COMMENT LETTER

December 30, 1997

Comment Letter on SEC Concept Release Regarding Equity Index Insurance Products, December 1997

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Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-6009

Re: Equity Index Insurance Products (File No. S7-22-97)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to express its views on the Commission's concept release regarding equity index annuities and other equity index insurance products (collectively, "EIPs").[2] The Institute believes that EIPs do not qualify for the exclusions from the federal securities laws available to traditional insurance products and that they present significant investor protection concerns that can be addressed only by regulating them as securities under the federal securities laws, including provisions of the Investment Company Act of 1940.[3]

I. Introduction And Background

Section 3(a)(8) of the Securities Act of 1933 exempts certain insurance contracts from the registration requirements thereunder.[4] In 1986, the Commission adopted Rule 151 under the Securities Act to establish a "safe harbor" from the federal securities laws for annuity contracts that satisfy the Rule's conditions.[5] These conditions derive from the applicable case law dealing with the insurance exemption of Section 3(a)(8).[6] Among the conditions are the requirements that the insurer assume the investment risk under the contract, and that the contract not be marketed primarily as an investment.

As discussed below, the Institute believes that EIPs fall outside the safe harbor of Rule 151 and are not entitled to rely on Section 3(a)(8), because investors, not insurers, assume the primary investment risk under EIP contracts, and EIP contracts can be fairly marketed only as securities. EIP contract values vary according to the investment experience of a "virtual" separate account (i.e., an external equity index), and most insurers apply that investment

experience to determine retrospectively—not prospectively, as Rule 151 requires—the "excess interest" to be credited to the contract. Moreover, because the return from an EIP investment, subject only to minimum guarantees, depends upon the performance of the equity markets, a fair explanation of these products requires insurance agents to discuss, and indeed emphasize, the risks of equity investments. Clearly, purchasers of EIPs need, and are entitled to, the protections of the federal securities laws in making an informed investment choice between an EIP and a registered variable product or another investment alternative.7

Basically, an EIP is a contract issued by an insurance company that provides minimum interest and return of principal guarantees, while crediting to the contract what insurers commonly refer to as "excess interest"—but what is actually an "equity return"—according to a formula that reflects the appreciation in an external equity index. Insurers typically link investment return to the value of the Standard & Poor's Composite Index of 500 Stocks, but also use other domestic and international indices, as well as composite indices that they may create. Indeed, an insurer could link investment return to the value of a portfolio of equity securities, such as a mutual fund that funds variable contracts issued by a registered separate account.

Although EIPs generally guarantee a return of principal (less contract expenses and charges) plus some minimum level of interest, as required by state nonforfeiture laws,8 the economic lure of an EIP is the potential for an investment return linked to the performance of an index of equity securities. Using extremely complicated indexing formulae,9 insurers measure the performance of the applicable index over a specified period—but without taking into account reinvested dividends. Insurers use "participation rates"—typically between 75% and 90%—to determine how much of the appreciation in the index they will use to calculate "excess interest."10

Since they were first introduced in 1995,11 EIPs have quickly become the "darling" of the insurance industry.12 Growth in EIP sales has been exponential—total industry sales by the end of 1997 are estimated in the $3 to $4 billion range,13 up from $0.2 billion in 1995. This growth parallels the bull market. Essentially, EIPs are the insurance industry's competitive response to the public demand to share in stock market-based returns. The rationale behind an EIP is that it will outperform traditional fixed insurance products during a bull market and outperform equity investments during a bear market.

EIPs provide insurance companies and their agents a way to compete in the equity markets without complying with the federal securities laws, without being registered with the NASD, and with insurance-style sales commissions that may be double the commissions payable for sales of regulated variable products.14 To date, most of the more than 30 companies offering EIPs have not registered their products with the Commission as a security under the Securities Act, in reliance on the exemption from registration for traditional insurance policies and annuity contracts available under Section 3(a)(8) of the Securities Act. The Institute believes that EIPs, with an equity indexing feature at their core, are far removed from traditional (fixed) insurance products and are regarded—and indeed promoted—in the marketplace as securities and as an alternative to a mutual fund or variable contract investment. Accordingly, the Institute believes that it is entirely appropriate that EIPs be regulated as securities under the federal securities laws.

