

September 10, 2008

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

**Re: File Number S7-14-08
Indexed Annuities and Certain Other Insurance Contracts**

Dear Ms. Harmon:

The Financial Planning Association® (“FPA®”)¹ welcomes the opportunity to comment on the Securities and Exchange Commission’s (“Commission” or “SEC”) proposal to curb misleading and fraudulent sales practices targeting the senior community. Rule 151A (the “Rule”)² would bring certain annuity products within the definition of a “security” that have become an increasing concern of securities regulators due to the aggressive marketing of these products as investments.

Under the Rule, indexed annuities would be treated as securities and not as annuity contracts or optional annuity contracts as defined under Section 3(a)(8) of the Securities Act of 1933 (“Securities Act”).³

FPA members are very familiar with indexed annuities, inasmuch as most financial planners specialize in retirement planning and 58 percent are licensed to sell insurance and annuity products. They may recommend annuities, including indexed annuities, as an important component of a client’s overall financial plan, but are required under a professional code of

¹The Financial Planning Association is the largest organization in the United States representing financial planners and affiliated firms, with approximately 28,000 individual members. Most are affiliated with investment adviser firms registered with the Securities and Exchange Commission or state securities administrators, and more than one-half are affiliated with broker-dealers. FPA is incorporated in Washington, D.C., where it maintains an advocacy office, with headquarters in Denver, Colo.

² Release Nos. 33-8933, 34-58022; File No. S7-14-08 (“Proposing Release”)

³ 15 U.S.C. 77c(a)(8)

ethics and FPA's bylaws⁴ to undertake detailed analysis of the product and the client's personal finances and goals before making any specific recommendations. When providing financial planning services, they must act in the client's best interest as a fiduciary, no matter if securities or insurance products are involved, and to disclose and manage those conflicts to the benefit of the client.⁵

Several years ago, expressing concern with misleading and abusive marketing practices in the sale of equity-indexed annuities, and knowing that the SEC had reviewed the issue years earlier, FPA urged the Commission to reopen the issue for further consideration.⁶ In reviewing the proposing release, FPA is generally supportive of Rule 151A as a reasonable, balanced approach to establishing needed additional oversight of indexed annuity sales and to provide consumers – particularly the more vulnerable aging population -- with enhanced protection. At the same time, the proposed industry exemption from reporting requirements under the Securities and Exchange Act of 1934 ("Exchange Act") recognizes the primary role state insurance regulators play in ensuring the soundness of the product and the insurer, and minimizes the regulatory burden of this rule on insurance companies without compromising consumer protection.

I. Defining the Product

As the SEC notes in the proposing release, indexed annuities typically include features widely associated by the public with security investments, including mutual funds and variable annuities.⁷ Indexed annuities have a minimum guaranteed return, but the actual return will vary based on the performance of a securities index, such as the S&P 500. More recently, they have been tied to less "well-known" indices such as T-Bill Funds, Fixed Income, or even Euro-Asia Funds, which give the further appearance of mimicking variable annuities and other investments.

Based on comments already submitted to the SEC, insurers involved in producing and selling indexed annuities generally prefer that these products fall within the Section 3(a)(8) exemption for annuities, while others, including FPA, have argued that the characteristics of indexed annuities should subject them to the Securities Act, and in certain circumstances, the fiduciary standard of the Investment Advisers Act of 1940 ("IAA"). Whether an annuity qualifies for the Securities Act exemption was addressed by the U.S. Supreme Court in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) ("*VALIC*"). In *VALIC* the court established a two-part test for whether an annuity qualifies for exemption under section 3(a)(8). The first part of the test is the allocation of investment risk between the insurance company and the customer, and the second part of the test is based on how the annuity is marketed.

⁴ <http://www.fpanet.org/docs/assets/Bylaws.pdf>

⁵ See CFP Board's Standards of Professional Conduct, rules 1.2, 1.4, and 2.2. The standards may be found at <http://www.cfp.net/Downloads/2008Standards.pdf>.

⁶ See March 3, 2005, FPA letter to SEC Chairman William H. Donaldson.

⁷ Proposing release at 27.

