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July 21, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: **File No. S7-16-11 – Product Definitions**
Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping
Securities and Exchange Commission Release Nos. 33-9204; 34-64372

Dear Secretary Stawick and Secretary Murphy:

NAFA, the National Association for Fixed Annuities, submits these comments in response to the Securities and Exchange ("SEC") and the Commodity Futures Trading ("CFTC") Commissions' ("Commissions") request for comments on joint proposed rules and proposed interpretations regarding certain definitions of terms contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] This comment letter will specifically address what NAFA believes is clearly a serious misinterpretation of the term "swap" as used in Title VII of the Dodd-Frank Act.[2] In essence, NAFA believes that the Commissions' proposed definition, which would treat many annuity products that are well regulated by state insurance departments as a "swap," is contrary to clear Congressional intent that such products not be treated as "swaps" and should be withdrawn and replaced with the language incorporating Section 3(a)(8) of the Securities Act of 1933 ("1933 Act").

[1] NAFA, the National Association for Fixed Annuities, is a national trade association dedicated exclusively to promoting the awareness and understanding of fixed annuities – including income, declared rate, market value adjusted and indexed. NAFA is the only association whose sole purpose is advocating for the fixed annuity product and educating regulators, legislators, consumers, members of the media, industry personnel, and distributors about fixed annuities and their benefits to retirees and those planning retirement. NAFA's membership of fixed annuity carriers and independent marketing organizations (or field organizations) represents over 114,000 agents, advisors and registered representatives selling fixed annuities. NAFA was founded in 1998 and is headquarted in Milwaukee, Wisconsin.

[2] For purposes of this letter, we are treating the term "swap" to also include "security-based swap".

Section 3(a)(8) clearly states what Congress intends with regard to insurance and annuity products being regulated by the states instead of federally regulated by the SEC. NAFA's desire is to ensure that retirees and those planning for retirement who choose fixed annuities to provide the guarantees of lifetime income and a savings safety net are not harmed by a misapplication of the term "swap" or the loss of the protections provided by state insurance regulation. It is critical that they remain under state insurance regulation and continue to be available through professional and trained insurance representatives to ensure that Americans may continue to enjoy access to these fundamental and necessary insurance savings products.

THE NEED TO RETAIN CURRENT DISTRIBUTION AND ACCESS TO FIXED ANNUITIES

The Commissions' proposals, while well intended, would cause significant confusion and hinder market access to a necessary and much needed retirement planning product. A fixed annuity is the only financial product that allows individuals and families to accumulate retirement savings, protect those savings from market losses and guarantee income for life. Other financial products do not offer such guarantees and in fact, consumers who rely on those strategies are subject to market risk that may seriously erode their ability to have sufficient retirement income. Unfortunately, outside of the fixed insurance marketplace, there is little understanding of or exposure to the variety of income planning choices available utilizing both immediate and deferred fixed annuities.

From the many publications on retirement planning published in the past five years, there is little dispute that a variety of distinct forces are converging to create a retirement income revolution. This convergence has been called "A Perfect Storm" and a "Time Bomb."[3] Some have called it a "Gray Tsunami,"[4] but whatever the title, experts agree the following factors combined could create retirement ruin for millions of retirees if they are not addressed. These factors include:

- the decreasing levels of Social Security benefits;
- the increase in the payroll tax and decrease in workers;
- the death of defined benefit plans;
- the aging of baby boomers; and
- the increase in life expectancy rates.

The decreasing levels of Social Security benefits over time can best be described as the "cliff effect." According to the Social Security Administration, individuals born in 1880 might have enjoyed an "implicit" rate of return of nearly 25%. From there it dropped to almost 12% percent for individuals born in the early 1900s, to just an inflation-adjusted rate of slightly over 1% for today's

[3] Philip J. Scrofani, "Perfect Storms and Ticking Time Bombs." *Sage Advice,* October 2005.

[4] Linda M. Springer, director of the U.S. Office of Personnel Management (OPM), January 31, 2006, *The Public Manager,* Spring 2006.

baby boomers and their children.

The increase in the payroll tax and decrease in workers contributing to Social Security has a negative impact on retirement savings. As the payroll tax increases to address the continued solvency issues of Social Security, individuals have less after-tax savings to contribute to alternative financial products with a likely higher return. That means today's workers nearing retirement face significant retirement funding issues.

