Coalition of Insurance Companies and Independent Marketing Organizations File Lawsuit Against the SEC Over New Annuities Regulation

WASHINGTON, DC, January 16, 2009 – A coalition of insurance companies and independent marketing organizations has filed suit in federal court to overturn Rule 151A, the newly published rule by the Securities and Exchange Commission that classifies indexed annuities as securities.

The suit was filed in the U.S. Court of Appeals for the District of Columbia Circuit, the court that typically hears cases about new agency regulations. It is the court that invalidated the SEC's hedge fund registration rule and twice rejected the Commission's mutual fund governance rule. The petitioners are represented by Eugene Scalia of Gibson Dunn & Crutcher LLP, which handled the mutual fund governance litigation against the SEC.

Indexed annuities are annuities that offer minimum guaranteed values and credit interest based on the performance of a market index such as the S&P 500. Because the purchaser is guaranteed the return of his or her principal with interest, subject to any surrender charges, indexed annuities are considered safer than securities products, which expose principal to market fluctuations.

Rule 151A was published in the Federal Register on January 16, 2009 and suit was filed the same day.

The petitioners' lawyer, Eugene Scalia, commented: "The securities laws say explicitly that annuities are to be regulated by the States, not the SEC. Unfortunately, the Commission engaged in a flawed rulemaking process whose result is a rule that conflicts with Congress's intent and with two Supreme Court decisions."

Jim Poolman, spokesperson for the Coalition for Indexed Products and former North Dakota Insurance Commissioner, noted that the SEC has decided to regulate indexed annuities at a time when the Commission has other pressing priorities. "It is unfortunate that the SEC seeks to duplicate state efforts to regulate indexed products when at the same time it has come under heavy criticism for failing to adequately meet its core mandate of overseeing the securities industry," he said.

In adopting the rule, the Commission retreated from initial suggestions that there were significant abuses in the sale of indexed annuities, and said that "the presence or absence of sales practice abuses is irrelevant" to its decision to adopt the rule. The regulation was appropriate, it said, "without regard to whether there is a single documented incident of abuse." The Commission conceded that the rule might cost insurance companies $100 million in the first year alone, but declined to give "comprehensive consideration" to whether existing state regulation was sufficient to protect consumers. The National Association of Insurance Commissioners and state insurance legislators opposed the rule.

In a letter to SEC Chairman Chris Cox, 19 members of Congress warned that the rule would "reduce product availability and consumer choice" and "effectively [place] the cost of the regulation squarely on the shoulders of consumers." Coalition spokesman Jim Poolman added: “It is ironic that indexed annuities have fared so much better during the recent financial crisis than securities products, and yet the SEC now wants to regulate indexed annuities, even though nobody lost a dime on indexed annuities as a result of the market meltdown.”

The petitioners in the case are: American Equity Investment Life Insurance Company, BHC Marketing, Midland National Life Insurance Company, National Western Life Insurance Company, OM Financial Life Insurance Company, and Tucker Advisory Group.

A Press Kit providing background on fixed indexed annuities and this litigation is attached for reference.

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Background On Suit Against SEC Regarding Its "Indexed Annuities" Rule, 151A

Tab

TAB 1

Summary of the Case

SUMMARY OF THE CASE

This case involves a legal challenge to the newly adopted "indexed annuity" rule of the Securities and Exchange Commission ("SEC"). 74 Fed. Reg. 3,138 (Jan. 16, 2009). Rule 151A requires that fixed indexed annuities, which until now have been within the exclusive jurisdiction of state insurance regulators, be registered as securities with the SEC. The rule exceeds the SEC's statutory authority and was adopted in violation of the Administrative Procedure Act ("APA").

Fixed indexed annuities are annuity contracts issued by state-regulated life insurance companies that credit interest based on a formula that is based in part on an external index, such as the S&P 500 Index.

Like other fixed annuities, fixed indexed annuities are subject to extensive state requirements and regulation. They must be approved by the insurance commissioner of the state they are issued, and may only be sold by state licensed insurance representatives. Over 40 states have suitability laws that require agents to consider the financial profile of a potential purchaser to determine whether a fixed indexed annuity would be appropriate and all states impose fair trade practice requirements with respect to the sale of fixed indexed annuities. Under state law, sellers of fixed indexed annuities typically must disclose various aspects of the products, and consumers have the right to rescind a purchase of a fixed indexed annuity for a certain time after purchase. Agents and insurers are also subject to state unfair trade practice laws that prohibit misrepresentations or misleading statements. Insurers must satisfy standard nonforfeiture laws which regulate minimum guaranteed contract values. States conduct extensive reviews of issuers' market conduct practices and oversee agent licensing and training.

States' regulation of annuities is described at greater length in pages 21-28 of the Coalition Comment Letter at Tab 9 of these materials.

The SEC is given responsibility for regulating securities by the Securities Act of 1933 ("1933 Act"). The Act specifically exempts from the definition of security any "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." *See* Section 3(a)(8), 15 U.S.C. § 77c(a)(8). With Rule 151A, the Commission has taken the position that fixed indexed annuities are actually securities, and is regulating them on that basis.

State insurance regulators strongly opposed the Commission's rule, as did the majority of the more than 4800 commenters in the rulemaking. The Iowa Insurance Division, which regulates insurance carriers who account for more than 40 percent of the fixed indexed annuities market, objected to the rule because "with all the actions being taken by the states in this area, Rule 151A is not necessary and will impede the efforts being made by state insurance regulators to assure proper sales, not only in the indexed annuity area, but in all fixed annuity sales. This will create more confusion and uncertainty in the marketplace." *See* Tab 11 to these materials, page 3. The National Association of Insurance Commissioners ("NAIC") asked the Commission to withdraw the rule, stating:

> As part of [NAIC members'] mission to facilitate the fair and equitable treatment of insurance consumers, insurance products, including indexed annuities, are subject to a myriad of state insurance laws, . . . includ[ing] state insurance advertising laws, replacement laws and producer licensing and continuing education laws among others.

See Tab 10, page 5.

The new rule was proposed on June 25, 2008 and was adopted by the Commission in a public meeting on December 17 after a period for public comment. The final rule was published in the Federal Register on January 16, 2009.

SEC Commissioner Troy A. Paredes voiced a strongly-worded dissent to adoption of the rule. The SEC was "entering into a realm that Congress prohibited us from entering," he said, adding that the rule "seem[s] to deviate from the approach taken by courts, including the Supreme Court," and "from prior positions taken by the Commission." He charged the Commission with assuming that "state insurance regulators are inadequate to regulate these products," and warned that the rule could disproportionately affect small

business, "ultimately to the detriment of consumers." His dissent is at Tab 3 to these materials.

The lawsuit challenging the rule was filed in the U.S. Court of Appeals for the District of Columbia Circuit on January 16, 2009. The plaintiffs—in legal parlance, the "petitioners"—are American Equity Investment Life Insurance Company, BHC Marketing, Midland National Life Insurance Company, National Western Life Insurance Company, OM Financial Life Insurance Company, and Tucker Advisory Group, Inc.

In the lawsuit, petitioners claim that the Commission has exceeded its authority under the '33 Act and violated the Administrative Procedure Act ("APA"), the law for federal rulemakings that was used in the successful suits against the Commission's hedge fund registration rule and mutual fund governance rule. Arguments expected in the litigation include the following:

- The SEC's action directly contradicts a federal court ruling that fixed indexed annuities are annuities, not securities. *Malone v. Addison Insurance Marketing, Inc.*, 225 F. Supp. 2d 743, 750 (W.D. Ky. 2002).
- The decision contradicts two Supreme Court decisions, which said that the "allocation of investment risk" between the insurance company and purchaser is one of three key determinants of whether a product is an annuity or a security. While admitting that insurance companies bore risk under indexed annuities, the Commission said that purchasers bore risk to the extent the "amounts payable by the issuer under the contract ***are more likely than not to exceed*** the amounts guaranteed under the contract." In other words, the SEC said that a purchaser's positive chances for making ***gains*** due to favorable stock market performance is a ***risk allocated to the purchaser,*** rather than to the insurer who must pay the additional, indexed-related gains. This topsey-turvey reasoning is what Commissioner Paredes criticized when he said that the rule "misconceptualizes investment risk."
- The Commission ignored the two other components of the Supreme Court's three-part test—whether the product is regulated by the states, and how it is marketed.

Regarding state regulation, the Commission said: "[W]e do not believe that the states' regulatory efforts, no matter how strong, can substitute for our responsibility to identify securities covered by the federal securities laws and the protections Congress intended to apply." 74 Fed. Reg. at 3,148. And with respect to marketing, the Commission acknowledged that the rule "does not explicitly incorporate a marketing factor"; it claimed it did not need to because the "very nature of an indexed annuity . . . is, to a very substantial extent, designed to appeal to purchasers on the prospect of investment growth." *Id.* at 3,146.

- When it first proposed the rule the Commission suggested that there were improper sales practices involving fixed indexed annuities, but it made no such finding in issuing the final rule. Instead it said that "***the presence or absence of sales practice abuses is irrelevant***" to its decision to act. *Id.* at 3,147 (emphasis added). The rule was a proper action by the Commission, it said, "***without regard to whether there is a single documented incident of abuse***." *Id.* (emphasis added). Petitioners will argue that this shows the Commission's misallocation of resources and priorities during this time of national financial crisis.
- Particularly given the absence of demonstrated widespread sales practice abuses and the thoroughness of state regulation, the Commission gave insufficient attention to the costs its rule will impose on insurance companies, agents, and consumers during these challenging financial times. One commenter estimated a $1.5 billion first-year income loss to distributors and a $300 million first-year income loss to insurance companies. *Id.* at 3,168. The Commission acknowledges that registration of FIAs will cost insurance companies $82.5 million (*id.* at 3,165) and that the first-year cost to insurance companies may exceed $100 million (*id.* at 3,169).

The petitioners will seek a ruling from the court before summer.

TAB 2

Petition for Review

IN THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

AMERICAN EQUITY INVESTMENT LIFE INSURANCE COMPANY, BHC MARKETING, MIDLAND NATIONAL LIFE INSURANCE COMPANY, NATIONAL WESTERN LIFE INSURANCE COMPANY, OM FINANCIAL LIFE INSURANCE COMPANY, AND TUCKER ADVISORY GROUP, INC., Petitioners, v. UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Respondent.	**PETITION FOR REVIEW** Case No. _____

The above named petitioners respectfully petition this Court, pursuant to Rule 15(a) of the Federal Rules of Appellate Procedure, Section 9(a) of the Securities Act of 1933, 15 U.S.C. § 77i(a), and Section 706 of the Administrative Procedure Act, 5 U.S.C. § 706, for review of a final rule of the United States Securities and Exchange Commission providing that fixed indexed annuities ("FIAs") are securities which must be registered, offered, and sold in accordance with the requirements of the Securities Act. The Commission adopted this rule ("Rule 151A") at an Open Meeting on December 17, 2008. The final rule release, a copy of which is attached hereto, was published in the Federal Register on January 16, 2009. Indexed Annuities and Certain Other Insurance Contracts; Final Rule, 74 Fed. Reg. 3,138 (January 16, 2009).

Petitioners ask this Court to hold the Commission's rule unlawful under the Securities Act and Administrative Procedure Act, to vacate the rule and its requirements, to issue a

permanent injunction prohibiting the Commission from implementing and enforcing the requirements, and for such other relief as the Court deems appropriate.

If the Commission does not grant a stay of its action, a motion for expedited review will be filed shortly.

Dated: January 16, 2009

Respectfully submitted,

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TAB 3

Dissent of
Commissioner Paredes

Opening Remarks and Dissent
by
Commissioner Troy A. Paredes

Regarding Final Rule 151A: Indexed Annuities and Certain Other Insurance Contracts

Open Meeting of the
Securities & Exchange Commission

December 17, 2008

Thank you, Chairman Cox.

I believe that proposed Rule 151A addressing indexed annuities is rooted in good intentions. For instance, at the time the rule was proposed, the Commission watched a television clip from *Dateline NBC* that described individuals who may have been misled by seemingly unscrupulous sales practices into buying these products. Part of our tripartite mission at the SEC is to protect investors, so there is a natural tendency to want to act when we hear stories like this.

However, our jurisdiction is limited; and thus our authority to act is circumscribed. Rule 151A is about this very question: the proper scope of our statutory authority.

In our effort to protect investors, we cannot extend our reach past the statutory stopping point. Section 3(a)(8) of the Securities Act of 1933 ('33 Act) provides a list of securities that are exempt from the '33 Act and thus, by design of the statute, fall beyond

the Commission's reach. The Section 3(a)(8) exemption includes, in relevant part, "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . of any State or Territory of the United States or the District of Columbia." I am not persuaded that Rule 151A represents merely an attempt to provide clarification to the scope of exempted securities falling within Section 3(a)(8). Instead, by defining indexed annuities in the manner done in Rule 151A, I believe the SEC will be entering into a realm that Congress prohibited us from entering. Therefore, I cannot vote in favor of the rule and respectfully dissent.

Rule 151A takes some annuity products (indexed annuities), which otherwise may be covered by the statutory exemption in Section 3(a)(8), and removes them from the exemption, thus placing them within the Commission's jurisdiction to regulate. If the Commission's Rule 151A analysis is wrong – which is to say that indexed annuities *do* fall within Section 3(a)(8) – then the SEC has exceeded its authority by seeking to regulate them. In other words, the effect of Rule 151A would be to confer additional authority upon the SEC when these products, in fact, are entitled to the Section 3(a)(8) exemption.

The Supreme Court has twice construed the scope of Section 3(a)(8) for annuity contracts in the *VALIC* and *United Benefit* cases.[1] I believe the approach embraced by Rule 151A conflicts with these Supreme Court cases. Although neither *VALIC* nor

[1] *See generally SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

United Benefit deals with indexed annuities directly, the cases nevertheless are instructive in evaluating whether such a product falls within the Section 3(a)(8) exemption. And despite the adopting release's efforts to discount its holding, at least one federal court applying *VALIC* and *United Benefit* has held that an indexed annuity falls within the statutory exemption of Section 3(a)(8).[2]

When fixing the contours of Section 3(a)(8), the relevant features of the product at hand should be considered to determine whether the product falls outside the Section 3(a)(8) exemption. Rule 151A places singular focus on investment risk without adequately considering another key factor – namely, the manner in which an indexed annuity is marketed.

Moreover, I believe that Rule 151A misconceptualizes investment risk for purposes of Section 3(a)(8). The extent to which the purchaser of an indexed annuity bears investment risk is a key determinant of whether such a product is subject to the Commission's jurisdiction. Rule 151A denies an indexed annuity the Section 3(a)(8) exemption when it is "more likely than not" that, because of the performance of the linked securities index, amounts payable to the purchaser of the annuity contract will exceed the amounts the insurer guarantees the purchaser. This approach to investment risk gives short shrift to the guarantees that are a hallmark of indexed annuities. In other words, the central insurance component of the product eludes the Rule 151A test. More to the point, Rule 151A in effect treats the possibility of upside, beyond the guarantee of principal and the guaranteed minimum rate of return the purchaser enjoys, as investment

[2] *See Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

risk under Section 3(a)(8). I believe that it is more appropriate to emphasize the extent of downside risk – that is, the extent to which an investor is subject to a risk of loss – in determining the scope of Section 3(a)(8). When investment risk is properly conceived of in terms of the risk of loss, it becomes apparent why indexed annuities may fall within Section 3(a)(8) and thus beyond this agency's reach, contrary to Rule 151A.

Not only does Rule 151A seem to deviate from the approach taken by courts, including the Supreme Court, but it also appears to depart from prior positions taken by the Commission. For example, in an amicus brief filed with the Supreme Court in the *Otto* case,[3] the Commission asserted that the Section 3(a)(8) exemption applies when an insurance company, regulated by the state, assumes a "sufficient" share of investment risk and there is a corresponding decrease in the risk to the purchaser, such as where the purchaser benefits from certain guarantees. Yet Rule 151A denies the Section 3(a)(8) exemption to an indexed annuity issued by a state-regulated insurance company that bears substantial risk under the annuity contract by guaranteeing principal and a minimum return.

In addition, Rule 151A seems to diverge from the analysis embedded in Rule 151. Rule 151 establishes a true safe harbor under Section 3(a)(8) and provides that a variety of factors should be considered, such as marketing techniques and the availability of guarantees. The Rule 151 adopting release even indicates that the rule allows for certain "indexed excess interest features" without the product falling outside the safe harbor.

[3] *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1987). The Supreme Court denied the petition for a writ of certiorari.

An even more critical difference between Rule 151 and Rule 151A is the effect of failing to meet the requirements under the rule. If a product does not meet the requirements of Rule 151, there is no safe harbor, but the product nevertheless may fall within Section 3(a)(8) and thus be an exempted security. But if a product does not pass muster under the Rule 151A "more likely than not" test, then the product is deemed to fall outside Section 3(a)(8) and thus is under the SEC's jurisdiction. In essence, while Rule 151 provides a safe harbor, Rule 151A takes away the Section 3(a)(8) statutory exemption.

I am not aware of another instance in the federal securities laws where a "more likely than not" test is employed, and for good reason. A "more likely than not" test does not provide insurers with proper notice of whether their products fall within the federal securities laws or not. If an insurer applies the test in good faith and gets it wrong, the insurer nonetheless risks being subject to liability under Section 5 of the Securities Act, even if the insurer had no intent to run afoul of the federal securities laws. In addition, under the "more likely than not" test, the availability of the Section 3(a)(8) exemption turns on the insurer's own analysis. Accordingly, it is at least conceivable that the same product could receive different Section 3(a)(8) treatment depending on how each respective insurer modeled the likely returns.

Further, I am concerned that Rule 151A, as applied, reveals that the "more likely than not" test, despite its purported balance, leads to only one result: the denial of the

Section 3(a)(8) exemption. In practice, Rule 151A appears to result in blanket SEC regulation of the entire indexed annuity market. The adopting release indicates that over 300 indexed annuity contracts were offered in 2007 and explains that the Office of Economic Analysis has determined that indexed annuity contracts with typical features would not meet the Rule 151A test. Indeed, the adopting release elsewhere expresses the expectation that almost all indexed annuity contracts will fail the test. If everyone is destined to fail, what is the purpose of a test? Further, there is at least some risk that in sweeping up the index annuity market, the rule may sweep up other insurance products that otherwise should fall within Section 3(a)(8).

The rule has other shortcomings, aside from the legal analysis that underpins it. These include, but are not limited to, the following.

First, a range of state insurance laws govern indexed annuities. I am disappointed that the rule and adopting release make an implicit judgment that state insurance regulators are inadequate to regulate these products. Such a judgment is beyond our mandate or our expertise. In any event, Section 3(a)(8) does not call upon the Commission to determine whether state insurance regulators are up to the task; rather, the section exempts annuity contracts subject to state insurance regulation.

Second, as a result of Rule 151A, insurers will have to bear various costs and burdens, which, importantly, could disproportionately impact small businesses. Some even have predicted that companies may be forced out of business if Rule 151A is

adopted. Such an outcome causes me concern, especially during these difficult economic times. Even when the economy is not strained, such an outcome is disconcerting because it can lead to less competition, ultimately to the detriment of consumers.

Third, the Commission received several thousand comment letters since Rule 151A was proposed in June 2008. Consistent with comments we have received, I believe that there are more effective and appropriate ways to address the concerns underlying this rulemaking. One possible alternative to Rule 151A would be amending Rule 151 to establish a more precise safe harbor in light of all the relevant facts and circumstances attendant to indexed annuities and how they are marketed. A more precise safe harbor would provide better clarity and certainty in this area – regulatory goals the Commission has identified – and would preserve the ability of insurers to find an exemption outside the safe harbor by relying directly on Section 3(a)(8) and the cases interpreting it. I believe further exploration of alternative approaches is warranted, as is continued engagement with interested parties, including state regulators.

In closing, I request that my remarks be included in the Federal Register with the final version of the release. My remarks today do not give a full exposition of the rule's shortcomings, but rather highlight some of the key points that lead me to dissent. I wish to note that these dissenting remarks just given represent my view after giving careful consideration to the range of arguments presented by the Commission's staff, particularly the Office of General Counsel, the commenters, and my own counsel, as well as those of

my fellow Commissioners. Although I cannot support the rule, I nonetheless thank the staff for the hard work they have devoted to its preparation.

TAB 4

Background on Indexed Annuities

INDEXED ANNUITIES

Indexed annuities are annuity contracts issued by life insurance companies that are subject to supervision by state insurance regulators. This supervision includes traditional solvency regulation as well as comprehensive state insurance disclosure and sales practice regulation. In 2007, indexed annuity sales were nearly $25 billion. Today, over $123 billion is invested in indexed annuities.

What is an Indexed Annuity?

An indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indexes is Standard & Poor's 500 Composite Stock Price Index (the S&P 500), which is an equity index.

When you buy an indexed annuity you own an insurance contract. You are not buying shares of any stock or index.

How Are They Different From Other Fixed Annuities?

An indexed annuity is different from other fixed annuities because of the way it credits interest. Some fixed annuities only credit interest calculated at a rate set in the contract. Other fixed annuities also credit interest at rates set from time to time by the insurance company but subject to certain guaranteed minimums set in the annuity contract and mandated by state non-forfeiture laws as discussed more fully below. Indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked but subject to certain guaranteed minimums. The formula determines how the interest, if in excess of the guaranteed minimums, is calculated and credited—if the indexing formula results in a rate less than the guaranteed minimum then the guaranteed minimum is credited. Whether interest it is credited above the minimum guarantees depends on the features of the particular annuity.

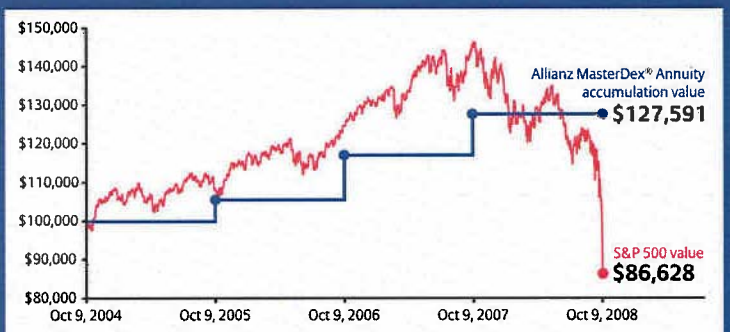
A critical feature of FIAs is the applicability of minimum nonforfeiture laws. These laws—which apply to fixed rate annuities also, but not to variable annuities—require

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.

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, but as high as $500,000, 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.

The guarantees afforded by fixed indexed annuities have proven particularly important to purchasers during the stock market decline of the past year. This is reflected in the graph on the next page, which compares the value of an FIA purchased in 2004 against the S&P 500 during that same period.

Is this insurance protection worth paying for?



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

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

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

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

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Annuities | Life insurance | Long term care insurance

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

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

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

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

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

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

Products are issued by Allianz Life Insurance Company of North America, and in New York, by Allianz Life Insurance Company of New York, New York City.
Allianz Life Insurance Company of New York is authorized to sell insurance and annuities in New York.

Product availability and features may vary by state.

P50614, P50614-NY

TAB 5

Background on the Administrative Procedure Act

ADMINISTRATIVE PROCEDURE ACT

The Administrative Procedure Act ("APA") is the most important law governing federal agency rulemaking. The APA prohibits federal agency action that is "in excess of statutory jurisdiction (or) authority," or that is "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with the law." 5 U.S.C. § 706(2). The Supreme Court has held that in rulemakings, federal agencies are required to provide a thorough explanation of the significant regulatory decisions and choices embodied in the final rule. Among other things, an agency must consider all important aspects of a problem, and the adopting release accompanying a final rule must establish a rational connection between the facts found and regulatory choices made. Agencies are required to consider adequately and to respond to comments submitted in the rulemaking record, including alternatives offered to the rule proposed, and to identify adequately and weigh costs and burdens that are likely to result from a rule. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983).

The Administrative Procedure Act is the law relied on by the court of appeals in ruling that the Commission had "failed adequately to justify departing from its own prior interpretation" and attempted to "accomplish its objective by a manipulation of meaning" in adopting its hedge fund registration rule. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). Similarly, in throwing out the Commission's mutual fund governance rule, the court relied on the APA to conclude, "the Commission relied on extra-record material critical to its costs estimates without affording an opportunity for comment to the prejudice of the [petitioner]." *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

TAB 6

Securities Act of 1933 (Excerpt)

SECURITIES ACT OF 1933 (EXCERPT)

Section 3(a)(8) of the ’33 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[.]

TAB 7

Chronology

CHRONOLOGY

July 1, 2008	Securities and Exchange Commission publishes proposed rule regarding fixed indexed annuities in the Federal Register.
October 17, 2008	Due to considerable interest in the proposed rule, Securities and Exchange Commission extends the deadline for comment on the proposed rule.
November 17, 2008	Extended comment period ends.
December 17, 2008	Securities and Exchange Commission adopts Rule 151A in an open meeting. Commissioner Paredes dissents.
January 16, 2009	The final rule is published in the federal register. 74 Fed. Reg. 3,138 (Jan. 16, 2009).
January 16, 2009	Petitioners file suit in the U.S. Court of Appeals for the District of Columbia Circuit challenging the fixed indexed annuity rule. The petitioners will seek a ruling from the court before summer.

TAB 8

Final Rule

Federal Register

Friday,
January 16, 2009

Part II

Securities and Exchange Commission

17 CFR Parts 230 and 240
Indexed Annuities and Certain Other Insurance Contracts; Final Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230 and 240

[Release Nos. 33–8996, 34–59221; File No. S7–14–08]

RIN 3235–AK16

Indexed Annuities And Certain Other Insurance Contracts

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting a new rule that defines the terms ''annuity contract'' and ''optional annuity contract'' under the Securities Act of 1933. The rule is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. The rule applies on a prospective basis to contracts issued on or after the effective date of the rule. We are also adopting a new rule that exempts insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, provided that certain conditions are satisfied, including that the securities are regulated under state insurance law, the issuing insurance company and its financial condition are subject to supervision and examination by a state insurance regulator, and the securities are not publicly traded.

DATES: *Effective Date:* The effective date of § 230.151A is January 12, 2011. The effective date of § 240.12h–7 is May 1, 2009. Sections III.A.3. and III.B.3. of this release discuss the effective dates applicable to rule 151A and rule 12h–7, respectively.

FOR FURTHER INFORMATION CONTACT: Michael L. Kosoff, Attorney, or Keith E. Carpenter, Senior Special Counsel, Office of Disclosure and Insurance Product Regulation, Division of Investment Management, at (202) 551–6795, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–5720.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') is adding rule 151A under the Securities Act of 1933 (''Securities Act'') [1] and rule 12h–7 under the Securities Exchange Act of 1934 (''Exchange Act'').[2]

[1] 15 U.S.C. 77a *et seq.*

[2] 15 U.S.C. 78a *et seq.*

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I. Executive Summary

We are adopting new rule 151A under the Securities Act of 1933 in order to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index.[3] Section 3(a)(8) of the Securities Act provides an exemption under the Securities Act for certain ''annuity contracts,'' ''optional annuity contracts,'' and other insurance contracts. The new rule prospectively defines certain indexed annuities as not being ''annuity contracts'' or ''optional annuity contracts'' under this exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The definition hinges upon a familiar concept: the allocation of risk. Insurance provides protection against risk, and the courts have held that the allocation of investment risk is a significant factor in distinguishing a security from a contract of insurance. The Commission has also recognized that the allocation of investment risk is significant in determining whether a particular contract that is regulated as insurance under state law is insurance for purposes of the federal securities laws.

Individuals who purchase indexed annuities are exposed to a significant investment risk—*i.e.*, the volatility of the underlying securities index. Insurance companies have successfully utilized this investment feature, which appeals to purchasers not on the usual insurance basis of stability and security, but on the prospect of investment growth. Indexed annuities are attractive to purchasers because they offer the promise of market-related gains. Thus, purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.

When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, this indicates that the majority of the investment risk for the fluctuating, securities-linked portion of the return is borne by the individual purchaser, not the insurer. The individual underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the securities-linked returns under the contract.

The federal interest in providing investors with disclosure, antifraud, and sales practice protections arises when individuals are offered indexed annuities that expose them to investment risk. Individuals who purchase such indexed annuities assume many of the same risks and rewards that investors assume when investing their money in mutual funds, variable annuities, and other securities. However, a fundamental difference between these securities and indexed annuities is that—with few exceptions—indexed annuities historically have not been registered as securities. As a result, most purchasers of indexed annuities have not received the benefits of federally mandated disclosure, antifraud, and sales practice protections.

In a traditional fixed annuity, the insurer bears the investment risk under the contract. As a result, such instruments have consistently been treated as insurance contracts under the federal securities laws. At the opposite end of the spectrum, the purchaser bears the investment risk for a traditional variable annuity that passes through to the purchaser the performance of underlying securities, and we have determined and the courts have held that variable annuities are securities under the federal securities laws. Indexed annuities, on the other hand, fall somewhere in between—they possess both securities and insurance features. Therefore, we have determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws will enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. Accordingly, we

[3] 17 CFR 230.151A. Rule 151A was proposed by the Commission in June 2008. *See* Securities Act Release No. 8933 (June 25, 2008) [73 FR 37752 (July 1, 2008)] (''Proposing Release'').

are adopting a new definition of ''annuity contract'' that, on a prospective basis, will define a class of indexed annuities that are outside the scope of Section 3(a)(8). We carefully considered where to draw the line, and we believe that the line that we have drawn, which will be applied on a prospective basis only, is rational and reasonably related to fundamental concepts of risk and insurance. That is, if more often than not the purchaser of an indexed annuity will receive a guaranteed return like that of a traditional fixed annuity, then the instrument will be treated as insurance; on the other hand, if more often than not the purchaser will receive a return based on the value of a security, then the instrument will be treated as a security. With respect to the latter group of indexed annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections.

We are aware that many insurance companies and sellers of indexed annuities, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to the proposal and adoption of rule 151A. Under these circumstances, we do not believe that insurance companies and sellers of indexed annuities should be subject to any additional legal risk relating to their past offers and sales of indexed annuities as a result of the proposal and adoption of rule 151A. Therefore, the new definition will apply prospectively only—that is, only to indexed annuities that are issued on or after the effective date of our final rule.

Finally, we are adopting rule 12h–7 under the Exchange Act, a new exemption from Exchange Act reporting that will apply to insurance companies with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors. Where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law, and where there is no trading interest in an insurance contract, the concerns that periodic and current financial disclosures are intended to address are generally not implicated.

The Commission received approximately 4,800 comments on the proposed rules. The commenters were divided with respect to proposed rule 151A. Many issuers and sellers of indexed annuities opposed the proposed rule. However, other commenters supported the proposed rule, including the North American Securities Administrators Association, Inc. (''NASAA''),[4] the Financial Industry Regulatory Authority, Inc. (''FINRA''),[5] several insurance companies, and the Investment Company Institute (''ICI'').[6] A number of commenters, both those who supported and those who opposed rule 151A, suggested modifications to the proposed rule. Sixteen commenters addressed proposed rule 12h–7, and all of these commenters supported the proposal, with some suggesting modifications. We are adopting proposed rules 151A and 12h–7, with significant modifications to address the concerns of commenters.

II. Background

Beginning in the mid-1990s, the life insurance industry introduced a new type of annuity, referred to as an ''equity-indexed annuity,'' or, more recently, ''fixed indexed annuity'' (herein ''indexed annuity''). Amounts paid by the insurer to the purchaser of an indexed annuity are based, in part, on the performance of an equity index or another securities index, such as a bond index.

The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s.[7] Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court.[8] Insurers have typically marketed and sold indexed annuities without registering the contracts under the federal securities laws.

In the years after indexed annuities were first introduced, sales volumes and the number of purchasers were relatively small. Sales of indexed annuities for 1998 totaled $4 billion and grew each year through 2005, when sales totaled $27.2 billion.[9] Indexed annuity sales for 2006 totaled $25.4 billion and $24.8 billion in 2007.[10] In 2007, indexed annuity assets totaled $123 billion, 58 companies were issuing indexed annuities, and there were a total of 322 indexed annuity contracts offered.[11] As sales have grown in more recent years, these products have affected larger and larger numbers of purchasers. They have also become an increasingly important business line for some insurers.[12]

The growth in sales of indexed annuities has, unfortunately, been accompanied by complaints of abusive sales practices. These include claims that the often-complex features of these annuities have not been adequately disclosed to purchasers, as well as claims that rapid sales growth has been fueled by the payment of outsize commissions that are funded by high surrender charges imposed over long periods, which can make these annuities unsuitable for seniors and others who may need ready access to their assets.[13]

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[4] NASAA is the association of all state, provincial, and territorial securities regulators in North America.

[5] FINRA is the largest non-governmental regulator for registered broker-dealer firms doing business in the United States. FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.

[6] ICI is a national association of investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts.

[7] *See* Securities Act Release No. 7438 (Aug. 20, 1997) [62 FR 45359, 45360 (Aug. 27, 1997)] (''1997 Concept Release''); NASD, *Equity-Indexed Annuities, Notice to Members 05–50* (Aug. 2005), available at: *http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p014821.pdf* (''NTM 05–50''); Letter of William A. Jacobson, Esq., Associate Clinical Professor, Director, Securities Law Clinic, and Matthew M. Sweeney, Cornell Law School '10, Cornell University Law School (Sept. 10, 2008) (''Cornell Letter''); Letter of FINRA (Aug. 11, 2008) (''FINRA Letter''); Letter of Investment Company Institute (Sept. 10, 2008) (''ICI Letter'').

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

[9] *NAVA, 2008 Annuity Fact Book*, at 57 (2008).

