News Bulletin

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SEC Regulation of Indexed Annuities?

On June 26, 2008, the Securities and Exchange Commission (the "SEC") published proposed Rules 151A and 12h-7 relating to indexed annuities and certain other insurance contracts. Rule 151A would clarify when such annuity contracts will be deemed securities and, therefore, subject to the federal securities laws. Rule 12h-7 would provide insurance companies an exemption from federal reporting requirements when selling such contracts, provided that the contracts being sold are regulated as insurance under applicable state law and meet certain other conditions. Due to the ambiguity surrounding the status of annuity contracts under current federal securities laws, the proposed rules, if adopted, will be applied prospectively and will become effective 12 months from the date that a final rule is published in the Federal Register.

Purpose of Proposed Rules

The purpose of the proposed rules is to provide regulatory certainty to issuers of annuity contracts while providing consumer protection from the improper marketing and sale of such products. In 2006, approximately 2,300 consumer complaints relating to sales of all types of annuity products were filed with the state insurance commissioners.[1] Most consumer complaints and lawsuits were filed by senior citizens who claim that the products were improperly marketed, agents misrepresented the products, or proper disclosure statements were not provided to, or signed by, the purchaser.[2] The most common fact pattern for complaints is the sale of an annuity contract to a senior citizen over the age of 75 who is unaware of the withdrawal penalties and lengthy maturity periods and most likely will either need the money prior to maturity or not live long enough to get back the amount of money paid in premiums to purchase such contract. Consumer class action lawsuits and attorney general actions alleging similar abuses also have been filed and settled in a number of states.[3]

In an attempt to reign in abuses, the National Association of Insurance Commissioners ("NAIC") and the Financial Industry Regulatory Authority, Inc. ("FINRA") have issued consumer alerts to inform senior citizens of the complexity of annuity contracts and to caution consumers to read all contract terms before purchasing such products. To further increase consumer protection, the NAIC adopted the Annuity Transactions Model Regulation in 2003. The regulation was further revised in 2006. In 2005, FINRA issued a notice to its members cautioning registered broker-dealers and associated persons that market such products. The notice addressed the

[1] See Testimony of Sandy Praeger, Kansas Insurance Commissioner and NAIC President-Elect Before the Senate Select Committee on Aging, September 5, 2007.

[2] See Malone v. Addison Ins. Mktg., Inc., 225 F. Supp. 2d 743 (W.D. Ky 2002). See Brian Ruiz Switzky, Lori Swanson Sues Another Insurer Over Annuities, Minneapolis St. Paul Business Journal, November 29, 2007. See Todd Ruger, Annuities Complaint Sends Up a Red Flag, Herald-Tribune, March 11, 2007. See also http://www.consumeraffairs.com/news04/2007/12/ca_annuity_scam.html (last viewed August 25, 2008) for articles relating to state actions brought against insurers in California, Minnesota, Illinois and North Carolina.

[3] Id.

responsibility of firms to supervise the sale by their associated persons of certain annuity contracts that are not registered under the federal securities laws.

According to SEC estimates, sales of equity-indexed annuities alone have increased from $14 billion in 2003 to over $25 billion in 2007. The SEC is proposing Rule 151A to require federal regulation of equity-indexed annuities and other similar insurance products in order to better protect consumers. Equity-indexed annuities are fixed annuities that earn interest or provide benefits that are linked to an external equity reference or index, most commonly the S&P 500. Equity-indexed annuities guarantee a minimum interest rate, but that interest rate can increase based on the performance of the external equity reference or index. Most equity-indexed annuity contracts guarantee a minimum payout of 90% of premiums paid plus at least 3% interest annually until maturity. Certain fees and penalties are charged for early withdrawal of funds or surrender of the annuity contract. The minimum guarantee, the amount of interest earned, and the amount of fees or penalties paid depend on factors that are product specific.

Current Regulation

Currently, under Section 3(a)(8) of the Securities Act of 1933 (the "Securities Act"), certain "annuity contracts" and "optional annuity contracts" are outside the scope of the Securities Act and are not subject to federal disclosure, antifraud and consumer protection regulations. Neither term is defined under the Securities Act but it is well-established that not all annuity contracts are exempt from the federal securities laws.