Indexed annuities provide for a minimum guaranteed return, which is an *indicia* of risk assumption on the part of the insurer. However, this alone is not sufficient to establish a level of risk assumption which necessarily qualifies an annuity for an exemption under Section 3(a)(8). In *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (“*United Benefit*”), the Supreme Court addressed this issue and concluded that the assumption of some investment risk in itself does not qualify an annuity for exemption under section 3(a)(8). Significantly, while a minimum guaranteed return mitigates the potential down-side investment risk for a customer the potential up-side benefit is typically capped. Thus the insurer assumes the risk of the more extreme fluctuations in the index, while the customer continues to bear the significant investment risk that falls between the minimum guaranteed return and the caps on potential returns.⁸

An additional risk borne by the customer, although it isn’t a risk directly tied to the performance of the index, is the typically high surrender charge that often is in force for a decade or more after the purchase of the annuity. For example, senior investors who need additional liquidity for emergency healthcare after purchasing an annuity may suffer overall losses if the policy is surrendered prematurely to free up cash flow. Securities, in contrast, are a relatively liquid financial product. Like annuities, investments in the stock market may not be the only solution for an individual, but each should be weighed by financial advisors, along with tax consequences and a host of other factors, in considering the best interests of the client. Ironically, the law of agency generally requires the insurance producer to act in the interest of the insurer, not the client, thereby making the management of conflicts and objective recommendations that much more difficult.

Yet the allocation of risk alone would not cause an annuity to be subject to regulation under the Securities Act. The second part of the *VALIC* test, which is reflected in the SEC’s proposed rule, is how the product is marketed. While admittedly a subjective test, the marketing of the product, like the risk allocation, is entirely within the control of the insurer. Unlike the risk allocation, it cannot be argued that this test impacts the fundamental elements and core use of the product. Instead, it simply affects the marketability of the product. Simply put, the insurer chooses to market these annuities as either investment products or as insurance products.

The Securities Act Rule 151 codifies the Supreme Court’s test and provides in part that the insurer assumes the risk on an annuity if it guarantees the principal and credited interest, which must be at least equal to that required under the applicable state law. It further requires that the rate of interest in excess of the minimum guaranteed rate must not be modified more frequently than once per year.⁹ The proposing release notes that indexed annuities may not rely on Rule 151’s safe harbor because the excess interest is calculated more than once per year.

⁸ In *Malone v. Addison Ins. Mktg. Inc.*, 225 F. Supp. 2d 743 (W.D.Ky 2002), (“*Malone*”) a district court made a factual determination that a particular indexed annuity was more akin to a fixed, rather than variable annuity, and was therefore exempt under 3(a)(8). The determination was based largely on the fact that the contract guaranteed 100% return on the premium, plus a guaranteed minimum annual return of 3%. As noted above, FPA believes the annuitant bears an investment risk notwithstanding the guaranteed return. Further, we do not believe *Malone* in any way precludes the Commission from promulgating Rule 151A.

⁹ 17 CFR 230.151(a)

It is against this backdrop that the SEC is proposing Rule 151A to provide further clarity in the application of the Supreme Court's two-part test. Simply, under proposed Rule 151A an annuity would not be exempt under Section 3(a)(8) if the amounts payable by the insurer are tied to the performance of a security or security index and those amounts are more likely than not to exceed the amounts guaranteed under the contract. Essentially, if the customer is more likely than not to be bearing an investment risk, the annuity would be considered a security.

FPA supports the SEC's approach and believes it represents a reasonable application of the VALIC test, consistent with the intent of the Securities Act. Notwithstanding any minimum guarantee, returns on these products are directly tied to the performance of a securities index, and the customer bears the risk of market fluctuations. Moreover, they are frequently marketed as investment products and customers are drawn to them as investment products, not as insurance products. For these reasons, customers can and should expect to enjoy substantially the same protections afforded purchasers of other securities investment products.

