3131

MEMORANDUM

To: File No. S7-14-08

From: Smeeta Ramarathnam
Office of Commissioner Aguilar

Date: December 19, 2008

Re: Indexed Annuities and Certain Other Insurance Contracts – Release No. 33-8933

On December 15, 2008, Commissioner Aguilar and Smeeta Ramarathnam, Counsel to the Commissioner, met with Eric L. Marhoun, Senior Vice President, General Counsel & Secretary, Old Mutual Financial Network; Tom McDonald, Baker & Hostetler LLP; and Robert Elconin, Lindquist & Vennum. The participants discussed proposed Rule 151A.

At the meeting, Old Mutual Financial Network provided various documents relating to proposed Rule 151A, including a 15-page handout titled "Old Mutual's View of SEC Rule 151A." Copies of the documents are attached to this memorandum.

Attachments

A PRESENTATION TO:

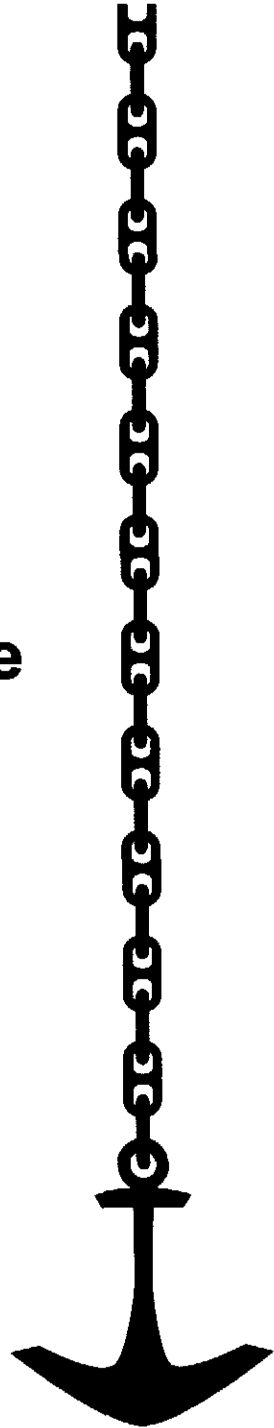
Hon. Kathleen Casey
Commissioner, SEC

Old Mutual's View of SEC Rule 151A

PRESENTED BY:

Eric Marhoun

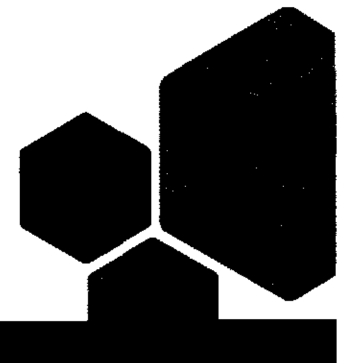
October 20, 2008



OLD MUTUAL
INVEST INSURE INNOVATE

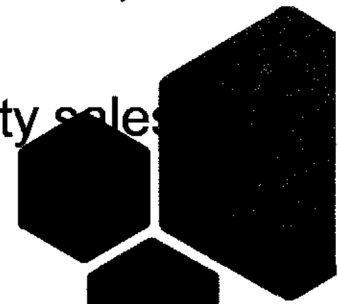
Executive Summary

- Rule 151A is unnecessary and overly burdensome – goes beyond marketing to seniors.
- Rule 151A ignores the efforts of State Insurance Commissioners in addressing sales practices.
- Rule 151A is so broadly written that it would apply to all annuities, and ultimately all interest-crediting life insurance.
- Rule 151A would have an adverse impact upon Old Mutual Financial, its 400 employees and 30,000 independent producers.



Background on Annuities

- A leading retirement product offered by life insurance companies offering:
  - Guaranteed retirement savings and asset protection
  - Probate efficiencies
  - Guaranteed income options like annuitization
- Benefits of FIAs:
  - Guaranteed accumulation with no up-front sales charge
  - Tax deferral
  - Withdrawal or annuitization rights
- Regulated by state insurance departments. 3 basic types: FIAs, declared rate and VAs.
- Growth from @$4B in 1998 to $25B in 2007; 10% of annuity sales



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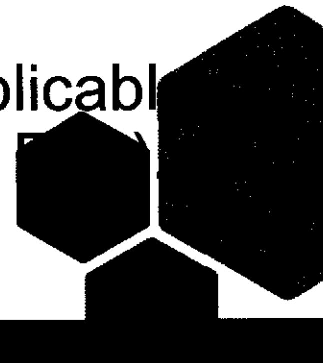
Overview of Rule 151A

- Proposed by the SEC without any real warning after over a decade of non-action by the SEC other than 2005 voluntary information request.
- Imposes an unprecedented two-prong test that could be read to apply to nearly all non-variable annuities and, ultimately, to all interest-crediting life insurance policies.
- Applies to insurance products which have been regulated as insurance products since their inception almost 13 years ago.
- Ignores State Insurance Department suitability regulation developed over the past 5-6 years applicabl to FIA sales practices (and prior Unfair Practices



Fixed Index Annuities ***not*** Securities

- Fixed Index Annuities (FIAs) are fixed annuities and have no market risk.
- The 151A release incorrectly equates the purchase of an FIA with an investment in a market index.
- The only difference between a traditional declared rate annuity and an FIA is the manner in which annual interest is calculated.
- In both cases, the full contract value, including premium plus interest credited in all prior years, is ***not*** exposed to ***any*** market risk.
- The consumer cannot lose money due to the market.

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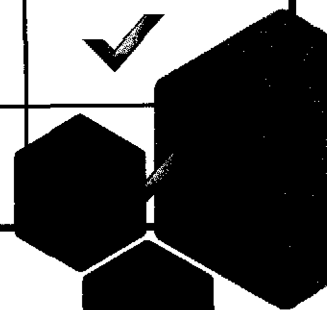
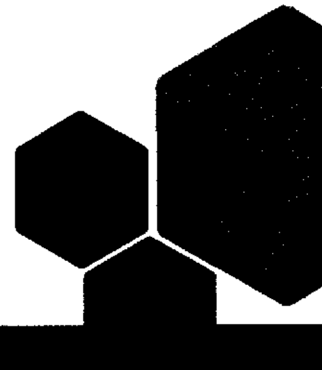
Comparison of Annuities

	Declared Rate Annuity	Fixed Index Annuity	Variable Annuity
Guarantee of premium and minimum interest	✓	✓	
Annual interest at rates declared by the insurer	✓		
Annual interest linked to an external index		✓	
Consumer bears Market Risk			✓
Tax-deferred growth	✓	✓	✓
No up front sales charges or annual fees	✓	✓	
Penalty-free 10% annual withdrawals starting in yr 2	✓	✓	✓
Penalty-free systematic interest withdrawals	✓	✓	✓
Surrender charges apply for withdrawals above 10%, waived at death	✓	✓	✓
Additional liquidity upon nursing home confinement or terminal illness or unemployment	✓	✓	[illegible]



Why Consumers Buy FIAs

- The SEC 151A release incorrectly concludes that FIAs are marketed and purchased primarily for market gains.
- FIAs are purchased primarily for safety of premium with the potential for additional credited interest.
- FIAs offer consumers the opportunity to earn a somewhat higher interest rate than would be paid on a declared rate product.



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Consumers Bear *no* Investment Risk

- The 151A release mistakenly states that an FIA purchaser assumes investment risk comparable to a variable annuity or mutual fund. **This is incorrect and has led to a totally unprecedented proposed Rule with 2-prongs having no basis in law.**
- FIA investment risk is limited to fluctuations in annual interest (similar to declared rate annuity) subject to a guaranteed minimum.
- Prong 1 – reference to a Security: Many insurance and bank products not regulated as securities have fluctuating levels of annual interest – including e.g. indexed certificates of deposit.
- Prong 2 – more likely than not in excess of guarantee: Many insurance products not regulated as securities provide for "excess value" above guaranteed minimums.

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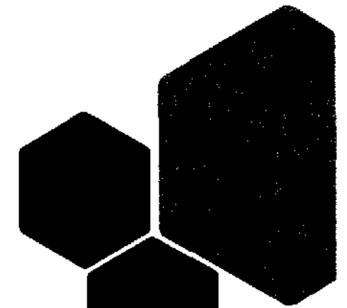
Insurer Investment Risk

- Fixed annuity insurers manage their "general account" securities to fund guaranteed FIA contract values.
- None of the risk of loss on general account securities is passed through to consumers.
- Variable annuities are "separate account" products where all investment experience of securities within the account is passed through to consumers, whether gain or loss.



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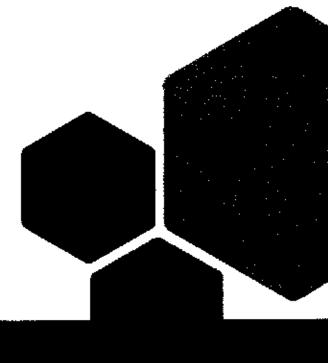
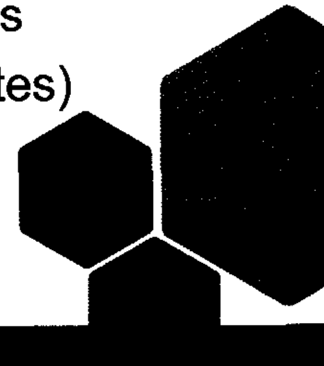
An Unnecessary Layer of Regulation

- Insurance Producers are already licensed and regulated by State Insurance Commissioners.
- Insurance Companies *as issuer* have duty to develop system of supervision with regard to annuity suitability.
- Insurance regulations impose disclosure and advertising requirements upon all annuity sales.
- Insurers apply suitability standards nationally.



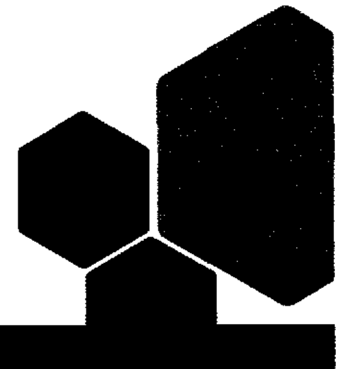
Insurance Regulation of Sales Practices

- The 151A release incorrectly states that the main focus of state insurance regulation is insurer financial solvency. **(Strongly disputed at SEC Senior Summit.)**
- State insurance regulation also covers (with some variation by state):
  - Annuity disclosure requirements
  - Suitability reviews
  - "Free-look" periods
  - Advertising
  - Unfair trade practices
  - Regulation of "replacements", or exchanges of annuities
  - Market conduct reviews of insurers
  - Levels of consumer guarantees in annuities/surrender charges
  - Agent licensing and training (specific FIA training in some states)
  - Insurance agent penalties for violations of sales rules



Complaints

- The 151A release states – with no evidence -- that complaints and abusive FIA sales practices are sharply increasing.
- NAIC complaint data shows fewer complaints regarding FIAs than VAs.
- NASAA maintains no complaint data that we (or others) have been able to locate.
- The NBC Dateline segment on FIAs featured only one actual consumer.



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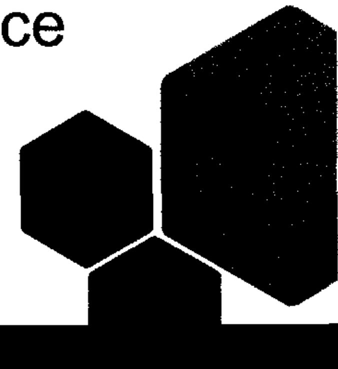
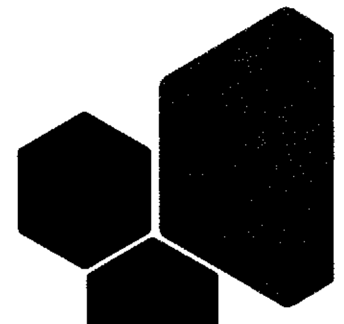
Insurance Regulation is Working

- The 151A release incorrectly states that fraud and abuse in sales to the elderly are closely linked to FIAs.
- Securities regulation is no more effective than state insurance regulation in protecting seniors from unscrupulous sales practices in sales of financial products.
- State insurance regulators are implementing new and enhanced protections for seniors, just as securities regulators are.
- SEC proposal will derail progress on sales practice regulation.



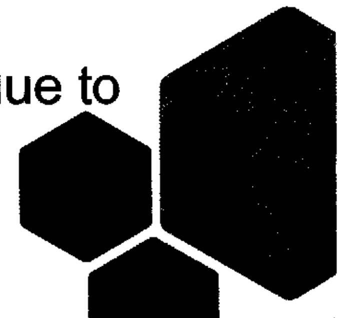
Old Mutual

- No Old Mutual FIA policyholder has ever lost a dime of contract value as a result of market volatility.
- Old Mutual conducts suitability reviews of all sales in all states.
- Old Mutual has a complaint ratio of less than 0.2% of all FIA contract-holders.



Additional Considerations

- Reach out to the NAIC, particularly the Annuity Suitability Working Group chaired by the Wisconsin Commissioner.
- Coordinate suitability enhancement efforts with the Annuity Working Group of which FINRA is a member.
- Rule 151A would have unintended consequences which have not been explored:
  - Diminish Guarantee Fund coverage for FIAs: "any policy or contract under which risk is born by the policyholder."
  - Diminish availability of product offerings in rural areas due to limitations imposed by OSJ requirements.



Comparison of Annuities

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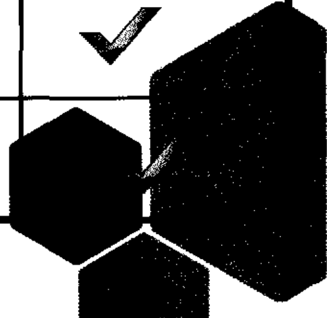
Consumer bears Market Risk			✓
Tax-deferred growth	✓	✓	✓
No up front sales charges or annual fees	✓	✓	
Penalty-free 10% annual withdrawals starting in yr 2	✓	✓	✓
Penalty-free systematic interest withdrawals	✓	✓	✓
Surrender charges apply for withdrawals above 10%, waived at death	✓	✓	✓
Additional liquidity upon nursing home confinement or terminal illness or unemployment	✓	✓	



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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,

Eugene Scalia

ES/djd

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.[1]

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").[2] 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

[1] 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.

[2] 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).[3]

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.").[4] 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.[5]

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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[3] 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.

[4] 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).

[5] 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.[6]

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

[6] 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).[7]

* * *

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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[7] 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.[8] 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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[8] 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.[9] 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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[9] 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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VIA COURIER

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

Re: *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 comments regarding the Securities and Exchange Commission's Proposed Rule 151A, which was published for comment on July 1, 2008.

Respectfully submitted,

Eugene Scalia /DJD

Eugene Scalia

ES/djd

Comments

of the

Coalition for Indexed Products

Regarding Proposed Rule 151A

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

September 10, 2008

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

The Coalition for Indexed Products (the "Coalition") hereby provides these comments on Proposed Rule 151A under the Securities Act of 1933 (the "Proposed Rule"). The Coalition comprises most of the largest fixed indexed annuity issuers, who together accounted for more than $17 billion in fixed indexed annuity sales in 2007. The Coalition is vitally interested in the Proposed Rule and welcomes this opportunity to comment.[1]

The Proposed Rule is profoundly flawed and the Coalition respectfully submits that the proposal should be withdrawn and that the Commission should affirm that fixed indexed annuities—as characteristically structured and offered by insurers today—are not securities within the meaning of the securities laws. As proposed, the rule would narrow the exclusion for annuity contracts in the Securities Act of 1933 (the "Act" or "'33 Act") in a way that is inconsistent with the plain text of the Act and the decisions of the courts. In place of the multi-factored consideration developed by the Supreme Court and previously endorsed by the Commission, the Proposed Rule would install a test that is centered upon a novel and groundless definition of "investment risk" and that ignores other important factors identified by the Court.

Properly understood, fixed indexed annuities are in fact annuities within the meaning of Section 3(a)(8) of the '33 Act, and the Commission's proposal to regulate them as securities manifests a misunderstanding both of these products and of the extensive state regulatory system for the oversight of all fixed annuity contracts. Because fixed indexed annuities already are thoroughly regulated by the states as Congress intended, the Commission also errs in claiming significant regulatory benefits for its proposal and is incorrect in claiming that the proposal will further efficiency, competition, and capital formation. In truth, the benefits claimed by the Commission already are realized through state regulation. The Proposed Rule would only impose an additional, unnecessary layer of conflicting regulatory requirements that would needlessly increase costs and drive from the market a substantial portion of the salesforce that insurers and consumers rely upon for the delivery of fixed indexed annuities. As it raises the

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[1] The Coalition's member companies are Allianz Life Insurance Company of North America, American Equity Investment Life Insurance Company, Aviva Life and Annuity Company, Conseco Insurance Company, EquiTrust Life Insurance Company, Life Insurance Company of the Southwest (a National Life Group company), Midland National Life Insurance Company, National Western Life Insurance Company, North American Company for Life and Health Insurance, OM Financial Life Insurance Company (an Old Mutual company), and OM Financial Life Insurance Company of New York.

costs paid by senior citizens and others for these popular products, the Proposed Rule would also restrict competition and the products available to consumers and would impose a burden that falls particularly hard on the small businessmen and women who are integral to the sale of annuities and other insurance products.

For these reasons and the reasons set forth at length below, the Coalition asks that the Commission withdraw its Proposed Rule and affirm that fixed indexed annuities as described below are annuity contracts that fall outside the Commission's regulatory authority.[2]

I. Factual Background: Fixed Indexed Annuities And Proposed Rule 151A.

A. Fixed Indexed Annuities.

Fixed Indexed Annuities ("FIAs") are annuity contracts under which purchasers receive a credit based upon the performance of one or more equity or bond indices, such as the S&P 500 Composite Stock Price Index or the Lehman Brothers Bond Index. Interest credited to an FIA contract is periodically "locked in" (typically on an annual basis) so that previously earned interest credits—like the principal itself—are protected against future decline in value.

The additional, index-based interest component of the contract gives the purchaser the opportunity to have his policy credited with a potentially higher interest rate than might be credited on traditional fixed-rate products—historically, FIA interest credits have averaged 1 to 2 percent higher than comparable fixed rates.[3] In years that the index declines, the purchaser receives no indexed interest, but all previously credited interest and premium payments are unaffected. The index-based component thus provides the purchaser the opportunity for higher indexed interest in years that the index rises, while protecting against index declines. Holders of fixed indexed annuities have experienced no reduction in contract values at any point during the volatile markets of recent years.

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[2] The Coalition previously requested an extension of the comment period for 90 days in order to fully respond to the issues raised in the Proposing Release. *See* Comment of the Coalition for Indexed Products (Aug. 19, 2008). The Coalition again emphasizes that, given more time, it could develop a fuller analysis of the Proposed Rule and provide a more complete response to the significant issues presented by the Proposing Release.

[3] *See Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 565 (7th Cir. 1991) (Easterbrook, J.) ("*AIAP*") (noting that traditional fixed annuities typically "carry relatively low (implicit) rates of return even in an inflation-free economy, because underwriters cannot readily hedge against changes in the economy-wide rate of return"). *See also* September 10, 2008, Statement of Mark Meyer, Ph.D., at 7 (attached as Addendum hereto) ("[T]he average annual credits will have an appreciably higher value than for the comparable fixed-rate annuity due to the typical historic characteristic of equity index increases exceeding the risk-free rate that is embedded in option pricing.").

The formula for calculating the amount of the indexed interest is generally reset annually in advance and includes a method to measure the change in the index, the percentage of the change allowed (the "participation rate"), and a minimum interest credit (the "floor") which is never less than zero. Upper-end "caps" are often applied to the amount of index-related credits for a given year—a 6 percent annual "cap" or 3 percent monthly cap, for example, would constitute the maximum amount credited that year or month for index-related gains. Features such as caps, participation rates, asset fees, spreads, and floors all have the effect of defining and moderating the impact of market factors by placing pre-determined upper and lower limits on the amount of the contract's index-related credits.

A critical feature of FIAs is the applicability of minimum nonforfeiture laws. These laws—which apply to fixed rate annuities also, but not to variable products—require FIAs to have a guaranteed minimum contract value even after any costs and charges are taken into account. Thus, after taking into account possible withdrawal charges discussed below, the contract value must be equal to at least 87.5 percent of initial premiums carried forward with interest at a rate of between 1 and 3 percent per year, depending on a legally-prescribed interest rate benchmark.[4]

Fixed indexed annuities generally also include liquidity options and mortality features. The liquidity options typically include (i) annual penalty-free withdrawals of up to 10 percent of the value of the contract; (ii) the ability to annuitize and receive a stream of payments for life and/or a specified period (these annuitization options frequently can be exercised before the end of the withdrawal charge period without the imposition of any withdrawal charge); (iii) a nursing home rider which permits increased withdrawals of a specified percentage of the contract value if the policyholder enters a nursing home; (iv) a terminal illness rider which permits a withdrawal of some or all of the contract value if the policyholder is terminally ill; and (v) for those fixed indexed annuities sold in qualified markets—such as Section 403(b), eligible governmental 457, and other 401(a) markets—policy loans may be issued up to statutory and/or plan limits.

Two mortality features are common in FIAs. Generally, upon the death of the policyholder (or annuitant), the full contract value is paid to the named beneficiaries without deduction of withdrawal charges. Policyholders may also sometimes annuitize their full contract value, without deduction of withdrawal charges, at any time after the first contract year for a period based on life expectancy.

When an FIA is sold, no sales charge is typically assessed. Instead, sales commissions are paid from the insurance company's general assets, allowing 100 percent of the premium paid

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[4] The minimum annual rate of interest is the lesser of (i) 3 percent per year or (ii) the five-year Constant Maturity Treasury Rate reported by the Federal Reserve, reduced by 1.25 to 2.25 percent but not less than 1 percent. *See* NAIC Standard Nonforfeiture Law. This guaranteed minimum nonforfeiture value applies only at surrender of the annuity contract; it does not establish a minimum policy value or cash value.

to be applied to the contract. In addition, minimum nonforfeiture laws guarantee that a contract owner will receive no less than 87.5 percent of premiums plus a minimum annual rate of interest even if the contract is surrendered in the first year, regardless of any otherwise applicable withdrawal charge. As reflected in the table attached hereto as Exhibit A, the guarantees in index products are comparable to those in traditional fixed-rate annuities.[5]

Unlike premiums from variable annuities, 100 percent of premiums from indexed annuities and other fixed annuities are deposited in the insurer's "general account" and, after deductions for expenses related to the sale of the annuity, invested in the general account. Indexed and other fixed annuity premiums are not placed in a segregated account as is the case of a variable annuity. A typical insurer's general account is invested in "permitted investments" as specified by state law, and consists primarily of high-quality fixed income securities, U.S. and government agency bonds, and other high-quality permitted assets.[6] The insurer bears the risk that changing interest rates and credit conditions will affect the value of the assets in its general account. Poor performance of the assets in the insurer's general account may require the insurer to reduce shareholders' equity to satisfy its obligations to policyholders. The insurer thus bears a wide variety of significant risks, including credit risk, prepayment and extension risk, interest rate risk, asset/liability matching risk, and hedging risk.

The insurer is required by state insurance laws to maintain prescribed levels of capital to support the risks of its business. Even higher capital levels may be required by rating agencies. The level of reserves the insurer maintains for its annuity liabilities is also governed by state insurance laws. Capital and reserve requirements for FIAs are calculated in a substantially identical manner to the calculation for traditional fixed annuities. Purchasers of FIAs are further protected by comprehensive "guaranty fund" laws similar to FDIC insurance. State insurance laws generally provide guarantee fund coverage of at least $100,000 per contract owner (in the event of the insurance company's insolvency) that is similar to the coverage for traditional fixed annuities, and substantially different from the coverage for traditional variable annuities.

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[5] As the Commission notes, some FIAs have been registered when there is an "absence of any guaranteed interest rate or the absence of a guaranteed minimum value." *See* Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release Nos. 33-8933, 34-58022, 73 Fed. Reg. 37,752, 37,754 n.17 (July 1, 2008) [hereinafter Proposing Release]. In this comment, we address FIAs as characteristically structured and offered by insurers today, namely, products that (1) meet state minimum nonforfeiture requirements; (2) declare participation rates, caps, and spreads a year in advance; (3) do not credit negative interest; and (4) "lock in" credited interest against future declines in value.

[6] A small portion of FIA premiums are not invested in typical general account bond investment assets but are invested in options and other similar types of vehicles to hedge against applicable market movements. Pursuant to most state laws, insurance companies in their general accounts are permitted to "hedge" but not "speculate." The insurance company—not the purchaser—assumes the potentially significant risks related to hedging, including changes in value and counterparty performance.

Companies that offer fixed indexed annuities generally adhere to advertising rules—some of which are prescribed by state law—that limit the ways in which fixed indexed annuities are marketed. For example, a variety of terms are prohibited that might confuse the customer as to the type of product being sold. The practice of Coalition members and the prevailing practice in the industry is to emphasize the safety and stability of the products, as well as the fact that FIAs are not investments in or alternatives to the stock market. Guaranteed minimum interest rates must be disclosed, and other similar features that protect against a reduction in value and provide long-term retirement security are also disclosed. The products are presented as long-term savings vehicles.

Except for the operation of the index interest crediting component of the product, the essential elements of fixed indexed annuities are identical to traditional fixed annuities. Unlike variable annuities and mutual funds, fixed indexed annuities do not credit "negative returns" to contract value. Also unlike variable annuities and mutual funds, fixed indexed annuities provide a guaranteed minimum nonforfeiture value. Fixed indexed annuities are subject to permitted investment laws, higher capital requirements, and guaranty fund coverage; variable annuities are not. All annuity products typically require a purchaser to pay fees for administrative costs or to agree to remain in the annuity contract for a certain period of time, with penalties—sometimes called surrender or withdrawal charges—for prematurely removing funds in excess of the amounts that are allowed by the many liquidity features noted above. It should go without saying that withdrawal charges—which are generally included in annuity contracts to cover the costs of premature withdrawals that impair the economic expectations on which the contract was based—are not a basis to distinguish fixed indexed annuities from other fixed annuities which share the same feature under close supervision of state law. *See also Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 567 (7th Cir. 1991) (Easterbrook, J.) ("*AIAP*") (stating withdrawal charges do "nothing to throw *investment* risk on the investor") (emphasis in original).

As discussed more fully at pages 20-27 below, states have a comprehensive regulatory system for fixed indexed annuities and other fixed annuity products, elements of which include mandatory disclosure of product terms; contract "readability"; evaluation of "suitability" of the product for the purchaser; monitoring of marketing; and authority to investigate complaints and institute enforcement actions regarding improper practices. Indeed, even as the Commission proposes to regulate fixed indexed annuities *as securities*, it has encouraged state regulation of the products *as annuities* and relies upon that regulation to this day.

B. The Proposed Rule.

Proposed Rule 151A would define a class of annuities that would be deemed ***not*** to be an annuity or optional annuity within the meaning of Section 3(a)(8) of the '33 Act. The Proposed Rule has two prongs. The first determines whether the product is within the bounds of the rule at all by inquiring whether the annuity is "indexed" in some fashion; the second prong then applies a purportedly closer analysis to determine whether the product is indeed *not* an annuity for purposes of Section 3(a)(8). Specifically, under Proposed Rule 151A an annuity would be a security 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;[7] and

(2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release Nos. 33-8933, 34-58022, 73 Fed. Reg. 37,752, 37,774 (July 1, 2008) [hereinafter Proposing Release]. The second prong purportedly accounts for investment risk borne by the purchaser. The status under the '33 Act of annuities that fall outside the definition (*i.e.*, are not "not an annuity") "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.

II. Fixed Indexed Annuities Are Annuity Contracts Within The Meaning Of Section 3(a)(8).

Section 3(a)(8) of the '33 Act excludes from the Act any annuity contract (or optional annuity contract) issued by an insurance company subject to the supervision of a state insurance commissioner (or similar entity or official).[8] The plain meaning and purpose of the Act, Supreme Court precedent, and lower court decisions all make clear that fixed indexed annuities as characteristically structured are covered by Section 3(a)(8) and are exempt from regulation by the Commission. The Commission should acknowledge this and withdraw its Proposed Rule.

A. Fixed Indexed Annuities Are Annuity Contracts Within The Plain Meaning Of The Statute.

Application of Section 3(a)(8) begins with the plain meaning of the words in the statute. *BedRoc Ltd., LLC v. United States*, 541 U.S. 176, 183 (2004). In relevant part, Section 3(a)(8)

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[7] "Security" would have the same meaning it has in Section 2(a)(1) of the '33 Act. *See* Proposing Release at 37,759.

[8] Section 3(a)(8) of the Act provides in full:

> Section 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> . . .
>
> (8) Any insurance or endowment policy or annuity contract or optional 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[.]

A product falling within Section 3(a)(8) is also exempt from all other provisions of the Act. *Tcherepnin v. Knight*, 389 U.S. 332, 342-43 n.30 (1967); Proposing Release at 37,755 n.27.

excludes "[a]ny insurance or endowment policy or annuity contract or optional annuity contract" from the Securities Act. Two things are notable about this language: First, if a contract is an annuity (and is issued by a corporation regulated by a state insurance commission or the like), it is exempt from SEC regulation. Section 3(a)(8) is not an invitation for the Commission to speculate about the *types* of annuities that Congress might have wished the SEC to regulate and those left for the states. And the Commission's view of the "regulatory and protective purposes" (Proposing Release at 37,757; citation omitted) of the securities laws will not suffice to regulate an instrument otherwise properly regarded as an annuity, not a security.

Second, the text of Section 3(a)(8) separately refers to insurance policies *and* annuity contracts—the two are not the same, and the Commission may not predicate a rule on the assumption that annuities must display *all* the characteristics of life insurance, for instance, and none that are associated with investments. "[C]ontracts of life insurance and of annuity are distinctly different," 1 J. Appleman & Appleman, *Insurance Law and Practice*, § 84, at 295 (1981), and in some respects "[a]nnuity contracts must . . . be recognized as investments rather than insurance." *Nationsbank of N.C. v. VALIC*, 513 U.S. 251, 259 (1995) (quoting Applebaum & Applebaum); Proposing Release at 37,757 n.42 (recognizing annuities as a "form of investment"). Thus, to show that a product entails elements of the "'investment experience'" (Proposing Release at 37,758; citation omitted) is merely to show that it possesses characteristics of an annuity, which are excluded under Section 3(a)(8). That fixed indexed annuities, like all annuities, display some investment characteristics not found in life insurance contracts is hardly a basis to conclude that they are securities that may be regulated by the Commission.[9]

It is notable as well that fixed indexed annuities are regulated thoroughly by the states, which recognize them as annuities, not securities. *See* Buyer's Guide To Fixed Deferred Annuities With Appendix For Equity-Indexed Annuities, National Association of Insurance Commissioners, at 6 (attached as Exhibit B): "When you buy an equity-indexed annuity you own an insurance contract. You are not buying share of any stock or index." *And see* Comment

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[9] The Proposing Release quotes out of context Justice Brennan's reference to "the investment experience" in his concurring opinion in *SEC v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65, 77-78 (1959) (Brennan, J., concurring). Justice Brennan referred in full to a stockholder being "a *sharer* in the investment experience *of the company*" that solicited her investment—literally, a shareholder. *Id.* at 77 (emphases added). In such a case, "the coin of the company's obligation is not money but is rather the present condition *of its investment portfolio*." *Id.* at 78 (emphasis added). It was this fact—not the fact of investment risk alone—that was central to Justice Brennan's conclusion that a variable annuity whose value was determined by the portfolio of the issuing company was a security. *See id.* at 78-79 ("[T]he majority of [the securities laws'] provisions are of greatest regulatory relevance . . . *where the investors . . . participate on an 'equity' basis in the investment experience of the enterprise*") (emphasis added); *id.* at 80 ("[W]here the investor is asked to put his money *in a scheme for managing it on an equity basis*, it is evident that the Federal Act's controls become vital.") (emphasis added). Even as it places inordinate reliance on this two-Justice concurring opinion, the Proposing Release quotes the opinion out of context and misses its essential point.

of the National Governors' Association (Sept. 4, 2008) ("States already regulate equity-indexed annuities as insurance products."). State regulation of the products is not dispositive, as the Supreme Court's decision in *VALIC* shows. But the Commission, like the Supreme Court, should "start with a reluctance to disturb the state regulatory systems that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements." *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65, 68 (1959). The Commission should be all the more reluctant when its Proposed Rule's parameters are defined by product features that are requirements of state law, such as minimum guarantees: The Commission cannot predicate a rule on a state law regulatory regime for *annuities*, and claim convincingly that it is regulating *securities*.

Indeed, the Commission is proceeding in an area where any claim to deference is at its low ebb. The McCarran-Ferguson Act, 15 U.S.C. § 1012(b), establishes a rule of construction under which federal law shall not be interpreted to "supersede any law enacted by any State for the purpose of regulating the business of insurance." McCarran-Ferguson "was intended to further Congress' primary objective of granting the States broad regulatory authority over the business of insurance." *U.S. Dep't of Treasury v. Fabe*, 508 U.S. 491, 505 (1993). Even apart from the constraints imposed on the Commission by McCarran-Ferguson, the courts recognize that deference to an agency's legal interpretations is misplaced when the agency's action would expand its own jurisdiction. *See Adams Fruit Co. v. Barrett*, 494 U.S. 638, 650 (1990) ("'[A]n agency may not bootstrap itself into an area in which it has no jurisdiction.'" (quoting *Fed. Mar. Comm'n v. Seatrain Lines, Inc.*, 411 U.S. 726, 745 (1973)).

B. Courts' Interpretation of Section 3(a)(8) Confirm That Fixed Indexed Annuities Are Annuity Contracts Under The Act.

The Commission attempts, as it must, to harmonize its proposed rule with two Supreme Court decisions: *SEC v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65 (1959) ("*VALIC*"), and *SEC v. United Benefit Insurance Co.*, 387 U.S. 202 (1967). However, the products in those cases were fundamentally different from both traditional fixed rate annuities and fixed indexed annuities. The purchaser in those cases acquired a share in a fund managed by the issuing company and assumed virtually the entire investment risk—namely, the risk of significant loss of principal due to negative investment performance—while the company assumed virtually none. The value of fixed indexed annuities, by contrast, does not depend upon investment management by the issuing company, and the products provide a statutorily defined minimum guaranteed value as well as possibly higher values as a result of the interest crediting methodology.

The difference between the products in those cases and FIAs is thus large, whereas any difference between FIAs and traditional annuities is literally at the margins. Fixed indexed annuities are indeed annuities, they are regulated as such by the states, and the Proposed Rule is neither legally justified nor warranted.

1. *VALIC* And *United Benefit.*

The products at issue in *VALIC* were variable annuities. Purchasers paid premiums which were invested in a fund consisting largely of common stock. Annuitants received a

proportionate interest in the investment fund, and benefits were paid according to the fund's after the fact, actual investment performance. There were no guaranteed payments, and the entire principal investment was thus subject to market performance. In the Court's words, the contracts "guarantee[d] nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest which has a ceiling but no floor." *VALIC*, 359 U.S. at 72 (footnote omitted).

On these facts, the Court held that the products were securities falling outside the exemption of Section 3(a)(8). "[T]he variable annuity place[d] *all* the investment risks on the annuitant," the Court emphasized, and "*none* on the company." *Id.* at 71 (emphasis added). There thus was not "true underwriting of risks, the one earmark of insurance . . . ." *Id.* at 73. "[T]he concept of 'insurance' involves some investment risk-taking on the part of the company," the Court explained, and "absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant . . . ." *Id.* at 71. Because the variable annuity had "no element of a fixed return," the returns it provided depended entirely "on the wisdom of the investment policy"; it therefore was properly regulated as a security. *Id.* at 70.[10]

In *United Benefit*, purchasers' premiums were placed in a "Flexible Fund," which was maintained as a separate account. The company—whose marketing materials emphasized the investment acumen of the fund managers and the opportunity to "'share in the growth of the country's economy'"—invested the Fund "with the object of producing capital gains as well as an interest return, and the major part of the fund [was] invested in common stocks." 387 U.S. at 205 & n.3. At any time before maturity the purchaser was entitled—in the Supreme Court's words—"to his *proportionate share* of the total fund," and could withdraw all or part of his share. *Id.* at 205 (emphasis added). Alternatively, the purchaser could demand cash payment of a "net premium guarantee" that rose from 50 percent of his premium payments in the first year to 100 percent after 10 years. *Id.* at 205-06. This guarantee was largely illusory, since the company had set it "by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so *that it would not have become operable under any prior conditions.*" *Id.* at 209 n.12 (emphasis added). The guarantee was thus "low enough that the [company's] risk of not being able to meet it through investment [was] insignificant." *Id.* at 209. *See also Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127, 1132 (7th Cir. 1986), *rev'd on rehearing*, 814 F.2d 1140 (7th Cir. 1987) ("[I]n both [*VALIC* and *United Benefit*,] the insurance company guaranteed a minimum return so low as to place the investment risk on the investor rather than on the insurance company.").

At maturity, the purchaser's interest in the fund terminated, and he could receive the cash value of the policy—as measured by his interest in the fund or the net premium guarantee, "whichever [was] larger"—or he could have his interest converted into a life annuity under

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[10] As noted, Justice Brennan based his concurring opinion on the view that "where [the investor shares in the investment experience of the insurance company itself], the federally protected interests in disclosure to the investor of the nature of the corporation to whom he is asked to entrust his money and the purposes for which it will be used become obvious and real." *Id.* at 78.

conditions specified in the contract. *United Benefit*, 387 U.S. at 205-06. As noted, the guarantee was so minimal that—based on market performance over the *past 50 years*—the company was expected to always have the returns to fund it from the purchaser's own payments.