The **death of defined benefit plans** is apparent from the unprecedented decrease in such plans. Not only has the number of active participants in defined benefit plans fallen dramatically, but a number of other factors have impacted Americans

A recent report by Babbel and Merrill[5] states that the last fifteen years has seen only one new pension program initiated. The number of pension plans in the U.S. peaked at 175,000 in 1983 and has since declined to less than 25,000. Meanwhile, 30% of the remaining programs will close within the next two years. At the same time, defined contribution plans (401(k), 403(b), etc.) have increased from 17,000 to over 650,000 plans in place today. With more and more retirement savings accumulating in these defined contribution plans, the demand for a pre-planned, guaranteed income stream will continue to grow. However, as a result of the recent economic crisis, the amount of money invested in these plans and available for retirement has taken a significant hit. Not only did the crisis severely reduce the amount of money in defined contribution plans, but many employers cut off their matching programs to curtail company expenses and improve profit and loss forecasts.

The **aging of baby boomers** means that more and more Americans enter retirement each year. Beginning in 2006, the first members of the largest generation in American history turned 60 and began leaving jobs and entering retirement. According to the Babbel and Merrill[6] report, this group represents 27% of the U.S. population and 47% of all households.

The **increase in life expectancy rates** is seriously contributing to Americans' retirement vulnerability. The probability that an individual retiring at age 65 will reach age 80 is over 70% for females, and over 62% for males. Married individuals have increased probabilities, as the chance that at least one spouse will reach age 80 is nearly 90% and the chance that one spouse will live to age 85 is more than 85%. (Ibbotson Associates, Inc., January 2003).

Ernst & Young's 2009 report[7] produced for Americans for a Secure Retirement showed that the economic crisis of 2008 and 2009 significantly increased the retirement vulnerability of both near and recent retirees. Without making serious reductions to expenses, three-fifths of new retirees could

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[5] David F. Babbel and Craig B. Merrill, Policy Brief: Personal Finance, *Investing your Lump Sum at Retirement*, (Wharton Financial Institutions Center, August 14, 2007) 2.

[6] Babbel and Merrill, page 3.

[7] Ernst & Young LLP, Updated Retirement Vulnerability Analysis: The Likelihood of Outliving their Financial Assets (June 2009) 2.

expect to outlive their financial resources. A startling 95% of middle-income married couples without defined benefit plans would outlive their income[8] and those without a guaranteed source of income beyond Social Security would have to reduce their standard of living by an average of 32% to avoid outliving their financial assets. Near retirees (defined as those seven years out from retirement) without a guaranteed source of income would have to reduce their standard of living by 45% to minimize the likelihood of outliving their financial assets.

Americans face three fundamental risks in planning for their retirement income:

> **Market Risk** – the risk that you will make money and lose money based on the performance of your portfolio and you will not have time to recover those losses;
>
> **Inflation Risk -** the risk that your pre-determined retirement income will be eroded by inflation and you will not be able to sustain your retirement lifestyle; and
>
> **Longevity Risk** – the risk that unexpected health or financial needs will deplete your savings or, even without those budget strains, you will simply outlive your savings.

Unfortunately, part of the primary focus of the investment community has been in managing client assets with the goal of maximizing wealth accumulation and asset growth and NOT income sustainability. Most investment advisors are biased toward a standard balanced (diversified) investment portfolio with a systematic withdrawal of a fixed income stream during the retirement period. Individuals relying on these types of retirement plans are headed toward retirement ruin because of the high likelihood they will exhaust savings while they are still alive.

THE STRENGTH OF STATE REGULATION OF ANNUITY PRODUCTS

The Commissions' proposed rules fail do not recognize the nature and extent of existing regulation of fixed annuities under state insurance law, including regulation of the insurers that issue, and the producers that market, such products, as well as ongoing state level initiatives to enhance regulatory oversight of fixed index annuities. We submit that a better understanding of the existing and developing state insurance law and corresponding state regulations will demonstrate that the Commissions' proposed rules are flawed. Because oversight of insured fixed annuity products is being met by state insurance regulation and because fixed annuities are issued by regulated insurers that are subject to a comprehensive set of regulations, owners of fixed annuities do not bear the risk of loss that the United States Supreme Court determined in the *Weaver* case[9] to be necessary in order to characterize a financial instrument as a security.

The Commissions' proposed rules give short shrift to the comprehensive regulatory scheme under state insurance law. Specifically, although the Commissions' Proposal purports consumer protections through federal disclosure and sales practices protections as the most important benefits to

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[8] Ernst & Young LLP 2.

[9] *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

consumers, the proposals do not attempt to acknowledge the many and varied aspects of state insurance regulation addressing these very topics including:

- Insurance company solvency and the adequacy of insurers' reserve;
- Organization and licensing of insurers;
- Regulation of the form and content of insurance policy and contract forms; and
- Regulation of insurers' and producers' market practices.