II. Consumer Protection

By proposing a reporting exemption for indexed annuities under the Exchange Act, the SEC is recognizing the important role insurance regulators play in approving these products and ensuring that customers will receive the guaranteed benefits for which they contracted. As noted in the proposing release, this has been the primary role of insurance regulators.¹⁰ Insurance regulators are well positioned to oversee the solvency of indexed annuity policies to ensure payouts throughout the life of the policy. However, not all states have adopted suitability requirements for annuity product sales, and most do not have a significant history of monitoring sales practices and enforcing suitability or antifraud standards, which are essential to ensuing protection for *investors* in securities products. Moreover, some states that have adopted suitability standards may lack the resources to vigorously enforce those standards. We have not seen any data that suggests those states have dedicated significant resources to this problem. In any event, Rule 151A would not preclude state insurance regulators from protecting purchasers of indexed annuities, but would bring the added resources and expertise of state and federal securities regulators to combat abusive sales practices.

The SEC notes that 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."¹¹ We agree. While improvements have been made to model rules, more could be done under state insurance laws, particularly in strengthening standards of competence, disclosure of conflicts, and managing those conflicts, difficult as it may be under the law of agency. In the absence of adequate suitability requirements and training as a minimum level of protection in all states, we are left with the current troubling situation – a product that varies in value based on the performance of a securities index -- and sold by an agent who may have no more knowledge of or experience in the securities markets than the customer. As we noted in our previous letter to the Commission, determining whether an indexed annuity is an appropriate investment for a client may require a complex review of, among other things, the tax-deferred treatment of earnings in the annuity, distribution options

¹⁰ Proposing release at 48.

¹¹ *Id.* at 27

and related penalties for early distribution, product liquidity, load costs versus costs and returns for alternative fixed-income products, and sales and early surrender charges. In the current regulatory scheme, therefore, we have insurance agents making what are essentially investment recommendations to their customers and purporting to assess the appropriateness of that recommendation in light of the customer's financial situation. Add to this the significant financial incentives for agents to sell these products and it is easy to see how senior investors in particular could easily end up buying products that run counter to their actual needs and financial goals in retirement.

The Commission long ago expressed concern with investor protection issues regarding this product. In a 1997 address to a conference on life insurance company products, the then-Director of the SEC Division of Investment Management noted:

We are concerned that product marketing sometimes may create the misimpression that equity index insurance products are a means for participating fully in upside market returns without any downside risk. It now appears that it may be very difficult to market these products without giving undue emphasis to their investment-related features. We are also concerned that the varied and complicated forms of these products may make it most difficult for investors to understand what they are buying, and perhaps for agents -- particularly agents unfamiliar with the securities markets -- to understand what they are selling.¹²

The SEC staff's concerns proved to be well-founded. Not only are large segments of the public confused regarding the potential income to be received from equity-indexed annuities, but to a certain extent so are some of the licensed producers. We believe much of this is due to inadequate training in the complexities of the product, such as little or no guidance by certain insurers to assist them in explaining obscure factors that can materially affect the value of the policy. We are therefore strongly supportive of the Commission's comments in the proposing release that additional information about critical costs such as surrender charges, the method of computing indexed returns, as well as guaranteed interest rates, among others, would be required disclosures under federal securities laws.¹³

Over the years, financial planners have provided FPA with an array of anecdotal and troubling examples that reinforce the need for more effective disclosure by the insurer to the agent, and the agent to the consumer. The examples cited below, which we believe are symptoms of a larger problem, reinforce the urgent need for regulators to establish a strong framework of protection with respect to internal controls for marketing and for disclosing critical features of these products to the purchaser. Following are some of the concerns cited by FPA members that should be addressed in any disclosure requirements that are promulgated for equity-indexed annuities:

¹² Barry J. Barbash, "Insurance Products: The Responsibilities of A Growing Industry," 15th Annual Advanced ALI-ABA Conference on Life Insurance Company Products, Washington, D.C., October 22, 1997. See <http://www.sec.gov/news/speech/speecharchive/1997/spch183.txt>

¹³ Proposing release at 70.