[10] *Id.*

[11] *Id.*

[12] *See, e.g.*, Allianz Life Insurance Company of North America (Best's Company Reports, Allianz Life Ins. Co. of N. Am., Dec. 3, 2007) (Indexed annuities represent approximately two-thirds of gross premiums written.); American Equity Investment Life Holding Company (Annual Report on Form 10–K, at F–16 (Mar. 14, 2008)) (Indexed annuities accounted for approximately 97% of total purchase payments in 2007.); Americo Financial Life and Annuity Insurance Company (Best's Company Reports, Americo Fin. Life and Annuity Ins. Co., Sept. 5, 2008) (Indexed annuities represent over 90% of annuity premiums and almost 60% of annuity reserves.); Aviva USA Group (Best's Company Reports, Aviva Life Insurance Company, July 14, 2008) (Indexed annuity sales represent more than 85% of total annuity production.); Investors Insurance Corporation (IIC) (Best's Company Reports, Investors Ins. Corp., July 10, 2008) (IIC's primary product has been indexed annuities.); Life Insurance Company of the Southwest (''LSW'') (Best's Company Reports, Life Ins. Co. of the Southwest, June 28, 2007) (LSW specializes in the sale of annuities, primarily indexed annuities.); Midland National Life Insurance Company (Best's Company Reports, Midland Nat'l Life Ins. Co., Jan. 24, 2008) (Sales of indexed annuities in recent years have been the principal driver of growth in annuity deposits.).

[13] *See* Letter of Susan E. Voss, Commissioner, Iowa Insurance Division (Nov. 18, 2008) (''Voss Letter'') (acknowledging sales practice issues and ''great deal'' of concern about suitability and disclosures in indexed annuity market). *See also*

Continued

We have observed the development of indexed annuities for some time and have become persuaded that guidance is needed with respect to their status under the federal securities laws. Given the current size of the market for indexed annuities, we believe that it is important for all parties, including issuers, sellers, and purchasers, to understand, in advance, the legal status of these products and the rules and protections that apply. Today, we are adopting rules that will provide greater clarity regarding the scope of the exemption provided by Section 3(a)(8). We believe our action is consistent with Congressional intent in that the definition will afford the disclosure, antifraud, and sales practice protections of the federal securities laws to purchasers of indexed annuities who are more likely than not to receive payments that vary in accordance with the performance of a security. In addition, the rules will provide relief from Exchange Act reporting obligations to the insurers that issue these indexed annuities and certain other securities that are regulated as insurance under state law. We base the Exchange Act exemption on two factors: First, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of these activities and assets under state insurance law; and, second, the absence of trading interest in the securities.

A. Description of Indexed Annuities

An indexed annuity is a contract issued by a life insurance company that generally provides for accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser either as a lump sum, upon death or withdrawal, or as a series of payments (an ''annuity''). During the accumulation period, the insurer credits the purchaser with a return that is based on changes in a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. The insurer also guarantees a minimum value to the purchaser.[14] The specific features of indexed annuities vary from product to product. Some key features, found in many indexed annuities, are as follows.

Computation of Index-Based Return

The purchaser's index-based return under an indexed annuity depends on the particular combination of features specified in the contract. Typically, an indexed annuity specifies all aspects of the formula for computing return in advance of the period for which return is to be credited, and the crediting period is generally at least one year long.[15] The rate of the index-based return is computed at the end of the crediting period, based on the actual performance of a specified securities index during that period, but the computation is performed pursuant to a mathematical formula that is guaranteed in advance of the crediting period. Common indexing features are described below.

- *Index.* Indexed annuities credit return based on the performance of a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. Some annuities permit the purchaser to select one or more indices from a specified group of indices.
- *Determining Change in Index.* There are several methods for determining the change in the relevant index over the crediting period.[16] For example, the ''point-to-point'' method compares the index level at two discrete points in time, such as the beginning and ending dates of the crediting period. Typically, in determining the amount of index change, dividends paid on securities underlying the index are not included. Indexed annuities typically do not apply negative changes in an index to contract value. Thus, if the change in index value is negative over the course of a crediting period, no deduction is taken from contract value nor is any index-based return credited.[17]
- *Portion of Index Change to be Credited.* The portion of the index change to be credited under an indexed annuity is typically determined through the application of caps, participation rates, spread deductions, or a combination of these features.[18] Some contracts ''cap'' the index-based returns that may be credited. For example, if the change in the index is 6%, and the contract has a 5% cap, 5% would be credited. A contract may establish a ''participation rate,'' which is multiplied by index growth to determine the rate to be credited. If the change in the index is 6%, and a contract's participation rate is 75%, the rate credited would be 4.5% (75% of 6%). In addition, some indexed annuities may deduct a percentage, or spread, from the amount of gain in the index in determining return. If the change in the index is 6%, and a contract has a spread of 1%, the rate credited would be 5% (6% minus 1%).

Surrender Charges

Surrender charges are commonly deducted from withdrawals taken by a purchaser.[19] The maximum surrender charges, which may be as high as 15–20%,[20] are imposed on surrenders made during the early years of the contract and decline gradually to 0% at the end of a specified surrender charge period, which may be in excess of 15 years.[21]

FINRA, Equity Indexed Annuities—A Complex Choice (updated Apr. 22, 2008), available at: *http://www.finra.org/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/Equity-IndexedAnnuities-AComplexChoice/P010614* (''FINRA Investor Alert'') (investor alert on indexed annuities); Office of Compliance Inspections and Examinations, Securities and Exchange Commission, et al., *Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars,* at 4 (Sept. 2007), available at: *http://www.sec.gov/spotlight/seniors/freelunchreport.pdf* (joint examination conducted by Commission, North American Securities Administrators Association (''NASAA''), and FINRA identified potentially misleading sales materials and potential suitability issues relating to products discussed at sales seminars, which commonly included indexed annuities); Statement of Patricia Struck, President, NASAA, at the Senior Summit of the United States Securities and Exchange Commission, July 17, 2006, available at: *http://www.nasaa.org/IssuesAnswers/Legislative_Activity/Testimony/4999.cfm* (identifying indexed annuities as among the most pervasive products involved in senior investment fraud); NTM 05–50, *supra* note 7 (citing concerns about marketing of indexed annuities and the absence of adequate supervision of sales practices).

[14] FINRA Investor Alert, supra note 13; National Association of Insurance Commissioners, *Buyer's Guide to Fixed Deferred Annuities with Appendix for Equity-Indexed Annuities,* at 9 (2007) (''NAIC Guide''); National Association for Fixed Annuities, *White Paper on Fixed Indexed Insurance Products Including 'Fixed Indexed Annuities' and Other Fixed Indexed Insurance Products,* at 1 (2006), available at: *http://www.nafa.us/index.php?act=attach&type=post&id=68* (''NAFA Whitepaper''); Jack Marrion, *Index Annuities: Power and Protection,* at 13 (2004) (''Marrion'').

[15] NAFA Whitepaper, *supra* note 14, at 13.

[16] *See* FINRA Investor Alert, *supra* note 13; NAIC Guide, *supra* note 14, at 12–14; NAFA Whitepaper, *supra* note 14, at 9–10; Marrion, *supra* note 14, at 38–59.

[17] NAIC Guide, *supra* note 14, at 11; NAFA Whitepaper, *supra* note 14, at 5 and 9; Marrion, *supra* note 14, at 2.

[18] *See* FINRA Investor Alert, *supra* note 13; NAIC Guide, *supra* note 14, at 10–11; NAFA Whitepaper, *supra* note 14, at 10; Marrion, *supra* note 14, at 38–59.

[19] *See* FINRA Investor Alert, *supra* note 13; NAIC Guide, *supra* note 14, at 3–4 and 11; NAFA Whitepaper, *supra* note 14, at 7; Marrion, *supra* note 14, at 31.

[20] The highest surrender charges are often associated with annuities in which the insurer credits a ''bonus'' equal to a percentage of purchase payments to the purchaser at the time of purchase. The surrender charge may serve, in part, to recapture the bonus.

[21] *See A Producer's Guide to Indexed Annuities 2007,* LIFE INSURANCE SELLING (June 2007), available at: *http://www.lifeinsuranceselling.com/Media/MediaManager/0607_IASurvey_1.pdf;* Equity Indexed Annuities, ANNUITYADVANTAGE, available at:

Imposition of a surrender charge may have the effect of reducing or eliminating any index-based return credited to the purchaser up to the time of a withdrawal. In addition, a surrender charge may result in a loss of principal, so that a purchaser who surrenders prior to the end of the surrender charge period may receive less than the original purchase payments.[22] Many indexed annuities permit purchasers to withdraw a portion of contract value each year, typically 10%, without payment of surrender charges.

Guaranteed Minimum Value

Indexed annuities generally provide a guaranteed minimum value, which serves as a floor on the amount paid upon withdrawal, as a death benefit, or in determining the amount of annuity payments. The guaranteed minimum value is typically a percentage of purchase payments, accumulated at a specified interest rate, and may not be lower than a floor established by applicable state insurance law. In the years immediately following their introduction, indexed annuities typically guaranteed 90% of purchase payments accumulated at 3% annual interest.[23] More recently, however, following changes in state insurance laws,[24] indexed annuities typically provide that the guaranteed minimum value is equal to at least 87.5% of purchase payments, accumulated at annual interest rate of between 1% and 3%.[25] Assuming a guarantee of 87.5% of purchase payments, accumulated at 1% interest compounded annually, it would take approximately 13 years for a purchaser's guaranteed minimum value to be 100% of purchase payments.

Registration

Insurers typically have concluded that the indexed annuities they issue are not securities. As a result, virtually all indexed annuities have been issued without registration under the Securities Act.[26]

B. Section 3(a)(8) Exemption

Section 3(a)(8) of the Securities Act provides an exemption for any ''annuity contract'' or ''optional annuity contract'' issued by a corporation that is subject to the supervision of the insurance commissioner, bank commissioner, or similar state regulatory authority.[27] The exemption, however, is not available to all contracts that are considered annuities under state insurance law. For example, variable annuities, which pass through to the purchaser the investment performance of a pool of assets, are not exempt annuity contracts.

The U.S. Supreme Court has addressed the insurance exemption on two occasions.[28] Under these cases, factors 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.

With regard to investment risk, beginning with *SEC* v. *Variable Annuity Life Ins. Co.* (''*VALIC*''),[29] the Court has considered whether the risk is borne by the purchaser (tending to indicate that the product is not an exempt ''annuity contract'') or by the insurer (tending to indicate that the product falls within the Section 3(a)(8) exemption). In *VALIC,* the Court determined that variable annuities, under which payments varied with the performance of particular investments and which provided no guarantee of fixed income, were not entitled to the Section 3(a)(8) exemption. In *SEC* v. *United Benefit Life Ins. Co.* (''*United Benefit*''),[30] the Court extended the *VALIC* reasoning, finding that a contract that provides for some assumption of investment risk by the insurer may nonetheless not be entitled to the Section 3(a)(8) exemption. The *United Benefit* insurer guaranteed that the cash value of its variable annuity contract would never be less than 50% of purchase payments made and that, after ten years, the value would be no less than 100% of payments. The Court determined that this contract, under which the insurer did assume some investment risk through minimum guarantees, was not an ''annuity contract'' under the federal securities laws. In making this determination, the Court concluded that ''the assumption of an investment risk cannot by itself create an insurance provision under the federal definition'' and distinguished a ''contract which to some degree is insured'' from a ''contract of insurance.'' [31]

In analyzing investment risk, Justice Brennan's concurring opinion in VALIC applied a functional analysis to determine whether a new form of investment arrangement that emerges and is labeled ''annuity'' by its promoters is the sort of arrangement that Congress was willing to leave exclusively to the state insurance commissioners. In that inquiry, the purposes of the federal securities laws and state insurance laws are important. Justice Brennan noted, in particular, that the emphasis in the Securities Act is on disclosure and that the philosophy of the Act is that ''full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.'' [32] We agree with the concurring opinion's analysis. Where an investor's investment in an annuity is sufficiently protected by the insurer, state insurance law regulation of insurer solvency and the adequacy of reserves are relevant. Where the investor's investment is not sufficiently protected, the disclosure

http://datafeeds.annuityratewatch.com/annuityadvantage/fixed-indexed-accounts.htm.

[22] FINRA Investor Alert, *supra* note 13; Marrion, *supra* note 14, at 31.

[23] 1997 Concept Release, *supra* note 7 (concept release requesting comments on structure of equity indexed insurance products, the manner in which they are marketed, and other matters the Commission should consider in addressing federal securities law issues raised by these products). *See also* Letter from American Academy of Actuaries (Jan. 5, 1998); Letter from Aid Association for Lutherans (Nov. 19, 1997) (comment letters in response to 1997 Concept Release). The comment letters on the 1997 Concept Release are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC (File No. S7–22–97). Those comment letters that were transmitted electronically to the Commission are also available on the Commission's Web site at *http://www.sec.gov/rules/concept/s72297.shtml.*

[24] *See, e.g.*, CAL. INS. CODE § 10168.25 (West 2007) & IOWA CODE § 508.38 (2008) (current requirements, providing for guarantee based on 87.5% of purchase payments accumulated at minimum of 1% annual interest); CAL. INS. CODE § 10168.2 (West 2003) & IOWA CODE § 508.38 (2002) (former requirements, providing for guarantee for single premium annuities based on 90% of premium accumulated at minimum of 3% annual interest).

[25] NAFA Whitepaper, *supra* note 14, at 6.

[26] In a few instances, insurers have registered indexed annuities as securities as a result of particular features, such as the absence of any guaranteed interest rate or the absence of a guaranteed minimum value. *See, e.g.,* Pre-Effective Amendment No. 4 to Registration Statement on Form S–1 of PHL Variable Insurance Company (File No. 333–132399) (filed Feb. 7, 2007); Pre-Effective Amendment No. 1 to Registration Statement on Form S–3 of Allstate Life Insurance Company (File No. 333–105331) (filed May 16, 2003); Initial Registration Statement on Form S–2 of Golden American Life Insurance Company (File No. 333–104547) (filed Apr. 15, 2003).

[27] The Commission has previously stated its view that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from the registration but not the antifraud provisions. Securities Act Release No. 6558 (Nov. 21, 1984) [49 FR 46750, 46753 (Nov. 28, 1984)]. *See also Tcherepnin* v. *Knight,* 389 U.S. 332, 342 n.30 (1967) (Congress specifically stated that ''insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act,'' (*quoting* H.R. Rep. 85, 73d Cong., 1st Sess. 15 (1933)).

[28] *VALIC, supra* note 8, 359 U.S. 65; *United Benefit, supra* note 8, 387 U.S. 202.

[29] *VALIC, supra* note 8, 359 U.S. at 71–73.

[30] *United Benefit, supra* note 8, 387 U.S. at 211.

[31] *Id.* at 211.

[32] *VALIC, supra* note 8, 359 U.S. at 77.

protections of the Securities Act assume importance.

Marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to the Securities Act ''annuity contract'' exemption. In *United Benefit,* the U.S. Supreme Court, in holding an annuity to be outside the scope of Section 3(a)(8), found significant the fact that the contract was ''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.'' [33] Under these circumstances, the Court concluded ''it is not inappropriate that promoters' offerings be judged as being what they were represented to be.'' [34]

In 1986, given the proliferation of annuity contracts commonly known as ''guaranteed investment contracts,'' the Commission adopted rule 151 under the Securities Act to establish a ''safe harbor'' for certain annuity contracts that are not deemed subject to the federal securities laws and are entitled to rely on Section 3(a)(8) of the Securities Act.[35] Under rule 151, an annuity contract issued by a state-regulated insurance company is deemed to be within Section 3(a)(8) of the Securities Act if (1) the insurer assumes the investment risk under the contract in the manner prescribed in the rule; and (2) the contract is not marketed primarily as an investment.[36] Rule 151 essentially codifies the tests the courts have used to determine whether an annuity contract is entitled to the Section 3(a)(8) exemption, but adds greater specificity with respect to the investment risk test. Under rule 151, an insurer is deemed to assume the investment risk under an annuity contract if, among other things,

(1) The insurer, for the life of the contract,

(a) Guarantees the principal amount of purchase payments and credited interest, less any deduction for sales, administrative, or other expenses or charges; and

(b) Credits a specified interest rate that is at least equal to the minimum rate required by applicable state law; and

(2) The insurer guarantees that the rate of any interest to be credited in excess of the guaranteed minimum rate described in paragraph 1(b) will not be modified more frequently than once per year.[37]

Indexed annuities are not entitled to rely on the safe harbor of rule 151 because they fail to satisfy the requirement that the insurer guarantee that the rate of any interest to be credited in excess of the guaranteed minimum rate will not be modified more frequently than once per year.[38]

III. Discussion of the Amendments

The Commission has determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws will enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are adopting a new definition of ''annuity contract'' that, on a prospective basis, defines a class of indexed annuities that are outside the scope of Section 3(a)(8). With respect to these annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections. We are also adopting a new exemption under the Exchange Act that applies to insurance companies that issue indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the presence of state oversight of insurance company financial condition and the absence of trading interest in these securities.

A. Definition of Annuity Contract

The Commission is adopting new rule 151A, which defines a class of indexed annuities that are not ''annuity contracts'' or ''optional annuity contracts'' [39] for purposes of Section 3(a)(8) of the Securities Act. Although we recognize that these instruments are issued by insurance companies and are treated as annuities under state law, these facts are not conclusive for purposes of the analysis under the federal securities laws.

1. Analysis

''Insurance'' and ''Annuity'': Federal Terms Under the Federal Securities Laws

Our analysis begins with the well-settled conclusion that the terms ''insurance'' and ''annuity contract'' as used in the Securities Act are ''federal terms,'' the meanings of which are a ''federal question'' under the federal securities laws.[40] The Securities Act does not provide a definition of either term, and we have not previously provided a definition that applies to indexed annuities.[41] Moreover, indexed

[33] *United Benefit, supra* note 8, 387 U.S. at 211.

[34] *Id.* at 211 (quoting *SEC* v. *Joiner Leasing Corp.,* 320 U.S. 344, 352–53 (1943)). For other cases applying a marketing test, see *Berent* v. *Kemper Corp.,* 780 F. Supp. 431 (E.D. Mich. 1991), aff'd, 973 F. 2d 1291 (6th Cir. 1992); *Associates in Adolescent Psychiatry* v. *Home Life Ins. Co.,* 729 F.Supp. 1162 (N.D. Ill. 1989), *aff'd,* 941 F.2d 561 (7th Cir. 1991); and *Grainger* v. *State Security Life Ins. Co.,* 547 F.2d 303 (5th Cir. 1977).

[35] 17 CFR 230.151; Securities Act Release No. 6645 (May 29, 1986) [51 FR 20254 (June 4, 1986)]. A guaranteed investment contract is a deferred annuity contract under which the insurer pays interest on the purchaser's payments at a guaranteed rate for the term of the contract. In some cases, the insurer also pays discretionary interest in excess of the guaranteed rate.

[36] 17 CFR 230.151(a).

[37] 17 CFR 230.151(b) and (c). In addition, the value of the contract may not vary according to the investment experience of a separate account.

[38] Some indexed annuities also may fail other aspects of the safe harbor test.

In adopting rule 151, the Commission declined to extend the safe harbor to excess interest rates that are computed pursuant to an indexing formula that is guaranteed for one year. Rather, the Commission determined that it would be appropriate to permit insurers to make limited use of index features, provided that the insurer specifies an index to which it would refer, no more often than annually, to determine the excess interest rate that it would guarantee for the next 12-month or longer period. For example, an insurer would meet this test if it established an ''excess'' interest rate of 5% by reference to the past performance of an external index and then guaranteed to pay 5% interest for the coming year. Securities Act Release No. 6645, *supra* note 35, 51 FR at 20260. The Commission specifically expressed concern that index feature contracts that adjust the rate of return actually credited on a more frequent basis operate less like a traditional annuity and more like a security and that they shift to the purchaser all of the investment risk regarding fluctuations in that rate. *See infra* note 71 and accompanying text.

[39] An ''optional annuity contract'' is a deferred annuity. *See United Benefit, supra* note 8, 387 U.S. at 204. In a deferred annuity, annuitization begins at a date in the future, after assets in the contract have accumulated over a period of time (normally many years). In contrast, in an immediate annuity, the insurer begins making annuity payments shortly after the purchase payment is made, *i.e.*, within one year. *See* Kenneth Black, Jr., and Harold D. Skipper, Jr., *Life and Health Insurance,* at 164 (2000).

[40] *See VALIC, supra* note 8, 359 U.S. at 69. Although the McCarran-Ferguson Act, 15 U.S.C. 1012(b), provides that ''No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance,'' the United States Supreme Court has stated that the question common to both the federal securities laws and the McCarran-Ferguson Act is whether the instruments are contracts of insurance. *See VALIC, supra* note 8. Thus, where a contract is not an ''annuity contract'' or ''optional annuity contract,'' which we have concluded is the case with respect to certain indexed annuities, we do not believe that such contract is ''insurance'' for purposes of the McCarran-Ferguson Act.

[41] The last time the Commission formally addressed indexed annuities was in 1997. At that time, the Commission issued a concept release requesting public comment regarding indexed insurance contracts. The concept release stated that ''depending on the mix of features * * * [an indexed insurance contract] may or may not be entitled to exemption from registration under the Securities Act'' and that the Commission was

annuities did not exist and were not contemplated by Congress when it enacted the insurance exemption.

We therefore analyze indexed annuities under the facts and circumstances factors articulated by the U.S. Supreme Court in *VALIC* and *United Benefit.* In particular, we focus on whether these instruments are ''the sort of investment form that Congress was * * * willing to leave exclusively to the State Insurance Commissioners'' and whether they necessitate the ''regulatory and protective purposes'' of the Securities Act.[42]

Type of Investment

We believe that the indexed annuities that will be included in our definition are not the sort of investment that Congress contemplated leaving exclusively to state insurance regulation. According to the U.S. Supreme Court, Congress intended to include in the insurance exemption only those policies and contracts that include a ''true underwriting of risks'' and ''investment risk-taking'' by the insurer.[43] Moreover, the level of risk assumption necessary for a contract to be ''insurance'' under the Securities Act must be meaningful—the assumption of an investment risk does not ''by itself create an insurance provision under the federal definition.'' [44]

The annuities that ''traditionally and customarily'' were offered at the time Congress enacted the insurance exemption were fixed annuities that typically involved no investment risk to the purchaser.[45] These contracts offered the purchaser ''specified and definite amounts beginning with a certain year of his or her life,'' and the ''standards for investments of funds'' by the insurer under these contracts were ''conservative.'' [46] Moreover, these types of annuity contracts were part of a ''concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.'' [47] Thus, Congress exempted these instruments from the requirements of the federal securities laws because they were a ''form of 'investment' * * * which did not present very squarely the problems that [the federal securities laws] were devised to deal with,'' and were ''subject to a form of state regulation of a sort which made the federal regulation even less relevant.'' [48]

In contrast, when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract, 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.

By purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for participation in future securities-linked returns. The value of such an indexed annuity reflects the benefits and risks inherent in the securities market, and the contract's value depends upon the trajectory of that same market. Thus, the purchaser obtains an instrument that, by its very terms, depends on market volatility and risk.

Such indexed annuity contracts provide some protection against the risk of loss, but these provisions do not, ''by [themselves,] create an insurance provision under the federal definition.'' [49] Rather, these provisions reduce—but do *not eliminate*—a purchaser's exposure to investment risk under the contract. These contracts may to some degree be insured, but that degree may be too small to make the indexed annuity a contract of insurance.[50]

Thus, the protections provided by indexed annuities may not adequately transfer investment risk from the purchaser to the insurer when amounts payable by an insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. Purchasers of these annuities assume the investment risk for investments that are more likely than not to fluctuate and move with the securities markets. The value of the purchaser's investment is more likely than not to depend on movements in the underlying securities index. The protections offered in these indexed annuities may give the instruments an aspect of insurance, but we do not believe that these protections are substantial enough.[51]

Need for the Regulatory Protections of the Federal Securities Acts

We also analyze indexed annuities to determine whether they implicate the regulatory and protective purposes of the federal securities laws. Based on that analysis, we believe that the indexed annuities that are included in the definition that we are adopting present many of the concerns that Congress intended the federal securities laws to address.

Indexed annuities are similar in many ways to mutual funds, variable annuities, and other securities. Although these contracts contain certain features that are typical of insurance contracts,[52] they also may contain ''to a very substantial degree elements of investment contracts.'' [53] Indexed annuities are attractive to purchasers precisely because they offer participation in the securities markets. However, indexed annuities historically have not been registered with us as securities. Insurers have treated these

''considering the status of [indexed annuities and other indexed insurance contracts] under the federal securities laws.'' *See* 1997 Concept Release, *supra* note 7, at 4–5.

The Commission has previously adopted a safe harbor for certain annuity contracts that are entitled to rely on Section 3(a)(8) of the Securities Act. However, as discussed in Part II.B., indexed annuities are not entitled to rely on the safe harbor.

[42] *See VALIC, supra* note 8, 359 U.S. at 75 (Brennan, J., concurring) (''* * * if a brand-new form of investment arrangement emerges which is labeled 'insurance' or 'annuity' by its promoters, the functional distinction that Congress set up in 1933 and 1940 must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners. In that inquiry, an analysis of the regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed becomes relevant.'').

[43] *Id.* at 71–73.

[44] *See United Benefit, supra* note 8, 387 U.S. at 211 (''[T]he assumption of investment risk cannot by itself create an insurance provision. * * * The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.'').

[45] *See VALIC, supra* note 8, 359 U.S. at 69.

[46] *Id.* (''While all the States regulate 'annuities' under their 'insurance' laws, traditionally and customarily they have been fixed annuities, offering the annuitant specified and definite amounts beginning with a certain year of his or her life. The standards for investment of funds underlying these annuities have been conservative.'').

[47] *Id.* (''Congress was legislating concerning a concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.'').

[48] *Id.* at 75 (Brennan, J., concurring).

[49] *See United Benefit, supra* note 8, 387 U.S. at 211 (finding that while a ''guarantee of cash value'' provided by an insurer to purchasers of a deferred annuity plan reduced ''substantially the investment risk of the contract holder, the assumption of investment risk cannot by itself create an insurance provision under the federal definition.'').

[50] *Id.* at 211 (''The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.'').

[51] *See VALIC, supra* note 8, 359 U.S. at 71 (finding that although the insurer's assumption of a traditional insurance risk gives variable annuities an ''aspect of insurance,'' this is ''apparent, not real; superficial, not substantial.'').

[52] The presence of protection against loss does not, in itself, transform a security into an insurance or annuity contract. Like indexed annuities, variable annuities typically provide some protection against the risk of loss, but are registered as securities. Historically, variable annuity contracts have typically provided a minimum death benefit at least equal to the greater of contract value or purchase payments less any withdrawals. More recently, many contracts have offered benefits that protect against downside market risk during the purchaser's lifetime.

[53] *VALIC, supra* note 8, 359 U.S. at 91 (Brennan, J., concurring).

annuities as subject only to state insurance laws.

There is a strong federal interest in providing investors with disclosure, antifraud, and sales practice protections when they are purchasing annuities that are likely to expose them to market volatility and risk. We believe that individuals who purchase indexed annuities that are more likely than not to provide payments that vary with the performance of securities are exposed to significant investment risks. They are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Moreover, they are more likely than not to experience market volatility because they are more likely than not to receive payments that vary with the performance of securities.

We believe that the regulatory objectives that Congress was attempting to achieve when it enacted the Securities Act are present when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the guaranteed amounts. Therefore, we are adopting a rule that will define such contracts as falling outside the insurance exemption.

2. Commenters' Concerns Regarding Commission's Analysis

Many commenters raised significant concerns regarding the Commission's analysis of indexed annuities under Section 3(a)(8). Commenters argued that the Commission's analysis is inconsistent with applicable legal precedent, particularly the *VALIC* and *United Benefit* cases. Specifically, the commenters argued that the purchaser of an indexed annuity does not assume investment risk in the sense contemplated by applicable precedent, that the Commission failed to take into account the investment risk assumed by the insurer, and that the Commission's analysis ignored the factors of marketing and mortality risk which have been articulated in applicable precedents. In addition, commenters questioned the need for federal securities regulation of indexed annuities, arguing that there is no evidence of widespread sales practice abuse in the indexed annuity marketplace, that state insurance regulators are effective in protecting purchasers of indexed annuities, and that the Commission's disclosure requirements would not result in enhanced information flow to purchasers of indexed annuities. We disagree with each of these assertions for the reasons outlined below.

Commission's Analysis is Consistent With Applicable Precedents

We disagree with commenters who argued that the Commission's analysis is inconsistent with applicable legal precedents, particularly the *VALIC* and United Benefit cases.[54] These commenters asserted, first, that because of guarantees of principal and minimum interest, the purchaser of an indexed annuity does not assume investment risk in the sense contemplated by applicable precedent which, in their view, is the risk of loss of principal. Second, the commenters argued that the Commission's analysis failed to take into account the investment risk assumed by the insurer, including the risk associated with guaranteeing principal and a minimum interest rate and with guaranteeing in advance the formula for determining index-linked return. Third, commenters argued that the Commission's analysis is inconsistent with precedent because it does not take into account the manner in which indexed annuities are marketed.[55] Fourth, commenters faulted the Commission's analysis for ignoring mortality risk.[56]

Our investment risk analysis is an application of the Court's reasoning in the *VALIC* and *United Benefit* cases, and rule 151A applies that analysis with a specific test to determine the status under the federal securities laws of indexed annuities. Indexed annuities are a relatively new product and are different from the securities considered in those cases. These very differences have resulted in the uncertain legal status of indexed annuities from their introduction in the mid-1990s. Like the contract at issue in *United Benefit*, indexed annuities present a new case that requires us to determine whether ''a contract which to some degree is insured'' constitutes a ''contract of insurance'' for purposes of the federal securities laws.[57] Indexed annuities offer to purchasers a financial instrument with uncertain and fluctuating returns that are, in part, securities-linked. We believe that whether such an instrument is a security hinges on the likelihood that the purchaser's return will, in fact, be based on the returns of a securities index. In cases where the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract, the amount the purchaser receives will be dependent on market returns and will vary because of investment risk. In such a case, we have concluded that, on a prospective basis, the indexed annuity is not entitled to rely on the Section 3(a)(8) exemption. Though the contract may to some degree be insured, it is not a contract of insurance because of the substantial investment risk assumed by the purchaser.

A number of commenters equated investment risk with the risk of loss of principal for purposes of analysis under Section 3(a)(8) and argued that, because of guarantees of principal and minimum interest, the purchaser of an indexed annuity does not assume investment risk. We disagree. While the potential for loss of principal was important in the *VALIC* and *United Benefit* cases and helpful in analyzing the particular products at issue in those cases, it is by

[54] *See, e.g.*, Letter of Advantage Group Associates, Inc. (Nov. 16, 2008) (''Advantage Group Letter''); Letter of Allianz Life Insurance Company of North America (Sept. 10, 2008) (''Allianz Letter''); Letter of American Academy of Actuaries (Sept. 10, 2008) (''Academy Letter''); Letter of American Academy of Actuaries (Nov. 17, 2008) (''Second Academy Letter''); Letter of American Equity Investment Life Holding Company (Sept. 10, 2008) (''American Equity Letter''); Letter of American National Insurance Company (Sept. 10. 2008) (''American National Letter''); Letter of Aviva USA Corporation (Sept. 10, 2008) (''Aviva Letter''); Letter of Aviva USA Corporation (Nov. 17, 2008) (''Second Aviva Letter''); Letter of Coalition for Indexed Products (Sept. 10, 2008) (''Coalition Letter''); Letter of Committee of Annuity Insurers regarding proposed rule 151A (Sept. 10, 2008) (''CAI 151A Letter''); Letter of Lafayette Life Insurance Company (Sept. 10, 2008) (''Lafayette Letter''); Letter of Maryland Insurance Administration (Sept. 9, 2008) (''Maryland Letter''); Letter of the Officers of the National Association of Insurance Commissioners (Sept. 10, 2008) (''NAIC Officer Letter''); Letter of National Association for Fixed Annuities (Sept. 10, 2008) (''NAFA Letter''); Letter of National Association of Insurance and Financial Advisers (Sept. 10, 2008) (''NAIFA Letter''); Letter of National Conference of Insurance Legislators (Nov. 25, 2008) (''NCOIL Letter''); Letter of National Western Life Insurance Company (Sept. 10, 2008) (''National Western Letter''); Letter of Old Mutual Financial Network (Sept. 10, 2008) (''Old Mutual Letter''); Letter of Sammons Annuity Group (Sept. 10, 2008) (''Sammons Letter''); Letter of Transamerica Life Insurance Company (Sept. 10, 2008) (''Transamerica Letter''); Letter of Transamerica Life Insurance Company (Nov. 17, 2008) (''Second Transamerica Letter'').

Other commenters, however, supported the Commission's interpretation of Section 3(a)(8) and applicable legal precedents. *See, e.g.*, ICI Letter, *supra* note 7; 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 Company (Oct. 7, 2008) (''K&L Gates Letter'').

[55] *See, e.g.*, Coalition Letter, *supra* note 54; Letter of The Hartford Financial Services Group, Inc. (Sept. 10, 2008) (''Hartford Letter''); NAFA Letter, *supra* note 54.

[56] *See, e.g.*, CAI 151A Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[57] *See United Benefit, supra* note 8, 387 U.S. at 211 (''The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.'').

no means the only type of investment risk. Defining risk only as the possibility of principal loss or an approximate equivalent, as suggested by commenters, fails to account for important forms of risk and leads to conclusions inconsistent with the contemporary understanding of investment risk. Such a limited definition of risk would thus be incomplete.

One widely accepted definition of ''risk'' in financial instruments is the degree to which returns deviate from their statistical expectation.[58] Accordingly, even investments guaranteeing a positive minimum return over long investment horizons, such as indexed annuities, may have returns that meaningfully and unpredictably deviate from the expected return and therefore have investment risk under this definition.