In two separate United States Supreme Court decisions,[4] the court held that variable annuity contracts were not exempt from the Securities Act requirements based on two factors: (1) the investment risk was borne by the purchaser; and (2) the products were marketed as investments, rather than insurance. In SEC v. Variable Annuity Life Ins. Co. ("VALIC"), the annuity contract at issue was a pure variable annuity contract that the court held to be a security with only a nominal insurance component. After the VALIC decision, insurers began designing hybrid products combining both variable and fixed components to avoid having their annuity contracts classified as securities.

One such product was scrutinized in SEC v. United Benefit Life Ins. Co ("United"). The insurer developed a deferred annuity contract that invested premiums in common stocks to produce both capital gains and interest returns. Prior to maturity, the purchaser was guaranteed a cash value no less than 50% percent of net premiums. After ten years, the purchaser was guaranteed 100% of net premiums. At maturity, the purchaser could either choose to receive the cash value from investments or convert that value into a fixed life annuity. The court held that such an annuity contract would not be exempt from the federal securities laws. Issuers would still be required to register the annuity contract if the insurer serves as an investment agency and allows the purchaser to share in its gains or losses prior to the maturity date. Following these decisions, it was clear that Section 3(a)(8) did not exempt annuity contracts containing a variable component from federal securities laws. Unfortunately, the United decision did not provide guidance to issuers of other types of hybrid annuity contracts. The most common form of hybrid annuity contract is the equity-indexed annuity contract. Because there are many variations on this type of annuity contract, for each new form of equity-indexed annuity that an issuer brings to the market, a fact-intensive analysis must be performed to determine whether or not such contract falls within the scope of the Securities Act.

In 1986, the SEC attempted to remedy any remaining uncertainty relating to whether or not an annuity contract was a security by adopting Rule 151. Rule 151 is a "safe harbor" derived from judicial precedent and is meant to clarify which annuity contracts are exempt under Section 3(a)(8). An issuer of an annuity contract that is neither a pure fixed annuity contract nor a variable annuity contract must be able to meet the following three conditions to rely on the safe harbor:

[4] See SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). See also SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

- the product must be issued by an insurer that is subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States;
- the insurer must assume investment risk, which includes the following:

  (1) the value of the contract does not vary according to the investment experience of a separate account;

  (2) the insurer guarantees the purchaser the principal amount of premiums and interests, less deductions for sales, administrative, and other expenses; and

  (3) any interest credited in excess of the guaranteed minimum must not be modified more frequently than once per year; and

- the product may not be marketed primarily as an investment.

Despite the SEC's attempt to clarify what constitutes an 'annuity contract" or an "optional annuity contract," Rule 151 still leaves much uncertainty for issuers of annuity contracts, especially equity-indexed annuity contracts. In Malone v. Addison Insurance Marketing, Inc., 225 F. Supp. 2d 743 (W.D.Ky 2002) ("Malone"), the court relied on Rule 151 in deciding that a particular equity-indexed annuity contract met the requirements of the Rule 151 safe harbor and therefore was exempt from regulation under the Securities Act. However, in making that determination, the court performed a fact-intensive analysis of the annuity contract and the conditions under which it was marketed to the purchaser. In its opinion, the court made clear that "each analysis in this area therefore requires the court's particular attention to the instrument at issue" and that a discussion of the relevant characteristics of both fixed and variable annuities is required before a given annuity contract can be classified based on the criteria established by the U.S. Supreme Court in the VALIC and United cases.

Proposed Rule 151A

Proposed Rule 151A focuses on investment risk when determining whether or not an equity-indexed annuity contract or similar type of insurance contract is outside the scope of the Section 3(a)(8) exemption. The proposed rule will define annuity contracts as outside the scope of the Section 3(a)(8) exemption if:

- the amounts payable by the insurer 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, and
- the amounts payable by the insurer under the contract are "more likely than not" to exceed the amounts guaranteed under the contract.

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:

- methodology, including its assumptions, are reasonable,
- computations were materially accurate, and
- 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 and not more than three years prior to the date on which a particular contract is issued).

Proposed 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 proposed rule, the insurer must perform its own analysis to determine if the annuity contract (a) is exempt from 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.