- Certain EIA carriers are not fully disclosing or providing adequate training to producers regarding risks to consumers that are unique to indexed products, unless the agent knows enough about the different products to ask for the information. These include:
 - lower payouts if the policy holder annuitizes during the surrender period;
 - a lower interest rate at the time the policy is issued (the so-called “guaranteed interest rate”) than represented at the point of sale, due to a non-forfeiture NAIC model law that allows insurers to alter the guaranteed rate at issue, or after issue;¹⁴
 - a lower rate than the so-called “guaranteed” interest rate represented to the buyer that may be applied after the surrender period ends, thereby diluting the effect of compound returns.
- Certain EIA carriers failing to disclose to their licensed agents when the product’s underlying investments have been downgraded through a change to the AM Best rating, thereby creating more risk for purchasers. In one notable case, one insurer allegedly misrepresented to agents how far the rating actually went down (A++ to B) and refused to explain the reasons.
- Certain EIA carriers not fully disclosing to producers the expected performance differences among different performance crediting options such as Point to Point, Monthly Point to Point, Monthly Averaging and others; nor is such information disclosed to the consumer. Instead, agents are misled by applying slightly higher caps for lower performing options in representing potential returns to clients.
- Certain EIA carriers allegedly failing to inform their agents and disclose to consumers that the company will lower caps and/or pars when the markets go up, thereby strictly limiting the chances for market share participation that was otherwise advertised and/or represented in the marketing materials
- Certain EIA carriers misrepresenting that the “guaranteed interest rate” will be applied to 100% of the premium when it is not generally disclosed that the effective guaranteed rate may be lower. For example, this happens when the guaranteed rate is promoted as 3%, but fails to disclose that it applies only to 70% of the premium, resulting in an effective rate of 2.1%.
- The use of misleading software illustrations by certain carriers applying the much higher S&P500 Index performance to hypothetical EIA returns, but not disclosing the limits on returns due to policy caps.

¹⁴ Requirements for interest rate adjustments may vary by state. See, e.g., Utah H.B. 52 (enrolled), 2004 session, “Individual Deferred Annuities – Nonforfeiture Amounts,” page 6, sec. (5)(b)(i).

- Certain EIA carriers ignoring, at best, the abusive practice of some licensed agents promoting reverse mortgages to access a home's equity for the purpose of investing the proceeds in an EIA that may generate even less income than an often costly reverse mortgage.

It is hoped that these examples offer additional perspective to the myriad investor protection challenges that need to be addressed through enforcement – whether by the SEC, state regulators, or both. FPA believes proposed rule 151A is an important first step in gaining better control over the sale of these investment products for the benefit of the public and in particular, senior investors who have been the target of many of these predatory sales practices.

III. Equity-Indexed Universal Life Insurance

FPA notes that equity-indexed universal life insurance policies also are available in the marketplace and are being promoted as investment alternatives by a number of marketing organizations. While not the subject of proposed Rule 151A, they share many of the characteristics of indexed annuities. Going forward we suggest that the SEC consider whether the principles underlying Rule 151 and proposed Rule 151A would be applicable to equity-indexed universal life insurance.

IV. Investment Advice

While FPA is supportive of the proposed Rule, we hesitate to agree with the SEC's conclusion that *all* persons effecting certain indexed annuity transactions under the Rule should be required to be associated with, or registered as broker-dealers.¹⁵ Investment advisers are not legally required to be affiliated with a broker-dealer in order to manage a client's securities portfolio and, indirectly, effect securities transactions. They are able to do so by maintaining discretionary authority, or a limited power of attorney, over a client's securities portfolio that allows the transactions to be executed through discount brokerage firms, but at the direction of the fiduciary adviser. Further, financial planners do not currently need to be licensed as insurance producers in order to assist their clients in implementing life insurance or annuity transactions. Instead, they may recommend that their clients purchase no-load products or refer them to a licensed producer if they are not so licensed themselves.

We say this because we are concerned that if the SEC adopts the Rule the marketplace may quickly move beyond it if low-load or no-load annuity products eventually become available through discount broker-dealers. Similar to the current regulatory environment that allows investment advisers to direct securities transactions through a discount broker, we would not want to see them inadvertently required to register as, or become affiliated with broker-dealers, in order to implement certain components of a financial plan.