In applying Section 3(a)(8), the Court first determined to analyze the accumulation period in which the purchaser was invested in the "Flexible Fund" as a free-standing product, since there was no necessary link to the annuity that the purchaser was able, but not required, to obtain at maturity. The Court then found "little difficulty" concluding that the Fund fell outside of Section 3(a)(8)'s provision for annuities and in fact was an investment contract under Section 2 of the Act. Far from being structured in a manner resembling traditional annuities, "'Flexible Fund' arrangements require special modifications of state law," the Court emphasized—specifically, their essentially illusory "guarantee" required an exemption from state nonforfeiture laws (which apply with full force to FIAs). *Id.* at 211. The products, the Court further emphasized, resulted in the purchaser literally holding a "proportionate share" in a Fund that had been marketed based on "the experience of United's management in professional investing" rather than on "the usual insurance basis of stability and security." *Id.* The fact that the company purported to back-stop the purchaser with a cash-value guarantee did not convert into an annuity an interest that, at heart, was simply a share in a fund invested in common stock. The purchaser was a shareholder, and the fact that his investment "to some degree is insured" by a minimal guarantee did not render his investment "a contract of insurance." *Id.*

2. Fixed Indexed Annuities Meet The *VALIC* And *United Benefit* Test.

Under the criteria applied in *VALIC* and *United Benefit*, fixed indexed annuities as characteristically structured are plainly annuities exempt from SEC regulation by Section 3(a)(8). The purchaser of a fixed indexed annuity is not subjecting his entire principal—*or any part of it*—to the vagaries of the market or the performance of an individual security. It is thus an entirely different arrangement than in *VALIC*, where the purchaser essentially had "nothing except an interest in the portfolio of common stocks or other equities." *VALIC*, 359 U.S. at 72. In *United Benefit*, where the purchaser again held a "proportionate share" in a fund of common stocks in a manner that was "somewhat similar to . . . the variable annuities" in *VALIC*, the Court made clear that providing (effectively illusory) insurance of the participant's securities investment did not thereupon convert an investment in securities into an insurance (or annuity) contract. The purchaser's interest was explicitly investment in a stock fund, and the Court treated it as such. *See also Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 567 (7th Cir. 1991) (Easterbrook, J.) ("*AIAP*") (distinguishing circumstances where "the seller [is] supplying only investment advice"). As observed in note 9 above, the Proposing Release places heavy reliance on the two-Justice concurring opinion in *VALIC* authored by Justice Brennan, yet the whole thrust of that opinion is that the securities laws are triggered when "investors . . . participate on an 'equity' basis in the investment experience" of the issuing company. *VALIC*, 359 U.S. at 79.

Fixed indexed annuities, by contrast, possess the essential elements of a traditional declared rate annuity except that purchasers' interest credit is tied to the performance of a stock index rather than being an express declared rate. Accordingly, state insurance laws themselves—which distinguish between variable and fixed products and exempt variable products from protections provided to fixed products, as *United Benefit* recognizes—classify

FIAs as fixed products and regulate them as such. The fact that an FIA's value may relate in part to equities' performance cannot be a sufficient reason to treat them as securities because if *any* link to a stock or group of stocks took a product outside of Section 3(a)(8), then *VALIC* and *United Benefit* would simply have said so. Rather than consult the multiple factors that it did, the Court would merely have observed that the products' value increased or decreased with the performance of equities; that this constituted "investment risk"; and that the products therefore were securities. The Court applied no such analysis—and the Commission may not apply it now.

In other respects as well, the contrast between FIAs and *VALIC* and *United Benefit* is plain. State nonforfeiture laws guarantee that a contract owner will receive no less than 87.5 percent of premiums even if the contract is surrendered in the first year, and assure that this amount will increase at a minimum annual rate of 1 to 3 percent for the life of the contract. This guarantee is real, genuine, and different in kind from the United Benefit guarantee that had required an exemption from state nonforfeiture laws in order to be set so low "that it would not have become operable." *United Benefit*, 387 U.S. at 209 n.12. In *United Benefit* the Court also placed significant weight on the fact that the Flexible Fund guarantees were "substantially" lower than guarantees for traditional annuities (*id.* at 208), whereas the guarantees for FIAs are quite comparable to those for traditional fixed annuities. *See* Exhibit A (showing that the guarantees in index products are comparable to those in traditional fixed-rate annuities).

For these and other reasons, purchasers of FIAs bear no "investment risk" as that term is properly understood, while the risk borne by the insurer is considerable. From the day of issue, purchasers of FIAs are assured that in the absence of early withdrawal they will receive their principal plus interest. Even in the event of early withdrawal, they are assured the lion's share of their principal due to state nonforfeiture laws. The insurer, on the other hand, must realize returns sufficient to fund payment of the guaranteed minimum value, as well as any index-related interest credits. The withdrawal charge itself is not an "investment risk," it is a charge of a type that is prevalent under an infinite variety of contracts whose economic value depends in part on their duration and which provide, accordingly, for compensation in the event of early termination. *See AIAP*, 941 F.2d at 567 (stating withdrawal charges do "nothing to throw *investment* risk on the investor") (emphasis in original). The charge typically decreases to zero over time and is limited so as to not encroach the minimum guaranteed value. It is taken regardless of the performance of the index, and has not been set or adjusted with reference to the long-term performance of any security or group of securities. *Compare United Benefit*, 387 U.S. at 209 n.12 (stating the company had set its guarantee "by analyzing the performance of common stocks"). Most policies annually exempt up to 10 percent of the value of the policy from withdrawal charges.

Finally, as noted at page 5 above, it is the practice of companies that issue FIAs and the states that regulate them to take numerous precautions to ensure that the products are marketed primarily for the safety and assurances that they offer, rather than as an invitation to share in the "investment experience" of the issuing company. *VALIC*, 359 U.S. at 78-79 (Brennan, J.).

For these reasons, the courts have had no difficulty determining that fixed indexed annuities and similar products are covered by Section 3(a)(8). Applying the principles articulated in *VALIC* and *United Benefit*, the court in *Malone v. Addison Insurance Marketing,*

Inc., found that the insurer of an FIA had assumed as much or more investment risk than the purchaser because it was obligated to return the premium plus the greater of 3 percent or the S&P Index, regardless of how the market performed. 225 F. Supp. 2d 743, 750 (W.D. Ky. 2002). The court noted that there was no direct correlation between the benefit payments and the performance of the investments made with the contract owner's premium. *Id.* ("Plaintiff's benefit payments from American Equity were not directly dependent on the performance of investments made with her money. That is to say, as a structural matter, Plaintiff's contract did not operate like a variable annuity: her payments were not a function of a personalized portfolio and her principal was not held in an independent account."). The only investment uncertainty assumed by the investor, the court found, was whether she would receive interest beyond 3 percent per year on her premium payment:

> Plaintiff's risk was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have been worth more than 134 percent at the end of the ten-year contract period. That type of risk—that she could have gotten a better deal but for the pressure she encountered to enter into this particular contract—is not the type of risk central to determining whether a security exists.

Id. at 751.[11]

Other court decisions are consistent with *Malone* and conflict with the Proposed Rule's approach, under which all fixed indexed annuities would be deemed securities through a test that effectively ignores the risk borne by the insurer. In *AIAP*, for example, the Seventh Circuit held that a "Flexible Annuity" with characteristics similar to fixed indexed annuities fell within the Section 3(a)(8) exemption. In assessing the risks borne by insurer and insured, Judge Easterbrook noted that "[n]o annuity transfers all of the risk to the seller." Rather,

> [a]ny fixed annuity places on the buyer the risk that the seller's portfolio will perform too poorly to finance the promised payments. Section 3(a)(8) therefore necessarily exempts annuities that leave purchasers with some investment risk. If on the other hand a seller just pins the label "annuity" on a mutual fund, in which the buyer bears all of the risk, § 3(a)(8) is inapplicable.

941 F.2d at 566. The court also emphasized that with the product there, as with FIAs, the interest component did not depend upon the investment management or advice of the issuer such that it "made the 'annuity' look like a mutual fund, with the seller supplying only investment advice." *Id.* at 567. (It bears noting also that linking a company's obligation to pay to the performance of its own account directly moves risk from company to purchaser. By contrast, when a company must make payments based on factors other than its own portfolio's

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[11] The Proposing Release acknowledges only *Malone*'s alternative holding that the fixed indexed annuity qualified under SEC Rule 151, while ignoring the court's holding that the fixed indexed annuity fell within Section 3(a)(8). *See* Proposing Release, at 37,757 n.41; *Malone*, 225 F. Supp. 2d at 751.

performance, no such direct transfer of risk occurs; the company bears the risk of having to pay regardless of its portfolio's performance.) *See also 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).

In *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), the Seventh Circuit initially applied *VALIC* and *United Benefit* to hold that a product with both a fixed interest rate and a non-fixed excess interest rate was not an annuity, but subsequently reversed itself based on a factor not present with fixed indexed annuities. In its initial decision in *Otto*, the Seventh Circuit understood that discretionary changes in the excess interest rate affected only new deposits, and that "past deposits would continue to earn the interest rate in effect at the time the deposit was made," that is, that "VALIC in effect guarantees the excess interest on every deposit for the life of the annuity contract." *Id.* at 1140. After briefing on a petition for rehearing the court reversed itself and held that the product was a security, because—briefing had disclosed—VALIC had the "unfettered discretion" to change the current (excess) interest rate on past deposits, as well as "the absolute right to stop all excess interest payments on all deposits, past or present." *Id.* at 1141. The "claimed right to change established excess interest rates and to eliminate excess interest payments entirely *at any time* surely tends to shift the investment risk from VALIC" to the purchaser, the court explained. *Id.* (emphasis in original). With fixed indexed annuities, by contrast, excess interest is typically locked-in once earned, becoming a guarantee for which the company then bears the risk. Further, the interest crediting formula is stated in advance, is subject to statutorily prescribed minimums, and, once set, may not be changed by the insurer during the stated period.

The Commission, for its part, took the position that even *with* the company's complete discretion to set excess interest rates, the product in *Otto* remained an annuity. The Commission filed a Supreme Court *amicus* brief urging certiorari to review and reverse a "case [that] has caused great interest and concern in the insurance industry." Brief for the United States as *Amicus Curiae* at 5, *Variable Life Annuity Ins. Co. v. Otto*, 486 U.S. 1026 (May 23, 1988) (denying certiorari) [hereinafter *Otto Amicus Brief*]. In marked contrast to its Proposing Release—where the risk borne by the company is effectively ignored—the Commission stated in *Otto* that "it is clear that the assumption of substantial 'investment risk' by the insurance company is one *crucial* factor." *Id.* at 6 (emphasis added). The government explained:

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

Id. at 7 (emphasis added and footnote omitted). By placing no weight on the investment risk assumed by the insurer in fixed indexed annuity contracts, the Proposed Rule now takes a

position contrary to the Supreme Court's, the lower federal courts', and the Commission's own repeated pronouncements.

III. In Designating Fixed Indexed Annuities As Securities, The Proposal Misconstrues "Investment Risk," Misconstrues The Supreme Court Cases On Which It Purports To Rely, And Adopts A Test That Omits Factors That The Proposing Release Concedes Are Important In Distinguishing Annuities From Securities; The Proposal Is Arbitrary And Capricious And Should Be Withdrawn.

The Executive Summary to the Proposing Release promises a rule that is based "upon a familiar concept: The allocation of risk." "Insurance provides protection against risk," the Commission explains, "and the courts have held that the allocation of investment risk is a significant factor in distinguishing a security from a contract of insurance." Proposing Release at 37,752.

The rule and analysis that the Commission provides, however, fall short of those benchmarks. The courts have, as the Commission says, made the *allocation* of investment risk "a significant factor" in applying 3(a)(8). But the Proposing Release overlooks both sides of that allocation by ignoring the risk borne by the company; it distorts the two-sided nature of this allocation by adopting a novel definition of investor risk that is far from "familiar"; and it fails to give any weight to other factors emphasized by the Supreme Court and acknowledged by the Commission to be significant.

The Proposed Rule reaches an erroneous conclusion via an analysis that is arbitrary, capricious, and contrary to law. It should be withdrawn.

A. The Likelihood Of Additional Financial Returns Is Not "Investment Risk."

The Proposing Release posits that the likelihood of additional financial returns due to the performance of securities is "investment risk," and makes this effectively the sole determinant of whether a widespread and popular product that is regulated by every state in the country as an annuity is nonetheless a security for purposes of Section 3(a)(8). In doing so, the Release contorts the concept of "investment risk."

As used in *VALIC*, *United Benefit*, and common parlance, a purchaser's primary investment risk is the ***risk*** to his ***investment***—the possibility that his principal will be lost. It is for this reason that the Supreme Court placed more emphasis on the guarantee to the purchaser than on any other single factor, focusing intently on what assurance the purchaser had that he would get all or substantially all of his money back. An increased likelihood that after the withdrawal period an investor will get back a guaranteed amount *and more* is not risk at all—to the contrary, the more certain an investor is to receive an amount higher than what was guaranteed, the less risk he takes. *Compare Webster's New World Dictionary*, Second College Edition (1976) (defining risk as "the chance of injury, damage, or loss; dangerous chance; hazard," or, in the insurance sense, "a) the chance of loss b) the degree of probability of loss c) the amount of possible loss to the insuring company"). The indexed interest in FIAs is in fact a potential benefit. Although that benefit may be greater in one period than another, it does not affect the value of the underlying asset. In locating "investment risk" in the probability of

earning additional money—the more, the riskier, evidently—the Commission has adopted a truly peculiar and insupportable predicate for its rule. *See* the further discussion in the September 10, 2008, Statement of Mark Meyer, Ph.D., attached as Addendum hereto.

The court in the *Malone* case recognized this basic economic truth: "Plaintiff's risk was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have been worth more than 134 percent at the end of the ten-year contract period. *That type of risk—that she could have gotten a better deal but for the pressure she encountered to enter this particular contract—is not the type of risk central to determining whether a security exists.*" 225 F. Supp. 2d at 751 (emphasis added) (citing *VALIC*, 359 U.S. at 71). The possibility of extra benefits on a guaranteed contract is simply not a "risk" that may be made the central consideration in whether fixed indexed annuities are annuity contracts under Section 3(a)(8).

Indeed, the Commission's definition of risk in this manner has absurd consequences that further render it arbitrary, capricious, and contrary to law. Under the Commission's approach, an FIA with an interest crediting formula that was likely to yield no indexed interest would be deemed *not* to present risk to warrant regulation as a security. Suppose that a broker-dealer sits down with a client and tells her that two possible investments have been identified, one that is almost certain to return $100 and one that presents a high likelihood of plummeting to $40—and that he recommends she purchase the latter product because it presents less risk. Is that an analysis the Commission endorses? Ordinarily the Commission regards its regulatory interests to increase, not decrease when investors are induced to acquire products whose value is more likely than not to decline.

In addition to defying common sense, the approach of the Proposing Release turns *VALIC* and *United Benefit* on their head. The Court in both cases was concerned about circumstances where investors might lose their whole investment, or come away with nothing more than a minimal guarantee. The Commission now proposes to regulate precisely when the investor *will* receive a substantial guarantee and is likely to receive interest on top of this as well. That approach is insupportable. And to the extent the Commission's answer is that any equity-related component presents "investment risk"—either "upside" or "downside"—which is sufficient to render it a security, *VALIC* and *United Benefit* are a full reply to that as well: If *any link* to equities rendered a contract a security, then *VALIC* and *United Benefit* would simply have said so, rather than identifying the numerous considerations that the Proposing Release itself first acknowledges, then ignores.

The Commission's treatment of investment risk in the Release conflicts with its *amicus* brief in *Otto* as well. There, the Commission emphasized that purchasers "did not bear the common investment risk that changes in the market will erode *[their] capital contributions*." Additionally, the company "guaranteed an interest rate of 3-1/2% or 4% on principal and accrued interest so that Otto knew that her contributions would produce some income." *Otto Amicus Brief* at 7 (emphasis added). On these facts, the Commission deemed any risk borne by the purchaser to be insufficient to convert the contract to a security, even though—the brief acknowledged—the purchaser "did have some investment risk" because the product carried a declared rate of 14.5 percent; this was "over ten points higher than the guaranteed minimum rate"; and this excess rate (as well as excess interest earned in prior years) "*could be reduced or*

eliminated at [the company's] discretion." *Id.* at 8 (emphasis added). The Commission bears the burden of squaring the concept of "investment risk" set forth in this Proposed Rule with its prior statements in the Supreme Court.

The mistaken concept of investment risk in the Proposing Release causes the Commission to make a number of other misstatements. For example, the Proposing Release states that "[i]ndexed annuities are similar in many ways to mutual funds, variable annuities, and other securities," and that the purchaser of an indexed annuity "assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities." Proposing Release at 37,757-59. That is profoundly inaccurate. The principal investment risk borne by purchasers of mutual funds and variable annuities is the loss or decline in value of their capital due to a decline in the underlying securities. That is the risk the Supreme Court focused on in *VALIC* and *United Benefit*, and it is not a risk borne by purchasers of fixed indexed annuities because of the guarantee to principal and minimum interest supplied by state nonforfeiture laws. The risk to one's principal investment posed by mutual funds and variable annuities simply is not comparable.[12]

B. The Proposed Rule Fails To Consider Key Factors Identified By The Supreme Court In Applying Section 3(a)(8).

In making a mistaken concept of "investment risk" effectively the sole determinant of when an FIA is actually a security, the Proposed Rule commits another fundamental error: It neglects other factors that the Supreme Court repeatedly has said are central considerations in applying Section 3(a)(8). Under the Supreme Court's cases, the Commission concedes,

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[12] The mischaracterization of investment risk in the Proposing Release also leads it to inaccurately portray the role of withdrawal charges in fixed indexed annuities and annuities generally. Instead of treating them as a normal contract term, paragraph (b)(1) of the Proposed Rule provides in effect that withdrawal charges are not to be taken into account when determining amounts payable but are taken into account when determining amounts guaranteed. This effectively guarantees that FIAs with withdrawal charges will "fail" the test and become securities regardless of any other feature, since as long as there is a withdrawal charge the amount payable will exceed the amount guaranteed by at least the amount of the withdrawal charge. The Release attempts to justify excluding withdrawal charges from amounts payable by stating that the Commission is "proposing this calculation 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." Proposing Release at 37,761. However, that "differential impact" based on assumed holding periods *is equally applicable to the determination of amounts guaranteed.* Neither the Release's rationale nor anything else justifies treating withdrawal charges differently in determining the amounts payable from the amounts guaranteed. The Commission's proposed treatment of withdrawal charges now also conflicts with its adoption of Rule 151, where it stated that a withdrawal charge "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.

"[F]actors that are important to a determination of an annuity's status under Section 3(a)(8) include (1) the allocation of investment risk between insurer and purchaser, and (2) the manner in which the annuity is marketed." Proposing Release at 37,755. Yet, the Proposed Rule provides for no consideration of the investment risk borne by the insurer, nor for how the FIA is marketed. These omissions conflict with *VALIC*, *United Benefit*, and the entire body of Section 3(a)(8) caselaw. They render the Proposed Rule arbitrary and capricious and contrary to law for that reason, and because the Commission has proposed a rule that fails to give effect to the "facts and circumstances factors" that the rule's Proposing Release says are determinative. Proposing Release at 37,757.[13]

1. The Proposed Rule Improperly Omits Consideration Of Insurers' Investment Risk.

In *VALIC* and *United Benefit*, the Supreme Court considered the risk borne by both insurer and insured and in reaching its decision in both cases emphasized that the insurer took virtually no investment risk. In the words of the Commission's Supreme Court *amicus* brief in *Otto*, "[I]t is clear that the assumption of substantial 'investment risk' by the insurance company is one *crucial* factor." *Otto Amicus Brief* at 6 (emphasis added). Yet, the Proposing Release essentially focuses exclusively on the purported risk borne by the purchaser, without meaningfully acknowledging or discussing the risks of the insurer.

That is error, and whatever rule the Commission adopts must give significant weight to the risk borne by the company. That requires an analysis of the guarantees provided by the company because each guarantee places an investment risk on the company (and, conversely, takes that risk off of the purchaser). In a typical fixed indexed annuity, the insurer bears significant investment risk by providing (1) guarantees of principal, (2) guarantees reflected in the minimum nonforfeiture value or otherwise, (3) guarantees of previously credited interest, (4) the guarantee to credit indexed interest in accordance with the performance of the relevant index and the terms of the contract, and (5) for the establishment of the precise terms of the index interest crediting method prospectively, at the beginning of each term. Importantly, while a stock index's failure to indicate indexed interest credits in a given year does not itself cause loss to the insurer, the insurer assumes risk in the years the index *does* require credits because under the typical contract it locks those gains in for the purchaser and guarantees them regardless of the performance of the insurer's investments in the years ahead. In this respect a down year in the markets can indeed increase exposure for the insurer because the company may experience a *decrease* in the funds that *it has* available to cover its guarantees even as the purchaser is assured

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[13] The Commission's narrow approach is also inconsistent with the approach courts have taken in applying insurance exceptions found in other federal statutes, such as the McCarran-Ferguson Act and ERISA. *See, e.g., Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 129 (1982) (explaining multiple factors in determining the "business of insurance" exception in McCarran-Ferguson); *Ky. Ass'n of Health Plans v. Miller*, 538 U.S. 329, 330, 342 (2003) (applying ERISA insurance exception when it "substantially affect[s] the risk pooling arrangement between the insurer and the insured").

previously credited interest and the increase set forth in the guaranteed minimum non-forfeiture value provided under state law.

The insurer takes on risk in other respects as well: Risk inheres in the limits many contracts place on the company's ability to change the terms of the indexed interest crediting method (*i.e.*, limits on changes in caps, participation rates, spreads, etc.) during the life of the contract. Further risk results from limitations on, and the uncertainty of, the company's ability to hedge against its risks. And, the courts and Commission have recognized that the company's assumption of mortality risk must be weighed under Section 3(a)(8). *See VALIC*, 359 U.S. at 71; *Grainger v. State Sec. Life Ins. Co.*, 547 F.2d 303, 305 (5th Cir. 1977); Definition of Annuity Contract or Optional Annuity Contract, Release No. 33-6645, 51 Fed. Reg. 20,254, 20,256; *Otto Amicus Brief* at 9.

Finally, the Proposed Rule fails because it does not *weigh* the investment risk borne by the company against that borne by the purchaser and because its focus on the purchaser's indexed interest "risk" lacks any proportionality—it addresses solely whether any indexed interest is likely to be paid and not the potential *amount* of indexed interest relative to the guaranteed amounts. There is no assessment of where the greater risk lies; rather, the proposal essentially converts *VALIC*'s concern that the purchaser not bear *all* the risk into a rule that the purchaser bear *no* risk. Under the caselaw that is clear error, and for a rule that purports to be founded on "a familiar concept: the *allocation* of risk," it is arbitrary and capricious. Proposing Release at 37,752 (emphasis added).

2. The Proposed Rule Does Not Consider Product Marketing.

The Supreme Court has made clear that marketing must be taken into account in applying Section 3(a)(8), and the Proposing Release acknowledges as much, stating that marketing "is another significant factor" in applying the exemption. Proposing Release at 37,756 (citing *United Benefit*, 387 U.S. at 211).[14]

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[14] It was important in *United Benefit* not merely that the Flexible Fund was being marketed as an *investment* (all annuities are investments to a degree), but that the company was marketing *its own investment management*. United Benefit trumpeted "the experience of United's management in professional investing," the Court observed in the passage cited in the Proposing Release, and thereby "pitched to the same consumer interest in growth *through professionally managed investment*" as mutual funds do. 387 U.S. at 211 & n.15 (emphasis added). Fixed indexed annuities are not marketed on the basis of the companies' investment acumen at all, since—unlike *VALIC* and *United Benefit*—the performance of purchasers' equity-related component has no relationship to the issuer's investment experience. *Compare also* Justice Brennan's concurrence, 359 U.S. at 78, emphasizing 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 federally protected interests" underlying the securities laws are triggered.

Despite this, the Proposed Rule takes no account of marketing. Instead, the text of the Proposed Rule effectively designates all fixed indexed annuities as securities even though—as discussed above—companies' descriptions of the products are ordinarily careful to emphasize the guarantee of principal, minimum interest, and other features that further financial stability and security, and promotional materials explain the interest crediting feature and that it is not a means of participating in the stock market. Three representative marketing brochures are attached herewith as Exhibit C. In this respect, too, the Commission has arbitrarily and capriciously purported to rely on Supreme Court cases interpreting 3(a)(8), yet adopted a test that omits factors that the Commission itself recognizes to be "significant."

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In *VALIC* and *United Benefit* the Supreme Court evaluated products whose value depended largely or entirely on the performance of equities and considered multiple factors before determining those products to be securities. The Proposing Release, while paying lip service to the multiple factors considered by the Court, effectively adopts a bright line rule under which an annuity whose value depends at all on the performance of equities is a security instead. That manifestly is not the law.

IV. The Costs of Rule 151A Would Greatly Exceed Its Benefits, And The Rule Would Hinder Efficiency, Competition, And Capital Formation.

The Commission is required by law to consider the effects of the Proposed Rule on efficiency, competition, and capital formation. It is prohibited from adopting "any . . . rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [this chapter]," and a failure to adequately appraise a rule's effects on efficiency, competition, and capital formation will itself result in invalidation of the rule. Proposing Release at 37,771 (citing 15 U.S.C. §§ 77b(b); 78c(f)); 15 U.S.C. § 78w(a)(2); *see also Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

The analysis in the Proposing Release of the Rule's costs and benefits—and accordingly, its effect on efficiency, competition, and capital formation—is plainly deficient. The release betrays a profound misapprehension of the scope and extent of existing state regulation of FIAs, and as a consequence claims benefits from SEC regulation that are illusory because the claimed benefits of regulation already are being realized. The result is that the Proposed Rule will increase regulatory costs with no compensating benefit; indeed SEC regulation in this area would frustrate regulatory initiatives that the states and FINRA have recently launched at the SEC's own encouragement. *Compare VALIC*, 359 U.S. at 68 ("We start with a reluctance to disturb the state regulatory systems that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements."). *And see* Comment of National Governors' Association (Sept. 4, 2008) (stating the Proposed Rule would "subject[] these products to dual regulation").

In short, FIAs are annuities that are comprehensively regulated by state law, and by exceeding the parameters delineated by the Court and Congress—as shown in the preceding sections—the Proposed Rule will impose excessive, unjustifiable costs that impair efficiency, competition, and capital formation.[15]

A. The Proposed Rule Is Not Efficient.

The Commission is claiming that through this regulation, it will achieve efficiencies. Because annuities already are extensively regulated, however, the Commission cannot claim further efficiencies without a comprehensive consideration of the existing state law regulatory regime, the efficiencies that regime already realizes, and—correspondingly—the respects in which that state regime falls short and further gains may be achieved by the Commission. And yet, to the extent it refers to state regulation at all, the Proposing Release betrays a serious misapprehension of state law requirements. The regulation of annuities may vary from state-to-state, although states increasingly are adopting model rules proposed by industry and regulatory associations. Further, many companies incorporate the practices endorsed by the model rules into their nationwide policies, with the effect that model disclosure and suitability practices are followed by leading providers in all states.

The Proposing Release states that state insurance regulation "is focused on insurance company solvency and the adequacy of insurers' reserves." Proposing Release at 37,762. That is incorrect; state regulation of fixed indexed annuities and other annuities and insurance products is far broader and includes the following:

- Suitability requirements. As discussed more fully below, suitability regulations require an agent to consider the financial profile of a potential purchaser and other factors to determine whether purchase of a fixed indexed annuity would be appropriate.
- "Free Look" periods. Allow a purchaser to rescind a purchase of a fixed indexed annuity, typically up to 15 days after purchase.
- Annuity disclosure requirements. As discussed more fully below, states require significant disclosure about the contents, terms, and conditions of fixed indexed annuities.

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[15] As reflected in the statement by the Court in *VALIC*, existing state regulation of annuities presents questions of federalism that must be weighed by the Commission. The President has directed by Executive Order that when federalism concerns are present, agencies should "encourage States to develop their own policies to achieve program objectives and to work with appropriate officials in other States" and, "where possible, [agencies should] defer to the States to establish standards." Executive Order 13132, *Federalism*, 64 Fed. Reg. 43,255, 43,256 (Aug. 4, 1999). This Order does not apply to the Commission by its terms, but reflects solemn considerations that the Commission must weigh.

- Advertising laws. States limit the manner in which fixed indexed annuities are marketed. Several states require that companies submit to the responsible agency materials regarding both the product and the product advertising, to monitor whether the product will be marketed in a way that is understandable to consumers. *See, e.g.*, GA. COMP. R. & REGS. 120-2-71-.15 (6) (2008).

- Unfair trade practices and penalties. States regulate deceptive and unfair trade practices, including misrepresentations or misleading statements regarding fixed indexed annuities, and use their enforcement and investigative authority to pursue complaints regarding any type of annuity product. *See, e.g.*, NAIC Model Unfair Trade Practices Act §§ 3-4. Insurance agents can receive penalties or fines for violating certain sales rules as well.

- Market conduct reviews of insurers. Insurers' products and business practices receive a top-down review from state authorities on a periodic basis (usually every three years), giving the state an opportunity to assure itself that products are being designed and marketed within the parameters of state law.

- Agent licensing and training. States require insurance agents to be knowledgeable about the products they sell and the laws that govern those products and to verify the suitability of annuity products for potential purchasers. For example, Iowa requires the completion of a four-hour training course specific to indexed products and that each insurer have a system in place to verify compliance with the training requirement. IOWA ADMIN. CODE r. 191-15.82, 15.84.

Beginning as it does with a misapprehension of the nature and extent of state insurance regulation, the Proposing Release proceeds to claim efficiencies from "extending the benefits of the ***disclosure*** and ***sales practice protections*** of the federal securities laws" to fixed indexed annuities; those protections, the Proposing Release claims, "would enable investors to make more informed investment decisions." Proposing Release at 37,771 (emphases added).

1. State Law Extensively Regulates Disclosures.

With respect to disclosures specifically, the Proposing Release claims that the rule will yield benefits by requiring disclosure of "information about costs (such as surrender charges); the method of computing indexed return (*e.g.*, applicable index, method for determining change in index, caps, participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits)." Proposing Release at 37,768. Remarkably, however, companies selling fixed indexed annuities *already* disclose this information to potential purchasers. A representative disclosure statement is attached herewith as Exhibit D. For example, the Annuity Disclosure Model Regulation of the National Association of Insurance Commissioners ("NAIC"), which has been adopted by 22 states, requires disclosure of the following on annuity contracts:

- An explanation of the initial ceiling rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;

- The guaranteed, non-guaranteed, and determinable elements of the contract, their limitations, if any, and an explanation of how they operate;

- Periodic income options both on a guaranteed and non-guaranteed basis;

- Any value reductions caused by withdrawals from or surrender of the contract;

- How value in the contract can be accessed;

- The death benefit, if available, and how it will be calculated;

- A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract; and

- The impact of any rider, such as a long-term care rider.[16]

In many states, the purchaser and insurance agent are both required to sign disclosure statements as a condition of policy issuance. And states that have not yet adopted the NAIC's Annuity Disclosure Model Regulation have alternative, significant disclosure requirements. For example, New York requires that a company selling a fixed-indexed annuity disclose "a statement in bold type to the effect that the [fixed indexed annuity] provides benefits linked to an external equity index and does not participate directly in the equity market." N.Y. INS. LAW § 3209(b)(2)(A). New York also requires disclosure about the equity index formula, participation rates, any caps on the index, minimum guaranteed values, and withdrawal charges. *Id.* California requires explicit disclosure about surrender charges and requires specific disclosures for agents doing business in the homes of seniors. CAL. INS. CODE §§ 789.10, 10127.13.[17]

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[16] Annuity Disclosure Model Regulation Section 5(B).

[17] Although not all model laws and regulations promulgated by the NAIC have been adopted by all states, it is important to note that many model laws are accepted by insurance companies as establishing a floor of conduct for their business across the country. For example, most companies substantively comply with the disclosure requirements of the NAIC Annuity Disclosure Model Regulation even though not every state has adopted that model regulation. So even though some laws vary from state to state, companies that operate nationally tend to follow many of the model laws and regulations for purposes of uniformity and efficiency. And of course, states that have not adopted model regulations often adopt their own requirements to provide comparable protections.

Many states also require insurers to deliver a buyer's guide, written by the NAIC, at the point of sale for fixed annuities, including fixed indexed annuities. *See* Exhibit B. The 9-page guide provides a simple, easy-to-understand description of different types of annuities and explains the components of fixed-indexed annuities, such as indexing method, charges and administrative fees, and withdrawal penalties. The guide also identifies questions a potential purchaser should ask about a fixed-indexed annuity before purchasing the product. Meanwhile, industry groups such as the American Council of Life Insurers ("ACLI") and the Association for Insured Retirement Solutions ("NAVA") have been actively working with the NAIC, FINRA, and the SEC itself to develop short-form, plain English disclosure templates that harmonize and simplify the disclosures provided to annuity purchasers. These templates are expected to establish a uniform format for fixed, indexed and variable annuities, so that consumers receive readable, comparable information across products and companies. These documents pass the "Flesch" test, a test that all annuity contracts must pass which analyzes the document for comprehension by a reader at the 10th grade level.

As FINRA and the SEC itself evidently have recognized in promoting the development of short-form, point-of-sale disclosure materials, materials of this nature most effectively communicate the necessary disclosures to purchasers of annuities. There is no basis to believe that the prospectus required by Form S-1 (the registration statement form on which most fixed indexed annuities would be registered), which has been designed to provide information on a fundamentally different type of financial product and its issuer, will provide more effective disclosures than materials honed from years of experience to communicate information on annuities specifically. These types of prospectuses are in fact too lengthy and complex to function as effective disclosure vehicles for annuity products. Many of its disclosure requirements—such as executive compensation and a description of the company's business—are irrelevant to purchasers of fixed indexed annuities. Nor can a document as lengthy and complex as a prospectus serve as an effective disclosure vehicle at the point-of-sale, which is the point at which disclosures about annuities have been judged to be most valuable. Indeed, a prospectus may very well obscure the information that a potential purchaser of fixed indexed annuities would most benefit from knowing.[18]

In short, the SEC has no basis to claim benefits from applying disclosure requirements that it designed for fundamentally different products to an area where there is a pre-existing

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[18] The Commission's requirements are ill-suited to FIAs in many other ways as well. For example, in a typical securities offering, the company must register a particular dollar amount of securities and pay a registration fee based on that amount. Selling or issuing more than that dollar amount results in selling unregistered securities, with concomitant legal consequences. This dollar amount requirement is generally easily satisfied in a typical securities offering, but would create an obligation on the part of issuers of FIAs to constantly monitor the amount sold versus the amount stated in the registration statement. Also, because FIAs would be offered on a continuous basis, the registration statement would have to be refiled and updated annually in the form of a post-effective amendment subject to Commission review, further increasing the burden.

disclosure system developed—with the encouragement in part of FINRA and the SEC—to effectively impart information about annuities specifically.

2. Sales Practices Are Heavily Regulated By The States.

As to the supposed benefits from SEC "sales practice protections," the Proposing Release cites a single instance of the claimed protections: The application of broker-dealer requirements, it claims, would impose an "obligation to make only recommendations that are suitable." Proposing Release at 37,768. Once again, however, the state regulatory regime *already* imposes extensive suitability requirements. In 2003 the NAIC adopted the Senior Protection in Annuity Transactions Model Regulation, which in 2006 was expanded to purchasers of all ages and renamed the Suitability in Annuity Transactions Model Regulation. The Model Regulation—which already has been adopted in more than 33 states—provides for robust standards and procedures to ensure that the "insurance needs and financial objectives of [purchasers or annuities] at the time of the transaction are appropriately addressed." The Regulation's protections exceed those in FINRA suitability Rule 2310 by imposing a supervisory role on insurers and requiring that, among other things, insurers endeavor to obtain information on consumers' financial status, tax status, investment objectives, and other information appropriate for making informed recommendations to the consumer. *See* NAIC Suitability in Annuity Transactions Model Regulation § 6(B), (D). In May 2007, FINRA jointly released a statement with regulators from North Dakota, Iowa, and Minnesota in support of the NAIC Model Annuity Suitability Regulation; the statement is the first significant initiative of the Annuity Working Group, which was established by the Minnesota Department of Commerce and FINRA following the May 2006 Annuity Roundtable to evaluate the regulatory standards governing annuities.

Once again, moreover, states have adopted suitability requirements separate from the NAIC model rules. Florida, for example, recently enacted laws requiring agents to have an objectively reasonable basis "for believing that the recommendation [for a product] is suitable for the senior consumer based on the facts disclosed by the senior consumer as to his or her investments and other insurance products and as to his or her financial situation and needs." FLA. STAT. § 627.454(4)(a) (2008). In making the suitability determination, the agent must gather relevant information from the senior consumer. *Id.* § 627.4554(4)(b).[19]

Importantly, these state suitability requirements have—unlike FINRA requirements—been tailored to annuities and annuity-like products specifically, which present different suitability questions than securities. A consumer's suitability to purchase a security is primarily a matter of *risk tolerance*—*i.e.*, the consumer's inclination and ability to take investment risk. Suitability for an annuity, on the other hand, is seen as concerned primarily with *liquidity*, that is,

[19] A review of actual responses to these suitability forms refutes the unsubstantiated assertion in the Proposing Release that "[i]ndexed annuities are attractive to purchasers because they promise to offer market-related gains." *Id.* at 37,752. A sampling by some Coalition members of recent suitability forms reveals that the large majority of purchasers acquire fixed indexed annuities for stability of premium.

whether the initial payment and flow of income provided by the annuity are appropriate for the purchaser. In short, the suitability requirements that the Proposing Release identifies as a benefit of the rule are unnecessary in light of comprehensive state requirements, and are a poor fit in any event with the needs of purchasers of annuities. Sample suitability statements are attached as Exhibit E.[20]

In addition to the measures identified above, further enhancements to state requirements are underway. State regulators have charged the Suitability in Annuity Sales Working Group of the NAIC's Life and Annuity "A" Committee with developing uniform guidelines for agent training, supervision, and monitoring to further protect consumers from improper sales and marketing practices. The "A" Committee is also considering a model NAIC regulation to prohibit the misleading use of senior-specific certifications and designations by agents in the solicitation and sale of life insurance or annuity products. And, the ACLI is developing Suitability Monitoring Standards for use in implementing the supervisory procedures in the NAIC Suitability Model Regulation. These Monitoring Standards build upon SEC and FINRA rules and guidance on supervisory "best practices," including the recommendations in the *Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products* (June 2004).