II. EIPs Are Not Exempt From Federal Securities Regulation As "Insurance"

As noted above, in 1986 the Commission adopted Rule 151 as a "safe harbor"15 from the federal securities laws for variations in traditional (fixed) annuity contracts16 that Congress, in Section 3(a)(8) of the Securities Act, deemed to be "insurance" and not "securities." Like fixed annuities, EIPs offer a guaranteed minimum return; however, unlike fixed annuities, an investment return related to the market performance of an index of equity securities is an integral feature of EIPs. That feature is the economic inducement behind EIPs and causes EIPs to fall outside the safe harbor of Rule 151 and the Section 3(a)(8) insurance exemption.

Rule 151's safe harbor is available only if: (i) the contract is issued by a corporation subject to state regulation as an issuer of insurance contracts; (ii) the issuer assumes the investment risk under the contract; and (iii) the contract is not marketed primarily as an investment. EIPs fail to meet conditions (ii) and (iii) because investors, not insurers, assume the primary investment risk under EIPs, and because EIPs can be fairly marketed only as securities.

A. Investors, Not Insurers, Assume The Primary Investment Risk Under EIP Contracts

Although an insurer need not assume all the investment risk for a contract to qualify for the insurance exemption under Section 3(a)(8), the Supreme Court in United Benefit made clear that the investment risk assumed by the insurer must predominate over the investment risk assumed by the investor.17 Under Rule 151, an issuer will be deemed to assume the investment risk sufficient for purposes of Section 3(a)(8) only if: (i) the value of the contract does not vary according to the investment experience of a separate account; (ii) the insurer guarantees principal and a specified rate of interest for the life of the contract; and (iii) the insurer guarantees that it will not modify the rate of any discretionary excess interest more frequently than once per year.

An EIP's use of an external equity index shifts to the contract owner all of the investment risk with respect to the so-called "excess interest" rate.18 The "excess interest" rate is the predominant investment risk under an EIP contract and that rate varies according to the investment experience of a "virtual" separate account (i.e., an external equity index). Moreover, most insurers determine retrospectively—not prospectively, as Rule 151 requires—the "excess interest" to be credited to the EIP contract.

1. EIP Contract Values Vary According To The Investment Experience Of A "Virtual" Separate Account

Insurers typically support their obligations under EIP contracts with assets in their general accounts. However, it is simply form over substance to conclude from this that EIPs satisfy Rule 151's condition that the contract value not vary according to the investment experience of a separate account.19 An EIP is essentially a derivative product that achieves the economic effect of a securities investment without an actual investment in that security. It is, in substance, a "virtual" separate account that provides the equity return—the so-called "excess interest"—from an EIP investment.

2. Most EIP Contracts Determine "Excess Interest" Retrospectively

As an initial matter, the term "excess interest" used in connection with an EIP contract is a misnomer. Under an EIP contract, an insurer does not promise "excess interest"—by definition, income derived from a fixed-income investment. Rather, the insurer promises what is, in fact, an "equity return" related to the performance of the "virtual" separate account (i.e., the external equity index). The actual return is based on an equity-linked formula that reflects change in principal value but not dividends. Such an equity return is not "excess interest" in any meaningful sense of the term. Nor is the equity return in any sense "discretionary." Instead, the insurer is contractually obligated to credit to an EIP contract whatever portion of the return, if any, is required by the contract's indexing formula (and the various, complicated components of this feature).

Even if equity return could be properly characterized as "excess interest," the fact that most EIP contracts determine "excess interest" rates retrospectively prevents those contracts from satisfying Rule 151's conditions. Rule 151 makes clear that, once determined, the excess interest rate must be guaranteed under the contract for the "next" 12-month or longer period. Thus, the safe harbor covers only those contracts which provide that the actual excess interest rate, as opposed to the excess interest rate formula, is determined prospectively for at least the next 12-month period, not retrospectively.

Most EIP contracts do not satisfy this condition because only their indexing formulae, participation rates and applicable margins, caps, or floors are determined at the beginning of the contract and guaranteed for a period of at least a year. The rate of "excess interest," if any, that will be credited under the contracts depends on the performance of the applicable equity index during the upcoming year. Thus, an EIP investor does not know in advance what rate will be applied and is deprived of information that would help the investor decide whether to keep funds in an EIP or withdraw them and invest them elsewhere.20 Subject to the minimum guarantees specified in the contract, the purchaser remains exposed to the speculative risk of an investment in a portfolio of equity securities.

