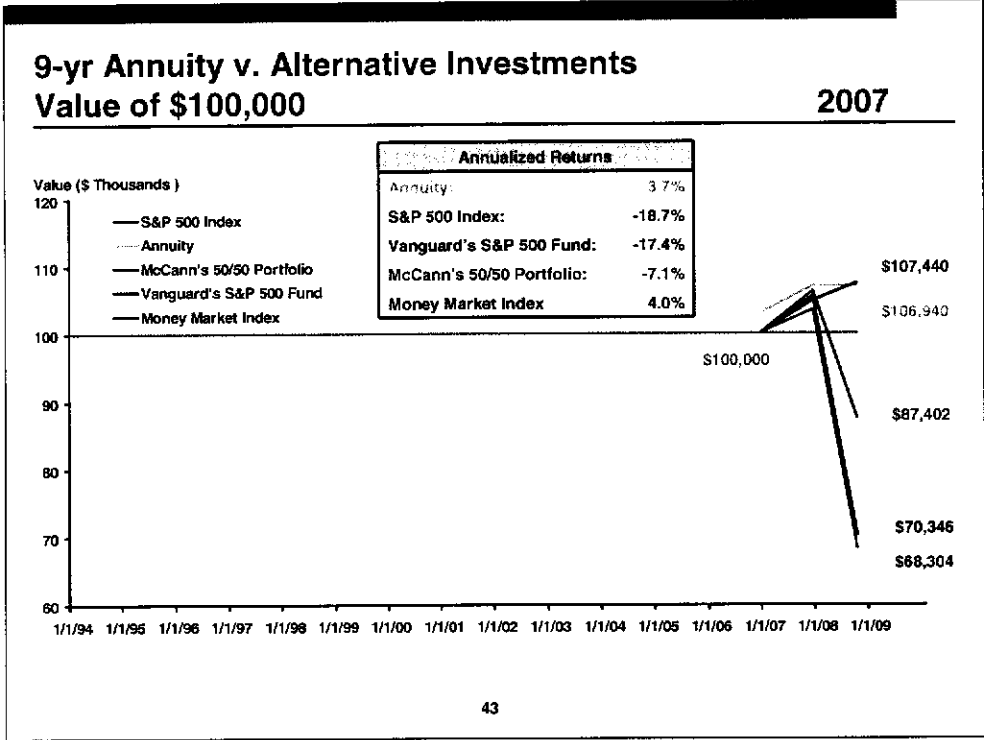
# 9-yr Annuity v. Alternative Investments

## Value of \$100,000

2006

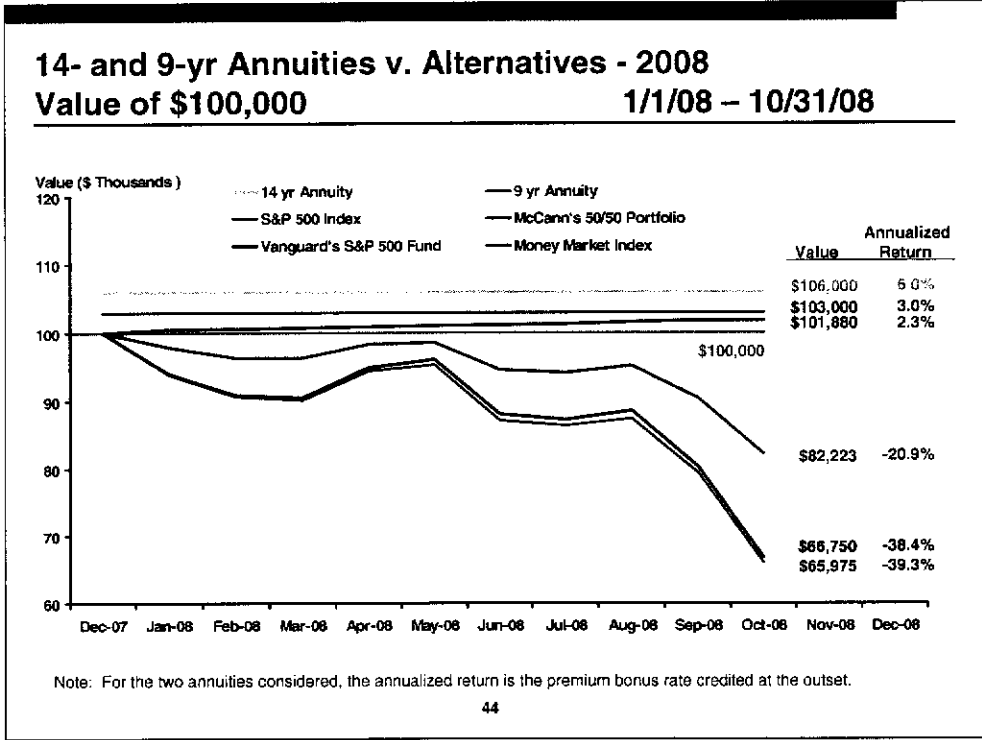


Annualized Returns	
Annuity:	6.9%
S&P 500 Index:	-8.5%
Vanguard's S&P 500 Fund:	-7.0%
McCann's 50/50 Portfolio:	-1.7%
Money Market Index	4.2%



Note again, similar to the 14-year annuity, that for 9-year annuities, each year for every year since these policies began to be issued in 1995, they have outperformed McCann's 50/50 portfolio, in spite of his assertion that his portfolio would outperform annuities 98-99.8% of the time. 100% is higher than 0.2%, or even 2%, as McCann has predicted. Of course, we are using his measure of "performance" which focuses strictly on the maturity payoff value. This is an inadequate measure of performance because it ignores many valuable options associated with the annuity, and ignores consumer risk tolerance, health, mortality, tax status, and so forth. Including these factors would make the annuity performance even more highly valued.

Will this "superior performance" (using McCann's measure of performance) continue in the future? I have no idea... and neither does Dr. McCann, his assertions notwithstanding.

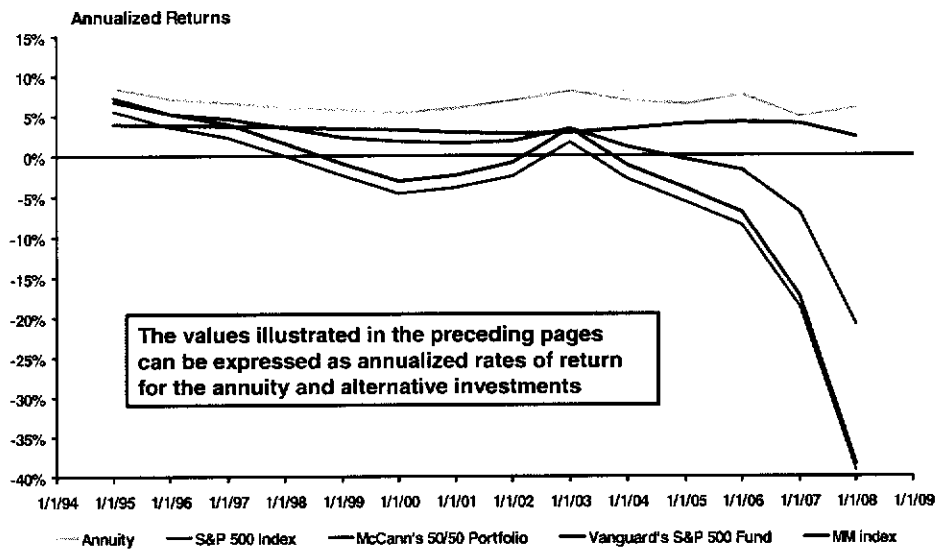


This page combines both annuities for the period 1/1/08 – 10/31/08.

Note that the S&P Index would need to appreciate by 61% during the last two months of this year before it would break even with the 14-year annuity, and by 56% to break even with the 9-year annuity.

If these rates of appreciation occur over multiple years, it will not catch up with the annuities, because the annuities will also appreciate.