Yet another state initiative not accounted for in the Proposing Release is the Interstate Insurance Product Regulation Commission ("IIPRC"), an interstate compact that allow insurers in participating states to make one product registration filing—via an electronic filing system—to seek approval of their product in all participating states. *See* www.insurancecompact.org. The IIPRC adopts uniform product standards and assists the member states in enforcing those standards. The IIPRC was adopted in March 2004 and became operational in May 2006; 33 states have already joined the IIPRC, and five others have legislation pending to join. The IIPRC has adopted standards regarding registration of fixed indexed annuities including, among other things, the readability of contract forms presented to purchasers. *See* www.insurancecompact.org/rulemaking_records/080530_Ind_Imm_NonVar.pdf.

Finally, and as noted, state laws provide additional protections beyond the regulation of disclosure and sales practices that the Commission claims as benefits of the Proposed Rule. Annuity writers are subject to market conduct examinations by the insurance regulator in their state of domicile and in any other state where they do business. These wide-ranging exams focus increasingly on product suitability. Annuity writers are also subject to state unfair trade practice statutes which prohibit the misrepresentation of product terms and conditions, and are within the jurisdiction of the state attorneys general, several of whom have brought high profile

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[20] There are a number of features of FIAs that can make them particularly appropriate for senior citizens. For example, FIAs help avert risk, protect against inflation, provide tax deferral advantages, protect assets from creditors and fraud, avoid probate delays, and, in some cases, compensate purchasers for nursing home care. *See* September 10, 2008, Statement of Mark Meyer, Ph.D., at 7-12 (attached as Addendum hereto).

enforcement cases alleging unsuitable sales and replacements of fixed and indexed annuities to seniors.[21]

For all of the reasons identified above, the measures that the Proposing Release claims as benefits are in fact protections that are currently provided—or are exceeded—under existing law. The Rule would only impose further costs and burdens on efficiency with no compensating benefit, adding on top of existing state laws an unnecessary, largely duplicative layer of federal requirements that were developed around securities generally and have not—like this extensive state regulation—been tailored to annuity products and purchasers particularly. The Proposing Release estimates that registration requirements alone would impose $82 million in additional costs. Proposing Release at 37,770. In fact the costs will be much higher due, for example, to the costs to insurance agents who do not currently have a securities license. The cost to an individual agent of registering *and operating* as a broker-dealer would be prohibitively expensive. According to Schedule A of the FINRA bylaws, registration and examination fees can be up to $4,000. In addition to these fees, the legal costs of registering and applying for membership with FINRA, the cost of completing the necessary forms, and the costs of ongoing compliance could require a "start-up" cost of $25,000 and between $50,000 to $100,000 annually to maintain the registration. Agents would also have to meet CLE requirements, pay licensing fees, and buy study materials or enroll in a course to pass licensing examinations.

In light of these costs, evidently, the Proposing Release concedes that individual and small distributors not currently registered as broker-dealers will likely forgo registration and enter into networking arrangements with registered broker-dealers. *Id.* at 37,772. This alternative will also be inordinately expensive, however, because under current industry practice

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[21] The Release states that growth in the sale of fixed indexed annuities has been accompanied by an increase in complaints of abusive sales practices. No factual support is provided for that statement, and the Proposing Release simply errs in stating that "concerns about potentially abusive sales practices and inadequate disclosure have grown." Proposing Release at 37,755. In fact, NAIC data reflect that fewer "closed confirmed" complaints have been made regarding FIAs than either variable annuities or fixed-rate annuities. The Proposing Release also relies on a statement the former president of NASAA made regarding fixed investment annuities and senior investment fraud, *id.* at 37,755, but NASAA has refused requests by Coalition members that it provide information that supports these claims. (NASAA, unlike the NAIC, does not maintain a system for recording complaints about annuities products.) The reliance of the Proposing Release on the joint examination of free lunch seminars, *id.*, is also misplaced. The "free lunch report" examined broker-dealers' compliance with the securities laws in "free lunch" seminar sales. The report did not examine independent insurance agents, who are the principal sellers of fixed indexed annuities. Within the report, 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 fixed indexed annuities presented a particular problem or were even extensively offered at "free lunch" events.

the agent will *still* bear expenses that include examination fees, state registration fees, and possibly a pro rata share of the associated broker-dealer's increased compliance costs, such as costs associated with capturing and supervising electronic communications pursuant to Exchange Act rule 17a-4(b)(4) and FINRA Rule 2210. And of course, the agent will have to share a portion of his commissions with the registered broker dealer. Altogether, one industry commentary estimates that total costs of the rule will exceed $700 million. Jack Marrion, *The Proposed Rule Will Sock It To Index Annuity Distributors*, National Underwriter, *available at* http://www.lifeandhealthinsurancenews.com/cms/nulh/Weekly%20Issues/issues/2008/29/Focus/L29cover2.[22]

The Commission's failure to address the extensive state regulation in this area contrasts notably with the numerous recent occasions in which it has recognized the importance of avoiding duplicative regulatory and enforcement systems. In adopting Regulation R, for example, which exempts banks from broker-dealer registration for certain activities, the Commission actively "sought to minimize" duplicative regulatory burdens and to defer to banking regulators. *Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks*, 72 Fed. Reg. at 56,514, 56,549 (Oct. 3, 2007). Currently, the Commission is requesting comment on a program to reallocate responsibilities for surveillance and detection of insider trading among various securities exchanges, again to avoid "regulatory duplication [that] would add unnecessary expenses." *Program for Allocation of Regulatory Responsibilities*, 73 Fed. Reg. 48,248, 48,248 (Aug. 18, 2008). And, in another recent change announced with much fanfare, the Commission will exempt foreign private issuers from registration requirements of Section 12(g) of the Exchange Act if, among other things, non-U.S. disclosure documents are posted on the company's website. *See Exemption from Registration Under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers*, 73 Fed. Reg. 10,102, 10,105 (Feb. 25, 2008). In each of these cases, the Commission crafted its proposal in light of the existing regulatory regime for the particular product or practice, with the objective of avoiding or eliminating unnecessary regulatory duplication. The failure to do so here is further evidence that the Commission has proceeded in a precipitous, arbitrary, and capricious manner.

B. The Proposed Rule Would Impair Competition.

The assessment in the Proposing Release of effects on competition is, like its efficiency analysis, flawed and incomplete.

The Release speculates that enhanced disclosure requirements and the removal of regulatory uncertainty regarding the status of fixed indexed annuities under the securities laws will encourage more broker-dealers and insurers to enter the market. Proposing Release at 37,769. That is mistaken. As an initial matter, the "regulatory uncertainty" described by the

[22] Several comments to the Proposed Rule have cited this analysis. *See, e.g.*, Comment of Courtney A. Juhl (Aug. 15, 2008); Comment of Bruce E. Dickes (July 16, 2008); Comment of Dane Streeter (July 16, 2008); Comment of Michael A Harness, Jr. (July 10, 2008); Comment of Andrew Unkefer (July 7, 2008).

Commission is a makeweight; the market for fixed indexed annuities is robust—as the Proposing Release observes elsewhere—and any "uncertainty" regarding the legal classification of FIAs is as easily dispelled by the Commission *rejecting* the Proposed Rule as it is by adopting a rule that could draw legal challenge due to its plain tension with Supreme Court precedent.

With respect to the possibility that more broker-dealers and insurers might enter the market, all evidence points to the contrary, as the Proposing Release admits could be the case:

> If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by Proposed Rule 151A and register those annuities that are outside the insurance exemption under the Proposed Rule, there will be fewer issuers of indexed annuities, which may result in reduced competition. Any reduction in competition may affect investors through potentially less favorable terms of insurance products and other financial products, such as increases in direct or indirect fees.

Proposing Release at 37,770. Currently, more than 90 percent of fixed indexed annuities are distributed by independent insurance agents, rather than by broker-dealers. Advantage Group Associates, Inc., Advantage Index Sales & Market Report 4th Quarter 2007 Part 1, at 10 (2008). Many of those independent insurance agents lack the securities licenses that would be required if fixed indexed annuities were to become subject to the securities laws. If the Proposed Rule is adopted, a significant percentage of these agents must be expected to cease selling FIAs after concluding that the cost of being licensed and subject to additional regulation as broker-dealers is not worth the benefits of selling fixed indexed annuities. Indeed, one recent report shows that this already is the trend in the industry, with more people who sell insurance products dropping their securities licenses than acquiring them, citing, among other things, the costs of compliance and continuing education to maintain licenses for products that represent a small portion of the agent's portfolio.[23] The Proposed Rule will exacerbate this trend, thereby constraining consumers' choices and increasing prices by reducing competition and raising costs among those who do remain in the market.

C. *The Proposal Would Not Promote Capital Formation.*

Regarding capital formation, the Proposing Release claims only that benefits will result from "improving the flow of information between insurers that issue indexed annuities, the distributors of those annuities, and investors." Proposing Release at 37,771. No "improvements" can be claimed, however, without delineating where the states' current, highly-developed means for providing information fall short; the respects in which a system designed to govern the "flow of information" about securities will improve on the informational practices and requirements tailored specifically to products with the features of an annuity; and how those supposed benefits will exceed the costs that undeniably they will impose.

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[23] *Practice Management Support: Giving Producers What They Need Industry Report* 9-10 (LIMRA 2008).

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The Commission lacks the legal authority to regulate fixed indexed annuities and doing so would be a poor policy decision that gives short-shrift to extensive state regulatory efforts. The Proposed Rule would impose substantial, needless costs on those who sell and buy these valued products, and cannot be reconciled with the Commission's obligation to give due weight to the effects of its actions on efficiency, competition, and capital formation.

V. The Proposed Rule Would Impose Unjustified Costs On Small Business In Particular.

Under the Regulatory Flexibility Act, the Commission is required to prepare a "regulatory flexibility analysis" unless it can certify that the Proposed Rule will not "have a significant economic impact on a substantial number of small entities." 5 U.S.C. §§ 603(a), 605(b). The Commission has made no such certification—it has prepared an initial regulatory flexibility analysis instead—and thereby tacitly concedes that the Proposed Rule would in fact have a significant economic impact on small businesses and the men and women who own them and work for them. Proposing Release at 37,771-73.

In fact, the Proposed Rule understates the extent to which the costs identified in Section IV above would fall on small businesses in particular. The Release states "that there may be small entities among distributors of indexed annuities" and that the Rule would affect those "who are not currently parties to a networking arrangement or registered as broker-dealers." Those distributors, the Release theorizes, would opt to contract with registered broker-dealers in order to continue distributing FIAs. This would impose "legal costs in connection with entering into a networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement." Proposing Release at 37,772.

The true costs would be higher as just shown: If the agents who currently sell FIAs forgo registration as broker-dealers, as they are likely to do, then by contracting with broker-dealers they would incur not only legal costs and monitoring costs, but also have to share commissions that they earn from FIAs. That would function as an additional incentive not to offer the product, increasing the likelihood that the effect of this Proposed Rule would be to seriously impair the existing distribution channels for fixed indexed annuities, curtailing the products' availability, and increasing their cost.

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.

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ADDENDUM

Statement of Mark F. Meyer, Ph.D., Regarding SEC Proposed Rule 151A

I am a Vice-President and co-leader of the Insurance Economics Practice at CRA International. I received a Ph.D. in Economics from the University of Michigan in 1987, with concentrations in industrial organization, econometrics, and applied microeconomic theory. Since then, as detailed in the attached *curriculum vitae*, I have been employed at a major law firm and several economic consulting firms applying economic, financial and quantitative theory and practice to a range of business and public policy issues.

I have been requested by the Coalition for Indexed Products to review a new rule proposed by the Securities and Exchange Commission[1] that would likely classify a certain type of annuity, denoted "indexed annuity"[2] in the SEC's materials, as a financial security subject to regulation by the SEC. This Proposed Rule 151A has many implications for a wide range of parties and will undoubtedly elicit numerous comments covering a wide range of issues. In this statement, I address three aspects where I see deficiencies in the analysis supporting the Proposed Rule presented by the SEC: (1) the definition or characterization of investment risk, (2) the risks and returns associated with fixed indexed annuities compared with traditional fixed annuities, and (3) the suitability of fixed indexed annuities for seniors.

I. The Characterization of "Investment Risk" in the Proposed Rule

The definition or characterization of "risk" appears to be central to the SEC's analysis regarding the Proposed Rule. It is important to be clear regarding what constitutes the kinds of risk important to FIA owners and to distinguish this from the kind of risk to which the Proposed Rule 151A is directed.

The fundamental meaning of "risk" has undergone a slow evolution over time from its early Greek (Plato, 360 B.C.) and Latin (Tacitus, 109 A.D.) roots, but in large measure it has remained unchanged, focusing primarily on disaster, peril, danger, and hazard. Its etymology is discussed elsewhere (Cline, 2004). Fast forward 2,400 years and we find its primary meanings continue to define risk by reference to undesirable outcomes – the potential for loss. Today, the most common definitions of risk overwhelmingly remain associated with the existence of hazard, danger, peril, exposure to loss, pain, injury or destruction (e.g., *Webster's Revised Unabridged Dictionary*). In the *Merriam-Webster's Dictionary of Law*, the meaning is narrowed to: possibility of loss or injury; liability for loss or injury if it occurs; the chance of loss; and uncertainty with regard to loss. In the medical field, risk is associated with: the possibility of suffering a harmful event; a factor or course involving uncertain danger (*American Heritage Stedman's Medical Dictionary*); possibility of loss, injury, disease or death (*Merriam-Webster*

[1] Proposed Rule 151A under the Securities Act of 1933 (the "Proposed Rule").

[2] I will use the term "fixed indexed annuities," (or "FIAs") to refer to this product subsequently.

Medical Dictionary). Indeed, in the lexicon of 30 other languages, from Arabic to Swedish, the predominant meaning of the concept of "risk" is associated with the chance of something bad happening.

In the financial economics community, however, some have altered the meaning of risk to incorporate the potential for uncertain gain as well as loss – "the chance that an investment's actual return will be different than expected" (*Investopedia*). Broad definitions of this type have been criticized because, as knowledgeable investors know, for almost all securities the chance that their realized return will be different from the expected return approaches 100%. This is because the "different-from-expected" definition focuses only on the probability ("frequency" in insurance parlance) without regard to the magnitude ("severity" in insurance parlance) of the deviations from expected return. The focus on loss, however, remains central to the idea of investment risk for many in the finance community, as the entry in *Barron's Dictionary of Finance and Investment Terms 3rd Ed.* indicates where risk is defined as the "measurable possibility of losing or not gaining in value."

To the extent that some in the field of financial economics continue to use a characterization of investment risk that incorporates a consideration of upside potential as well as downside loss (both weighted equally), while the understanding of risk across other disciplines (as well as in common usage) focuses on bad outcomes, it is instructive to recognize how this unique financial economics definition came about and why it is not appropriate in most circumstances.

The early measures of investment risk clearly focused on loss or lower returns. For example, Irving Fisher (1906) characterized risk as "the chance of earnings falling below the interest-paying line." The economic literature made a distinction between risk and uncertainty in 1921 with the work of Frank Knight, who associated risk with deviations from the expected outcome where the probabilities and magnitudes are known, and uncertainty, where the probabilities and magnitudes are unknown (Knight, 1921). With the introduction of modern portfolio theory (Markowitz, 1950, 1952), the risk inherent in financial securities began to be measured by the calculation of the standard deviation of returns. This turn of events was motivated primarily by its mathematical tractability, although Markowitz admitted (1959) that a much better treatment of risk would focus on its semi-variance (downside variance).[3] Computers were in their nascent stages in those years and could more easily calculate the (complete) variance of a distribution rather than work through all the observations in a distribution to focus only on the downside risk. Hence, the association of the notion of risk with the mathematical calculation of variance (and standard deviation) was a compromise that at the time could be justified in terms of computational ease and efficiency, at the expense of a possible distortion of the concept of risk.

The use of the standard deviation as a measure of financial risk was embraced by Sharpe's Capital Asset Pricing Model (1964)[4] and, although today's computers can easily handle

[3] Markowitz received the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel ("Nobel Prize in Economics") for his work in financial economics in 1990.

[4] Sharpe shared the 1990 Nobel Prize in Economics with Markowitz (and Merton M. Miller).

downside risk measures, two-sided measures of risk (incorporating upward and downward movements with equal weights) continue to be used in some quarters. Yet there are only two conditions under which these simple measures of two-sided risk (such as variance or standard deviation) correlate perfectly with downside risk, which captures what is more popularly considered risk: a Gaussian (i.e., "normal") distribution of rates of return, or a quadratic utility function for investors. However, there is now extensive economic literature showing that across almost all classes of securities, rate of return distributions are anything but Gaussian, and that quadratic utility functions are anything but rational and have been highly criticized by many of the most eminent economists of the last 50 years (Hicks, 1962; Arrow, 1963; Borch, 1969; Feldstein, 1969; Hirshleifer, 1970; Mao, 1970; Rothschild and Stiglitz, 1970; Hakansson, 1972).[5] It is noteworthy that in his seminal paper Markowitz (1950, p. 326) proposed to condense probability information in terms of moments and realized that the higher statistical moments may be relevant. Nevertheless, he limited himself to the mean and variance for the purposes of his analysis.

Today modern finance has progressed beyond those rudimentary risk measures and more sophisticated risk measures focus on downside loss, or the ratio of upward potential to downside loss. These measures of risk that have been developed during this "post-modern portfolio theory era" (Rom and Ferguson, 1994) are closer to the original concept and common understanding of risk that look toward the chance and magnitude of bad outcomes. "Upside risk" measures have not gained traction, except as potential reward measures in relation to loss measures (Sortino *et al*, 1999). Perhaps the best-known measure of downside risk in the investment literature is Roy's Safety First criterion (1952), which measures the chances of the investment value falling below some predefined disaster level. Other popular measures of risk aversion (which incorporate risk into utility theory) were developed by Arrow (1964, 1970) and Pratt (1964), both of which weigh losses more heavily in utility functions displaying any risk aversion.

Financial economists have since designed other more sophisticated measures to remedy the deficiencies associated with two-sided (and symmetric) risk measures such as standard deviation, variance and beta. These newer measures take into account the asymmetries and non-normality that typify asset returns. Early efforts focused on semi-variance rather than variance (Mao, 1970 and Markowitz 1959, 1970) as a measure of risk on the grounds that semi-variance concentrates on reducing losses, as opposed to variance which considers gains, as well as losses, as undesirable. Later risk measures took into account the entire probability distribution of returns. Having its origins in "majorization theory" (Hardy *et al.*, 1934) the extensive literature that treats investment decision-making by considering the entire distribution of returns is known as stochastic dominance (Quirk and Saposnik, 1962; Fishburn, 1964; Hadar and Russell, 1969; Hanoch and Levy, 1969; Levy, 1992; and Vickson, 1975, 1975, 1977; Whitmore and Findlay, 1978). Later works of Bawa (1975, and many subsequent works authored or co-authored by him), Fishburn (1977), Levy (2006) and others have refined the treatment of risk by focusing on the lower-partial moments of the distributions of returns. These risk measures return attention to

[5] Arrow and Stiglitz received the Nobel Prize in Economics in 1972 and 2001, respectively.

the loss measures that are consistent with popular understandings of risk. Examples of recent risk measures that take into account asymmetries in the return distribution and emphasize loss include the Sortino Ratio (Sortino and Van der Meer, 1991) the Leland measure (Leland, 1999), value-at-risk, conditional value-at-risk measures, and robust, "fat-tailed" measures of downside risk (Dutta and Perry, 2006). It is these measures that represent the state of art on risk measurement in the field of financial economics.

The use of models that emphasize the importance of investor loss aversion is confirmed by research in the emerging field of behavioral finance where such loss aversion behavior on the part of investors is clear and compelling. As stated by Sortino *el al.* (1999), "recent research in the behavioral finance area describes how investors want to behave. In general, investors do not seek the highest return for a given level of risk, as portfolio theory assumes. According to Shefrin and Statman (1998) investors seek upside potential with downside protection."

Given this backdrop of the development of concepts and measures of risk in the financial economics world, let me return to consider the core of the SEC's rationale for the Proposed Rule, which appears to be that: "When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, the majority of the investment risk for the fluctuating, equity-linked portion of the return is borne by the individual purchaser, not the insurer." There are several problems with such an *ad hoc* standard, both in terms of its inconsistency with any accepted economic theory, its debatable calculation, and its perverse incentives.

As others have explained, FIAs are annuity contracts where purchasers receive a credit based on the positive performance of one or more equity or fixed income indexes (such as the S&P 500 Composite Stock Price Index™ or the Lehman Brothers Bond Index™). As a consequence of this structure, FIAs do not incur negative returns when the underlying equity or fixed income index for the fluctuating part of the return declines. FIAs do have minimum guaranteed values that increase each year <u>and</u> they have the <u>potential</u> to have higher (and only higher) values should the indexes move upward.

With regard to its consistency with economic theory, it is clear that the concept of risk permeating the Proposed Rule 151A analysis is focused on what economists have dubbed "upside potential," and not the "downside threat" – at least from the consumer's point of view. In other words, the SEC's stated concern appears to ignore the elimination of downside risk inherent in the FIAs and focuses solely on the uncertain amount of any upside potential to the consumer. This is a curious and improper way of looking at the situation. The individual FIA purchaser does not suffer any downside investment risk. That downside investment risk is entirely upon the shoulders of the guarantor, which in this case is the insurer. Essentially, the consumer has a contract with upside potential and a guarantee of principal. The insurer is "short" this position and the consumer's upside can be a potential loss to the insurer if it does not take steps to offset this risk. There are two general approaches that an insurer takes to meet its guarantees, which include providing a portion of the upside movement in the indexes to which the return formula is linked. The first approach is hedging through dynamic trading.

Under the dynamic trading approach, a portion of this risk can be hedged by the insurer through dynamically synthesizing options by taking multiple positions (typically seven) in index futures each trading day and rebalancing them on a daily basis, or more often, as necessary, according to a complex algorithm. In addition, this dynamic hedging approach requires the purchase of multiple interest rate caps, combined with the sale of interest rate floors, and a managed, laddered portfolio of zero-coupon bonds in order to meet its guarantees. Because there is no perfect hedge available, the insurer incurs much basis risk and uses its own capital to secure its promised returns. For a typical portfolio of FIAs, such an approach would entail more than 25,000 trades over a 15-year period. Compare this to the single payment of the consumer and it is apparent which party is shouldering the greater part of the investment risk!

An alternative approach to hedging the investment risk contained in FIAs is to enter into private contracts (because traded options do not adequately cover the contractual risks in FIAs) with third parties willing to manufacture and write options. Such specialized contracts are tedious to create and involve counterparty risk, as well as frequent updating as experience emerges with lapses, exercise of policy options, morbidity and mortality. The insurer may attempt to hedge a portion of the counterparty risk through individualized credit default swap contracts, or it may absorb the downside loss potential on its own by using its surplus capital. In either case, the basis risk arising from the unhedgeable elements of the FIA will have to be absorbed by the insurer.

A contract that offers the greater of a minimum guaranteed return each period or an indexed return will have a probability approaching 100% over time of generating a cumulative return that is greater than that guaranteed, provided that there is a "ratcheted" return provision in the contract. The SEC did not state that the calculation of its "more likely than not" threshold was a monthly, annual, or contract lifetime feature. The ratchet feature is common in almost all FIAs, which means that the consumer locks in any gains over multiple periods. A "risk measure" that categorizes virtually everything as being "more likely than not to exceed the amounts guaranteed under the contract" is analytically meaningless in such circumstances.

The SEC's Proposed Rule 151A would likely create perverse incentives to insurers that may wish to avoid yet another layer of regulation. If an insurer wants to be "under the wire" for regulatory purposes, it need do nothing more than adjust the parameters of its contracts going forward to ensure that nothing more than the minimum guaranteed return is ever credited. It is difficult to fathom that the intention in giving the SEC oversight in the regulation of securities was to protect consumers from any "upside potential" or to motivate financial institutions to adjust contracts so that consumers could not benefit from higher than minimum guaranteed returns.

Understanding the structure of FIAs makes two points immediately obvious. First, as discussed above, the only "investment risk" that the FIA purchaser accepts for the fluctuating portion of the FIA return is the "risk" of higher returns. The insurer either absorbs or hedges against the costs it will incur occasioned by the upward movement in the relevant indexes. Second, contrary to the presumption embedded in the analysis associated with the SEC's Proposed Rule 151A, the insurer retains significant amounts of "investment risk" in providing FIAs to consumers. The

SEC's ill-advised focus on only one facet of "investment risk" has blinded it to the larger investment risk profile, and the overall risk mitigation capabilities, of FIAs.

FIA premiums go into the selling insurers' general account, and the payments arising from FIAs come from the general account. The investment performance of the general account, therefore, is crucial when evaluating the overall risk inherent in FIAs. To the extent that the general account return performance is subpar, the insurer is at risk because the overall guarantees embedded in the FIAs must still be met. The analysis accompanying the SEC's Proposed Rule 151A ignores this reality. The risks the insurer retains in providing FIAs include: (1) the risk of capital loss as the general account assets lose value due to rising interest rates or declining stock prices, (2) the liquidity risk associated with both equities and fixed income securities, (3) the counterparty risk associated with swap and derivative positions, (4) and numerous other financial market and counterparty risks.

I note that the SEC's efforts to regulate overall market performance and the management and reporting of corporate finances is the primary benefit that it can provide to purchasers of FIAs. As FIAs' upside potential relies on indexes comprised of numerous individual securities (that are often traded on exchanges or in OTC markets), FIA providers have no ability to manipulate the index results. The SEC, however, through its regulatory capabilities devoted to fostering greater market efficiency and transparency, as well as good corporate management and reporting, benefits the purchasers of FIAs quite significantly.

This is an appropriate task for SEC enforcement and one, I contend, where the regulatory benefit/cost ratio will substantially exceed that associated with the regulation of indexed annuities. Regulating markets and corporate disclosures addresses systemic risks in the economy and is considerably more amenable to SEC regulation than the individualized characteristics of FIAs. It is important to note that FIAs are issued specific to each individual at a particular point in time. FIAs have numerous options that the purchaser can exercise, and the collection of options exercised by each purchaser specifically addresses the individualized needs and desires of that purchaser. Extending SEC regulation to such individually designed financial instruments could well involve the SEC in disputes where extremely particularized investigations would be needed to attain resolution. As a federal agency with national (and international) scope, SEC enforcement resources are likely better focused on more systemic issues.

II. Comparing Rates of Return Between FIAs and Traditional Fixed Annuities

To the best of my current knowledge, there is no comprehensive and competent examination in the public, peer-reviewed literature comparing the risk and return characteristics of FIAs and traditional fixed annuities. Nevertheless, examination of the crediting mechanisms / characteristics of these two products suggests that, over a long enough period of time, FIAs would likely yield a return notably higher than that available in an appropriately comparable traditional fixed annuity with only somewhat greater dispersion.

Both FIAs and traditional fixed annuities guarantee payments of premium and a positive return on premiums paid (reduced by any applicable withdrawal charges). The difference, of course, is that in the traditional fixed annuity product the purchaser typically will receive only the amount that is guaranteed, and there is no variation or dispersion over time in that amount. In the FIA, on the other hand, the amount the purchaser will ultimately receive may vary with the experience of the underlying index, which is uncertain at the time of purchase, and will exhibit variation or dispersion over time. The downside movement in returns, however, is truncated at zero. FIAs, therefore, have a variation in (expected and, most likely, actual) returns higher than that associated with traditional fixed annuities. The variation in the FIA returns is the "price" of obtaining the upside potential arising from the index experience.

Although FIAs are, of course, not guaranteed to return more than traditional fixed annuities, a number of actuarial simulation studies performed in the industry to investigate the index features in FIAs have found that the average annual credits will have an appreciably higher value than for the comparable fixed-rate annuity due to the typical historic characteristic of equity index increases exceeding the risk-free rate that is embedded in option pricing.

III. The Suitability of Annuities, Including FIAs, for Seniors

There are a number of reasons why annuities, including FIAs of the type covered by the Proposed Rule, are suitable for senior citizens. American senior citizens face a substantial risk that the SEC cannot regulate and that annuities, including FIAs, can alleviate – the risk of outliving their assets. In the following paragraphs I will list a number of benefits that annuities, including FIAs, offer consumers. One likely effect of adopting Proposed Rule 151A is that some sellers of traditional fixed income annuities would no longer be able to also provide FIAs to their consumers. For these sellers and their customers, the effect of adopting Proposed Rule 151A would be to limit their ability to craft retirement income strategies that benefit from the upside in the equity or fixed income markets.

1) Risk Aversion and Age

Many scholarly studies and population surveys have documented that the elderly have less tolerance for financial risk than younger people. Intuitively this makes sense as seniors have very limited ability to rebuild their financial nest egg. This is particularly true for single women.[6] For example, a 2007 survey of the elderly revealed that 28% were not willing to place their assets in any investment that could generate negative returns over any given year (Matthew Greenwald, 2007, p. 34). Annuities and certificates of deposit both provide protection against loss of principal throughout their accumulation periods; few other assets accomplish this feat. Some FIAs even allow annuitization any time after the first anniversary, and allow annual or monthly withdrawals, typically up to 10% per year, without

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[6] An extensive bibliography of findings regarding the relative risk tolerance of men versus women is provided in Babbel (2008).

subjecting the owner to any surrender penalties. This is more than twice the withdrawal rate an individual can get through bond ownership in today's yield environment, without invading principal, and more than six times the level an individual can get through stock ownership at today's dividend levels, without being subject to market price losses. If an individual invades principal, she is subject to reverse dollar-cost-averaging, which means that she will have to sell more bonds or stocks when the market is down in order to achieve a particular income objective, and then will have fewer bonds or stocks to ride the market back up. The losses from reverse dollar-cost-averaging have proven to be substantial over the three to four business cycles that typically occur during a retirement phase. The losses are particularly pronounced if the individual enters into retirement at the beginning of a downward cycle. With annuity withdrawals or payouts, the individual is not subject to such risk. Based on historical figures, money that is expected to last more than 30 years in a stable market can become extinguished in fewer than 14 years if an individual is holding a portfolio of bonds (60%) and stock (40%) at retirement, or in fewer than 7 years if one has all of their savings in stock.

Deferred annuities, including the FIA contracts at issue in the Proposed Regulation, may be attractive vehicles for risk-averse or inexperienced investors. For inexperienced investors, or those unwilling or unable to extend the effort to trade their own portfolios, traditional and indexed annuities offer a low-risk and worry-free investment alternative. This is supported by the 2007 NAVA survey on Investment Risk and Guarantees, which indicates that large "segments of older Americans are open to products, such as annuities, that allow them to minimize their fears while investing in the stock market" (Matthew Greenwald, 2007, p.10).

Indexed annuities allow for some equity or fixed income market upside exposure, yet are suitable for senior citizens due to the embedded guarantees. The purchase of an indexed annuity can help to achieve a more remunerative investment strategy without subjecting invested funds to the losses associated with market downturns.

2) Protection from Outliving One's Assets

The need to protect against outliving one's assets has increased in recent years. The erosion of confidence in Social Security promises and adequacy of benefits, the accelerating demise of corporate pension programs,[7] the rising costs of healthcare, the erosion of retirement income occasioned by inflation, and an increasing American life expectancy have all contributed to a greater emphasis on private saving for retirement (Munnell, 2003).

As annuities were first developed to ensure that policyowners did not outlive their assets (Poterba, 1997), an annuity can be an important part of a retirement plan. A fixed annuity

[7] The number of defined contribution plans has risen from approximately 341,000 plans in 1980 to approximately 653,000 plans in 2004. Conversely, the number of defined benefit plans has decreased from approximately 148,000 plans to 47,000 plans over the same period. Refer to the "Facts" from Employee Benefit Research Institute, June 2007.

enables the annuitant to receive a steady, monthly payment during the annuity's liquidation phase for a desired amount of time, typically for the duration of the annuitant's life. A 2007 NAVA survey on Investment Risk and Guarantees indicated that guaranteed lifetime income is important to older Americans. "A large majority (82%) of older Americans feel that investments with guaranteed lifetime payments provide supplemental income and peace of mind" (Matthew Greenwald, 2007, p. 8).

One particular segment of the population at risk to outlive their assets is women. Married women generally outlive their husbands by six years (Babbel, 2008). Also, older women are 50% more likely than older men to live in poverty. A New York Life Insurance Company survey conducted in March 2006 found that "only 54% of women expressed confidence that they would be able to maintain their lifestyle after their husband's death" (Babbel, 2008, p.6). These data points emphasize that certain profiles within the population rely on products that provide guaranteed income and that can help offset increased medical expenditures.

Apart from inflation-indexed Social Security payments, many elderly people may be living on fixed incomes from pensions, immediate annuities, and interest income. It is impossible for economists to forecast inflation over the 20-35-year typical horizon of retirement with any accuracy, yet the elderly are especially vulnerable to the cumulative effects of inflation on the purchasing power of their fixed income.[8] Having one or more deferred annuities, particularly an annuity that increases in value as an index increases, allows a senior to continue accumulating assets in a safe (and tax-efficient) manner, so that when the need arises, it is available to be partially or wholly annuitized to supplement one's income.

Some of the FIAs under consideration for inclusion in the Proposed Rule offer an annuitant the ability to convert the contract to one of the settlement options including income for a specified period, for their lifetimes, and other annuitization options anytime after the first contract year.

3) Benefits from the Upside Potential of Equity or Fixed-Income Markets

One of the major attractions specific to FIAs is the ability of the purchaser to benefit from some of the upside potential of the equity or fixed-income markets while simultaneously eliminating all of the downside exposure to those markets and assuring a guaranteed stream of payments. Most seniors hope that they will have many years of enjoyable retirement. The benefit from the possible upward movements of the equity market (and elimination of the downward movements) is an attractive feature of FIAs for seniors looking at a long retirement period.

[8] For example, over each ten-year period since America abandoned the gold standard in January of 1972, inflation has eroded the value of fixed income payments by anywhere from 21% to 53%.

Seniors can, of course, get exposure to equity markets by investing in a well-diversified portfolio of mutual funds. Such a tactic, however, exposes them to drops in stock prices and the ravages of reverse dollar-cost-averaging described above. The more sophisticated can mitigate this risk by purchasing options or actively managing their portfolio(s). This approach, however, incurs costs and few (if any) seniors have the ability to manage their portfolios adequately over a long retirement period. Purchasing an FIA hands the responsibility for hedging against a downturn in the index to professional investors and, more importantly, the FIA provider guarantees that the purchaser never suffers the loss.

4) Benefits of Stability and Guaranteed Rates of Return

Recent research has shown that senior citizens generally earn about 2% less per year, on average, on their stock and bond portfolios than people below 55 years in age, even after adjusting for the riskiness of the portfolios (Korniotis and Kumar, 2007). This can have a large cumulative negative effect upon the amount of capital available to provide income for one's later years, and when people compare annuity returns to what can be earned in alternative investments they need to account for this fact. With an FIA, one gets the benefit of more stable asset growth than that available through many other methods, with protection against negative returns. Few, if any, individuals can replicate guaranteed rates of return of an FIA over a long period of time without taking notable downside risk.

5) Nursing Home Care

One of the risks of the elderly is incurring the expense of nursing home care. The annual cost of a private room averaged $75,000 in 2007. Consider an elderly person who is getting by with about $37,500 per year on a fixed income. When the need for nursing home care arises, such a person may not be able to afford it without going onto the welfare rolls, and would have to seek Medicaid and whatever levels of care such a program would support. Medicare does not cover such expenses. A person could plan for this through long-term care insurance, if there was enough foresight to have purchased it long prior to the need. However, the person may not wish to spend the money on insurance coverage that may never be needed. A person could purchase a step-up immediate annuity at the onset of retirement at 65 years of age, which would increase payments from $37,500 per year to $75,000 at some pre-specified date, such as 85 years of age. But what if the person guesses wrong about the age that such coverage will ultimately be needed? And what if the person guesses wrong about the amount that such coverage will ultimately cost 20 years later? And what if the person never needs the coverage, having died before nursing home care was required? A deferred annuity, including one that provides benefits associated with the upside movement in equity or fixed income markets, provides a good way to hedge against these risks.

Most FIAs provide a nursing care provision that allows between 20% and 100% withdrawals without any penalty, regardless of when the need arises after the first anniversary of the policy. Many FIAs also have a terminal illness rider available. A person can deduct the amount that is greater than 7.5% of her adjusted gross income, which would typically be the case for people undergoing nursing home care. The costs of qualified long-term care services can generally be included as medical expenses. Accordingly, the money placed in a

deferred FIA will escape taxation during the accumulation phase, and if used for nursing home care, may ultimately escape it altogether. Should such care not be needed, the accumulated funds may be used for other purposes, such as conversion into an immediate annuity or a period-certain annuity. In either case, the annuitant benefits from an exclusion ratio that exempts from taxation a portion of each payment related to the basis of the contract and period over which it is expected to be returned. In the interim, the funds continue to accumulate tax-deferred interest until they are fully expended, in the case of a period-certain annuity, or until death in the case of a life annuity. Contrast this with an alternative non-qualified savings plan for such eventualities as nursing home care. The funds would be taxable throughout the accumulation period, and the amount of funds would typically be subject to capital losses that could jeopardize the individual at the time nursing home care is required.

