INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

September 10, 2008

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Ms. Harmon:

The Investment Company Institute[1] is pleased that the Commission has instituted this rulemaking to clarify the status of indexed annuities under the federal securities laws.[2] Since the mid-1990s, insurance companies typically have marketed and sold these products without registration under the Securities Act of 1933 ("Securities Act"), in reliance on the exemptions available to traditional insurance products. We believe that, as a general matter, indexed annuities – whose return is calculated based upon the performance of a securities index (*e.g.*, S&P 500 Index) – should be registered with the Commission and afforded the full range of protections available under the federal securities laws.[3]

The Institute is aware of concerns that the Commission's proposal is overbroad and thus could reach insurance contracts traditionally regulated under state insurance laws. While the Commission

---

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.14 trillion and serve almost 90 million shareholders.

The Institute developed its positions on this rulemaking with input from, among others, members of the Institute's Variable Insurance Products Advisory Committee.

[2] *See Indexed Annuities and Certain Other Insurance Contracts*, SEC Release Nos. 33-8933 and 34-58022 (June 25, 2008), 73 Fed. Reg. 37,752 (July 1, 2008) ("Proposing Release"). Page number citations in this letter reference the Proposing Release as posted on the Commission's website, which is available at http://www.sec.gov/rules/proposed/2008/33-8933.pdf.

[3] This position is consistent with that articulated by the Institute in 1997, in response to the Commission's initial request for comments on the status of indexed annuities under the federal securities laws. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Dec. 30, 1997 ("1997 Letter"). *See also Equity Index Insurance Products*, SEC Rel. No. 33-7438 (Aug. 20, 1997), 62 Fed. Reg. 45,359 (Aug. 27, 1997) ("Concept Release"). We recommend that the Commission post on its website all comment letters submitted in response to the Concept Release, because those letters are pertinent to this rulemaking and, at this time, are not readily accessible by the public.

must thoughtfully analyze the comments that it receives regarding the scope and application of the proposed rule (including those outlined in this letter), the Institute urges the Commission to resolve the very longstanding uncertainty regarding the status of indexed annuities, for the benefit of both investors and market participants.[4]

The Institute also supports the Commission's related proposal to exempt certain insurance companies from filing reports under the Securities Exchange Act of 1934, as amended ("Exchange Act"), with respect to indexed annuities and certain other securities registered under the Securities Act. Because state insurance regulators periodically examine the financial condition of insurance companies and require them to file annual reports regarding their financial condition, we concur with the Commission's assessment that the imposition of duplicative Exchange Act reporting requirements is unnecessary under these particular circumstances.

Indexed Annuities Should be Registered Under the Federal Securities Laws

Section 3(a)(8) of the Securities Act exempts certain insurance contracts, including "annuity contracts" and "optional annuity contracts," from the registration requirements of the Securities Act. Whether a particular contract fits within the Section 3(a)(8) exemption generally is determined based upon a facts and circumstances analysis of factors articulated by the U.S. Supreme Court and other authorities, including the contract's allocation of investment risk between the purchaser and the insurer, and the manner in which the contract is marketed.[5] Consistent with these factors, the Commission in 1986 adopted Securities Act Rule 151, a "safe harbor" under Section 3(a)(8), for variations in traditional (*i.e.,* fixed) annuity contracts.[6]

---

[4] *See, e.g.,* Letter from Thomas M. Selman, Executive Vice President, Corporate Financing/Investment Companies Regulation, FINRA, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, dated Aug. 11, 2008 ("FINRA Letter") at 2 ("uncertainty about the status of [indexed annuities] has impeded the ability of FINRA and other regulators to ensure that indexed annuity investors receive comparable protections under the securities laws to products so similar that investors cannot reasonably distinguish them from indexed annuities"); *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars*, Report by the Commission's Office of Compliance Inspections and Examinations, North American Securities Administrators Association and Financial Industry Regulatory Authority, Sept. 2007 (explaining that the most commonly discussed products at sales seminars included indexed annuities, mutual funds, variable annuities, and other investment products). A copy of the report is available on the Commission's website at http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.

[5] Proposing Release at 8 (citing *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) and *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967)).

[6] Rule 151 provides that an annuity contract issued by a state-regulated insurance company is deemed to be within the Section 3(a)(8) exemption if (i) the insurance company assumes the investment risk under the contract in a manner prescribed in the rule, including by providing certain minimum guarantees, and (ii) the contract is not marketed primarily as an investment. Although contracts that do not satisfy Rule 151 may rely directly on Section 3(a)(8), the Commission has stated that the rationale underlying the conditions in Rule 151 is relevant to any Section 3(a)(8) determination. *See Definition of Annuity Contract or Optional Annuity Contract*, SEC Rel. No. 33-6645 (May 29, 1986).