Thus, the retrospective determination of the equity return makes an EIP look like a mutual fund with the contract owner assuming the investment risk with respect to all of the equity return in excess of the guaranteed minimum.22 It is the lure of that equity return, not the guaranteed minimum, that induces an investor to choose an EIP over a traditional insurance product. That fact clearly emerges from any analysis of the way EIPs can be fairly marketed.

B. EIP Contracts Can Be Fairly Marketed Only As Securities

The Commission noted in the Rule 151 Adopting Release that the Supreme Court in United Benefit found that the insurer had advertised its product by "emphasizing the possibility of investment return and the experience of United's management in professional investing."22 The Commission observed that "[t]he Supreme Court found this activity to be highly relevant in concluding that the contract [did] not fall within the insurance exclusion of section 3(a)(8) of the [Securities] Act."23 Accordingly, the Commission made the marketing of an annuity product a critical factor in determining whether such a product could take advantage of Rule 151's safe harbor from federal securities regulation.

Those engaged in the marketing of EIPs recognize that EIPs are designed for investors seeking to achieve the "upside" potential stock market return without the "downside" risk that ordinarily accompanies equity investments. Thus, a fair explanation of EIPs requires communication about the equity securities markets. Insurance agents cannot properly

differentiate equity-linked products from traditional insurance products without emphasizing the equity-linked investment return of EIPs. 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 uncertain return of an equity-linked product. Accordingly, EIPs can be fairly marketed only as equity products and, thus, fail the "marketing" test under Rule 151.

III. Purchasers Of EIPs Need The Protections Of The Federal Securities Laws

EIPs may well be an appropriate addition to the variety of equity-based products now being offered to the American public. Certainly, it is not the Commission's function to determine otherwise. It is the Commission's responsibility, however, to apply securities regulation uniformly to all those who seek to market the "intricate merchandise"[24] of securities. The federal securities laws, including the system of industry self-regulation, represent the Congressionally mandated system for comprehensive controls over securities sales practices, including selling incentives for the merchandising of securities. Congress has deemed these controls necessary for the effective regulation of the securities industry and for the maintenance of investor confidence in those markets. If EIPs can be sold without regulation under the federal securities laws, the pattern of investor protection for those who seek investment return in the securities markets will be seriously jeopardized. State insurance regulation is no substitute. As Justice Brennan noted in VALIC, "[t]he system [of state insurance regulation] does not depend on disclosure to the public."[25]

In the absence of federal securities regulation, EIP contract owners will have no assurance that they will receive adequate disclosure of the risks involved in seeking the "upside" potential (i.e., the risks of securities investments) or that they will receive marketing material that provides a fair and balanced presentation of the risks and rewards of these products. As one observer noted, the marketing material for some EIPs is "extremely misleading," lacking, among other things, adequate disclosure that the formulae for measuring equity returns do not include dividends and that substantial differences exist between simple and compounded returns. [26] In addition, Moody's Investors Service Inc. recently reported its concern over advertising that suggested that equity index annuities had no traditional surrender charges when in fact "actual surrender penalties can be quite significant." [27]

Such misrepresentations are hardly unexpected, given the complexity of EIPs, the lack of securities training provided to the unregistered insurance agents who market those products, the absence of a disclosure focus in traditional insurance regulation, and the inability of individual state insurance regulators to adequately regulate nationwide selling practices of insurers subject to their jurisdiction. The potential for abusive selling practices is exacerbated by the fact that although EIPs compete directly with mutual funds and registered variable contracts, they have been free from the regulatory burdens imposed by the federal securities laws and they pay agents commissions that may be double those available from selling regulated products.[28]

The important investor protections afforded under the Investment Company Act must also be considered by the Commission in fashioning an appropriate regulatory framework for EIPs. The Supreme Court in VALIC made clear that the regulation of an insurance product as a security and an investment company under the federal securities laws does not depend on whether the insurer decides to place the contract reserves in a separate account or to fund the guaranteed promises made by the contract through its general account.[29]

The Institute does not mean to suggest that the entire panoply of Investment Company Act

regulation should be mechanically applied to separate accounts for EIPs. Just as in the case of variable contracts issued by insurance companies, an appropriate pattern of regulation can be fashioned through use of the Commission's exemptive power under Section 6(c) of the Investment Company Act. But, as in the case of separate accounts for variable insurance contracts, there is no reason why basic provisions of the Investment Company Act should not be applied for the protection of investors in EIPs. These protections should include at a minimum the Investment Company Act protection regarding custody of investment company assets and limits on selling compensation. In the Institute's view, the application of such protections, along with the disclosure requirements of the Securities Act and the broker-dealer regulatory provisions of the Securities Exchange Act of 1934, are just as important for investors in EIPs as the courts and the Commission have found them to be for investors in the other types of variable insurance products.