6) Protection of Assets from Creditors or Fraud

One of the great fears of the elderly is that someone will obtain control of their assets and that they will lose their financial security without recourse to additional earning power. The elderly who have easily accessible, fully liquid assets are more prone to having someone abscond with their money, whether it be a related or unrelated party. In the case of a related party, who is assisting an aged person with daily living skills, the aged person is particularly vulnerable to emotional pressure to transfer assets with the implicit or explicit threat that care will be withheld if such transfer is not effected. Annuities are protected from creditors in most states, and the procedures involved in liquidating a portion or all of an annuity in order to meet an unwise disposal of their assets serves as a deterrent. A surrender penalty may be involved, as well as a delay of a month or so. This interval will relieve pressure on the aged person to transfer assets for such unwise purposes.

7) Tax Deferral

The classic approach taken by financial planners is to encourage tax deferral until one reaches a lower tax bracket at retirement. In today's uncertain tax environment, where certain tax preferences are scheduled to expire, an election is approaching, and a growing federal deficit, it cannot reasonably be assumed that tax rates will remain the same, or that one will slide into a lower tax bracket as one ages. Therefore, it is prudent to leave some flexibility in the timing of the realization of taxable income.

Research has demonstrated that for a person who purchases a deferred annuity at age 65 or beyond, the tax deferral benefit on a deferred annuity that is later converted (or exchanged) into an immediate annuity can exceed 200 basis points per year. In other words, for an alternative set of assets to produce a similar amount of after-tax income, they would need to generate more than 2% higher pre-tax return per year than the yield on an annuity. Several conditions affect the size of this tax benefit, including prevailing yields, length of time the annuity remains in deferral, length of remaining life, and the composition of the alternative portfolio among assets that generate capital gains, dividends, and ordinary income.

8) Avoidance of Probate Delays and Disclosures

Some people purchase deferred annuities as a convenient method of wealth transfer, in case the assets are not needed to provide for lifetime income. If one annuitizes the wealth at the onset of retirement, there may be nothing to transfer to one's heirs upon death.

The probate process can take a great deal of time. The settlement time frame for many estates is from nine months to two years. Complex or contested estates can take much longer. With few exceptions, your heirs will have to wait until probate is concluded to receive the bulk of their inheritance. Depending on the state, probate and administrative fees can consume between 6 and 10 percent of your estate. That percentage is calculated before any deductions or liens are taken out.

Privacy is an important issue for many people, especially as it pertains to their financial matters. Probated wills are public documents, but life insurance and annuity polices are private contracts. They do not have to be mentioned in a will and do not normally pass through probate. As a result, life insurance and annuity policies can be used to pass along assets with the utmost confidentiality and privacy intact.

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Prior to joining CRA International, Dr. Meyer was a senior economist at the Princeton Economics Group, Inc., senior managing economist and a director in the New York office of the Law & Economics Consulting Group, Inc., and an economist at the law firm of Skadden, Arps, Slate, Meagher & Flom in New York.

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November 17, 2008

Via Hand Delivery

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Supplemental Comment regarding Indexed Annuities and Certain Other Insurance Contracts File No. S7-14-08

Dear Ms. Harmon:

On September 10, 2008, Old Mutual Financial Network ("Old Mutual")[1] submitted a comment to the Securities and Exchange Commission (the "Commission" or "SEC") setting forth its legal and factual analysis in opposition to proposed rule 151A.[2] On November 17, 2008, Old Mutual filed a supplemental comment letter providing responses to issues raised by Commissioner Casey and Jim Burns of the Commission's staff in a meeting on October 20, 2008 with me and Tom McDonald to discuss proposed rule 151A.

In this supplemental comment, Old Mutual examines the differential impact of the current financial crisis on the owners of variable annuities regulated by the Commission and owners of the indexed annuities regulated under state insurance law. During this period of severe worldwide financial stress, variable annuities have performed as designed, shifting market losses to contract owners, resulting in significant losses of principal. In contrast, indexed annuities have shielded contract owners from the loss of principal while protecting and preserving contract values at minimum rates of interest established under state insurance law.

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[1] Old Mutual Financial Network ("Old Mutual") is the marketing name for the U.S. life insurance and annuity operations of Old Mutual plc. Working through its network of established insurance companies (OM Financial Life Insurance Company, OM Financial Life Insurance Company of New York), Old Mutual is headquartered in Baltimore, MD; maintains a National Sales Office in Atlanta, GA, and service centers in Nebraska and Atlanta. The companies that comprise Old Mutual deliver a diverse portfolio of annuities and life insurance products via an established group of master general agents. Products are distributed in 50 states and the District of Columbia. Old Mutual has nearly one million policyholders nationwide. As of June 30, 2008, Old Mutual had $18 billion in statutory-basis assets.

[2] Old Mutual's comment is publicly available at http://www.sec.gov/comments/s7-14-08/s71408-1832.pdf.

ND: 4848-8908-0835

The widely differing outcomes experienced by owners of variable annuities and indexed annuities in this financial crisis underscores the misguided nature of rule 151A's premise that indexed annuities include structural risk transfer mechanisms similar to variable annuities and therefore must be regulated as such. We also address certain comments filed with the Commission which advocate the application of this flawed concept to indexed annuities. Finally, we urge the Commission to carefully consider the potentially negative impact the adoption of proposed rule 151A may have on existing and future rights of indexed annuity owners under state insurance law and regulation. In particular, we invite the Commission's careful attention to the social and economic damage which may result from the loss of state insolvency guarantee law protection currently applicable to indexed annuities in the fifty states, the District of Columbia and Puerto Rico as a result of the reclassification of indexed annuities as securities.

I. INDEXED ANNUITIES ARE NOT PURCHASED FOR THE SAME REASONS VARIABLE ANNUITIES AND MUTUAL FUNDS ARE PURCHASED AND REGULATING THEM AS SUCH IS A MISTAKE.

The Commission has stated that people buy indexed annuities "for many of the same reasons that individuals purchase mutual funds and variable annuities and open brokerage accounts"[3] and therefore require federal disclosure, antifraud, and sales practice protection.[4]

Comments filed with the Commission in this proceeding by owners of indexed annuities paint an entirely different picture and do not support the Commission's view regarding the reasons why people buy indexed annuities. Buyers of indexed annuities have stated in filed comments that they bought their contracts for the guarantee of principal provided by the insurance company and for potentially better rates of interest than they might obtain through a traditional certificate of deposit or a traditional declared rate fixed annuity. These filed contract owner comments are generally consistent with the reasons why people buy Old Mutual's indexed annuities.[5]

In our initial comment letter filed with the Commission, we noted that disclosures the SEC finds important for buyers of indexed annuities are being provided under state insurance laws regulating disclosure and sales practices.[6] Commenters supporting the adoption of proposed Rule 151A urge (without examining or analyzing state insurance laws regulating disclosure and sales practices) that the federal disclosure, antifraud and sales practice protections which currently apply to variable annuities are superior to state insurance regulated disclosure and sales practice protections. These commenters apparently view the federal disclosure regime as a "magic bullet" to cure the ills of allegedly uninformed buyers. As discussed in Section I. A. immediately below, federal disclosure has not proved a "magic bullet" for many buyers of

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[3] Indexed Annuities and Certain Other Insurance Contracts, Release No. 33-8933 (the "Proposing Release") at 5.

[4] *Id.* at 6.

[5] For example, in an internal review of randomly selected suitability forms for contracts issued by Old Mutual, buyers most often cited principal protection as their most important goal in buying the contract.

[6] *Supra* note 2.

variable annuities, who, despite receiving the detailed disclosures required under Form N-4 for variable annuities, apparently may still not understand the risks they assumed when they bought a variable annuity.[7]

A. Variable Annuity Owners Experience Market Loss, While Indexed Annuity Owners Experience Safety of Principal and Locked In Gains.

Market losses driven by the current financial crisis have fallen unequally on owners of variable annuities and owners of indexed annuities. Owners of variable annuities, despite receiving the benefit of mandatory and comprehensive federal disclosure, antifraud and sales practice protections detailing the possible risk of losing their entire investment in a variable annuity[8] reportedly are now concerned about *the safety* of their variable annuities!

> Many owners of variable annuities have endured a double whammy lately: Their investment-account balances have taken a hit, as have the financial-strength ratings on the insurers that issued their annuities.
>
> Agents and brokers say they've received a flood of calls from clients in recent weeks *about the safety of their variable annuities*, in part fueled by the stock-market turmoil and the government rescue of insurer American International Group Inc.[9]

This reported lack of understanding about the risks being assumed by variable annuity buyers—despite receiving the benefit of mandatory and comprehensive federal disclosure, antifraud and sales practice protections—is further highlighted by proposed Maryland regulation COMAR 31.04.14.04, which provides in part:

> An insurer delivering or issuing for delivery in this State a variable annuity contract shall deliver to the applicant for the contract, and obtain a written acknowledgement of receipt from the applicant coincident with or before the execution of the application, the following disclosure that:

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[7] Perhaps the true issue is not a debate over the adequacy of state versus federal disclosure but rather how to insure that annuity buyers use the important disclosure materials they are given. The Proposing Release does not address this issue. The Proposing Release offers no empirical evidence based on focus group studies or otherwise that an additional layer of federal disclosure for indexed annuities would be worth its cost.

[8] Typical variable annuity prospectus disclosure: "We do not guarantee the investment results of any Separate Account. There is no assurance that the value of your Contract will equal the total of the payments you make to us."

[9] M.P. McQueen, *Are Annuities at Risk Now? Some Answers*, Wall St. J., Oct. 29, 2008 (emphasis added). In quoting this article, we deplore its mischaracterization of American International Group, Inc. as an insurer. As a parent company of several insurers, American International Group, Inc. is not itself an insurer. The obligations of American International Group, Inc., as a non-insurer, are not subject to important insurance guarantees provided by state insurance guaranty laws and present different risks to its investors and counterparties than do the general account insurance obligations of its insurance subsidiaries which enjoy important insurance guarantees provided by state insurance guaranty laws.

(1) is printed in at least 12 point type; and
(2) Shall read as follows: "Please be aware that the non-guaranteed benefits of the variable annuity contract for which you are applying are not protected by the Maryland Life and Health Insurance Guaranty Corporation. Only the account values guaranteed by the insurer are protected by the Maryland Life and Health Insurance Guaranty Corporation up to the statutory limits."

The newly proposed notice joins an existing notice that must be delivered with the variable annuity to the buyer. The proposed regulation is necessitated by "recent financial problems in the market."[10]

The record in this rulemaking proceeding demonstrates that owners of indexed annuities have not suffered the market losses experienced by owners of variable annuities. We are not aware of any comment among the more than 4,000 comments filed with the Commission by an owner of an indexed annuity who has expressed angst over the possibility of not being credited enough interest or wishing they had purchased a mutual fund or variable annuity or opened a brokerage account.

B. An Insurer's Use of an Index, as Part of a Formula to Set an Excess Interest Crediting Rate, is Not Equivalent to the Risk and Reward Transfer Provisions of a Variable Annuity.

1. NASAA Comment Letter

The North American Securities Administrators Association, Inc. (NASAA), a strong proponent of Proposed Rule 151A, agrees with the SEC's statement in the Proposing Release that indexed annuities expose investors to investment risks that are virtually identical to the risks of investing in mutual funds and variable annuities.[11] NASAA's comment letter refers to a paper prepared by an economist named Dr. Craig J. McCann ("McCann"), whose firm is named Securities Litigation & Consulting Group, Inc. We note that McCann is a paid plaintiff's expert witness in numerous class actions brought against fixed annuity insurers. McCann's paper argues that indexed annuities are "quite similar to equity-participation securities."[12] McCann dismisses the insurance features which serve to distinguish indexed annuities from equity-participation securities as "virtually worthless bells and whistles"[13]—an argument that suggests that the very state insurance solvency and nonforfeiture guarantees that have protected index annuity owners

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[10] E-mail from Brenda A. Wilson, FLMI, Associate Commissioner, Life and Health Section, Maryland Insurance Administration to Leah Walters, American Council of Life Insurers (Oct. 29, 2008 12:05:07 EST) (on file with author).

[11] See comment letter of North American Securities Administrators Association, Inc., citing *An Economic Analysis of Equity-Indexed Annuities*, Prepared by Craig J. McCann, PhD, CFA, Securities Litigation & Consulting Group, Inc. publically available at http://www.sec.gov/comments/s7-14-08/s71408-1759.pdf.

[12] *Id.*, McCann paper at 4.

[13] *Id.*, McCann paper at 5.

in the recent market collapse—guarantees not found in equity-participation securities—have no value at all.

Although we believe the lack of understanding of insurance products, lack of empirical evidence, and weakness of substantiation and objectivity of argument are self-evident within McCann's paper, we believe the egregious nature of the paper warrants at the least a summary response.

- Variable annuities involve a pass-through of investment performance to the consumer, both gains and losses. Variable annuities operate like investment companies.[14] The variable annuity contract owner—not the insurer—bears the risk of market losses.
- Traditional declared rate fixed annuities leave the crediting of current interest rates to the discretion of the insurer. This is fundamental to the business of insurance.
- Fixed indexed annuities guarantee the consumer that current interest rates will be determined according to a mathematical formula, which includes inputs based on the performance of the referenced index, but can never be less than zero. Any participation rate, cap or spread that is included in the mathematical formula used to determine what portion of an increase in the referenced index will be credited for the period is set in advance for an initial period when the contract is issued and may be reset periodically thereafter at the discretion of the insurer, as with interest rates under a traditional declared rate fixed annuity as noted above. The insurer—not the owner of an indexed annuity—bears the risk of market losses.
- The fact that current interest rates are in whole or in part at the discretion of the insurer in traditional fixed and indexed annuities does not equate to the consumer bearing investment risk, as recent market conditions have highlighted. Where the insurer bears all of the risk on the underlying general account assets, and determines in its discretion what it can pay contract owners above minimum guarantees, it is conducting the business of insurance and absorbing any risk of loss that the consumer might otherwise bear.
- A hypothetical variable annuity contract owner that invested in the S&P 500 on October 9, 2007 when the S&P 500 closed at 1565.15 would be down more than 44% as of November 14, 2008, whereas a hypothetical indexed annuity contract owner may have received 0% current interest but would have suffered no loss during this same period. The variable annuity investor in this example needs the S&P 500 to return to 1565.15 (from 873.29 as of the close of the market on November 14, 2008) simply to be whole. In contrast, the indexed annuity owner has the potential to earn significant interest on the full initial premium as the S&P 500 index gradually claws back to 1565.15.[15]

[14] SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 81-92 (1959) (Brennan, J., concurring).

[15] By way of example, we include an illustration comparing account values as of 10/31/08 for Old Mutual's most popular product when issued on 10/31/2004, 10/31/05, 10/31/06 and 10/31/07 compared to an S&P index without dividends or splits and a ETF SPYDER where S&P gains include dividends and splits. The differences speak for

- The account value in a fixed indexed annuity is not a notional value. It is the value of the contract available to the contract owner as in any traditional fixed (or variable) annuity. Whether in fixed or variable annuities, the account value will be subject to a surrender charge if accessed during the surrender charge period. The surrender charge is not what makes a variable annuity a security and should not be what determines if a fixed indexed annuity is "virtually identical" to a variable annuity. In a traditional fixed or fixed indexed annuity, the account value will never be less than a guaranteed minimum value. In a variable annuity there is no minimum account value.[16]

- Fixed indexed annuities and equity-participation securities are similar in terms of utilizing an index to determine an amount, but vastly different in terms of securing the payment of the amount so determined. An equity-participation security is an unsecured debt obligation with future payout based solely on the credit of the issuer. A fixed indexed annuity is a state regulated insurance product with future payout backed by assets of the insurer's general account. Although the insurer bears the risk of investment performance on its general account assets, its investments and solvency requirements are highly regulated by state insurance departments. These state insurance protections are notably absent from equity-participation securities.[17]

2. K&L | Gates Comment Letter on Behalf of Variable Annuity Insurers.

Certain comments submitted to the Commission suggest that the investment risk borne by a purchaser of a fixed indexed annuity is derived from the retrospective nature of interest crediting. One commenter appears to argue that while traditional fixed annuities are properly exempted under Section 3(a)(8) of the Securities Act of 1933, indexed annuities are not. The comment stated "Because fixed annuities, in contrast, guarantee interest at rates stated in advance, a purchaser knows what the relative risks and rewards are in deciding whether to make an initial purchase, make additional payments and/or exchange into another product."[18] This is

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themselves but range from a loss of 37.5% on the S&P Index compared to a 3% credit for an FIA issued 10/31/07 and a loss of 2.1% on the ETF SPYDER to a 6.8% credit for an FIA issued 10/31/04. See Schedule 1.

[16] By way of example, we include an illustration showing actual Available Cash Surrender Values relative to the Old Mutual FIA illustrated in Schedule 1. The illustration speaks for itself but demonstrates that as of 10/31/08 each of the FIAs issued as of October 31st for the prior 4 years have an Available Cash Surrender Value greatly in excess of the value available in an S&P Index or ETF SPYDER. See Schedule 2.

[17] See Eleanor Laise, *Another 'Safe' Bet Leaves Many Burned*, Wall St. J., Nov. 11, 2008 ("With Wall Street in turmoil, many of the risks of structured products are now coming to light....Principal-protected notes typically are designed to return the principal investment at maturity, along with some portion of the gains in an underlying benchmark, such as the Standard and Poor's 500 stock index. Yet investors selling before maturity may not recoup their full investment, and the principal protection depends on the issuer's ability to meet its obligations...When an issuer goes belly up, as Lehman Brothers Holdings Inc. did in September, structured product investors are generally left standing in line with other creditors and may face a long wait to determine how much, if anything, they'll be able to recover").

[18] Comment letter of K&L | Gates on behalf of AXA Equitable Life Insurance Company, Hartford Financial Services Group, Inc., Massachusetts Mutual Life Insurance Company, MetLife, Inc. and New York Life Insurance

an argument of form over substance. This argument ignores the effect of surrender charges on a traditional fixed annuity, and ignores the fact that current interest rates are typically set in advance for only one year at a time—not for the entire surrender charge period. An owner of a fixed annuity who is not pleased with the rate declared in advance is no less restricted from "exchang[ing]" into another product than is the owner of a fixed indexed annuity because both would incur surrender charges (during the surrender charge period). Further, the decision whether to purchase a traditional fixed annuity or to make additional purchase payments into a traditional fixed annuity based on current declared interest rates is a decision with a one-year time horizon where interest rates are declared annually. The long-term nature of an annuity contract would indicate that the purchaser of a traditional fixed annuity should be prepared to hold the contract for a period well beyond the period of certainty regarding the current interest rate, and thus the one year of certainty is not a substantive reason to distinguish the "investment" risk in a traditional fixed annuity from the "investment" risk in a fixed indexed annuity.

II. THE ADOPTION OF RULE 151A MAY NEGATIVELY IMPACT EXISTING STATE INSURANCE SOLVENCY GUARANTEES PROTECTING PURCHASERS OF INDEXED ANNUITIES AND MAY RESULT IN A COMPLETE LOSS OF GUARANTY ASSOCIATION COVERAGE IN SOME JURISDICTIONS.

As noted in the Proposing Release, state insurance regulation includes the regulation of insurers' financial condition.[19] In spite of close supervision by state insurance regulators of insurer capital ratios, insurers can fail. The "safety net" that protects life insurance policy holders and annuity

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Company publically available at http://www.sec.gov/comments/s7-14-08/s71408-1942.pdf. Several of these insurers previously filed individual comment letters with the Commission. AXA Equitable Life Insurance Company, publically available at http://www.sec.gov/comments/s7-14-08/s71408-1725.pdf; Hartford Financial Services Group, Inc., publically available at http://www.sec.gov/comments/s7-14-08/s71408-1646.pdf; MetLife, Inc. publically available at http://www.sec.gov/comments/s7-14-08/s71408-1835.pdf and New York Life Insurance Company publically available at http://www.sec.gov/comments/s7-14-08/s71408-1862.pdf. As the Commission evaluates these comment letters it may wish to consider whether the comments of some or all of these insurers—as companies that offer variable annuities and certain fixed annuities (but not fixed indexed annuities—and have expressed no interest in their comment letters in offering indexed annuities to the public if the Commission would only clarify the status of these products by adopting proposed rule 151A)—are more deeply rooted in limiting competition in the U.S. market place for annuity product offerings by eliminating indexed annuities from that market.

Some of the variable annuity insurers participating in the K&L | Gates comment letter individually expressed concern that sensationalized reporting of indexed annuity sales abuse may hurt sales of all annuities. For example, see the comment letter of Hartford Financial Services Group, Inc. ("Unfortunately, the significant regulatory activity and negative media coverage in recent years, much of which has resulted from and focused on inappropriate sales practices involving EIAs, might dissuade some consumers from even considering whether any annuities can help them achieve their financial goals") and the comment letter of MetLife, Inc. ("Further, unsuitable sales and marketing of EIAs may tarnish the reputation of annuity products as a whole"). In our initial comment letter we reviewed the applicable legal precedent of the United States Supreme Court and its application to indexed annuities. Negative media coverage of a particular insurance product is not a substantive factor in determining the availability of an exemption under Section 3(a)(8) of the Securities Act of 1933.

[19] Proposing Release at 57.

contract owners if an insurance company does become insolvent is provided by the life and health insurance guaranty association laws of the fifty states, the District of Columbia and Puerto Rico. According to the National Association of Life and Health Insurance Guaranty Associations ("NOLHGA"),[20] in the last 25 years state guaranty associations have:

- provided protection to more than 2.3 million policyholders
- guaranteed more than $21.2 billion in coverage benefits
- contributed $4.4 billion to ensure that policyholders received their benefits.[21]

The scope of coverage under guaranty association laws is purely statutory[22] and varies according to state law. Most states provide at least $100,000 in withdrawal and cash values for traditional annuity contracts—including non-registered indexed annuities. In computing the guaranteed amount, some states cap the amount of interest according to a statutory formula. Some states apply these caps without regard to whether an indexing formula is employed to compute interest under the contract. Some states also exclude any indexed interest that has not been credited to the contract at the time of the insurer's impairment or insolvency.

Although the wording varies, all guaranty associations exclude from coverage "that portion or part of any policy or contract under which the risk is borne by the policyholder."[23] Since the

[20] The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) is a voluntary association made up of the life and health insurance guaranty associations of all 50 states, the District of Columbia, and Puerto Rico. NOLHGA was founded in 1983 when the state guaranty associations determined that there was a need for a mechanism to help them coordinate their efforts to provide protection to policyholders when a life or health insurance company insolvency affects people in many states. http://www.nolhga.com/aboutnolhga/main.cfm/location/whatisnolhga.

[21] http://www.nolhga.com/policyholderinfo/main.cfm/location/systemworks.

[22] Honeywell, Inc. v. Mn. Life and Health Ins. Guaranty Ass'n., 518 N.W. 2d 557 (Minn. 1994).

[23] Ala. Code § 27-44-3 (LexisNexis 2008) ((b) This chapter shall not apply to: (2) That portion or part of any policy or contract under which the risk is borne by the policyholder.); Alaska Stat. § 21.79.020 (LexisNexis 2008) ((c) This chapter does not apply to (2) that part of the risk borne by the policy or contract holder;); Ariz. Rev. Stat. § 20-682 (LexisNexis 2008) (B. This article does not apply to: 1. Any policies or contracts, or any part of such policies or contracts, under which the risk is borne by the policyholder, including variable plans and contracts.); Ark. Code Ann. § 23-96-106 (2008) (A. This chapter shall not provide coverage for: (1) A portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract owner;); Cal. Ins. Code § 1067.02 (Deering 2008) ((b)(2) This article shall not provide coverage for any of the following: (A) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policyholder or contractholder.); Colo. Rev. Stat. § 10-20-104 (2008) ((b) This article shall not provide coverage for: (I) Any portion of a policy or contract not guaranteed by the member insurer, or under which the risk is borne by the policy or contract holder;); Conn. Gen. Stat. Ann. § 38a-860 (2008) ((f)(2) Said sections 38a-858 to 38a-875, inclusive, shall not provide coverage for: (A) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Del. Code Ann. tit. 18, § 4403 (2008) ((b)(2) This chapter shall not provide coverage for the following: a. Any portion of a policy or contract not guaranteed by the insurer or under which the risk is borne by the policy or contract owner;); D.C. Code Ann. § 31-5402 (LexisNexis 2008) ((b)(2) Coverage shall not be provided for: (A) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the holder of the policy, contract, or certificate;); Fla. Stat. Ann. § 631.713 (LexisNexis

2008) ((3) This part does not apply to: (b) That portion or part of any policy or contract under which the risk is borne by the policyholder.); Ga. Code Ann. § 33-38-2 (2008) ((c) This chapter shall not apply to: (2) That portion or part of any policy or contract under which the risk is borne by the policyholder;); Haw. Rev. Stat. Ann. § 431:16-203 (LexisNexis 2008) ((b)(2) This part shall not provide coverage for: (A) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Idaho Code § 41-4303 (2008) ((2) This chapter shall not apply to: (b) That portion or part of any policy or contract under which the risk is borne by the policyholder;); 215 Ill. Comp. Stat. Ann. 5/531.03 (LexisNexis 2008) ((b) This Article shall not provide coverage for: (i) that portion or part of such policies or contracts under which the risk is borne by the policyholder;); Ind. Code Ann. § 27-8-8-2.3 (LexisNexis 2008) ((e) This chapter does not provide coverage for or with respect to the following: (1) A part of a certificate, policy, or contract: (B) under which the risk is borne by the payee, certificate holder, or the policy or contract owner.); Iowa Code § 508C.3 (2008) (3.This chapter does not apply to: *b*. That portion or part of a policy or contract under which the risk is borne by the policyholder.); Kan. Stat. Ann. § 40-3008 (2006) ((n) The contractual obligations of the impaired or insolvent insurer for which the association becomes, or may become, liable shall be as great as but no greater than the contractual obligations of the impaired or insolvent insurer would have been in the absence of an impairment or insolvency unless such obligations are reduced as permitted by subsection (e) but the association shall not provide coverage for: (1) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Ky. Rev. Stat. Ann. § 304.42-030 (LexisNexis 2008) ((2)(b) This subtitle shall not provide coverage for: 1. Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract owner;); La. Rev. Stat. Ann. § 22:1395.3 (2008) (B.(2) This Part shall not provide coverage for: (a) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder.); Me. Rev. Stat. Ann. tit. 24-A, § 4603 (2008) (2. EXCEPTIONS. This chapter does not apply to: B. Any policies or contracts, or any part of these policies or contracts, under which the risk is borne by the policyholder;); Md. Code Ann., Ins. § 9-403 (LexisNexis 2008) ((b)(2) Coverage may not be provided under this subtitle for: (i) any part of a policy or contract: 1. that is not guaranteed by the insurer, or under which the risk is borne by the policyholder or contract holder;); Mass. Ann. Laws ch. 175 § 146B (LexisNexis 2008) ((4)(B)(2) This section shall not provide coverage under: -- (a) any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Mich. Comp. Laws Serv. § 500.7704 (LexisNexis 2008) ((5) This chapter does not provide coverage for the following: (a) A portion of a policy or contract not guaranteed by the insurer or under which the risk is borne by the policy or contract owner, including, but not limited to, the nonguaranteed portion of a variable or separate account product.); Minn. Stat. Ann. § 61B.19 (West 2008) (Subd. 3. Limitation of coverage. Sections 61B.18 to 61B.32 do not provide coverage for: (1) a portion of a policy or contract not guaranteed by the insurer, or under which the investment risk is borne by the policy or contract holder;); Miss. Code Ann. § 83-23-205 (2008) ((2)(b) This article shall not provide coverage for (i) A portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract owner;); Mo. Ann. Stat. § 376.717 (West 2008) (3. Sections 376.715 to 376.758 shall not provide coverage for: (1) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Mont. Code Ann. § 33-10-201 (2007) ((10) This part does not provide coverage for: (a) policies or contracts or any part of the policies or contracts not guaranteed by the member insurer or under which the risk is borne by the policyowner;); Neb. Rev. Stat. Ann. § 44-2703 (LexisNexis 2008) ((2)(b) The act shall not apply to: (i) Any portion of any policy or contract not guaranteed by the insurer or under which the risk is borne by the policy or contract holder;); Nev. Rev. Stat. Ann. § 686C.035 (LexisNexis 2008) (1. This chapter does not provide coverage for: (a) A portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the owner of the policy or contract.); N.H. Rev. Stat. Ann. § 408-B:5 (LexisNexis 2008) (II.(b) This chapter shall not provide coverage for: (1) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); N.J. Stat. Ann. § 17B:32A-3 (West 2008) (c. This act shall not provide coverage for: (1) any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); N.M. Stat. Ann. § 59A-42-3 (LexisNexis 2008) (B. Chapter 59A, Article 42 NMSA 1978 shall not apply as to: (2) that portion or part of any policy or contract under which the risk is borne by the policyholder;); N.Y. Ins. Law § 7703 (Consol. 2008) ((b) This article shall not apply to: (2) That portion or part of any policy, contract or agreement under which the risk is borne by the holder thereof;); N.C. Gen. Stat. § 58-62-21 (2008) ((c) This Article does not provide coverage for: (1) Any part of a policy not guaranteed by the insurer, or

withdrawal and cash values of variable contracts regulated by the Commission are expressly excluded from the scope of guaranty association coverage, the Commission's erroneous conclusion that the purchaser of an indexed annuity is "exposed to significant investment risk"[24] coupled with the adoption of proposed rule 151A requiring these contracts to be registered as securities with the Commission may effectively exclude these contracts from the scope of guaranty association coverage.[25]

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under which the risk is borne by the policyholder;); N.D. Cent. Code § 26.1-38.1-01 (2008) (3. This chapter does not provide coverage for: a. Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy owner or contract owner;); Ohio Rev. Code Ann. § 3956.04 (LexisNexis 2008) ((B)(2) This chapter does not provide coverage for any of the following: (a) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Okla. Stat. Ann. tit. 36, § 2025 (West 2008) (B.2.This act shall not provide coverage for: a. any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Or. Rev. Stat. § 734.790 (2007) ((3) ORS 734.750 to 734.890 do not provide coverage for: (b) That portion or part of any policy or contract under which the risk is borne by the policyholder.); 40 Pa. Cons. Stat. § 991.1703 (2008) ((b) (2) This article shall not provide coverage for any of the following: (i) Any portion of a policy or contract not guaranteed by the insurer or under which the risk is borne by the policy or contract holder.); P.R. Laws Ann. tit. 26 § 3903 (2005) ((b)(2) This chapter shall not provide coverage for: (A) Any portion of a policy or contract which is not guaranteed by the insurer or under which the risk is assumed by the policy or contract holder;); R.I. Gen. Laws § 27-34.3-3 (2008) ((b)(2) This chapter shall not provide coverage for: (i) A portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract owner;); S.C. Code Ann. § 38-29-40 (2007) ((2) This chapter does not apply to: (a) Any policy or contract or part thereof under which the risk is borne by the policyholder.); S.D. Codified Laws § 58-29C-46 (2008) (B.(2) This chapter may not provide coverage for: (a) A portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract owner;); Tenn. Code Ann. § 56-12-204 (2008) ((b)(2) This part does not provide coverage for: (A) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Tex. Ins. Code 463.203 (2007) ((b) This chapter does not provide coverage for: (1) any part of a policy or contract not guaranteed by the insurer or under which the risk is borne by the policy or contract owner;); Utah Code Ann. § 31A-28-103 (2008) ((b) This part does not provide coverage for: (i) a portion of a policy or contract: (B) under which the risk is borne by the policy or contract owner;); Vt. Stat. Ann. tit. 8, § 4153 (2007) ((b)(2) This subchapter shall not provide coverage for: (A) any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Va. Code Ann. § 38.2-1700 (2008) (C. This chapter shall not apply to: 2. That portion or part of any policy or contract under which the risk is borne by the policyholder;); Wash. Rev. Code Ann. § 48.32A.025 (LexisNexis 2008) ((2)(b) This chapter does not provide coverage for: (i) A portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract owner;); W. Va. Code § 33-26A-3 (2008) ((b)(2) This article shall not provide coverage for: (A) Any portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder;); Wis. Stat. § 646.01 (2007) ((1)(b) Exceptions. This chapter does not apply to any of the following: 1. Any portions of a life insurance policy or annuity contract that is not guaranteed by the insurer or under which the risk is borne by the policy or policyholder.); Wyo. Stat. Ann. § 26-42-103 (2008) ((c) This act shall not provide coverage for: (i) Any portion of a policy or contract not guaranteed by the insurer or under which the risk is borne by the policyholder or contract holder;).

[24] Proposing Release at 5.

[25] Following recent market turmoil, the U.S. Treasury Department ("Treasury Department") determined it was necessary to provide a temporary guarantee program for money market funds. The Treasury Department stated the following rationale for its unprecedented action:

> Money market funds play an important role as an investment vehicle for many Americans; they are also a fundamental source of financing for our capital markets and financial institutions.

* * *

Old Mutual appreciates the SEC's re-opening of the comment period for 30 days and the opportunity to submit additional comments on the proposed rule. During the initial comment period, on August 1, 2008, Old Mutual filed a formal request with the Commission in this rulemaking proceeding to extend the comment period to January 8, 2009 to permit its company management to ascertain the precise impact of the proposal. Regrettably, the SEC did not agree to extend the comment period during the initial comment period and gave no indication after it closed that it would re-open the comment period. We believe the proposed rule deserves more analysis than the re-opened 30 day comment period has permitted, especially in view of the November 14, 2008 statement of Director Donohue that a final rule proposal, if made by staff, will exclude "traditional" fixed annuities.[26] If so, the Commission should re-consider its

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> Maintaining confidence in the money market fund industry is critical to protecting the integrity and stability of the global financial system. This action will enhance market confidence and alleviate investors' concerns about the ability for money market mutual funds to absorb a loss.

http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml.

Indexed annuities play an important role for Americans saving for retirement and other long term needs. Congress encourages the use of annuities for the accumulation of long term savings by individuals through favorable tax code provisions. Considerations paid for indexed annuities become part of an insurer's general account. Insurers, acting principally as long term lenders, invest general account assets in the economy, thus serving as a fundamental source of long term financing and capital formation in the nation's economy. "Life insurers are the largest source of bond financing for America's corporations. They provide $2.5 trillion in liquidity to the economy." Frank Keating, Letter to the Editor, *Insurers Are Major Source of Capital*, Wall St. J., Nov. 12, 2008. By way of comparison, "prime money funds, which invest in commercial paper, held roughly $2 trillion in assets in early September, and fell to $1.56 trillion by early October." Diya Gullapalli, *Money Funds Lag Despite U.S. Action,* Wall St. J., Nov. 12, 2008.

Thus, the Treasury Department's stated rationale for the temporary guarantee program for money market funds is even more compelling for indexed annuities because insurer's general account investments provide longer term sources of capital. Accordingly, since the Commission's adoption of proposed rule 151A may result in the loss of solvency guarantees currently provided by state law for indexed annuities, we urge the Commission to work with the Treasury Department to provide alternative permanent guarantees of these important savings products to replace existing permanent state insurance solvency guarantees which may be nullified if proposed rule 151A is adopted.

[26] In remarks before the ALI-ABA Life Insurance Products Conference on November 14, 2008, Andrew J. Donohue, Director of the Commission's Division of Investment Management stated that the staff is reviewing and analyzing comments received in this rulemaking, and went on to say:

Several comments expressed concern that the rule as proposed is overbroad in its scope, so that it could be read to cover traditional fixed annuities. In the proposing release for the rule, the Commission contrasted the two types of annuities, noting that in the case of an indexed annuity the purchaser assumes substantially different risks and benefits. Notably, at the time that such a contract is purchased, the risk for the unknown, unspecified, and fluctuating securities-linked portion of the return is primarily assumed by the purchaser. If the staff makes a final rule recommendation, we would expect to make clear that traditional fixed annuities are excluded. http://www.sec.gov/news/speech/2008/spch111408ajd.htm

In view of Director Donohue's quoted remarks, it is disturbing that insurers arguing for narrowing of the proposed rule, see note 16 *supra*, have not provided the Commission with a rigorous comparative analysis of why the public, under applicable precedents of the U.S. Supreme Court and the Commission's guidance, is not also equally entitled to the protections of federal disclosure, antifraud and sales practice protections when the public buys certain traditional non-registered annuity contracts (i.e., market value adjusted annuities, group annuities and discretionary

decision to end the comment period today, especially when one considers that the traditional fixed annuities to which Director Donohue is referring include some which are directly tied to the value of underlying securities held by the insurer and depend directly on the investment acumen of the issuing insurance company.

We also note that the unreasonably short comment period has not allowed Old Mutual to fully determine the extent to which Rule 151A will limit consumer choice by causing independent insurance producers to forego the offering of indexed annuities in order to avoid costly compliance with securities regulation registration requirements.[27]

In any event, we respectfully reserve the right to supplement our comments herein with the Commission. If you have any questions about our supplemental comments or would like any additional information, please contact me at (410) 895-0082.

Sincerely,

Eric Marhoun
Senior Vice President & General Counsel

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. Parades

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

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excess interest contracts) offered by these insurers. Is the owner of a "traditional fixed annuity" in the form of a (non-registered) market value annuity contract that computes its account value by reference to underlying investments specifically selected and actively managed by the insurer not equally or more deserving under U.S. Supreme Court precedents and the Commission's guidance of federal disclosure, antifraud and sales practice protections than the owner of an indexed annuity whose value is computed by reference to a commercial index that the insurer does not actively manage or control and involves no mark up or down of account values based on the holdings of the insurer's general account?