Within the realm of market practice regulation, regulators pay particular attention to unfair trade practices (including unfair sales practices such as false advertising, churning, twisting, etc.), disclosure, suitability and supervision, illustrations, producer licensing, education and training, and consumer complaints.

THE COMMISSIONS' PROPOSED "SWAPS" DEFINITION CONFLICTS WITH CLEAR CONGRESSIONAL INTENT, IS FUNDAMENTALLY FLAWED, AND SHOULD BE REPLACED BY LANGUAGE INCORPORATING SECTION 3(A)(8) OF THE SECURITIES ACT OF 1933

The legislative history of the Dodd-Frank Act reveals no evidence that Congress intended that insurance and annuity products should be regulated as swaps.[10] Congressional intent is so clear that the Commissions' Proposing Release regarding the "swaps" definition unequivocally and specifically acknowledged this fact by noting: "The Commissions do not interpret [the Dodd-Frank Act's language] to mean that products historically treated as insurance products should be included within the swap or security-based swap definition." The release also notes that "[t]he Commissions are aware of nothing in Title VII to suggest that Congress intended for insurance products to be regulated as swaps," and it points out that provisions of the Dodd-Frank Act show that insurance and annuity products are to be regulated by different regulatory schemes.

NAFA applauds and fully agrees with the Commissions' clear statement of Congressional intent that insurance and annuity products are not to be treated as "swaps" and are to remain subject to state insurance regulation, consistent with the long-standing federal policy expressed in the McCarran-Ferguson Act, and not be federally regulated as "swaps." That said, NAFA must emphasize that in this case the Commissions are "saying one thing but doing another." The proposed rules would generally subject annuity products, as well as many insurance products, to federal regulation as "swaps." This is a very serious and very fundamental error, and we must in the strongest terms urge that the Commissions revise the proposed rule and "do what they said" with regard to Congressional intent by using language, based upon Section 3(a)(8) of the 1933 Act, that does not generally sweep

[10] Further Definition of "Swap," "Security-Gased Swap," and "Security-Based Swap Agreement"; Mixed Swaps' Security-Based Swap Agreement Recordkeeping, Release No. 33-9204, 34-64372, 76 Fed. Reg. 29818 (May 23, 2011) ("Proposing Release").

insurance and annuity products into the "swaps" definition.

Section 3(a)(8) has long been recognized as the definitive provision as to where Congress intends to separate securities products that are subject to SEC regulation from "insurance" and "annuity" products that are to be left to state insurance regulation. This provision's criteria are well understood, have a long history of interpretation by the SEC and the courts, and are quite suitable for the Commissions to use in determining what insurance or annuity products should be excluded from the definition of "swaps" in the proposed rules.[11] In addition to the interpretative history of Section 3(a)(8), it is important to recognize that Congress just took the extraordinary step in passing Section 989J of the Dodd-Frank Act (the so-called "Harkin Amendment"), further clarifying and reaffirming its intent as to what insurance and annuity products should be excluded from federal regulation as a security by the SEC and left instead to continued state insurance regulation. In essence, the SEC had sought to treat fixed indexed annuities as securities that would it would regulate. Congress rejected the SEC's position in passing the Harkin Amendment and clarified that an annuity product falls within the 1933 Act's exemption in Section 3(a)(8), provided that the value of the product does not change based on the investment experience of a separate account, the product complies with any applicable state nonforfeiture laws, and the product is offered by an insurance company subject to suitability requirements contained in the NAIC's Model Suitability Regulation.

NAFA was actively involved in the legislative process and helped secure the passage of Section 989J. We have no doubt that Congressional intent is quite clear, and we believe that it is nothing short of preposterous to suggest that on the one hand Congress clearly intended in one section of the Dodd-Frank Act to exclude insurance and annuity products from federal regulation and then in another section intended to sweep them into federal regulation as "swaps."

The American Council of Life Insurers ("ACLI") and the Committee of Annuity Insurers ("CAI"), who are our industry trade partners, have provided the Commissions with lengthy analyses and detailed commentaries regarding the myriad specific flaws in the Commissions' proposed definition. As we generally concur with and endorse the ACLI's and CAI's position, NAFA deems it unnecessary to restate their many comments regarding concerns arising from the proposed definition. However, we do want to highlight several key points to illustrate NAFA's special concerns with regard to the proposed rules from the annuity industry's perspective.