The Institute believes that indexed annuities should be registered with the Commission as securities. First, in many cases, the purchaser of an indexed annuity – and not the issuing insurance company – assumes the primary investment risk under the contract. Second, it can be difficult to fairly market certain indexed annuities as other than securities.

Indexed annuities, like other annuity contracts, generally guarantee a return of principal (less contract expenses and charges) plus some minimum level of interest (together, the "guaranteed amount"). The economic lure of an indexed annuity, however, is the potential for the purchaser to earn more than the guaranteed amount, in the form of so-called "excess interest."[7] In this context, the excess interest component is determined by reference to the investment return of a specified securities index.[8] Moreover, the rate of return to be credited under the terms of the contract is determined retrospectively, by looking back at the actual performance of the index during the relevant period. The retrospective determination of the investment return under the terms of the contract makes the indexed annuity perform in this respect like an index mutual fund, with the purchaser of the indexed annuity assuming the investment risk with respect to the return in excess of the guaranteed amount.[9]

In addition, it can be difficult to fairly market certain indexed annuities as other than securities. Those marketing such annuities recognize that they are designed for investors seeking to achieve the "upside" potential returns of the stock and other securities markets without the "downside" risk that ordinarily accompanies those investments.[10] Thus, a fair explanation of these indexed annuities requires communication about the stock and bond securities markets. Insurance agents cannot properly differentiate for their customers the securities index-linked products from traditional insurance products without emphasizing the securities index-linked investment return of indexed annuities. Otherwise, a salesperson would have no basis for recommending that an investor forego the guaranteed return of a traditional insurance product in favor of the return enhancement provided by the excess interest component of a securities index-linked product.

This conclusion – that indexed annuities should be registered with the Commission – is consistent with the investor protection goals of the federal securities laws. As both the Commission and FINRA have recognized, indexed annuities are complex products with a history of sales practice

---

[7] *See, e.g., Equity-Indexed Annuities – A Complex Choice*, FINRA Investor Alert (Apr. 22, 2008), available at http://www.finra.org/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/Equity-IndexedAnnuities-AComplexChoice/P010614 (if the purchaser of an indexed annuity does not receive any "index-linked interest," he or she could lose money on the investment).

[8] The purchaser's index-based return will depend upon the particular combination of features specified in the contract. Proposing Release at 10.

[9] This issue is discussed more fully on page 6 of the 1997 Letter.

[10] *See generally* National Association of Securities Dealers, 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 (encouraging member firms to supervise transactions in equity-indexed annuities as though they are securities).

abuses.[11] Applying the provisions of the Securities Act and the Securities Exchange Act to these products will ensure that the purchaser of an indexed annuity receives full disclosure regarding the contract's terms and associated risks, and protection of both the antifraud rules and FINRA's requirements regarding suitability and supervision of sales personnel. In so doing, the Commission would ensure that purchasers of indexed annuities would be afforded the full range of protections under the federal securities laws.[12]

Scope of the Commission's Proposal

Proposed Rule 151A under the Securities Act would define a class of annuity contracts that are outside the scope of the Section 3(a)(8) exemption. Specifically, paragraph (a) of the proposed rule would exclude from the exemption any contract issued by an insurance company and subject to regulation as an annuity under state insurance law, if (1) amounts payable by the issuer under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities; and (2) amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

While the Institute strongly supports the Commission's intention to extend the protections of the federal securities laws to indexed annuities, many of our insurance company members (as well as members affiliated with insurance companies) have raised concerns that paragraph (a) of the proposed rule is drafted too broadly, such that it could require the registration of certain annuities that traditionally have been viewed as insurance products. It is our understanding that individual insurance companies, as well as insurance industry trade associations, are carefully analyzing the scope of the proposed rule and intend to provide the Commission with specific comment on this issue.[13]

Institute Comments on Issuer Determinations Under Proposed Rule 151A

Paragraph (b) of proposed Rule 151A addresses the manner in which an insurance company would determine, for purposes of paragraph (a) of the rule, whether the amounts payable under a particular indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract. It provides that such a determination, if made at or prior to issuance of the contract, will be considered conclusive if:

- both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;

---

[11] *See, e.g.*, Proposing Release at 8; FINRA Letter, *supra* note 4, at 2-3.