[27] In an informal survey of Old Mutual producers, over 40% of the non-securities registered producers who responded stated that they would not offer FIAs if Rule 151A is adopted.

Schedule 1

OM Indexed Annuity Illustration - Actual Return vs. S&P 500 Return from Issue to Contract Anniversary (10/31/2008)

- Illustration is based on Spectrum Rewards Choice 9 (9 year SC product), since it is the largest block of OM's Indexed Annuities [$1.6B of AV as of June,2008]
- The Illustration assumes a one-time premium of $100,000. The Account Value at issue includes the initial premium and the applicable first year Premium Bonus.

Example

#1 EIAST9 - Spectrum Rewards Choice 9 Issued 10/31/2004

FIA vs. SPY from 10/31/2004 to 10/31/2008

End of Pol Yr	Anniv Date	S&P 500	S&P Ret	Index * Credit Rate	Applied ** Credit Rate	SC %	Premium Bonus %	FIA Historical: AV	CSV	MGSV	SPY Historical: SPY #	SPY Ret	SPY Investment	Available CSV less SPY
0	@ Issue	1,130				12.0%	3.0%	103,000	88,000	88,000	105.4		100,000	(12,000)
1	Oct-05	1,207	6.8%	4.2%	4.2%	11.0%	0.0%	107,350	95,541	90,914	114.0	8.2%	108,249	(12,707)
2	Oct-06	1,378	14.2%	12.3%	12.3%	10.0%	0.0%	120,588	109,735	94,955	133.2	16.8%	126,426	(16,692)
3	Oct-07	1,549	12.4%	8.0%	8.0%	9.0%	0.0%	130,194	119,648	97,956	151.4	13.7%	143,749	(24,101)
4	Oct-08	969	-37.5%	-45.5%	0.0%	8.0%	0.0%	130,194	120,820	101,042	96.8	-36.1%	91,913	28,907

S&P Annual Return => -3.8% Annuity Annual Return => 6.8% 4.8% SPY # Annual Return => -2.1%

* The Index Credit Rate is based on a One-Year Monthly Point-to-Point Equity Index Option.
** The applied credit rate has a floor of 0%, since the Index Credit for the contract is never less than $0.
\# The SPY values are adjusted to include dividends and splits.

#2 EIAST9 - Spectrum Rewards Choice 9 Issued 10/31/2005

FIA vs. SPY from 10/31/2005 to 10/31/2008

End of Pol Yr	Anniv Date	S&P 500	S&P Ret	Index * Credit Rate	Applied ** Credit Rate	SC %	Premium Bonus %	FIA Historical: AV	CSV	MGSV	SPY Historical: SPY #	SPY Ret	SPY Investment	Available CSV less SPY
0	@ Issue	1,207				12.0%	3.0%	103,000	88,000	88,000	114.0		100,000	(12,000)
1	Oct-06	1,378	14.2%	10.2%	10.2%	11.0%	0.0%	113,507	101,021	90,914	133.2	16.8%	116,792	(15,771)
2	Oct-07	1,549	12.4%	6.0%	6.0%	10.0%	0.0%	120,336	109,505	94,955	151.4	13.7%	132,796	(23,290)
3	Oct-08	969	-37.5%	-46.5%	0.0%	9.0%	0.0%	120,336	110,589	97,956	96.8	-36.1%	84,909	25,680

S&P Annual Return => -7.1% Annuity Annual Return => 6.4% 3.4% SPY # Annual Return => -5.3%

#3 EIAST9 - Spectrum Rewards Choice 9 Issued 10/31/2006

FIA vs. SPY from 10/31/2006 to 10/31/2008

End of Pol Yr	Anniv Date	S&P 500	S&P Ret	Index * Credit Rate	Applied ** Credit Rate	SC %	Premium Bonus %	FIA Historical: AV	CSV	MGSV	SPY Historical: SPY #	SPY Ret	SPY Investment	Available CSV less SPY
0	@ Issue	1,378				12.0%	3.0%	103,000	88,000	88,000	133.2		100,000	(12,000)
1	Oct-07	1,549	12.4%	8.1%	8.1%	11.0%	0.0%	111,360	99,110	90,914	151.4	13.7%	113,702	(14,592)
2	Oct-08	969	-37.5%	-45.4%	0.0%	10.0%	0.0%	111,360	101,337	94,955	96.8	-36.1%	72,701	28,637

S&P Annual Return => -16.2% Annuity Annual Return => 5.5% 0.7% SPY # Annual Return => -14.7%

#4 EIAST9 - Spectrum Rewards Choice 9 Issued 10/31/2007

FIA vs. SPY from 10/31/2007 to 10/31/2008

End of Pol Yr	Anniv Date	S&P 500	S&P Ret	Index * Credit Rate	Applied ** Credit Rate	SC %	Premium Bonus %	FIA Historical: AV	CSV	MGSV	SPY Historical: SPY #	SPY Ret	SPY Investment	Available CSV less SPY
0	@ Issue	1,549				12.0%	3.0%	103,000	88,000	88,000	151.4		100,000	(12,000)
1	Oct-07	969	-37.5%	-45.9%	0.0%	11.0%	0.0%	103,000	91,670	90,914	96.8	-36.1%	63,940	27,730

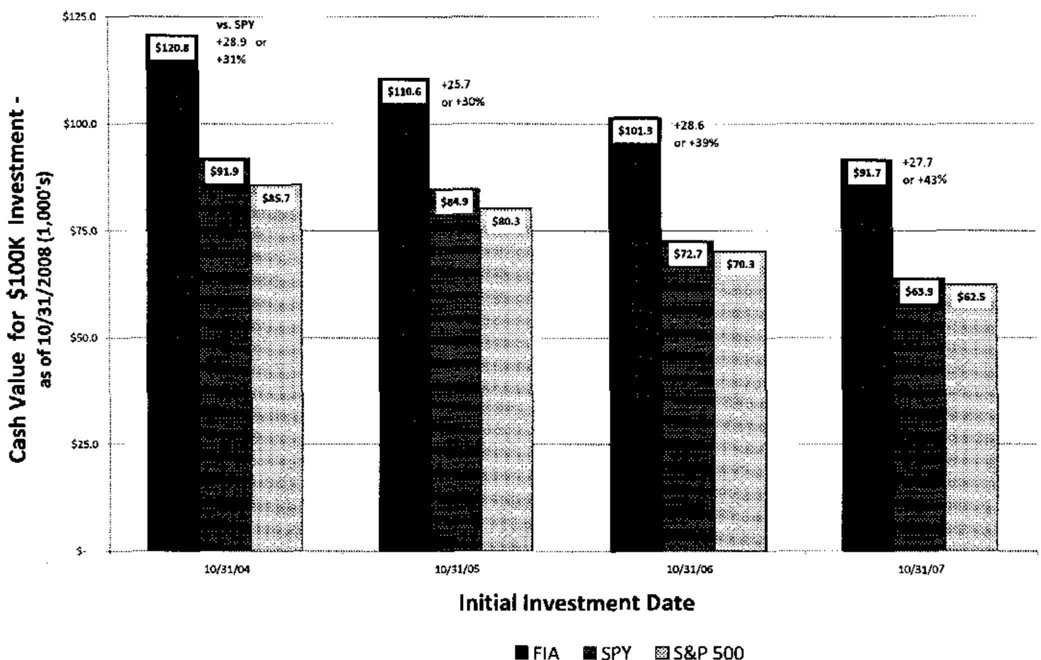
S&P Annual Return => -37.5% Annuity Annual Return => 3.0% -8.3% SPY # Annual Return => -36.1%

Graph Data

Value As of 10/31/2008

Investment Date	FIA	SPY	Diff	% Diff	S&P 500
10/31/04	$ 120.8	$ 91.9	28.9	31%	$ 85.7
10/31/05	$ 110.6	$ 84.9	25.7	30%	$ 80.3
10/31/06	$ 101.3	$ 72.7	28.6	39%	$ 70.3
10/31/07	$ 91.7	$ 63.9	27.7	43%	$ 62.5

Schedule 2



28.9	31%	35.3			
25.7	30%	30.0			
28.6	39%	31.1			
27.7	43%	30.2			
					Divd Yld
		85.5	91.9	107.5%	1.8%
		80.6	84.9	105.3%	1.7%
		70.3	72.7	103.4%	1.7%
		62.6	63.9	102.1%	2.1%

Old Mutual Financial Network

September 10, 2008

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Indexed Annuities and Certain Other Insurance Contracts
File No. S7-14-08

Dear Ms. Harmon:

Old Mutual Financial Network ("Old Mutual")[1] is pleased to have the opportunity to offer its comments in response to the request by the Securities and Exchange Commission (the "Commission" or "SEC") in Release No. 33-8933[2] (the "Proposing Release") for comments on proposed rule 151A that would define certain indexed annuities as not being "annuity contracts" or "optional annuity contracts" under Section 3(a)(8) of the Securities Act of 1933 (the "1933 Act").

Old Mutual opposes adoption of proposed rule 151A. The first section of this letter addresses our concern regarding the lack of need for the proposed rule particularly in light of state insurance disclosure and sales practice protections. The second and third sections discuss potentially significant collateral damage the rule may cause the non-indexed business of insurance arising from the breadth of the rule. The fourth section notes serious inconsistencies between the proposed rule, Section 3(a)(8), and guiding precedent. The last section outlines the proposed rule's adverse impact on consumers as they will bear the costs of the rule.

I. THE PROPOSING RELEASE DOES NOT ESTABLISH A NEED FOR FEDERAL REGULATION

The Proposing Release states "purchasers of indexed annuities have not received the benefits of federally mandated disclosure and sales practice protection,"[3] cites "complaints of abusive sales

[1] Old Mutual Financial Network ("Old Mutual") is the marketing name for the U.S. life insurance and annuity operations of Old Mutual plc. Working through its network of established insurance companies (OM Financial Life Insurance Company, OM Financial Life Insurance Company of New York), Old Mutual is headquartered in Baltimore, MD; maintains a National Sales Office in Atlanta, GA, and service centers in Nebraska and Atlanta. The companies that comprise Old Mutual deliver a diverse portfolio of annuities and life insurance products via an established group of master general agents. Products are distributed in 50 states and the District of Columbia. Old Mutual has nearly one million policyholders nationwide. As of June 30, 2008, Old Mutual had $18 billion in statutory-basis assets.

[2] *See* Indexed Annuities and Certain Other Insurance Contracts, Rel. No. 33-8933, 34-58022 (June 25, 2008).

[3] Proposing Release at 6.

Old Mutual Financial Network is the marketing name for OM Financial Life Insurance Company (Home Office, Baltimore, MD); and OM Financial Life Insurance Company of New York (Home Office, Purchase, NY). Variable annuity products are distributed through Old Mutual Financial Network Securities, member NASD.

practices,"[4] and states that protections provided by these contracts are "not...substantial enough."[5] Yet it fails to produce evidence of abusive sales practices, fails to acknowledge state regulation of disclosure and sales practices, and disregards state regulation of guarantees.

A. No Empirical Evidence Has Been Provided

The Proposing Release identifies consumer protection, especially protection of seniors, as one of the driving needs in support of the rule.[6] As evidence of this need the Proposing Release cites the statement of Patricia Struck, then President of the North American Securities Administrators Association ("NASAA"), at the first Senior Summit in June, 2006.[7] In her statement, Ms. Struck reports survey data NASAA obtained from its members about complaints involving indexed annuities and complaints involving variable annuities.[8] Because Ms. Struck's statement reports this information in the aggregate, and not separately for indexed annuities, these survey results effectively preclude meaningful analysis of this body of evidence by the Commission and the public. It certainly does not warrant the extrapolation of nontransparent combined results to the entire population of indexed annuity plans currently available in the U.S. retirement market place.[9] At the same time, the Proposing Release fails to mention, consider or analyze any of the consumer protection safeguards adopted by state insurance regulators to protect purchasers of the non-registered indexed annuities. In short, the SEC has failed to provide any empirical data regarding abuses related to the sale of indexed annuity contracts that would implicate a federal interest.

B. The Proposing Release Fails to Acknowledge State Regulation of Disclosure and Sales Practices

Since indexed annuity contracts were first introduced in the mid-1990s they have been uniformly regulated under the supervision of state insurance regulators and state insurance law as fixed annuity contracts. This uniform state insurance regulatory treatment of indexed annuities is significant in determining status of contracts under Section 3(a)(8) and differs from the uncertain

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[4] Proposing Release at 8.

[5] Proposing Release at 26.

[6] *See* Proposing Release at 8, 15-17.

[7] *See* Proposing Release Note 25, at 16.

[8] *Id.* Ms. Struck states "The NASAA survey also found that unregistered securities, variable annuities and equity-indexed annuities are the most pervasive financial product involved in senior investment fraud. In California, 75 percent of the state's senior investment fraud cases involve unregistered securities. Cases involving variable or equity-indexed annuities were 65 percent of the caseload in Massachusetts, 60 percent of the caseload in Hawaii and Mississippi." We urge the SEC to publish the entire survey, including the survey instrument and all data gathered in the survey, to permit its review by interested parties. Details of the survey do not appear to be publicly available on NASAA's website or otherwise.

[9] Old Mutual has received fewer than 3 complaints per thousand in-force indexed annuity contracts for calendar years 2005, 2006, 2007 and through June 30, 2008.

state insurance regulatory status of the variable annuity contract noted by the U.S. Supreme Court in SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) ("VALIC").[10]

The state insurance regulatory landscape surrounding indexed annuities includes state insurance disclosure and sales practice regulation which the Proposing Release fails to consider. It also includes standard nonforfeiture laws—part of insurer solvency regulation which the Proposing Release recognizes and gives deference to in the context of proposed rule 12h-7[11]—which establish the minimum guarantees provided by indexed annuities.

1. State Regulation of Disclosure and Sales Practices Obviates the Need for Federal Regulation

In the cost/benefit analysis of the Proposing Release, the Commission states:

> Disclosures that would be required for registered indexed annuities include information about costs (such as surrender charges); the method of computing indexed return (*e.g.*, applicable index, method for determining change in index, caps, participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits). We think there are significant benefits to the disclosures provided under the federal securities laws.[12]

The Annuity Disclosure Model Regulation[13] provides disclosure standards to protect consumers and foster consumer education. The regulation specifies the minimum information which must be disclosed and the method for disclosing it. In particular, the following disclosures must be given in the form of a written disclosure statement at point of sale under Section 4 B. of the regulation:

> At a minimum, the following information shall be included in the disclosure document required to be provided under this regulation:
> (1) The generic name of the contract, the company product name, if different, and form number, and the fact that it is an annuity;
> (2) The insurer's name and address;

[10] The *VALIC* Court observed that state insurance regulatory treatment of the then new variable annuity was far from uniform:

> Some States deny these "annuity" contracts any status as "insurance". Others accept them under their "insurance" statutes. It is apparent that there is no uniformity in the rulings of the States on the nature of these "annuity" contracts.

359 U.S. 65, 69.

[11] Proposing Release at 47.

[12] Proposing Release at 70.

[13]NAIC 245-1. The goal of this regulation is to ensure that purchasers of annuity contracts understand certain basic features of annuity contracts.

(3) A description of the contract and its benefits, emphasizing its long-term nature, including examples where appropriate:

(a) The guaranteed, non-guaranteed and determinable elements of the contract, and their limitations, if any, and an explanation of how they operate;

(b) An explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;

(c) Periodic income options both on a guaranteed and non-guaranteed basis;

(d) Any value reductions caused by withdrawals from or surrender of the contract;

(e) How values in the contract can be accessed;

(f) The death benefit, if available and how it will be calculated;

(g) A summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract; and

(h) Impact of any rider, such as a long-term care rider.

(4) Specific dollar amount or percentage charges and fees shall be listed with an explanation of how they apply.

(5) Information about the current guaranteed rate for new contracts that contains a clear notice that the rate is subject to change.

Finally, in addition to requiring a product-specific disclosure statement, the Annuity Disclosure Model Regulation also requires delivery of the Buyers Guide for Equity-Indexed Annuities.[14]

State insurance departments undertake an exacting review of each indexed annuity contract before the contract may be offered in the state. In connection with that review, state insurance regulators typically request very detailed information about the contract and practices regarding the offer and sale of the contract. State insurance regulators may condition the sale of a particular indexed annuity on prior regulatory review. Notably, this review generally includes a review of the product-specific disclosure statement and related materials.[15] Indexed annuity disclosure statements and related marketing materials are made to conform to applicable insurance laws in each jurisdiction where the product is sold.[16]

Disclosures the SEC finds important are being given under state insurance laws regulating disclosure and sales practices. Proposed rule 151A will result in a duplication of disclosure at

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[14] For examples of this specialized state insurance regulatory disclosure for equity-indexed annuities, *see* http://www.idfpr.com/doi/life_annuities/equityindex.asp and http://www.dora.state.co.us/Insurance/regs/4-1-12%20attach.pdf.

[15] *See, e.g.,* Minnesota Department of Commerce, Checklist for Annuities, http://www.state.mn.us/mn/externalDocs/Commerce/Annuities_031103093332_lh45chk.pdf (requiring insurers provide "a copy of the disclosure statement that will accompany contracts, i.e., a form that the policyholder signs, certifying that he/she understands the key features of the contract, which features shall be addressed clearly and completely in the disclosure document").

[16] Section 9 of the Advertisements of Life Insurance and Annuities Model Regulation requires insurers maintain advertising files and requires an authorized officer to state, as part of the insurer's annual statement filed with the insurance commissioner, that advertisements disseminated by or on behalf of the insurer in the state during the preceding statement year "complied or were made to comply in all respects with the provisions of these rules and the insurance laws of this state."

the consumer's expense and without any added benefit to the consumer. We believe the Commission must take into account the nature, extent and effectiveness of state insurance disclosure and sales practice regulation both in evaluating the need for the regulatory protections of the federal securities laws and in making the required cost/benefit analysis related to proposed rule 151A. The cost/benefit analysis is deficient in that regard because the Commission has ignored state insurance laws regulating disclosure and sales practices.

In addition to the Annuity Disclosure Model Regulation, the growing body of state insurance disclosure and sales practice regulation we believe the Commission should consider in this rulemaking proceeding include the following:

- The Suitability in Annuity Transactions Model Regulation[17]
- The Insurance and Annuity Replacement Model Regulation[18]
- The Advertisements of Life Insurance And Annuities Model Regulation[19]
- State "free look" requirements[20]
- State oversight and approval of products and related product disclosure, including the work of the Interstate Insurance Product Regulation Commission[21]
- State insurance unfair trade practice law and regulation[22]

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[17] Initially adopted by the National Association of Insurance Commissioners ("NAIC") in 2003 as the Senior Protection in Annuity Transactions Model Regulation, this regulation now applies without regard to the age of the purchaser. It establishes standards and procedures for recommendations to consumers in connection with annuity transactions. These standards insure that the insurance needs and financial objectives of consumers at the time of the transaction are appropriately addressed. In particular, Section 6 B. requires the insurance producer (or the insurer if no producer is involved) to make reasonable efforts to obtain information regarding the purchaser's financial and tax status, investment objectives and other information used or considered to be reasonable in making recommendations to the consumer.

[18] The purpose of this regulation is to regulate the activities of insurers and producers with respect to the replacement of existing life insurance and annuities by establishing minimum standards of conduct to be observed in replacement or financed purchase transactions. The regulation assures that purchasers receive the information needed to make an informed purchase decision.

[19] This regulation establishes minimum standards and guidelines to assure a full and truthful disclosure to the public of all material and relevant information in the advertising of life insurance policies and annuity contracts.

[20] *See* Md. Code Ann. Ins. § 16-105(2008)(requiring notice prominently printed on the face of the annuity contract informing owner of right to cancel policy within 10 days of delivery). The Buyers Guide for Indexed Annuities calls attention to this right as follows: "When you receive your contract, read it carefully. It may offer a "free look" period for you to decide if you want to keep the contract. Ask your agent or insurance company for an explanation of anything you don't understand. If you have a specific complaint or can't get the answers you need from your agent or company, contact your state insurance department."

[21] *See* note 15 *supra* and Interstate Insurance Product Regulation Commission, Rule Establishing Uniform Standards for Index-Linked Interest Crediting Features for Deferred Non-Variable Annuity Products (May, 2008) http://www.insurancecompact.org/rulemaking_records/080530_index_linked_crediting.pdf.

[22] *See e.g.*, Md. Code Ann. Ins. § 27-102(prohibiting unfair trade practices); Md. Code Ann. Ins. § 27-202—216 (defining unfair and deceptive acts and practices);COMAR 31.15.01(unfair trade practices in advertising);COMAR 31.15.04 (unfair trade practices in solicitation of annuity contracts).

- State insurance department market conduct examinations[23]
- Enforcement actions by state insurance regulators and state attorneys general[24]

Proponents of proposed rule 151A may argue that the Commission should ignore various model regulations or laws noted above for the Commission's review which have not been promulgated or enacted in every jurisdiction. In this regard, the Commission should consider that insurers doing business throughout the United States routinely develop one disclosure form for each product and then use it in all jurisdictions where they conduct business, including jurisdictions that have not yet adopted particular NAIC model laws or regulations. The Commission followed a similar path when it set the specified rate of interest under Rule 151(b).[25]

The Commission's Division of Investment Management previously observed that Justice Brennan "in declaring that state insurance law did not provide adequate protection to an investor in a mutual fund...*appeared to focus on the absence of disclosure requirements in state law*".[26] The world of insurance disclosure and sales practice regulation has evolved considerably since VALIC was decided on March 23, 1959. Today there is "no absence of disclosure requirements in state law" applicable to indexed annuity contracts. We urge the Commission to consider state insurance disclosure and sales practice protections.[27]

2. State Regulation of Minimum Values

Indexed annuities include important guarantees of principal and credited interest under state insurance solvency regulation designed to protect contractowners that did not apply to the

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[23] *See, e.g.*, Vermont Department of Insurance
http://www.bishca.state.vt.us/InsurDiv/market_conduct_exams/a_marketconduct_reports2.htm

Missouri Department of Insurance, Financial Institutions and Professional Registrations
http://insurance.mo.gov/cgi-bin/MCExamsList.pl

[24] *See, e.g*, Pennsylvania Department of Insurance, Enforcement Actions, Michael J. Kman, Jr., Docket No. CO 00-01-002 (March 3, 2000)(Respondent sold three index annuity products and misrepresented to his clients that there would not be a surrender charge if their contracts were surrendered prior to maturity. After the sale, Respondent asserts he became aware of the surrender charge. The clients requested their annuity contracts be rescinded and the full amount of their deposits be refunded, which the insurer did. Respondent has been placed under a two year period of license supervision). http://www.ins.state.pa.us/ins/cwp/view.asp?a=1276&q=528650&pp=3

[25] Under Rule 151(b) the Commission tied the minimum rate required to be credited to the relevant nonforfeiture law in the jurisdiction in which the contract is issued, or, if the jurisdiction had not adopted such law, or no longer mandated that a minimum rate apply to existing contracts, then "the specified rate under the contract must at least be equal to the minimum rate then required for individual annuity contracts by the NAIC Standard Nonforfeiture Law." *See* Definition of Annuity Contracts or Optional Annuity Contracts, Rel. No. 33-6645 (May 29, 1986)(Adopting Release at 7)(hereinafter referred to as "Release 6645").

[26] Division of Investment Management, United States Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Management, 393 at note 84 (May, 1992)(hereinafter referred to as "Protecting Investors")(emphasis added).

[27] We also urge the Commission to consider that in contrast to the well developed state regulation of disclosure applicable to indexed annuities, neither the proposed rule nor the Commission's Form S-1include any disclosure standards specific to indexed annuities. Moreover, there is no office of the SEC charged with regulating these products. By contrast to state insurance regulators, the SEC has no experience whatsoever regulating indexed annuity contracts.

variable annuity considered by the Supreme Court in SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) ("United Benefit").

In particular, state insurance nonforfeiture laws[28] set a floor for benefit payments by establishing the interest rate used to calculate these benefits and the minimum amount of the initial and subsequent purchase payments to which this rate must apply. Nonforfeiture laws were initially enacted to protect purchasers of insurance contracts—not to protect the insurance companies issuing the insurance contracts,[29] although they clearly play a supporting role in regulating insurer solvency today.[30]

In contrast to United Benefit's Flexible Fund annuity, purchase payments under indexed annuities are insurer general account—not variable separate account—assets. The purchaser of an indexed annuity does not participate in the investment experience of the insurer's general account. This fact is significant because state insurance nonforfeiture laws protect purchasers of general account deferred annuities, including indexed annuities, before annuity payments begin.[31] State insurance nonforfeiture laws *do not* protect purchasers of variable annuities[32] who

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[28] State nonforfeiture laws generally trace their origins to public outrage over tontine policies sold in the United States from the time of the Civil War until the early 1900s, when they were outlawed as a result of legislation adopted in New York in 1906. This legislation resulted from a recommendation of the Armstrong Committee investigations of the insurance industry in New York in 1905.

Under a tontine policy, a dividend was paid only if the insured survived the time period specified in the contract. In its report the Armstrong Committee noted that the three largest New York insurers at that time "sold mostly tontine policies on which dividends had fallen far short of the estimates made for policyholders at the time of purchase." George A. Norris, Voices from the Field – A History of the National Association of Life Underwriters (National Association of Life Underwriters, 1989).

"Tontine insurance held certain appeals. The policyholder was offered the possibility of munificent returns on his investment if he adhered to his contractual agreement. Management, on the other hand, accumulated large amounts of capital since, unlike annual-dividend insurance, it did not have to disperse yearly payments. Furthermore, since the company did not pay a cash surrender value on tontine policies, lapsed money was not returned. This amount proved sizable; a twenty-five percent or higher lapse rate was common." H. Roger Grant, Insurance Reform Consumer Action in the Progressive Era, 7 (The Iowa State University Press, 1979).

[29] See Alfred N. Guertin, *Developments in Standard Non-Forfeiture and Valuation Legislation,* Journal of the American Association of University Teachers of Insurance, Vol. 13, No. 1, 5-15 (Mar. 1946) (Discussing post-Armstrong investigation legislative initiatives, Guertin states at 7: "The conference of Governors, Attorneys General and Commissioners and its Committee of Fifteen was dealing with disclosures developed by [the Armstrong] investigation. *It was not an emergency involving the solvency of companies, however.* It is understandable, therefore, that their report did not contain recommendations on the matter of reserves from the standpoint of solvency of companies. *They were interested in the practices of companies in their relation to policyholders.*")(Emphasis added).

[30] *See, i.e.*, Report of the American Academy of Actuaries' Annuity Nonforfeiture Section 6 Work Group on Section 6 of the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities (Boston, June, 2005), https://www.actuary.org/pdf/life/nonforfeit_6_june05.pdf (standard nonforfeiture law addresses insurer solvency, equity between surrendering and continuing policyholders and "smoothness", i.e., to gradually eliminate any difference between the cash surrender value of the surrendering policyholder and the paid up annuity value of the continuing policyholder as the policy approached maturity).

[31] *See, i.e.,* Md. Code Ann. Ins. § 16-501(7) (2008).

[32] *See, i.e.,* Md. Code Ann. Ins. § 16-501(4) (2008).

assume ("underwrite") the risk that the surrender value of the variable annuity will be less than what they paid for it, and therefore receive the alternative protections of the federal securities laws which focus on disclosure in lieu of a state regulated guarantee of principal.

Importantly, the minimum guaranteed surrender values in *general account* indexed annuities are determined through state legislative processes regulating the business of insurance rather than being determined at the insurer's discretion. The guaranteed surrender values in Old Mutual's *general account* indexed annuities are determined in accordance with state insurance nonforfeiture laws which provide significantly stronger guarantees than the one considered and rejected by the Supreme Court in United Benefit.

Like all other deferred annuity contracts, indexed annuity contracts credit interest during the accumulation period.[33] The amount of interest an insurer is obligated to credit under a deferred indexed annuity contract is determined under the most favorable to the contract owner of two outcomes: (1) by a formula set forth in the contract which takes into account changes in a commercially published index of securities; or, (2) according to an annual minimum guaranteed rate of interest determined under state insurance nonforfeiture laws.

One state regulatory advocacy group seeking jurisdiction over indexed annuities blatantly ignores applicable state insurance law when it claims that guarantees under indexed annuities are "established by insurers in their discretion, usually at very low rates."[34] In fact, minimum guarantees under these non-registered contracts are established by the Standard Nonforfeiture Law for Individual Deferred Annuities adopted through legislative process in 47 states and the District of Columbia.[35] These state insurance solvency laws protect purchasers of *general account* indexed annuities against the risk of "insignificant" guarantees like the one included in the *separate account* variable annuity examined by the Supreme Court in United Benefit.

In considering the issue of what constitutes an adequate guarantee of principal under an indexed annuity contract, the Commission should take into account that under state insurance solvency laws, insurers offering these contracts are not legally required to provide cash surrender values prior to maturity.[36] However, most insurers include a provision that allows for a lump sum settlement at maturity or at any other time before annuity payments begin.

When insurers include cash surrender and partial withdrawal rights in their indexed annuities, state nonforfeiture laws strike a balance between contractowners who hold their contracts until benefits begin and contractowners who elect to "cash out" before annuity payments begin. Long term insurance contracts are not demand deposit accounts; there is a significant cost to insurers

[33] The Proposing Release at 9 states "During the accumulation period, the insurer credits the purchaser with a **return** that is based on changes in a securities index…." The insurer credits interest under an indexing formula; it does not pass through a "return."

[34] NASAA's Briefing Paper in Support of the SEC's Proposed Rule on Equity Indexed Annuities, p. 1 (August 11, 2008).

[35] The Van Elsen Report, http://www.veconsulting.com/resources/idanlmap.pdf (August 30, 2005).

[36] *See, i.e.,* Md. Code Ann., Ins. § 16-503 (2008).

who provide the right to surrender a long term contract on any day.[37] Nevertheless, purchasers who elect to "cash out" of these contracts receive—at a minimum—the guaranteed cash value mandated under state nonforfeiture law.

The Commission noted in Release 6645 it had received a substantial number of comments requesting that it clarify proposed language in Rule 151(b)(2)(i) to avoid any appearance of favoring front-end loaded contracts over those that incorporate contingent deferred sales charges or defray sales and other expenses through a charge against contract value. In response to these comments, the Commission modified the rule slightly to adopt the substance of the suggested revisions. In doing so, the Commission noted that "the rule does not discriminate against contracts that do not have front-end charge structures."[38]

Few states specifically cap commission rates; for those that don't, state insurance nonforfeiture laws implicitly cap sales charges by requiring minimum cash surrender values in all indexed annuities that provide cash surrender values. In other words, no matter what the commission rate is on the contract, in a non-variable, non-registered fixed account indexed annuity, the insurer can never utilize a contingent deferred sales charge (surrender charge) that causes the value payable to the owner of the contract to fall below the minimum guaranteed amount under state insurance nonforfeiture laws.

The Proposing Release notes that under current state nonforfeiture laws, indexed annuities typically provide that the guaranteed minimum value is equal to at least 87.5% of purchase payments, accumulated at an annual interest rate of between 1% and 3%.[39] The Proposing Release further notes that, assuming application of the lowest state authorized guarantee of 87.5% of the premium accumulated at the lowest possible rate of one percent, it will take approximately 13 years for a purchaser's guaranteed minimum value to equal 100% of the purchase payments.[40] The SEC's current view that state insurance nonforfeiture guarantees are not "substantial enough"[41] stands in marked contrast to the favorable views previously expressed by its Division of Investment Management on the significant protections provided by state insurance nonforfeiture and reserve laws.

The Division of Investment Management in the context of recommending that the Commission propose amendments to the Investment Company Act to exempt variable insurance contracts from the charge restrictions in sections 26 and 27, instead requiring that charges under these contracts be reasonable in the aggregate, noted the comparable role played by state insurance nonforfeiture laws:

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[37] *See, e.g.*, TIAA-CREF's analysis of why it cannot afford to waive restrictions in its Traditional Annuity which does not provide lump-sum cash withdrawal benefits, and instead only allows participants to withdraw their funds from the Traditional Annuity in 10 annual installments. TIAA-CREF Traditional Annuity Contract 2007 Legislation – Optional Retirement Program (2008) www.unf.edu/dept/humanres/articles/tiaa_cref_orp.pdf.

[38] *See* Release 6645 at 6.

[39] *See* Proposing Release at 13.

[40] *Id.*

[41] Proposing Release at 26.

> State insurance law, particularly its nonforfeiture provisions, is designed to achieve objectives that are similar to the restrictions of sections 26 and 27. Like section 27(d) of the Investment Company Act, nonforfeiture law protects contract owners from paying excessive charges by limiting an insurer's deduction when an owner voluntarily surrenders his or her contract. In deciding what is appropriate for an insurer to retain, state officials, through the nonforfeiture requirements, attempt to balance the extent to which an insurer has not recovered the expenses incurred in issuing the contract and the extent to which the surrendering contract owner has prepaid for services for which he or she will never receive. Because selling costs are usually a key component of unamortized expenses, nonforfeiture law, like section 27(d), helps to limit the amount of these expenses an insurer may keep.
>
> Less directly, state reserve requirements, like sections 26 and 27 of the Investment Company Act, also protect a contract owner from paying excessive charges for contract services. The reserve requirements achieve this aim in two important respects: (1) by requiring that mortality costs be determined in accordance with prescribed mortality tables; and (2) by requiring that prepaid premiums or cash value be credited with a minimum rate of interest. While reserve requirements do not affect directly the amount of expenses that may be deducted under a contract, they generally assure the maintenance of minimum values so that guaranteed benefits can be provided.[42]

While numerous commenters have attacked commissions paid by some insurers as excessive, and the Commission has offered its view that minimum cash surrender values are not adequate ("we do not believe these protections are substantial enough"),[43] Congress has not yet repealed the McCarran-Ferguson Act and nothing in VALIC or United Benefit empowers the Commission to substitute its judgment for the applicable state legislature's determination of what "fraction of the benefits will be payable in fixed amounts" under fixed annuity contracts. One indexed annuity referenced in the Proposing Release[44] that is currently registered with the Commission offers sales commissions of up to 15%. Yet, to our knowledge, FINRA has not proposed a rule for registered indexed annuities similar to its Conduct Rule 2830 which prohibits FINRA members from offering investment company shares when aggregate sales charges exceed a certain level specified in the rule.

II. THE PROPOSED RULE IS OVERLY BROAD ON ITS FACE

The Commission states in the Proposing Release that its proposed rule 151A "is intended to clarify the status under the federal securities laws of indexed annuities."[45] Contrary to the stated intent, proposed rule 151A *on its face*[46] does not limit the scope of its application to the

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[42] See Protecting Investors at 411-412.

[43] *See* Proposing Release at note 51 and accompanying text.

[44] *See* Proposing Release at note 17.

[45] Proposing Release at 5.

[46] *See* Proposing Release at 93-94.

regulation of certain indexed annuities. Instead, proposed rule 151A potentially sweeps within its ambit most of the general account life insurance and annuity contract business of U.S. life insurers. Proposed rule 151A, if adopted in its current form, effectively repeals or significantly amends Section 3(a)(8) in the absence of Congressional action to do so.

A. The Overbroad Scope of Rule 151A Would Lead to Uncertainty in Interpretation And Application of the Rule

All life insurance company general account products with cash values must credit current interest or determine values above guaranteed values by reference to performance of general account investments. Insurers must invest purchase payments they receive for general account indexed annuities in accordance with state insurance solvency laws regulating permitted investments. Importantly, these laws do not distinguish insurance company general account investments by type of product. Instead, these state insurance laws apply to the entire reserve an insurer is required to maintain for all general account products it sells. Depending on the products an insurer offers, this may include life, health and disability insurance as well as annuities.

For example, OM Financial Life Insurance Company, domiciled in Maryland, must comply with Maryland Insurance Code § 5-511(a-1) when it invests purchase payments it receives under its indexed annuities. This statute provides:

> Each life insurer shall have and continually maintain an amount equal to its entire reserves, as required by this article, in any combination of the types of assets authorized by subsections (c) through (p) of this section subject to the limit, if any, set for each type or class of investment.

OM Financial Life Insurance Company must also comply with the cited statute when it invests the premiums it receives for its general account life insurance policies as well as when it invests the purchase payments it receives for its traditional fixed annuities.

The assets permitted under the quoted insurance regulatory law include various types of securities as defined in Section 2(a)(1) of the Securities Act. OM Financial Life Insurance Company accordingly holds various securities, as defined in Section 2(a)(1) of the Securities Act as part of its statutory general account reserves as mandated by Maryland insurance law.

At a minimum, OM Financial Life Insurance Company of necessity must calculate amounts it will actually pay under each of its general account annuities and life insurance policies having a cash value—not just its indexed annuities—in whole or in part, by reference to the performance of a security, including a group or index of securities it holds as part of its statutory reserves for these contracts, thus satisfying the first part of the new test in Proposed Rule 151A(a)(1).

Depending on how broadly the Commission or a court subsequently interprets "amounts payable" in proposed Rule 151A(a)(1), the proposed rule may reach a variety of other contracts, such as long term care insurance policies that have cash values. This test may also extend to features of contracts that do not have cash values, but have current pricing elements that deliver

"performance" that is better than the guaranteed maximum pricing, for example, current non-guaranteed premiums on indeterminate premium term life insurance policies.[47]

B. Indexed Annuity Contracts Fall Within the Section 3(a)(8) Exemption

The text of Section 3(a)(8) does not support the test set forth in proposed rule 151A(a)(1). Section 3(a)(8) exempts from the registration requirements of the 1933 Act:

> Any insurance or endowment policy or annuity contract or optional 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.

Indexed annuities are annuity contracts issued by insurance corporations that are subject to the supervision of state insurance regulators. This supervision includes traditional solvency regulation as well as state insurance disclosure and sales practice regulation. This supervision has been continuous since indexed annuities were first introduced in the mid-1990's.