For example, accepting the definition of risk suggested by commenters as a complete characterization of risk would lead to the conclusion that any two assets that both guarantee return of principal equally have no risk. However, we believe that the market would generally view an asset where the future payoff of the amount over the guaranteed principal return is uncertain to be more risky than a zero-coupon U.S. government bond maturing at the same date, which also guarantees principal return but has a nearly certain future payoff. Defining risk as the potential for loss of principal, or principal plus some minimal amount, misses important aspects of risk as commonly understood. While U.S. government bonds are commonly accepted as the standard benchmark of a nominally risk-free rate of return because their returns are considered to be nearly certain at specific horizons, the definition suggested by commenters fails to distinguish between these risk-free assets and assets that are protected against principal loss but that have uncertain payoffs above the guaranteed principal return.[59]

Additionally, under the definition of risk suggested by the commenters, most assets with positive expected returns would appear to have little to no risk over long horizons. As an example, using reasonable assumptions it can be estimated that a value-weighted portfolio of New York Stock Exchange (''NYSE'') stocks has approximately a 6% chance of returning less than principal in 10 years, and approximately a 1% chance of returning less than principal in 20 years.[60] Despite these relatively low probabilities of losing principal over long periods of time, we believe that it is generally understood that market participants, even those with long investment horizons, bear meaningful investment risk when investing in such a diversified portfolio of stocks. Indeed, investors generally consider modest long-term returns, even if greater than 0% or some minimal rate, to be undesirable outcomes when the expected return was substantially greater. We therefore believe that the commenters' suggestion that such a portfolio is without risk is at odds both with the commonly accepted meaning of the term as well as with the definition of risk generally accepted by financial economists.

The purchaser of an indexed annuity assumes investment risk because his or her return is not known in advance and therefore varies from its expected value. When the amounts payable to the purchaser are more likely than not to exceed the guaranteed amounts, the investment risk assumed by the purchaser of an indexed annuity is substantial, and we believe that the contract should not be treated as an ''annuity contract'' for purposes of the federal securities laws. We also note that indexed annuities are not, in fact, without the risk of principal loss. An indexed annuity purchaser who surrenders the contract during the surrender charge period, which for some indexed annuities may be in excess of 15 years, may receive less than his or her original principal. Unlike a purchaser of a fixed annuity, a purchaser of an indexed annuity is dependent on favorable securities market returns to overcome the impact of the surrender charge and create a positive return rather than a loss.

We also disagree with commenters who argued that the Commission's analysis failed to take into account the investment risk assumed by the insurer, including the risk associated with guaranteeing principal and a minimum interest rate and with guaranteeing in advance the formula for determining securities-linked return. We agree with commenters that, in analyzing the status of indexed annuities under the federal securities laws, it is important to take into account the relative significance of the risks assumed by the insurer and the purchaser. In our analysis, the Commission does not ignore the risk assumed by the insurer as the commenters suggest. In fact, the rule, as proposed and adopted, specifically contemplates different outcomes based on the relative risks assumed by the insurer and purchaser. When the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed, the contract loses the insurance exemption under rule 151A.

Unlike a traditional fixed annuity where the investment risk for the contract is assumed by the insurer, or a traditional variable annuity where the investment risk for the contract is assumed by the purchaser, the very mixed nature of indexed annuities led the Commission to carefully consider the relative risks assumed by both parties to the contract. The fact that the rule does not define all indexed annuities as outside Section 3(a)(8), but rather sets forth a test for analyzing these contracts, reflects the Commission's understanding that the status of these contracts under the federal securities laws hinges on the allocation of risk between both the insurer and the purchaser. Specifically, the rule recognizes that where the insurer is more likely than not to pay an amount that is fixed and guaranteed by the insurer, significant investment risks are assumed by the insurer and such a contract may therefore be entitled to the Section 3(a)(8) exemption. Conversely, where the purchaser is more likely than not to receive an amount that is variable and dependent on fluctuations and movements in the securities markets, rule 151A recognizes the significant investment risks assumed by the purchaser and specifies that such a contract would not be considered to fall within Section 3(a)(8). Moreover, both the guaranteed interest rate within an indexed annuity and the formula for crediting interest are typically reset on an annual basis. This provides insurers with a number of ways to reduce or eliminate their investment risks, including hedging market risk through the purchase of options or other derivatives and adjusting guarantees downwards in subsequent years to offset losses in earlier years of a contract. For purposes of analysis under Section 3(a)(8), we do not consider these investment risks to be comparable to

[58] Zvi Bodie, Alex Kane and Alan J. Marcus, *Investments*, at 143 (2005) (''The standard deviation of the rate of return is a measure of risk.'').

[59] Zvi Bodie, Alex Kane and Alan J. Marcus, *Investments*, at 144 (2005).

[60] Our Office of Economic Analysis conducted a simulation, in which annual returns from the Center for Research in Security Prices (''CRSP'') capitalization-weighted NYSE index, annually rebalanced, from 1926 through 2007, are drawn randomly and aggregated (a bootstrap procedure). This procedure replicates the observed mean, standard deviation, skewness, kurtosis, and other observed moments of returns, but assumes that returns are intertemporally independent. Realized 10-year returns in this period are negative 4% of the time, and there have been no 20-year negative returns.

those of the indexed annuity purchaser, who bears the risk of a fluctuating and uncertain return based on the performance of a securities index.

Some commenters argued that the Commission's investment risk analysis is inconsistent with its own position in the Brief for the United States as Amicus Curiae in *Variable Annuity Life Insurance Company, et al.* v. *Otto* (''*VALIC* v. *Otto*'').[61] That matter involved an annuity in which the insurer guaranteed principal and a minimum rate of interest and also could, in its discretion, credit excess interest above the guaranteed rate. The Commission argued that by guaranteeing principal and an adequate fixed rate of interest, and guaranteeing payment of all discretionary excess interest declared under the contract, the insurer assumed sufficient investment risk under the contract for it to fall within Section 3(a)(8), notwithstanding the assumption of the risk by the contract owner that the excess interest rate could be reduced or eliminated at the insurer's discretion.

We agree with commenters that our analysis is different from the position taken by the Commission in the *VALIC* v. *Otto* brief. However, this results from the fact that indexed annuity contracts are different from the contracts considered in *VALIC* v. *Otto*. Unlike the contracts in that case, which were annuity contracts that provided for wholly discretionary payment of excess interest, indexed annuities contractually specify that excess interest will be calculated by reference to a securities index. As a result, the purchaser of an indexed annuity is contractually bound to assume the investment risk for the fluctuations and movements in the underlying securities index. The contract in *VALIC* v. *Otto* did not impose this securities-linked investment risk on the purchaser. Moreover, we note that the Supreme Court did not grant certiorari in *VALIC* v. *Otto*. The final opinion in the case was rendered by the Seventh Circuit and was to the effect that, as a result of the insurer's discretion to declare excess interest under the contract, the insurer's guarantees were not sufficient to exempt the contract from the federal securities laws. Thus, the Commission's position in the case was not adopted by either the Seventh Circuit or the Supreme Court. We believe that the position articulated in the *VALIC* v. *Otto* brief is not relevant in the context of indexed annuities and, to the extent that the brief may imply otherwise, the position taken in the brief does not reflect the Commission's current position. Where the contractual return paid by an insurer under an annuity contract is retroactively determined based, in whole or in part, on the returns of a security in a prior period, we do not believe that fact—and the investment risk that it entails—can be ignored in determining whether the contract is an ''annuity contract'' that is entitled to the Section 3(a)(8) exemption.

Though rule 151A does not explicitly incorporate a marketing factor, we disagree with commenters who argued that the Commission's analysis is inconsistent with precedent, because it does not take into account the manner in which indexed annuities are marketed.[62] The very nature of an indexed annuity, where return is contractually linked to the return on a securities index, is, to a very substantial extent, designed to appeal to purchasers on the prospect of investment growth.[63] This is particularly true in the case of indexed annuities that rule 151A defines as not ''annuity contracts''—*i.e.*, indexed annuities where the purchaser is more likely than not to receive securities-linked returns. It would be inconsistent with the character of such an indexed annuity, and potentially misleading, to market the annuity without placing significant emphasis on the securities-linked return and the related risks. We disagree with commenters who argued that purchasers do not buy indexed annuities on the basis of the prospect for investment growth, but rather on the basis of guarantees and stability of principal.[64] We agree with commenters that purchasers of indexed annuities, just like purchasers of variable annuities, have a blend of reasons for their purchase, including product guarantees and tax deferral.[65] However, we also believe that purchasers who are uninterested in the growth offered by securities-linked returns would opt for higher fixed returns in lieu of the lower fixed returns, coupled with the prospect of securities-linked growth, offered by indexed annuities. Indeed, data submitted by one indexed annuity issuer confirm that almost half (46.60%) of its 2008 indexed annuity purchasers identify the prospect for growth as a reason for their purchase.[66] Just as with variable annuities, the fact that indexed annuities appeal to purchasers for a variety of reasons does not detract from the significant appeal of securities-linked growth. Accordingly, we have concluded that, in light of the nature of indexed annuities, it is unnecessary to include a separate marketing factor within rule 151A. The Supreme Court did not address marketing in *VALIC*. Similarly, we have concluded that a separate marketing analysis is unnecessary in the case of indexed annuities that are addressed by rule 151A.

Nor do we agree with commenters who argued that the Commission's analysis departs from precedent in that it does not take into account mortality risk.[67] In both *VALIC* and *United Benefit*, the Supreme Court found the investment risk test to be determinative (together with the marketing test in the case of United Benefit) that an insurance contract was not entitled to the Section 3(a)(8) exemption. While the Commission has stated, and we continue to believe, that the presence or absence of assumption of mortality risk may be an appropriate factor to consider in a Section 3(a)(8) analysis,[68] we do not believe that it should be given undue weight in determining the status of a contract under the federal securities laws, where it is clear from the nature of the investment risk that the contract is not an ''annuity contract'' for securities law purposes. We have concluded that this is the case for an indexed annuity where the amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

Some commenters criticized the Commission for failing to adequately address a federal district court decision, *Malone* v. *Addison Ins. Marketing, Inc.* (''*Malone*''),[69] where the court

[61] Brief for the United States as Amicus Curiae on Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit, *VALIC* v. *Otto*, No. 87–600, October Term, 1987. *See, e.g.*, Aviva Letter, *supra* note 54; CAI 151A Letter, *supra* note 54; Coalition Letter, *supra* note 54; NAFA Letter, *supra* note 54.

[62] *See, e.g.*, Coalition Letter, *supra* note 54; NAFA Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[63] *See, e.g.*, K&L Gates Letter, *supra* note 54. *But see* Letter of National Western Life Insurance Company (Nov. 17, 2008) (''Second National Western Letter'') (criticizing the K&L Gates position).

[64] *See, e.g.*, Allianz Letter, *supra* note 54; American Equity Letter, *supra* note 54; Coalition Letter, *supra* note 54.

[65] *See, e.g.*, Allianz Letter, *supra* note 54 (55.45% purchased indexed annuities because of guarantees and 54.88% because of tax deferral).

[66] *See* Allianz Letter, *supra* note 54. *But see* Coalition Letter, *supra* note 54 (sampling by some indexed annuity issuers reveals that a large majority of purchasers acquire fixed annuities for stability of premiums). We are not able to ascertain from the statement in the Coalition Letter the degree to which purchasers identified growth as a goal as the letter addressed only stability of premiums.

[67] *See, e.g.*, CAI 151A Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[68] Securities Act Release No. 6645, *supra* note 35.

[69] 225 F.Supp. 2d 743 (W.D. Ky. 2002).

determined that a particular indexed annuity was entitled to rely on Section 3(a)(8).[70] We disagree with the *Malone* court's analysis of investment risk, which, we believe, understated the investment risk to the purchaser of an indexed annuity from the fluctuating and uncertain securities-linked return and therefore is inconsistent with applicable legal precedent. We also disagree with the court's interpretation of the Commission's rule 151 safe harbor, which does not apply to indexed annuities. As we discussed in the proposing release, in that case, the district court concluded that the contracts at issue fell within the Commission's rule 151 safe harbor notwithstanding the fact that they apparently did not meet the test articulated by the Commission in adopting rule 151, *i.e.*, specifying an index that would be used to determine a rate that would remain in effect for at least one year.[71] Instead, the contracts appear to have guaranteed the index-based formula, but not, as required by rule 151, the actual rate of interest.

Need for Federal Securities Regulation

Some commenters agreed that federal securities regulation is needed with respect to indexed annuities.[72] Other commenters questioned the need for federal securities regulation of indexed annuities, and we disagree with those commenters. These commenters argued, first, that there is no evidence of widespread sales practice abuse in the indexed annuity marketplace, which would suggest a need for federal securities regulation.[73] Second, commenters argued that state insurance regulators are effective in protecting purchasers of indexed annuities.[74] Third, commenters argued that the Commission's disclosure requirements would not result in enhanced information flow to purchasers of indexed annuities.[75]

We believe that the commenters who argued that regulation of indexed annuities under the federal securities laws is unnecessary because there is no evidence of widespread sales abuse misunderstand the exemption under Section 3(a)(8) of the Securities Act as well as our purpose in proposing, and now adopting, rule 151A. Some of these commenters cited data that they argued demonstrated that the incidence of abuse in the indexed annuity marketplace is low.[76] Some of these commenters argued that the proposing release failed to present persuasive evidence of sales practice abuse.[77]

A vital aspect of the Commission's mission is investor protection. As a result, reports of sales practice abuses surrounding a product, indexed annuities, whose status has long been unresolved under the federal securities laws, are a matter of grave concern to us. However, the presence or absence of sales practice abuses is irrelevant in determining whether an annuity contract is entitled to the exemption from federal securities regulation under Section 3(a)(8) of the Securities Act. Where an annuity contract is entitled to the Section 3(a)(8) exemption, the federal securities laws do not apply, and purchasers are not entitled to their protections, regardless of whether sales practice abuses may be pervasive. Where, however, an annuity contract is not entitled to the Section 3(a)(8) exemption, which we have concluded is the case with respect to certain indexed annuities, Congress intended that the federal securities laws apply, and purchasers are entitled to the disclosure and suitability protections under those laws without regard to whether there is a single documented incident of abuse.

This view is consistent with applicable precedent which makes clear that the necessity for federal regulation arises from the characteristics of the financial instrument itself. This has been the approach of the United States Supreme Court in the two leading precedents. In those cases, the Court made a realistic judgment about the point at which a contract between a purchaser and an insurance company tips from being the sole concern of state regulators of insurance to also become the concern of the federal securities laws.

The *United Benefit* Court observed that the products at issue in that case 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.''[78] They were ''pitched to the same consumer interest in growth through professionally managed investment,'' and, as a result, the Court concluded that it seemed ''eminently fair that a purchaser of such a plan be afforded the same advantages of disclosure which inure to a mutual fund purchaser under Section 5 of the Securities Act.''[79]

The *United Benefit* decision picked up and extended a theme previously discussed in Justice Brennan's concurring opinion in *VALIC.* Justice Brennan examined the differing nature of state regulation of insurance and federal regulation of the securities markets. He looked at the nature of the obligation the insurer assumed and its connection to the regulation of investment policy. He concluded that there came a point when the ''contract between the investor and the organization no longer squares with the sort of contract in regard to which Congress in 1933 thought its 'disclosure' statute was unnecessary.''[80]

It is precisely this realistic judgment about identifying the appropriate circumstances in which to apply the disclosure and other regulatory protections of the federal securities laws that rule 151A makes. That is why the rule adopts the principle that an indexed annuity providing for a combination of minimum guaranteed payments plus a potentially higher payment dependent on the performance of a securities index does not qualify for the insurance exclusion in Section

[70] *See, e.g.*, Coalition Letter, *supra* note 54; NAFA Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[71] *See supra* note 38.

[72] *See, e.g.*, Letter of Joseph P. Borg, Director, Alabama Securities Commission (Aug. 5, 2008) (''Alabama Letter''); Cornell Letter, *supra* note 7; Letter of Financial Planning Association (Sept. 10, 2008) (''FPA Letter''); FINRA Letter, *supra* note 7; Hartford Letter, *supra* note 55; ICI Letter, *supra* note 7; Letter of Max Maxfield, Secretary of State, State of Wyoming (Sept. 9, 2008) (''Wyoming Letter'').

[73] *See, e.g.*, American Equity Letter, *supra* note 54; Coalition Letter, *supra* note 54; Letter of FBL Financial Group (Sept. 8, 2008) (''FBL Letter''); Lafayette Letter, *supra* note 54; Maryland Letter, *supra* note 54; NAIFA Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[74] *See, e.g.*, Allianz Letter, *supra* note 54; Academy Letter, *supra* note 54; Letter of American Bankers Insurance Association (Sept. 10, 2008) (''American Bankers Letter''); American Equity Letter, *supra* note 54; American National Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54; Letter of Connecticut Insurance Commissioner (Aug. 25, 2008) (''Connecticut Letter''); Letter of Iowa Insurance Commissioner (Sept. 10, 2008) (''Iowa Letter''); Maryland Letter, *supra* note 54; NAFA Letter, *supra* note 54; NAIC Officer Letter, *supra* note 54; NAIFA Letter, *supra* note 54; National Western Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54; Transamerica Letter, *supra* note 54.

[75] *See, e.g.*, Allianz Letter, *supra* note 54; Aviva Letter, *supra* note 54.

[76] See, *e.g.*, Advantage Group Letter, *supra* note 54; American Equity Letter, *supra* note 54; Maryland Letter, *supra* note 54; NAIFA Letter, *supra* note 54; Letter of Old Mutual Financial Network (Nov. 12, 2008) (''Second Old Mutual Letter''); Letter Type A (''Letter A''); Letter Type E (''Letter E''). ''Letter Type'' refers to a form letter submitted by multiple commenters, which is listed on the Commission's Web site *(http://www.sec.gov/comments/s7-14-08/s71408.shtml)* as a single comment, with a notation of the number of letters received by the Commission matching that form type.

[77] *See, e.g.*, American Equity Letter, *supra* note 54; FBL Letter *supra* note 73; Maryland Letter, *supra* note 54; NAIFA Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54; Second National Western Letter, *supra* note 63.

[78] *United Benefit, supra* note 8, 387 U.S. at 211.

[79] *Id.*

[80] *VALIC, supra* note 8, 359 U.S. at 72.

3(a)(8) when the amounts payable by the insurer under the contact are more likely than not to exceed the amounts guaranteed under the contract.

Our intent in adopting rule 151A is to clarify the status of indexed annuities under the federal securities laws, so that purchasers of these products receive the protections to which they are entitled by federal law and so that issuers and sellers of these products are not subject to uncertainty and litigation risk with respect to the laws that are applicable. We expect that clarity will enhance investor protection in the future, and indeed will help prevent future sales practice abuses, but rule 151A is not based on the perception that there are widespread sales abuses in the indexed annuity marketplace. Rather, the rule is intended to address an uncertain area of the law, which, because of the growth of the indexed annuity market and allegations of sales practice abuses, has become of pressing importance.

A number of commenters cited efforts by state insurance regulators to address disclosure and sales practice concerns with respect to indexed annuities as evidence that federal securities regulation is unnecessary and could result in duplicative or overlapping regulation.[81] Commenters argued that state regulation extends beyond overseeing solvency and adequacy of the insurers' reserves, and that it is also addressed to investor protection issues such as suitability and disclosure.[82] Commenters cited, in particular, the NAIC Suitability in Annuity Transactions Model Regulation,[83] which has been adopted in 35 states,[84] and its adoption by the majority of states as evidence that states are addressing suitability concerns in connection with indexed annuity sales.[85] Commenters also noted that a number of states have adopted the NAIC Annuity Disclosure Model Regulation,[86] which has been adopted in 22 states and which requires delivery of certain disclosure documents regarding indexed annuity contracts.[87] Commenters also cited the existence of state market conduct examinations, the use of state enforcement and investigative authority, and licensing and education requirements applicable to insurance agents who sell indexed annuities.[88]

Commenters described a number of recent and ongoing efforts by state insurance regulators. Some commenters cited efforts being undertaken by individual states. For example, commenters cited an Iowa regulation which recently became effective requiring that agents receive indexed product training approved by the Iowa Insurance Division before they can sell indexed annuity products.[89] In addition, commenters stated that Iowa has partnered with the American Council of Life Insurers (''ACLI'') to operate a one-year pilot project with some ACLI members using templates developed for disclosure regarding indexed annuities, with the goal of assuring uniformity among insurers in the preparation of disclosure documents.[90] Commenters also noted recent efforts by state regulators addressed to annuities generally, such as the creation of NAIC working groups to review and consider possible improvements to the NAIC Suitability in Annuity Transactions Model Regulation and the NAIC Annuity Disclosure Model Regulation.[91]

We applaud the efforts in recent years of state insurance regulators to address sales practice complaints that have arisen with respect to indexed annuities, and it is not our intention to question the effectiveness of state regulation. Nonetheless, we do not believe that the states' regulatory efforts, no matter how strong, can substitute for our responsibility to identify securities covered by the federal securities laws and the protections Congress intended to apply. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws. Indeed, at least one state insurance regulator acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts.[92] Where the purchaser of an indexed annuity assumes the investment risk of an instrument that fluctuates with the securities markets, and the contract therefore does not fall within the Section 3(a)(8) exemption, the application of state insurance regulation, no matter how effective, is not determinative as to whether the contract is subject to the federal securities laws.

Some commenters also cited voluntary measures taken by insurance companies, such as suitability reviews and the provision of plain English disclosures, as a reason why federal securities regulation of indexed annuities is unnecessary.[93] While these voluntary measures are commendable, they are not a substitute for the provisions of the federal securities laws that Congress mandated.

Finally, we note that some commenters argued that regulation of indexed annuities by the Commission would not enhance investor protection, in particular because the Commission's disclosure scheme is not tailored to these contracts.[94] Commenters cited a number of factors, including the lack of a registration form that is well-suited to indexed annuities, questions about the appropriate method of accounting to be used by insurance companies that issue indexed annuities, questions about advertising restrictions that may apply under the federal securities laws, and concerns about parity of the registration process vis-à-vis mutual funds. We acknowledge that, as a result of indexed annuity issuers having historically offered and sold their contracts without

[81] *See, e.g.*, Allianz Letter, *supra* note 54; American Bankers Letter, *supra* note 74; American Equity Letter, *supra* note 54; FBL Letter *supra* note 73; Maryland Letter, *supra* note 54; NAFA Letter, *supra* note 54; Letter of National Association of Health Underwriters (Sept. 10, 2008) (''Health Underwriters Letter''); National Western Letter, *supra* note 54; Letter of Vermont Department of Banking, Insurance, Securities and Health Care Administration (Nov. 17, 2008).

[82] *See, e.g.*, Allianz Letter, *supra* note 54; American Equity Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54; Maryland Letter, *supra* note 54; NAFA Letter, *supra* note 54; NAIFA Letter, *supra* note 54; National Western Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[83] NAIC Suitability in Annuity Transactions Model Regulation (Model 275–1) (2003).

[84] National Association of Insurance Commissioners, Draft Model Summaries, available at: *http://www.naic.org/committees_models.htm*.

[85] *See, e.g.*, Letter A, *supra* note 76; American Bankers Letter, *supra* note 74; CAI 151A Letter, *supra* note 54; NAFA Letter, *supra* note 54; NAIC Officer Letter, *supra* note 54; NAIFA Letter, *supra* note 54.

[86] NAIC Annuity Disclorues Model Regulation (Model 245–1) (1998).

[87] *See, e.g.*, Aviva Letter, *supra* note 54; CAI 151A Letter, *supra* note 54; NAFA Letter, *supra* note 54; NAIC Officer Letter, *supra* note 54; NAIFA Letter, *supra* note 54.

[88] *See, e.g.*, American Equity Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54; Maryland Letter, *supra* note 54; NAIC Officer Letter, *supra* note 54; NAFA Letter, *supra* note 54.

[89] *See, e.g.*, Aviva Letter, *supra* note 54; Iowa Letter, *supra* note 74; NAIC Officer Letter, *supra* note 54.

[90] *See, e.g.*, Iowa Letter, *supra* note 74; NAIC Officer Letter, *supra* note 54.

[91] *See, e.g.*, NAIC Officer Letter, *supra* note 54.

[92] *See* Voss Letter, *supra* note 13 (proposing to accelerate NAIC efforts to strengthen the NAIC model laws affecting indexed annuity products and urge adoption by more of the member states).

[93] *See, e.g.*, Allianz Letter, *supra* note 54; American Equity Letter, *supra* note 54; Letter of R. Preston Pitts (Sept. 10, 2008) (''Pitts Letter''); Sammons Letter, *supra* note 54; Karlan Tucker, Tucker Advisory Group, Inc. (Sept. 10, 2008) (''Tucker Letter'').

[94] *See, e.g.*, Letter of American Council of Life Insurers (Sep. 19, 2008) (''ACLI Letter''); Allianz Letter, *supra* note 54; Aviva Letter, *supra* note 54; CAI 151A Letter, *supra* note 54; National Western Letter, *supra* note 54; Sammons Letter, *supra* note 54; Transamerica Letter, *supra* note 54.

complying with the federal securities laws, the Commission has not created specific disclosure requirements tailored to these products. This fact, though, is not relevant in determining whether indexed annuities are subject to the federal securities laws. The Commission has a long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance.[95] We note that we are providing a two-year transition period for rule 151A, and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities. We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.

3. Definition

Scope of the Definition

Rule 151A will apply, as proposed, to a contract that is 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.[96] This language is the same language used in Section 3(a)(8) of the Securities Act. Thus, the insurance companies covered by the rule are the same as those covered by Section 3(a)(8).

In addition, in order to be covered by the rule, a contract must be subject to regulation as an annuity under state insurance law.[97] The rule will not apply to contracts that are regulated under state insurance law as life insurance, health insurance, or any form of insurance other than an annuity, and it does not apply to any contract issued by an insurance company if the contract itself is not subject to regulation under state insurance law.[98] Thus, rule 151A itself will not apply to indexed life insurance policies,[99] in which the cash value of the policy is credited with a guaranteed minimum return and a securities-linked return. The status of an indexed life insurance policy under the federal securities laws will continue to be a facts and circumstances determination, undertaken by reference to the factors and analysis that have been articulated by the Supreme Court and the Commission. We note, however, that the considerations that form the basis for rule 151A are also relevant in analyzing indexed life insurance because indexed life insurance and indexed annuities share certain features (*e.g.*, securities-linked returns).

The adopted rule, like the proposed rule, expressly states that it does not apply to any contract whose value varies according to the investment experience of a separate account.[100] The effect of this provision is to eliminate variable annuities from the scope of the rule.[101] It has long been established that variable annuities are not entitled to the exemption under Section 3(a)(8) of the Securities Act, and, accordingly, the new definition does not cover them or affect their regulation in any way.[102]

Definition of ''Annuity Contract'' and ''Optional Annuity Contract''

We are adopting, with modifications to address commenters' concerns, the proposal that an annuity issued by an insurance company would not be an ''annuity contract'' or an ''optional annuity contract'' under Section 3(a)(8) of the Securities Act if the annuity has two characteristics. As adopted, those characteristics are as follows. First, the contract specifies that amounts payable by the insurance company under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities.[103] Second, amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.[104]

Annuities Subject to Rule 151A

The first characteristic, as proposed and as adopted, is intended to describe indexed annuities, which are the subject of the rule. As proposed, this characteristic would simply have required that amounts payable by the insurance company 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.[105] We have modified this characteristic to address the concern expressed by many commenters that, as proposed, the first characteristic was overly broad and would reach annuities that were not indexed annuities.[106] Commenters were concerned that the rule could, for example, be interpreted as extending to traditional fixed annuities, where amounts payable under the contract accumulate at a fixed interest rate, or to discretionary excess interest contracts, where amounts payable under the contract may include a discretionary excess interest component over and above the guaranteed minimum interest rate offered under the contract.[107] With both traditional fixed annuities and discretionary excess interest contracts, the interest rates are often based, at least in part, on the performance of the securities held by the insurer's general account.

The modified language of the first characteristic addresses commenters' concerns in three ways. First, the language requires that the contract itself specify that amounts payable by the insurance company are calculated by reference to the performance of a security. Thus, a contract will not be covered by the proposed rule unless the insurance company is contractually bound to pay amounts that are

[95] *See* Form N–4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N–6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

[96] Rule 151A(a).

[97] *Id.* We note that the majority of states include in their insurance laws provisions that define annuities. See, *e.g.*, ALA. CODE § 27–5–3 (2008); CAL. INS. CODE § 1003 (West 2007); N.J. ADMIN. CODE tit. 11, § 4–2.2 (2008); N.Y. INS. LAW § 1113 (McKinney 2008). Those states that do not expressly define annuities typically have regulations in place that address annuities. *See, e.g.*, Iowa Admin. Code § 191–15.70 (5078) (2008); Kan. Admin. Regs. § 40–2–12 (2008); Minn. Stat. § 61B.20 (2007); Miss. Code Ann. § 83–1–151 (2008).

[98] One commenter was concerned that rule 151A might apply to a certain type of health insurance contract, where some portion of any favorable financial experience of the insurer is refunded to the insured.'' Letter of America's Health Insurance Plans (Sep. 10, 2008) (''AHIP Letter''). Rule 151A will not apply to contracts that are regulated under state insurance law as health insurance.

[99] *See, e.g.*, Aviva Letter, *supra* note 54; Sammons Letter, *supra* note 54 (requesting clarification that rule 151A does not apply to indexed life insurance policies).

[100] Rule 151A(d).

[101] The assets of a variable annuity are held in a separate account of the insurance company that is insulated for the benefit of the variable annuity owners from the liabilities of the insurance company, and amounts paid to the owner under a variable annuity vary according to the investment experience of the separate account. *See* Black and Skipper, *supra* note 39, at 174–77 (2000).

[102] *See, e.g., VALIC, supra* note 8, 359 U.S. 65; *United Benefit, supra* note 8, 387 U.S. 202. In addition, an insurance company separate account issuing variable annuities is an investment company under the Investment Company Act of 1940. *See Prudential Ins. Co. of Am.* v. *SEC,* 326 F.2d 383 (3d Cir. 1964).

[103] Rule 151A(a)(1).

[104] Rule 151A(a)(2).

[105] Proposed rule 151A(a)(1).

[106] *See, e.g.*, ACLI Letter, *supra* note 94; Allianz Letter, *supra* note 54; Aviva Letter, *supra* note 54; Letter of AXA Equitable Life Insurance Company (Sept. 10, 2008) (''AXA Equitable Letter''); Letter of Financial Services Institute (Sept. 10, 2008) (''FSI Letter''); CAI 151A Letter, *supra* note 54; Hartford Letter, *supra* note 55; NAFA Letter, *supra* note 54; NAIFA Letter, *supra* note 54; Letter of NAVA (Sept. 10, 2008) (''NAVA Letter''); Old Mutual Letter, *supra* note 54; Sammons Letter, *supra* note 54; Second Academy Letter, *supra* note 54; Transamerica Letter, *supra* note 54.

[107] *See, e.g.*, Letter of Association for Advanced Life Underwriting (Oct. 31, 2008); AXA Equitable Letter, *supra* note 106.

dependent upon the performance of a security. While an insurance company may, in fact, look to the performance of the securities in its general account in, for example, establishing the rate to be paid under a traditional fixed annuity, such a contract does not itself obligate the insurer to do so or undertake in any way that the purchaser will receive payments that are linked to the performance of any security. Second, the language requires that the amounts payable by the insurance company be calculated at or after the end of one or more specified crediting periods by reference to the performance during the crediting period of a security. That is, in order to be covered by the rule, an annuity contract must provide that the amount to be paid with respect to a crediting period is determined retrospectively, by reference to the performance during the period of a security. This retrospective determination of amounts to be paid is characteristic of indexed annuities and eliminates from the scope of the rule discretionary excess interest contracts, pursuant to which a specified interest rate may be established by reference to the past performance of a security or securities and applied on a prospective basis with respect to a future crediting period. Third, limiting the rule to contracts where the amount payable is determined retrospectively addresses the concerns of the commenters that the rule, as proposed, could reach annuity contracts covered by the rule 151 safe harbor.[108] As explained above, contracts where the amount payable is determined retrospectively do not fall within rule 151.[109]

Rule 151A, like the proposed rule, will apply whenever any amounts payable under the contract under any circumstances, including full or partial surrender, annuitization, or death, satisfy the first characteristic of the rule. If, for example, a contract specifies that the amount payable under a contract upon a full surrender is not calculated at or after the end of one or more specified crediting periods by reference to the performance during the period or periods of a security, but the amount payable upon annuitization is so calculated, then the contract would need to be analyzed under the rule. As another example, if a contract specifies that amounts payable under the contract are partly fixed in amount and partly dependent on the performance of a security in the manner specified by the rule, the contract would need to be analyzed under the rule.

We note that, like the proposal, rule 151A applies to contracts under which amounts payable are calculated by reference to the performance of a security, including a group or index of securities. Thus, the rule, by its terms, applies to indexed annuities but also to other similar annuities where the contract specifies that amounts payable are retrospectively calculated by reference to a single security or any group of securities.[110] The federal securities laws, and investors' interests in full and fair disclosure and sales practice protections, are equally implicated, whether amounts payable under an annuity are retrospectively calculated by reference to a securities index, another group of securities, or a single security.

