

Comments of the Maryland Insurance Administration on
Proposed SEC Rules 151A and 12h-7

Executive Summary

The Maryland Insurance Administration (“MIA”) submits these comments to the Securities and Exchange Commission (the “Commission”) on proposed Commission Rules 151A and 12h-7. The MIA respectfully urges the Commission not to adopt these rules.

The proposed rules are based on two premises. The first premise is that indexed annuities are securities; the second premise is that state insurance authorities do not adequately regulate indexed annuities. Both of these premises are false. Because indexed annuities operate like insurance, not securities, the Commission’s historic position that they are properly subject to state insurance regulation, not federal securities regulation, is correct. Further, because indexed annuities are insurance products, the MIA, as a state insurance regulator, regulates them. The MIA’s counterparts in other states do likewise.

The regulatory gap which the Commission’s new rules propose to fill does not exist. These proposed rules are classic examples of a solution in search of a problem. Moreover, the Commission’s proposal to add a new layer of unneeded and duplicative federal regulation will add burdens, increase costs, create confusion, and not increase consumer protection.

1. Indexed annuities are insurance products, not securities.

The Commission has not regulated indexed annuities in the past and, instead, has recognized, pursuant to section 3(a)(8) of the Securities Act of 1933, that their regulation properly lies with state insurance regulators. Section 3(a)(8) exempts annuity contracts, as well as other insurance products, from federal securities regulation when they are issued by a corporation subject to state insurance regulation. An examination of how indexed annuities operate confirms that these products are, as the Commission has viewed them for many years, exempt from the Commission's regulation as insurance products. Evidence that equity indexed annuities are insurance products, not securities, includes the following:

- The account value of an equity indexed annuity is held in the insurer's general fund. The account value in an equity indexed annuity is not invested in equities.
- The insurer on an equity indexed annuity contract guarantees a minimum rate of interest which will be credited to the account value and guarantees indexed interest pursuant to a contractual formula irrespective of the performance of the insurer's assets; therefore, the insurer, not the policyholder, bears the market risk on the insurer's assets that the rate of return may be lower than the guaranteed rate of interest.
- The insurer can limit the amount of interest which will be credited to an equity indexed annuity by reducing the "participation rate" (in

advance only) and/or by stating a maximum rate which will be credited.¹ Thus, there is no pass-through of investment performance.

- The interest that may be credited to the equity indexed annuity account value at a rate more than the rate guaranteed in the contract is similar to the “excess interest” that may be credited to a traditional deferred annuity or a universal life insurance contract and to the dividends which are traditionally expected on a whole life insurance contract.

In sum, the Commission’s historic practice of not regulating indexed annuities is correct because it is the view consistent with the fact that indexed annuities are insurance products, not securities, and are exempt under section 3(a)(8). The Commission should not change its historic position.

2. The MIA regulates indexed annuities.

A. Maryland’s statutory and regulatory framework

Given that indexed annuities operate as insurance products, they have been (and are) regulated – and extensively so – as insurance products. The MIA regulates the insurers that underwrite these products; the MIA regulates the producers who sell these products; and the MIA regulates the products themselves.

¹ The interest to be credited to an equity indexed annuity contract is linked to an external index, usually Standard & Poor’s 500 Composite Stock Price Index. The interest is declared by the insurer at the beginning of each year and must be at least the amount required by the Annuity Nonforfeiture Law, currently between 1% and 3%. In addition, the insurer guarantees that the crediting rate will be at least a percentage of the return realized by the index (the “participation rate”). The insurer declares this participation rate in advance annually. The insurer may state a maximum rate that will be credited regardless of how the index performs.

Set forth below are the relevant Maryland statutory and regulatory citations.² The Maryland regulatory structure is illustrative of state insurance regulatory structures; comparable regulatory regimes exist in other states.

Regulation of insurers

- §2-201 – provides enforcement authority for violations of the Insurance Article;
- §2-205 – authorizes examination of insurers;
- §4-101 –addresses the requirements for a Certificate of Authority (including mandatory and discretionary grounds to deny, refuse to renew, suspend and revoke authority);
- §4-205 –lists “acts of insurance” which may not be done without a license;
- §5- 101 –relates to assets, liabilities, reserves, and investments of insurers;
- §7-101 –relates to Maryland’s Acquisition Disclosure and Control Act;
- §9-101 –addresses circumstances where an insurer may become impaired (solvency).

Regulation of producers

- §2-206 - examination of agents;
- §10-103 - requires a license for insurance sales;
- §10-105, §10-107, §10-109, §10-116, and §10-117, requirements for an insurance license, including examinations, continuing education, and regular updating;
- §10-112 – issuance of producer license;
- §10-118 - termination with cause from carrier;
- §10-126 - permits denials, suspensions, revocations, and refusals to renew or reinstate any licensed agent;
- §12-201 - §12-210 – addresses forms of annuity products
- §27-102 - prohibits unfair trade practices;

² All statutory citations are to the Insurance Article of the Annotated Code of Maryland; the regulatory citations are to the Code of Maryland Regulations (“COMAR”).

- §27-103 and §27-104 - permits cease and desist orders for practices/acts that are defined and for practices not expressly defined, respectively;
- §27-202 through 216 – defines “unfair and deceptive acts/practices” such as misrepresentations, false statements, boycott, coercion, intimidation, inducements, unfair discrimination, rebates, twisting, tie-in sales, and improper premiums and charges;
- §27-301 - §27-306 – prohibits unfair claim settlement practices
- §27-403 - requires return of unused premiums and prohibits false or misleading claims;
- §27-405 and §27-406 – defines unlicensed activity and unregulated insurers as fraudulent.