## 14-yr Annuity v. Alternative Investments Annualized Returns from Start Date through 10/31/08

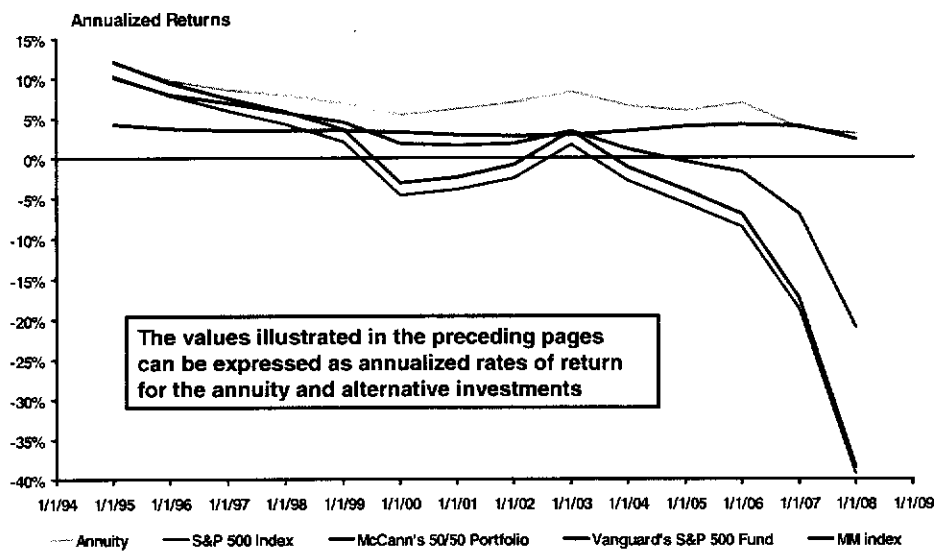


The values illustrated in the preceding pages can be expressed as annualized rates of return for the annuity and alternative investments

This slide shows the annualized rates of return for each 14-year annuity from the issue date through 10/31/08. The annuity always dominates.

## 9-yr Annuity v. Alternative Investments

Annualized Returns from Start Date through Term or 10/31/08



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This chart shows the annualized rates of return for each 9-year annuity from the issue date through the end of nine years or 10/31/08, whichever comes first. We see that the annuity dominates except for 1/1/95 (against the TR fund) and 1/1/07 (against the MM index)



### 3. The Long-Run View

In this section we use monthly returns from Jan-26 through Feb-08 to discuss:

1. Non-normality of monthly S&P log-returns
2. Distribution of crediting rates under both empirical and independent log-normal monthly return distributions
3. Success rate of 14 and 9 year annuities compared to McCann's alternatives, based on actual return distribution not the assumption of NID.

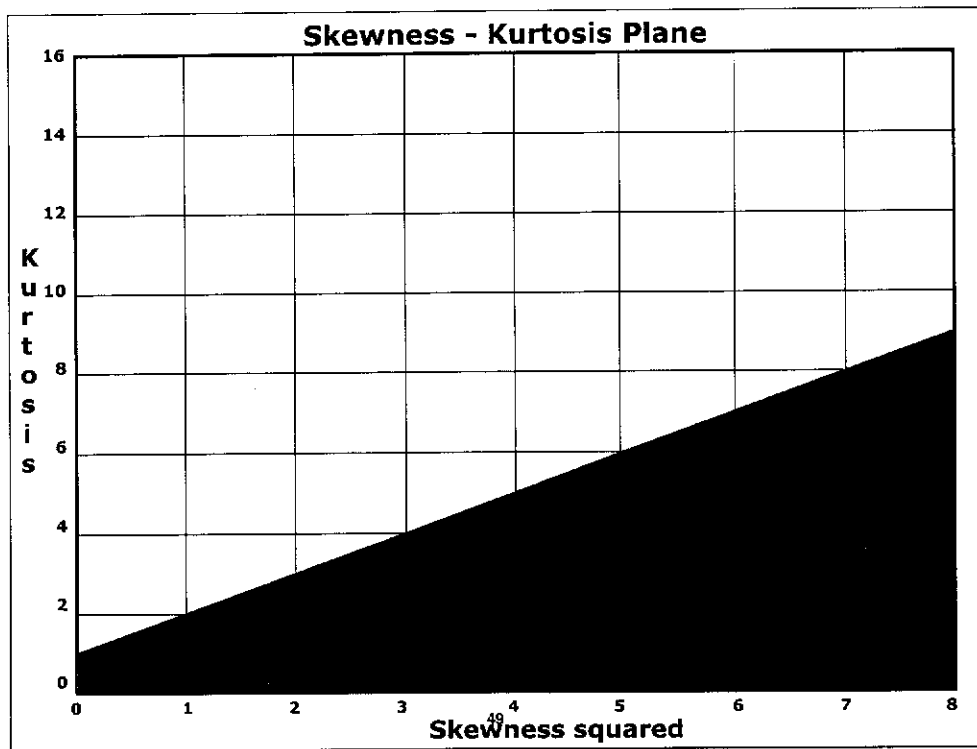
### **3. Long-Run View**

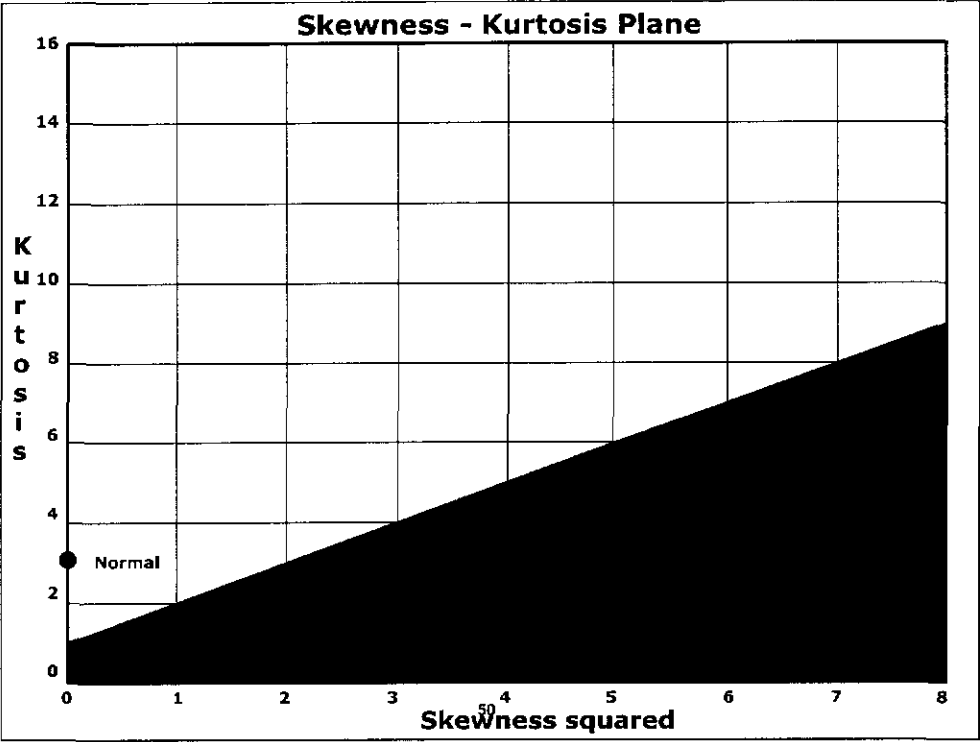
#### **Equity Indexed Annuities Performance Analysis**