Proposed Rule 12h-7

Proposed Rule 12h-7 would provide insurance companies that are covered by the proposed rule with an exemption from the duty under Section 15(d) of the Exchange Act of 1934 (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.

To be eligible for the exemption, both the issuer and the security must be "covered." To be a "covered issuer," the issuer must be a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States. To be a "covered security," the security must be subject to regulation under the insurance laws of the domiciliary state of the insurer or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.

In addition, the following three conditions must be met:

- the issuer must file an annual statement of its financial condition with, and the insurer must be supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of the insurer's domiciliary state;
- the security may not be listed, traded, or quoted on an exchange, alternative trading system, inter-dealer quotation system, electronic communications network, or any other similar system, network, or publication for trading or quoting; and
- the issuer must take steps reasonably designed to ensure that a trading market for the security does not develop, including requiring written notice to, and acceptance by, the insurer prior to any assignment or other transfer of the security and reserving the right to refuse assignments or other transfers of the security at any time in a non-discriminatory manner.

Proposed Rule 12h-7 would not apply to insurance company separate accounts which are not regulated as insurance, but rather are registered as investment companies under the Investment Company Act of 1940.

Comments Relating to the Proposed Rules

The comment period for the proposed rules is open until September 10, 2008, although the NAIC and 18 state legislators are seeking a 90-day extension to study the proposal. To date, a number of comments have been filed with the SEC. Most comments have been made by insurance professionals opposed to proposed Rule 151A. The principal points made by opponents are that the proposed rules (a) conflict with judicial precedent, (b) attempt to regulate products that are already adequately regulated, and (c) harm consumers. Commenters address the fact that equity-indexed annuities are not variable products. Citing VALIC, United and Malone, opponents distinguish variable products where purchasers bear investment risk from hybrid products that more closely resemble fixed annuities where insurers bear most, if not all, investment risk. Opponents point out that indexed annuity contracts are adequately regulated by state insurance regulation and subject to NAIC oversight and in some cases, FINRA oversight. Some commenters see the proposed rules as a turf war between securities and insurance industry players, especially given the recent growth of annuity products market. The disclosure and registration disclosure document for an annuity product must be filed with, and approved by, the state insurance department in each state where the product will be marketed or sold. Certain disclosures are required by statute and failure to comply with the requirements can result in civil fines, department sanctions or license revocation. Opponents also fear that the proposed rules will injure consumers because consumer protection under federal securities laws often requires long, expensive litigation whereas licensed insurance companies must respond to consumer complaints within ten days of being notified by the state insurance department, with resolution of most complaints reached in 30 days. In addition, the increased costs of complying with federal securities law requirements will result in fewer products going to market and higher fees associated with such products.

Effect of Proposed Rules

The benefits of proposed Rule 151A include enhanced disclosure to consumers, sales practice protections for consumers, including anti-fraud protection under Rule 10b-5, greater regulatory certainty for issuers of annuity contracts, and possibly enhanced competition among annuity contracts and competing investment products.

However, there are also many costs associated with proposed Rule 151A. Persons effecting transactions in annuity contracts that fall outside the scope of the Section 3(a)(8) exemption would be required to be registered broker-dealers or become associated persons of a broke-dealer through a networking arrangement. The selling broker-dealer and its registered representatives would be subject to FINRA oversight. Analyses would need to be periodically performed for each form of annuity contract to determine if the annuity contract meets the "more likely than not" test and whether or not an exemption to registration under the Securities Act is available. For annuity contracts that fall outside the scope of the Section 3(a)(8) exemption, registration statements would need to be filed with the SEC and prospectuses prepared, printed and delivered to purchasers. The increased time it would take to bring a new form of annuity contract to the market and the costs involved, including internal costs, consulting costs and regulatory compliance costs, may ultimately reduce competition if insurers choose not to offer products that fail to meet the Section 3(a)(8) exemption. For insurers who choose to leave the market, the costs also include loss of revenue from sales of such products.

Proposed Rule 12h-7 would exempt qualified insurers who sell covered securities and meet the exemption conditions from meeting the reporting requirements under the Exchange Act. Although this exemption off-sets some regulatory costs, it may not be enough to keep the existing indexed annuity market active and competitive.

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