In VALIC, the Court observed its:

> reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of 'insurance,' they speak with the authority of a long tradition. For the regulation of 'insurance' though within the ambit of federal power [citation omitted], has traditionally been under the control of the States.[48]

Indexed annuities are annuities within the plain meaning of the statute. Congress has not acted to repeal this statute. Similarly, Congress has not acted to repeal the McCarran-Ferguson Act under which Congress left the business of regulating insurance to the states. As discussed above, the states have uniformly regarded indexed annuities as part of the business of insurance since they were first introduced in the mid-1990's and have regulated these contracts as traditional deferred annuity contracts are regulated under those laws—laws that are "in actual effect." In proposing rule 151A, the SEC takes a position inherently inconsistent with the U.S. Supreme Court's reluctance in VALIC "to disturb the state regulatory schemes that are in actual effect." In doing so the SEC proposes a rule so broad that it effectively repeals Section 3(a)(8) for an ill-defined class of contracts much broader than indexed annuities.

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[47] In an indeterminate premium term policy, the premium may fluctuate between the current charge and a maximum amount stated in the insurer's premium tables, which are based on the insurer's mortality experience, expenses, and investment returns. See http://www.finweb.com/insurance/types-of-term-policies.html

[48] 359 U.S. 65, 68-69.

III. THE TEST IN PROPOSED RULE 151A(A)(2) IS OVERLY BROAD AND MEANINGLESS WHEN ONLY ONE OUTCOME IS POSSIBLE

Since any general account product that credits interest over and above guaranteed minimums must necessarily do so by reference to the performance of securities held as part of the insurer's general account reserves, nearly every product that is subject to the test will be a security. In fact, it is difficult to conceive of any saleable product that potentially credits excess interest that would not be a security. As such, the "test" is not a pass-fail test. It is a fail-only test. As a practical matter, a test with only one outcome is a meaningless test and could just as easily be restated as "any product that potentially credits nonguaranteed interest is a security."

IV. THE TEST IN PROPOSED RULE 151A(A)(2) IS CONTRARY TO AND INCONSISTENT WITH SECTION 3(A)(8) AND GUIDING PRECEDENT CITED IN THE PROPOSING RELEASE

Proposed rule 151A incorporates a new test that is neither derived from nor supported by Section 3(a)(8) or the U.S. Supreme Court decisions interpreting the scope of Section 3(a)(8) cited in the Proposing Release. Stated differently, the new test—which essentially defines investment risk as the risk the contractowner will receive less excess indexed interest than hoped for over and above the minimum guaranteed rate of interest established by the applicable state nonforfeiture law—is contrary to Section 3(a)(8) and guiding precedent cited in the Proposing Release. The new test completely ignores the fact that indexed annuities protect contractowners against the *very* risks implicating the need for federal securities law protections in VALIC and United Benefit.

A. Proposed Rule 151A Fails to Evaluate State Regulated Guarantees

1. VALIC

In VALIC, the Supreme Court held that the variable annuity at issue 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. The variable annuity guaranteed "nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor."[49]

The key investment characteristic that caused the annuity at issue in VALIC to fall outside the scope of Section 3(a)(8) was that the insurer provided *no* guarantee of principal and interest. The Supreme Court contrasted the variable annuity at issue in VALIC with traditional insurance contracts, noting that the "common understanding of "insurance" involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts."[50] The Court also noted that "companies that issue these [general account] annuities take the risk of failure"[51] because an

[49] 359 U.S. 65, 72.

[50] 359 U.S. 65, 71.

[51] *Id.*

insurer may not obtain a large enough return on the premiums it invests to meet its contractual guarantees.

Unlike the variable annuity contract examined by the Supreme Court in VALIC, insurers issuing non-registered indexed annuities today provide at least the guaranteed minimum values required by state nonforfeiture laws.[52] Thus, unlike a variable annuity, which contains no guarantee of principal and interest or guaranteed minimum values, there is always an insurance guarantee present in indexed annuities that "at least some fraction of the benefits will be payable in fixed amounts." Indexed annuities have a significant floor which is established by state legislatures in regulating the business of insurance.

Old Mutual's indexed annuities are not variable annuities. The annuitant has no interest in a portfolio of common stocks or other equities. The value and benefits offered under Old Mutual's indexed annuities are independent of the investment experience of the insurance company's general account. Assets supporting Old Mutual's obligations under its indexed annuities are part of the insurance company general account—not a variable separate account—and as part of its statutory reserve, do not support any other general account liability to any greater or lesser extent.

In particular, Old Mutual's indexed annuities provide the following guarantees:

- The guarantee of principal and all previously credited interest;

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[52] Indexed annuities comply with the same state standard nonforfeiture law that traditional fixed annuities comply with, as contrasted to registered indexed annuities that comply with a modified guaranteed annuity state regulation (contracts with certain market value adjustment ("MVA") features) or variable annuities that pass the actual investment experience of a separate account through to contract holders and which are not subject to a state standard nonforfeiture law.

To paraphrase VALIC, state legislatures in regulating the business of insurance adopt nonforfeiture laws that determine "what fraction of the benefits will be payable in fixed amounts" under indexed annuity contracts. The Proposing Release recognizes the protection that state insurance law provides in regulating the financial condition of *insurers* in the context of proposed rule 12h-7. It fails to appropriately consider the equally important protection that state insurance law provides to *purchasers* of indexed deferred annuities—including those who choose for whatever reason to surrender their contracts while a surrender charge remains applicable.

From a product perspective, state insurance law addresses *insurer* solvency through a variety of laws including but not limited to:

- valuation laws which regulate reserves an insurer must hold by type of contract
- investment laws which specify permitted investments and investment concentration for general account products; and,
- risk-based capital requirements.

Obviously, these laws intended to protect insurer solvency indirectly protect *purchasers* of contracts by facilitating the likelihood that the insurer will be able to pay its contractual obligations when due. However, **state insurance law also directly protects *purchasers* by requiring insurers to provide certain minimum benefits to persons who surrender these contracts.** *See* Black and Skipper, Life & Health Insurance, 13th Ed. p. 754-756. "Concepts of Equity" (2000).

- The guarantee that an index credit will never be less than zero, in other words, there will be no negative interest;
- Guaranteed surrender charges that do not vary with the investment performance of the insurer's general account;
- Guaranteed surrender charges that do not vary with changes in market interest rates, in other words, Old Mutual's indexed annuities do not include MVA features of any kind;[53]
- Guaranteed surrender charges that do not reduce the surrender value below the minimum permitted values under state insurance nonforfeiture laws regulating the business of insurance;
- Guaranteed surrender charges that are fixed percentages established at contract issue and are contingent solely on when a surrender or early annuitization occurs during the surrender charge period;
- Guaranteed surrender charges that are unrelated to any change in the underlying indexes referenced by the interest crediting formulas in the contract;
- Guaranteed surrender values that are computed using a "specified rate of interest" as defined in Rule 151 and will always equal or exceed the minimum nonforfeiture amount required under state nonforfeiture laws regulating the business of insurance;
- A guaranteed death benefit before annuity payouts begin, paid without the assessment of surrender charges which might otherwise be lawfully imposed under state nonforfeiture laws regulating the business of insurance; and,
- Guaranteed annuity purchase rates on annuity payout options which include life contingent payments, which are established at contract issue and may not be changed by the insurer when longevity improves.

In contrast to the SEC's position that the guarantees provided by indexed annuities are not "substantial enough," these state regulated insurance guarantees assumed by the insurance company place all the investment risk on the insurance company and none on the annuitant. The insurance "companies that issue these annuities take the risk of failure."[54]

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[53] The cost to an insurer of foregoing an MVA has been estimated to be as much as 100 basis points annually:

"The 'two-tiered annuity,' where one interest rate is available to those policyholders who surrender in a lump sum, whereas a higher rate is available to those who receive their benefit in the form of an annuitization over several years, was developed to reward policyowners who do not subject the insurer to the "cost" of book value surrender. However, critics of this form of annuity argue that those who surrender in a lump sum are receiving an amount that is unfairly low, and that the buyer of such policies might be forced into receiving this lower value by an unexpected emergency.
While this criticism appears to have merit, it ignores the difference in costs to the insurer, which can be measured as the price of the option granted to the policyowner to receive the lump sum value without adjustment for market value losses of the assets backing such annuity. Such an option mandates that the insurer must invest portions of the funds received in shorter duration securities than it would invest in if such an option were not present. This option has been priced by some studies that indicate this "cost" to be as much as 100 basis points annually."
NAIC Proceedings 1993, Vol. IB, p. 1429

[54] 359 U.S. 65, 71.

2. United Benefit

In United Benefit, the Supreme Court held that the variable annuity at issue was not an "annuity" within the meaning of Section 3(a)(8) because the insurer promised "to serve as an investment agency and allow the policyholder to share in its investment experience" and while the insurer provided a guaranteed surrender value, it was "insignificant."

In United Benefit, the Supreme Court analyzed a variable annuity under which the insurer invested the net premiums through a *separate account* established under Nebraska insurance law,[55] primarily in common stocks[56] and the contract owner bore the investment risk. In United Benefit the annuity at issue fell outside the scope of Section 3(a)(8) because the guarantee of principal was not meaningful.

At any time before maturity, the insurer provided a guaranteed surrender value under the contract equal to the greater of:

- her proportionate share of the fund; or
- a cash surrender value equal initially to 50% of net premiums in the first five years, increasing to 100% of net premiums after 10 years.[57]

Notably, United Benefit was not obligated to offer *any* guarantee in its variable annuity. Accordingly, under the Nebraska state insurance regulatory scheme governing insurance company *separate account* products, United Benefit was free to set the terms of the guarantee in its favor rather than the contract owner's under most economic scenarios.[58]

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[55] Following the VALIC decision in 1959, state legislatures adopted laws authorizing life insurance companies to: (1) issue variable annuities; and, (2) establish separate accounts. A variable separate account is an asset account maintained independently from the insurer's general investment account and is used primarily for retirement plans and variable products. This arrangement permits wider latitude in the choice of investments, particularly in equities. 2007 Life Insurers Fact Book, *supra*, note 18.

Section 2(a)(14) of the 1933 Act defines separate account as "an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, the District of Columbia, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company."

Purchase payments for a *general account* indexed annuity are not held in a variable separate account. The purchaser of an annuity issued by a variable separate account participates in the investment gains and losses of the separate account. In contrast, the assets of the general account belong to the insurance company. General account assets are used by the insurance company in support of the business it conducts, including the payment of guaranteed obligations it has assumed under the terms of the general account indexed annuities it issues. *The purchaser of a general account indexed annuity does not participate in the gains or losses of the general account of an insurer.*

[56] 387 U.S. 202, 205.

[57] *Id.*

[58] The record in United Benefit showed that "United set its guarantee by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so that it would not become operable under any prior conditions." 387 U.S. 202, 209.

The "guaranteed surrender value" in United Benefit's variable annuity was not required by law; rather, it was apparently added to United Benefit's variable annuity in an attempt to satisfy the assumption of investment risk requirement that the Supreme Court found lacking in VALIC.

B. Proposed Rule 151A Fails to Evaluate Investment Risk Assumed by the Insurer

Insurers issuing fixed annuities (both traditional and indexed) assume a variety of investment risks including:

- the risk that they will have insufficient funds to meet all contractual obligations.
- the risk of disintermediation. This is the risk that interest rates will rise and contract owners will exercise their right to surrender the contracts. To pay these surrender values, the insurer must sell assets, primarily bonds, from its general account at depressed market values, in which case the insurer may incur substantial losses well in excess of any surrender charges the insurer may collect. Some insurers have addressed this risk by shifting it to the contract owner through a registered MVA feature; Old Mutual's indexed annuities do not include any MVA features, and Old Mutual retains one hundred percent of the disintermediation risk under its indexed annuities.
- reinvestment risk. This is the risk that as bonds in the insurer's general account mature or coupons are paid, available bond returns are reduced to a level that will not support the guarantees embedded in the contract including the guarantees dictated by state nonforfeiture laws.

In addition to these risks, insurers issuing fixed indexed annuities face a variety of other investment risks related to the strategies they employ to hedge the risks they assume when they agree to pay interest based in part on changes in an external index they neither control nor manage:

- counterparty or credit risk. This is the risk that the hedge asset purchased to fund the indexed crediting strategy may not return the required amount needed to credit the contractually agreed upon rate of interest due to default of the issuing party. If this occurs, the insurer must still pay the calculated rate of interest due under the contract from its general account assets.
- the risk that the hedge program will return less than the amount needed to credit the contractually agreed upon rate of interest. This occurs frequently as insurers must make assumptions concerning persistency (how many contract owners will keep their contracts rather than surrender them) and strategy allocations (how contract owners may choose to allocate their contract value among various interest crediting options available under the contract)—with the timing of each of these events being determined solely by the contract owner without regard to, or knowledge of, the insurer's general account assets which support its contractual obligations.

In each case, regardless of the results of any hedge strategy the insurer may employ, the insurer must credit interest as determined in accordance with the interest crediting formula in the contract. Under no circumstance may the insurer credit a lesser amount of interest because the

insurer's hedge strategy failed to produce the funds necessary to honor the insurer's contractual obligation. The insurer alone bears this risk.

The Proposing Release omits any discussion of these investment risks insurers assume when they issue indexed annuity contracts. Instead, proposed rule 151A's new test equates "investment risk" with indexed interest credited on the initial investment that exceeds the minimum guaranteed rate of interest established by the applicable state nonforfeiture law. This risk is not the type of investment risk the U.S. Supreme Court in VALIC defined as relevant in Section 3(a)(8) analysis.

C. Proposed Rule 151A Adopts an Incorrect Measure of Investment Risk

The Proposing Release indicates annuity owners assume the investment risk under the contract when they are "more likely than not to receive payments that vary in accordance with the performance of a security."[59] Under proposed rule 151A(a)(2), this investment risk is present when "amounts payable" are more likely than not to exceed "amounts guaranteed."[60]

Proposed Rule 151A(a)(2) equates amounts of current interest[61] to be received by the contract owner under the terms of the index-linked interest crediting formula to investment risk assumed by the owner of an indexed annuity. But the risk of what the current interest rate will be is not an investment risk of the type indicative of a non-exempt security under Section 3(a)(8). It is fundamental to the business of insurance and exists in all contracts in which the insurer indicates it will (or may) credit a current interest rate that exceeds the state mandated minimum guaranteed rate of interest established by state legislatures in regulating the business of insurance.

The Proposing Release indicates the consumer "underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the equity-linked returns under the contract."[62] This statement confuses the uncertainty of not knowing what current interest rates the insurer will declare in the future with underwriting of investment risk. In every traditional fixed annuity the consumer bears the risk that the insurance company may not declare a current interest rate that exceeds the state mandated minimum guaranteed rate of interest.

The difference between "amounts payable" and "amounts guaranteed" is simply a measure of excess interest declared by an insurance company, not investment risk.[63] Historically, crediting

[59] Proposing Release at 5.

[60] Proposed Rule 151A(a)(2).

[61] Note that the "more likely" standard indicates that *more* current interest indicates more consumer risk, which is inconsistent with the solvency point of view that the obligation to pay more current interest indicates more insurer risk.

[62] Proposing Release at 6.

[63] Under Subsection (b)(1) of Proposed Rule 151A surrender charges would also be included in this difference. Insofar as the Proposed Rule intends to deem a contract a security if it charges a contingent deferred sales charge, we would consider this preemptive of state regulation of insurance which establishes minimum contract surrender values for fixed annuities and therefore imposes maximum permissible surrender charges. In any event, we disagree in concept with a rule dictating when charges should be taken into account. If amounts payable at a point in time or

of excess interest has been indicative of insurance company risk taking, not risk taking by the annuity owner. Once a current interest rate is declared the insurance company is obligated to credit contract values at that interest rate regardless of whether its general account assets perform consistently with the declared rate of current interest.

The Rule 151 Proposing Release[64] distinguished the *frequency* of crediting of current interest from the *amount* of current interest to be credited and noted that the amount to be credited, although indicative of the amount of risk the insurer bears, is a solvency risk adequately addressed by state insurance regulation:

> Of course, the degree of investment risk assumed by the insurer also is based on the *amount* of discretionary excess interest it guarantees. But that risk, *i.e.*, the risk that the insurer, by making imprudent investments or because of insolvency, will not be able to satisfy its contractual obligations, is the type of risk that Congress deemed to be adequately addressed by state insurance regulation. See VALIC, 359 U.S. at 77 (emphasis added).[65]

Similarly, to the extent any purchaser of an indexed annuity bears a risk of insurer insolvency there is adequate state regulation. The Proposing Release acknowledges in connection with the proposal of Rule 12h-7 that solvency risks are adequately addressed by state regulation: "[I]nvestors who purchase these securities are primarily affected by issues relating to the insurer's financial ability to satisfy its contractual obligations—issues that are addressed by state law and regulation."[66]

D. Proposed Rule 151A Disregards Marketing as a Factor under Section 3(a)(8) And Therefore Is Inconsistent With Supreme Court And Other Judicial Precedent

The Proposing Release acknowledges that "marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to the Securities Act 'annuity contract' exemption" [67] and cites the applicable language from United Benefit.[68] The Proposing Release further states that the Commission analyzes "indexed annuities under the facts and circumstances factors articulated by the U.S. Supreme Court in VALIC and United Benefit."[69] However, the Proposing Release fails to analyze the marketing of indexed annuities. Further, proposed rule

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upon happening of an event (surrender) are net of charges then charges should be taken into account, and if amounts guaranteed at a point in time or upon happening of an event (death) are not net of charges then charges should not be taken into account.

[64] Definition of 'Annuity Contract or Optional Annuity Contract', Rel. No. 33-6558 (Nov. 21, 1984)(proposing Rule 151).

[65] *Id.* at Note 18.

[66] Proposing Release at 7.

[67] Proposing Release at 19.

[68] *Id.*

[69] Proposing Release at 23.

151A does not incorporate a requirement that the class of contracts to be denied the exemption must, in accordance with United Benefit, be "marketed in a manner that appeals to the purchaser not on the usual basis of stability and security but on the prospect of 'growth' through sound investment management." The omission of this factor from proposed rule 151A is startling given the emphasis the Proposing Release places on abusive sales practices.

In United Benefit the Supreme Court first articulated the "marketing test" for purposes of determining which contracts meet the requirements of Section 3(a)(8). The Supreme Court based its conclusion in part on the manner in which the variable annuities were advertised. The Supreme Court noted that United Benefit's annuity, and others like it, were *not* promoted "on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management."[70] Such contracts were marketed to compete with mutual funds and were "pitched to the same consumer interest in growth through professionally managed investment."[71]

The obligation not to market an indexed annuity primarily as an investment, however, does not preclude an insurer from discussing what may be considered to be the investment aspects of the contract. In Associates in Adolescent Psychiatry v. Home Life Insurance Company, the federal district court determined that the annuity contract was not marketed primarily as an investment just because isolated statements in the company's sales literature referred to the investment aspects of the annuity contract.[72] The court noted that certain statements in marketing materials mentioned the desirability of excess interest as a way of taking advantage of fluctuating interest rates, and that the "sales pitch" for the contract emphasized the insurer's abilities in the management and investment of money. In its opinion, the court stated that the sales literature:

> "does not, when read *as a whole*, promote the [annuity] primarily as an investment....Undoubtedly the document refers to the investment aspects and tax-favored features of the plan, and the Court does not question that Home Life and its representatives promoted the company's investment abilities in hawking the [annuity]. But that is simply a consequence of the [annuity's] nature as a retirement funding vehicle; shrewd investment is necessary in order to save enough for comfortable retirement."[73]

This finding of the Home Life court was reiterated in the decision of the federal district court in Berent v. Kemper Corp.[74] In finding that the life insurance policies in question were marketed primarily as insurance, the court determined that "the facts that the sales brochures also discuss the investment features of the policies and that Plaintiffs...perceived the policies as investment

[70] 387 U.S. 202.

[71] *Id.*

[72] 729 F. Supp 1162 (N.D. Ill., 1989); *aff'd*, 941 F.2d 561 (7th Cir.1991), *cert denied*, 502 U.S. 1099 (1992).

[73] *Id.* at 1174 (emphasis added).

[74] 780 F. Supp. 431 (E.D. Mich. 1991); *aff'd*, 973 F. 2d 1291 (6th Cir. 1992).

vehicles does not change...the conclusion that the...policies were not marketed primarily as investments."[75]

More recently, the federal district court in Malone v. Addison Insurance Marketing, Inc.,[76] applying the United Benefit marketing test, analyzed a marketing brochure (that promised "stability and flexibility"), the contract form, and a disclosure form for an equity indexed annuity and found that the materials did not demonstrate the contract was marketed as an investment. Specifically, the Malone court said:

> [M]aking reference to investments in the context of assuring the security of an annuitant's premium, and an aggressive marketing strategy related to the potential for growing that premium have distinct legal significance....[The] Court must determine...if it appears the marketing emphasis was clearly more correlated to the prospect [of] growth in lieu of stability.
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> [The] brochure, though it mentions the company's "sound financial management," does so in the context of explaining that the company promises "stability and flexibility".... In addition, the contract itself states plainly... "that past S&P 500 Index activity is not intended to predict future activity and that the S&P 500 Index does not include dividends".... Moreover, the one-page summary Plaintiff signed, which focused on how her Contract Value was calculated at any one point to assure her the initial principal plus interest, did not emphasize the potential increase in her assets, but focused on explaining to her that she was guaranteed her principal plus three percent interest.[77]

The court concluded that the contract was exempt from the federal securities laws under Section 3(a)(8).[78]

The Commission has not promulgated rules prescribing acceptable or unacceptable marketing techniques for purposes of determining a product's status under Section 3(a)(8). However, it has agreed with judicial determinations that references to investment features of a contract do not necessarily preclude a court from finding that the contract was not marketed primarily as an investment. When adopting the standard under Rule 151 that a contract not be marketed primarily as an investment, the Commission explained that

> "[b]y adopting this standard...the SEC is not saying, nor has it ever said, that an insurer in marketing its product cannot describe the investment nature of the contract, including its interest rate sensitivity and tax-favored status... [A] marketing approach that fairly and accurately describes both the insurance and investment features of a particular contract, and that emphasizes the product's

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[75] *Id.* at 443.

[76] 225 F. Supp. 2d 743 (W.D. Ky, 2002).

[77] *Id.* at 753-754.

[78] The Proposing Release is critical of Malone's findings under Rule 151 but it does not criticize the court's ruling under Section 3(a)(8).

usefulness as a long-term insurance device for retirement or income security purposes, would undoubtedly 'pass' the rule's marketing test."[79]

Old Mutual controls the content of its indexed annuity marketing materials to comport with these standards and the standards applicable to the advertising of these contracts under state insurance law. By not considering marketing as a factor, the proposed rule is inconsistent with Supreme Court and other judicial precedent.

E. Proposed Rule 151A Disregards Mortality Risks as a Factor under Section 3(a)(8)

Both judicial[80] and Commission interpretations recognize that mortality risk is an important consideration in determining whether annuity contracts come within the Section 3(a)(8) exclusion. In a general statement of policy issued on April 5, 1979, the Commission identified the assumption of mortality risks and investment risks as central features of life insurance or annuity contracts.[81] In the release adopting Rule 151, however, the Commission withdrew Release 6051 and abandoned this requirement for purposes of the safe harbor. Nevertheless, the Commission continued to express the view that mortality risk may be an appropriate factor to consider determining the availability of an exemption from Section 3(a)(8).[82]

Old Mutual's indexed annuities provide a death benefit before annuity payouts begin. This death benefit is significant in that interest is calculated under the indexing formula until the death benefit is calculated. This contrasts with the general contract surrender value under which no indexed interest is credited to amounts surrendered during an indexing period.

In addition, although not required to do so under applicable state nonforfeiture law, when Old Mutual pays the death benefit under an indexed annuity, it waives any remaining surrender charge. Because Old Mutual waives surrender charges when it pays a death benefit under its indexed annuities, the value of the death benefit may be even greater to seniors than it is to younger retirement savers. In any event, Old Mutual assumes a significant traditional insurance mortality risk in providing this benefit that proposed rule 151A fails to consider.

In addition to assuming the mortality risks associated with the death benefit Old Mutual provides under its indexed annuities, Old Mutual assumes other significant mortality risks under its

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[79] Release 6645 at 13.

[80] Grainger v. State Security Life Insurance Co., 547 F.2d 303, 307 (5th Cir. 1977)(considering the relationship between the size of the death benefit and the size of premium payments as part of the court's Section 3(a)(8) analysis), reh'g. denied, 563 F.2d 215 (5th Cir. 1977), cert. denied sub nom. Nimmo v. Grainger, 436 U.S. 932 (1978); Dryden v. Sun Life Assurance Co. of Canada, 737 F. Supp. 1058 (S.D. Ind. 1989)(concluding that the insurer's obligation to pay a fixed sum to a designated beneficiary upon the death of the owner of a life insurance policy caused the insurer to bear the risk of poor performance of its investments).

[81] Statement of Policy Regarding the Determination of the Status Under the Federal Securities Laws of Certain Contracts Issued by Insurance Companies, Rel. No. 33-6051 (Apr. 5, 1979)(hereinafter referred to as "Release 6051").

[82] *See, e.g.*, Brief for the United States as Amicus Curiae at 9, Variable Annuity Life Insurance Co. v. Otto, No 87-600 (1988).

indexed annuities in connection with annuity payment options it provides based on life contingencies. By currently guaranteeing life annuity options that can be selected at some future time, Old Mutual assumes a mortality risk that the longevity of its annuitants may be greater than it assumed when it issued the contract.

V. PROPOSED RULE 151A WILL HAVE THE UNINTENDED CONSEQUENCE OF REDUCING LONG TERM VALUE TO CONSUMERS INTERESTED IN GUARANTEED GENERAL ACCOUNT PRODUCTS

About 77 million baby boomers are expected to retire over the next few years. Many of these retirees will not have a source of guaranteed monthly income for their lifetime apart from Social Security benefits. A recent study commissioned by Americans for Secure Retirement, a coalition of more than 50 organizations representing women's, small business, agricultural, Hispanic and African American groups concluded that retirees would be much better prepared if they had a guaranteed source of retirement income beyond Social Security.[83]

Annuities are insurance contracts that pay a steady stream of income for either a fixed period of time or for the lifetime of the annuity owner, in addition to providing a number of other important guarantees. Because they guarantee a stream of income for life, annuities protect senior consumers against the real and growing possibility of outliving their financial resources due to factors such as increased longevity, rising health care costs, declining investment markets and reductions in Social Security benefits.

Consumers saving for retirement benefit when they have a variety of registered and non-registered products from which to choose. Consumers who have selected indexed annuities over variable annuities, mutual funds or other securities for some portion of their retirement savings have generally done so to obtain stable income, a guarantee of principal and interest that has been credited to the contract, and the other guarantees that indexed annuities provide.

A. Additional Costs of Issuing Registered Products will Be Passed Through to Consumers

Insurance companies issuing registered indexed annuities will incur additional one-time and permanent additional costs. Many of these costs are noted in the Proposing Release, such as costs of performing the required test, cost of registering products,[84] cost of printing prospectuses and mailing them to investors, costs of life insurance agents entering into networking arrangements with broker-dealers, and loss of revenue.

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[83] Nancy Treos, "Many Retirees Face Prospect of Outliving Savings, Study Says" The Washington Post, July 13, 2008.

[84] The Proposing Release estimates aggregate annual costs of $82,500,000 assuming 400 contracts each year will be filed on Form S-1. This works out to a per contract cost of $206,500 for preparing and filing registration statements for indexed annuities. Using this figure, it will cost Old Mutual in excess of $4,500,000 to file the 22 indexed annuities it currently offers. This figure does not include prospectus print and mailing costs or the cost of hiring independent actuarial consultants to develop or validate the company's testing procedures.

Costs not noted may include:

- costs related to due diligence undertaken by professionals and required in connection with the preparation and filing of a registration statement on Form S-1;[85]
- costs to design, develop and maintain new recordkeeping systems required in connection with registered products;[86]
- costs of destroying existing inventories of marketing materials;
- costs of preparing and filing new advertising materials[87] with FINRA;
- costs of administering registered products in excess of the costs of administering non-registered products;
- costs related to increased audit expenses, including the need to inform independent auditors about the companies' controls, procedures and assumptions related to its registered contract business operations;
- costs to build or modify systems due to direct requirements of the proposed rule (e.g., to provide prospectuses and confirms) or indirect consequences of the proposed rule (e.g., possible product design revisions);
- costs associated with negotiating and preparing selling agreements between the insurance company, its principal underwriter and registered broker-dealers;[88]
- costs associated with staffing reductions including in some cases, costs of compliance with "plant closing" laws for insurers downsizing or exiting altogether;
- costs of staffing additions and staffing replacements as new needs are determined, for example, adding wholesalers by firms that do not currently distribute their product through broker-dealers;
- costs arising from increased litigation expense and professional witness fees; and
- costs attributable to increased insurance and bonding expense.

These costs would necessarily be passed through to the consumer in the form of lower guarantees, lower credited interest rates, higher surrender charges, higher optional feature charges or other product design modifications. Additional costs to the consumer will necessarily

[85] The Proposing Release at 76 mentions only the costs of preparing and reviewing disclosure; it does not address the costs of professional due diligence examination required in connection with the preparation of a registration statement on Form S-1.

[86] The Proposing Release at 76 mentions only the cost of retaining records. For companies that do not currently issue registered contracts these costs may be significant.

[87] Note, however, in the absence the SEC's adoption of a rule for indexed annuities comparable to Rule 482, the SEC adversely and unfairly burdens the marketing of indexed annuities vis-a-vis variable annuities and mutual funds.

[88] This cost will be greater for insurers who currently lack a variable contract or mutual fund distribution platform. The Proposing Release at 75 and 77-78 mentions only the cost of entering into networking agreements which applies to distributors, not insurers.

result in lower long term retirement value to consumers which is not a desirable outcome given the current retirement crisis in America.

B. Proposed Rule 151A Will Have the Effect of Decreasing Competition and/or Product Availability

Because indexed annuities are currently regulated as insurance, the Commission is well aware of the fact that insurance agents unaffiliated with broker-dealers are the primary distributors of indexed annuities today. We expect some of these insurance licensed only providers will become affiliated with broker-dealers as an associated person. We expect far more will not do so. Purchasers of indexed annuities currently can choose among providers: the purchaser can select an insurance licensed only provider, or may choose an insurance licensed provider who is also an associated person of a registered broker-dealer. Proposed rule 151A will eliminate the first choice entirely.

In view of the costs associated with registered products, we expect some insurers will simply stop selling these contracts altogether, and as a result, will lose significant revenues. In some cases, if an insurer can not find other revenue sources, it may need to merge with another company or cease doing business altogether.

On the other hand, insurers who choose to offer non-registered contracts following adoption of Rule 151A will need to design their contracts so that the indexing formula more often than not returns no more than the applicable state nonforfeiture guaranteed rate of interest. Insurers offering such contracts may find that those contracts are uncompetitive with other alternative long term savings vehicles in many, if not most, interest rate environments.

The effect of the adoption of Rule 151A clearly will be to reduce consumer choice and increase the costs of owning an indexed annuity contract.

C. Registration of Products Will Have the Effect of Reducing Guarantees In Products and/or Transferring Greater Investment Risk to Consumers

Indexed annuities already registered with the Commission,[89] because of the MVA feature contained in these contracts, may not guarantee minimum interest rates or may provide guaranteed minimum values that are less than what those values would be if they were computed under the standard nonforfeiture laws applicable to indexed annuities.[90]

In view of the significant cost to insurers of providing the guarantees required by the standard nonforfeiture law for individual deferred annuities applicable to indexed annuities, we believe it is reasonable to conclude that some insurers will simply file the product with the Commission as a separate account variable annuity on Form N-4, utilizing index funds as the underlying

[89] *See* Proposing Release at Note 17 and accompanying text.

[90] Nonforfeiture values for annuities with MVA features are not determined under the standard nonforfeiture law for individual deferred annuities that applies to indexed annuities; rather, nonforfeiture values for MVA contracts are set under a separate regulation.

investment option, and by doing so, eliminate the requirement to provide any of the guarantees now found in non-registered indexed annuities.

Other insurers may find ways to shift additional risk to the purchaser of a registered indexed annuity. For example, rather than guarantee no negative interest, perhaps an insurer will guarantee that no more than 1% negative interest will be credited during the applicable crediting period. Other insurers may reduce the interest crediting period from at least 12 months to something less.

The clear result would appear to be that the costs of owning an indexed annuity contract would increase.

* * *

Old Mutual appreciates the opportunity to provide comments on this proposal. In accordance with the Proposing Release at 2, we are filing this paper comment in triplicate with the Commission's Acting Secretary. On August 1, 2008, Old Mutual filed a formal request with the Commission in this rulemaking proceeding to extend the comment period to January 8, 2009 to permit its company management to ascertain the precise impact of the proposal. We believe the proposed rule deserves more analysis than the current comment period has permitted, especially since it potentially requires registration with the Commission of a number of insurance products offered today by insurers that do not offer indexed annuities and who are likely unaware of the need to analyze the impact of the proposed rule on their contracts. In any event, we respectfully reserve the right to supplement our comments herein with the Commission should it elect to extend the comment period. If you have any questions about our comments or would like any additional information, please contact me at (410) 895-0082.

Sincerely,

Eric Marhoun
Senior Vice President & General Counsel

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. Parades

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

November 17, 2008

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

Attention: Ms. Florence E. Harmon
Acting Secretary

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

Dear Commissioners:

The National Association for Fixed Annuities ("NAFA") appreciates this opportunity to submit additional comments on Rule 151A ("Proposed Rule 151A" or "Proposed Rule")[1] that the Commission has proposed under the Securities Act of 1933.

As the Commission knows, NAFA is an organization created to provide training and education to foster better understanding of fixed annuities, including declared-rate, indexed and immediate annuities. It is the only independent, non-profit organization dedicated exclusively to the education and promotion of these products.[2]

A. NAFA Comments

NAFA submitted its original comments on Proposed Rule 151A to the Commission in a detailed 126-page letter, dated September 10, 2008.

Today, NAFA is submitting additional comments that address certain financial aspects of Proposed Rule 151A in two enclosures to this letter. NAFA intends these additional comments to provide certain information requested, and respond to certain questions asked, by the Commission in its Proposing Release.

The enclosures consist of:

1. a paper by NAFA entitled "Economic Impact of Rule 151A" ("NAFA Report"), and

2. a paper commissioned by NAFA and developed by CRA International entitled "Report on Dr. McCann's Analysis" ("CRA Report"). (Dr. McCann's analysis was submitted to the Commission by letter, dated September 10, 2008.)

The CRA Report provides a rebuttal to criticisms of fixed indexed annuities asserted by Dr. McCann in a letter to the Commission, dated September 10, 2008.

1 The Commission proposed Rule 151A in Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 8933, Securities Exchange Act Release No. 58022 (June 25, 2008) ("Commission's Proposing Release"). The Commission reopened the comment period in Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 8976, Securities Exchange Act Release No. 58769 (Oct. 10, 2008).

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

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The NAFA Report responds to the Commission's request for comments on its cost/benefit analysis in Section VI.B. of the Commission's Proposing Release. In addition to the costs detailed in the NAFA Report, NAFA submits that the Commission's cost/benefit analysis fails to consider additional costs of Proposed Rule 151A, including costs to consumers of potentially lower crediting rates under registered fixed indexed annuities, and the resulting lower retirement savings for consumers. NAFA submits that the Commission's 30-day extension of the comment period did not provide the industry with sufficient time to conduct a complete analysis of the costs of Proposed Rule 151A.

B. Commission's Comment Process

Today marks the end of the second comment period for Proposed Rule 151A. The Commission proposed Rule 151A on June 25, 2008 and granted an unreasonably short comment period (covering two national holidays and summer vacation) to September 10, 2008. Then, despite the almost unanimous chorus of requests from every corner of the insurance industry to extend the comment period, the Commission refused. Finally and without any forewarning, the Commission announced, on October 17, 2008, a limited 30-day extension until today.

This last extension was particularly perverse, as it came five weeks after the initial period had closed. Those five weeks would have been put to good use by those in the industry to collect data and complete studies empirically demonstrating the costs and the flaws in the rationale for Proposed Rule 151A. As it was, the industry, including NAFA, had just 30 days to submit additional comments.

C. NAFA Position

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

At the same time, NAFA, with all due respect for the Commission, firmly believes that state insurance regulators are better positioned than the Commission to achieve these public interest objectives while promoting efficiency, competition and capital formation. Accordingly, NAFA opposes the Commission's Proposed Rule 151A. The Proposed Rule, for the reasons set out in NAFA's comment letter of September 10, 2008:

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

As a result, Proposed Rule 151A is flawed and arguably invalid. NAFA believes that a court would vacate[3] the Proposed Rule.

NAFA urges the Commission to withdraw Proposed Rule 151A, rely on current and developing state insurance law and initiatives, and reinvigorate its traditional liaison with state insurance regulators. NAFA's rationale is spelled out, in detail, in its letter to the Commission, dated September 10, 2008.

If the Commission has any question or needs further information, please contact the undersigned at (414) 332-9306 or kim@nafa.us.

Very truly yours,

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

Kim O'Brien
Executive Director

Enclosures (2)
WDC 207101v2

Comments on Dr. McCann's Analysis Submitted as Part of NASAA's Comment Letter to the SEC, Dated September 10, 2008[1]

Miguel A. Herce, Ph.D

CRA International, Inc.