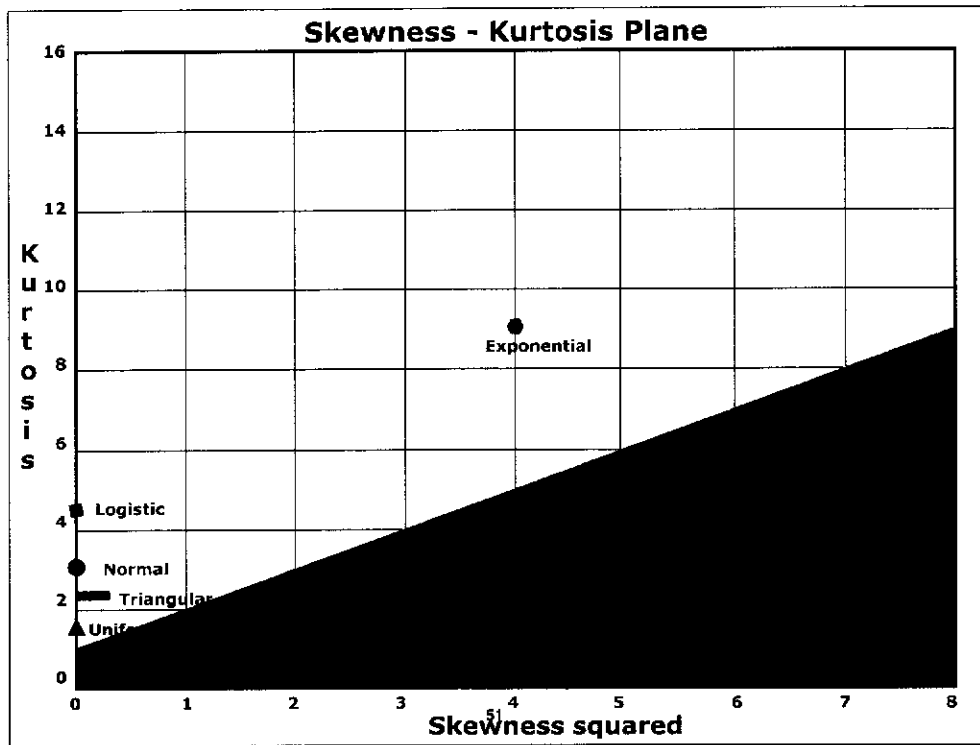
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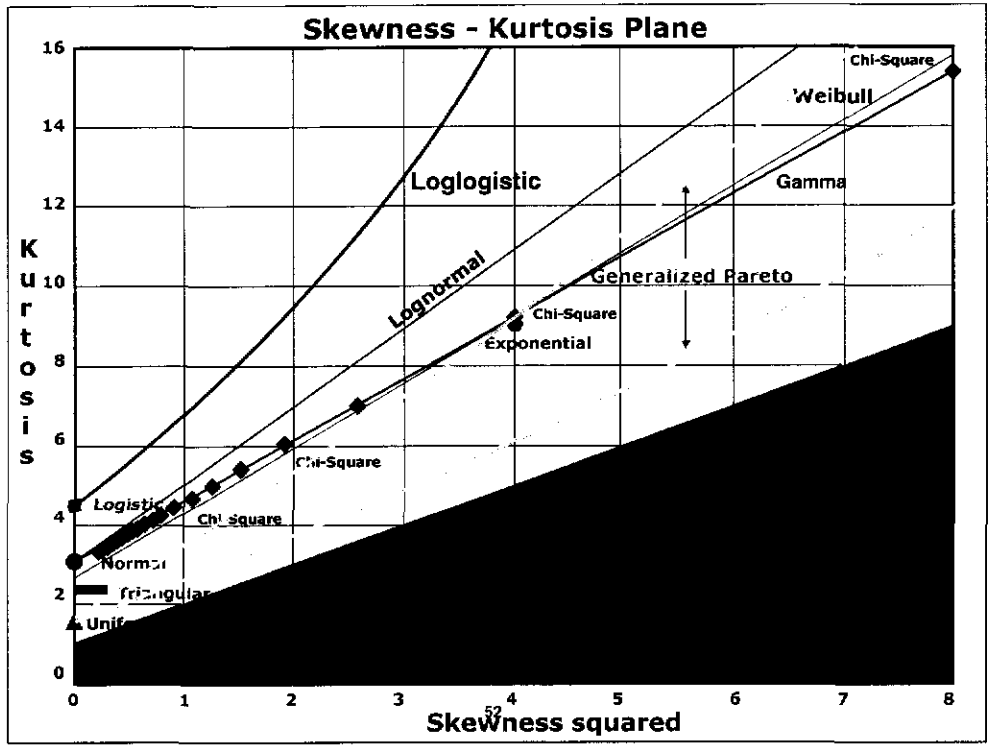
- In Dr. McCann's research on FIAs, he has assumed that the rates of return on the S&P 500 Total Return Index are normally distributed.
- This assumption is embedded in all of his simulations and in his risk-neutral pricing methodology, upon which his conclusions regarding FIAs are based. We test his assumption over the available data from January 1926 through October 2008, *as well as various sub-periods*.
- **The test results indicate that the normality assumption is unwarranted.**
  - Dr. McCann's conclusion that the 14-yr annuity beats a 50/50 portfolio of stocks and bonds no more than 2% (and in some cases, 0.2%) of the time is based on a simulation of normally, independently distributed monthly index returns
  - Our finding that stock returns are not normally distributed renders his simulation irrelevant; moreover, our use of the historical record demonstrates how his simulation cannot even begin to accommodate patterns of returns that actually did happen

