December 19, 2008

Update – SEC Regulation of Indexed Annuities

On December 17, 2008, the SEC approved Rule 151A granting the SEC the authority to regulate certain indexed annuity products. The rule will be effective for all applicable annuity products issued on or after January 12, 2011. At such time, all indexed annuity products within the scope of Rule 151A will have to be registered with the SEC, sold via a prospectus, and sold only by those who are registered with the Financial Industry Regulatory Authority ("FINRA") as broker-dealers. The SEC approved the rule in a 4-1 vote, with Commissioner Troy Paredes providing a lengthy dissent that he requested be included in the Federal Register when the final rule is published. Rule 12h-7 also passed with minor modifications to address Exchange Act reporting requirements for insurers issuing indexed annuity products.

As was first discussed in detail in our client alert, *SEC Regulation of Indexed Annuities?*, published on September 3, 2008, Section 3(a)(8) of the Securities Act provides an exemption from registration under Section 5 of the Securities Act for certain insurance and annuity contracts. However, Rule 151A provides that an indexed annuity is not an "annuity contract" under Section 3(a)(8) if certain conditions are present.

Rule 151A, in its final form, defines annuity contracts as outside the scope of the Section 3(a)(8) if:

> (a) amounts payable by the issuer under the contract are calculated <u>at or after the end of one or more specified crediting periods</u>, in whole or in part, by reference to the performance <u>during the crediting period or periods</u> of a security, including a group or index of securities, and
>
> (b) the amounts payable by the insurer under the contract are "more likely than not" to exceed the amounts guaranteed under the contract.

Annuity contracts that fall within this definition will be treated as "securities" not eligible for the exemption from registration. If an insurer relies on the Section 3(a)(8) exemption when issuing an annuity contract, the burden of proof will rest with the insurer to demonstrate that the annuity contract does not meet the above test.

An insurer can rely on its determination that the annuity contract does not meet the two-pronged test if the insurer can demonstrate that its:

> (a) methodology, including its assumptions, are reasonable,
>
> (b) computations were materially accurate, and
>
> (c) determination was made at or prior to the issuance of the annuity contract (no more than six months prior to the date that the form of contract is first offered).

As adopted, Rule 151A will only require that such determination be made not more than six months prior to the date on which the form of contract is first offered, rather than also requiring that the issuer make the determination not more than three years prior to the date on which a particular contract is issued as first proposed. The SEC will also permit surrender and other charges to be reflected both in amounts payable and amounts guaranteed in determining whether the amounts payable are more likely than not to exceed the amounts guaranteed under the contract.

Rule 151A will not provide a safe harbor under Section 3(a)(8) for annuity contracts that do not meet the "more likely than not" test. If an insurer wishes to sell an annuity contract that does not fall within the definition created by the rule, the insurer must perform its own analysis to determine if the annuity contract (a) is exempt from the federal securities laws under Section 3(a)(8), (b) is subject to federal securities laws based on the investment risk and marketing tests established under federal case law, or (c) falls within the safe harbor created under existing Rule 151.

SEC Chairman Christopher Cox announced the adoption of Rule 151A as a new way to help protect seniors and other investors from fraudulent and abusive sales practices that occur in connection with indexed annuities by imposing SEC disclosure requirements and Securities Act liability on issuers of such products.[1] However, many in Congress, the insurance industry and the financial markets do not share his view. From the time Rule 151A was proposed until its passage, the SEC received thousands of comment letters urging it to leave the regulation of indexed annuities in the hands of state insurance regulators. The National Association of Insurance Commissioners (the "NAIC"), nineteen members of Congress, including the House Financial Services Committee, and the American Bankers Association were only a few of the industry leaders opposed to SEC oversight.[2] Opponents believe that the sale of indexed annuities is already adequately regulated by state insurance departments and guidance has been provided to those selling the products through releases by state insurance departments and FINRA. Thirty-three states have already adopted legislation based on the NAIC's Suitability in Annuity Transactions Model.[3] Furthermore, twenty-two states have adopted the NAIC Annuity Disclosure Model Regulation, and seventeen life insurers have joined a pilot program sponsored by the American Council of Life Insurers and the Iowa Insurance Department that requires the participants to use a template disclosure form for annuity sales in all states where such products are sold.