[12] Proposing Release at 32-33.

[13] If the Commission evaluates these comments and determines that no changes to proposed Rule 151A are necessary, we believe the Commission must provide additional guidance in any adopting release on the types of annuity contracts that would be covered by the rule and those that would not.

- the insurance company's computations in support of the determination are materially accurate; and

- the determination is made not 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.

The Institute is concerned that application of the proposed method outlined in paragraph (b) of the rule and described in the Proposing Release[14] could lead to anomalous results among insurers or results that run counter to the purposes of the federal securities laws. For example, different insurance companies offering substantially similar indexed annuity contracts could well reach different conclusions on the question of whether the particular contract would come within proposed Rule 151A, with the result being different legal protections for similarly situated purchasers. We believe that this outcome would be at odds with the intended purpose of the rule, which is to "provide certainty to both insurers and investors."[15] Accordingly, we recommend that the Commission revise paragraph (b) so as to ensure more certainty and more consistency across the insurance industry in the application of proposed Rule 151A.

We further believe that the status of an indexed annuity under the federal securities laws should not be allowed to differ within a single contract based upon the particular mix of benefits or other options that may be selected by a purchaser. Instead, any determination under paragraph (a)(2) with respect to the registration of an indexed annuity should be applied consistently across all forms of that contract.

Finally, we recommend that the Commission revisit the provision in proposed paragraph (b)(2)(iii) that would, in effect, require an insurance company to evaluate the securities law status of a particular indexed annuity every three years. Under this provision, it is possible, for example, that an indexed annuity could be registered with the Commission as a security, based upon the results of the insurer's initial determination under Rule 151A(a), but then "de-registered" with respect to future sales if the insurer's subsequent determination under the rule reached a different conclusion. This could be the case even though the features of the contract remained constant during the three-year period. We believe that such an outcome would not be consistent with the purposes of the federal securities laws.

---

[14] The Proposing Release explains that, in making this determination, an insurance company would have to analyze expected outcomes under various scenarios involving different facts and circumstances. These facts and circumstances would include, among other things, the particular features of the annuity contract, the particular options selected by the purchaser, and the performance of the relevant benchmark. The insurance company also would need to make various assumptions regarding insurer behavior, purchaser behavior and market behavior; as the Proposing Release recognizes, a reasonable assumption by one insurer may differ from a reasonable assumption by another insurer.

[15] Proposing Release at 36-37.

Proposed Exemption from Exchange Act Reporting

The Commission also is proposing to exempt insurance companies from certain Exchange Act reporting requirements. Proposed rule 12h-7 would apply to indexed annuities and other securities issued by an insurance company that are registered under the Securities Act and regulated as insurance under state law. It would require, among other things, that (i) the relevant securities are not publicly traded and (ii) the insurance company takes "reasonable steps" to ensure that a trading market for the relevant securities does not develop.

We support this proposal, and agree with the Commission's conclusion that the imposition of Exchange Act reporting requirements on those insurance companies that issue indexed annuities and certain other securities that are regulated as insurance under state laws is duplicative and unnecessary.[16] Similarly, we agree with the Commission that it is appropriate for the proposed exemption to extend to contracts regulated under state insurance laws that provide certain guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage or advisory account.

The proposed rule would specify that, in taking steps reasonably designed to ensure that a trading market for the relevant securities does not develop, an insurance company must "require[e] written notice to, and acceptance by, the [insurance company] prior to any assignment or other transfer of the securities and reserve[e] the right to refuse assignments or other transfers at any time on a non-discriminatory basis."[17] We understand from our insurance company members that state regulators have sought to facilitate transfers of annuity contracts and in some cases may not approve the issuance of a contract that places limits on its transferability. We urge the Commission and its staff to consult with state insurance regulators regarding this issue, in order to ensure that any condition to the availability of this Exchange Act exemption not conflict with the requirements placed on insurance companies by state insurance regulators.

*　*　*　*　*

[16] The Proposing Release states that a key basis for the proposed exemption is that investors are already entitled to the financial condition protections of state law and that, under the federal system of regulation, Exchange Act reporting may be unnecessary. Proposing Release at 52.

[17] Proposed Rule 12h-7(e).

The Institute appreciates the opportunity to provide comments on these proposals. If you have any questions about our comments or would like additional information, please contact me at (202) 326-5815, Susan Olson at (202) 326-5813 or Rachel Graham at (202) 326-5819.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

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

Andrew J. Donohue, Director
Susan Nash, Associate Director
Division of Investment Management