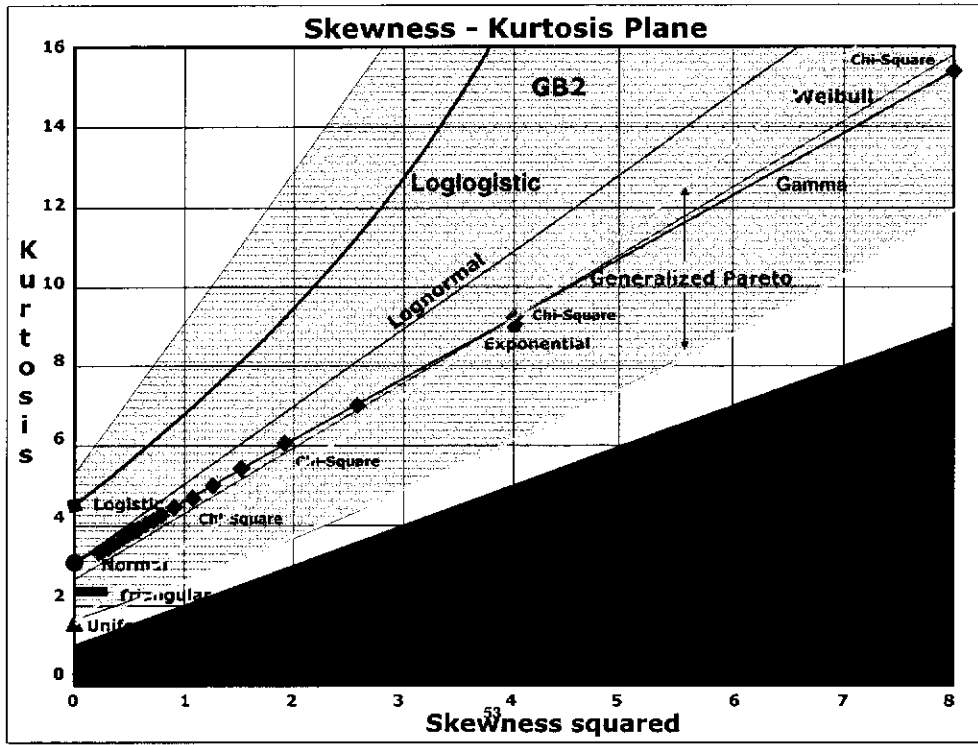


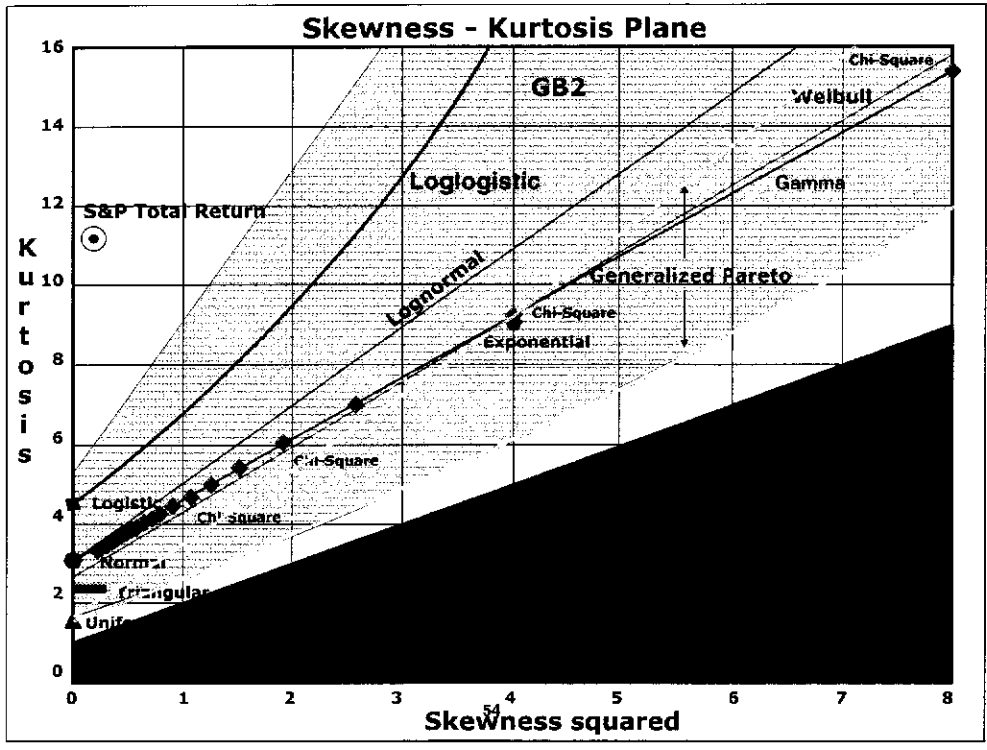


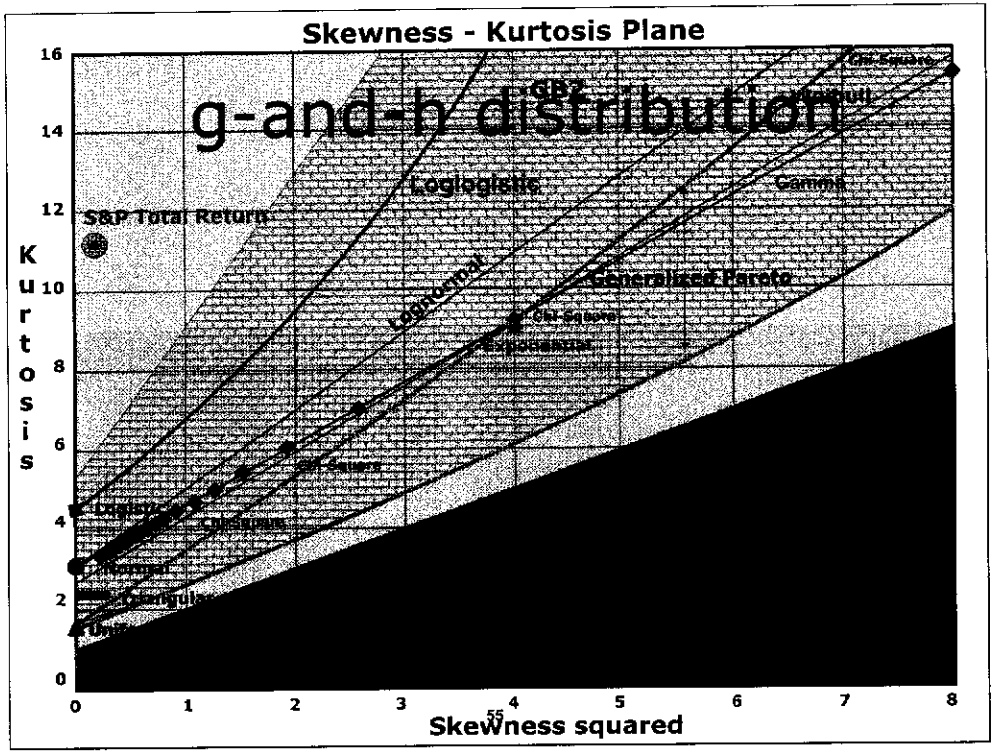












**Jarque-Bera (JB) Test on Monthly S&P 500 Returns  
Jan-1926 through Oct-2008**

The JB test combines the asymmetry (skewness) and peakedness (kurtosis) of a distribution to check for normality

The test reports very large values, compared to 27.63, indicating that the chances of normally distributed returns are far less than one in one million

Statistic	S&P 500	Total Return
N	994	994
Mean	0.44%	0.77%
STDEV	5.54%	5.51%
Skewness	-0.525	-0.483
Kurtosis	11.020	11.050
JB Test-Statistic	2,709.55	2,722.31
P-Value	0.0000%	0.0000%

Odds	Critical Values
5 in 100 (5%)	5.99
1 in 100 (1%)	9.21
1 in 1,000 (0.1%)	13.82
1 in 1 million (0.0001%)	27.63

A test-statistic greater than 5.99 means that chances are less than 5% that the data are normally distributed, and so on.



**According to the Jarque-Bera test for normality,  
there is less than one chance in one bicentillion  
that the actual underlying distribution of monthly  
equity returns is normally distributed...**

**How much is one bicentillion?**



## **Equity Indexed Annuities Performance Analysis**

### **3. Long-Run View**

---

- **We consider monthly returns for the period Jan-1926 through Feb-2008 and compare implied annuity account values with the values of alternative investments over the full terms of the various annuities considered**
  - We assume that an annuity is issued at the beginning of each month starting on January of 1926
  - We compare the annuity's annualized returns over the term of the contract with annualized returns for alternative investments over the same period
  - A normality test strongly concludes that monthly S&P returns are not normally distributed. This conclusion makes Dr. McCann's simulation irrelevant and justifies our use of the historical record to compare annuities with alternative investments
  
- **The data used in this section are monthly returns on the S&P 500 index, and intermediate-term government bonds from Morningstar's SBBI**
  - Monthly returns are adjusted for fund fees based on Vanguard's stock and bond funds data used in the previous section

### **3. Long-Run View**

#### **Equity Indexed Annuities Performance Analysis**

---

- **We next consider monthly S&P 500 Index returns for the period January 1926 through February 2008 and calculate implied account values and the value of alternative investments over the full term of the various annuities considered**
- **We then look at the annualized rates of return on annuities and alternative investments over the accumulation phases of the annuities**
  - We assume that an annuity is issued at the beginning of every month, starting January 1, 1926 and ending March 1, 1994 (for the 14-year annuity) or March 1, 1999 (for the 9-year annuity)
  - The alternative investment also starts on the same day, and has the same investment horizon, as the corresponding annuity
  - The annualized returns for the annuity are calculated for all historical paths and histograms are constructed to compare the performance of annuities and alternative investments
  - In the spirit of Dr. McCann's treatment of dividends, we construct a Total Return Index by adding a constant dividend yield to the monthly S&P 500 Index return

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- 1) All are held to term
- 2) None of these annuities include any of the post-1/1/95 annuities already considered
- 3) We are not pretending we issue annuities in 1926 or 1927, or any other year, for that matter. Rather, we are looking at the litigated annuities and simply using the empirical distribution of historical returns as a better or more realistic representation of what could happen than McCann's simplistic "normal return distribution"
- 4) The historical realized annual return on the S&P, with dividends, was 12.25%, roughly equivalent to McCann's assumed 10% + 2.5% dividends; however, its standard deviation was close to 20%, which exceeds McCann's standard deviation of 15%

### **3. Long-Run View**

#### **Percent of Times the Annuity Beats Alternative Investments**

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**"... there is a pretty broad range of asset allocations that give you the stock and bond portfolio being better 98, 98.5, almost 99 percent of the time."**

**Craig McCann, Ph.D., CFA.**

### 3. Long-Run View

#### Percent of Times the Annuity Beats Alternative Investments

"... there is a pretty broad range of asset allocations that give you the stock and bond portfolio being better 98, 98.5, almost 99 percent of the time."

Craig McCann, Ph.D., CFA.

S&P 500 Index	41.9%	58.0%
S&P 500 Total Return Fund	21.5%	37.1%
50/50 Portfolio	33.8%	63.3%
50/50 Portfolio (Z-Bond)	25.0%	56.3%

62

Here we are considering only the final payoff amount, as per McCann. Each of these annuity periods used allows the annuity to mature at full term. The final annuity issued was in 1994, which would mature in 2008 in the case of a 14-year annuity.