The term ''security'' in rule 151A has the same broad meaning as in Section 2(a)(1) of the Securities Act. Rule 151A does not define the term ''security,'' and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Securities Act have the same meanings defined in the Act.[111]

''More Likely Than Not'' Test

The second characteristic sets forth the test that would define a class of indexed annuity contracts that are not ''annuity contracts'' or ''optional annuity contracts'' under the Securities Act and that, therefore, are not entitled to the Section 3(a)(8) exemption. As adopted, the second characteristic defines that class to include those contracts where the amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

We are adopting the second characteristic as proposed. As explained above, by purchasing such an indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns. As a result, the purchaser assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities. The rule that we are adopting will provide the purchaser of such an annuity with the same protections that are provided under the federal securities laws to other investors who participate in the securities markets, including full and fair disclosure regarding the terms of the investment and the significant risks that he or she is assuming, as well as protections from abusive sales practices and the recommendation of unsuitable transactions. Some commenters raised concerns about the proposed rule's treatment of *de minimis* amounts of securities-linked returns.[112] These commenters suggested that the smaller the amount of securities-linked return, the less investment risk is assumed by the purchaser, and the more is assumed by the insurer. In particular, commenters suggested that where the securities-linked return is *de minimis* the purchaser does not assume the primary investment risk under the contract.[113] However, based on our current understanding, we believe that almost all current indexed annuity contracts provide for securities-linked returns that are more likely than not to exceed a *de minimis* amount in excess of the guaranteed return. Nevertheless, in the case of an indexed annuity contract that is more likely than not to provide only a *de minimis* securities-linked return in excess of the guaranteed return, the Commission and the staff would be prepared to consider a request for relief, if appropriate.

Under rule 151A, amounts payable by the insurance company under a contract will be more likely than not to exceed the amounts guaranteed under the contract if this is the expected outcome more than half the time. In order to determine whether this is the case, it will be necessary to analyze expected outcomes under various scenarios involving different facts and circumstances. In performing this analysis, the amounts payable by the insurance company under any particular set of facts and circumstances will be the amounts that the purchaser[114] would be entitled to receive from the insurer under those facts and circumstances. The facts and circumstances include, among other things, the particular features of the annuity contract (*e.g.*, the relevant index, participation rate, and other features), the particular options selected

[108] AXA Equitable Letter, *supra* note 106; Hartford Letter, *supra* note 55; ICI Letter, *supra* note 7; K&L Gates Letter, *supra* note 54.

[109] *See supra* note 38 and accompanying text.

[110] A commenter inquired whether an annuity product whose returns were indexed to the consumer price index, a real estate index, or a commodities index would be considered a security. Letter of Meaghan L. McFadden (Aug. 13, 2008). Rule 151A, by its terms, does not apply to such an annuity.

[111] 17 CFR 230.100(b).

[112] *See, e.g.*, CAI 151A Letter, *supra* note 54; National Western Letter, *supra* note 54; Sammons, *supra* note 54.

[113] *See, e.g.*, CAI 151A Letter, *supra* note 54; National Western Letter, *supra* note 54; Sammons, *supra* note 54.

[114] For simplicity, we are referring to payments to the purchaser. The rule, however, references payments by the insurer without reference to a specified payee. In performing the analysis, payments to any payee, including the purchaser, annuitant, and beneficiaries, must be included.

by the purchaser (*e.g.*, surrender or annuitization), and the performance of the relevant securities benchmark (*e.g.*, in the case of an indexed annuity, the performance of the relevant index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index). The amounts guaranteed under a contract under any particular set of facts and circumstances will be the minimum amount that the insurer would be obligated to pay the purchaser under those facts and circumstances without reference to the performance of the security that is used in calculating amounts payable under the contract. Thus, if an indexed annuity, in all circumstances, guarantees that, on surrender, a purchaser will receive 87.5% of an initial purchase payment, plus 1% interest compounded annually, and that any additional payout will be based exclusively on the performance of a securities index, the amount guaranteed after 3 years will be 90.15% of the purchase payment (87.5% × 1.01 × 1.01 × 1.01).

Determining Whether an Annuity Is Not an ''Annuity Contract'' or ''Optional Annuity Contract'' Under Rule 151A

We are adopting, with modifications to address commenters' concerns, the provisions of proposed rule 151A that address the manner in which a determination will be made regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract. Rule 151A is principles-based, providing that a determination made by the insurer at or prior to issuance of a contract will be conclusive, provided that: (i) Both the insurer's methodology and the insurer's economic, actuarial, and other assumptions are reasonable; (ii) the insurer's computations are materially accurate; and (iii) the determination is made not earlier than six months prior to the date on which the form of contract is first offered.[115] We have eliminated the proposed requirement that the insurer's determination be made not more than three years prior to the date on which a particular contract is issued. The rule specifies the treatment of charges that are imposed at the time of payments under the contract by the insurer, and we have modified the proposal in order to provide for consistent treatment of these charges in computing both amounts payable by the insurance company and amounts guaranteed under the contract.[116]

We are adopting this principles-based approach because we believe that an insurance company should be able to evaluate anticipated outcomes under an annuity that it issues. We believe that many insurers routinely undertake similar analyses for purposes of pricing and valuing their contracts.[117] In addition, we believe that it is important to provide reasonable certainty to insurers with respect to the application of the rule and to preclude an insurer's determination from being second guessed, in litigation or otherwise, in light of actual events that may differ from assumptions that were reasonable when made.

As with all exemptions from the registration and prospectus delivery requirements of the Securities Act, the party claiming the benefit of the exemption—in this case, the insurer—bears the burden of proving that the exemption applies.[118] Thus, an insurer that believes an indexed annuity is entitled to the exemption under Section 3(a)(8) based, in part, on a determination made under the rule will—if challenged in litigation—be required to prove that its methodology and its economic, actuarial, and other assumptions were reasonable, and that the computations were materially accurate.

The rule provides that an insurer's determination under the rule will be conclusive only if it is made at or prior to issuance of the contract. Rule 151A is intended to provide certainty to both insurers and investors, and we believe that this certainty will be undermined unless insurance companies undertake the analysis required by the rule no later than the time that an annuity is issued. The rule also provides that, for an insurer's determination to be conclusive, the computations made by the insurance company in support of the determination must be materially accurate. An insurer should not be permitted to rely on a determination of an annuity's status under the rule that is based on computations that are materially inaccurate. For this purpose, we intend that computations will be considered to be materially accurate if any computational errors do not affect the outcome of the insurer's determination as to whether amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

In order for an insurer's determination to be conclusive, both the methodology and the economic, actuarial, and other assumptions used must be reasonable. We recognize that a range of methodologies and assumptions may be reasonable and that a reasonable methodology or assumption utilized by one insurer may differ from a reasonable assumption or methodology selected by another insurer. In determining whether an insurer's methodology is reasonable, it is appropriate to look to methods commonly used for pricing, valuing, and hedging similar products in insurance and derivatives markets.

An insurer will need to make assumptions in several areas, including assumptions about (i) insurer behavior, (ii) purchaser behavior, and (iii) market behavior, and will need to assign probabilities to various potential behaviors. With regard to insurer behavior, the insurer will need to make assumptions about discretionary actions that it may take under the terms of an annuity. In the case of an indexed annuity, for example, an insurer often has discretion to modify various features, such as guaranteed interest rates, caps, participation rates, and spreads. Similarly, the insurer will need to make assumptions concerning purchaser behavior, including matters such as how long purchasers will hold a contract, how they will allocate contract value among different investment options available under the contract, and the form in which they will take payments under the contract. Assumptions about market behavior will include assumptions about expected return, market volatility, and interest rates. In general, insurers will need to make assumptions about any feature of insurer, purchaser, or market behavior, or any other factor, that is

[115] Rule 151A(b)(2).

[116] Rule 151A(b)(1).

[117] *See generally* Black and Skipper, *supra* note 39, at 26–47, 890–99. Several commenters who issue indexed annuities disputed that insurers undertake these analyses. *See, e.g.*, American Equity Letter, *supra* note 54; National Western Letter, *supra* note 54; Sammons Letter, *supra* note 54. Other commenters, however, confirmed that these analytical methods exist and are used by insurers for internal purposes. *See, e.g.*, Aviva Letter, *supra* note 54; Academy Letter, *supra* note 54. We give substantial weight to the views of the American Academy of Actuaries (''Academy'') on this point, given their expertise in this type of analysis, and are not persuaded that the contrary comments of several issuers are representative of industry practice. See Black's Law Dictionary 39 (8th ed. 2004) (An actuary is a statistician who determines the present effects of future contingent events and who calculates insurance and pension rates on the basis of empirically based tables.); American Academy of Actuaries, Mission, available at: *http://www.actuary.org/mission.asp* (The mission of the Academy is to, among other things, provide independent and objective actuarial information, analysis, and education for the formation of sound public policy.).

[118] *See, e.g.*, SEC v. *Ralston Purina*, 346 U.S. 119, 126 (1953) (an issuer claiming an exemption under Section 4 of the Securities Act carries the burden of showing that the exemption applies).

material in determining the likelihood that amounts payable under the contract exceed the amounts guaranteed.

In determining whether assumptions are reasonable, insurers should generally be guided by both history and their own expectations about the future. An insurer may look to its own, and to industry, experience with similar or otherwise comparable contracts in constructing assumptions about both insurer behavior and investor behavior. In making assumptions about future market behavior, an insurer may be guided, for example, by historical market characteristics, such as historical returns and volatility, provided that the insurer bases its assumptions on an appropriate period of time and does not have reason to believe that the time period chosen is likely to be unrepresentative. As a general matter, assumptions about insurer, investor, or market behavior that are not consistent with historical experience would not be reasonable unless an insurer has a reasonable basis for any differences between historical experience and the assumptions used.

In addition, an insurer may look to its own expectations about the future in constructing reasonable assumptions. As noted above, insurers routinely analyze anticipated outcomes for purposes of pricing and valuing their contracts. We expect that, in making a determination under rule 151A, an insurer will use assumptions that are consistent with the assumptions that it uses for other purposes, such as pricing and valuation. In addition, an insurer generally should use assumptions that are consistent with its marketing materials. In general, assumptions that are inconsistent with the assumptions that an insurer uses for other purposes will not be reasonable under rule 151A.

As noted above, we are adopting a principles-based approach because we believe that it will provide reasonable certainty to insurers with respect to the application of the rule. We recognize, however, that a number of commenters expressed concern that the principles-based approach provides insufficient guidance regarding implementation and the methodologies and assumptions that are appropriate and could result in inconsistent determinations by different insurance companies and present enforcement and litigation risk.[119] Some commenters suggested that the Commission address these concerns by providing guidance as to how to make the determination under the rule, which, they asserted, could result in greater uniformity and consistency in the application of the rule.[120] While we believe that further guidance may, indeed, be helpful in response to specific questions of affected insurance companies, we note that commenters generally did not articulate with specificity the areas where they believe that further guidance is required. As a result, in order to provide guidance in the manner that would be most helpful, we encourage insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance, which we will consider during the two-year period between adoption of rule 151A and its effectiveness.[121]

Like the proposal, rule 151A requires that, in order for an insurer's determination to be conclusive, the determination must be made not more than six months prior to the date on which the form of contract is first offered.[122] For example, if a form of contract were first offered on January 1, 2012, the insurer would be required to make the determination not earlier than July 1, 2011. We are not adopting the proposed requirement that the insurer's determination be made not more than three years prior to the date on which the particular contract is issued.[123] We were persuaded by the commenters that if the status of a form of contract under the federal securities laws were to change, over time, from exempt to non-exempt and vice versa, this would present practical difficulties resulting from the possibility that an annuity could be exempted from registration at one time but be required to be registered subsequently and vice versa, as well as heightened litigation and enforcement risk.[124] We believe that the substantial uncertainties and resulting potential costs introduced by the proposed requirement that a contract's status be redetermined every three years would be inconsistent with the intent of rule 151A, which is to clarify the status of indexed annuities.

Rule 151A, as adopted, requires that, in determining whether amounts payable by the insurance company are more likely than not to exceed the amounts guaranteed, both amounts payable and amounts guaranteed are to be determined by taking into account all charges under the contract, including, without limitation, charges that are imposed at the time that payments are made by the insurance company.[125] For example, surrender charges would be deducted from both amounts payable and amounts guaranteed under the contract. This is a change from the proposal, which would have required that, in determining whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract, amounts payable be determined without reference to any charges that are imposed at the time of payment, such as surrender charges, while those charges would be reflected in computing the amounts guaranteed under the contract.[126]

We are making the foregoing change because we are persuaded by commenters who argued that the proposed provision could result in contracts being determined not to be entitled to the Section 3(a)(8) exemption irrespective of the likelihood of securities-linked return being included in the amount payable.[127] Specifically, commenters argued that as long as the surrender charge is in effect, the amount payable would always exceed the amount guaranteed if the surrender

[119] *See, e.g.*, Academy Letter, *supra* note 54; ACLI Letter, *supra* note 94; Aviva Letter, *supra* note 54; AXA Equitable Letter, *supra* note 106; CAI 151A Letter, *supra* note 54; FINRA Letter, *supra* note 7; Letter of Genesis Financial Products, Inc. (Aug. 29, 2008) (''Genesis Letter''); Letter of Janice Hart (Aug. 15, 2008) (''Hart Letter''); ICI Letter, *supra* note 7; National Western Letter, *supra* note 54; Sammons Letter, *supra* note 54.

[120] *See, e.g.*, FINRA Letter, *supra* note 7; Hart Letter, *supra* note 119; ICI Letter, *supra* note 7; NAIC Officer Letter, *supra* note 54.

[121] *See infra* text accompanying notes 129 and 130.

[122] Rule 151A(b)(2)(iii).

[123] Proposed rule 151A(b)(2)(C).

[124] *See, e.g.*, Aviva Letter, *supra* note 54; Sammons Letter, *supra* note 54. *See* also ICI Letter, *supra* note 7 (possibility that indexed annuity's status under the federal securities laws could change is not consistent with the purposes of the federal securities laws).

[125] Rule 151A(b)(1). In many cases, amounts guaranteed under annuities are not affected by charges imposed at the time payments are made by the insurer under the contract. This is a result of the fact that guaranteed minimum value, as commonly defined in indexed annuity contracts, equals a percentage of purchase payments, accumulated at a specified interest rate, as explained above, and this amount is not subject to surrender charges. However, under some indexed annuity contracts, the amounts guaranteed are affected by charges imposed at the time payments are made. For example, a purchaser buys a contract for $100,000. The contract defines surrender value as the greater of (i) purchase payments plus index-linked interest minus surrender charges or (ii) the guaranteed minimum value. The maximum surrender charge is equal to 10%. The guaranteed minimum value is defined in the contract as 87.5% of premium accumulated at 1% annual interest. If the purchaser surrenders within the first year of purchase, and there is no index-linked interest credited, the surrender value would equal $90,000 (determined under clause (i) as $100,000 purchase payment minus 10% surrender charge), and this amount would be the guaranteed amount under the contract, not the lower amount defined in the contract as guaranteed minimum value ($87,500).

[126] Proposed rule 151A(b)(1).

[127] *See, e.g.*, Aviva Letter, *supra* note 54; CAI 151A Letter, *supra* note 54; Coalition Letter, *supra* note 54.

charge were subtracted from the latter but not the former. The commenters further argued that bona fide surrender charges should not result in a contract being deemed a security, since a surrender charge is an expense and does not represent a transfer of risk from insurer to contract purchaser. Because the rule, as adopted, requires surrender charges to be subtracted from both amounts payable and amounts guaranteed, the surrender charges will not affect the determination of whether a contract is a security (*i.e.*, the determination of whether amounts payable are more likely than not to exceed the amounts guaranteed).

Effective Date

The effective date of rule 151A is January 12, 2011. We originally proposed that rule 151A, if adopted, would be effective 12 months after publication in the **Federal Register**. We are persuaded by commenters, however, that additional time is required for, among other things, making the determinations required by the rule, preparing registration statements for indexed annuities that are required to be registered, and establishing the needed infrastructure for distributing registered indexed annuities.[128] Based on the comments, we believe that a January 12, 2011 effective date will provide the time needed to accomplish these tasks.[129] We note that, during this period, the Commission intends to consider how to tailor disclosure requirements for indexed annuities and will also consider any requests for additional guidance that we receive concerning the determinations required under rule 151A.[130]

The new definition in rule 151A will apply prospectively as we proposed—that is, only to indexed annuities issued on or after January 12, 2011. We are using our definitional rulemaking authority under Section 19(a) of the Securities Act, and the explicitly prospective nature of our rule is consistent with similar prospective rulemaking that we have undertaken in the past when doing so was appropriate and fair under the circumstances.[131]

We are aware that many insurance companies and sellers of indexed annuities, such as insurance agents, broker-dealers, and registered representatives of broker-dealers, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this rulemaking. Under these circumstances, we do not believe that issuers and sellers of indexed annuities should be subject to any additional legal risk relating to their past offers and sales of indexed annuity contracts as a result of the proposal and adoption of rule 151A.[132]

Several commenters requested clarification of the statement that rule 151A will apply prospectively to indexed annuities issued on or after the rule's effective date (*i.e.*, January 12, 2011).[133] As a result, we are clarifying that if an indexed annuity has been issued to a particular individual purchaser prior to January 12, 2011, then that specific contract between that individual and the insurance company (including any additional purchase payments made under the contract on or after January 12, 2011) is not subject to rule 151A, and its status under the federal securities laws is to be determined under the law as it existed without reference to rule 151A. By contrast, if an indexed annuity is issued to a particular individual purchaser on or after January 12, 2011, then that specific contract between that individual and the insurance company is subject to rule 151A, even if the same form of indexed annuity was offered and sold prior to January 12, 2011, and even if the individual contract issued on or after January 12, 2011, is issued under a group contract that was in place prior to January 12, 2011.

The Commission believes that permitting new sales of an existing form of contract (as opposed to additional purchase payments made under a specific existing contract between an individual and an insurance company) after the rule's effective date without reference to the rule is contrary to the purpose of the rule. If the rule were not applicable to all contracts issued on or after the effective date without regard to when the forms of the contracts were originally sold, then two substantially similar contracts could be sold after the effective date, one not subject to the rule and one subject to the rule, even though they present the same level of risk to the purchaser and present the same need for investor protection. The fact that one was designed and released into the marketplace prior to January 12, 2011, and the other was designed and released into the marketplace after that date should not be a determining factor as to the availability of the protections of the federal securities laws. We note that, because we have extended the effective date to January 12, 2011, insurers should have adequate time to prepare for compliance with rule 151A.

Some commenters raised concerns that the registration of an indexed annuity as required by rule 151A could cause offers and sales of the same annuity that occurred on an unregistered basis after adoption but prior to the effective date of the rule, January 12, 2011, to be unlawful under Section 5 of the Securities Act.[134]

We reiterate that nothing in this adopting release is intended to affect the current analysis of the legal status of indexed annuities until the effective date of rule 151A. Therefore, after the adoption of rule 151A but prior to the effective date of the rule:

- An indexed annuity issuer making unregistered offers and sales of a contract that will not be an ''annuity contract'' or ''optional annuity contract'' under rule 151A may continue to do so until the effective date of rule 151A without such offers and sales being

[128] Letter of American International Group (Sept. 10, 2008) (''AIG Letter''); Aviva Letter, *supra* note 54; CAI 151A Letter, *supra* note 54; NAVA Letter, *supra* note 106; Letter of New York Life Insurance Company (Sept. 18, 2008) (''NY Life Letter''); Sammons Letter, *supra* note 54.

[129] AIG Letter, *supra* note 128 (recommending transition period of 2 years); Aviva Letter, *supra* note 54 (at least 24 months); CAI 151A Letter, *supra* note 54 (24 months); Letter of NAVA (Nov. 17, 2008) (''Second NAVA Letter'') (at least 24 months); NY Life Letter, *supra* note 128 (at least 24 months).

[130] *See supra* text accompanying notes 95 and 121.

[131] *See, e.g.*, Securities Act Release No. 4896 (Feb. 1, 1968) [33 FR 3142, 3143 (Feb. 17, 1968)] (''The Commission is aware that for many years issuers of the securities identified in this rule have not considered their obligations to be separate securities and that they have acted in reliance on the view, which they believed to be the view of the Commission, that registration under the Securities Act was not required. Under the circumstances, the Commission does not believe that such issuers are subject to any penalty or other damages resulting from entering into such arrangements in the past. Paragraph (b) provides that the rule shall apply to transactions of the character described in paragraph (a) only with respect to bonds or other evidence of indebtedness issued after adoption of the rule.''). *See also* Securities Act Release No. 5316 (Oct. 6, 1972) [37 FR 23631, 23632 (Nov. 7, 1972)] (''The Commission recognizes that the 'no-sale' concept has been in existence in one form or another for a long period of time. * * * The Commission believes, after a thorough reexamination of the studies and proposals cited above, that the interpretation embodied in Rule 133 is no longer consistent with the statutory objectives of the [Securities] Act. * * * Rule 133 is rescinded prospectively on and after January 1, 1973. * * *'').

[132] *See* FSI Letter, *supra* note 106 (asking for clarification that, like insurance company issuers, independent broker-dealers and their affiliated financial advisers are not subject to any additional legal risk relating to past offers and sales of indexed annuities as a result of rule 151A).

[133] *See, e.g.*, AIG Letter, *supra* note 128; Hartford Letter, *supra* note 55; Letter of North American Securities Administrators Association (Sept. 10, 2008) (''NASAA Letter'').

[134] *See, e.g.,* Aviva Letter, *supra* note 54; CAI 151A Letter, *supra* note 54; Sammons Letter, *supra* note 54.

unlawful under Section 5 of the Securities Act as a result of the pending effectiveness of rule 151A; and

• An indexed annuity issuer that wishes to register a contract that will not be an ''annuity contract'' or ''optional annuity contract'' under rule 151A may continue to make unregistered offers and sales of the same annuity until the earlier of the effective date of the registration statement or the effective date of the rule without such offers and sales being unlawful under Section 5 of the Securities Act as a result of the pending effectiveness of rule 151A.

Annuities Not Covered by the Definition

Rule 151A applies to annuities where the contract specifies that amounts payable by the insurance company under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities. The rule defines certain of those annuities (annuities under which amounts payable by the issuer are more likely than not to exceed the amounts guaranteed under the contract) as not ''annuity contracts'' or ''optional annuity contracts'' under Section 3(a)(8) of the Securities Act. The rule, however, does not provide a safe harbor under Section 3(a)(8) for any other annuities, including any other indexed annuities. The status under the Securities Act of any annuity, other than an annuity that is determined under rule 151A to be not an ''annuity contract'' or ''optional annuity contract,'' continues 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.[135]

Some commenters suggested that the Commission, instead of adopting a rule that defines certain indexed annuities as not being ''annuity contracts'' under Section 3(a)(8), should instead define a safe harbor that would provide that indexed annuities that meet certain conditions are entitled to the Section 3(a)(8) exemption.[136] We are not adopting this approach for two reasons. First, such a rule would not address in any way the federal interest in providing investors with disclosure, antifraud, and sales practice protections that arise when individuals are offered indexed annuities that expose them to investment risk. A safe harbor would address circumstances where purchasers of indexed annuities are not entitled to the protections of the federal securities laws; one of our primary goals is to address circumstances where purchasers of indexed annuities are entitled to the protections of the federal securities laws. We are concerned that many purchasers of indexed annuities today should be receiving the protections of the federal securities laws, but are not. Rule 151A addresses this problem; a safe harbor rule would not. Second, we believe that, under many of the indexed annuities that are sold today, the purchaser bears significant investment risk and is more likely than not to receive a fluctuating, securities-linked return. In light of that fact, we believe that is far more important to address this class of contracts with our definitional rule than to address the remaining contracts, or some subset of those contracts, with a safe harbor rule.

B. Exchange Act Exemption for Securities That Are Regulated as Insurance

The Commission is also adopting new rule 12h–7 under the Exchange Act, which provides an insurance company with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities issued by the company that are registered under the Securities Act and regulated as insurance under state law.[137] Sixteen commenters supported the exemption.[138] No commenters opposed the exemption. We are adopting this exemption, with changes to the proposal that address commenters' concerns, because we believe that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. We base that view on two factors: first, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of those activities and assets under state insurance law; and, second, the absence of trading interest in the securities.[139] The new rule imposes conditions to the exemption that relate to these factors and that we believe are necessary or appropriate in the public interest and consistent with the protection of investors.

State insurance regulation is focused on insurance company solvency and the adequacy of insurers' reserves, with the ultimate purpose of ensuring that insurance companies are financially secure enough to meet their contractual obligations.[140] State insurance regulators require insurance companies to maintain certain levels of capital, surplus, and risk-based capital; restrict the investments in insurers' general accounts; limit the amount of risk that may be assumed by insurers; and impose requirements with regard to valuation of insurers' investments.[141] Insurance companies are required to file annual reports on their financial condition with state insurance regulators. In addition, insurance companies are subject to periodic examination of their financial condition by state insurance regulators. State insurance regulators also preside over the conservation or liquidation of companies with inadequate solvency.[142]

State insurance regulation, like Exchange Act reporting, relates to an entity's financial condition. We are of the view that, in appropriate circumstances, it may be unnecessary for both to apply in the same situation, which may result in duplicative regulation that is burdensome. Through Exchange Act reporting, issuers periodically disclose their financial condition, which enables investors and the markets to independently evaluate an issuer's income, assets, and balance sheet. State insurance regulation takes a different approach to the issue of financial condition, instead relying on

[135] As noted in Part II.B., above, indexed annuities are not entitled to rely on the rule 151 safe harbor.

[136] *See, e.g.,* Academy Letter, *supra* note 54; AIG Letter, *supra* note 128; Aviva Letter, *supra* note 54; Second Academy Letter, *supra* note 54; Second Aviva Letter, *supra* note 54; Second Transamerica Letter, *supra* note 54; Letter of Life Insurance Company of the Southwest (Sept. 10, 2008) (''Southwest Letter''); Voss Letter, *supra* note 13.

[137] The Commission received a petition requesting that we propose a rule that would exempt issuers of certain types of insurance contracts from Exchange Act reporting requirements. Letter from Stephen E. Roth, Sutherland Asbill & Brennan LLP, on behalf of Jackson National Life Insurance Co., to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Dec. 19, 2007) (File No. 4–553) available at: *http://www.sec.gov/rules/petitions/2007/petn4-553.pdf.*

[138] *See, e.g.,* ACLI Letter, *supra* note 94; Allianz Letter, *supra* note 54; AXA Equitable Letter, *supra* note 106; Letter of Committee of Annuity Insurers regarding proposed rule 12h–7 (Sept. 10, 2008) (''CAI 12h–7 Letter''); FSI Letter, *supra* note 106; Letter of Great-West Life & Annuity Insurance Company (Sept. 10, 2008) (''Great-West Letter''); ICI Letter, *supra* note 7; Letter of MetLife, Inc. (Sept. 11, 2008) (''MetLife Letter''); NAVA Letter, *supra* note 106; Sammons Letter, *supra* note 54.

[139] *See* Section 12(h) of the Exchange Act [15 U.S.C. 78*l*(h)] (Commission may, by rules, exempt any class of issuers from the reporting provisions of the Exchange Act ''if the Commission finds, by reason of the number of public investors, *amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer,* or otherwise, that such action is not inconsistent with the public interest or the protection of investors.'') (emphasis added).

[140] Black and Skipper, *supra* note 39, at 949.

[141] *Id.* at 949 and 956–59.

[142] *Id.* at 949.

state insurance regulators to supervise insurers' financial condition, with the goal that insurance companies be financially able to meet their contractual obligations. We believe that it is consistent with our federal system of regulation, which has allocated the responsibility for oversight of insurers' solvency to state insurance regulators, to exempt insurers from Exchange Act reporting with respect to state-regulated insurance contracts. Commenters asserted that, in light of the protections available under state insurance regulation, periodic reporting under the Exchange Act by state-regulated insurers does not enhance investor protection with respect to the securities covered under the rule.[143]

Our conclusion is strengthened by the general absence of trading interest in insurance contracts. Insurance is typically purchased directly from an insurance company. While insurance contracts may be assigned in some circumstances, they typically are not listed or traded on securities exchanges or in other markets. As a result, outside the context of publicly owned insurance companies, there is little, if any, market interest in the information that is required to be disclosed in Exchange Act reports.

1. The Exemption

Rule 12h–7 provides an insurance company that is covered by the rule with an exemption from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of the Exchange Act with respect to certain securities registered under the Securities Act.[144]

Covered Insurance Companies

The Exchange Act exemption applies to an issuer that is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States.[145] In the case of a variable annuity contract or variable life insurance policy, the exemption applies to the insurance company that issues the contract or policy. However, the exemption does not apply to the insurance company separate account in which the purchaser's payments are invested and which is separately registered as an investment company under the Investment Company Act of 1940 and is not regulated as an insurance company under state law.[146]

Covered Securities

The exemption applies with respect to securities that do not constitute an equity interest in the insurance company issuer and that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.[147] The exemption does not apply with respect to any other securities issued by an insurance company. As a result, if an insurance company issues securities with respect to which the exemption applies, and other securities that do not entitle the insurer to the exemption, the insurer will remain subject to Exchange Act reporting obligations. For example, if an insurer that is a publicly held stock company[148] also issues insurance contracts that are registered securities under the Securities Act, the insurer generally would be required to file Exchange Act reports as a result of being a publicly held stock company. Similarly, if an insurer raises capital through a debt offering, the exemption does not apply with respect to the debt securities.

The exemption is available with respect to securities that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.[149] Rule 12h–7 is a broad exemption that applies to any contract that is regulated under the insurance laws of the insurer's home state because we intend that the exemption apply to all contracts, and only those contracts, where state insurance law, and the associated regulation of insurer financial condition, applies. A key basis for the exemption is that investors are already entitled to the financial condition protections of state law and that, under our federal system of regulation, Exchange Act reporting may be unnecessary. Therefore, we believe it is important that the reach of the exemption and the reach of state insurance law be the same. A single commenter addressed the scope of securities with respect to which the proposed exemption would apply, supporting the Commission's approach and noting that limiting the exemption to enumerated types of securities would require the Commission to revisit the rule every few years, or would provide a significant barrier to the introduction of new investment products.[150]

The Exchange Act exemption applies both to certain existing types of insurance contracts and to types of contracts that are developed in the future and that are registered as securities under the Securities Act. The exemption applies to indexed annuities that are registered under the Securities Act. However, the Exchange Act exemption is independent of rule 151A and applies to types of contracts in addition to those that are covered by rule 151A. There are at least two types of existing insurance contracts with respect to which the Exchange Act exemption applies, contracts with so-called ''market value adjustment'' (''MVA'') features and insurance contracts that provide certain

[143] CAI 12h–7 Letter, *supra* note 138; ICI Letter, *supra* note 7; MetLife Letter, *supra* note 138.

[144] Introductory paragraph to rule 12h–7. *Cf.* Rule 12h–3(a) under the Exchange Act [17 CFR 240.12h–3(a)] (suspension of duty under Section 15(d) of the Exchange Act to file reports with respect to classes of securities held by 500 persons or less where total assets of the issuer have not exceeded $10,000,000); Rule 12h–4 under the Exchange Act [17 CFR 240.12h–4] (exemption from duty under Section 15(d) of the Exchange Act to file reports with respect to securities registered on specified Securities Act forms relating to certain Canadian issuers).

Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement that has become effective under the Securities Act to file reports and other information and documents required under Section 13 of the Exchange Act [15 U.S.C. 78m] with respect to issuers registered under Section 12 of the Exchange Act [15 U.S.C. 78*l*]. Section 13(a) of the Exchange Act [15 U.S.C. 78m(a)] requires issuers of securities registered under Section 12 of the Act to file annual reports and other documents and information required by Commission rule.

[145] Rule 12h–7(a). The Exchange Act defines ''State'' as any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. Section 3(a)(16) of the Exchange Act [15 U.S.C. 78c(a)(16)]. The term ''State'' in rule 12h–7 has the same meaning as in the Exchange Act. Rule 12h–7 does not define the term ''State,'' and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Exchange Act have the same meanings defined in the Exchange Act. *See* rule 240.0–1(b) [17 CFR 240.0–1(b)].

[146] The separate account's Exchange Act reporting requirements are deemed to be satisfied by filing annual reports on Form N–SAR. 17 CFR 274.101. *See* Section 30(d) of the Investment Company Act [15 U.S.C. 80a–30(d)] and rule 30a–1 under the Investment Company Act [17 CFR 270.30a–1].

[147] Rule 12h–7(a)(2).

[148] A stock life insurance company is a corporation authorized to sell life insurance, which is owned by stockholders and is formed for the purpose of earning a profit for its stockholders. This is in contrast to another prevailing insurance company structure, the mutual life insurance company. In this structure, the corporation authorized to sell life insurance is owned by and operated for the benefit of its policy owners. Black and Skipper, *supra* note 39, at 577–78.

[149] A domiciliary state is the jurisdiction in which an insurer is incorporated or organized. *See* National Association of Insurance Commissioners Model Laws, Regulations and Guidelines 555–1, § 104 (2007).

[150] Great-West Letter, *supra* note 138.

guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.

Contracts including MVA features have, for some time, been registered under the Securities Act.[151] Insurance companies issuing contracts with these features have also complied with Exchange Act reporting requirements.[152] MVA features have historically been associated with annuity and life insurance contracts that guarantee a specified rate of return to purchasers.[153] In order to protect the insurer against the risk that a purchaser may make withdrawals from the contract at a time when the market value of the insurer's assets that support the contract has declined due to rising interest rates, insurers sometimes impose an MVA upon surrender. Under an MVA feature, the insurer adjusts the proceeds a purchaser receives upon surrender prior to the end of the guarantee period to reflect changes in the market value of its portfolio securities supporting the contract.[154]

More recently, some insurance companies have registered under the Securities Act insurance contracts that provide certain guarantees in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.[155] As a result, the insurers become subject to Exchange Act reporting requirements if they are not already subject to those requirements. These contracts, often called ''guaranteed living benefits,'' are intended to provide insurance to the purchaser against the risk of outliving the assets held in the mutual fund, brokerage, or investment advisory account.[156]

As noted above, the Exchange Act exemption also applies with respect to a guarantee of a security if the guaranteed security is subject to regulation under state insurance law.[157] We are adopting this provision because we believe that it is appropriate to exempt from Exchange Act reporting an insurer that provides a guarantee of an insurance contract (that is also a security) when the insurer would not be subject to Exchange Act reporting if it had issued the guaranteed contract. This situation may arise, for example, when an insurance company issues a contract that is a security and its affiliate, also an insurance company, provides a guarantee of benefits provided under the first company's contract.[158]

Finally, the exemption is not available with respect to any security that constitutes an equity interest in the issuing insurance company. As a general matter, an equity interest in an insurer is not covered by the exemption because it is not subject to regulation under state insurance law and often is publicly traded. Nonetheless, we believe that the rule should expressly preclude any security that constitutes an equity interest in the issuing insurance company from being covered by the exemption. Where investors own an equity interest in an issuing insurance company, and are therefore dependent on the financial condition of the issuer for the value of that interest, we believe that they have a significant interest in directly evaluating the issuers' financial condition for themselves on an ongoing basis and that Exchange Act reporting is appropriate.