* * *

The Institute appreciates the opportunity to comment on the Commission's concept release on the federal securities law issues raised by EIPs. If you have any questions regarding the matters discussed herein, please contact the undersigned at 202/326-5815 or Amy Lancellotta at 202/326-5824.

Sincerely,

Craig S. Tyle
General Counsel

cc: Barry P. Barbash, Director
Susan Nash, Assistant Director
Division of Investment Management
Securities and Exchange Commission

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,718 open-end investment companies ("mutual funds"), 440 closed-end investment companies, and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.265 trillion, accounting for approximately 95% of total industry assets, and have over 59 million individual shareholders.

2 Equity Index Insurance Products, Securities Act Release No. 7438, 62 Fed. Reg. 45,359 (Aug. 27, 1997) (the "Release").

3 The Institute's comments expressed herein are general in nature. We note, however, that the Release solicits specific comment on a number of issues regarding the structure, operation, and marketing of EIPs. The Institute is not in a position to provide specific comments on those issues. Nonetheless, the Institute strongly believes that the status of EIPs under the federal securities laws should not depend upon the structural and operational intricacies of any particular product or the specific marketing approach taken by an insurer.

4 Section 3(a)(8) of the Securities Act exempts from registration under the Act "[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 . . . ."

5 Definition of Annuity Contract or Optional Annuity Contract, Securities Act Release No. 6645, [1986-87 Transfer Binder] Fed. Sec. Law Rep. (CCH) ¶ 84,004 (May 29, 1986) (the "Rule 151 Adopting Release").

6 SEC v. Variable Annuity Life Insurance Co. of America, 359 U.S. 65 (1959) ("VALIC"); SEC v. United Benefit Life Insurance Co., 387 U.S. 202 (1967) ("United Benefit").

7 To the extent EIPs are marketed to persons who would otherwise invest in fixed investment products, such as certificates of deposit or government bonds, the disclosure of the risks of equity investments is particularly important.

8 For example, state nonforfeiture laws for individual fixed annuities require that single premium equity index annuities guarantee the return of an amount at least equal to 90% of premium, accumulated at an annual interest rate of at least 3%.

9 As described in the Release, among the indexing formulae EIPs may employ are the "look back" or "high water mark" method, the "low water mark" method, and the "point to point" method. In some cases, an EIP may employ more than one method. In addition to indexing formulae, EIPs may have other features including, but not limited to: single or multiple premium payments; varying terms (e.g., three, five, seven, or nine years); and a choice of terms or indices or both.

10 The "excess interest" rate also may be subject to, among other features, a "cap" (or maximum), a "floor" (or minimum), or a "vesting feature," which limits the amount of "excess interest" available to the contract owner for withdrawal over the course of a prescribed term.

11 See, e.g., "More Insurers Expected to Jump on Indexed Bandwagon," Bank Investment Product News, Feb. 3, 1997, at 11.

12 Less than two years ago, only a handful of insurers offered equity index annuities; now, more than 30 insurers offer equity index annuities with more than 50 product variations. See, e.g., Jack Marrion, "EIA Status Report: They Number Over 50," National Underwriter, July 21, 1997, at 13. Furthermore, five companies offer equity index life insurance products. See Deanne L. Osgood, "Equity Indexed Annuity: State of the Market Address," Printed Remarks at Institute for International Research, Conference on Fixed Annuities '97 (Workshop on Equity Index Annuities), Sept. 17, 1997. At present, companies offering EIPs tend to be smaller insurance companies. Significantly, general insurance agents who are not registered as broker-dealers with the National Association of Securities Dealers, Inc. (the "NASD") account for a large percentage of EIP sales. See, e.g., James B. Smith, Jr., "Survey Shows Strong Interest in Offering EIAs," National Underwriter, Jan. 20, 1997, at 14; Jim Connolly, "Cos. Give Agents Extra Support With EIAs," National Underwriter, Sept. 1, 1997, at 23.