### 3. Long-Run View

#### Percent of Times the Annuity Beats Alternative Investments

S&P 500 Index	41.9%	58.0%
S&P 500 Total Return Fund	21.5%	37.1%
50/50 Portfolio	33.8%	63.3%
50/50 Portfolio (Z-Bond)	25.0%	56.3%

**Contrary to Dr. McCann's assertions, the 14-yr annuity, as well as the 9-yr annuity, beat the alternative investments a lot more often than 2% of the time, from 21.5% to 63.3% of the time, based on the long-run historical evidence**

### **3. Long-Run View**

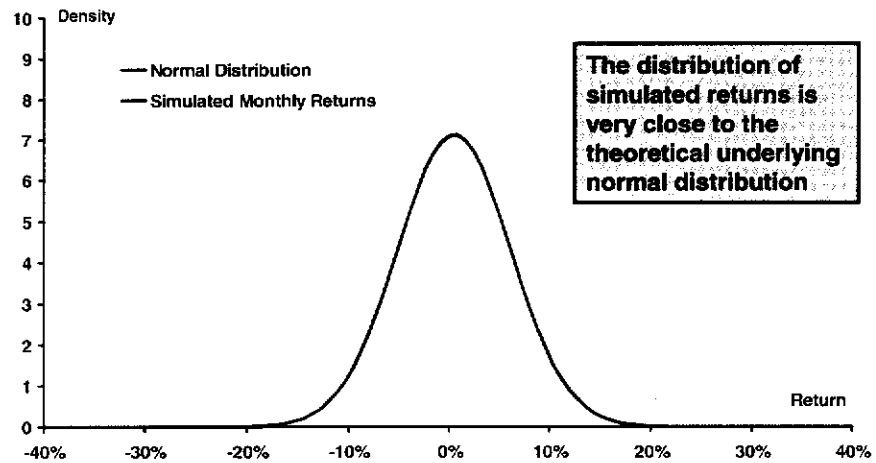
#### **Non-Normality, Dependence and Crediting Rates**

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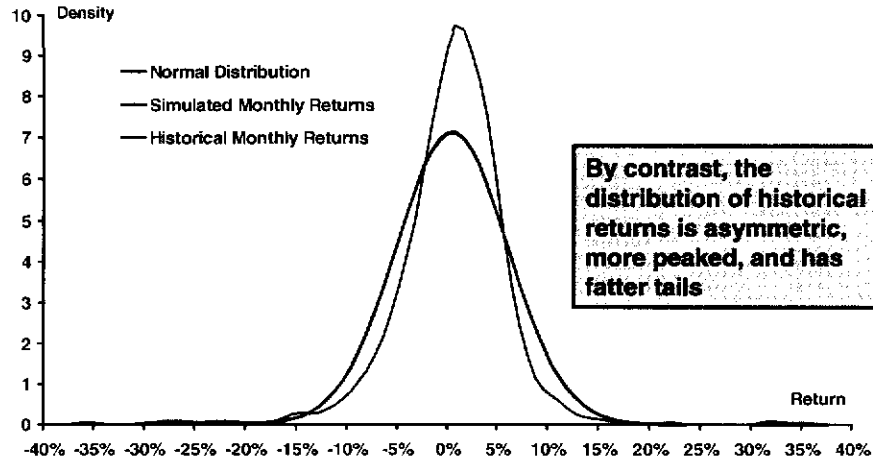
- **Dr. McCann's Simulation, used in both his "Benefit of the Bargain" and "Out of Pocket" calculations is flawed not only because his normality assumption fails, but also because:**
  - The assumption that monthly S&P 500 returns are independent also fails (p-value of lack of correlation test is 0.0199)
  - The crediting rate formulas, when combined with the non-normality of, and dependence among monthly S&P 500 returns result in a distribution of crediting rates that is fundamentally different from the one implied by Dr. McCann's simulations
  
- **The following slides illustrate the fundamentally different historical and simulated distributions and implied crediting rate distributions**
  - Monthly S&P Index returns are simulated with the same mean and variance as the historical monthly returns
  - And they are simulated under Dr. McCann's assumptions of normality and independence
  - The corresponding annual crediting rates are also derived for both the historical and simulated return series
  - We simulate 600,000 monthly returns and 50,000 corresponding crediting rates



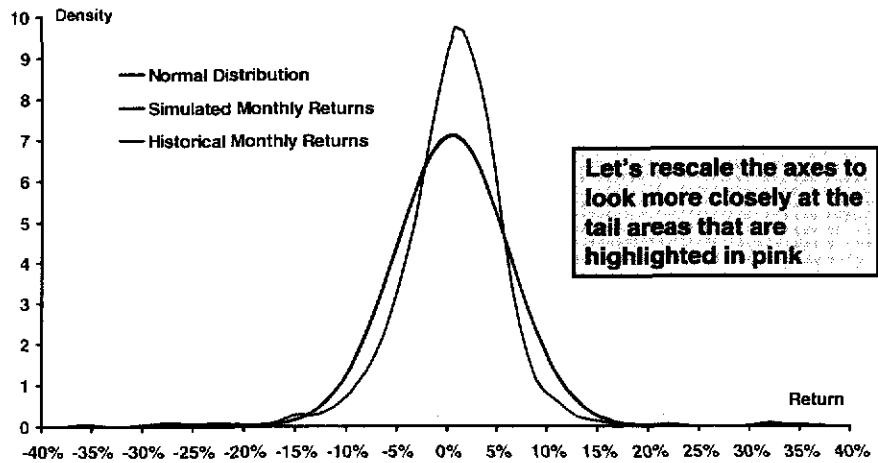
## Distribution of Historical (Jan-26 through Feb-08) and Simulated Monthly S&P 500 Returns



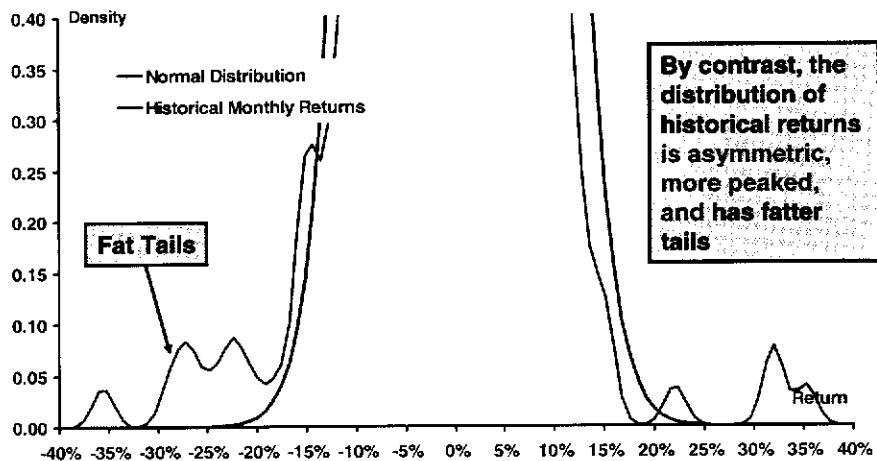
## Distribution of Historical (Jan-26 through Feb-08) and Simulated Monthly S&P 500 Returns



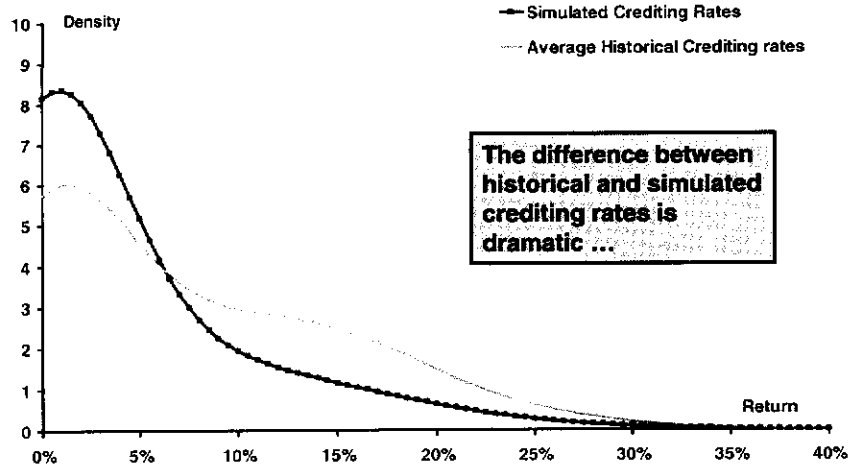
## Distribution of Historical (Jan-26 through Feb-08) and Simulated Monthly S&P 500 Returns