Regulation of product/contract

- §12-203 –addresses the requirement that forms must be submitted for approval before being sold in Maryland;
- §16-400 –addresses the required contract provisions, including grace period, incontestability, misstatement of age or sex, crediting of dividends, and reinstatement provisions;
- §16-500 - the Maryland Standard Nonforfeiture Law for Individual Deferred Annuities;
- COMAR 31.09.09 – Maryland Illustrations regulation
- COMAR 31.15.01 – Addresses Unfair Trade Practices in advertising;
- COMAR 31.15.04 – Addresses Unfair Trade Practices in solicitation of annuity contracts;
- COMAR 31.09.12 – entitled “Suitability in Annuity Transactions” is Maryland’s broadly protective suitability regulation, setting forth standards and procedures for each recommendation to a consumer that results in a transaction involving an annuity product so that the insurance needs and financial objectives of the consumer at the time of the transaction are appropriately addressed. This regulation applies to insurers, agencies, and producers with respect to all annuity transactions and specifically incorporates the National Association of Securities Dealers (a/k/a Financial Industry Regulation Authority) Conduct Rules pertaining to suitability for the recommendation of variable annuities.

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

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

B. MIA staff devoted to regulating indexed annuities

Maryland’s regulatory regime is not a “paper tiger.” The laws on paper are backed up by substantial resources devoted to the enforcement of these laws. For example, the MIA has competent professional staff who specialize in annuity marketing; others who specialize in life insurance and annuity complaints; examiners who are qualified to examine equity indexed annuity activities; analysts who review annuity filings; staff who conduct examinations and audits; and staff who perform market conduct examinations. All of these resources are available to and, as appropriate, are applied to the effective regulation of indexed annuities.

C. MIA's market conduct activities

As detailed above, the MIA has ample legal authority to oversee all aspects of the indexed annuity industry. Pursuant to these authorities, the MIA has completed in the past five years market conduct examinations of the following companies that write equity indexed annuities:

AXA Equitable Life Insurance Company
F & G Life Insurance Company (now Old Financial Life Insurance Company)
Hartford Life & Annuity Company
Jackson National Life Insurance Company
New York Life Insurance Company
Prudential Life Insurance Company
Union Labor Life Insurance Company

No violations with respect to equity indexed annuities were found during these examinations.

D. The MIA receives few consumer complaints involving indexed annuities

The MIA's complaint files refute the assertion that there is a large and growing problem in the area of indexed annuities. Complaints about equity indexed annuities represent less than 1/2 of 1% of the complaints received by the MIA's Life and Health Unit. The MIA received a grand total of four complaints relating to indexed annuities in 2004, nine in 2005, seven in 2006, and three in

2007. So, over the four years, 2004-2007, the MIA received 23 complaints in this area. This is not evidence of a major problem.

3. The predictable and avoidable costs of duplicating state regulation.

The Commission will likely receive comments from the indexed annuity industry and others about the administrative burdens and financial costs associated with adding a new duplicative layer of federal regulation. The MIA wishes to highlight a different and, arguably, far more serious potential cost resulting from this proposed new layer of regulation.

A benefit of the present system is the certainty it provides as to where regulatory authority and responsibility for indexed annuities lies: it lies with state insurance regulators. That certainty will be lost if federal regulation is added to the mix. An inevitable downside of parallel state-federal regulatory systems will be disputes (some legitimate, some not) about whether a state rule or practice conflicts with and thus is preempted by a federal law. The industry players most in need of regulatory oversight will be creative in manufacturing these disputes.

Thus, a perverse or unintended consequence of the Commission's proposal, if it is pursued, is that it will create holes in a regulatory system that at present is seamless. This will be confusing to consumers and weaken consumer protection by allowing bad actors to argue that they are beyond the reach of state regulation.

With all due respect, it seems highly improbable that the Commission will devote the same level of resources to the protection of Maryland consumers as the MIA does now. Federal regulation in this area is, therefore, likely to hurt, not help, Maryland consumers.

4. The Commission has failed to consider adequately the views of states.

Without prior consultation with the states, the Commission issued its proposed rules and the Commission set a short comment period on this major change. While the Commission received numerous requests to extend the comment period, including a request from the Maryland Insurance Commissioner, the Commission ignored these requests. The Commission's treatment of this matter is disrespectful of the states' long-standing interests in this area of state authority. The Commission's approach is inconsistent with principles of federalism. *See* Executive Order 13132, § 3(a) (August 4, 1999) (agencies of the United States, other than independent regulatory agencies, shall, to the extent practicable, consult with state officials before any action is taken "that would limit the policymaking discretion of the States"). While the Executive Order is not binding on the Commission, its philosophy and rationale should guide how the Commission proceeds.

5. Conclusion

States, including Maryland, are regulating indexed annuities now and doing so effectively. The paucity of consumer complaints that the MIA has received is proof that there is no need for a new layer of federal regulation. Furthermore, there is reason to believe that the Commission's proposed rules, if adopted, will weaken consumer protection. And finally, the Commission has proceeded in this matter far too quickly and without allowing interested parties sufficient time to develop and to present their views. For all these reasons, the Commission should not adopt the proposed rules.

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