2. Conditions to Exemption

As described above, we believe that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the existence of state regulation of insurers' financial condition and because of the general absence of trading interest in insurance contracts. The Exchange Act exemption that we are adopting, like the proposal, is subject to conditions that are designed to ensure that both of these factors are, in fact, present in cases where an insurance company is permitted to rely on the exemption. We have modified the conditions related to trading interest in one respect to address the concerns of commenters. We have also added a condition to the proposed rule in order to address a commenter's concern.

Regulation of Insurer's Financial Condition

In order to rely on the exemption, an insurer must file an annual statement of its financial condition with, and the insurer must be supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or any officer performing like functions, of the insurer's domiciliary state.[159] Commenters did not address this condition, and we are adopting this condition as proposed. This condition is intended to ensure that an insurer claiming the exemption is, in fact, subject to state insurance regulation of its financial condition. Absent satisfaction of this condition, Exchange Act reporting would not be duplicative of state insurance regulation, and the exemption would not be available.

Absence of Trading Interest

The Exchange Act exemption is subject to two conditions intended to insure that there is no trading interest in securities with respect to which the exemption applies, and we are modifying the proposed conditions in one respect to address the concerns of commenters. First, the securities may not be listed, traded, or quoted on an exchange, alternative trading system,[160] inter-dealer quotation system,[161] electronic communications network, or any other similar system, network, or publication for trading or quoting.[162] This condition is designed to ensure that there is no established trading market for the securities. Second, the issuing insurance company must take steps reasonably designed to ensure that a trading market for the securities does

[151] Securities Act Release No. 6645, *supra* note 35, 51 FR at 20256–58.

[152] *See, e.g.,* ING Life Insurance and Annuity Company (Annual Report on Form 10–K (Mar. 31, 2008)); Protective Life Insurance Company (Annual Report on Form 10–K (Mar. 31, 2008)); Union Security Insurance Company (Annual Report on Form 10–K (Mar. 3, 2008)).

[153] Some indexed annuities also include MVA features. *See, e.g.,* Pre-Effective Amendment No. 4 to Registration Statement on Form S–1 of PHL Variable Insurance Company (File No. 333–132399) (filed Feb. 7, 2007); Initial Registration Statement on Form S–1 of ING USA Annuity and Life Insurance Company (File No. 333–133153) (filed Apr. 7, 2006); Pre-Effective Amendment No. 2 to Registration Statement on Form S–3 of Allstate Life Insurance Company (File No. 333–117685) (filed Dec. 20, 2004).

[154] See Proposing Release, *supra* note 3, 73 FR at 37764 (describing MVA features).

[155] *See, e.g.,* PHL Variable Life Insurance Company, File No. 333–137802 (Form S–1 filed Feb. 25, 2008); Genworth Life and Annuity Insurance Company, File No. 333–143494 (Form S–1 filed Apr. 4, 2008).

[156] *See* Proposing Release, *supra* note 3, 73 FR at 37764 (describing guaranteed living benefits).

[157] The Securities Act defines ''security'' in Section 2(a)(1) of the Act [15 U.S.C. 77b(a)(1)]. That definition provides that a guarantee of any of the instruments included in the definition is also a security.

[158] For example, an insurance company may offer a registered variable annuity, and a parent or other affiliate of the issuing insurance company may act as guarantor for the issuing company's insurance obligations under the contract.

[159] Rule 12h–7(c). *Cf.* Section 26(f)(2)(B)(ii) and (iii) of the Investment Company Act [15 U.S.C. 80a–26(f)(2)(B)(ii) and (iii)] (using similar language in requirements that apply to insurance companies that sell variable insurance products).

[160] For this purpose, ''alternative trading system'' would have the same meaning as in Regulation ATS. *See* 17 CFR 242.300(a) (definition of ''alternative trading system'').

[161] For this purpose, ''inter-dealer quotation system'' would have the same meaning as in Exchange Act rule 15c2–11. *See* 17 CFR 240.15c2–11(e)(2) (definition of ''inter-dealer quotation system'').

[162] Rule 12h–7(d).

not develop.[163] This includes, except to the extent prohibited by the law of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States,[164] or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any state, requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis. This condition is designed to ensure that the insurer takes reasonable steps to ensure the absence of trading interest in the securities.

We are adopting the first condition, relating to the absence of listing, trading, and quoting on any exchange or similar system, network, or publication for trading or quoting, as proposed. We are not adopting the suggestion of a commenter that the Commission limit this condition to exchanges and other similar systems, networks, and publications for trading or quoting that are registered with, or regulated by, the Commission or a self-regulatory organization.[165] The commenter argued that, absent this limitation, insurance companies would be placed in the position of enforcing the Commission's requirements by identifying any exchanges and other similar systems, networks, and publications for trading or quoting that may arise from time to time and operate in violation of the Commission's rules and regulations. We disagree that this limitation is appropriate. We have determined that the exemption provided by rule 12h–7 is necessary or appropriate in the public interest and consistent with the protection of investors, in part, because of the absence of trading interest in the insurance contracts covered by the exemption. We do not believe that there would be an absence of trading interest where an insurance contract trades on an exchange or similar system, network, or publication for trading or quoting, whether regulated by the Commission or not.

We are modifying the second condition, which requires the issuing insurance company to take steps reasonably designed to ensure that a trading market for the securities does not develop. As the condition was proposed, this would have included requiring written notice to, and acceptance by, the insurance company prior to any assignment or transfer of the securities and reserving the right to refuse assignments or other transfers of the securities at any time on a non-discriminatory basis.[166] Under the adopted rule, these particular steps will continue to be required, except to the extent that they are prohibited by the law of any state or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any state.

This modification addresses the concern expressed by several commenters that the proposed condition could, in some circumstances, be inconsistent with applicable state law.[167] The commenters stated that some states may not permit restrictions on transfers or assignments and, indeed, that some states specifically grant contract owners the right to transfer or assign their contracts. In proposing the condition relating to restrictions on assignment, it was not our intent to require restrictions that are inconsistent with applicable state law. Our modification to rule 12h–7 clarifies this and, accordingly, addresses the commenters' concern.

Three commenters requested that the second condition be removed in its entirety.[168] These commenters stated that the second condition is unnecessary, because the first should give sufficient comfort that a trading market will not arise. The commenters also stated that this condition would be difficult to apply. One of the commenters stated that the condition is ambiguous, and that there is no clear definition of ''trading market'' in the federal securities laws.[169] We continue to believe that the second condition is important because it will ensure that the issuer takes steps reasonably designed to preclude the development of a trading market. We do not believe that, as modified to address concerns about inconsistency with state law, the second condition will be unduly difficult to apply.

Two commenters requested that rule 12h–7 include a transition period for filing required reports under the Exchange Act for any insurance company previously relying on the rule that no longer meets its conditions.[170] We do not believe that it would be appropriate to include such a transition period because, if an insurer no longer meets the conditions, this generally would mean that either the securities are not regulated as insurance under state law or the securities are traded or may become traded. In such a case, the very basis on which we are granting the exemption would no longer exist. Therefore, we have determined not to include such a transition period in rule 12h–7. If an issuer no longer meets the conditions of the rule, it will immediately become subject to the filing requirements of the Exchange Act. We would, in any event, expect situations where an insurance company ceases to meet the conditions of rule 12h–7 to be extremely rare. In such a case, at an insurer's request, we would consider, based on the particular facts and circumstances, whether individual exemptive relief to provide for a transition period would be appropriate.

Prospectus Disclosure

We are adding a condition to proposed rule 12h–7 to require that, in order for an insurer to be entitled to the Exchange Act exemption provided by the rule with respect to securities, the prospectus for the securities must contain a statement indicating that the issuer is relying on the exemption provided by the rule.[171] This addresses a commenter's request that the Commission clarify that reliance on the exemption is optional because some insurers may conclude that the benefits that flow from the ability to incorporate by reference Exchange Act reports may outweigh any costs associated with filing those reports.[172] The new condition will permit an insurance company that desires to remain subject to Exchange Act reporting requirements to do so by omitting the required statement from its prospectus. The new provision also has the advantage of providing notice to investors of an insurer's reliance on the exemption. An insurer who does not include this statement will be subject to mandatory Exchange Act reporting.[173]

[163] Rule 12h–7(e).

[164] *See supra* note 145 for a discussion of the term ''State'' as used in rule 12h–7.

[165] CAI 12h–7 Letter, *supra* note 138.

[166] Proposed rule 12h–7(e).

[167] Allianz Letter, *supra* note 54; CAI 12h–7 Letter, *supra* note 138; ICI Letter, *supra* note 7; NAVA, *supra* note 106; Sammons Letter, *supra* note 54.

[168] CAI 12h–7 Letter, *supra* note 138; Sammons Letter, *supra* note 54; Transamerica Letter, *supra* note 54; Second Transamerica Letter, *supra* note 54.

[169] CAI 12h–7 Letter, *supra* note 138.

[170] Letter of Committee of Annuity Insurers regarding proposed rule 12h–7 (Nov. 17, 2008) (''Second CAI 12h–7 Letter''); Second Transamerica Letter, *supra* note 54.

[171] Rule 12h–7(f).

[172] CAI 12h–7 Letter, *supra* note 138. *See* Form S–1, General Instruction VII.A. (incorporation by reference permitted only if, among other things, registrant subject to Exchange Act reporting requirements); Form S–3, General Instruction I.A.2. (Form S–3, which permits incorporation by reference, available to registrant that, among other things, is required to file Exchange Act reports).

[173] As described above, the exemption applies to an insurance company that issues a variable annuity contract or variable life insurance policy,

Continued

3. Effective Date

The effective date of rule 12h–7 is May 1, 2009.

IV. Paperwork Reduction Act

A. Background

Rule 151A contains no new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[174] However, we believe that rule 151A will result in an increase in the disclosure burden associated with existing Form S–1 as a result of additional filings that will be made on Form S–1.[175] Form S–1 contains ''collection of information'' requirements within the meaning of the PRA. Although we are not amending Form S–1, we have submitted the Form S–1 ''collection of information'' (''Form S–1 Registration Statement'' (OMB Control No. 3235–0065)), which we estimate will increase as a result of rule 151A, to the Office of Management and Budget (''OMB'') for review and approval in accordance with the PRA.[176] We published notice soliciting comment on the increase in the collection of information requirements in the release proposing rule 151A and submitted the proposed collection of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11.

We adopted Form S–1 pursuant to the Securities Act. This form sets forth the disclosure requirements for registration statements that are prepared by eligible issuers to provide investors with the information they need to make informed investment decisions in registered offerings. We anticipate that, absent amendments to our disclosure requirements to specifically address indexed annuities, indexed annuities that register under the Securities Act would generally register on Form S–1.[177] As a result, we have assumed, for purposes of our PRA analysis, that this would be the case. We note, however, that we are providing a two-year transition period for rule 151A and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities.[178]

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The information collection requirements related to registration statements on Form S–1 are mandatory. There is no mandatory retention period for the information disclosed, and the information disclosed will be made publicly available on the EDGAR filing system.

B. Summary of Information Collection

Because rule 151A will affect the number of filings on Form S–1 but not the disclosure required by this form, we do not believe that the rules will impose any new recordkeeping or information collection requirements. However, we expect that some insurance companies will register indexed annuities in the future that they would not previously have registered. We believe this will result in an increase in the number of annual responses expected with respect to Form S–1 and in the disclosure burden associated with Form S–1. At the same time, we expect that, on a per response basis, rule 151A will decrease the existing disclosure burden for Form S–1. This is because the disclosure burden for each indexed annuity on Form S–1 is likely to be lower than the existing burden per respondent on Form S–1. The decreased burden per response on Form S–1 will partially offset the increased burden resulting from the increase in the annual number of responses on Form S–1. We believe that, in the aggregate, the disclosure burden for Form S–1 will increase as a result of the adoption of rule 151A.

C. Paperwork Reduction Act Burden Estimates

For purposes of the PRA, we estimate that the rule will result in an annual increase in the paperwork burden for companies to comply with the Form S–1 collection of information requirements of approximately 60,000 hours of in-house company personnel time and approximately $72,000,000 for the services of outside professionals. These estimates represent the combined effect of an expected increase in the number of annual responses on Form S–1 and a decrease in the expected burden per response. These estimates include the time and the cost of preparing and reviewing disclosure, filing documents, and retaining records. Our methodologies for deriving the above estimates are discussed below.

We are adopting a new definition of ''annuity contract'' that, on a prospective basis, defines a class of indexed annuities that are not ''annuity contracts'' or ''optional annuity contracts'' for purposes of Section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities will, on a prospective basis, be required to register under the Securities Act on Form S–1.[179]

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but not to the associated separate account. *See supra* note 146 and accompanying text. On or after the effective date of rule 12h–7, the prospectus for a variable insurance contract with respect to which the insurer does not file Exchange Act reports (and therefore is relying on rule 12h–7) will be required to include the statement that the insurer is relying on rule 12h–7.

[174] 44 U.S.C. 3501 *et seq.*

[175] 17 CFR 239.11.

[176] 44 U.S.C. 3507(d); 5 CFR 1320.11.

[177] Some Securities Act offerings are registered on Form S–3 [17 CFR 239.13]. We do not believe that rule 151A will have any significant impact on the disclosure burden associated with Form S–3 because we believe that very few, if any, insurance companies that issue indexed annuities will be eligible to register those contracts on Form S–3. In order to be eligible to file on Form S–3, an issuer must, among other things, have filed Exchange Act reports for a period of at least 12 calendar months. General Instruction I.A.3. of Form S–3. Very few insurance companies that issue indexed annuities are currently eligible to file Form S–3. Further, any insurance companies that issue indexed annuities and rely on the Exchange Act reporting exemption that we are adopting will not meet the eligibility requirements for Form S–3. We believe that very few, if any, issuers of indexed annuities will choose to be subject to the reporting requirements of the Exchange Act because of the costs that this would impose. In any event, the number of indexed annuity issuers that choose to be subject to the reporting requirements of the Exchange Act would be insignificant compared to the total number of Exchange Act reporting companies, which is approximately 12,100. The number of indexed annuity issuers in 2007 was 58. NAVA, *supra* note 9, at 57.

We also do not believe that the rules will have any significant impact on the disclosure burden associated with reporting under the Exchange Act on Forms 10 K, 10 Q, and 8 K. As a result of rule 12h–7, insurance companies will not be required to file Exchange Act reports on these forms in connection with indexed annuities that are registered under the Securities Act, and, as noted in the prior paragraph, we believe that very few, if any, issuers of indexed annuities will choose to be subject to the reporting requirements of the Exchange Act because of the costs that this would impose. While rule 12h 7 will permit some insurance companies that are currently required to file Exchange Act reports as a result of issuing insurance contracts that are registered under the Securities Act, to cease filing those reports, the number of such companies is insignificant compared to the total number of Exchange Act reporting companies. Likewise, we do not believe that the prospectus statement required under rule 12h–7 for insurers relying on that rule will have any significant impact on the disclosure burden associated with registration statements for insurance contracts that are securities (Forms S–1, S–3, N–3, N–4, and N–6). We do not believe that the currently approved collections of information for these forms will change based on the rule 12h–7 prospectus statement.

[178] As noted above, some commenters expressed concern about what they believed to be a lack of a registration form that is well-suited to indexed annuities. *See supra* text accompanying notes 94 and 95.

[179] Some Securities Act offerings are registered on Form S–3, but we believe that very few, if any, insurance companies that issue indexed annuities

We received numerous comment letters on the proposal, and we have revised proposed rule 151A in response to the comments. However, we do not believe that any of the modifications affect the estimated reporting and cost burdens discussed in this PRA analysis. These modifications include:

○ Revising the proposed definition so that the rule will apply to a contract that specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities;[180]

○ Eliminating the provision in proposed rule 151A that the issuer's determination as to whether amounts payable under the contract are more likely than not to exceed the amounts guaranteed under the contract be made not more than three years prior to the date on which the particular contract is issued;[181] and

○ Adopting a requirement that amounts payable by the issuer and amounts guaranteed are to be determined by taking into account all charges under the contract, including, without limitation, charges that are imposed at the time that payments are made by the issuer.[182]

We do not believe that any of these changes will affect the annual increase in the number of responses on Form S–1 or the hours per response required. As we state below, we assume that all indexed annuities that are offered on or after January 12, 2011, will be registered, and that each of the 400 registered indexed annuities will be the subject of one response per year on Form S–1. We do not expect the changes in the rule, as adopted, to affect our estimates of the increase in the number of annual responses required on Form S–1. The first change, revising the scope of the rule, addresses commenters' concerns that the rule was overly broad and would reach annuities that were not indexed annuities, such as traditional fixed annuities and discretionary excess interest contracts. While the revision clarifies the intended scope of the rule to address these concerns, our PRA estimates with respect to the proposed rule were based on the intended scope of the proposed rule, which did not extend to these other types of annuities. As a result, this change has no effect on our estimates of the number of responses required on Form S–1. Our PRA estimates assume that all indexed annuities that are offered will be registered, and we do not believe that this assumption is affected by the elimination of the requirement that an insurer's determination under rule 151A be made not more than three years prior to the date on which a particular contract is issued or the change to the manner of taking charges into account under the rule. In addition, the changes in the rule will not affect the information required to be disclosed by Form S–1, or the time required to prepare and file the form.

Increase in Number of Annual Responses

For purposes of the PRA, we estimate that there will be an annual increase of 400 responses on Form S–1 as a result of the rule. In 2007, there were 322 indexed annuity contracts offered.[183] For purposes of the PRA analysis, we assume that 400 indexed annuities will be offered each year. This allows for some escalation in the number of contracts offered in the future over the number offered in 2007. Our Office of Economic Analysis has considered the effect of the rule on indexed annuity contracts with typical terms and has determined that these contracts would not meet the definition of ''annuity contract'' or ''optional annuity contract'' if they were to be issued after the effective date of the rule. Therefore, we assume that all indexed annuities that are offered will be registered, and that each of the 400 registered indexed annuities will be the subject of one response per year on Form S–1,[184] resulting in the estimated annual increase of 400 responses on Form S–1.

Decrease in Expected Hours per Response

For purposes of the PRA, we estimate that there will be a decrease of 120 hours per response on Form S–1 as a result of the rule. Current OMB approved estimates and recent Commission rulemaking estimate the hours per response on Form S–1 as 950.[185] The current hour estimate represents the burden for all issuers, both large and small. We believe that registration statements on Form S–1 for indexed annuities will result in a significantly lower number of hours per response, which, based on our experience with other similar contracts, we estimate as 600 hours per indexed annuity response on Form S–1. We attribute this lower estimate to two factors. First, the estimated 400 indexed annuity registration statements will likely be filed by far fewer than 400 different insurance companies,[186] and a significant part of the information in each of the multiple registration statements filed by a single insurance company will be the same, resulting in economies of scale with respect to the multiple filings. Second, many of the 400 responses on Form S–1 each year will be annual updates to registration statements for existing contracts, rather than new registration statements, resulting in a significantly lower hour burden than a new registration statement.[187] Combining our estimate of 600 hours per indexed annuity response on Form S–1 (for an estimated 400 responses) with the existing estimate of 950 hours per response on Form S–1 (for an estimated 768 responses),[188] our new estimate is 830 hours per response $(((400 \times 600) + (768 \times 950))/1168)$.

Net Increase in Burden

To calculate the total effect of the rules on the overall compliance burden for all issuers, large and small, we added the burden associated with the 400 additional Forms S–1 that we estimate will be filed annually in the future and subtracted the burden associated with our reduced estimate of 830 hours for each of the current estimated 768 responses. We used current OMB approved estimates in our calculation of the hours and cost burden associated with preparing, reviewing, and filing Form S–1.

Consistent with current OMB approved estimates and recent Commission rulemaking,[189] we estimate that 25% of the burden of preparation of Form S–1 is carried by the company

will be eligible to register those contracts on Form S–3. *See supra* note 177.

[180] Rule 151A(a)(1).

[181] Proposed Rule 151A(b)(2)(iii).

[182] Rule 151A(b)(1).

[183] *See* NAVA, *supra* note 9, at 57.

[184] Annuity contracts are typically offered to purchasers on a continuous basis, and as a result, an insurer offering an annuity contract that is registered under the Securities Act generally will be required to update the registration statement once a year. *See* Section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)] (when prospectus used more than 9 months after effective date of registration statement, information therein generally required to be not more than 16 months old).

[185] These estimates have been revised by other rules that the Commission has adopted, and OMB approval is pending. *See* Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8876, available at: *http://www.reginfo.gov/public/do/DownloadDocument?documentID=90204&version=0* (''33–8876 Supporting Statement'').

[186] The 322 indexed annuities offered in 2007 were issued by 58 insurance companies. *See* NAVA, *supra* note 9, at 57.

[187] *See supra* note 184.

[188] *See* 33–8876 Supporting Statement, *supra* note 185.

[189] *See* Securities Act Release No. 8878 (Dec. 19, 2007) [72 FR 73534, 73547 (Dec. 27, 2007)].

internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of $400 per hour.[190] The portion of the burden carried by outside professionals is reflected as a cost, while the burden carried by the company internally is reflected in hours.

The tables below illustrate our estimates concerning the incremental annual compliance burden in the collection of information in hours and cost for Form S–1.

INCREMENTAL PRA BURDEN DUE TO INCREASED FILINGS

Estimated increase in annual responses	Hours/ response	Incremental burden (hours)
400	830	332,000

INCREMENTAL DECREASE IN PRA BURDEN DUE TO DECREASE IN HOURS PER RESPONSE

Estimated decrease in hours/response	Current estimated number of annual filings	Incremental decrease in burden (hours)
(120)	768	(92,200)

SUMMARY OF CHANGE IN INCREMENTAL COMPLIANCE BURDEN

Incremental burden (hours)	25% Issuer (hours)	75% Professional (hours)	$400/hr. professional cost
240,000	60,000	180,000	$72,000,000

D. Response to Comments on Commission's Paperwork Reduction Act Analysis

A few commenters commented on the Commission's Paperwork Reduction Act analysis in the Proposing Release.[191] One commenter stated that external costs of registering indexed annuities on Form S–1 will vary considerably depending on whether the insurer has previously prepared a Form S–1.[192] The commenter stated that, for insurers that have not previously prepared a Form S–1 registration statement, external legal costs could be as high as $250,000–$500,000 for each registration statement. The same commenter estimated external legal costs for an issuer that has previously filed a Form S–1 at $50,000–$100,000. Another commenter estimated external legal costs for preparation and filing of a Form S–1 registration statement with the SEC at $350,000 for the first few years, which, the commenter stated, would decrease over time as the insurer gained more expertise.[193] However, these commenters did not specify the sources of these cost estimates or how they were made.

As stated above, we estimate the average burden per indexed annuity response on Form S–1 to be 600 hours. We further estimate that 75% of that burden will be carried by outside professionals retained by the issuer at an average cost of $400 per hour. Accordingly, we estimate the cost for outside professionals for each indexed annuity registration statement on Form S–1 to be on average $180,000 ((600 × .75) × $400). We do not believe that it is necessary to change our estimate of outside professional costs based on the commenters' estimated costs. The $250,000–$500,000 range cited by the commenters is for an issuer that has not previously filed a Form S–1, with commenters acknowledging that the costs to an experienced filer would be lower (as low as $50,000–$100,000). Our $180,000 estimate reflects outside professional costs incurred not only by first-time Form S–1 filers, but also the costs of preparing Form S–1 for contracts offered by experienced Form S–1 filers, as well as annual updates to existing Form S–1 registration statements, which we expect to be significantly lower than costs incurred by first-time filers.

One commenter cites a cost of $255,000 for the insurer to prepare a registration statement.[194] It is not clear whether this cost represents only external costs or total costs. The commenter also estimates the cost of preparing a registration statement for certain types of carriers at $62,500 [195] and further indicates that there are 27 such carriers issuing indexed annuities, which is approximately half the number of insurers currently issuing indexed annuities.[196] Because the commenter does not provide information as to the basis for the $255,000 figure, and because the $62,500 figure is substantially below the Commission's estimate of $180,000, we are not revising our estimate of the burden of registering an indexed annuity on Form S–1 to reflect these estimates.

Another commenter stated that the Commission's estimate of outside professional costs of $400 per hour does not reflect market rates for securities counsel.[197] However, the commenter did not cite a different rate and did not explain the basis for its disagreement with the $400 per hour rate cited by the Commission. Our estimate of $400 per hour for outside professionals retained by the issuer is consistent with recent rulemakings and is based on discussions between our staff and several law firms.[198] Accordingly, we are not changing our estimate of the cost per hour of outside professional costs. The commenter further stated that the estimates of time involved are low for persons unfamiliar with the process of registration of securities under the federal securities laws and the anticipated need for interaction with Commission staff. However, as discussed, our estimate of time required to prepare a registration statement reflects time needed not only by first-time Form S–1 filers, but also the time involved in preparing Form S–1 for contracts offered by experienced Form S–1 filers, as well as annual updates to the existing Form S–1 registration statement, which we expect to be significantly less than time needed by first-time filers. We are not revising our estimate of time involved in preparing registration statements on Form S–1.

V. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. Rule 151A is intended to clarify the status under the federal securities laws

[190] *Id.* at note 110 and accompanying text.

[191] *See, e.g.,* Allianz Letter, *supra* note 54; Second Aviva Letter, *supra* note 54; Letter of National Association for Fixed Annuities (Nov. 17, 2008) (''Second NAFA Letter''); Transamerica Letter, *supra* note 54.

[192] Allianz Letter, *supra* note 54.

[193] Second Aviva Letter, *supra* note 54.

[194] Second NAFA Letter, *supra* note 191.

[195] This estimate is for carriers ''without variable authority.'' The commenter does not explain the meaning of the phrase ''without variable authority.''

[196] NAVA, *supra* note 9, at 57 (58 companies issued indexed anuities in 2007).

[197] Transamerica Letter, *supra* note 54.

[198] *See, e.g.,* Securities Act Release No. 8909 (Apr. 10, 2008) [73 FR 20512, 20515 (Apr. 15, 2008)] (''Revisions to Form S–11 Release'').

of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption for certain insurance contracts. The rule prospectively defines certain indexed annuities as not being ''annuity contracts'' or ''optional annuity contracts'' under this insurance exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. With respect to these annuities, investors are entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections. We are also adopting new rule 12h–7 under the Exchange Act, which exempts certain insurance companies from Exchange Act reporting with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law.

In the Proposing Release, we identified certain costs and benefits and requested comment on our cost-benefit analysis, including identification of any costs and benefits not discussed. We also requested that commenters provide empirical data and factual support for their views.

Discussed below is our analysis of the costs and benefits of rules 151A and 12h–7, as well as the issues raised by commenters. As noted above, we are sensitive to the costs imposed by our rules and we have estimated the costs associated with adoption of rule 151A. We emphasize, however, that the burdens of complying with the federal securities laws apply to all market participants who issue or sell securities under the federal securities laws. Rule 151A, by defining those indexed annuities that are not entitled to the Section 3(a)(8) exemption, does not impose any greater or different burdens than those imposed on other similarly situated market participants. Rather, the effect of rule 151A is that issuers and sellers of indexed annuities that are not entitled to the Section 3(a)(8) exemption are treated in the same manner under the federal securities laws as issuers and sellers of other registered securities, and that investors purchasing these instruments receive the same disclosure, antifraud, and sales practice protections that apply when they are offered and sold other securities that pose similar investment risks.

A. Benefits

We anticipate that the rules will benefit investors and covered institutions by: (i) Creating greater regulatory certainty with regard to the status of indexed annuities under the federal securities laws; (ii) enhancing disclosure of information needed to make informed investment decisions about indexed annuities; (iii) applying sales practice protections to those indexed annuities that are outside the insurance exemption; (iv) enhancing competition; and (v) relieving from Exchange Act reporting obligations insurers that issue certain securities that are regulated as insurance under state law.

Regulatory Certainty

Rule 151A will provide the benefit of increased regulatory certainty to insurance companies that issue indexed annuities and the distributors who sell them, as well as to purchasers of indexed annuities. The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court. Rule 151A will bring greater certainty into this area by defining a class of indexed annuities that are outside the scope of the insurance exemption and by providing that an insurer's determination, in accordance with the rule, will be conclusive.

Indexed annuities possess both insurance and securities features, and fall somewhere between traditional fixed annuities, which are clearly insurance falling within Section 3(a)(8), and variable annuities, which are clearly securities. We have carefully considered where to draw the line, and we believe that the line that we have drawn is rational and reasonably related to fundamental concepts of risk and insurance.

Some commenters agreed that the proposal would provide greater regulatory certainty.[199] One commenter stated that current uncertainty regarding the status of indexed annuities has impeded the ability of regulators to protect indexed annuity consumers,[200] and another stated that it is apparent that clarification is needed and will set a clear national standard of regulatory oversight for indexed annuities.[201] Some commenters, however, expressed concern that the principles-based approach provides insufficient guidance regarding implementation and the methodologies and assumptions that are appropriate and could result in inconsistent determinations by different insurance companies and present enforcement and litigation risk.[202] While we believe that further guidance may be helpful in response to specific questions from affected insurance companies, commenters generally did not articulate with specificity the areas where they believe that further guidance is required. As a result, in order to provide guidance in the manner that would be most helpful, we encourage insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance, which we will consider during the two-year period between adoption of rule 151A and its effectiveness.

Disclosure

Rule 151A extends the benefits of full and fair disclosure under the federal securities laws to investors in indexed annuities that, under the rule, fall outside the insurance exemption. Without such disclosure, investors face significant obstacles in making informed investment decisions with regard to purchasing indexed annuities that expose them to investment risk. Indexed annuities are similar in many ways to mutual funds, variable annuities, and other securities. Investors in indexed annuities are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Extending the federal securities disclosure regime to indexed annuities under which amounts payable by the insurer are more likely than not to exceed the amounts guaranteed should help to provide investors with the information they need.

Disclosures 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. This information will be public and accessible to all investors, intermediaries, third party information providers, and others through the

[199] *See, e.g.*, Advantage Group Letter, *supra* note 54; Cornell Letter, *supra* note 7; FINRA Letter, *supra* note 7; ICI Letter, *supra* note 7; Letter of State of Washington Department of Financial Institutions Securities division (Nov. 17, 2008) (''Washington State Letter'').

[200] FINRA Letter, *supra* note 7.

[201] Washington State Letter, *supra* note 199.

[202] *See supra* note 119.

Commission's Electronic Data Gathering, Analysis and Retrieval (''EDGAR'') system. Public availability of this information will be helpful to investors in making informed decisions about purchasing indexed annuities. The information will enhance investors' ability to compare various indexed annuities and also to compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. The potential liability for materially false and misleading statements and omissions under the federal securities laws will provide additional encouragement for accurate and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell them.[203]

In addition, we believe that potential purchasers of indexed annuities that an insurer determines do not fall outside the insurance exemption under the rule may benefit from enhanced information that will help a purchaser to evaluate the value of the contract and, specifically, the index-based return. Specifically, an indexed annuity that is not registered under the Securities Act after the effective date of rule 151A would reflect the insurer's determination that investors in the annuity will not receive more than the amounts guaranteed under the contract at least half the time.

A number of commenters acknowledged the need for improved disclosures and agreed that indexed annuity purchasers will benefit from disclosures required under the federal securities laws.[204] These commenters noted that indexed annuities are complicated products that can confuse experienced investment professionals and consumers, and strongly supported rule 151A as improving critical disclosures about these products. One commenter expressed strong support for enhanced disclosures regarding critical costs of indexed annuities, such as surrender charges, and the method of computing indexed returns, as well as guaranteed interest rates.[205] Another commenter noted that the Commission could greatly improve consumer protection by subjecting indexed annuities that are not ''annuity contracts'' under rule 151A to the ''thorough, standardized, accessible, and transparent disclosure requirements and antifraud rules of the federal securities laws.'' [206]

However, some commenters argued that the proposed rule would not result in enhanced disclosure, in particular because the Commission's disclosure scheme is not tailored to indexed annuities and Form S–1 is not well-suited to indexed annuities.[207] We acknowledge that, as a result of indexed annuity issuers having historically offered and sold their contracts without complying with the federal securities laws, the Commission has not created specific disclosure requirements tailored to these products. This fact, though, is not relevant in determining whether indexed annuities are subject to the federal securities laws. The Commission has a long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance.[208] We note that we are providing a two-year transition period for rule 151A, and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities. We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.

Some commenters also cited recent efforts by state insurance regulators to address disclosure concerns with respect to indexed annuities as evidence that federal securities regulation is unnecessary.[209] However, as we state above, we disagree. We do not believe that the states' regulatory efforts, no matter how strong, can substitute for our obligation to identify securities covered by the federal securities laws and the protections Congress intended to apply. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws.

We have carefully considered the concerns raised by commenters, and we continue to believe that rule 151A will greatly enhance disclosures regarding indexed annuities. In addition to the specific benefits described above, we anticipate that these enhanced disclosures will also benefit the overall financial markets and their participants.

We anticipate that the disclosure of terms of indexed annuities will be broadly beneficial to investors, enhancing the efficiency of the market for indexed annuities through increased competition. Disclosure will make information on indexed annuity contracts, including terms, publicly available. Public availability of terms will better enable investors to compare indexed annuities and may focus attention on the price competitiveness of these products. It will also improve the ability of third parties to price contracts, giving purchasers a better understanding of the fees implicit in the products. We anticipate that third-party information providers may provide services to price or compare terms of different indexed annuities. Analogously, we note that public disclosure of mutual fund information has enabled third-party information aggregators to facilitate comparison of fees.[210] We believe that increasing the level of price transparency and the resulting competition through enhanced disclosure regarding indexed annuities would be beneficial to investors. It could also expand the size of the market, as investors may have increased confidence that indexed annuities are competitively priced.