### Distribution of Historical (Jan-26 through Feb-08) and Simulated Monthly S&P 500 Returns – Focus on Tails



## 14-yr Annuity: Historical and Simulated Crediting Rates

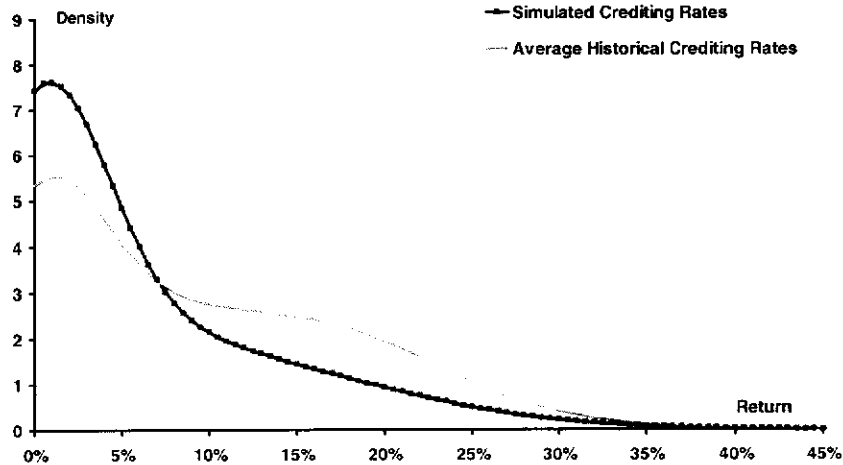


**The difference between historical and simulated crediting rates is dramatic ...**

Note: Since the minimum guarantee applies to the terminal value of the policy, it is not incorporated in the calculation of the crediting rate distributions. This understates the ability of the annuity to beat alternative investments.

Average crediting rate distribution

## 9-yr Annuity Historical and Simulated Crediting Rates



Note: Since the minimum guarantee applies to the terminal value of the policy, it is not incorporated in the calculation of the crediting rate distributions. This understates the ability of the annuity to beat alternative investments.

Average crediting rate distribution



#### **4. Do Critics Value FIAs Correctly?**

Critique of McCann's quasi-risk-neutral valuation approach:

1. Ignores valuable options. We incorporate mortality risk and penalty-free withdrawals even assuming the naïve complete-markets, log-normal return assumptions of McCann. We do not even include the valuable option to switch indexing buckets.
2. We also ignore the inappropriateness of assuming complete markets and independent log-normal return distribution.

#### **4. Do Critics Value FIAs Correctly**

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- **Dr. McCann uses the risk-neutral valuation approach**
  - Assumes complete markets
  - Assumes log-normally, independently distributed index returns
  
- **This valuation approach does not incorporate the value of annuity features such as mortality risk, penalty-free withdrawals, the option to switch crediting buckets, etc.**
  
- **I apply Dr. McCann's model to a 17-year annual point-to-point annuity, with a 7% annual cap, a 10% premium bonus.**
  - I incorporate mortality risk and penalty-free withdrawal features using the company's mortality tables
  - I assume that 10% of the initial premium can be withdrawn annually and that the minimum account value is \$1,000.



**Relevance of Mortality Risk and Penalty-Free Withdrawals  
(per dollar of premium)**

[1]	Dr. McCann's Value of 17-year Annuity:	\$0.69
[2]	Estimated Value of Annuity Using Correct 100% Participation Rate:	\$0.76

*Panel A: Incorporating Mortality Risk*

Discount Rate	Purchase at Age 65		Purchase at Age 75		Purchase at Age 80	
	Female	Male	Female	Male	Female	Male
[3] AA Insurer's Rate	\$0.79	\$0.81	\$0.83	\$0.86	\$0.88	\$0.90
[4] Risk-Free Rate	\$0.88	\$0.90	\$0.92	\$0.94	\$0.95	\$0.97

*Panel B: Incorporating Mortality Risk and Penalty-Free Withdrawals (at 10% per year)*

Discount Rate	Purchase at Age 65		Purchase at Age 75		Purchase at Age 80	
	Female	Male	Female	Male	Female	Male
[5] AA Insurer's Rate	\$0.95	\$0.96	\$0.96	\$0.98	\$0.98	\$0.99
[6] Risk-Free Rate	\$1.00	\$1.00	\$1.01	\$1.02	\$1.02	\$1.03

The annuity in this case is a 17-year annual point-to-point annuity with an annual cap of 7% and a premium bonus of 10%.

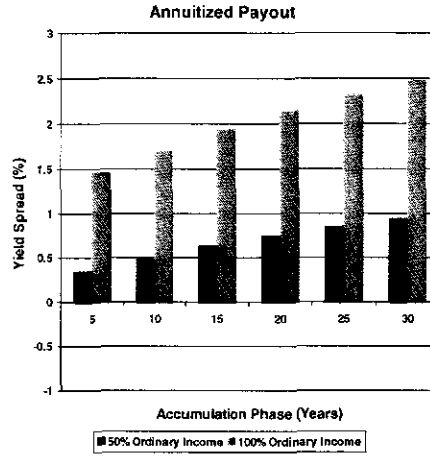
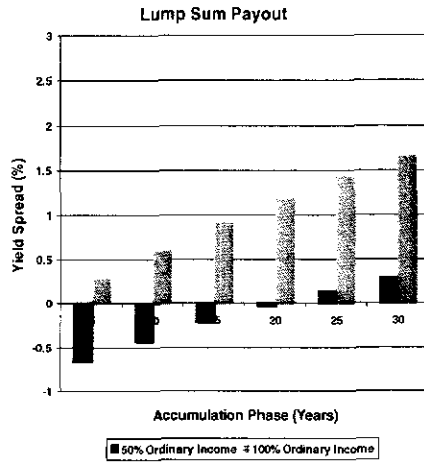
73

This is an index annuity with an annual point-to-point crediting rate, an annual cap of 7%, a premium bonus of 10% and a minimum guaranteed rate of 2.25%. The surrender charge period is 17 years.

Note, these figures are still ignoring several items that, if included, would improve the benefit-to-cost ratios even more:

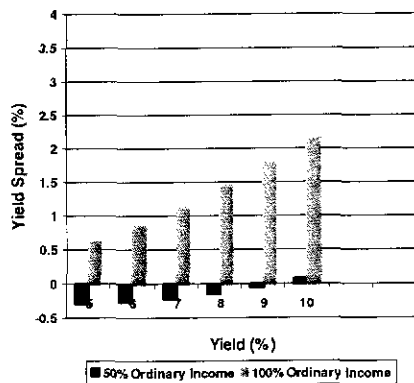
- 1) non-normal rates of return (we showed that using a realistic or historical distribution of returns, there was double the likelihood of achieving high crediting rates (10%-30%) than would be produced using McCann's fictitious "normal" rate of return distribution with independently and identically distributed increments.
- 2) It ignores tax deferral benefits, which can range as high as 100-350 basis points per year – in other words, an alternative asset would have to earn that much more per year than an annuity in order to break even in after-tax dollars; for some classes of people, this could be a negative benefit
- 3) It ignores risk aversion and downside risk

## Effect of Time Horizon on Yield Spread

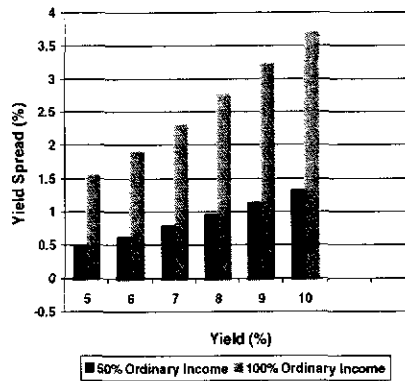


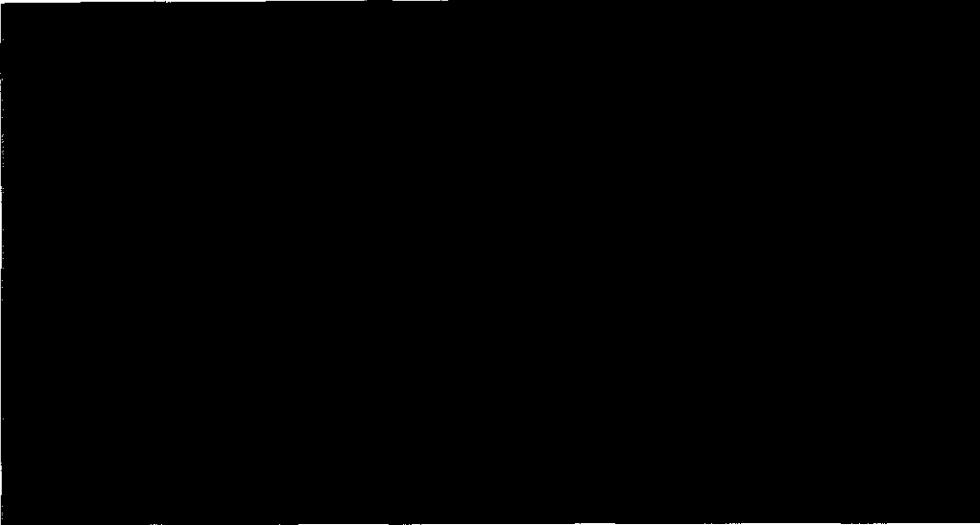
## Effect of Investment Yield on Yield Spread

Lump Sum Payout



Annuitized Payout





## 5. Risk Tolerance and FIA Suitability

Again, focusing only on the distribution of crediting rates under realistic assumptions and ignoring valuable options, we observe that many rational investors with very moderate degrees of risk aversion will value FIAs more than McCann's alternatives.