In addition to emphasizing the existence of legislation and guidance regarding the sale of indexed annuities, opponents of the rule question the SEC's authority to regulate such products given the language of Section 3(a)(8) of the Securities Act and existing case law from the U.S. Supreme Court. This issue was raised in many comment letters and was addressed in detail in Commissioner Paredes' dissent in which he stated:

> Rule 151A takes some annuity products (indexed annuities), which otherwise may be covered by the statutory exemption in Section 3(a)(8), and removes them from the exemption, thus placing them within the Commission's jurisdiction to regulate. If the Commission's Rule 151A analysis is wrong - which is to say that indexed annuities do fall within Section 3(a)(8) - then the SEC has exceeded its authority by seeking to regulate them. In other words, the effect of Rule 151A would be to confer additional authority upon the SEC when these products, in fact, are entitled to the Section 3(a)(8) exemption. The Supreme Court has twice construed the scope of Section 3(a)(8) for annuity contracts in the *VALIC* and *United Benefit* cases.[4] I believe the approach embraced by Rule 151A conflicts with these Supreme Court cases. Although neither *VALIC* nor *United Benefit* deals with indexed annuities directly, the cases nevertheless are instructive in evaluating whether such a product falls within the Section 3(a)(8) exemption. And despite the adopting release's

[1] SEC Press Release 2008-298, *SEC Improves Protections for Seniors and Other Investors in Equity-Indexed Annuities* (December 17, 2008).
[2] Sean P. Carr, *The Coalition for Indexed Products; SEC Ignores Congressional, State, and Industry Opposition to Indexed Annuity Proposal,* BestWire (December 18, 2008).
[3] *Id.*
[4] *See generally SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

efforts to discount its holding, at least one federal court applying *VALIC* and *United Benefit* has held that an indexed annuity falls within the statutory exemption of Section 3(a)(8).[5]

Noting that Rule 151A seemed to deviate from the approach taken by courts, including the U.S. Supreme Court, Commissioner Paredes further argued that it also departs from prior positions taken by the SEC. For example, in an *amicus* brief filed with the U.S. Supreme Court in the *Otto* case,[6] the SEC asserted that "the Section 3(a)(8) exemption applies when an insurance company, regulated by the state, assumes a "sufficient" share of investment risk and there is a corresponding decrease in the risk to the purchaser, such as where the purchaser benefits from certain guarantees." Yet, Paredes noted, Rule 151A denies the Section 3(a)(8) exemption to an indexed annuity issued by a state-regulated insurance company that bears substantial risk under the annuity contract by guaranteeing principal and a minimum return.

Given Commissioner Paredes' strong dissent questioning the SEC's authority to regulate indexed annuity products, and the thousands of comment letters opposing the rule, some commentators believe that legal action may be brought challenging the rule even before it becomes effective.[7] Although the debate over this regulation seems far from over, insurers need to recognize that for now Rule 151A is here to stay. Until a successful challenge is brought to invalidate the rule or the SEC revises its scope, insurers should begin developing products and seeking approvals of indexed annuity products at the state level prior to the 2011 effective date to avoid disruptions in the market.

Rule 12h-7 provides insurance companies that are covered by the rule with an exemption from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of the Exchange Act with respect to indexed annuities and certain other securities issued by the insurer that are registered under the Securities Act and regulated as insurance under state law. The rule was adopted as proposed with two minor revisions. The SEC revised the requirements under the proposed rule so that the insurer is not required to take any steps that are inconsistent with state law when meeting the requirement that it ensure that a trading market in the securities does not develop. The SEC also added a condition that requires the insurer add a statement to any prospectus with respect to which the Exchange Act exemption is being claimed stating that the insurer is relying on such exemption. Failure to include such statement will subject the insurer to Exchange Act reporting requirements.

Contacts

Melissa D. Beck
(212) 336-4319
mbeck@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

Chiahua Pan
(212)468-8052
cpan@mofo.com

About Morrison & Foerster

---

[5] Speech by SEC Commissioner: Opening Remarks and Dissent Regarding Proposed Rule 151A Indexed Annuities and Certain Other Insurance Contracts by Commissioner Troy A. Paredes, U.S. Securities and Exchange Commission Open Meeting of the Securities and Exchange Commission (December 17, 2008).
[6] *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1987). The Supreme Court denied the petition for a *writ of certiorari*.
[7] Sean P. Carr, *The Coalition for Indexed Products; SEC Ignores Congressional, State, and Industry Opposition to Indexed Annuity Proposal*, BestWire (December 18, 2008).