November 17, 2008

In this report I evaluate Dr. McCann's claims that Fixed Indexed Annuities (FIAs) are "complex contracts" whose issuers "obfuscate investment risks by repackaging what is actually a simple underlying investment in securities," and whose performance is such that, based on Dr. McCann's simulation exercise, "99.8% of the time [an] investor would be better off with [an alternative investment in] Treasury securities and stocks than with [an] equity indexed annuity."[2] I also evaluate what I consider to be Dr. McCann's irrelevant and erroneous calculations, and the negatively biased conclusions he bases on such calculations. Finally, I provide extensions and variations to some of Dr. McCann's calculations to shed greater insight on FIAs, their attributes, and their performance under realistic conditions

I believe that the five serious deficiencies I analyze in depth, as well as with the many other deficiencies I comment upon in a more cursory manner, are central to Dr. McCann's very partial and negatively biased view of the merits of FIAs. The SEC should not take Dr. McCann's analysis at face value.

In this report I do not maintain that FIAs are appropriate for all individuals or even all seniors. Contrary to Dr. McCann's almost universal rejection of FIAs, I submit, based on long accepted economic principles of rational choice, that a rigorous analysis of FIA

[1] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, submitted to the North American Securities Administrators Association (NASAA).
[2] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, pp. 1, 27. Following industry practice I use the term "fixed indexed annuities" (FIAs) instead of the alternative "equity-indexed annuities" (EIAs).

performance leads to the conclusion that, given a choice, many rational individuals beyond moderate degrees of risk aversion will favor FIAs over the kind of alternative investments Dr. McCann envisions. I also submit that an even larger group of individuals would benefit from having FIAs as a component of a portfolio of retirement savings vehicles.

I. Market Risk

Upside volatility does not impose risk to purchasers. FIAs, when used as intended, truly truncate or eliminate downside market risk, while keeping only a portion of the upside volatility. But Dr. McCann's naïve view of risk as identical to volatility hides an even deeper misunderstanding of who transfers market risk to whom.

Insurance companies try to avoid market risk. But, contrary to Dr. McCann's assertions, they do not do so by passing on the market risk to policyholders. Indeed, they go to great lengths to make sure that both the companies and the policyholders, especially persisting policyholders, are protected from market risk. This is the reason why an insurer's target accounting spreads (which Dr. McCann disingenuously refers to as an expense ratio) are what they are, say 2.5% per year. This is also the reason why these spreads are not anything like mutual funds' expense ratios.

Ironically, Dr. McCann's argument that insurers pass along all of the market risk to investors can be legitimately applied to his favorite purveyors of sound investments, mutual fund companies. By charging annual expense fees calculated as a percent of asset value under management, and by charging significant front- or back-end loads calculated as a percent of asset value transferred, a mutual fund company is able to truly and completely pass virtually all portfolio market risks along to fund shareholders. Arguably, the mutual fund industry as a whole is designed to pass along virtually all portfolio market risks to mutual fund shareholders. Accordingly, unlike insurance companies and banks, mutual fund companies are required to hold very little risk capital.

II. Crediting Methods and other features of FIAs

Dr. McCann discusses two basic methods used to credit interest in an FIA, the *point-to-point method* and the *averaging method*, but it is the latter method that he discusses in detail and on which he reports calculations.[3] I believe that Dr. McCann's analysis concerning the averaging method is very limited in scope and, more importantly, incorrect.

According to the averaging method, the crediting rate for a given year is calculated as the greater of zero or the ratio of the average of the monthly index values to the index value at the end of the previous year, minus one. Dr. McCann is fully aware that the crediting rates obtained under both the point-to-point and the averaging method cannot be negative. First, he states that "[a]s with the point-to-point method, the percentage difference in the month-end average level during the contract year from the level at the beginning of the year is reduced by one or more gimmicks and the resulting credit, *if positive*, is applied to the prior anniversary's scrip value." (Italics added) Second, the formula he reproduces in Equation 1 of his report clearly shows that the crediting rate cannot be negative.[4]

In spite of his awareness of non-negative crediting rates, Dr. McCann has chosen to illustrate the averaging method by ignoring the impossibility of negative crediting rates. Figure 1 of his report shows a December 31, 2004 value of 544 for the monthly averaging index he constructs. This figure also shows the monthly averaging index declining after it peaks in the year 2000.

I have replicated the calculations in Figure 1 of Dr. McCann's report and included a monthly averaging index which, consistent with non-negative crediting rates and Dr. McCann's awareness of them, has a floor of zero percent.[5] This index also has a value of 100 at the start of 1975 and grows to 962 by December 31, 2004, which is 77% higher than the errant figure of 544 calculated by Dr. McCann. In Figure 1 below I show the various indices considered by Dr. McCann as well as the monthly averaging index with a zero percent floor. Figure 2 shows the same indices on a logarithmic scale to illustrate more clearly the periods

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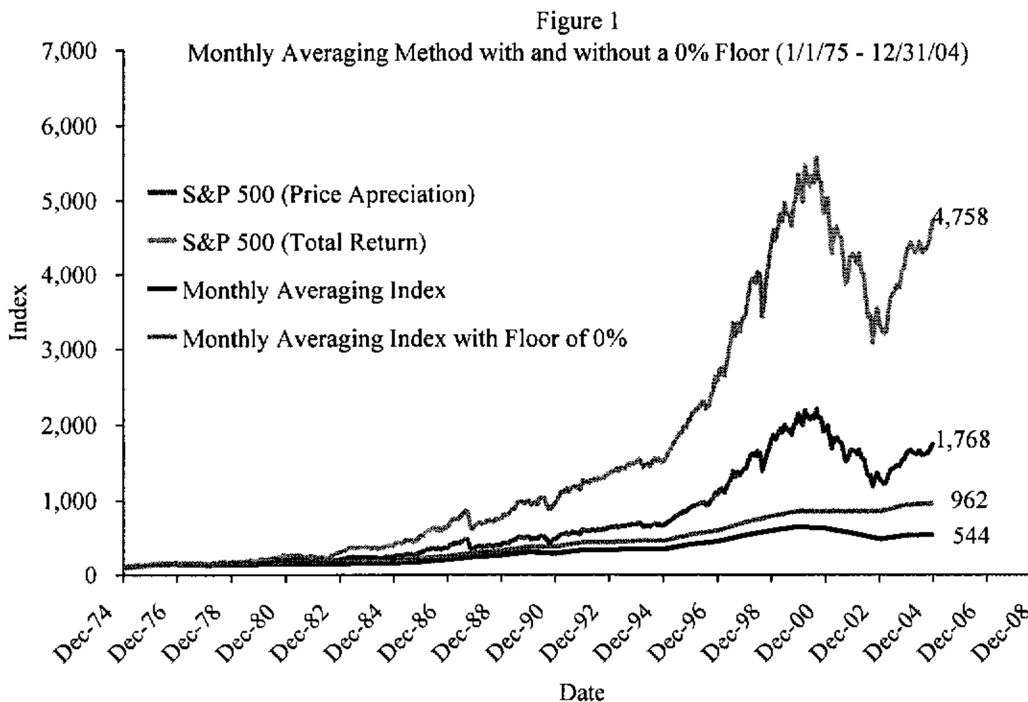
[3] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, Section III.D., and Figures 1 and 2. Note that the point-to-point method is more widely used.

[4] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, pp. 9,10.

[5] While I am able to replicate Dr. McCann's values of 1,768 and 544 for the S&P 500 index without dividends and his version of the monthly averaging index, Dr. McCann reports a value of 4,921 for the S&P 500 index with dividends as of 12/31/04. This is 3.4% higher than the value of 4,758 I obtained using monthly return data from Morningstar's SBBI 2008 Yearbook and Bloomberg.

where the monthly averaging index falls but the monthly averaging index with a floor of zero percent stays constant. I conclude, and I believe Dr. McCann would agree with me, that the value of 544 and the monthly averaging index he constructs are irrelevant for any informed analysis of an FIA's crediting method.



Dr. McCann's calculations over the period 1975 – 2004 imply annualized rates of return of 10.0%, 13.7% and 5.8%, respectively, for the S&P 500 index with no dividends, the S&P 500 index with dividends, and Dr. McCann's Monthly Averaging Index with no floor.[6] My calculations for the Monthly Averaging Index with a zero percent floor imply an annualized return of 7.8% over the same period. This is a respectable return for an index that is guaranteed never to decline in value and many moderately risk-averse, rational individuals would consider an FIA based on such an index to be quite appealing.

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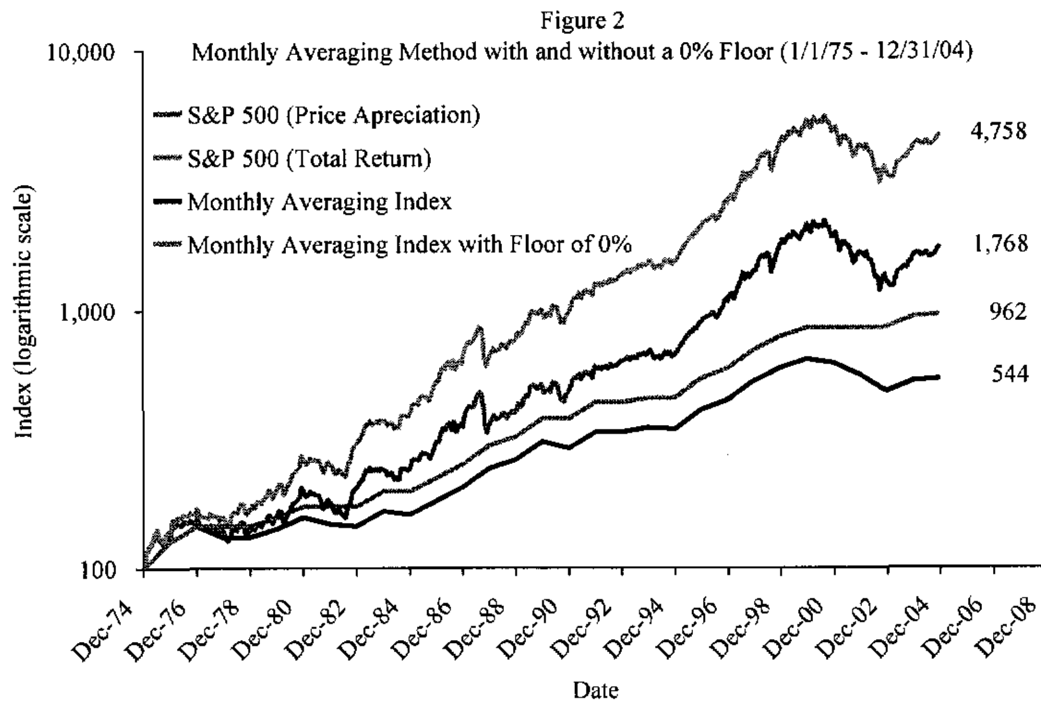
[6] Note that in practice, index mutual funds would incur loads, fees, taxes, and tracking error over time whereas the stock index itself to which the crediting rates are tied, is not affected by any of these drains; moreover, money grows tax deferred in an annuity. To see the impact of tax deferral on after-tax annuity accumulation values, see "Measuring the Tax Benefit of a Tax-Deferred Annuity," David F. Babbel and Ravi Reddy, October 4, 2008, Wharton Financial Institutions Center Policy Brief. This can be downloaded at: http://fic.wharton.upenn.edu/fic/Policy%20page/AnnuityTaxation1.pdf



As telling as constructing an appropriate monthly average index is, it is also useful to consider the implications for retirement savings of recent financial events. The US and international stock markets are sharply down from what they were a year ago. Many record-breaking daily declines in stock prices observed during September and October of this year are among the largest since 1926 and many experts believe that stocks will perform modestly over the next few years. Indeed, over the past ten years (from October 31, 1998 through October 31, 2008) the S&P500 index *with dividends* has returned an average of only 0.40% per year.

The implications of events over this decade and, in particular, the 2000 – 2002 period and the past year in US and international stock (and bond) markets for retirement savings, an area where FIAs play an important role, are staggering. In light of this it is therefore striking that, for his report to the SEC as part of NASAA's comment letter of September 10, 2008, Dr. McCann has chosen to recycle two charts based on data through the end of 2004, from

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previous work he did up to January 2006, without bothering to update and correct such work.[7]

Consistent with the preceding discussion, I have extended Dr. McCann's indices, as well as the monthly average index with a floor of zero percent, through the end of October 2008. I report my findings in Figure 3 below.[8]

The value of 4,095 for the S&P 500 index with dividends and the value of 1,058 for the monthly averaging index with a zero percent floor imply annualized rates of return over the 1/1/75 – 10/31/08 period of 11.6%, and 7.2%, respectively.[9]

[7] Figures 1 and 2 in Dr. McCann's report to the SEC are exact reproductions of Figures 1 and 2 in his working paper, with Dengpan Luo, PhD, An Overview of Equity-Indexed Annuities, 2006, downloadable from slcg's webpage www.slcg.com. Dr. McCann's report to the SEC as part of NASAA's Comment letter is dated September 10, 2008. Although the US financial markets have experienced their most dramatic declines in September and October of 2008, these markets have been declining steadily since October of 2007.

[8] The value of 533 for the monthly average index with no floor is based on a an average of monthly S&P 500 levels from November 2007 through October 2008, used as an estimate of what the average for the months of January through December 2008 would be. Using the January through October 2008 monthly average results in a monthly averaging index value of 519.82. In any case, the monthly average index return for 2008 will most likely be negative and so the contribution to the monthly averaging index with a floor of zero percent will most likely be zero as reflected in a value of at least 1,058.

[9] The tax advantage accorded to annuities through tax deferral can actually be quite substantial over periods as long as the 30-year period considered by Dr. McCann, as well as for shorter periods. If a more suitable benchmark portfolio of CDs or bonds, or even a mixed portfolio of stocks and bonds is used, this tax advantage for consumers becomes even more apparent. A portfolio producing ordinary income would have to earn 100-350 basis points more per year to keep pace with the after-tax earnings produced by an annuity. See Babbel and Reddy, *op cit.*

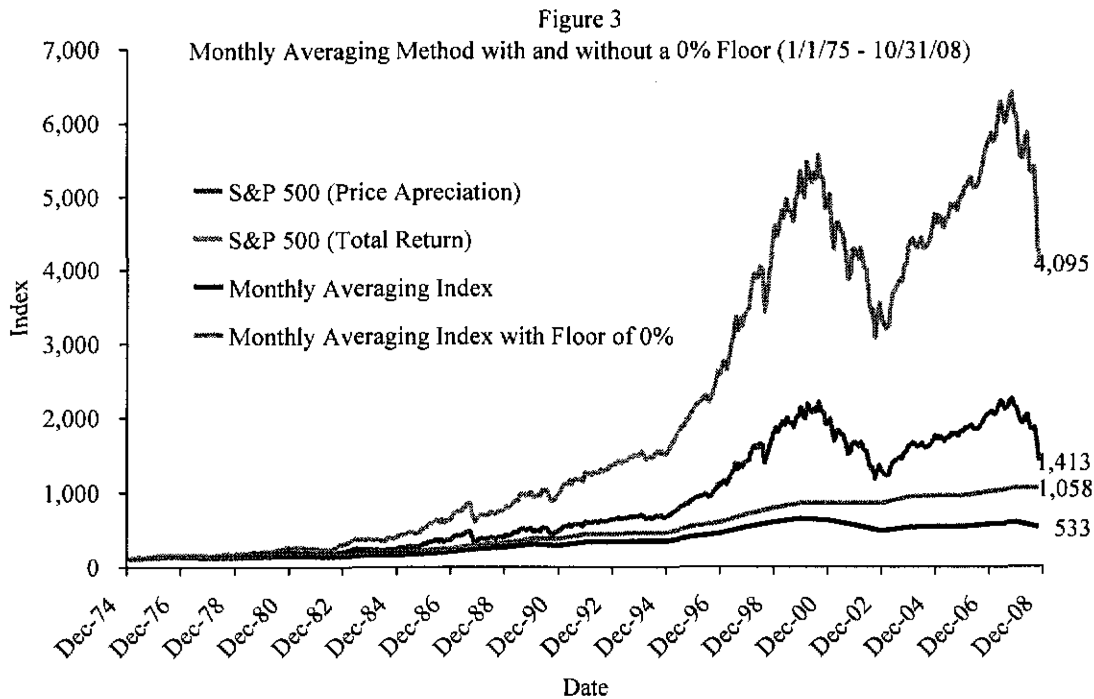


Figure 3
Monthly Averaging Method with and without a 0% Floor (1/1/75 - 10/31/08)

As indicated above, an appropriate monthly averaging index with a floor of zero percent has an appealing property that insulates it from the severe downturns that stocks experience. And while Figure 3 shows that over close to 34 years the S&P 500 index with dividends is almost four times the size of the monthly averaging index with a zero percent floor, this comparison is misleading for the reason that no FIA has a surrender charge period of 34 years, typical periods being 10 to 15 years.

I have shown that extending Dr. McCann's period through October 31, 2008 significantly reduces the annualized returns on the S&P indices but does not reduce the return on the monthly averaging index as much. I have also considered other periods ending on October 31, 2008, either because their length is more consistent with the surrender charge period of a typical FIA or due to the relevance of recent events. Table 1 below reports annualized returns for the indices of interest over these other periods.

Table 1. Monthly Averaging Method – Annualized Return for Selected Periods

Period	S&P 500 with no	S&P 500 with	Monthly Averaging	Monthly Averaging

	Dividends	Dividends	index (no floor)	Index (0% floor)
01/01/75 – 12/31/04	10.0%	13.7%	5.8%	7.8%
01/01/75 – 10/31/08	8.1%	11.6%	5.1%	7.2%
01/01/95 – 10/31/08	5.5%	7.4%	3.2%	6.2%
01/01/98 – 10/31/08	-0.02%	1.6%	-0.03%	3.8%
12/31/99 – 10/31/08	-4.6%	-3.0%	-2.2%	2.4%
10/31/07 – 10/31/08	-37.5%	-36.1%	-15.4%	0.0%

Inspection of Table 1 shows that considering periods such as 1995 – 2008 and 1998 – 2008 results in the monthly averaging index exceeding the S&P index with no dividends in the former period, and beating both indices over the last ten years. If, in addition, we note that FIAs often enjoy a premium bonus, say 5% to 10%, and that a mutual fund which tracks the S&P 500 total return index is subject to annual fees and other expenses, we begin to understand that an FIA's crediting rate based on the monthly averaging method is much higher in actuality than Dr. McCann erroneously illustrates.

I also look at the impact, as of October 31, 2008, of investing in stocks or purchasing an FIA whose crediting rate is based on the monthly averaging index with a floor of zero percent around the two recent peaks, December 31, 1999 and October 31, 2007. If there is any need to comment on the last two rows of Table 1 above it is to note that the odds of observing an annual return of negative 36.1% or lower are about two in one hundred, based on monthly returns since January 1926.[10]

Dr. McCann is aware that considering just a single 30-year path, or even considering a few paths as shown in Table 1 above, does not provide a complete description of the relative performance of the monthly averaging method. For this reason, Dr. McCann "constructed 241 10-year periods by rolling 10 years of data forward one month at a time from 1975 to 2004." This exercise allows him to report that, over a horizon of 10 years and starting with a base value of 100, average values of the S&P 500 index with dividends, the S&P 500 index with no dividends, and the S&P monthly averaging index were 463, 327, and 183,

[10] Using monthly return data, there are 983 12-month periods starting on January 1926 through October 2008, for which an annual return can be calculated. Annual returns of negative 36.1% or worse have occurred 18 times during this interval.

respectively. Dr. McCann then concludes that "[u]nsophisticated investors might believe that they will get 100% of the increase from 100 to 463 when in fact they receive only 23% of this increase."[11]

But Dr. McCann repeats the same error of ignoring the fact that an FIA's crediting rate provides a floor of zero percent each year, and his argument that the monthly averaging method with no floor of zero percent continues to generally perform so poorly when compared to the S&P 500 index with dividends is just as irrelevant as in the case of his analysis of the 30-year period from 1975 to 2004, and for the same reason.

I have shown in Table 1 above that when a floor of zero percent is combined with the monthly averaging method, the resulting annualized rates of return are significantly higher than what Dr. McCann's calculations imply.

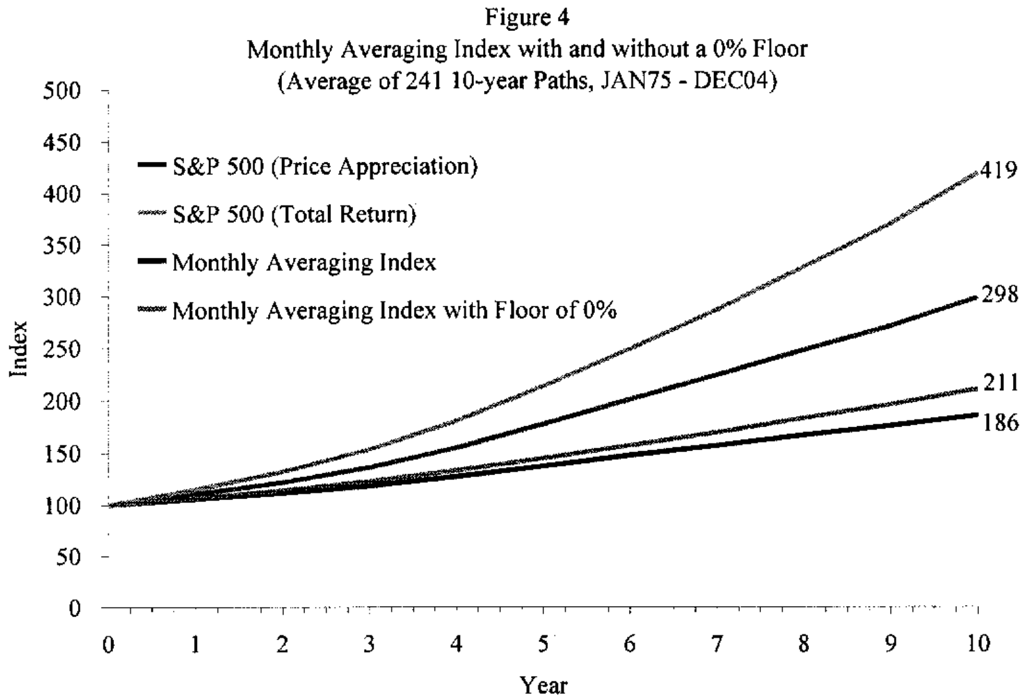
Next, I show that when all possible 10-year paths constructed for each month in Dr. McCann's period of 1975-2004 are properly analyzed, his values of 463, 327, and 183, and his conclusion that "[u]nsophisticated investors might believe that they will get 100% of the increase from 100 to 463 when in fact they receive only 23% of this increase," continue to be irrelevant in an informed analysis of the monthly averaging method.

I revise the calculations Dr. McCann illustrates in Figure 2 of his report in two ways. First, I construct 241 10-year paths for each of the indices of interest. Each path starts with a value of 100 and grows at the annual rate implied by the corresponding index for each of the ten years in the path. For instance, the S&P 500 index with dividends returned 37.21% in 1975 and so the index changed from 100 to 137.21 at the end of 1975. Over the ten years 1975 – 2004 this index grew from 100 to 396.27 returning an average of 14.8% per year. I construct a new path at the beginning of each month in the period so that I have a full ten-year path in each case. I then average all 241 paths for each of the indices of interest.

Second, I also construct a monthly averaging index with a zero percent floor, using the same methodology I have just described. Figure 4 below shows these average paths for the three

[11] See pp. 11 and 12 of Dr. McCann's report. The figure of 23% is calculated as the ratio of the increase in the monthly averaging index to the increase the S&P 500 index with dividends (83 ÷ 363 = 0.23)

indices Dr. McCann considers and for the monthly averaging index with a zero percent floor.[12]



The annualized returns for the S&P total return index, the monthly averaging index with no floor and the monthly averaging index with a floor of zero percent are, respectively, 15.4%, 6.4% and 7.7%.

I have also considered periods other than the 30 years from 1975 to 2004. In Table 2, I report the annualized rates of return for all these periods, for each of the four indices I construct.

Table 2. Monthly Averaging Method – Annualized Return over 10-Year Periods

Period	S&P 500 with no Dividends	S&P 500 with Dividends	Monthly Averaging index	Monthly Averaging Index

[12] My method of constructing the average paths is consistent with the notion of an average path and differs from the one considered by Dr. McCann. It is still the case, however, that Dr. McCann's monthly averaging index in Figure 2 of his report ignores the effect of a zero percent floor.

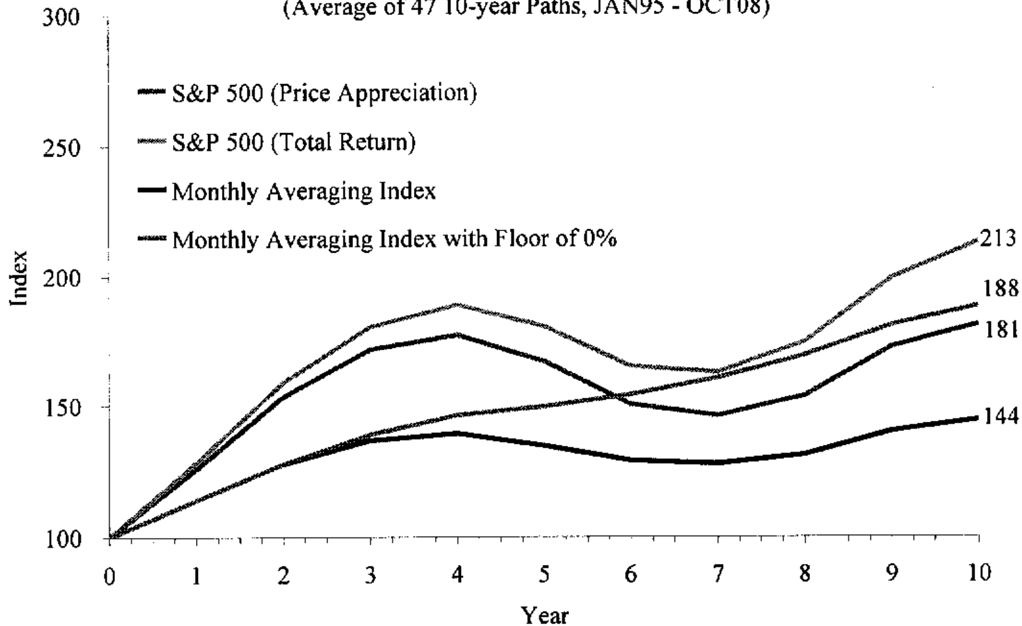
			(no floor)	(0% floor)
JAN75 – OCT04	11.6%	15.4%	6.4%	7.7%
JAN/75 – OCT08	10.8%	14.4%	6.0%	7.5%
JAN/26 – OCT08	7.6%	12.1%	4.2%	7.0%
JAN/95 – OCT08	6.1%	7.9%	3.7%	6.5%

As is the case with Table 1 above, Table 2 shows that ignoring the floor of zero percent is misleading and irrelevant for a discussion of the contribution of the monthly averaging method to an FIA crediting rate.

The period from January 1926 through October 2008 is relevant because of its length. It allows researchers to get a better sense of what the distribution of monthly stock returns actually is, rather than making distributional assumptions, such as log-normality, which are not supported by the available data. The extraordinary stock market volatility of the recent months indicates that rare events are not so rare after all. And in light of these events, it is perhaps unrealistic to expect that an S&P 500 total return fund may yield an average annual return of 15.4% (minus expenses, loads, taxes, and tracking error) over a period of ten years.

The last row in Table 2, showing annualized rates over the period from January 1995 to October 2008, is also of particular interest. Mutual fund companies usually report ex-post annualized returns for the funds they sell, including annualized returns "since inception." FIAs begun to be sold in the US in 1995 and therefore, in the spirit of the "since inception" information that mutual fund companies provide, it may be of interest to know what the average annualized rate of return is, over a ten-year period, for the indices of interest. Table 2 shows that this return is 6.5% for the monthly averaging index with a zero percent floor, not far from the 7.9% for the S&P 500 index with dividends. Note that if we add a 5% to 10% premium bonus to an FIA based on the monthly averaging index, and if fees and expenses (as well as other factors such as load, taxes, and tracking error) are deducted from the return on the S&P 500 index with dividends in order to approximate realistic index fund returns, the difference between a 6.5% return and a 7.9% return may well get reduced to zero. Figure 5 shows the evolution of the four average indices for the period of January 1995 through October 2008.

Figure 5
Monthly Averaging Index with and without a 0% Floor
(Average of 47 10-year Paths, JAN95 - OCT08)



Although Dr. McCann mentions the more popular point-to-point method that is also used to credit interest in an FIA, he does not present any calculations on the performance of a point-to-point index, subject to a cap, relative to the S&P 500 index with reinvested dividends. However, he does address this issue in the working paper he coauthored with Dr. Dengpan Luo, from where Figures 1 and 2 of Dr. McCann's report to the SEC came, and where he states that "[t]he effect of annual caps is dramatic because the average long run return to stocks is heavily influenced by years with unusually high returns. For example, the annualized price appreciation in the S&P 500 from 1975 to 2004 was 10.0%. If we cap the yearly increase at 14%, the resulting series has an annualized appreciation of only 5.5%."[13] As in the case of Dr. McCann's monthly averaging index calculations, this comparison of 10.0% versus 5.5% is flawed by failing to understand that an FIA's crediting rate based on the point-to-point method with a cap must also include a floor. When I correct Dr. McCann's calculation and include a floor of zero percent on the annual point-to-point return with an annual cap of 14%, the resulting annualized rate over the 30 years from 1975 to 2004 is

[13] Craig McCann, PhD and Dengpan Luo, PhD, An Overview of Equity-Indexed Annuities, 2006, downloadable from slcg's webpage www.slcg.com, Section III.G., pp. 8-9.

8.5%, not 5.5%. Table 3 below reports annualized rates for the capped point-to-point index, with and without a floor, for the same periods shown in Table 1.

Table 3. Point-to-Point Method – Annualized Return for Selected Periods

Period	S&P 500 with no Dividends	S&P 500 with Dividends	PtP Index with 14% Cap (no floor)	PtP Index with 14% Cap (0% floor)
01/01/75 – 12/31/04	10.0%	13.7%	5.5%	8.5%
01/01/75 – 10/31/08	8.1%	11.6%	4.2%	8.1%
01/01/95 – 10/31/08	5.5%	7.4%	1.0%	8.0%
01/01/98 – 10/31/08	-0.02%	1.6%	-2.3%	6.4%
12/31/99 – 10/31/08	-4.6%	-3.0%	-5.7%	4.7%
10/31/07 – 10/31/08	-37.5%	-36.1%	-36.1%	0.0%

Table 3 shows that ignoring a floor of zero percent when discussing a capped point-to-point method for crediting interest to an FIA is an egregious distortion and has dramatic consequences indeed.

In this Section of my report I have shown that Dr. McCann's analysis of an FIA's basic crediting methods is incorrect and irrelevant when his calculations ignore the basic feature of a zero percent floor in spite of Dr. McCann's awareness that crediting rates based on either the point-to-point or the monthly averaging methods cannot be negative. Consequently the conclusions that Dr. McCann derives from his analysis related to Figures 1 and 2 in Sections II and III of his report are irrelevant for the purpose of judging the merits of FIAs.

In the next two Sections I discuss Dr. McCann's claims that "99.8% of the time the investor would be better off with [a portfolio of] Treasury securities and stocks than with [an] equity-indexed annuity," and that the value of an FIA on the day of purchase can be as low as 70 cents per dollar.[14]

III. FIA Performance Compared to Stocks and Bonds

[14] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, Section VI.

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In his report, Dr. McCann describes a simulation exercise he has conducted where he compares the performance of an FIA to a portfolio of stocks and Treasury securities, which I will refer to as Dr. McCann's 30/70 portfolio, where 30% of the initial amount is invested in a simulated S&P 500 Total Return fund and the remaining 70% is invested in a 14-year zero-coupon Treasury strip.[15] He concludes, presumably based on a large number of simulated 14-year paths for the values of the FIA and the 30/70 portfolio, that "99.8% of the time the investor would be better off with the Treasury securities and stocks than with the equity-indexed annuity."[16]

I have not been able to replicate Dr. McCann's simulation experiment since the information he provides is incomplete and some of it appears to be contradictory (is there an "index margin of 4%," or is it a "4% monthly cap" – see pp. 26, 27), but I have been able to replicate similar experiments Dr. McCann has conducted elsewhere where he has similarly claimed that various versions of his mixed portfolio of stocks and a Treasury security beat a 14-year monthly point-to-point FIA "98, 98.5, almost 99 percent of the time," depending on the initial allocation between stocks and bonds.

Central to Dr. McCann's various simulation experiments is the assumption that index returns are identically, independently, and log-normally distributed with a certain mean and variance.[17] This assumption turns out to be far from realistic. A Jarque-Bera test for normality of a random time series, applied to continuously compounded monthly S&P 500 capital gains returns from January 1926 to October 2008 yields a test-statistic value of 2706.[18] The corresponding value for continuously compounded monthly S&P 500 total returns is 2722. These values are so large, compared to a 5% critical value of 5.99, or a 0.0001% critical value of 27.63 (representing odds of one in one million), that one has to conclude that monthly S&P 500 returns are not log-normally distributed. Similar conclusions are affirmed for shorter subperiods.

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[15] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, pp. 26-28.
[16] Craig McCann, An Economic Analysis of Equity-Indexed Annuities, September 10, 2008, p. 27.
[17] See p. 9 and footnote 8 of Drs. McCann and Luo's slcg working paper of 2006 cited above. This log-normal distribution assumption implies a normal distribution of continuously compounded rates of return.
[18] Jarque, Carlos M. and Anil K. Bera (1980). Efficient tests for normality, homoskedasticity and serial independence of regression residuals, *Economics Letters* 6 (3): 255–259.

Based on the strong rejection of the log-normality assumption, Dr. McCann's success rates of 98% or 99% for his portfolios of stocks and Treasury securities need to be reevaluated. In order to do so, I approximate the actual distribution of monthly S&P Index returns with the empirical distribution of historical monthly returns from January 1926 through the present. More specifically, when looking at an *n*-year FIA, I consider all possible *n*-year paths beginning on January 1926. Each path has $12 \times n$ consecutive months and this allows me to preserve the distributional features, including short-term dependencies, contained in the actual data. For each path I construct an *n*-year value of the annuity and any alternative investment. It is then possible to calculate the fraction of the time that the *n*-year annuity beats the alternative investment in a realistic setting.

I consider a monthly point-to-point FIA with a monthly cap of 3.5%, a 0.0% annual floor, a premium bonus of 6%, a minimum guarantee of 1.5% per year and a surrender charge period of 14 years. This is the annuity Dr. McCann claims a simulation exercise shows being worse than his portfolio 98%, 98.5% or even 99% of the time. I also consider another monthly point-to-point FIA with a monthly cap of 4.25%, a 0.0% annual floor, a premium bonus of 3%, a minimum guarantee of 2.15% per year and a surrender charge period of 9 years. These two annuities are actual annuities that have been sold by issuers in recent years.

I compare the 14- or 9-year annuity value to 14- or 9-year values of three alternative investments. First I look at an S&P 500 total return "fund" constructed from the historical S&P 500 index with no dividends, plus a 2.25% annual dividend yield and minus a 0.20% annual expense fee.[19] Next I consider a "50/50-Z" portfolio where half of the initial amount is invested in the total return fund just described and the other half is invested in an *n*-year zero-coupon bond. My third portfolio also has half of the initial amount invested in the total return fund and the other half invested in a "bond fund" whose return is the historical Intermediate Term Government Bond return (from the SBBI database) minus annual fees of 0.26%. I refer to this portfolio as the 50/50 portfolio. To aid comparison with Dr. McCann's approach, none of these portfolios are ever rebalanced. Historical data are monthly returns on the S&P 500 Index with no dividends and on Intermediate Term Government Bonds from

[19] Note that loads, tracking error and tax treatment are not included in my comparison. Including these factors would result in better FIA performance.

January 1926 through February 2008. This period results in 819 14-year paths and 879 9-year paths.

Table 4 reports the percent of times that the 14- and the 9-year annuities beat the alternative investments.

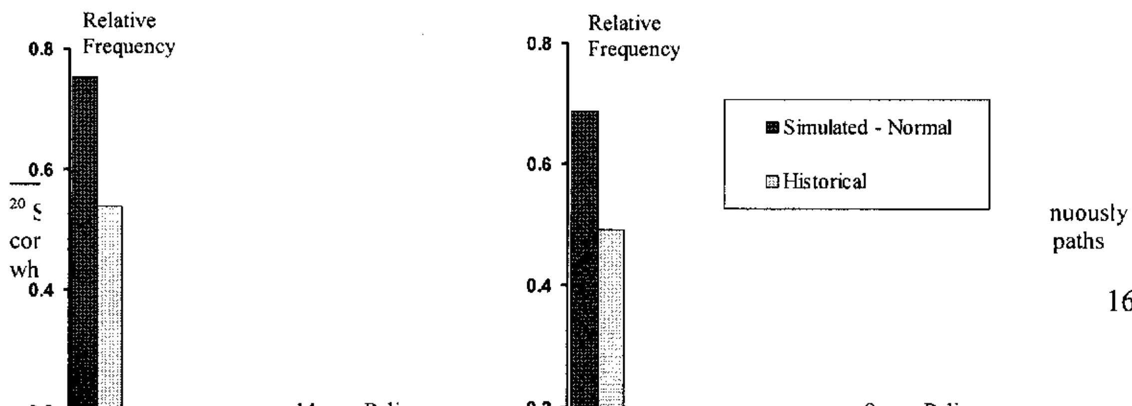
Table 4. Percent of times FIA Beats Alternative Investments

Alternative Investment	14-Year FIA	9-Year FIA
S&P 500 Total Return Fund	21.5%	37.1%
50/50-Z Portfolio	25.0%	56.3%
50/50 Portfolio	33.8%	63.3%

The percent of times the FIAs of interest beat alternative investments reported in Table 1 are much higher than the 2% or 1% that Dr. McCann seems to obtain in his simulation experiments. These rates are surely better in reality since mutual funds investors often buy high and sell low. I believe that his unrealistic assumption that index returns are log-normally and independently distributed is the main reason why success rates differ so much. Figure 6 shows histograms of annual crediting rates for the 14- and the 9-year annuities calculated under both the normal distribution assumption and the actual empirical distribution of historical monthly returns.