The Commissions' approach in the proposed rules is basically to treat an insurance or annuity product as a "swap" unless it can come within the exclusions set forth in the proposed rule. NAFA believes that the proper approach, which is consistent with Congressional intent, is to treat such products as insurance that are not swaps unless they fail to meet criteria set forth in Section 3(a)(8) of the 1933 Act. Simply put, instead of the "you are a swap until proven insurance," the operative

[11] We acknowledge, of course, that merely calling a product "insurance" or an "annuity" does not always mean that the product is necessarily one that Congress intended to be subject only to state insurance regulation. It is beyond the scope of this comment letter to review the lengthy interpretative history of Section 3(a)(8), but we do note that it is clear that some products (e.g., "variable annuities") do not meet this provision's criteria and, accordingly, are subject to federal regulation by the SEC. On the other hand, it is equally clear that most insurance and annuity products do meet the Section 3(a)(8) criteria and are subject only to state insurance regulation.

presumption should be "you are insurance until proven a swap."

In any case, NAFA must emphasize that many of the tests or criteria in the proposed "swaps" definition as to whether an insurance or annuity product is to be excluded from this definition are written so that they improperly exclude a wide range of insurance products----including in particular many key annuity products----that are regulated by the states and that Congress never intended be deemed swaps. To take but three examples of many:

- One of the proposed tests is that the product not be traded, apart from the insured interest, on an organized or over-the-counter market. This test alone would have the effect of treating vast numbers of annuity products as swaps because such products are assignable and therefore appear to violate this requirement.

- A second proposed criterion is that the beneficiary must have an insurable interest under the contract and must have the related risk of loss for the contract's duration. This would disqualify annuities because annuity products are not based on a "risk of loss" and annuities pay the contracted for benefits irrespective of and not based on any "loss."

- A third proposed criterion would require that a provable loss occur and that any payment or indemnity be restricted to the "value" of the insurable interest. Once again, this does not work for fixed annuities because many pay a death benefit which can include premium paid, interest and bonuses. Thus, because of a loss of life, a death benefit can be triggered that can be the full annuity value without any surrender charges and not some "value of insurable interest." In situations when fixed annuities do not pay the full account value (e.g., early surrender) they pay an account value that is based on the contractual guarantees and not based on "insurable interest."

NAFA also has a serious concern regarding, and objection to, a criterion that the Proposing Release says the Commissions may add to the proposed rules. This additional possible criterion would require that any payment under the contract not be based on the price, rate or level of a financial instrument, asset, interest or any commodity. NAFA strongly opposes adding any such criterion because it would prevent many annuities from being excluded from the definition of "swap" as Congress clearly intended. For example, fixed indexed annuities, a very popular and important retirement product, typically base interest payments on positive changes to a popular index (e.g., S&P 500). Similarly, many fixed annuities base interest rates credited to the annuity on the interest rates of U.S. Treasury or corporate bonds. Clearly, these annuity products, which are subject to extensive state insurance regulation and have nothing to do with the systemic risks this legislation was targeted at, should not be treated as "swaps."

In conclusion, NAFA is sensitive to the tremendous burdens that the Dodd-Frank Act has placed on the Commissions and their staff with regard to implementing Title VII. We are pleased that the Commissions in their Proposing Release correctly stated that Congress did not intend to treat insurance and annuity products that have long been subject to state regulation as now being deemed a "swap" and subject to federal regulation. However, as explained above in this comment letter, NAFA believes that the Commissions' approach in its proposed rules in defining what insurance and annuity products are deemed a "swap" is totally contrary to what they have acknowledged to be Congressional intent. Perhaps this perplexing situation has arisen, at least in part, because the Commissions' have not understood the many complexities of the insurance and annuity industry. We say this because so many of the proposed criteria are totally unsuitable and inappropriate for judging insurance and annuity products. In any case, while we respect and appreciate the hard work and good faith efforts of the Commissions and their staff, we urge them in the strongest terms possible to withdraw the definitional tests for a "swap" (and related terms) in the proposed rules and to shift to the Section 3(a)(8) definitional approach as suggested above. Our recommended approach is wholly consistent with Congressional intent, quite workable from a practical perspective and ensures American workers who are saving for retirement and today's current retirees have the unlimited and unrestricted opportunity to consider fixed annuities to fulfill their dreams and lifestyles.

NAFA appreciates the opportunity to submit these comments and hopes that they will help the Commissions understand why the proposed rules should be changed as we have requested. Please do not hesitate to contact me if you would like additional information or further clarification of NAFA's position on this matter.

Respectfully submitted,

Kim O'Brien
NAFA President & CEO