Moreover, while we believe that the suitability requirements currently in place for broker-dealers are an improvement over the status quo, we are not convinced that it would provide sufficient consumer protection, given the history of investor protection problems still associated with the sale of variable annuities, which is a close cousin of the indexed annuity. In looking at past SEC

¹⁵ Proposing release at 71.

interpretations of the definition of “investment adviser,” we believe the Commission should also examine whether certain sales activities of insurance producers rises to the level of “investment advice,” thereby subjecting the person to the much higher fiduciary and disclosure protections of the Investment Advisers Act of 1940 (“IAA”).

In Sec. 202(a)(11) of the IAA, for example, Congress broadly defined “investment adviser” as

Any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities....

In interpreting what constitutes the “advisability of investing in....securities,” the Commission has traditionally held a broad view of investment advice so that advising a client *not* to invest in the equity markets, such as is the comparative marketing pitch of EIA purveyors, may meet the definition of “investment adviser” in the IAA. As early as 1981, in IA Release 770, the SEC stated that

A person who, in the course of developing a financial program for a client, advises a client as to the desirability of investing in securities as opposed to, or in addition to, stamps, coins, direct ownership of commodities, or any other investment vehicle would also be “advising” others within the meaning of Section 202(a)(11).¹⁶

While the Commission recognized the need for flexibility in allowing other industry persons to “merely discuss in general terms the advisability of investment in securities” without triggering adviser registration, SEC staff also established reasonable limits to what could be construed as general advice by stating that such a person would be in the business of providing investment advice if

...on anything other than rare and isolated instances, he discusses the advisability of investing in, or issues reports or analyses as to specific securities or specific categories of securities (e.g., bonds, mutual funds, technology stocks, etc.).¹⁷

In other words, insurance producers would be in the business of giving investment advice under IA-770 by discussing with customers the advisability of investing in specific securities market indices. It would be completely unrealistic to expect an insurance producer whose paycheck depends on selling a line of indexed annuity products not to favorably compare the advantages of an equity-indexed annuity to the risks of its namesake in the market. Nor can opponents of the Rule claim that such comparisons to securities indices are rare or isolated instances. Abundant warnings can be found on regulators’ websites, in the media, and documented in one congressional hearing about the steady rise in systemic and abusive sales practices involving equity-indexed annuities.¹⁸

¹⁶ IA Release No. 770, Aug. 13, 1981, Vol. 23, No. 6, at 558.

¹⁷ *Id.* at 559-560.

¹⁸ See, e.g., FINRA investor alert “Equity-Indexed Annuities – A Complex Choice,” (updated Apr. 22, 2008); NASAA report entitled “NASAA Survey Shows Senior Investment Fraud Accounts for Nearly Half of all Complaints Received by State Securities Regulators,” July 17, 2006; and Senate Special Committee

Accordingly, FPA supports the Commission's adoption of the Rule without extending the comment period as some have suggested. We see no reason to prolong a debate over whether annuities are securities or insurance contracts – an issue that was first considered in promulgation of the Uniform Securities Act of 2002. Industry opponents and regulators have had their opportunity over six years to hone arguments opposing the definition of annuity as a "security" in that model state law.

Once the Rule is adopted, we believe sufficient time should be allowed for unregistered insurance producers to become associated with broker-dealers, or as the case may be, with investment adviser firms. Agents who decide to continue selling indexed annuities should be allowed sufficient time to prepare for and pass the required securities examinations, and to select a new firm if their current insurance company determines not to register.

V. Conclusion

FPA is pleased that the Commission has chosen to take a reasoned, measured approach to regulating indexed annuities. Rule 151A recognizes that indexed annuities have both insurance and securities characteristics, and proposes a system of dual insurance-securities oversight. Fundamental to considering the regulation a financial product are two questions:

- Does the financial professional understand the product being sold?
- Does the consumer understand the product he or she is purchasing?

Proposed Rule 151A is a significant step forward in helping ensure that the people selling annuities fully understand the product they are recommending, and that consumers are making an informed choice.

If you have any questions, or if FPA can provide additional information, please contact me at 202-449-6343, or dan.barry@fpanet.org.

Sincerely,



Daniel J. Barry
Director of Government Relations