The distribution of crediting rates based on actual returns assigns considerably less probability mass to crediting rates below 5% per year than the simulated distribution does. Consequently, significantly more probability mass is assigned to crediting rates higher than 5% under the historical return distribution, especially in the range 10% to 30%.[20]

Figure 6. Distribution of Empirical and Simulated Crediting Rates



[20] S ... cor ... wh ... nuously ... paths

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The results I report in Table 4 indicate that none of the FIAs I consider systematically beats any given alternative investment and that no alternative investment systematically beats any of the FIAs. There is, however, a well accepted framework of rational choice which I can use to illustrate the fact that many rational individuals will prefer an FIA to any of the alternative portfolios considered. This is the framework of expected utility which can be used to rank investment alternatives based on the full distribution of returns as a function of an individual's risk tolerance. Using the familiar power utility function

(1) $$U(1+r)=\frac{1}{(1-\rho)}\left[(1+r)^{1-\rho}-\rho\right] \quad \rho=0,1,2,\cdots,$$

where ρ is the coefficient of risk aversion I calculate the expected utility of wealth, $1 + r$, for the various instruments considered, where r is an annual crediting rate in the case of an FIA, and an annual return in the case of one of the portfolios considered. I also consider an investment on 3-month US Treasury bills. Since returns are random I calculate the expected utility associated with each alternative as a function of the risk aversion coefficient, as the average utility over the empirical distribution of crediting rates and returns for the various alternatives I consider (there are 82 annual return observations, from 1926 to 2007, for each alternative I consider. I do not include the 50/50-Z portfolio due to the presence of the 14- or 9-year zero-coupon bond). Figure 7 ranks each alternative for risk aversion coefficients between zero and 25.

Figure 7
Expected Utility of FIAs and Alternative Investments

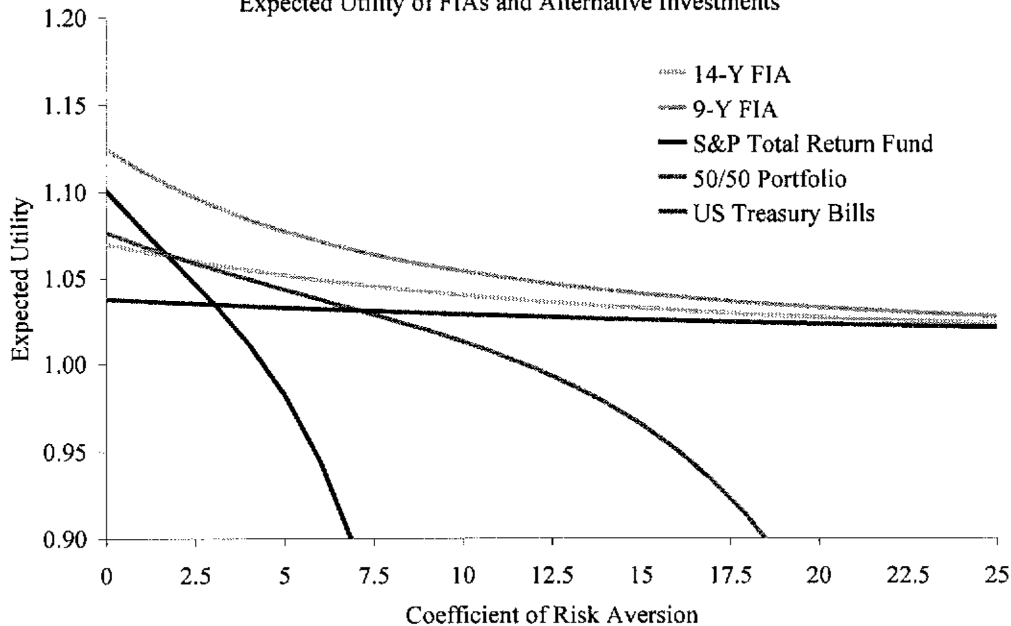


Figure 7 shows that rational individuals with risk aversion coefficients 2.5 or higher, a fairly moderate level, rank the 14 year annuity higher than any investment alternative and that rational individuals, no matter what their degree of risk aversion would prefer the 9 year annuity to any investment alternative. Based on my expected utility analysis I conclude that while rational individuals with a high tolerance for risk may prefer a portfolio of stocks and bonds to certain FIAs, even moderately risk-averse individuals will rationally prefer FIAs to stocks and bonds. From the point of view of diversification, an even larger number of rational individuals will consider FAIs as part of a prudent investment strategy.

IV. Valuation of FIA Features

Dr. McCann claims that the "value of the death benefit is less than 10 basis points per year." (p. 16) He claims to be valuing them from the consumer's perspective, yet this is clearly an allusion to what he purports to be an insurer's actuarial cost and has very little to do with an individual consumer's valuation of such benefit. In this section I present evidence to show that, even when using his valuation model, his calculation is incorrect, and that the death benefit for seniors is worth far more than he discloses.

Dr. McCann calculates the purchase day value of an FIA using a statistical version of a simple FIA valuation model that ignores many of the features which make FIAs attractive and distinct from the kind of investment products he compares them to.[21] This valuation approach is based on his assumptions that index returns are identically, independently log-normally distributed and that it is possible to replicate all contingent payoffs under the FIA.[22] These assumptions are simply not applicable to either index returns or to long-term, age-dependent products such as FIAs.

Dr. McCann's purchase day valuation models do not provide any meaningful guide to FIA valuation, not only because of his unrealistic assumptions on which they are based, but also because they attempt to value just one of the many features of an FIA.

To illustrate the shortcomings of the valuations Dr. McCann obtains I use his model to incorporate two of these features, mortality risk (the beneficiary receives the full annuity value should the policyholder die before the annuity's term) and penalty-free withdrawals (10% of account value). I consider an actual 17-year annual point-to-point annuity with a premium bonus of 10%, an annual cap of 7%, a 0.0% annual floor, a minimum guaranteed rate of 2.25% per year, and a participation rate of 100%, which Dr. McCann incorrectly believes is 50%. This annuity was sold in August 2005.

Table 5 reports the purchase day value that Dr. McCann estimates for this annuity, 69 cents per dollar of premium. I also report the corrected estimate when the participation rate is set at the correct level of 100%, 76 cents per dollar.

Finally, I report the impact on Dr. McCann's value estimates of incorporating mortality risk and penalty-free withdrawals. Depending on the age of the policyholder and the discount rate used in Dr. McCann's model, purchase day value estimates, even according to a simple model relying on unrealistic and wrong assumptions, actually range from 100 to 103 cents per dollar when the correct discount rate is used. Given the difference that using realistic distributional assumptions makes, as I have shown in the previous Section, and given that

[21] See p. 11 of Dr. McCann slcg working paper with Dr. Luo, An Overview of Equity-Indexed Annuities, 2006.
[22] See Serena Tiong, 2000, Valuation of Equity-Indexed Annuities, *North American Actuarial Journal*, 4, pp. 49-170.

one would have to incorporate a number of other annuity features to properly assess an FIA's value, I conclude that it is simply not credible to maintain that the purchase day value of an FIA is 69 cents per dollar of premium.

Table 5 - The Relevance of Mortality Risk and Penalty-Free Withdrawals
(Purchase Day Value Estimate per Dollar of Premium)

Dr. McCann's Estimated FIA Value:	$0.69
Estimated FIA Value Using Correct 100% Participation Rate:	$0.76

Panel A: Incorporating Mortality Risk

	Purchase at Age 65		Purchase at Age 75		Purchase at Age 80	
Discount Rate	Female	Male	Female	Male	Female	Male
AA Insurer's Rate	$0.79	$0.81	$0.83	$0.86	$0.88	$0.90
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)

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

V. Target Investment Spreads

Dr. McCann is operating under a serious misunderstanding when he equates target investment spreads to mutual fund loads and fees (pp. 16-22). He characterizes these spreads as ranging from "275 to 300 basis points implied annual cost of equity-indexed annuities (p. 16)." Later, in referring specifically to American Equity, he uses an average annual spread figure of 281 basis points (p. 19). This leads him to make statements that are entirely erroneous and misleading.[23] First, Dr. McCann must understand that there is a difference between a stated yield spread and an economic spread. Stated yields on assets are not their expected returns. Neither are stated crediting rates the expected cost of liabilities.

[23] See, for example, David F. Babbel and Stavros Zenios, "Pitfalls in the Analysis of Option-Adjusted Spreads." *Financial Analysts Journal* 48:4 (1992): 65-69.

Sophisticated financial institutions often speak in a "shorthand" manner by referring to stated yields and target earnings spreads instead of actual expected economic returns. People understand in these institutions that a targeted accounting earnings spread is sufficiently higher than the actual expected economic earnings spread to account for the cost of various risks. Were this not the case, nobody would invest in Treasuries or top-rated bonds. Of course, it is the economic returns that ultimately matter to an economic enterprise, not the accounting spreads. A typical insurer will have a target yield *together with a target credit quality, market sector, and maturity range.* That target yield will be set high enough to compensate for the portfolio losses that are likely to occur over long periods of time, including those stemming from debtor insolvency, default, delay, maturity extensions, sinking fund options, doubling-up provisions, call options, prepayment options, illiquidity, and other more arcane debt features. An insurer may have different portfolio yield targets for different instruments of the same credit rating – for example, the insurer may require yields on AA-rated mortgage-backed securities to be 50 to 100 basis points higher than those on AA-rated corporate debt, owing to the uncertainty of debtor prepayment speed on mortgages. This is what financial experts refer to as the premium required for "negative convexity."

Yields on almost all non-Treasury financial assets are higher than their expected returns, owing to such factors as possible default, sinking fund provisions, call features, and prepayment (or delayed payment) behavior on the part of borrowers, negative convexity, duration mis-match, foreign currency exposure, and so forth. These same institutions understand that the "certainty-equivalent" yield of a financial instrument is approximated by the yield of a Treasury bond of similar duration characteristics.[24] The stated asset yield (or portfolio yield, in the case of an insurer's general account) may be several percent higher than its expected return. For example, over the past 12 years the yield spreads on financial instruments of varying credit quality vs. Treasury bonds of similar duration have been as reported in Table 6:

[24] This is a simplification, of course. There are other complexities involved in fixed income security valuation that are not discussed here, but treated in the vast fixed income valuation literature. Basic treatments of some of these issues are provided in David F. Babbel and Craig Merrill, *Valuation of Interest-Sensitive Financial Instruments.* John Wiley, 1999; and Anthony M. Santomero and David F. Babbel, *Financial Markets, Instruments and Institutions.* McGraw-Hill, 2nd ed. 2001. More advanced treatments are available in an extensive literature, particularly in many recent issues of the *Journal of Finance, Review of Economic Studies, Journal of Financial and Quantitative Analysis, Journal of Fixed Income,* and elsewhere.

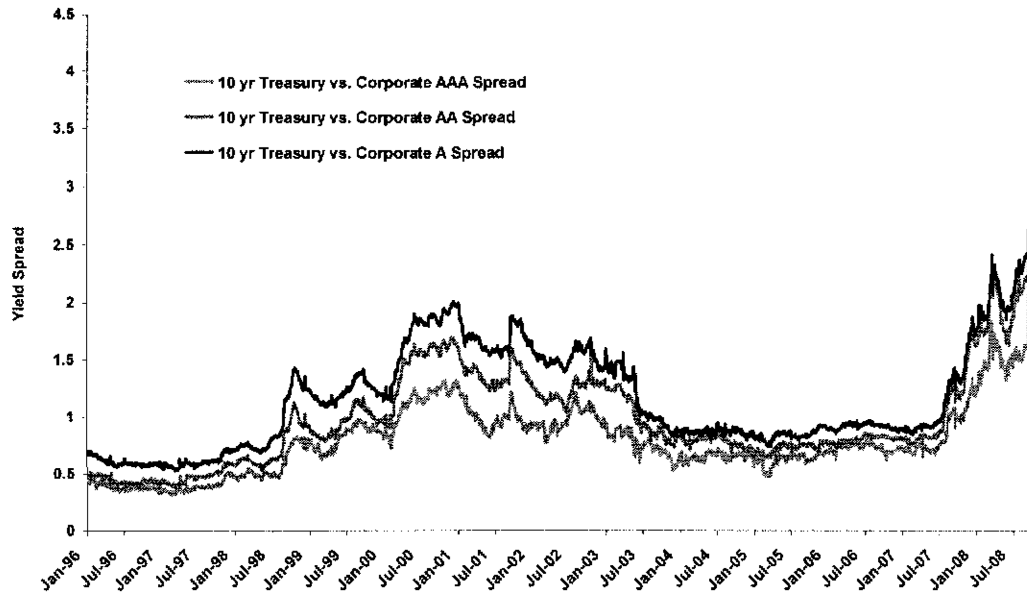
Table 6. Daily Yield Spreads over 10-Year Treasury Notes, Jan. 1996- Oct. 2008

Instrument	Low spread, in percent	High spread, in percent	Average spread, in percent
10-yr AAA-rated corp. bond	0.46	2.81	0.81
10-yr AA-rated corp. bond	0.48	3.83	1.00
10-yr A-rated corp. bond	0.70	4.11	1.18
10-yr BBB-rated corp. bond	0.74	4.86	1.62
10-yr BB-rated corp. bond	1.47	7.59	2.99
10-yr B-rated corp. bond	2.23	10.29	4.38
30-yr mortgage-backed security	0.61	3.91	1.57

Source: U.S. Federal Reserve Board of Governors and Bloomberg

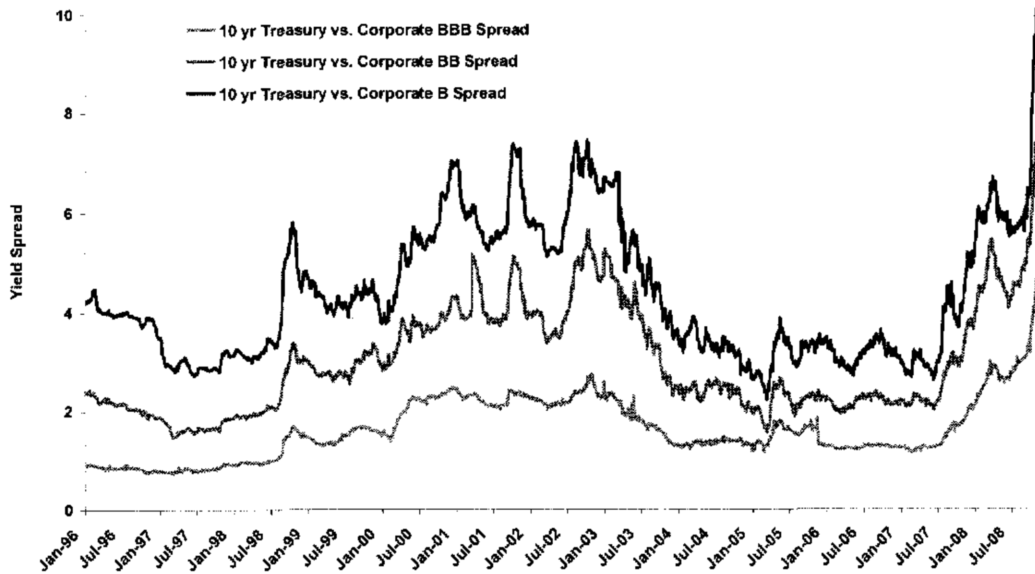
Figures 8, 9, and 10 show the daily yield spreads for the securities considered in Table 6.

Figure 8. 10 yr Treasury / Corporate Yield Spreads



Source: Bloomberg

Figure 9. 10 yr Treasury / Corporate Yield Spreads



Source: Bloomberg

Figure 10. 10 yr Treasury / 30 yr AA Rated MBS Yield Spread

Source: Bloomberg

Equally important, these average yield spreads will vary by sector (e.g., industrials, transportation, utilities, energy), by duration, and by individual company. Indeed, the range of yield spreads for a given maturity and a particular investment grade bond quality (e.g., A-rated) may vary by an additional 3% or more across other bonds of similar quality and tenor on any given day.[25] Spreads range even wider on non-investment quality bonds on any given day.

The insurer may actually earn the stated yield, but more often than not, the insurer will earn something different, and sometimes very different. The economic return of the instrument or asset portfolio can be determined only after knowing the timing and amount of any distributions, as well as the change in market price. In almost all cases, the promised yield is an upward-biased measure of the expected return, and more importantly, the certainty-equivalent yield. It is the difference between certainty-equivalent portfolio yields and liability costs that is a correct measure of business profitability; anything beyond or below that is more a function of the amount of risk taken on by the financial institution. The financial statements relied on by Dr. McCann in making his statements will not reflect the actual returns on financial assets at any point in time. Indeed, the accounting numbers on which his earnings spreads are based can show positive asset earnings at the same time that true economic earnings are very negative.

The "short-hand" of an insurer targeting a spread of, say, 3% may equate to an intrinsic profitability of 1%. Contrast this with the spread or margin charged by a mutual fund. In the case of a mutual fund, a 1% margin is the same charge in market values and in accounting entries. The market risk is absorbed by the mutual fund investor, and the margin will be earned regardless of what happens to the value of the fund. But not so for an insurer, who absorbs the major part of the risk each year and provides a guaranteed return to the policyowner based on a formula that cannot be changed until the crediting rate period concludes.

VI. Other Issues

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[25] See, for example, Jerome Fons, "Using Default Rates to Model the Term Structure of Credit Risk." *Financial Analysts Journal* 50:5 (1994): 25-32.

There are many other aspects of FIAs that Dr. McCann criticizes. I address them briefly in this Section.

Regarding Dr. McCann's statements on market value adjustment (MVA) factors (pp. 14-15), surely Dr. McCann is aware that such products are already regulated by the SEC, unless their possible downward adjustments are limited to be less than what would otherwise violate the nonforfeiture requirements of each state. Therefore, only the annuities with potentially more severe MVAs are those that are regulated by the SEC. Moreover, for products that do feature MVAs, the risk transfer allows the insurer to offer more attractive crediting rate terms, lower surrender charges, or otherwise more favorable terms to policyholders who will be less inclined to surrender their policies prematurely in search of higher yields as market conditions change.

Dr. McCann has stated that FIA issuers are generating extraordinary commissions to salesmen and profits to issuers, yet he has not given any evidence of either. Commissions for salesmen tend to average less than 1% per year of contract length, which is not dissimilar to other financial contracts sold at the retail level. Indeed, equity mutual funds have loads that can go as high as 8.5% (plus annual maintenance fees that generally exceed 1% per year). Moreover, investors switch from one fund to another after 3-4 years, on average, in search of better performance, and this behavior may generate new front-end or back-end loads with each switch.[26] The combination of these factors means that investors typically perform far worse than the market indices would suggest, generating only about half as much income over 20 years as the market indices.

Dr. McCann has pointed out that a rule proposal which exempts from SEC oversight only those equity-indexed annuity contracts whose payoffs are more likely than not to exceed the amounts guaranteed under the contract would exempt none, as all existing equity-indexed annuities would meet this criterion, requiring all to be registered under Federal securities laws (p. 2). If my interpretation of this provision is accurate, he is correct in his assessment.

[26] See John C. Bogle, "The relentless rules of humble arithmetic." *Financial Analysts Journal* 61:6 (2005): 22-35; Ilia D. Dichev, "What are stock investors' actual historical returns? Evidence from dollar-weighted returns." *American Economic Review* 97:1 (2007): 386-401; and DALBAR, "The Measurement of Success," *Quantitative Analysis of Investor Behavior* (2008).

However, this proposed rule is simply weird. Do consumers need the SEC to protect them from financial instruments that could return more than their guaranteed minimums?

Dr. McCann claims that "equity-indexed annuities are quite similar to equity-participation securities, which are traded on the American Stock Exchange under various brand names (p. 4)." I would point out that there are big differences. None offer the tax deferral of FIAs, none offer options that can parlay any gains during the accumulation period into continued tax deferral through annuitization, almost none lock in annual gains through ratcheting provisions, none offer guarantees backed by the general account of an insurer, and backstopped by the state insurance guaranty associations and National Organization of Life and Health Guaranty Association, almost none are traded in a liquid market, and any early dispositions are typically done with the issuing bank, none offer special early surrender provisions that allow cashing out at par value upon death, disability, or entrance into a nursing home, and none provide guaranteed cash-out provisions at each point in time throughout their lives. Moreover, equity participation securities are not being offered currently with other than very short maturities, because they are generally offered when volatility is low. It doesn't take much more to note that some of the most popular SEC-registered equity-participation securities were backed by Lehman Brothers, Bear Stearns, and Merrill Lynch. Many of these securities may already be worthless.

Dr. McCann seems to believe that annuities cannot be sold at prices which reflect their costs. In states where insurance prices are regulated, which occurs most often in certain property/casualty lines of business, laws are set to provide for insurer pricing that reflects their expected losses, marketing costs, administrative costs, loss adjustment expenses, and a fair rate of return on their capital. Dr. McCann's annuity pricing equivalent eliminates all but the annuity's analogue of "expected losses." I would note that in his mutual fund comparisons, he typically uses Vanguard as his benchmark. Vanguard, which offers *mutual* funds in their traditional sense, has been the lowest cost provider of index funds for many

years (although Fidelity recently began marketing an S&P Index fund on a loss-leader basis that features even lower maintenance expenses).[27]

Dr. McCann castigates annuities for linking their crediting rates to positive movements in the S&P or other stock indices (p. 7). Yet the equity participation securities he touts on p. 4 overwhelmingly link their returns to indices sans dividends, or individual stock prices. Moreover, the fact that FIAs are linked to positive returns in price indices without dividends simply means that the dividend returns are not "baked into their price." It would be feasible (albeit less convenient from a consumer's monitoring point of view) for an FIA to be linked to an index that includes dividends, but most options, futures, and private options that are used to hedge the risks faced by insurers who offer FIAs are based on price indices and not total return indices. Therefore, it is easier for the insurer to hedge this element of their annuity liabilities and the annuities are priced accordingly.

Dr. McCann has stated in footnote 6 that annuity "issuers obscure the simple economics of this investment by making it superficially extraordinarily complicated (p. 5)." This is an extraordinary claim. He obviously has not attempted to hedge one of these instruments. Issuers who hedge them with over-the-counter customized derivatives contracts must incur substantial basis risk, counterparty risk, and pooling risk; there are no derivative contracts available that hedge the many risks which face the issuer, and substantial amounts of capital are needed to handle the basis risk, counterparty risk, and pooling risk that remains after obtaining a derivatives contract that hedges one element of the annuity contract. An issuer may choose to purchase a counterparty credit default swap, or absorb the risk of default by putting its own capital at risk. If the insurer chooses to hedge the interest rate component, interest rate caps must be purchased and interest rate floors can be sold to lessen that hedging cost, but these also involve significant basis risk. Typically, available derivatives can hedge only one day out of every 365 days of an annual coverage period; if a death, disability, nursing home confinement, withdrawal, or surrender occurs on any other day, there is substantial basis risk involved. Insurers handle these risks through pooling, risk absorption through capital, and in the case of early surrender, the imposition of surrender charges.

[27] John C. Bogle, "Bringing Mutuality to Mutual Funds." *Rotman International Journal of Pension Management* 1:1 (2008): 54-64.

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For insurers who opt to dynamically hedge the hedgeable elements of their contracts, they may need to undertake over 20,000 trades for a 15-year annuity contract, where the hedges are typically enacted by taking multiple (e.g., seven) positions in the futures market on each day, where these positions are adjusted daily or more frequently, depending on market conditions. Yes, the annuities can be pooled, exposures can be netted against each other to some extent, and hedging economies can be achieved, but a good dynamic hedging program is not a trivial exercise like it may be in a theoretical world; in the real world there are many contingencies that Dr. McCann has overlooked, and talented financial managers are necessary to secure the promises of annuities through dynamic hedging.

Dr. McCann states that "equity-indexed annuities can be valued using standard, scientific methodologies. (p. 25)." I am aware of no annuity provider that prices annuities according to the model he uses, which relies on the earliest version of the Black-Scholes-Merton option pricing model to determine what he claims to be a fair price of an FIA. Indeed, if an insurer were to price annuities according to his formula, it is unlikely that an insurance regulator would approve its sale. Regulators ask insurers to show that they can remain financially viable under realistic market conditions, and the "normal distribution of rates of return" together with the constant interest rate and constant volatility that he assumes would fail their stress test criteria. His certitude about the model's pricing implications vis-à-vis what he purports to be a fair annuity price should be considered in light of the caution that Professor Merton gave regarding the application of option pricing models in the concluding paragraph of his Nobel Lecture of December 9, 1997: "Even this brief discourse on the application to finance practice of mathematical models in general and the option-pricing model in particular would be negligently incomplete without a strong word of caution about their use. At times we can lose sight of the ultimate purpose of the models when their mathematics become too interesting. The mathematics of financial models can be applied precisely, but the models are not at all precise in their application to the complex real world. Their accuracy as a useful approximation to that world varies significantly across time and place. The models should be applied in practice only tentatively, with careful assessment of their limitations in each application." Rather than exercise caution, especially in light off the fact that the real world violates all 20 of the underlying assumptions of the pricing model he has put forth, Dr. McCann proceeds with reckless abandon and posits his model price as a proper basis on

which courts may determine and assess damages to annuity purchasers. He has done this in every jurisdiction in which he has testified concerning annuity pricing.

Dr. McCann states that "Other things equal, equity-indexed annuities with longer surrender periods provide less value to investors than annuities with shorter maturities (p. 8)." He bases this statement on his pricing model mentioned above. The fact that his pricing model substantially underestimates the crediting rates provided to annuity purchasers (and in the medium to higher ranges of crediting rates, underestimates their frequency by roughly 100%), combined with his use of a model-inconsistent discount rate that would render suspect the value of every other derivative security, and even all U.S. Treasury bonds, together with the fact that he ignores most of the options provided by annuities, are the factors that create this artifact. Correcting the omissions and incorrect application of his model and this pricing anomaly vanishes.

On p. 8 of his submission, Dr. McCann criticizes two-tier annuities because their surrender penalties do not completely disappear over time unless the annuity holder opts to annuitize. He claims elsewhere that the probability of annuitizing a deferred annuity is typically less than 5%. He neglects to explain that by their very design, two-tier annuities provide a disincentive to surrender prematurely, and indeed are designed to perform best when the annuity purchaser annuitizes during the decumulation stage, rather than procure a lump-sum payout. The issuers of such two-tier annuities have lower lapsation than they would have otherwise, which allows them to invest in longer-term, less liquid assets and garner the higher returns that such assets typically fetch. These higher returns can be passed through to consumers via contractual parameters. Moreover, avoiding the deadweight costs of lapsation allows the annuity issuer to offer relatively attractive annuitization terms that can be based on cohort pricing at the outset of the contract purchase. Experience of annuitization under these contracts, while still early, is in excess of 60% -- a far cry above the 5% number cited by Dr. McCann as being typical.

On p. 9 of his submission, Dr. McCann castigates FIAs for reducing annual annuity accumulation values through "one or more gimmicks," but fails to recognize that in the absence of such contractual provisions, the annuity would be costlier to the consumer.

Dr. McCann dismisses the value of "bonus credits" (pp. 13-14), saying that they are fully offset by higher surrender charges, longer surrender periods and larger pricing spreads." While he offers two anecdotal examples, he fails to recognize that, without such bonus credits, there would be greater uncertainty to the purchaser about what the ultimate accumulation values will attain. With bonus credits, at least part of this uncertainty is resolved, and less is left to the future evolution of the reference index. Moreover, reducing the deadweight economic drains to policyholders imposed by those who surrender their policies prior to maturity provides the insurer the flexibility to offer more attractive provisions to all policyholders. Dr. McCann exhibits a severe misunderstanding of this issue.

Dr. McCann claims (p. 14) that the surrender charges can be as high as 25%. The only annuity with which I am familiar that imposes such a high surrender charge offers a 10% bonus credit, which is not forfeited upon surrender; accordingly, the net surrender charge is 15%, which amounts to about 1% per year of the policy period, consistent with most other annuities. This amount is necessary to collect from surrendering policyholders because of distribution costs. They could be imposed at a lower level as part of the purchase price to all policyholders, but it is deemed fairer to impose them only upon those who impose the costs; this allows more attractive terms to be set that can benefit policyholders who manage their annuity in the manner that it was designed.

VII. Concluding Remarks

A rigorous evaluation of Dr. McCann's calculations related to the merits of FIA crediting methods, the chances that FIAs perform better than investments in stocks and bonds, and the valuation of the maturity payoffs of FIA leads me to believe that his calculations are wrong, misleading, and based on assumptions not supported by the available data. Dr. McCann's conclusions, based on his flawed calculations, are negatively biased, unsubstantiated and wrongly maintain that FIAs are, qualitatively, similar to portfolios of stocks and bonds and, from a quantitative point of view, perform much worse than portfolios of stocks and bonds. None of Dr. McCann's conclusions should be taken at face value.

In this report I have corrected some of Dr. McCann's main errors and shown that FIAs are not qualitatively similar to portfolios of stocks and bonds. FIAs are rather very different

products and have many valuable features that contribute to their value. Dr. McCann's insistence in arguing that FIAs are comparable to mutual funds only reveals his lack of understanding of how FIAs work, how US financial markets work, and how competitive pressures in the insurance industry work. I have also shown that, even when compared to portfolios of stocks and bonds FIAs perform very well, especially when moderate risk-aversion levels are considered, and would be appealing to a very large class of rational individuals.

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Publications

"Endogenous exchange rate volatility, trading volume and interest rate differential in a model of portfolio selection," with May Hagiwara, UNC. *Review of International Economics*, Vol. 7, May 1999.

NAFA
National Association for Fixed Annuities
Securing **the Future!**

November 17, 2008

Economic Impact Analysis of Proposed Rule 151A

Total Additional Cost to Carrier and Distribution approximately	**$480,000,000**
Total First Year Business Income to Distribution approximately	**$1,500,000,000**
Total First Year Profit Loss to Insurance Companies approximately	**$300,000,000**

This Economic Impact Analysis is an estimation only of the initial operational costs and income losses incurred to comply with proposed rule 151A at its enactment. NAFA believes the information provided to be true and accurate, and a fair representation of the costs, fees and expenses associated with the distribution of a fixed indexed annuity in the event proposed Rule 151A is adopted and enacted. The information provided is a minimum projection and may be reasonably expected to increase under the circumstances as set forth in each category addressed below. Unfortunately due to the unreasonably short comment period NAFA has not had adequate time to do a more in depth analysis of long term capitalization requirements and ongoing marketing, compliance and operational expenses which will be necessary to distribute indexed annuities under the duplicative regulation and additional capital requirements for marketing organizations and insurance carriers. Accordingly, projections for years two and beyond are not provided; however, it is reasonably anticipated that continued business activity to comply with proposed Rule 151A will require significant financial resources, as set forth herein, in order to comply with both federal and state regulatory schemes.

I. Producers

Total Cost Estimate - $140,000,000

Currently, there are approximately 199,000 licensed and active insurance agents selling life and annuity products of whom approximately 80,000 to 90,000 sold fixed annuities in 2007[1]. Of these agents who sold fixed annuities in 2007, approximately 55% were not FINRA registered agents (Agent Sales Journal Annuity Study 2008). Producers without securities licensing who chose to become securities licensed will each have to spend between $5,000 and $6,000 each in licensing, broker-dealer registration, and exam fees. This figure is based on the study conducted by Gorilla Compliance, LLC which is summarized below. Assuming 30% become securities licensed the total cost will be over $140 million.

Total Income Loss Estimate - $1,500,000,000

Approximately $25 billion dollars of fixed indexed annuities were sold in 2007.[2] The average fixed indexed annuity sale was $52,000[3] totaling approximately 500,000 new fixed indexed annuity contracts. The loss of business income to the agents is significant. Industry experts estimate that fixed indexed annuity sales will drop from approximately $30 billion of premium a year (projected for 2008) to $10 billion[4] per year if Rule 151A is enacted. This equates to a loss of almost $1.5 billion in lost business income. Moreover, the average non-SEC licensed agent employs 1-4 individuals whose livelihoods will be severely jeopardized by the economic impact.

[1] LIMRA International
[2] LIMRA International 4th Quarter Study 2007
[3] Annuityspecs.com, President, Sheryl Moore
[4] The Advantage Compendium, Jack Marrion, President

II. Independent Marketing Organizations (IMO)

Total Cost Estimate - $92,000,000

The analysis set forth below regarding Rule 151A's impact on an IMO is based on a study conducted by Gorilla Compliance, October 2008, and is available through Danette Kennedy, President, Gorilla Compliance. The analysis is based on the following assumptions:

- IMO has two principals;
- IMO will obtain SEC licenses required by Rule 151A and adopt the required business model to distribute indexed annuities;
- IMO is an introductory broker domiciled in Kansas and conducting business in CA, CO, CT, KS, MO, NJ, OH, PA, and TX (the states with the largest amount of indexed annuity sales).

This estimate does **not** include the additional costs the IMO would incur for the following items for the two principals: 1) office equipment and furniture, 2) leased office space and utilities, 3) telephone system, 4) computer hardware, 5) travel expenses, 6) printing costs, and 7) employee benefits and programs such as 401(k), disability, life or health insurance, etc.

Many expenses/costs/fees are directly impacted by business growth. Higher costs are expected in year two and thereafter as the IMO increases the number of representatives affiliated with it and the number of jurisdictions in which it transacts business. The number of representatives affiliated with the IMO, including the number of jurisdictions, as well as the fee structure of each individual jurisdiction, will significantly impact the estimated costs and expenses. These costs and expenses will particularly increase due to the mandated net capital requirements – requirements which are arguably unnecessary with respect to insurance products where the issuer – which maintains significant reserves – is charged with the duty to supervise suitability. For example, the required fidelity bond, assuming 60 representatives/employees and $25,000 minimum fidelity bond will generate an approximate cost of $1,700.00. The number of branches affiliated with the IMO will impact the fidelity bond cost. There are approximately 150 IMOs without broker dealer licensing and the conservative cost estimate is $617,000 each for compliance with Rule 151A, with the total industry cost being estimated at over $90,000,000. IMOs average around 35 employees (some as large as 200 and others as small as 7 – 10); these dramatic cost increases will have a substantial impact on the IMOs' ability to retain employees.

Total Income Losses Estimate- $300,000,000

In addition, with an estimated $20 billion reduction in sales, the IMO revenue, which currently averages $1.50% of sales (includes all priced IMO commissions and bonuses), then IMOs will lose approximately $300 million in revenue income. IMOs with other lines of business revenue will need to change their business plan to recover revenue losses through additional sales of any fixed annuities that remain outside the securities registration, life insurance, LTC, etc. However, the impact to the many small businesses entities that IMOs

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III. Carriers

Total Cost Estimate - $237,000,000
Total Profit Loss Estimate - $300,000,000[5]

Carrier Financial Information

	Annuity Policies In Force		Total Policies[6]	Admitted Assets[7]
	Immediate	Deferred		(000)
Total FA Companies	1,855,815	35,263,890	567,625,819	$ 5,055,550,711
Total FIA Companies	600,425	13,838,662	145,374,496	$ 1,725,483,255
# of companies in AM Best Statement File 2007 Year End[8]				683
Companies with at least 1 deferred annuity policy				265
Companies selling FIAs				44

Rule 151A Carrier Expenses

	Carrier with Variable Authority		Carrier without Variable Authority		
	per Carrier	**Total (17)**	**per Carrier**	**Total (27)**	**Combined Total**
BD Startup			$3,000,000	$ 81,000,000	$ 81,000,000
BD Annual Maintenance	$1,000,000	$17,000,000	$1,000,000	$ 27,000,000	$ 44,000,000
New Compliance-Paralegal	$ 50,000	$ 850,000	$ 50,000	$ 1,350,000	$ 2,200,000
Legal Start Up Costs	$ 500,000	$ 8,500,000			$ 8,500,000
FINRA Implementation		$ 25,000			$ 25,000
FINRA Maintenance[9]	$ 2,000	$ 2,000			$ 2,000
State Fees	$ 20,000	$ 340,000	$ 20,000	$ 540,000	$ 880,000
S-1 Fees					$ 87,210,000[10]
Registration Statement Preparation			$ 62,500	$ 1,687,500	$ 1,687,500
State Filing	$ 5,000	$ 85,000	$ 5,000	$ 135,000	$ 220,000
Annual Audit	$ 50,000	$ 850,000	$ 50,000	$ 1,350,000	$ 2,200,000
Operations/Administration/ Systems	$ 100,000	$ 1,700,000	$ 250,000	$ 6,750,000	$ 8,450,000
Printing Prospectus/Supply Chain	$ 20,000	$ 340,000	$ 20,000	$ 540,000	$ 880,000
Additional Fees paid to FINRA impacting product pricing	.125 % on the first $100,000 in premium and continues on scale for every $1 of premium greater than $100,000				
Totals	**$1,747,000**	**$28,757,000**	**$4,402,500**	**$ 206,010,500**	**$237,254,500**

[5] Estimate based on one year sales of indexed annuities
[6] AM Best Report 2007 total life and annuity policies in force
[7] Total Net Admitted Assets (column 3 of Assets Exhibit); in 000s
[8] Defined using AM Best Groups and Unaffiliated Singles
[9] Annual Maintenance includes: salaries for CEO/COO/FINOP/2 Principals/1 Compliance Officer
[10] Annuity Specs 10/1/2008 states 342 IA products times $255 S-1 Fees

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