

Jack Marrión's
Comments On SEC
Proposal

**SEC Release Nos. 33-8933, 34-58022; File No.
S7-14-08**

The crux of this analysis is a possible response agents and smaller marketing organizations may be able to use to defeat the proposal, which is the proposal imposes undue economic hardship without meaningfully improving consumer protection.

I believe it would be ineffective for carriers, marketing organizations, agents and insurance regulators to say they are doing a good job when it comes to suitability and protecting consumers. For over five years the media, regulators, securities industry people and lawyers have been saying index annuities are bad products being sold by bad people to defraud seniors. And for over five years the industry has sat virtually silent allowing these accusations to be accepted as truth. It is too late for index annuity players or insurance regulators to attempt to wear the white hat. I believe a more effective strategy is to say security will not make the problem better; all it will do is impose unnecessary costs and be anti-competitive.

The following are some comments about the proposal and a more detailed response for agents and marketing companies to use with their elected representatives. SEC quotes are in italics.

Advantage Compendium Comments

"We are proposing 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 the following two characteristics.

First, 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.”

The SEC proposed rule would make all currently marketed index annuities securities. Why should index annuities be made securities?

“We have determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws would enhance investor protection”

What about Safe Harbor Guideline 151 describing when an annuity is not a security?

“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”

According to producers the overriding reason given for the purchase of index annuities is safety and avoidance of market risk – what exact opposite logic is the SEC using?

“these purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.”

Section 3

“When the amounts payable...are more likely than not to exceed the amounts guaranteed under the contract, the purchaser assumes substantially different risks and benefits. By purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to 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.”

Essentially the proposal says since the future return of an index annuity is unknown therefore it is a security. The reality is the future is always unknown. A bank money market account rate floats from day to day, universal life insurance rates float from year to year, an I Savings Bond return varies based on the inflation rate, and even SEC registration prices are not locked in forever. And yet none of these are viewed as securities. The proposal attempts to minimize the index annuity benefit that protects principal and credited interest from market loss by saying the benefit does not eliminate all risk. I submit that because of an unknown future it is impossible to eliminate all risk in any aspect of life and is therefore an invalid criterion to use. The criteria should be “can the consumer lose principal without taking any action of their own”.

“Should the proposed definition apply to forms of insurance other than annuities, such as life insurance or health?”

Altho the proposal only applies to index annuities there is nothing to stop the final rule to cover any other type of insurance that bases pricing or returns on an external index. If index life carriers are remaining quiet about the proposal in the hope they will be ignored, I believe this ostrich strategy will fail.

Section 6 Cost/Benefit Analysis

“Disclosures that would be required for registered indexed annuities include information about costs (such as surrender charges); the method of computing indexed return (e.g., applicable index, method for determining change in index, caps, participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits).”

All of this information is already included in the customer materials provided to the consumer and the consumer must sign a disclosure saying they are aware of these points.

“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.”

Only a regulator would argue that requiring a business to fill out fewer unnecessary forms than another business is a “savings” and yet the proposal says carriers will save \$15,414,600 because they will need to fill out fewer unnecessary forms than some other businesses.

“If an insurer ceases selling such annuities, the insurer may experience a loss of revenue.”

I wish to make this clear. If you can't sell a product it is not “may” lose revenue it is a fact.

“What are the costs of entering into a networking arrangement with a registered broker-dealer? How many entities currently distribute indexed annuities? Of those, how many have entered into a networking arrangement to sell other insurance products that are also securities (i.e., variable annuities)? How many have registered as broker-dealers to sell other insurance products that are also securities?”

Since NASD released 05-50 there has been a concerted effort by many index annuity carriers to broaden distribution through B/Ds. As of the first quarter of 2008 99% of index annuity sales were not placed through broker/dealers [Advantage Index Sales & Market Report]. This proposal disrupts or destroys virtually all of the existing distribution for the industry despite evidence that creating a new successful distribution channel may be impossible.

Section 7

“Section 2(b) of the Securities Act¹²¹ and Section 3(f) of the Securities Exchange Act¹²² 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.”

The proposal says it will. One of the arguments used is that B/Ds may currently 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. However, this wishful thinking is not evidenced by the facts.

Before FINRA and NASAA raised the specter of FIA illegitimacy sales of index annuities by broker/dealers were negligible; for the 1st quarter of 2003 sales of index annuities thru B/Ds were 0.3% and for the 1st quarter of 2004 sales of index annuities thru B/Ds were also 0.3%. Index annuity sales thru B/D channels had actually increased to 1.0% by the 1st quarter of 2008 [Advantage Index Sales & Market Report]. Index annuity sales increased during this period of “uncertain regulatory status” but were still negligible.

The proposal somehow manages to determine that capital formation will be enhanced and competition will be enhanced encouraging “insurers to innovate and introduce a range of new insurance contracts that are securities”. However, it does not provides evidence of this and dismisses the loss of carriers that will be unwilling or unable to compete in a securities environment by saying the loss of firms should be “considered in conjunction with the potential enhancements to competition”.