## **5. Risk Tolerance and FIA Suitability**

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- **The analysis in Sections 1 and 2 considers the distribution of annualized returns for the annuity and alternative investments over certain time periods**
- **This analysis is useful because it shows that it is not obvious that, as Dr. McCann argues, no rational investor will purchase annuities such as the ones considered**
- **But it does not conclusively demonstrate that there may be a large class of individuals who would rationally purchase FIAs in preference to the investment alternatives considered here**
- **By taking into account an individual's risk tolerance, it is possible to establish for what degrees of risk aversion a rational individual prefers an annuity to an alternative investment**

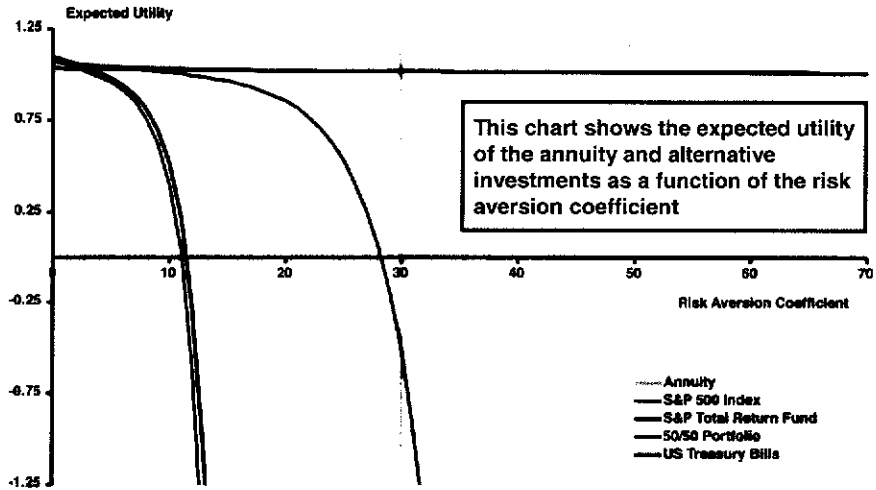
## 5. Risk Tolerance and FIA Suitability

**"The ... annuities are so inferior compared to readily available alternative investments – such as alternative investments in Treasury securities and in equity mutual funds – that class members would not rationally purchase these annuities if all material facts concerning the annuities were told to them."**

**Craig McCann, Ph.D., CFA**

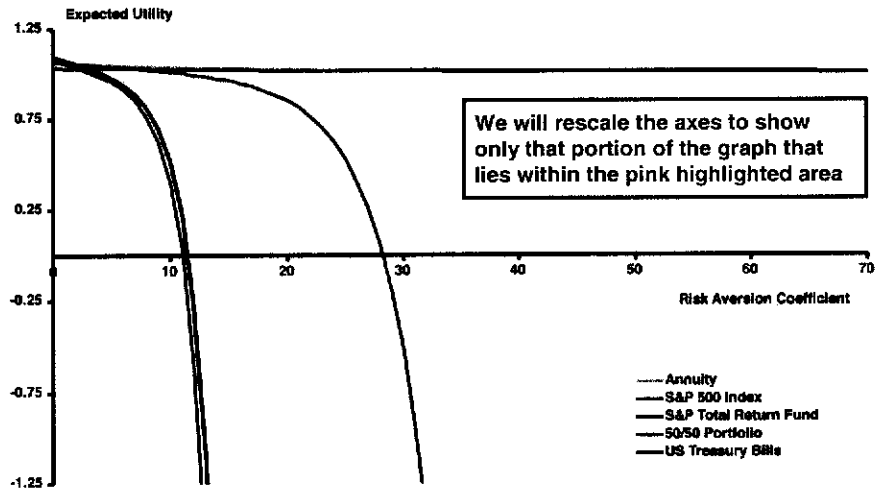
- **We conclude that many rational individuals will prefer annuities to alternative investments**
  - Based on the historical data used, moderately risk-tolerant individuals would generally prefer FIAs to alternative investments when forced to chose between an FIA and an alternative investment
  - And individuals who are even more risk-tolerant would include FIAs in a diversified portfolio
- **This conclusion disproves Dr. McCann's assertion**

## 14-yr Annuity v. Alternatives Impact of Risk Tolerance on Expected Utility



# 14-yr Annuity v. Alternatives

## Impact of Risk Tolerance on Expected Utility

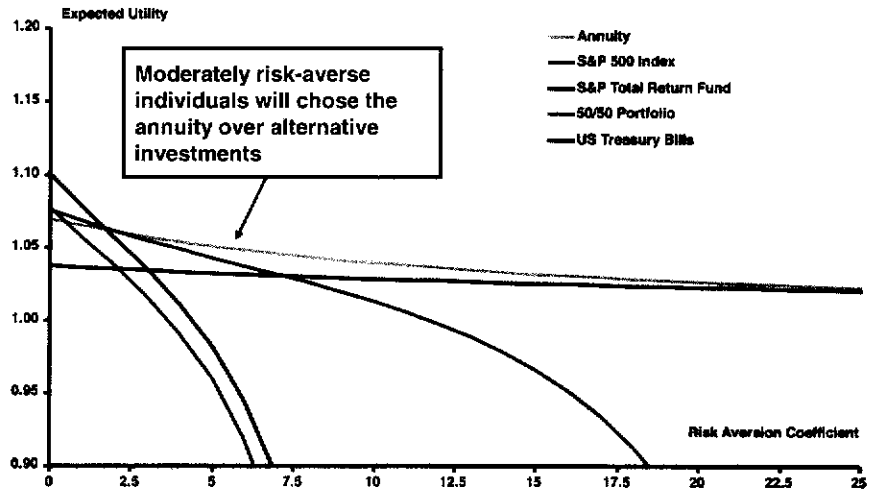


We will rescale the axes to show only that portion of the graph that lies within the pink highlighted area