Sales Practice Protections

Investors will also benefit because, under the federal securities laws, persons effecting transactions in indexed annuities that fall outside the insurance exemption under rule 151A will be required to be registered broker-dealers or become associated persons of a broker-dealer through a networking arrangement. Thus, the broker-dealer sales practice protections will apply to transactions in registered indexed annuities. As a result, investors who purchase these indexed annuities after the effective date of rule 151A will receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities will be subject to supervision by the broker-dealer with which they are associated. Both the selling broker-dealer and its registered representatives will be subject to the oversight of FINRA.[211] The registered broker-dealers

[203] *See, e.g.*, Section 12(a)(2) of the Securities Act [15 U.S.C. 77*l*(a)(2)] (imposing liability for materially false or misleading statements in a prospectus or oral communication, subject to a reasonable care defense). *See also* Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)]; rule 10–5 under the Exchange Act [17 CFR 240.10b–;5]; Section 17 of the Securities Act [15 U.S.C. 77q] (general antifraud provisions).

[204] *See, e.g.*, Alabama Letter, *supra* note 72; Cornell Letter, *supra* note 7; FPA Letter, *supra* note 72; Hartford Letter, *supra* note 55.

[205] FPA Letter, *supra* note 72.

[206] Hartford Letter, *supra* note 55.

[207] *See supra* note 94 and accompanying text.

[208] *See* Form N–4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N–6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

[209] *See supra* note 81 and accompanying text.

[210] *See, e.g.*, FINRA, Fund Analyzer, available at: *http://www.finra.org/fundanalyzer* (''FINRA Fund Analyzer'').

[211] *Cf.* NASD Rule 2821 (rule designed to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted

will also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as be subject to the Commission's general inspections and, where warranted, enforcement powers.

A number of commenters agreed that indexed annuity purchasers will benefit from the sales practice protections accorded by the federal securities laws.[212] These commenters indicated that sales practice protections accorded by the federal securities laws are the most effective means of preventing abusive sales practices. Some commenters specifically stated that the protections of the federal securities laws are needed for the protection of seniors in the indexed annuity marketplace.[213]

As stated above, however, a number of commenters argued that, because of efforts by state insurance regulators to address sales practice concerns with respect to indexed annuities, federal securities regulation is unnecessary and could result in duplicative or overlapping regulation.[214] Commenters cited, in particular, the adoption by the majority of states of the NAIC Suitability in Annuity Transactions Model Regulation.[215] Commenters also cited the existence of state market conduct examinations, the use of state enforcement and investigative authority, licensing and education requirements applicable to insurance agents who sell indexed annuities, and a number of recent and ongoing efforts by state insurance regulators.[216] Commenters also noted recent efforts by state regulators addressed to annuities generally, such as the creation of NAIC working groups to review and consider possible improvements to the NAIC Suitability in Annuity Transactions Model Regulation.[217]

However, for the same reasons that we do not believe recent state disclosure efforts can substitute for federally required disclosures, we do not believe that the state's efforts to address sales practice concerns, no matter how strong, can substitute for our responsibility to identify securities covered by the statutes and the protections Congress intended to apply. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws.[218] Where the purchaser of an indexed annuity assumes the investment risk of an instrument that fluctuates with the securities markets, and the contract therefore does not fall within the Section 3(a)(8) exemption, the application of state insurance regulation, no matter how effective, is not determinative as to whether the contract is subject to the federal securities laws.

Enhanced Competition

Rule 151A may result in enhanced competition among indexed annuities, as well as between indexed annuities and other competing financial products, such as mutual funds and variable annuities. Rule 151A will result in enhanced disclosure, and, as a result, more informed investment decisions by potential investors, which may enhance competition among indexed annuities and competing products. The greater clarity that results from rule 151A may enhance competition as well because insurers who may have been reluctant to issue indexed annuities while their status was uncertain may now decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities. Further, we believe that the Exchange Act exemption may enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption will reduce the regulatory costs associated with doing so. Increased competition may benefit investors through improvements in the terms of insurance products and other financial products, such as reductions of direct or indirect fees.

We anticipate that the disclosure of terms of indexed annuities will be broadly beneficial to investors, enhancing the efficiency of the market for indexed annuities through increased competition. Disclosure will make information on indexed annuity contracts, including terms, publicly available. Public availability of terms will better enable investors to compare indexed annuities and may focus attention on the price competitiveness of these products. It will also improve the ability of third parties to price contracts, giving purchasers a better understanding of the fees implicit in the products. We anticipate that third-party information providers may provide services to price or compare terms of different indexed annuities. Analogously, we note that public disclosure of mutual fund information has enabled third-party information aggregators to facilitate comparison of fees.[219] We believe that increasing the level of price transparency and the resulting competition through enhanced disclosure regarding indexed annuities would be beneficial to investors. It could also expand the size of the market, as investors may have increased confidence that indexed annuities are competitively priced.

A number of commenters argued that proposed rule 151A would hinder competition, citing a number of factors that they argued would result in indexed annuities becoming less available.[220] Commenters indicated that they did not believe that broker-dealers would become more willing to sell indexed annuities.[221] They stated that

protection to investors regarding deferred variable annuities). *See* Order Approving FINRA's NASD Rule 2821 Regarding Members' Responsibilities for Deferred Variable Annuities (Approval Order), Securities Exchange Act Release No. 56375 (Sept. 7, 2007), 72 FR 52403 (Sept. 13, 2007) (SR–NASD–2004–183); Corrective Order, Securities Exchange Act Release No. 56375A (Sept. 14, 2007), 72 FR 53612 (September 19, 2007) (SR–NASD–2004–183) (correcting the rule's effective date).

[212] *See, e.g.*, Alabama Letter, *supra* note 72; Cornell Letter, *supra* note 7; FPA Letter, *supra* note 72; FINRA Letter, *supra* note 7; Hartford Letter, *supra* note 55; Wyoming Letter, supra note 72.

[213] Alabama Letter, *supra* note 72; Wyoming Letter, *supra* note 72.

[214] *See supra* note 81 and accompanying text.

[215] NAIC Suitability in Annuity Transactions Model Regulation (Model 275–1) (2003). National Association of Insurance Commissioners, Draft Model Summaries, available at: *http://www.naic.org/committees_models.htm. See, e.g.,* Letter A, *supra* note 76; American Bankers Letter, *supra* note 74; CAI 151A Letter, *supra* note 54; NAFA Letter, *supra* note 54; NAIC Officer Letter, *supra* note 54; NAIFA Letter, *supra* note 54.

[216] *See, e.g.*, American Equity Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54; Iowa Letter, *supra* note 74; Maryland Letter, *supra* note 54; NAIC Officer Letter, *supra* note 54; NAFA Letter, *supra* note 54.

[217] *See, e.g.*, NAIC Officer Letter, *supra* note 54.

[218] Indeed, at least one state regulator acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts. *See* Voss Letter, *supra* note 13.

[219] *See, e.g.*, FINRA Fund Analyzer, *supra* note 210.

[220] *See, e.g.*, Advantage Group Letter, *supra* note 54; Allianz Letter, *supra* note 54; American Equity Letter, *supra* note 54; American National Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54; FBL Letter, *supra* note 73; National Western Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Southwest Letter, *supra* note 136.

We note that a number of commenters supporting the proposal are industry participants, such as insurers, *see, e.g.*, Hartford letter, *supra* note 55, and industry groups, *see, e.g.*, ICI letter, *supra* note 7.

[221] *See, e.g.*, Allianz Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54.

broker-dealers have limited ''shelf space'' for new products.[222] One commenter stated that a broker-dealer would incur start-up costs in selling indexed annuities, such as becoming familiar with the products, performing due diligence, setting up supervisory systems, introducing appropriate technology, and becoming licensed to sell insurance, and these costs would deter a broker-dealer from selling indexed annuities.[223] A number of commenters stated that many agents currently selling indexed annuities would stop selling them, rather than incur the costs of becoming licensed to sell securities and becoming associated with a broker-dealer.[224] Two commenters stated that some agents would not be able to associate with a broker-dealer due to remote locations of the agents, so that rural areas would be underserved.[225] Commenters further pointed to obstacles to distributors networking with registered broker-dealers.[226] Commenters also stated that some insurance companies may stop issuing indexed annuities, because of the rule's adverse impact on distribution and because of the costs that the rule would impose on insurers, such as the cost of registering indexed annuities.[227]

The Commission believes that there could be costs associated with diminished competition as a result of rule 151A. As the commenters note, some insurance companies may stop issuing indexed annuities, and some broker-dealers and agents may determine not to sell indexed annuities. We recognize that the impact of rule 151A on competition may be mixed, but, on balance, we continue to believe that rule 151A will provide the benefits described above and has the potential to increase competition. In this regard, the demand for financial products is relatively fixed, in the aggregate. Any potential reduction in indexed annuities sold under the rule would likely correspond with an increase in the sale of other financial products, such as mutual funds or variable annuities. Thus, total reductions in competition may not be significant, when effects on the financial industry as a whole, including insurance companies together with other providers of financial instruments, are considered. Within the insurance industry, if some insurers cease selling indexed annuities, it is also likely that these insurers will sell other products through the same distribution channels, such as annuities with fixed interest rates.

Relief From Reporting Obligations

The exemption from Exchange Act reporting requirements with respect to certain securities that are regulated as insurance under state law will provide a cost savings to insurers. We have identified approximately 24 insurance companies that currently are subject to Exchange Act reporting obligations solely as a result of issuing insurance contracts that are securities and that we believe will be entitled to an exemption from Exchange Act reporting obligations under rule 12h–7.[228] We estimate that, each year, these insurers file an estimated 24 annual reports on Form 10–K, 72 quarterly reports on Form 10–Q, and 26 reports on Form 8–K.[229] Based on current cost estimates, we believe that the total estimated annual cost savings to these companies will be approximately $15,414,600.[230]

One commenter estimated a higher cost savings.[231] The commenter estimated costs of $1.5–$2 million annually for an issuer to comply with Exchange Act reporting obligations. Under our current cost estimates, we estimate that it costs $642,275 per issuer[232] to comply with these obligations. We are not revising our estimate, however, because the commenter did not explain how it arrived at its estimate and we have no basis for determining whether or not it is accurate.

B. Costs

While the rules we are adopting will result in significant cost savings for insurers as a result of the exemption from Exchange Act reporting requirements, we believe that there will be costs associated with the rules. These include costs associated with: (i) Determining under rule 151A whether amounts payable by the insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract; (ii) preparing and filing required Securities Act registration statements with the Commission; (iii) printing prospectuses and providing them to investors; (iv) entering into a networking arrangement with a registered broker-dealer for those entities that are not currently parties to a networking arrangement or registered as broker-dealers and that intend to distribute indexed annuities that are registered as securities;[233] (v) loss of revenue to insurance companies that determine to cease issuing indexed annuities; and (vi) diminished competition that may result.

Some commenters opined that the benefits of the proposal to indexed annuity purchasers would outweigh any costs to the indexed annuity industry.[234] One commenter, for example, recognized that the proposal would impose some compliance costs

[222] *See, e.g.,* Allianz Letter, *supra* note 54; Aviva Letter, *supra* note 54.

[223] Allianz Letter, *supra* note 54.

[224] *See, e.g.,* Allianz Letter, *supra* note 54; American Equity Letter, *supra* note 54; Aviva Letter, *supra* note 54; Coalition Letter, *supra* note 54.

[225] Second Old Mutual Letter, *supra* note 76; Southwest Letter, *supra* note 136.

[226] *See, e.g.,* American Equity Letter, *supra* note 54; Coalition Letter, *supra* note 54; Old Mutual Letter, *supra* note 54.

[227] *See, e.g.,* Aviva Letter, *supra* note 54; National Western Letter, *supra* note 54; Old Mutual Letter, *supra* note 54.

[228] In addition, because we are adopting both rules 151A and 12h–7, insurers that currently are not Exchange Act reporting companies and that will be required to register indexed annuities under the Securities Act will be entitled to rely on the Exchange Act exemption and obtain the benefits of the exemption. We have not included potential cost savings to these companies in our computation because they are not currently Exchange Act reporting companies.

[229] These estimates are based on the requirement to file one Form 10–K each year and three Forms 10–Q each year, and on our review of the actual number of Form 8–K filings by these insurers in calendar year 2007.

[230] This consists of $8,748,950 attributable to internal personnel costs, representing 49,994 burden hours at $175 per hour, and $6,665,600 attributable to the costs of outside professionals, representing 16,664 burden hours at $400 per hour. Our estimates of $175 per hour for internal time and $400 per hour for outside professionals are consistent with the estimates that we have used in recent rulemaking releases.

Our total burden hour estimate for Forms 10–K, 10–Q, and 8–K is 66,658 hours, which, consistent with current OMB estimates and recent Commission rulemaking, we have allocated 75% (49,994 hours) to the insurers internally and 25% (16,664 hours) to outside professional time. *See* Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8819, available at: *http://www.reginfo.gov/public/do/DownloadDocument?documentID=42924&version=1.* The total burden hour estimate was derived as follows. The burden attributable to Form 10–K is 52,704 hours, representing 24 Forms 10–K at 2,196 hours per Form 10–K. The burden attributable to Form 10–Q is 13,824 hours, representing 72 Forms 10–Q at 192 hours per Form 10–Q. The burden attributable to Form 8–K is 130 hours, representing 26 Forms 8–K at 5 hours per Form 8–K. The burden hours per response for Form 10–K (2,196 hours), Form 10–Q (192 hours), and Form 8–K (5 hours) are consistent with current OMB estimates.

[231] Great-West Letter, *supra* note 138.

[232] The $642,275 cost was derived by dividing the total annual cost savings for all insurance companies that we believe will be entitled to the rule 12h–7 exemption ($15,414,600) by the number of such companies (24). *See supra* text accompanying notes 228 and 230.

[233] While some distributors may register as broker-dealers or cease distributing indexed annuities that will be required to be registered as a result of rule 151A, based on our experience with insurance companies that issue insurance products that are also securities, we believe that the vast majority will continue to distribute those indexed annuities via networking arrangements with registered broker-dealers, as discussed below.

[234] *See, e.g.,* Cornell Letter, *supra* note 7; NASAA Letter, *supra* note 133.

on the indexed annuity industry, but stated that these costs are minimal relative to the gains to investors in regulatory oversight.[235] The commenter stated that the rule would bring clarity regarding the status of indexed annuities under the federal securities laws and would subject indexed annuity sales to the application of suitability and antifraud protections under the federal securities laws.

A number of other commenters, however, stated that the Commission significantly underestimated the costs of the proposal.[236] As discussed below, these commenters stated that the proposal would impose substantial costs throughout the industry, affecting insurers, agents, marketing organizations. Commenters also stated that consumers would face additional costs as a result of the proposal, as the costs of product development and offering and selling registered securities are passed on to consumers.[237] We also received a number of comments specifically stating that the proposal would have an adverse impact on small entities, such as small insurance distributors.[238]

The following is a more detailed discussion of specific costs that we believe will be associated with the rule. We specifically identified and discussed each of these costs in the Proposing Release. We received comments on each identified cost.

Determination Under Rule 151A

Insurers may incur costs in performing the analysis necessary to determine whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts guaranteed under the contract. This analysis calls for the insurer to analyze expected outcomes under various scenarios involving different facts and circumstances. Insurers routinely undertake such analyses for purposes of pricing and valuing their contracts.[239] As a result, we believe that the costs of undertaking the analysis for purposes of the rule may not be significant. However, the determinations necessary under the rule may result in some additional costs for insurers that issue indexed annuities, either because the timing of the determination does not coincide with other similar analyses undertaken by the insurer or because the level or type of actuarial and legal analysis that the insurer determines is appropriate under the rule is different or greater than that undertaken for other purposes, or for other reasons. These costs, if any, could include the costs of software, as well as the costs of internal personnel and external consultants (*e.g.*, actuarial, accounting, legal).

Several commenters who issue indexed annuities disputed that insurers undertake these analyses.[240] Other commenters, however, confirmed that these analytical methods exist and are used by insurers for internal purposes.[241] We continue to believe that because insurers routinely undertake these types of analyses, the costs of doing so for purposes of the rule may not be significant.

Securities Act Registration Statements

As noted above, we believe that significant benefits arise from the registration of indexed annuities, including enhanced disclosures of critical information regarding these products. Without such disclosure, investors face significant obstacles in making informed investment decisions with regard to purchasing indexed annuities that expose investors to securities investment risk. Investors in indexed annuities are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Extending the federal securities disclosure regime to indexed annuities that impose investment risk should help to provide investors with the information they need. The costs of preparing and filing registration statements are not unique to indexed annuities that are outside the scope of the Section 3(a)(8) exemption for annuities as a result of rule 151A, but apply to all issuers of registered securities. However, we are sensitive to these costs and discuss them below, along with comments that we received on this analysis.

Insurers will incur costs associated with preparing and filing registration statements for indexed annuities that are outside the insurance exemption as a result of rule 151A. These include the costs of preparing and reviewing disclosure, filing documents, and retaining records. Our Office of Economic Analysis has considered the effect of the rule on indexed annuity contracts with typical terms and has determined that, more likely than not, these contracts would not meet the definition of ''annuity contract'' or ''optional annuity contract'' if they were issued after the effective date of the rule. For purposes of the PRA, we have estimated an annual increase in the paperwork burden for companies to comply with the rules to be 60,000 hours of in-house company personnel time and $72,000,000 for services of outside professionals.[242] We estimate that the additional burden hours of in-house company personnel time will equal total internal costs of $10,500,000[243] annually, resulting in aggregate annual costs of $82,500,000[244] for in-house personnel and outside professionals. These costs reflect the assumption that filings will be made on Form S–1 for 400 contracts each year, which we made for purposes of the PRA.

As indicated in our analysis for purposes of the PRA, we received several comments questioning our estimate of the costs of registering an indexed annuity on Form S–1.[245] One commenter stated that, for insurers that have not previously prepared a Form S–1 registration statement, external legal costs could be as high as $250,000–$500,000 for each registration statement.[246] However, the commenter did not specify the source of this range of cost estimates or how it was made. The $250,000–$500,000 range cited by the commenter is for an

[235] Cornell Letter, *supra* note 7.

[236] *See, e.g.*, Allianz Letter, *supra* note 54; ACLI Letter, *supra* note 94; American Equity Letter, *supra* note 54; Coalition Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Second Aviva Letter, *supra* note 54. Southwest Letter, *supra* note 136; Transamerica Letter, *supra* note 54.

[237] *See, e.g.*, American National Letter, *supra* note 54; National Western Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Southwest Letter, *supra* note 136.

[238] *See infra* Section VII.

[239] *See generally* Black and Skipper, *supra* note 39, at 26–47, 890–99.

[240] *See, e.g.*, American Equity Letter, *supra* note 54; National Western Letter, *supra* note 54; Sammons Letter, *supra* note 54. The commenters did not provide cost estimates for performing the analysis necessary under the rule.

[241] *See, e.g.*, Aviva Letter, *supra* note 54; Academy Letter, *supra* note 54. We give substantial weight to the views of the Academy on this point, given their expertise in this type of analysis, and are not persuaded that the contrary comments of several issuers are representative of industry practice. *See* BLACK'S LAW DICTIONARY 39 (8th ed. 2004) (An actuary is a statistician who determines the present effects of future contingent events and who calculates insurance and pension rates on the basis of empirically based tables.); American Academy of Actuaries, Mission, available at: *http://www.actuary.org/mission.asp* (The mission of the Academy is to, among other things, provide independent and objective actuarial information, analysis, and education for the formation of sound public policy.).

[242] *See supra* Part IV.C.

[243] This cost increase is estimated by multiplying the total annual hour burden (60,000 hours) by the estimated hourly wage rate of $175 per hour. Consistent with recent rulemaking releases, we estimate the value of work performed by the company internally at a cost of $175 per hour.

[244] $10,500,000 (in-house personnel) + $72,000,000 (outside professionals).

[245] *See, e.g.*, Allianz Letter, *supra* note 54; Second Aviva Letter, *supra* note 54; Second NAFA Letter, *supra* note 191.

[246] Allianz Letter, *supra* note 54.

issuer that has not previously filed a Form S–1, with the commenter acknowledging that the costs to an experienced filer would be lower (as low as $50,000 to $100,000).[247] Another commenter estimated external legal costs for preparation and filing of a Form S–1 registration statement with the SEC at $350,000 for the first few years, which, the commenter stated, would decrease over time as the insurer gained more expertise.[248] Our average $180,000 estimate reflects outside professional costs incurred not only by first-time Form S–1 filers, but also the costs of preparing Form S–1 for contracts offered by experienced Form S–1 filers, as well as annual updates to existing Form S–1 registration statements, which we expect to be significantly lower than costs incurred by first-time filers. Therefore, we do not believe that it is necessary to change our estimate of outside professional costs based on the commenters' estimated costs.

One commenter cites a cost of $62,500 per insurance company for ''Registration Statement Preparation'' but also appears to assume a cost of $255,000 per contract for registration statement preparation.[249] It is unclear how these estimates should be reconciled, and we are not revising our estimate of the burden of preparation of registration statement on the basis of the commenter's estimates.

Another commenter stated that the Commission's estimate of outside professional costs of $400 per hour does not reflect market rates for securities counsel.[250] However, the commenter did not cite a different rate and did not explain the basis for its disagreement with the $400 per hour rate cited by the Commission. Our estimate of $400 per hour for outside professionals retained by the issuer is consistent with recent rulemakings and is based on discussions between our staff and several law firms.[251] Accordingly, we are not changing our estimate of the cost per hour of outside professional costs.

The commenter further stated that the estimates of time involved are low for persons unfamiliar with the process of registration of securities under the federal securities laws and the anticipated need for interaction with Commission staff. However, our estimate of time required to prepare a registration statement reflects time needed not only by first-time Form S–1 filers, but also the time involved in preparing Form S–1 for contracts offered by experienced S–1 filers, as well as annual updates to the existing Form S–1 registration statement, which we expect to be significantly less than time needed by first-time filers. Therefore, we are not revising our estimate of time involved in preparing registration statements on Form S–1.

Commenters stated that insurers will be subject to significant additional costs as a result of having to register on Form S–1.[252] These include required registration fees for securities sold. One commenter estimated Commission registration fees, assuming sales of $5 billion annually, as $196,500.[253] Commenters also stated that the due diligence necessary to verify disclosures in the registration statement will require significant resources.[254] We acknowledge that these are additional costs associated with registration. However, these costs are not unique to indexed annuities, but are incurred by all issuers of registered securities.

Commenters also cited other costs of registration on Form S–1, such as preparation of financial statements in accordance with generally accepted accounting principles (''GAAP''), which, according to the commenters, many insurers currently do not do.[255] One commenter estimated a cost of at least several million dollars for an insurer to develop GAAP financial statements.[256] We acknowledge that if an indexed annuity issuer that did not currently prepare GAAP financial statements were required to do so in order to register its indexed annuities, the one-time start-up costs could be significant. We note that, during the two-year transition period for rule 151A, the Commission intends to consider how to tailor accounting requirements for indexed annuities.[257]

Based on the foregoing analysis, our estimates of the costs of registration for indexed annuities include the costs of preparing Form S–1 registration statements, totaling $82,500,000 annually, or $206,250 per contract, and, based on a commenter's estimate, registration fees of $196,000 assuming sales by an insurer of $5 billion annually. If the insurer does not already prepare financial statements in accordance with GAAP, the insurer will also incur costs of developing GAAP financials, which one commenter estimated to involve one-time start-up costs of at least several million dollars per insurer. Commenters also mentioned due diligence as a cost of registration, but did not separately break out its cost.

Costs of Printing Prospectuses and Providing Them to Investors

Insurers will incur costs to print and provide prospectuses to investors for indexed annuities that are outside the insurance exemption as a result of rule 151A. For purposes of the PRA, we have estimated that registration statements will be filed for 400 indexed annuities per year. In the Proposing Release, we estimated that it would cost $0.35 to print each prospectus and $1.21 to mail each prospectus,[258] for a total of $1.56 per prospectus. These estimates would be reduced to the extent that prospectuses are delivered in person or electronically, or to the extent that Securities Act prospectuses are substituted for written materials used today, rather than being delivered in addition to those materials.

One commenter questioned whether the cost of printing an indexed annuity prospectus on Form S–1 would be roughly equivalent to that of printing a mutual fund prospectus on Form N–1A, as we were assuming for purposes of our estimate in the proposing release.[259] The commenter, based on its internal projections of prospectus printing and mailing costs, stated that the indexed annuity prospectus would cost twice as much as the mutual fund prospectus. The commenter estimated printing costs for an indexed annuity prospectus on Form S–1 as $1.50 and the cost of mailing as $1.38 for a total cost of $2.88. In making its cost projections, the commenter assumed that the mutual fund prospectus would be 25 pages

[247] *Id.*

[248] Second Aviva Letter, *supra* note 54.

[249] Second NAFA Letter, *supra* note 191.

[250] Transamerica Letter, *supra* note 54.

[251] *See, e.g.*, Securities Act Release No. 8909 (Apr. 10, 2008) [73 FR 20512, 20515 (Apr. 15, 2008)] (''Revisions to Form S–11 Release'').

[252] *See, e.g.*, Allianz Letter, *supra* note 54; American Equity Letter, *supra* note 54; Old Mutual Letter, *supra* note 54; Transamerica Letter, *supra* note 54.

[253] Allianz Letter, *supra* note 54.

[254] National Western Letter, *supra* note 54; Old Mutual Letter, *supra* note 54.

[255] *See, e.g.*, Allianz Letter, *supra* note 54. *See* Second Aviva Letter, *supra* note 54.

[256] Second Aviva Letter, *supra* note 54.

[257] *See supra* note 95 and accompanying text.

[258] These estimates reflect estimates provided to us by Broadridge Financial Solutions, Inc. (''Broadridge''), in connection with our recent proposal to create a summary prospectus for mutual funds. The estimates depend on factors such as page length and number of copies printed and not on the content of the disclosures. Because we believe that these factors may be reasonably comparable for indexed annuity and mutual fund prospectuses, we believe that it is reasonable to use these estimates in the context of indexed annuities. *See* Memorandum to File number S7–28–07 regarding October 27, 2007 meeting between Commission staff members and representatives of Broadridge Financial Solutions, Inc. (Nov. 28, 2007) (''Broadridge Memo''). The memorandum is available for inspection and copying in File No. S7–28–07 in the Commission's Public Reference Room and on the Commission's Web site at *http://www.sec.gov/comments/s7-28-07/s72807-5.pdf.*

[259] Allianz Letter, *note* 54.

long, while the indexed annuity prospectus (including financial statements) would be 100 pages long. Our estimate of the cost of printing and mailing a mutual fund prospectus was based on an assumed page length of 45 pages.[260] We believe that the commenter's estimate of page length may be more realistic for a prospectus prepared on Form S–1.[261] Accordingly, we are revising our estimate of the costs of printing and mailing the prospectus to the costs cited by the commenter; *i.e.*, $1.50 for printing the prospectus and $1.38 for mailing for a total cost of $2.88.[262] Though we have revised our estimate as described above, we believe that the revised estimate is conservative because some indexed annuity issuers who file Exchange Act reports and incorporate their financial statements from their Exchange Act reports by reference may have significantly shorter prospectuses as a result.[263]

Another commenter estimated the cost per insurance company of ''printing prospectuses/supply chain'' [264] at $20,000 per insurance company for a combined total of $880,000. The commenter does not explain how it arrived at this estimate. Moreover, because the commenter's estimate is for total cost per insurance company and does not specify the number of prospectuses printed by each insurance company, and our estimate is a per prospectus cost, we are not able to compare the two estimates. Thus, we are not revising our estimate of the cost of printing prospectuses and providing them to investors.

[260] Broadridge Memo, *supra* note 258.

[261] *See* Pre-effective Amendment No. 4 to Registration Statement on Form S–1 of PHL Variable Insurance Company (File No. 333–132399) (filed Feb. 7, 2007) (67-page prospectus); 257 Pre-effective Amendment No. 1 to Registration Statement on Form S–1 of Golden America Life Insurance Company (File No. 333–67660) (filed Feb. 8, 2002) (170-page prospectus).

[262] Allianz Letter, *supra* note 54. This revision does not affect our estimate of the cost burden for Form S–1 under the Paperwork Reduction Act. Printing and mailing costs are not ''collections of information'' for purposes of the Paperwork Reduction Act.

[263] *See* Pre-effective Amendment No. 4 to Registration Statement on Form S–1 of PHL Variable Insurance Company (File No. 333–132399) (filed Feb. 7, 2007) (20 pages of the prospectus are attributable to financial statements); Pre-effective Amendment No. 1 to Registration Statement on Form S–1 of Golden America Life Insurance Company (File No. 333–67660) (filed Feb. 8, 2002) (63 pages of the prospectus are attributable to financial statements).

[264] Second NAFA Letter, *supra* note 191. It is not fully clear what the commenter intends by ''supply chain,'' but we are citing the estimate, because it references printing of prospectuses.

Networking Arrangements With Registered Broker-Dealers and Other Related Costs

Rule 151A may impose costs on indexed annuity distributors that are not currently parties to a networking arrangement or registered as broker-dealers. These costs are not unique to indexed annuity distributors but apply to all distributors of federally registered securities that are not registered broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors will likely enter into a networking arrangement with a registered broker-dealer. Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement will impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor will incur 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. However, while there are costs of entering into a networking arrangement and monitoring compliance with the terms of the arrangement, distributors in networking arrangements will not be subject to the full range of costs associated with obtaining and maintaining broker-dealer registration.

One commenter estimated that the cost of registering as a broker-dealer, taking into account only the legal and regulatory work of initial setup,[265] licensing, and staffing could be between $250,000–$500,000.[266] Another commenter estimated the cost of forming a registered broker-dealer at $800,000.[267] The same commenter cites a cost of $3 million for ''BD startup'' in a separate comment.[268] As we discuss above, however, we believe it is more likely that distributors will enter into networking arrangements with registered broker-dealers, rather than register as broker-dealers.

Some commenters disagreed that distributors would enter into networking arrangements with registered broker-dealers, stating that the cost of networking would be too high.[269] One of these commenters stated that networking would be inordinately expensive.[270] The commenter stated that under current industry practice, a distributor would bear expenses when using a networking arrangement that include examination fees, state registration fees, and possibly a pro rata share of the associated broker-dealer's increased compliance costs, and would have to share a portion of his commissions with the registered broker-dealer.[271] Commenters did not provide estimates of the cost of networking. We recognize that a distributor will incur costs in entering into networking arrangement. We estimate the upper bound of entering into a networking agreement to be the equivalent of the cost of establishing a registered broker-dealer. Commenters provided a range of cost estimates for establishing a registered broker-dealer from $250,000 to $3 million. However, these costs are not unique to indexed annuities. For example, issuers of insurance products registered as securities, such as variable annuities, may incur networking costs, as do banks involved in networking arrangements. Moreover, while we would expect networking to be generally more cost-effective than registration as a broker-dealer, to the extent that it is not, broker-dealer

[265] Allianz Letter, *supra* note 54. Initial setup includes registering the broker-dealer with the Commission, developing extensive written policies and procedures tailored to its business, obtaining a fidelity bond, registering its offices as branch offices, and setting up a procedure for a principal review of all applications, as well as review of advertisements, business cards, letterhead, office signage, correspondence, and e-mails.

[266] Allianz Letter, *supra* note 54.

[267] Memorandum from the Division of Investment Management Regarding a November 10, 2008 Meeting with Representatives of the National Association for Fixed Annuities (Nov. 26, 2008). One commenter stated that the costs of registering and operating as a broker-dealer include FINRA registration and examination fees of up to $4,000. The commenter further stated that the legal cost associated with registering and applying for membership with FINRA, the cost of completing the necessary forms, and the costs of ongoing compliance could result in start-up costs of $25,000 and between $50,000 to $100,000 annually to maintain the registration. Coalition Letter, *supra* note 54.

[268] Second NAFA Letter, *supra* note 191.

[269] *See, e.g.*, American Equity Letter, *supra* note 54; Coalition Letter, *supra* note 54.

[270] Coalition Letter, *supra* note 54.

[271] Coalition Letter, *supra* note 54. One commenter indicated its belief that insurance agencies are only permitted to enter into networking arrangements with affiliated broker-dealers. Therefore, the commenter stated that insurance agencies without an affiliated broker-dealer would not appear to be able to take advantage of networking arrangements. We disagree with the commenter's interpretation and note that, in our view, insurance agencies may enter into networking arrangements with unaffiliated broker-dealers.

registration remains an option for indexed annuity distributors.

Commenters also cited additional costs that agents will incur as a result of the rule.[272] For example, commenters cited annual securities registration and licensing fees, including FINRA fees and state securities fees, that agents would be required to pay. With regard to state registration fees, one commenter estimated that an agent selling in all 50 states would pay approximately $3,100 in initial state securities registration fees and nearly $3,000 annually in ongoing state securities fees.[273] We recognize that agents may incur additional registration and licensing costs and are sensitive to the impact of such costs. However, these fees are paid by all sellers of securities and are not unique to those selling indexed annuities. The fees are a product of the regulatory structure mandated by Congress under the federal securities laws, which is intended to provide sales practice and other protections to investors.