13 See, e.g., Linda Koco, "Index Product Design, Sales Still Surging," National Underwriter, Sept. 1, 1997, at 49.

14 See, e.g., Lindsey Randolph, "For TSAs, Clean Products Are Better Than Clever Ones," National Underwriter, July 21, 1997, at 7 [hereinafter "Clean Products"].

15 Contracts that meet the conditions of the safe harbor are deemed to fall within Section 3(a)(8). Contracts outside of the safe harbor may also rely directly on Section 3(a)(8); however, the Rule 151 Adopting Release makes clear that the rationale underlying the

Rule’s conditions is relevant to any Section 3(a)(8) determination.

16 The Commission noted in proposing Rule 151 that "[u]nder a traditional annuity contract, the insurer assumes the investment risk because it guarantees for the life of the contract (1) the principal amount of purchase payments made and interest credited thereto, and (2) to pay a specified rate of interest." Definition of Annuity Contract or Optional Annuity Contract, Securities Act Release No. 6558, [1984-85 Transfer Binder] Fed. Sec. Law Rep. (CCH) ¶ 83,710 at 87,159 n.3 (Nov. 21, 1984) (the "Rule 151 Proposing Release").

17 In United Benefit, the Court held that even though the investment risk to the contract holder was reduced by the insurer’s promise that the cash value of the contract would not fall below the aggregate amount of premiums deposited with the insurer, "the assumption of an investment risk cannot by itself create an insurance provision under the federal definition. The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized." United Benefit, 387 U.S. at 211.

18 As discussed in the release adopting Rule 151, the Commission in proposing the rule had "intended to exclude from the ‘safe harbor’ any contract pursuant to which excess interest is determined in accordance with an external formula or index (‘index feature’), such as a composite bond index or Treasury bill rate." The Commission reasoned that "an insurer which uses an index feature externalizes its discretionary excess interest rate, and thus shifts to the contractowner all of the investment risk regarding fluctuations in that rate." However, as the Rule 151 Adopting Release states,"[a]fter reviewing the comments [on the Rule 151 Proposing Release], the Commission . . . determined that it would be appropriate to extend the rule to permit insurers to make limited use of index features in determining the excess interest rate . . . ." Rule 151 Adopting Release at 88,136 (emphasis added). An external equity index used to determine equity-linked return is at the core of the EIP contract design. Such use of an external equity index cannot reasonably be characterized as "limited."

19 There is further precedent apart from VALIC, United Benefit and their progeny for applying a specialized regulatory scheme to the assets of an insurer’s general account. The Supreme Court has ruled that an insurance company’s general account assets are treated as plan assets under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the insurer is subject to ERISA’s fiduciary responsibility provisions, to the extent those assets fund policies that are not "guaranteed benefit policies" within the meaning of Section 401(b)(2) of ERISA. The Court’s decision was based largely on its finding that the insurer did not assume the investment risk under the contract, notwithstanding the fact that the "free funds" under the contract were placed in its general account. John Hancock Mutual Life Insurance Co. v. Harris Trust & Savings Bank, 350 U.S. 86 (1993). It is significant that the Court’s analysis in Harris relied heavily upon its earlier decisions construing the insurance policy exemption in Section 3(a)(8) of the Securities Act.

20 Cf. Associates in Adolescent Psychiatry v. Home Life Insurance Company of New York, 729 F. Supp. 1162 (N.D. Ill. 1989), aff’d, 941 F.2d 561 (7th Cir. 1991).

21 Id.

22 Rule 151 Adopting Release at 88,137 (citation omitted).

23 Id. at 88,137.

24 H.R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1933).

25 VALIC, 359 U.S. at 77.

26 David Shapiro, "EIA Plans Post Thorny Compliance Concerns," National Underwriter, June 2, 1997, at 15.

27 Jim Connolly, "Equity Index Annuity Sales Soar, But Concern Also Rises," National Underwriter, Jan. 20, 1997, at 1.

28 Clean Products, supra note 14.

29 In this regard, the Commission should evaluate the appropriateness of applying Investment Company Act regulation to the reserves that fund an EIP, whether or not those reserves have been placed in a separate account.