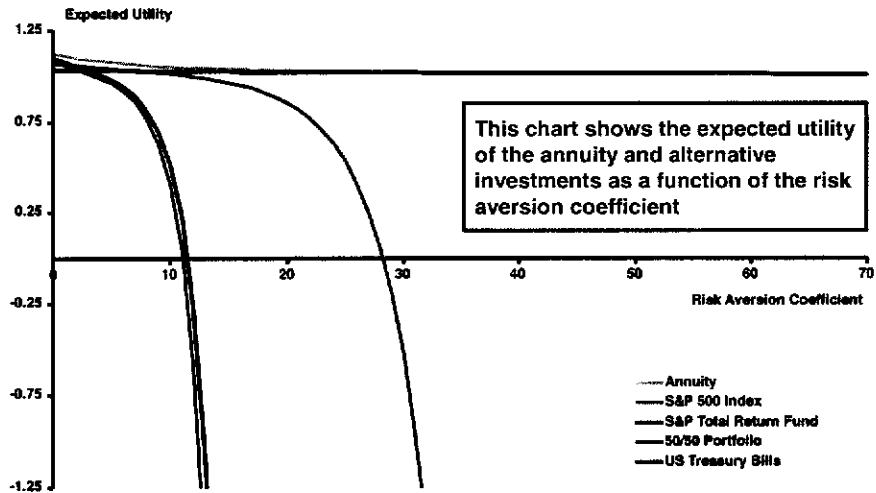
# 14-yr Annuity v. Alternatives

## Impact of Risk Tolerance on Expected Utility - Detail

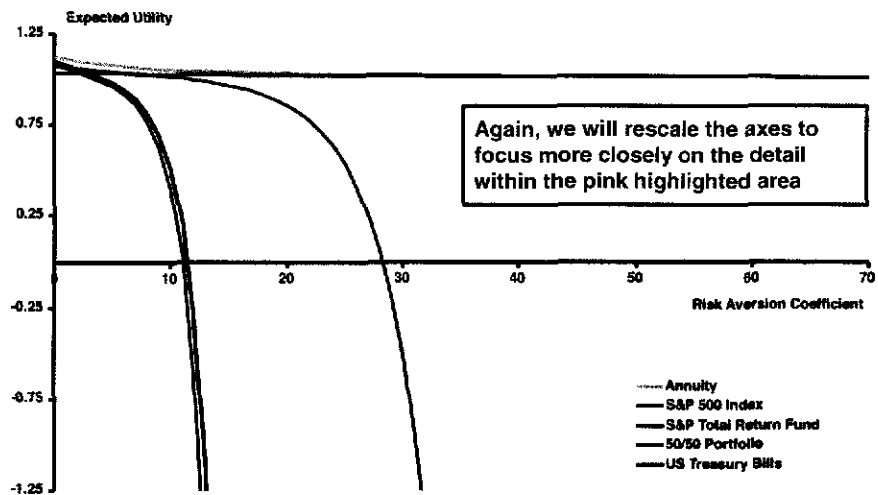


# 9-yr Annuity v. Alternatives

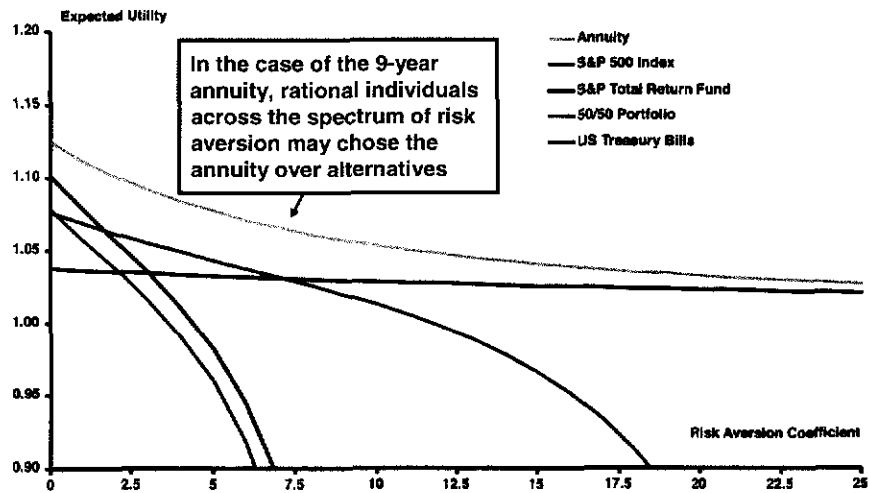
## Impact of Risk Tolerance on Expected Utility



## 9-yr Annuity v. Alternatives Impact of Risk Tolerance on Expected Utility

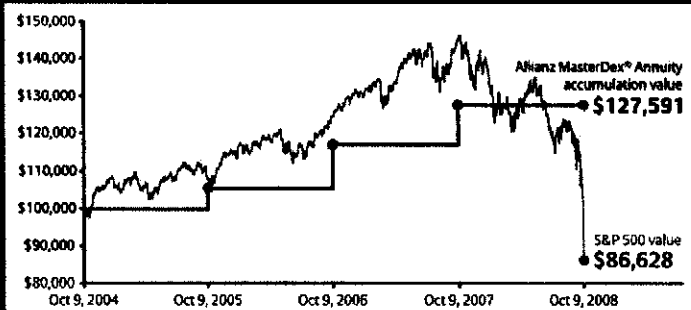


## 9-yr Annuity v. Alternatives Impact of Risk Tolerance on Expected Utility - Detail



**End of Presentation**

# Is this insurance protection worth paying for?



Fixed annuities are insurance products and not investments. Results will vary based on the crediting method and the allocation options chosen, caps, spreads and/or participation rates. Although there is a monthly cap on positive monthly interest credits, there is no established limit on negative monthly interest. Results will also vary by the index value at the time of the initial purchase, as well as at each monthly and annual contract anniversary valuation, regardless of interim index values. To illustrate, this example represents actual values of a single tier Allianz MasterDex Annuity for the four year period from October 9, 2004 to October 9, 2008. If this example commenced when the contract first became available on 5/25/04, the corresponding 'accumulation value' would be less (\$123,260) due to the difference in the S&P 500 index at that time as incorporated into the interest crediting method. This example assumes 100% allocation to the S&P 500 index option with the monthly sum crediting method. The cap, which is declared annually and guaranteed to never be less than 1.0%, averaged 3.06%. This example represents actual past interest crediting and does not guarantee future interest crediting. The S&P 500 value includes dividends.

Today's market volatility can make fixed index annuities more attractive than ever. They don't lose a dime of their value when the contract conditions are met. A surrender charge will be imposed for a single tier product that is surrendered early, and a penalty will apply if a two tier product is not annuitized as described below. The initial principal and credited interest are locked in, protected, and guaranteed safe.

Annuities are designed to meet long-term needs for retirement income and have a variety of income and annuitization options. Because fixed annuities are insurance products and not investments, they provide guarantees against loss of principal and credited interest, and the reassurance of a death benefit for beneficiaries.

To learn how an Allianz annuity can be an important part of your financial strategy, ask your financial professional or call 800.950.7855.

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**Allianz** 

Indexed interest credited may be limited by caps, spreads, and/or participation rates. Ask your financial professional for current information or call the number above to receive a consumer brochure and Statement of Understanding.

Single tier annuities have surrender periods that vary by product. If you surrender your contract during this period, we will apply a surrender charge. This may result in a loss of bonus (on bonus annuity contracts), any earned interest, and a partial loss of principal. Two tier annuities require that the annuity be held for a minimum period and annuitized over a minimum period. Failure to do so will result in similar losses of bonus, interest and principal.

Fixed index annuities are insurance products. They are not securities, and although an external index may affect your contract values, the contract does not directly participate in any stock or investments. You are not buying shares of stock or shares of an index fund. It is not possible to invest directly in an index. As reflected above, during periods when the index does not grow or declines, the contract value remains stable, but no additional interest is credited to the contract value.

Guarantees are backed by the financial strength and claims-paying ability of the issuing company.

**The purchase of an annuity is an important financial decision. You should have a full discussion with your financial professional before making any decision.**

## Allianz Life Insurance Company of North America Allianz Life Insurance Company of New York

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Allianz Life Insurance Company of New York is authorized to sell insurance and annuities in New York.

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Product availability and features may vary by state.

PS0614, PS0614-NY



\*The chart compares the 12-year accumulation value (premiums + interest credited) of LSW's SecurePlus Gold (Policy Form Nos. 7912 and 7918), an indexed annuity, and LSW's SPDA 5 (Policy Form No. 7682), a traditional fixed annuity. Both policy terms have a 10 year withdrawal charge period.

The above illustration is reflective of a single premium payment into both LSW annuities, with an issue date of 10/21/1996. Past interest credited results are no indication or guarantee of future interest credits. \*Interest rate is annual effective rate.

## LSW...Proven Results!

### *The Trusted Leader in Indexed Annuities.™*

Life Insurance Company  
of the Southwest



Form No. 9473LSW (1108)

Over twelve years ago, LSW was one of the first companies in the industry to develop a fixed indexed annuity. Today, we continue to design and deliver quality fixed indexed products to help diversify a customer's financial portfolio and to meet his or her long-term retirement savings needs.

LSW designs fixed indexed annuities with one major goal in mind; to provide significant guarantees with the potential of providing more interest than a traditional fixed annuity. It is that simple. Over the last 12 years, LSW has met this goal, delivered on its promises, and has met its policyholders' expectations.

If you are a financial professional or a marketing organization who values your reputation and puts the needs of your clients first, then we invite you to join LSW, a company that promotes innovation, integrity, and outstanding marketing practices. We at LSW do not hide our renewal rate history. *We know of its critical importance to our policyholders, and we publish it!*

***LSW...Integrity You Can Retire On!™***