Several commenters cited an industry source that estimated loss to distributors as a result of the rule as approximately $800 million.[274] This source estimates that agents would lose about $200 million in income by having to share commissions with the broker-dealers with which the agent is associated. The source estimates that fees charged by the broker-dealer and by FINRA would amount to another $22.5 million. The sharing of commissions, as well as the fees charged by the broker-dealer and by FINRA are necessary expenses of selling registered securities. For marketing organizations, the source estimates that indexed annuity sales would drop by 60% and marketing organization compensation would be reduced from around $500 million-$700 million a year today to $60 million-$200 million as a result of the rule. However, the source does not explain the basis for the estimate of the decline in sales. Moreover, if the marketing organization registers as, or enters into a networking arrangement with, a broker-dealer, it would have opportunities to sell other types of securities, and may be able to compensate for any declines in sales of indexed annuities that may occur. We believe that even at the high end of costs suggested by commenters, given the imperative of the federal securities laws and the size of the industry, these costs are nonetheless justified.

Possible Loss of Revenue

Insurance companies that determine that indexed annuities are outside the insurance exemption under rule 151A could either choose to register those annuities under the Securities Act or to cease selling those annuities. If an insurer ceases selling such annuities, the insurer may experience a loss of revenue. Commenters agreed that some insurers may stop selling indexed annuities as a result of the rule and that they would experience a loss of revenue.[275] One commenter estimated a total first year loss to insurance companies of approximately $300,000,000 as a result of the rule.[276] The commenter argued that industry experts state indexed annuity sales will drop from approximately $30 billion of premium per year (projected for 2008) to $10 billion per year as a result of the rule.[277] However, the commenter does not explain how this estimate was determined. We believe that even at the high end of costs suggested by commenters, given the imperative of the federal securities laws and the size of the industry, these costs are nonetheless justified.

The amount of lost revenue for insurance companies would depend on actual revenues prior to effectiveness of the rules and to the particular determinations made by insurers regarding whether to continue to issue registered indexed annuities. However, the loss of revenue may be offset, in whole or in part, by gains in revenue from the sale of other financial products, as purchasers' need for financial products will not diminish. These gains could be experienced by the same insurers who exit the indexed annuity business or they could be experienced by other insurance companies or other issuers of securities or other financial products.

Commenters also stated that sellers of indexed annuities may lose revenue because rule 151A may cause them to cease selling these products.[278] One commenter estimated a first-year income loss to distributors of $1.5 billion, based on an estimated decline in indexed annuity sales from approximately $30 billion (projected for 2008) to $10 billion per year, as a result of the rule.[279]

The amount of lost revenue for sellers of indexed annuities would depend on actual revenues prior to effectiveness of the rules and to the particular determinations made by distributors regarding whether to continue to sell registered indexed annuities. The loss of revenue may be offset, in whole or in part, by gains in revenue from the sale of other financial products, as purchasers' need for financial products will not diminish.

Commenters also cited indirect or collateral costs associated with the rule.[280] For example, if insurers exit the indexed annuities business; this will result in a reduction in personnel of those who are no longer needed to administer the products.[281] Commenters also stated that if insurers chose to stop offering indexed annuities because of the rule, third-party service providers who helped support the administration and/or sale of the insurer's indexed annuities may also incur costs.[282]

A number of commenters cited job loss as a consequence of the rule. Loss of employment, these commenters argued, would affect current employees of insurance companies, agents, and others.[283] Demand for financial products is relatively fixed in the aggregate. Within the insurance industry, some employees of insurance companies and agents will likely find employment in other areas of the insurance industry.

Possible Diminished Competition

There could be costs associated with diminished competition as a result of our rules. In order to issue indexed annuities that are outside the insurance exemption under rule 151A, insurers would be required to register those annuities as securities. If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by rule 151A and register those annuities that are outside the insurance exemption under the rule,

[272] *See, e.g.*, Allianz Letter, *supra* note 54; Coalition Letter, *supra* note 54; Southwest Letter, *supra* note 136.

[273] Allianz Letter, *supra* note 54.

[274] Letter of Advisors Excel (Aug. 20, 2008); Coalition Letter, *supra* note 54; Letter of Courtney A. Juhl (Aug. 15, 2008), citing Jack Marrion, *The Proposed Rule Will Sock it to Index Annuity Distributors,* National Underwriter Life & Health/Financial Services Edition, Aug. 4, 2008, at 13, available at: *http://www.lifeandhealthinsurancenews.com/cms/nulh/Weekly%20Issues/issues/2008/29/Focus/L29cover2.*

[275] *See, e.g.*, Allianz Letter, *supra* note 54; National Western, *supra* note 54.

[276] Second NAFA Letter, *supra* note 191.

[277] *Id.,* citing ''The Advantage Compendium, Jack Marrion, President.'' The commenter does not provide a specific citation, and we have been unable to find the source of the estimate provided by the commenter.

[278] *See, e.g.*, Second Old Mutual Letter, *supra* note 76; Southwest Letter, *supra* note 136.

[279] Second NAFA Letter, *supra* note 191. This commenter also estimated a first-year income loss of $300 million for independent marketing organizations.

[280] Allianz Letter, *supra* note 54; Aviva Letter, *supra* note 54; National Western Letter, *supra* note 54.

[281] *See, e.g.*, Allianz Letter, *supra* note 54.

[282] *See, e.g.*, Allianz Letter, *supra* note 54.

[283] *E.g.*, Letter of Todd F. Gregory (Aug. 5, 2008); Letter of Terry R. Lucas (Sept. 9, 2008); National Western Letter, *supra* note 54; Letter of Randall L. Whittle (Aug. 8, 2008).

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. A number of commenters agreed that diminished competition would result in indexed annuity purchasers receiving less favorable terms. However, the commenters did not provide data in this regard.[284]

It is currently unknown whether new providers will enter the market for indexed annuities. We note, however, that the possibility for new entrants created by this rule is beneficial to competition, even if they do not enter the market. If the indexed annuity market becomes sufficiently uncompetitive and economic profits increase, new entrants will likely arrive, putting downward pressure on prices. Thus, any reduction in regulatory barriers to entry created by increased regulatory certainty can have the effect of increasing competition and reducing prices, a direct benefit to investors. It is currently unknown whether new providers will enter the market for indexed annuities. We note, however, that the possibility for new entrants created by this rule is beneficial to competition, even if they do not enter the market. If the indexed annuity market becomes sufficiently uncompetitive and economic profits increase, new entrants will likely arrive, putting downward pressure on prices. Thus, any reduction in regulatory barriers to entry created by increased regulatory certainty can have the effect of increasing competition and reducing prices, a direct benefit to investors.

Additional Costs

Commenters provided further information on costs for insurance companies. One commenter estimated a total first-year cost to insurance companies of $237,000,000.[285] Components of this cost are identified as broker-dealer startup, broker-dealer annual maintenance, new compliance costs, legal start-up costs, FINRA implementation, FINRA maintenance, state fees, Form S–1 fees, including registration statement preparation, state filing, annual audit, operations/administration/systems, printing prospectus supply chain, and additional fees paid to FINRA impacting product pricing. Much of these costs appear to be attributable to setting up a broker-dealer. As noted above, however, we do not believe that insurers would need to establish a broker-dealer to continue to sell indexed annuities. An insurer could make use of existing broker-dealers and avoid the costs of starting a broker-dealer. If those costs are avoided, the commenter's estimate could be reduced by at least $135,727,000 (the total cost attributable to the costs of starting a broker-dealer as estimated by the commenter). This still leaves a total first-year cost to insurance companies of over $100,000,000. We recognize this is a substantial cost. However, these costs are not unique to indexed annuities but are the costs of offering and selling any registered securities. All issuers of securities must incur such costs, and issuers of indexed annuities will not incur higher costs as a result of the rule than any other issuer of securities.

One commenter cited the cost that may be incurred if the insurer needs to find additional distributors as a result of existing distributors dropping out of the indexed annuity market because of the costs they would incur under the rule.[286] However, this is no different from any securities issuer, all of whom must use distribution channels subject to the federal securities laws.

The Commission has carefully considered the costs cited by the commenters. These include the costs that the commenters state will be incurred by insurers, distributors, and agents. We have also considered the collateral costs cited by the commenters, and the possibility of loss of employment cited by the commenters. While we have taken the costs of the rule into account, we also continue to believe that the rule will result in substantial benefits to indexed annuity purchasers, in the form of enhanced disclosure and sales practice protections, greater regulatory certainty for issuers and sellers of indexed annuities, enhanced competition, and relief from reporting obligations. While the costs of the rule may be significant, where an annuity contract is not entitled to the Section 3(a)(8) exemption, which we have concluded is the case with respect to certain indexed annuities, the federal securities laws apply, and participants in the indexed annuity market will need to bear the costs of compliance with the federal securities laws, as do any other participants in the securities markets. Furthermore, notwithstanding these costs, our rule imposes no greater costs than those imposed on other market participants who issue or sell securities.

VI. Consideration of Promotion of Efficiency, Competition, and Capital Formation; Consideration of Burden on Competition

Section 2(b) of the Securities Act[287] and Section 3(f) of the Securities Exchange Act[288] require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act[289] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

A. Efficiency

For the following reasons, we believe that rule 151A will promote efficiency by extending the benefits of the disclosure and sales practice protections of the federal securities laws to indexed annuities that are more likely than not to provide payments that vary with the performance of securities.

The required disclosures will enable investors to make more informed investment decisions. As discussed above, disclosures that will 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). This information will be public and accessible to all investors, intermediaries, third party information providers, and others through the SEC's EDGAR system. Public availability of this information will be helpful to investors in making informed decisions about purchasing indexed annuities. The enhancement of investor decision-making that will result from the public availability of information about indexed annuities

[284] *See, e.g.*, American Equity, *supra* note 54; American National, *supra* note 54; National Western, *supra* note 54.

[285] Second NAFA Letter, *supra* note 191.

[286] *See, e.g.*, American Equity Letter, *supra* note 54.

[287] 15 U.S.C. 77b(b).

[288] 15 U.S.C. 78c(f).

[289] 15 U.S.C. 78w(a)(2).

will ultimately lead to more efficient capital allocation in the securities markets.

Investors will also receive the benefits of the sales practice protections, including a registered representative's obligation to make only recommendations that are suitable. Under the federal securities laws, persons effecting transactions in indexed annuities that fall outside the insurance exemption under rule 151A will be required to be registered broker-dealers or become associated persons of a broker-dealer. As a result, investors who purchase these indexed annuities after the effective date of rule 151A will receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities will be subject to supervision by the broker-dealer with which they are associated. Both the selling broker-dealer and its registered representatives will be subject to the oversight of FINRA. The registered broker-dealers will also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as be subject to the Commission's general inspections and, where warranted, enforcement powers. These sales practice protections will promote suitable recommendations to investors, which will lead to enhanced decision-making by investors and, ultimately, to greater efficiency in the securities markets.

Some commenters argued that rule 151A, as proposed, would not promote efficiency, because it would be duplicative of state insurance regulation of indexed annuities.[290] These commenters argued that disclosure and suitability concerns in connection with indexed annuity sales are already addressed by state insurance regulation, and further indicated that state insurance regulation is more closely tailored to indexed annuities than federal securities regulation.

We do not believe that these efforts, no matter how strong, can substitute for the federal securities law protections that apply to instruments that are regulated as securities. The federal securities laws were designed to provide uniform protections, with respect to both disclosure and sales practices, to investors in securities. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws. Indeed, at least one state insurance regulator acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts.[291] Where the purchaser of an indexed annuity assumes the investment risk of an instrument that fluctuates with the securities markets, and the contract therefore does not fall within the Section 3(a)(8) exemption, the application of state insurance regulation, no matter how effective, is not determinative as to whether the contract is subject to the federal securities laws, which provide uniform and enforceable protections for investors. In addition, during the transition period between adoption and the effective date of rule 151A, we intend to consider how to tailor disclosure requirements for indexed annuities.

One commenter stated that the Commission cannot claim further efficiencies without a comprehensive consideration of the existing state law regulatory regime, the efficiencies that regime already realizes, and the respects in which that state regime falls short and further gains may be achieved by the Commission.[292] The commenter further stated that the proposal would only impose further costs and burdens on efficiency with no compensating benefit, adding an unnecessary, largely duplicative layer of federal requirements that were developed for securities and have not been tailored to annuity products and purchasers generally.[293] We disagree that the Commission must undertake a comprehensive consideration of the existing state law regulatory regime and that there are no benefits from the federal securities laws. Congress has determined that securities investors are entitled to the disclosure, antifraud, and sales practice protections of the federal securities laws. The burdens that are uniformly imposed on issuers and sellers of all types of securities are part of those laws, and it is not the Commission's role to reevaluate the efficiencies of that regulatory structure for each particular instrument that is a security.

B. Competition

We also anticipate that, because rule 151A will improve investors' ability to make informed investment decisions, it will lead to increased competition between issuers and sellers of indexed annuities, mutual funds, variable annuities, and other financial products, and increased competitiveness in the U.S. capital markets. The greater clarity that results from rule 151A also may enhance competition because insurers who may have been reluctant to issue indexed annuities, while their status was uncertain, may decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities.

We have carefully considered the concerns raised by commenters, and we continue to believe that rule 151A will greatly enhance disclosures regarding indexed annuities. In addition to the specific benefits described above, we anticipate that these enhanced disclosures will also benefit the overall financial markets and their participants.

We anticipate that the disclosure of terms of indexed annuities will be broadly beneficial to investors, enhancing the efficiency of the market for indexed annuities through increased competition. Disclosure will make information on indexed annuity contracts, including terms, publicly available. Public availability of terms will better enable investors to compare indexed annuities and may focus attention on the price competitiveness of these products. It will also improve the ability of third parties to price contracts, giving purchasers a better understanding of the fees implicit in the products. We anticipate that third-party information providers may provide services to price or compare terms of different indexed annuities. Analogously, we note that public disclosure of mutual fund information has enabled third-party information aggregators to facilitate comparison of fees.[294] We believe that increasing the level of price transparency and the resulting competition through enhanced disclosure regarding indexed annuities would be beneficial to investors. It could also expand the size of the

[290] *See e.g.*, Coalition Letter, *supra* note 54; NAFA Letter, *supra* note 54. *But see* Washington State Letter, *supra* note 199 (noting its experience with variable annuities and synergy of complementary regulation by the insurance regulator focused on solvency and the securities regulator focused on investor protection).

[291] *See* Voss Letter, *supra* note 13 (proposing to accelerate NAIC efforts to strengthen the NAIC model laws affecting indexed annuity products and urge adoption by more of the member states).

[292] Coalition Letter, *supra* note 54.

[293] *Id.*

[294] *See, e.g.*, FINRA, Fund Analyzer, available at: *http://www.finra.org/fundanalyzer* (''FINRA Fund Analyzer'').

market, as investors may have increased confidence that indexed annuities are competitively priced.

The Commission believes that there could be costs associated with diminished competition as a result of rule 151A. As the commenters note, some insurance companies may stop issuing indexed annuities, and some broker-dealers and agents may determine not to sell indexed annuities. We recognize that the impact of rule 151A on competition may be mixed, but, on balance, we continue to believe that rule 151A will provide the benefits described above and has the potential to increase competition. In this regard, the demand for financial products is relatively fixed, in the aggregate. Any potential reduction in indexed annuities sold under the rule would likely correspond with an increase in the sale of other financial products, such as mutual funds or variable annuities. Thus, total reductions in competition may not be significant, when effects on the financial industry as a whole, including insurance companies together with other providers of financial instruments, are considered. Within the insurance industry, if some insurers cease selling indexed annuities, it is also likely that these insurers will sell other products through the same distribution channels, such as annuities with fixed interest rates.

We conclude, in any event, that the importance of providing the protections of the federal securities laws to indexed annuity purchasers is significant notwithstanding any burden on competition that may result from the operation of the rule. In addition, the rule will provide other benefits. It will bring about clarity in what has been an uncertain area of law. In addition, issuers and sellers of these products will no longer be subject to uncertainty and litigation risk with respect to the laws that are applicable.

Some commenters argued that regulation under the federal securities laws of indexed annuities will place them at a competitive disadvantage to variable annuities and mutual funds because the Commission's disclosure scheme is not tailored to these contracts.[295] Commenters cited a number of supposed defects, including the lack of a registration form that is well-suited to indexed annuities, questions about the appropriate method of accounting to be used by insurance companies that issue indexed annuities, and concerns about parity of the registration process vis-a-vis mutual funds.

We acknowledge that, as a result of indexed annuity issuers having historically offered and sold their contracts without complying with the federal securities laws, the Commission has not created specific disclosure requirements tailored to these products. This fact, though, is not relevant in determining whether indexed annuities are subject to the federal securities laws. The Commission has a long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance.[296] We note that we are providing a two-year transition period for rule 151A, and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities. We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.

One commenter indicated that the rule creates a competitive disadvantage for indexed annuities to the advantage of fixed annuities and suggests that that the Commission improperly failed to consider competition between indexed and fixed annuities.[297] Fixed annuities do not involve assumption of significant investment risks by purchasers. By contrast, indexed annuities that fall outside the insurance exemption under rule 151A do impose significant investment risk on purchasers, and, like other securities, they require the protections of the federal securities laws. Securities and non-securities are subject to different regulatory regimes as a result of Congressional action; it is not the Commission's role to revisit that determination by Congress.

C. Capital Formation

We also anticipate that the increased market efficiency resulting from enhanced investor protections under rule 151A could promote capital formation by improving the flow of information among insurers that issue indexed annuities, the distributors of those annuities, and investors. Public availability of this information will be helpful to investors in making informed decisions about purchasing indexed annuities. The information will enhance investors' ability to compare various indexed annuities and also to compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. The potential liability for materially false and misleading statements and omissions under the federal securities laws will provide additional encouragement for accurate, relevant, and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell them.[298]

Some commenters criticized the Commission's consideration of whether the rule will promote capital formation.[299] One commenter specifically questioned whether the proposed rule would improve the flow of information with regard to indexed annuities, suggesting that the Commission should delineate where the states' current disclosure regime falls short, and how the rule would improve upon it, as well as how the benefits of the rule would exceed its costs.[300] We disagree. It is not our intention to question the effectiveness of state regulation. We continue to believe that applying the federal securities disclosure scheme to indexed annuities will enhance disclosure of information needed to make informed investment decisions. The information will enhance investors' abilities to compare various indexed annuities and also compare indexed annuities with mutual funds, variable annuities, and other securities and finanancial products. We believe that state insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws. At least one state regulator has acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts.[301] Congress has prescribed a uniform federal regulatory scheme for securities having already weighed whether the federal securities laws are well-suited to securities. In addition, the courts have recognized that labeling a product as insurance does not remove it from the federal regulatory scheme.

The federal securities laws will further improve upon the state structure because of the Commission's long

[295] Allianz Letter, *supra* note 54; Sammons Letter, *supra* note 54; Second Aviva Letter, *supra* note 54.

[296] *See* Form N–4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N–6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

[297] NAFA Letter, *supra* note 54.

[298] *See, e.g.*, Section 12(a)(2) of the Securities Act [15 U.S.C. 77l(a)(2)] (imposing liability for materially false or misleading statements in a prospectus or oral communication, subject to a reasonable care defense). *See also* Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)]; rule 10b–5 under the Exchange Act [17 CFR 240.10b–5]; Section 17 of the Securities Act [15 U.S.C. 77q] (general antifraud provisions).

[299] *See, e.g.*, Coalition Letter, *supra* note 54; NAFA Letter, *supra* note 54.

[300] Coalition Letter, *supra* note 54.

[301] See Voss Letter, *supra* note 13.

history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance,[302] the federal regulatory scheme's uniformity in application, the suitability requirements enforced by FINRA, as well as the Commission and FINRA's robust enforcement powers and the private remedies allowed under the federal securities laws.

Another commenter stated that the proposed rule would only promote capital formation if it resulted in increased sales of indexed annuities, and that the Commission has not analyzed the rule to the point where it can determine whether or not it will increase indexed annuity sales.[303] We strongly disagree that the correct measure of whether the rule will promote capital formation is if it results in increased sales of indexed annuities. We believe that capital formation would be enhanced through increased competition among indexed annuities and among indexed annuities and other financial products, such as variable annuities and mutual funds, and the innovation and better terms in indexed annuities for investors that may result from this competition. Better information leads to increased competition and greater investor confidence in markets which will in turn lead to willingness to invest and facilitate capital formation. Moreover, it is not possible to predict with certainty whether indexed annuity sales will themselves increase or decrease as a result of the rule. The Commission has taken both possibilities into account. In any event, we believe, first, that the importance of protecting purchasers of these products under the federal securities laws is significant notwithstanding any reduction in capital formation that may result from fewer sales of indexed annuities and second, that any such reduction is likely to be offset by an increase in capital formation through sales of other financial products.

Rule 12h–7 provides insurance companies with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities that are regulated as insurance under state law. We are adopting this exemption because the concerns that Exchange Act financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract. Accordingly, we believe that the exemption will improve efficiency by eliminating potentially duplicative and burdensome regulation relating to insurers' financial condition. Furthermore, we believe that rule 12h–7 will not impose any burden on competition. Rather, we believe that the rule will enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption will reduce the regulatory costs associated with doing so. We also anticipate that the innovations in product development could promote capital formation by providing new investment opportunities for investors.

VII. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act.[304] It relates to the Commission's rule 151A that defines the terms ''annuity contract'' and ''optional annuity contract'' under the Securities Act of 1933 and rule 12h–7 that exempts insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, subject to certain conditions, both of which we are adopting in this Release. The Initial Regulatory Flexibility Analysis (''IRFA'') which was prepared in accordance with 5 U.S.C. 603 was published in the Proposing Release.

A. Need For and Objectives of Rules

We are adopting the definition of the terms ''annuity contract'' and ''optional annuity contract'' to provide greater clarity with regard to the status of indexed annuities under the federal securities laws. We believe this will enhance investor protection and provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are adopting the exemption from Exchange Act reporting because we believe that the concerns that periodic financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract.

B. Significant Issues Raised By Public Comment

In the Proposing Release, we requested comment on the number of small entity insurance companies, small entity distributors of indexed annuities, and any other small entities that may be affected by the rules, the existence or nature of the potential impact and how to quantify the impact of the rules. A number of commenters stated that costs and burdens arising from rule 151A would have a significant and adverse impact on small entities, such as small insurance distributors.[305] Commenters have estimated the number of small entities to be adversely affected by this rule to range from thousands to tens of thousands of small entities.[306] Insurance distributors that would be affected by the rule are not registered with the Commission. For that reason, we do not have information pertaining to the number of such distributors, or the number of small distributors. While commenters provided a range of numbers of small entities, they did not explain the basis for their estimates.

Some commenters stated that the estimate of the burden on small entities in the proposing release is understated.[307] In particular, one commenter stated that small entities among distributors who network with registered broker-dealers will incur not only legal and monitoring costs, as the Proposing Release recognized, but will also have to share commissions that they earn from the sales of indexed annuities.[308] While we did not specifically address sharing of commissions in the Proposing Release, we recognize that networking may cause small distributors to share commissions with registered broker-dealers. However, we continue to believe that networking may be more cost-effective than

[302] *See e.g.*, Form N–4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N–6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

[303] NAFA Letter, *supra* note 54.

[304] 5 U.S.C. 604 *et seq.*

[305] *See, e.g.*, Letter A, *supra* note 76; Letter of Dennis Absher (Jul. 25, 2008) (''Absher Letter''); Letter of James Brenner (Jul. 7, 2008) (''Brenner Letter''); Letter E, *supra* note 76; Letter of Dustin R. Montgomery (Sep. 11, 2008) (''Montgomery Letter''); Letter of Raymond J. Ohlson, The Ohlson Group, Inc. (Jul. 22, 2008) (''Ohlson Letter''); Letter of Steven A Sewell (Aug. 25, 2008) (''Sewell Letter''); Letter of Donna Tupper (Sept. 11, 2009) (''Tupper Letter'').

[306] *See, e.g.*, Letter of Matthew Coleman (Jul. 11, 2008) (''Coleman Letter''); Letter of Bruce E. Dickes (Jul. 16, 2008) (''Dickes Letter''); Letter Type K (''Letter K''); Letter of Larry A. Kaufman (Aug. 27, 2008) (''Kaufman Letter''); Letter of Dejah F. LaMonte (Sep. 3, 2008) (''LaMonte Letter''); Letter of Kyle Mann (Sep. 9, 2008) (''Mann Letter'').

[307] *See, e.g.*, Coalition Letter, *supra* note 54.

[308] Coalition Letter, *supra* note 54.

registering as a broker-dealer. We recognize that a distributor will incur costs in entering into networking arrangement. However, these costs are not unique to indexed annuities. For example, issuers of insurance products registered as securities, such as variable annuities, may incur networking costs, as do banks involved in networking arrangements. Moreover, while we would expect networking to be generally more cost-effective than registration as a broker-dealer, to the extent that it is not more efficient, broker-dealer registration remains an option for indexed annuity distributors. We believe that the upper bound of the cost of entering into a networking agreement is the equivalent of the costs of establishing a registered broker-dealer. Commenters provided a range of cost estimates for establishing a registered broker-dealer, ranging from $250,000 to $3 million.

As discussed below, it is the view of the Commission that, despite any adverse impact to small entities that may result, rule 151A is a necessary measure for the protection of purchasers of indexed annuities. Rule 151A will result in significant benefits to indexed annuity purchasers, including federally mandated disclosure and sales practice protections. Moreover, rule 151A offers benefits to all entities, large and small, such as greater regulatory certainty with regard to the status of indexed annuities under the federal securities laws and enhance competition. We do not anticipate that rule 151A will impose different or additional burdens on small entities than those imposed on other small entities who issue or distribute securities. Commenters generally supported rule 12h–7 and did not raise any issues regarding the effect of rule 12h–7 on small entities.

C. Small Entities Subject to the Rules

The Commission's rules define ''small business'' and ''small organization'' for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission.[309] Rule 0–10(a) [310] defines an issuer, other than an investment company, to be a ''small business'' or ''small organization'' for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year.[311] No insurers currently issuing indexed annuities are small entities.[312] In addition, no other insurers that would be covered by the Exchange Act exemption are small entities.[313]

While there are no small entities among the insurers who are subject to the new rules 151A and 12h–7, we note that there may be a substantial number of small entities among distributors of indexed annuities.[314] Rule 0–10(c) [315] states that the term ''small business'' or ''small organization,'' when referring to a broker-dealer that is not required to file audited financial statements prepared pursuant to rule 17a–5(d) under the Exchange Act,[316] means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. Rule 0–10(a) [317] states that the term ''small business'' or ''small organization,'' when used with reference to a ''person,'' other than an investment company, means a ''person'' that, on the last day of its most recent fiscal year, had total assets of $5 million or less.

D. Reporting, Recordkeeping, and Other Compliance Requirements

Rule 151A will result in Securities Act filing obligations for those insurance companies that, in the future, issue indexed annuities that fall outside the insurance exemption under rule 151A, and rule 12h–7 will result in the elimination of Exchange Act reporting obligations for those insurance companies that meet the conditions to the exemption. As noted above, no insurance companies that currently issue indexed annuities or that would be covered by the exemption are small entities.

However, rule 151A may affect indexed annuity distributors that are small entities and that are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer. Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement would impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor will incur 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.[318] Entities that enter into such networking arrangements would not be subject to ongoing reporting, recordkeeping, or other compliance requirements imposed by the federal securities laws. If any of these entities were to choose to register as broker-dealers as a result of rule 151A,[319] they would be subject to ongoing reporting, recordkeeping, and other compliance requirements applicable to registered broker-dealers. Compliance with these requirements, if

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[309] *See* rule 157 under the Securities Act [17 CFR 230.157]; rule 0–10 under the Exchange Act [17 CFR 240.0–10].

[310] 17 CFR 240.0–10(a).

[311] Securities Act rule 157(a) [17 CFR 157(a)] generally defines an issuer, other than an investment company, to be a ''small business'' or ''small organization'' for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year and it is conducting or proposing to conduct a securities offering of $5 million or less. For purposes of our analysis, however, we use the Exchange Act definition of ''small business'' or ''small entity'' because that definition includes more issuers than does the Securities Act definition and, as a result, assures that the definition we use would not itself lead to an understatement of the impact of the amendments on small entities.

[312] The staff has determined that each insurance company that currently offers indexed annuities has total assets significantly in excess of $5 million. The staff compiled a list of indexed annuity issuers from four sources: AnnuitySpecs, Carrier List, *http://www.annuityspecs.com/Page.aspx?s=carrierlist;* Annuity Advantage, Equity Indexed Annuity Data, *http://www.annuityadvantage.com/annuitydataequity.htm;* Advantage Compendium, Current Rates, *http://www.indexannuity.org/rates_by_carrier.htm;* and a search of Best's Company Reports (available on Lexis) for indexed annuity issuers. The total assets of each insurance company issuer of indexed annuities were determined by reviewing the most recent Best's Company Reports for each indexed annuity issuer.

[313] The staff has determined that each insurance company that currently offers contracts that are registered under the Securities Act and that include so-called market value adjustment features or guaranteed benefits in connection with assets held in an investor's account has total assets significantly in excess of $5 million. The total assets of each such insurance company were determined by reviewing the Form 10–K of that company and, in some cases, Best's Company Reports (available on Lexis).

[314] *See supra* note 306 and accompanying text.

[315] 17 CFR 240.0–10(c).

[316] 17 CFR 240.17a–5(d).

[317] 17 CFR 240.0–10(a).

[318] *See* discussion *supra* Part V.B. The costs borne by distributors entering into networking arrangements will be borne by both large and small distributors of registered indexed annuities.

[319] *See, e.g.*, Submission for OMB Review; Comment Request, OMB Control No. 3235–0012 [72 FR 39646 (Jul. 19, 2007)] (discussing the total annual burden imposed by Form BD).

applicable, would impose costs associated with accounting, legal, and other professional personnel, and the design and operation of automated and other compliance systems.[320]

E. Commission Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the adoption of rule 151A and rule 12h–7, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Further clarifying, consolidating, or simplifying the requirements for small entities;
- Using performance standards rather than design standards; and
- Providing an exemption from the requirements, or any part of them, for small entities.

Because no insurers that currently issue indexed annuities or that will be covered by the Exchange Act exemption are small entities, consideration of these alternatives for those insurance companies is not applicable. Small distributors of indexed annuities that choose to enter into networking arrangements with registered broker-dealers, which we believe will be likely once rule 151A is adopted, would not be subject to ongoing reporting, recordkeeping, or other compliance requirements. However, because some small distributors may choose to register as broker-dealers, we did consider the alternatives above for small distributors.

Commenters did not suggest any alternatives specifically addressed to small entities. Some commenters suggested that the Commission, instead of adopting a rule that defines certain indexed annuities as not being ''annuity contracts'' under Section 3(a)(8), should instead define a safe harbor that would provide that indexed annuities that meet certain conditions are entitled to the Section 3(a)(8) exemption.[321] We are not adopting this approach for two reasons. First, such a rule would not address in any way the federal interest in providing investors with disclosure, antifraud, and sales practice protections that arise when individuals are offered indexed annuities that expose them to investment risk. A safe harbor would address circumstances where purchasers of indexed annuities are not entitled to the protections of the federal securities laws; one of our primary goals is to address circumstances where purchasers of indexed annuities are entitled to the protections of the federal securities laws. We are concerned that many purchasers of indexed annuities today should be receiving the protections of the federal securities laws, but are not. Rule 151A addresses this problem; a safe harbor rule would not. Second, we believe that, under many of the indexed annuities that are sold today, the purchaser bears significant investment risk and is more likely than not to receive a fluctuating, securities-linked return. In light of that fact, we believe that is far more important to address this class of contracts with our definitional rule than to address the remaining contracts, or some subset of those contracts, with a safe harbor rule.

The Commission believes that different registration, compliance, or reporting requirements or timetables for small entities that distribute registered indexed annuities would not be appropriate or consistent with investor protection. The rules will provide investors with the sales practice protections of the federal securities laws when they purchase indexed annuities that are outside the insurance exemption. These indexed annuities would be required to be distributed by a registered broker-dealer. As a result, investors who purchase these indexed annuities after the effective date of rule 151A would receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities would be subject to supervision by the broker-dealer with which they are associated, and the selling broker-dealers would be subject to the oversight of FINRA. The registered broker-dealers would also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as to be subject to the Commission's general inspections and, where warranted, enforcement powers.

Different registration, compliance, or reporting requirements or timetables for small entities that distribute indexed annuities may create the risk that investors will receive lesser sales practice and other protections when they purchase a registered indexed annuity through a distributor that is a small entity. We believe that it is important for all investors that purchase indexed annuities that are outside the insurance exemption to receive equivalent protections under the federal securities laws, without regard to the size of the distributor through which they purchase. For those same reasons, the Commission also does not believe that it would be appropriate or consistent with investor protection to exempt small entities from the broker-dealer registration requirements when those entities distribute indexed annuities that fall outside of the insurance exemption under our rules.

Through our existing requirements for broker-dealers, we have endeavored to minimize the regulatory burden on all broker-dealers, including small entities, while meeting our regulatory objectives. Small entities that distribute indexed annuities that are outside the insurance exemption under our rule should benefit from the Commission's reasoned approach to broker-dealer regulation to the same degree as other entities that distribute securities. In our existing broker-dealer regulatory framework, we have endeavored to clarify, consolidate, and simplify the requirements applicable to all registered broker-dealers, and the rules do not change those requirements in any way. Finally, we do not consider using performance rather than design standards to be consistent with investor protection in the context of broker-dealer registration, compliance, and reporting requirements.

VIII. Statutory Authority

The Commission is adopting the amendments outlined above under Sections 3(a)(8) and 19(a) of the Securities Act [15 U.S.C. 77c(a)(8) and 77s(a)] and Sections 12(h), 13, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78*l*(h), 78m, 78o, 78w(a), and 78mm].

List of Subjects in 17 CFR Parts 230 and 240

Reporting and recordkeeping requirements, Securities.

Text of Rules

■ For the reasons set forth in the preamble, the Commission amends Title 17, Chapter II, of the Code of Federal Regulations as follows:

[320] *See supra* notes 265–268 and accompanying text.