Agent Response to SEC Release Nos. 33-8933, 34-58022; File No. S7-14-08

The **Regulatory Flexibility Act** can be used to fight a proposed rule if empirical data shows there would be significant impact on small entities (\$5 million assets or less); the **Small Business Regulatory Enforcement Fairness Act** can be used to fight a proposed rule if it can be shown: the rule causes an annual effect on the economy of \$100 million or more; a major increase in costs or prices for consumers or individual industries would result; or there would be a significant adverse effects on competition, investment, or innovation.

Altho there are many large MOs in the FIA world that would be “large entities” under the rule there are dozens more that would be small ones In addition, there may well be 100,000 annuity agents that would be affected by the proposal and a significant percentage would have business assets not over \$5 million. Does this proposed rule pose a significant impact on these “small entities”?

A 3-year old Advantage Compendium survey found 45% of index annuity producers did not have securities registration. To continue to sell index annuities under the proposal would require these 45,000 agents (a newer valid survey is desired to support this number) to train for and pass at least a Series 6 exam, and then hook up with a broker/dealer that would charge fees and or share in the agent income. In addition, the agent would more likely than not be required to send every scrap of paper they share with the public in their non-securities business to the B/D’s compliance department so the B/D could either approve use of the public marketing letter/script/product, or affirm it is not in anyway securities related. I am hearing that many B/D’s are erring on the conservative side and effectively controlling every aspect of their representatives’ non-securities business life in fear of FINRA.

If B/D and FINRA fees alone averaged \$500 a year the additional cost would be \$22.5 million. This does not take into account the agent man-hours lost in productive time usually spent with consumers that would be spent in preparing forms and sending in non-securities sales and public materials because of FINRA’s lack of clear guidelines on what the B/D should examine.

The total street level agent commission paid out on FIAs in 2007 was \$2 billion [calculated based on Advantage Index Sales Marketing Report sales and commission figures]. If commission levels remained the same – and I believe they would drop – and the broker/dealer only took 10% of the commission as their fee the annuity agents would lose \$200 million in income. Between securities registration fees and even a low level of commission sharing the proposal would cost agents \$222.5 million a year. In addition, there will be agents that cannot or will not obtain securities registration and will be forced to stop selling index annuities. This lack of product will reduce agent sales, and a greater reliance on remaining fixed annuity products with lower commissions – primarily multi-year rate annuities – will substantially reduce agent income. A more “empirical” cost analysis is needed, but it would not be difficult to do.

The proposal would have a profound impact on marketing organization revenues. MOs currently provide product training, lead generation and index annuity products to agents. They generally do not provide a direct supervisory role, altho they may assist the carrier in ensuring that carrier consumer-related requirements for policy sales are performed by the agent. For these services the MO receives an override above the agent commission generally of 2% to 3% on index annuity sales. In 2007 this would have translated into income of \$453 to \$680 million. If FIAs become securities the broker/dealer would bear total responsibility for the supervision of agent FIA sales. FIA product selection, agent training, ensuring suitability of the sale, delivering the policy and even how the agent prospects, would be the B/D’s responsibility. If the MO was involved in the process at all their primary function would be that of a product wholesaler for the carrier. Annuity wholesaler compensation is in the 0.15% to 1% range. Even if FIA sales did not drop due to the proposal MOs could see their annual compensation fall to \$60 to \$200 million.

Adding together the most conservative estimate of additional expenses to insurance agents with lost revenues to marketing organizations, the proposal could result in a loss of \$852 million to insurance industry distribution channels. Most of this loss would be incurred by small entities, it would have a significant effect on the economy, and it would result in a major increase in costs for insurance agents. I believe that losses and extra costs can be empirically shown to result from this proposal. I do not know whether an “empirical” case can be made showing significant adverse effects on competition, investment, or innovation, but I cannot imagine that the loss of almost a billion dollars in an industry would have a positive effect.

The rationale behind the SEC proposal is “We believe this would enhance investor protection”, but there is nothing to support this. Variable annuities are registered securities, but the total variable annuity complaints from 2004 thru 2006 were 507 versus 353 index annuity complaints for the same period [<http://www.naic.org/cis/index.do>]. Indeed, a review of NASD *Notice to Members* for 2004 and 2005 finds 1,415 cases listing securities registered individuals fined, barred or suspended from the NASD for not protecting investors, but only one case alleging inappropriate suitability wherein a fixed annuity was mentioned [NASD Case #C11040048].

Although Patricia D. Struck, of the North American Securities Administrators Assoc. (NASAA) said at the SEC Seniors Summit, “Cases involving variable or equity-indexed annuities represented an estimated 65 percent of the caseload in Massachusetts, and 60 percent of the caseload in Hawaii and Mississippi” according to the NAIC database for 2005, there were a total

of 8 closed index annuity complaints in Hawaii and 14 in Massachusetts. Mississippi had a significant 39 complaints, but 17 of these were from one company going through reorganization and did not appear to be sales conduct related. Including index annuities in her statement appears designed to cause guilt by association and is intellectually dishonest. To use an example, it would be like saying “90% of NASAA members have been convicted of drunk driving or parking violations”. Now my hypothetical data may show that only one member ever had a DWI and all the rest were merely ticketed for lapsed parking meters, but the inference is there.

The conclusion is obvious. The proposal will do nothing to enhance investor protector, but it will subject tens of thousands of insurance agents to financial hardship due to lower revenues and higher costs.

Jack Marrion
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