[321] *See, e.g.*, Academy Letter, *supra* note 54; AIG Letter, *supra* note 128; Aviva Letter, *supra* note 54; Second Academy Letter, *supra* note 54; Second Aviva Letter, *supra* note 54; Second Transamerica Letter, *supra* note 54; Letter of Life Insurance Company of the Southwest (Sept. 10, 2008) (''Southwest Letter''); Voss Letter, *supra* note 13.

PART 230—GENERAL RULES AND REGULATONS, SECURITIES ACT OF 1933

■ 1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z–3, 77sss, 78c, 78d, 78j, 78*l*, 78m, 78n, 78o, 78t, 78w, 78*ll*(d), 78mm, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

■ 2. Add § 230.151A to read as follows:

§ 230.151A Certain contracts not ''annuity contracts'' or ''optional annuity contracts'' under section 3(a)(8).

(a) *General.* Except as provided in paragraph (c) of this section, a contract that is 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, and that is subject to regulation under the insurance laws of that jurisdiction as an annuity is not an ''annuity contract'' or ''optional annuity contract'' under Section 3(a)(8) of the Securities Act (15 U.S.C. 77c(a)(8)) if:

(1) The contract specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities; and

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

(b) *Determination of amounts payable and guaranteed.* In making the determination under paragraph (a)(2) of this section:

(1) Amounts payable by the issuer under the contract and amounts guaranteed under the contract shall be determined by taking into account all charges under the contract, including, without limitation, charges that are imposed at the time that payments are made by the issuer; and

(2) A determination by the issuer at or prior to issuance of the contract shall be conclusive, provided that:

(i) Both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;

(ii) The computations made by the issuer in support of the determination are materially accurate; and

(iii) The determination is made not more than six months prior to the date on which the form of contract is first offered.

(c) *Separate accounts.* This section does not apply to any contract whose value varies according to the investment experience of a separate account.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 3. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.* ; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

■ 4. Add § 240.12h–7 to read as follows:

§ 240.12h–7 Exemption for issuers of securities that are subject to insurance regulation.

An issuer shall be exempt from the duty under section 15(d) of the Act (15 U.S.C. 78o(d)) to file reports required by section 13(a) of the Act (15 U.S.C. 78m(a)) with respect to securities registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), provided that:

(a) The issuer is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State;

(b) The securities do not constitute an equity interest in the issuer and are either subject to regulation under the insurance laws of the domiciliary State of the issuer or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction;

(c) The issuer files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of the issuer's domiciliary State;

(d) The securities are not listed, traded, or quoted on an exchange, alternative trading system (as defined in § 242.300(a) of this chapter), inter-dealer quotation system (as defined in § 240.15c2–11(e)(2)), electronic communications network, or any other similar system, network, or publication for trading or quoting;

(e) The issuer takes steps reasonably designed to ensure that a trading market for the securities does not develop, including, except to the extent prohibited by the law of any State or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any State, requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis; and

(f) The prospectus for the securities contains a statement indicating that the issuer is relying on the exemption provided by this rule.

January 8, 2009.

By the Commission.

Elizabeth M. Murphy,

Secretary.

Opening Remarks and Dissent by Commissioner Troy A. Paredes

Regarding Final Rule 151A: Indexed Annuities and Certain Other Insurance Contracts

Open Meeting of the Securities & Exchange Commission

December 17, 2008

Thank you, Chairman Cox.

I believe that proposed Rule 151A addressing indexed annuities is rooted in good intentions. For instance, at the time the rule was proposed, the Commission watched a television clip from *Dateline NBC* that described individuals who may have been misled by seemingly unscrupulous sales practices into buying these products. Part of our tripartite mission at the SEC is to protect investors, so there is a natural tendency to want to act when we hear stories like this.

However, our jurisdiction is limited; and thus our authority to act is circumscribed. Rule 151A is about this very question: The proper scope of our statutory authority.

In our effort to protect investors, we cannot extend our reach past the statutory stopping point. Section 3(a)(8) of the Securities Act of 1933 ('33 Act) provides a list of securities that are exempt from the '33 Act and thus, by design of the statute, fall beyond the Commission's reach. The Section 3(a)(8) exemption includes, in relevant part, ''[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner * * * of any State or Territory of the United States or the District of Columbia.'' I am not persuaded that Rule 151A represents merely an attempt to provide clarification to the scope of exempted securities falling within Section 3(a)(8). Instead, by defining indexed annuities in the manner done in Rule 151A, I believe the SEC will be entering into a realm that Congress prohibited us from entering. Therefore, I cannot vote in favor of the rule and respectfully dissent.

Rule 151A takes some annuity products (indexed annuities), which otherwise may be covered by the statutory exemption in Section 3(a)(8), and removes them from the exemption, thus placing them within the Commission's jurisdiction to regulate. If the Commission's Rule 151A analysis is wrong—which is to say that indexed annuities do fall

within Section 3(a)(8)—then the SEC has exceeded its authority by seeking to regulate them. In other words, the effect of Rule 151A would be to confer additional authority upon the SEC when these products, in fact, are entitled to the Section 3(a)(8) exemption.

The Supreme Court has twice construed the scope of Section 3(a)(8) for annuity contracts in the *VALIC* and *United Benefit* cases.[1] I believe the approach embraced by Rule 151A conflicts with these Supreme Court cases. Although neither *VALIC* nor *United Benefit* deals with indexed annuities directly, the cases nevertheless are instructive in evaluating whether such a product falls within the Section 3(a)(8) exemption. And despite the adopting release's efforts to discount its holding, at least one federal court applying *VALIC* and *United Benefit* has held that an indexed annuity falls within the statutory exemption of Section 3(a)(8).[2]

When fixing the contours of Section 3(a)(8), the relevant features of the product at hand should be considered to determine whether the product falls outside the Section 3(a)(8) exemption. Rule 151A places singular focus on investment risk without adequately considering another key factor—namely, the manner in which an indexed annuity is marketed.

Moreover, I believe that Rule 151A misconceptualizes investment risk for purposes of Section 3(a)(8). The extent to which the purchaser of an indexed annuity bears investment risk is a key determinant of whether such a product is subject to the Commission's jurisdiction. Rule 151A denies an indexed annuity the Section 3(a)(8) exemption when it is ''more likely than not'' that, because of the performance of the linked securities index, amounts payable to the purchaser of the annuity contract will exceed the amounts the insurer guarantees the purchaser. This approach to investment risk gives short shrift to the guarantees that are a hallmark of indexed annuities. In other words, the central insurance component of the product eludes the Rule 151A test. More to the point, Rule 151A in effect treats the possibility of upside, beyond the guarantee of principal and the guaranteed minimum rate of return the purchaser enjoys, as investment risk under Section 3(a)(8). I believe that it is more appropriate to emphasize the extent of downside risk—that is, the extent to which an investor is subject to a risk of loss—in determining the scope of Section 3(a)(8). When investment risk is properly conceived of in terms of the risk of loss, it becomes apparent why indexed annuities may fall within Section 3(a)(8) and thus beyond this agency's reach, contrary to Rule 151A.

Not only does Rule 151A seem to deviate from the approach taken by courts, including the Supreme Court, but it also appears to depart from prior positions taken by the Commission. For example, in an amicus brief filed with the Supreme Court in the *Otto* case,[3] the Commission asserted that the Section 3(a)(8) exemption applies when an insurance company, regulated by the state, assumes a ''sufficient'' share of investment risk and there is a corresponding decrease in the risk to the purchaser, such as where the purchaser benefits from certain guarantees. Yet Rule 151A denies the Section 3(a)(8) exemption to an indexed annuity issued by a state-regulated insurance company that bears substantial risk under the annuity contract by guaranteeing principal and a minimum return.

In addition, Rule 151A seems to diverge from the analysis embedded in Rule 151. Rule 151 establishes a true safe harbor under Section 3(a)(8) and provides that a variety of factors should be considered, such as marketing techniques and the availability of guarantees. The Rule 151 adopting release even indicates that the rule allows for certain ''indexed excess interest features'' without the product falling outside the safe harbor.

An even more critical difference between Rule 151 and Rule 151A is the effect of failing to meet the requirements under the rule. If a product does not meet the requirements of Rule 151, there is no safe harbor, but the product nevertheless may fall within Section 3(a)(8) and thus be an exempted security. But if a product does not pass muster under the Rule 151A ''more likely than not'' test, then the product is deemed to fall outside Section 3(a)(8) and thus is under the SEC's jurisdiction. In essence, while Rule 151 provides a safe harbor, Rule 151A takes away the Section 3(a)(8) statutory exemption.

I am not aware of another instance in the federal securities laws where a ''more likely than not'' test is employed, and for good reason. A ''more likely than not'' test does not provide insurers with proper notice of whether their products fall within the federal securities laws or not. If an insurer applies the test in good faith and gets it wrong, the insurer nonetheless risks being subject to liability under Section 5 of the Securities Act, even if the insurer had no intent to run afoul of the federal securities laws. In addition, under the ''more likely than not'' test, the availability of the Section 3(a)(8) exemption turns on the insurer's own analysis. Accordingly, it is at least conceivable that the same product could receive different Section 3(a)(8) treatment depending on how each respective insurer modeled the likely returns.

Further, I am concerned that Rule 151A, as applied, reveals that the ''more likely than not'' test, despite its purported balance, leads to only one result: The denial of the Section 3(a)(8) exemption. In practice, Rule 151A appears to result in blanket SEC regulation of the entire indexed annuity market. The adopting release indicates that over 300 indexed annuity contracts were offered in 2007 and explains that the Office of Economic Analysis has determined that indexed annuity contracts with typical features would not meet the Rule 151A test. Indeed, the adopting release elsewhere expresses the expectation that almost all indexed annuity contracts will fail the test. If everyone is destined to fail, what is the purpose of a test? Further, there is at least some risk that in sweeping up the index annuity market, the rule may sweep up other insurance products that otherwise should fall within Section 3(a)(8).

The rule has other shortcomings, aside from the legal analysis that underpins it. These include, but are not limited to, the following.

First, a range of state insurance laws govern indexed annuities. I am disappointed that the rule and adopting release make an implicit judgment that state insurance regulators are inadequate to regulate these products. Such a judgment is beyond our mandate or our expertise. In any event, Section 3(a)(8) does not call upon the Commission to determine whether state insurance regulators are up to the task; rather, the section exempts annuity contracts subject to state insurance regulation.

Second, as a result of Rule 151A, insurers will have to bear various costs and burdens, which, importantly, could disproportionately impact small businesses. Some even have predicted that companies may be forced out of business if Rule 151A is adopted. Such an outcome causes me concern, especially during these difficult economic times. Even when the economy is not strained, such an outcome is disconcerting because it can lead to less competition, ultimately to the detriment of consumers.

Third, the Commission received several thousand comment letters since Rule 151A was proposed in June 2008. Consistent with comments we have received, I believe that there are more effective and appropriate ways to address the concerns underlying this rulemaking. One possible alternative to Rule 151A would be amending Rule 151 to establish a more precise safe harbor in light of all the relevant facts and circumstances attendant to indexed annuities and how they are marketed. A more precise safe harbor would provide better clarity and certainty in this area—regulatory goals the Commission has identified—and would preserve the ability of insurers to find an exemption outside the safe harbor by relying directly on Section 3(a)(8) and the cases interpreting it. I believe further exploration of alternative approaches is warranted, as is continued engagement with interested parties, including state regulators.

In closing, I request that my remarks be included in the **Federal Register** with the final version of the release. My remarks today do not give a full exposition of the rule's shortcomings, but rather highlight some of the key points that lead me to dissent. I wish to note that these dissenting remarks just given represent my view after giving careful consideration to the range of arguments presented by the Commission's staff, particularly the Office of General Counsel, the commenters, and my own counsel, as well as those of my fellow Commissioners. Although I cannot support the rule, I nonetheless thank the staff for the hard work they have devoted to its preparation.

[FR Doc. E9–597 Filed 1–15–09; 8:45 am]

BILLING CODE 8011–01–P

[1] *See generally SEC* v. *Variable Annuity Life Ins. Co. of Am.,* 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.,* 387 U.S. 202 (1967).

[2] *See Malone* v. *Addison Ins. Mktg., Inc.,* 225 F. Supp. 2d 743 (W.D. Ky. 2002).

[3] *Otto v. Variable Annuity Life Ins. Co.,* 814 F.2d 1127 (7th Cir. 1987). The Supreme Court denied the petition for a writ of certiorari.

TAB 9

Coalition Comment Letter

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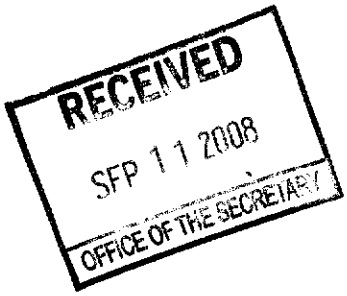


Ms. Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

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

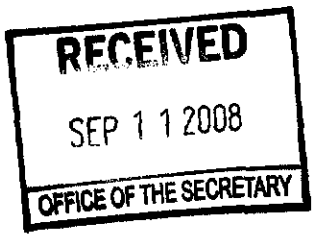
of the

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 stock-holder 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 re-named 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,

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[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

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[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.

Of counsel:

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TAB 10

NAIC Comment Letter

National Association of Insurance Commissioners

September 10, 2008

Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F. Street N.E.
Washington D.C. 20549-1090
File Number: S7-14-08

Dear Chairman Cox:

We write as the officers of the National Association of Insurance Commissioners (NAIC) and respectively submit these comments on the proposed rule issued by the Securities and Exchange Commission (SEC) which is intended to define the terms "annuity contract" and "optional annuity contract" under the Securities Act of 1933. The proposed rule also would add an exemption for certain insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act. You may receive additional comments from individual state departments of insurance.

General Comments

We are sending you this letter as a formal request to withdraw the SEC proposed rule on indexed annuities and certain other insurance contracts or, at the very least, delay its adoption given state insurance regulators' past activities to date in this area and what we are currently doing. This rule is not needed. If it is adopted, we feel that our current activities to address emerging issues concerning indexed annuities will be delayed or lose momentum altogether because states and the insurance industry will have to shift their focus to complying with your rule. This would not be in the best interest of the consumers that state insurance regulators and the SEC both wish to protect.

As we have described in our previous letters to you, state insurance commissioners, all of whom are NAIC members, have for many years clearly believed and have treated indexed annuities as insurance under their state laws subjecting the products, the companies and producers selling these products to state insurance regulatory oversight. As part of our mission to facilitate the fair and equitable treatment of insurance consumers, insurance products, including indexed annuities, are subject to a myriad of state insurance laws, not just those that relate to insurance company solvency. Those laws include state insurance advertising laws, replacement laws and producer licensing and continuing education laws among others. Thirty-three states have adopted the NAIC Advertisements of Life Insurance and Annuities Model Regulation or related legislation or regulations. This model sets forth 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. Likewise, a large number of states, 43 to date, have adopted the NAIC Life Insurance and Annuities Replacement Model Regulation or something similar. This model regulates the activities of both insurance companies and producers with respect to the replacement of existing life insurance and annuities. To protect the interest of life insurance consumers, it also establishes minimum standards of conduct that must be followed regarding replacement transactions to ensure that insurance consumers receive sufficient information to make a decision in his or her best interest regarding a

replacement and to reduce the opportunity for misrepresentation and incomplete disclosure. We also want to draw your attention to the NAIC state insurance producer licensing and continuing education laws. Every state ensures a minimum level of competency for producers by requiring producers to pass a test, answer background check questions as part of the application process and obtain a license prior to selling, soliciting or negotiating life insurance and annuity products. As part of this process, some states also require producers to complete pre-licensing education. In addition, all states require insurance producers to complete ongoing continuing education to maintain this license. Finally, some states, like Iowa, mandate specific indexed product training before producers are allowed to sell indexed products.

In the proposed rule, it is suggested that one main reason for its promulgation was to bring indexed annuities under the protection of the federal securities laws because these products are not being sufficiently regulated by state insurance regulators. We would disagree with this premise. We wish to call your attention to the specific efforts of NAIC members in the last two years to increase oversight of the sale of indexed annuities and the efforts undertaken by the industry to raise standards relating to the sale of these products to all purchasers. Those efforts are having beneficial effects on sales transactions and are leading to further reforms as we have highlighted below.

The NAIC has developed model laws and regulations, bulletins and a "Buyer's Guide to Annuities" to assist consumers in purchasing indexed annuities and to assist state insurance commissioners with the regulation of indexed annuities. To date, 33 states have adopted the NAIC Suitability in Annuity Transactions Model Regulation or related legislation. In addition, 22 states have adopted the NAIC Annuity Disclosure Model Regulation or related legislation. Most insurance companies follow this model as a standard throughout the country. The Buyer's Guide to Annuities includes a section on indexed annuities. A small group of regulators are currently updating the Buyer's Guide to Annuities to enhance the information provided to consumers about indexed annuities.

In June, the NAIC approved a national alert to warn older consumers to question the alleged credentials of some advisors to seniors. A Producer Bulletin was also approved to remind producers of their responsibilities to only sell suitable annuities and not to misuse their senior designation certifications. All of these efforts place the burden on insurance companies to make certain the requirements are being followed by producers. Some of our members, like the Kansas Department of Insurance, have already issued similar alerts and bulletins and posted them on their Web sites. In July, the NAIC Life Insurance and Annuities Committee adopted a model regulation on the use of senior-specific certifications and professional designations in the sale of life insurance and annuity products. This model regulation is patterned after the North American Securities Administrators Association (NASAA)'s recently adopted rule. The full NAIC membership is scheduled to adopt this new model at the NAIC meeting in Washington, DC later this month. As you see, the NAIC and its members take very seriously their responsibility to safeguard insurance consumers and particularly, to protect vulnerable seniors.

We also want to make you aware of some unique state initiatives. Earlier this year, Iowa teamed with the American Council of Life Insurers (ACLI) in a pilot project to assure adequate disclosures are uniformly made to consumers on annuity sales under the model disclosure regulations. Seventeen companies are participating in Iowa's pilot project and using the template disclosure form for all or some of their annuity products (indexed and otherwise) throughout all states. This pilot project will be evaluated for its usefulness to both insurance producers and consumers. If the disclosure templates prove to be useful, then the pilot project could be extended to include additional states later this year. In 2007, Wisconsin created an annuity sales supervision advisory committee charged with establishing standards for insurer supervisory systems in the sale of annuity products. Also, we note New Hampshire joined Iowa, Missouri and Illinois earlier this year in encouraging the Insurance Marketplace Standards Association (IMSA) to establish "best practices" for the supervision of annuity transactions. It is anticipated that IMSA will issue a final report later this

month. IMSA has already established best practices for the suitability of annuity sales and the disclosure of all annuity products sold and for agent training.

The NAIC Life Insurance and Annuities Committee identified annuity suitability as a priority for the Committee and created a working group that is reviewing and considering changes to the NAIC Suitability in Annuity Transactions Model Regulation to improve the regulation of annuity sales and to provide insurers uniform guidance in developing agent training, supervision and monitoring standards in order to better protect annuity consumers from unsuitable sales and abusive sales and marketing practices. As it works to develop recommendations, this working group has reached out to the Financial Industry Regulatory Authority (FINRA) and others in the regulator and regulated community in a collaborative effort to resolve any issues it discovers during its review of the NAIC model that may need to be addressed.

In June, the NAIC Life Insurance and Annuities Committee established a new working group to look at revising the NAIC Annuity Disclosure Model Regulation to improve the disclosure of information provided for annuity products, both generally and specifically, and to provide insurers uniform guidance in developing disclosure information and documents and monitoring distribution thereof in order to better inform annuity consumers about the annuity product purchased and how it works. This working group will also examine an emerging concern with the use of illustrations in annuity sales and solicitation. We, as state insurance regulators, intend to proactively examine the manner in which illustrations are being used and whether such use is appropriate.

Specific Comments

In the proposed rule, you ask for comments on a number of specific questions. If you choose not to withdraw the proposed rule or delay its adoption, please accept our comments below on those questions of particular interest to us as state insurance regulators. However, we would respectively request the right to comment in more detail at a later date.

As we have noted in our Aug. 14, 2008 letter to you, we are in the process of conducting a data call of the top insurance companies selling indexed annuities. The purpose of the data call will be to provide additional detail on the sales and marketing practices of these insurance companies. We have convened a small group of our members to review and analyze the information we receive from this data call to determine additional information we can share with you on how states regulate indexed annuities and any current or emerging issues in the marketplace.

Scope of the Proposed Definition (§230.151A (a))

Section 230.151A(a) would apply to a contract that is 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. Among the specific questions you ask regarding the scope of the proposed definition is whether it should apply to other forms of insurance other than annuities, such as life insurance or health insurance. We answer “No” it should not. Life insurance is clearly within the purview of state insurance laws and regulations and should remain so. The regulation of individual health insurance plans and policies has always been within the purview of state insurance regulators. In addition, although employee welfare benefit plans are subject to dual federal and state regulation under the Employee Retirement Income Security Act of 1974 (ERISA), states have the authority to regulate those plans that provide health benefits through an insurer. Also, we note that health insurance is not an investment product. The insured is entitled to benefits agreed to in accordance with the health insurance contract. As such, the SEC should not extend its proposed definition to health insurance.

Definition of "Annuity Contract" and "Optional Annuity Contract" (§230.151A (a))

Section 230.151A(a) proposes that an annuity issued by an insurance company would not be an "annuity contract" or an "optional annuity contract" under Section 3(a)(8) of the Securities Act (15 U.S.C. 77c(a)(8)) if the annuity has the following two characteristics: First, the amounts payable by the insurance company 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; second, amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract. If the annuity meets both of these characteristics, then the proposed rule would classify it as a security. As acknowledged in the commentary for the proposed rule, indexed annuities have a guaranteed minimum value. That is the reason why this product is an insurance product and not a security. The principal is guaranteed. The index is used to determine the crediting rate of interest to the account, and does not affect the account value directly as in a variable annuity, so the insured does not bear the investment risk directly. In addition, once the interest is credited to the policy, it becomes guaranteed and the company is now at risk to pay that also. There are surrender charges, but this is true of a standard fixed annuity as well.

The proposed rule defines an indexed annuity as not being annuity contract within the meaning of Section 3(8) of the Securities Act if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. This would also be true for standard fixed annuities. Although there is a minimum guaranteed interest rate underlying the contract, fixed annuities also use a declared interest rate that is higher than the minimum guarantee. Policyholders will get letters announcing new rates going forward. The contract does not contain language as to how the carrier will determine this rate. A key difference with the indexed annuity is that the contract describes how this rate is determined (i.e. tied to an index). Whereas variable annuities are in separate accounts, the indexed annuity is typically in the general account of a carrier as are standard fixed annuities. The insurance carrier bears the investment risk, not the owner.

Determining Whether an Annuity Is Not an "Annuity Contract" or "Optional Annuity Contract" under Proposed Rule 151A (§230.151A (b))

Section 230.151A(b) requires an insurer to make a determination of the more likely than not test at or prior to issuance of a contract and that determination would be conclusive if: (a) both the methodology and the economic, actuarial and other assumptions used in the determination are reasonable; (b) the computations made by the issuer in support of the determination are materially accurate; and (c) the determination is not made more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued. You have asked a number of questions related to these determinations to be made by insurers. We do not have specific comments on these questions other than to state that additional guidance may need to be included to ensure the integrity of these determinations. It is not clear within your proposed rule which regulator is going to determine whether or not a company is in compliance with the requirements.

Annuities not Covered by the Proposed Definition (§230.151A (a))

Section 230.151A(a) proposes that an annuity issued by an insurance company would not be an "annuity contract" or an "optional annuity contract" under Section 3(a)(8) of the Securities Act if the annuity meets certain specified characteristics as discussed above. You ask whether the proposed regulation should include a safe harbor under Section 3(a)(8) of the Securities Act for any annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. We believe that a safe harbor is not necessary. The current exemption under Section 3(a)(8) of the Securities Act provides this safe harbor.

Exchange Act Exemption for Securities that are Regulated as Insurance

In addition to the proposed new rule in §230.151A, the SEC is proposing new rule §240.12h-7. Section 240.12h-7 would exempt an insurer from the reporting requirements under Section 13(a) of the Exchange Act (15 U.S.C. 78m(a)) with respect to securities that are required to be registered under the Securities Act of 1933. You request specific comments on whether this exemption from the reporting requirements for securities that are regulated insurance under state law is appropriate. We believe that this exemption is appropriate for the reasons stated in the proposed rule. One main goal of insurance regulators is to ensure the financial solvency of insurance companies. As such, the reporting requirements under the Exchange Act would be duplicative and impose unnecessary regulation. However, we would also like to point out that insurance regulators also have another equally important goal—to protect insurance consumers. As we have outlined above, the NAIC and its members have a strong record in this area, in addition to ensuring the financial solvency of insurance companies.

We do have one suggestion, however, for this part of your proposal. We suggest that the scope of this exemption be expanded to permit licensed insurance producers to keep selling those products that would, under the proposed rule, no longer be exempt from Section 3(a)(8) of the Securities Act, without having to obtain a securities license. As we have noted in our general comments above, state insurance producer licensing and continuing education laws already provide strong consumer protections for this product. Requiring an additional securities license for insurance producers to sell this product is unnecessary.

We appreciate the opportunity to submit comments on the proposed regulation. We urge you, however, to withdraw the proposed rule or, at the very least, delay its adoption. As the NAIC officers and as State Insurance Commissioners, we would be pleased to meet with you to discuss the extensive and ongoing regulatory initiatives taken by state insurance commissioners to regulate the sale of indexed annuities and other annuities.

Sincerely,

Sandy Praeger
Kansas Insurance Commissioner
NAIC President

Roger A. Sevigny
New Hampshire Insurance Commissioner
NAIC President-Elect

Jane L. Cline
West Virginia Insurance Commissioner
NAIC Vice President

Susan E. Voss
Iowa Insurance Commissioner
NAIC Secretary-Treasurer

cc: Kristin Kaepplein
U.S. Securities and Exchange Commission

TAB 11

Iowa Insurance Division Comment Letter

Fields of Opportunities

STATE OF IOWA

CHESTER J. CULVER
GOVERNOR

PATTY JUDGE
LT. GOVERNOR

SUSAN E. VOSS
COMMISSIONER OF INSURANCE

September 10, 2008

Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F. Street N.E.
Washington D.C. 20549-1090

Re: File Number S7-14-08

Dear Chairman Cox:

The Iowa Insurance Division submits these comments on proposed SEC Rule 151A, a proposed rule about which Chairman Cox and Commissioner Voss have met and discussed.

The Iowa Insurance Division not only regulates insurance in the State of Iowa but also regulates securities, and, as such we are a member of the North America Securities Administrators Association. As a member, we do not agree with NASAA's stated position of supporting Rule 151A. As a member, I am troubled with the misinformation that NASAA has provided the SEC in its brief fated August 11, 2008, and I will set forth several areas that I believe are inaccurate in that brief.

Insurance is a major industry in Iowa and its insurance carriers have, in the first quarter of 2008, issued approximately 44% of the premium received on indexed annuities. Between Iowa carriers and Minnesota carriers, the two states have approximately 2/3rds of the indexed annuity premium received.

In the fall of 2005, the Iowa Insurance Division summoned the 5 major Iowa indexed annuity carriers to its offices to discuss the rising market conduct issues relating to the sale of indexed annuities. It also included in that group, two other major carriers that sell a small amount of indexed annuities but who also sell a large amount of other fixed annuity and variable products. After that discussion, Iowa developed a plan to bring more discipline to the market, including support of the NAIC Model Suitability Regulation, which is based on FINRA Rule 2310, except without any limitation concerning age. We invited the Insurance Department of Minnesota to join us in the plan so we could have an influence on carriers with approximately 67% of the market. Minnesota joined us in the endeavor and we worked together to get the carriers to focus on raising the standards of their marketing efforts. Iowa supported the subsequent change in the NAIC Model which removed the age restriction. At the March 2006 National Association of Insurance Commissioners (NAIC) meeting, Iowa set forth its program to the NAIC A and D Committees outlining its program and asked the other Insurance Commissioners to support the plan. Iowa also asked the Insurance Marketplace Standards Association (IMSA) to develop best practices for the sale of indexed annuities which they accomplished in less than 6 months.

In that 2 year period Iowa has taken the following action to raise the standard of market conduct by indexed annuity carriers:

1. Adopted the NAIC Suitability Model Act and advised companies that the regulation places the ultimate responsibility of suitability on the company no matter what distribution system is used by the company.
2. Encourage states to adopt the NAIC Annuity Disclosure Model which Iowa has had on force since 2004.
3. Adopted training requirements for producers which require companies to assure that (a) its producers have completed 4 hours of general indexed product training approved by the Iowa Insurance Division prior to their appointment to sell the individual products of that particular company.
4. Asked that the Insurance Marketplace Standards Association (IMSA) adopt specific best practices for its members to follow in the suitability of sales, disclosure of products and training of agents, which IMSA did and has now broadened to include all annuities. IMSA members are required to apply these best practices in all states in all annuity transactions.
5. Increased our review of indexed products to assure that the companies are providing adequate disclosure, proper advertising and targeting proper buyers before we approve the product.
6. Worked, and are working, on the national level in the NAIC with other states to assure that the highest standard of market conduct on indexed annuity transactions in maintained by the companies, regardless as to whether the state has adopted the suitability and disclosure regulations.
7. Received assurances by the Iowa domestic carriers (44% of the premium) that they are following the heightened standards required by Iowa in all states regardless of whether the state has adopted the model regulations.
8. Worked, and are working, with FINRA on cooperative efforts to harmonize the regulation and oversight of annuity transactions. In that effort, Iowa and FINRA have agreed that FINRA will oversee the sales of variable annuities and that Iowa will rely on FINRA's oversight, that Iowa and FINRA will share information on insurance issues and that FINRA will share training, as much as possible, on annuity suitability and supervision of annuity sales. For example, FINRA has met with NAIC Commissioners and conducted a FINRA session at NAIC meetings this year, and, in September of this year, will help train insurance regulators on suitability issues and examinations.
9. Have been an active member of the Annuity Roundtable Steering Committee which was established after the Annuity Roundtable held in May 2006.
10. Have encouraged NASAAS to work with Insurance Regulators in senior symposiums being held and also sweeps of free lunches but have been unsuccessful in getting such joint work with NASAA, and, have asked NASAA to consider working more closely with insurance regulators in helping to get bad producers out of the market.
11. Partnered with the American Council of Life Insurers (ACLI) to run a one year pilot project with some ACLI members using templates developed for disclosure of indexed and other fixed annuity products. 17 companies are currently enrolled in the pilot project and we are beginning to begin to develop the program to measure the effectiveness of the disclosure templates for the consumer. This is an important program to assure uniformity among companies in the preparation of disclosure documents which most companies are now using nationwide, even to states that do not have disclosure requirements.

I have gone through this litany of actions because I want you to know that insurance regulators have imposed many new standards and practices in the indexed product area in the last two years and are just beginning to have an effect on the indexed annuity market place. Imposition of proposed Rule 151A will have a chilling effect on this activity as companies have to comply with a new regulator in this area while

still meeting the new requirements imposed by states. By Minnesota and Iowa Insurance Regulators taking action through their domestic carriers, we have affected approximately 2/3rds of the indexed annuity market without worrying about what other states have done by formal regulation.

The SEC and NASAA have made statements to the effect that insurance regulators are concerned with insurance carrier solvency and not market conduct issues but you can tell from the above, and by comments from other states and the NAIC, that is not an accurate statement at all. No one has done more in the last two years to change the compliance culture of the annuity carriers, than the carriers themselves and insurance regulators, especially those in Iowa and Minnesota. 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. In addition, although FINRA Rule 2821 only applies to variable annuities, we encourage our companies to use the concepts of that rule to develop supervision oversight of the producer's sales. We are in the process of recommending new supervision processes to the NAIC based on Rule 2821 for fixed annuity, including indexed annuity, transactions to the NAIC Suitability Working Group chaired by Wisconsin.

Consequently, it is the Iowa Insurance Divisions position that indexed annuities are clearly insurance products subject to all state insurance laws and with all the risk of loss on the carriers issuing the annuity contract, and not the owner. In addition, with all the actions being taken by the states in this area, Rule 151A, is not necessary and will impede the efforts being made by state insurance regulators to assure proper sales, not only in the indexed annuity area, but in all fixed annuity sales. This will create more confusion and uncertainty in the market place.

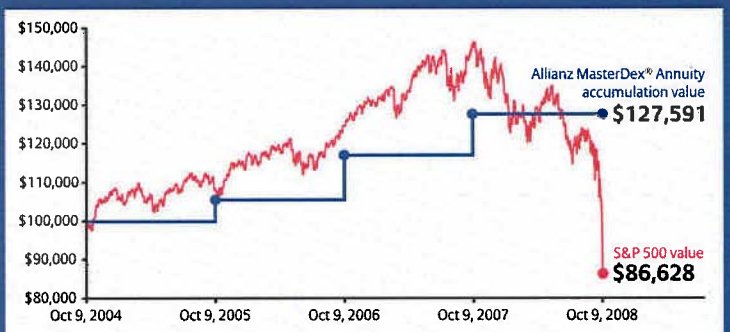
In addition, proposed Rule 151A would limit distribution to the broker-dealer distribution system, which would remove the availability of the product to many consumers because everyone does not have, nor do they want, a broker-dealer representing them but would rather work with their insurance producers. With the imposition of the new standards in the marketplace by insurance regulators and the carriers, the removal of the product availability to all consumers is not consumer protection.

I will be available for any additional information you may need in the future.

Sincerely,

Jim Mumford
First Deputy Commissioner

Is this insurance protection worth paying for?



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

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

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

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

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

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

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

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

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

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

Products are issued by Allianz Life Insurance Company of North America, and in New York, by Allianz Life Insurance Company of New York, New York City.
Allianz Life Insurance Company of New York is authorized to sell insurance and annuities in New York.

Product availability and features may vary by state.

P50614, P50614-NY