MEMO# 22678

July 10, 2008

SEC Proposes To Clarify Status Of Indexed Annuities, Exempt Insurance Companies From Certain Exchange Act Reporting Requirements; Conference Call On July 21

[22678]

July 10, 2008

TO: VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 21-08 RE: SEC PROPOSES TO CLARIFY STATUS OF INDEXED ANNUITIES, EXEMPT INSURANCE COMPANIES FROM CERTAIN EXCHANGE ACT REPORTING REQUIREMENTS; CONFERENCE CALL ON JULY 21

The Securities and Exchange Commission has proposed a new rule under the Securities Act of 1933 that would define certain indexed annuities as being outside the "insurance exemption" in the Securities Act if the amounts payable by the insurer under the annuity contract are more likely than not to exceed the amounts guaranteed under the contract. The proposed rule, which would have the effect of requiring these indexed annuity contracts to be registered with the Commission as securities, would apply prospectively to contracts issued on or after the rule's effective date. The Commission also is proposing a new rule that would exempt insurance companies from the reporting requirements of the Securities Exchange Act of 1934 with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. [1] The Commission's proposal is briefly summarized below.

Comments on the proposal are due on September 10. We will hold a conference call to discuss the proposal on Monday, July 21 at 2:00 pm Eastern time. The dial-in number for the call is 888/889-4951 and the passcode is 58236.

If you plan to participate on the call, please RSVP to Maureen Maher via email (mmaher@ici.org) on or before 12 pm Eastern time on July 21. If you cannot participate, please provide any comments to Rachel Graham by phone (202/326-5819) or email (rgraham@ici.org).

Background

As described in the Proposing Release, an indexed annuity is a contract issued by a life insurance company that generally provides for accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser either as a lump sum, upon death or withdrawal, or as a series of payments (an "annuity"). During the accumulation period, the insurer credits the purchaser with a return that is based on changes in a securities index, such as the S&P 500 Index. The return depends on the particular combination of features specified in the contract. The insurer also guarantees a minimum value to the purchaser. [2]

Section 3(a)(8) of the Securities Act provides an exemption for any "annuity contract" or "optional annuity contract" issued by a corporation subject to supervision by an insurance commissioner, bank commissioner, or similar state regulatory authority. [3] Not all contracts that are considered annuities under state insurance law qualify for the exemption. Rather, the issue of whether a particular contract fits within the Section 3(a)(8) exemption generally is determined based upon a facts and circumstances analysis of factors articulated by the U.S. Supreme Court. These factors include the allocation of investment risk between insurer and purchaser, and the manner in which the annuity contract is marketed. [4]

Consistent with these factors, the Commission in 1986 adopted a safe harbor provision under Section 3(a)(8). Rule 151 under the Securities Act provides that an annuity contract issued by a state-regulated insurance company is deemed to be within the Section 3(a)(8) exemption if (1) the insurer assumes the investment risk under the contract in the manner prescribed in the rule, including by providing certain minimum guarantees, and (2) the contract is not marketed primarily as an investment. The Proposing Release states that indexed annuities do not qualify for the Rule 151 safe harbor because they fail to satisfy the requirement that the insurance company must guarantee that the rate of any interest to be credited in excess of the contract's guaranteed minimum rate will not be modified more frequently than once per year. [5]

Since the introduction of indexed annuities in the mid-1990s, insurers have typically marketed and sold these products without complying with the federal securities laws. In 1997, the Commission issued a concept release requesting comments on the structure of these annuities, the manner in which they are marketed, and "other matters to be considered in addressing federal securities law issues raised by these products." [6] In recent years, according to the Proposing Release, sales of indexed annuities have grown dramatically. During the same period, the guarantees provided by such products have been reduced, and concerns about potentially abusive sales practices and inadequate disclosure have grown. [7] As a result, the Commission has "become persuaded that guidance is needed with respect to [the status of indexed annuities] under the federal securities laws." [8]

Proposed Rule 151A under the Securities Act

As proposed, new Rule 151A under the Securities Act would define a class of annuity contracts that are outside the scope of the Section 3(a)(8) exemption. Specifically, the rule would apply to any contract that is issued by a corporation subject to supervision by an insurance commissioner, bank commissioner or similar state regulatory authority, and that is subject to regulation as an annuity under state insurance law, if:

- amounts payable by the issuer 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 (paragraph (a)(1)); and
- amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract (paragraph (a)(2)).[9]

Under the proposed rule, a determination by the issuer at or prior to issuance of the contract as to whether the amounts payable under the contract are more likely than not to exceed the amounts guaranteed will be considered conclusive, if:

- both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;
- the issuer's computations in support of the determination are materially accurate; and
- the determination is made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued.

The rule would not apply to any contract "whose value varies according to the investment experience of a separate account" (e.g., variable annuities).

The Proposing Release explains that paragraph (a)(1) of the proposed rule broadly defines a class of contracts that "in all cases, require further scrutiny because they implicate the factors articulated by the U.S. Supreme Court as important in determining whether the Section 3(a)(8) exemption is applicable." It further explains that, to make the determination required by paragraph (a)(2) of the proposed rule, an issuer would have to analyze expected outcomes under various scenarios involving different facts and circumstances. These facts and circumstances would include, among other things, the particular features of the annuity contract, the particular options selected by the purchaser, and the performance of the relevant benchmark. According to the Proposing Release, insurers routinely undertake this type of analysis for purposes of pricing and hedging their contracts. [10]

The Proposing Release explicitly recognizes that, for purposes of making the determination required by the rule, a range of methodologies and assumptions may be reasonable, and a reasonable methodology or assumption by one insurer may differ from a reasonable methodology or assumption selected by another insurer. Among the assumptions an insurer will need to make are assumptions about its own behavior (e.g., how it may exercise its discretion to modify various features of the contract), purchaser behavior (e.g., length of holding period, the form of payment elected), and market behavior (e.g., expected return, market volatility, interest rates). The Proposing Release notes that, as a general matter, assumptions that are not consistent with historical experience would not be considered reasonable, unless the insurer has a reasonable basis for differences between historical experience and the assumptions used. [11]

The Proposing Release further notes that assumptions that are reasonable when a contract is originally offered may or may not continue to be reasonable at a subsequent time when the insurer continues to offer the contract. For this reason, the proposed rule would provide a window of time during which the determination must be made with respect to a particular contract. The Commission believes this approach would address the changing nature of reasonable assumptions, while permitting an insurer to rely on its determination for a significant period of time (i.e., three years) once it has been made. [12]

The Commission acknowledges that many insurance companies "have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this release." It thus proposes to apply new Rule 151A prospectively, so as not to subject insurance companies "to any additional legal risk relating to their past offers and sales of indexed annuity contracts as a result of our proposal or its eventual adoption." The Commission also proposes that the effective date of any final rule would be 12 months after publication in the Federal Register, so as to provide the industry with sufficient time to conduct the required analysis and comply with any applicable requirements under the federal securities laws. [13]

The Proposing Release seeks comment on a wide range of issues regarding proposed Rule 151A, particularly with respect to the scope of the proposed rule and the manner in which an insurer would have to determine that amounts payable under the contract are more likely than not to exceed the amounts guaranteed under the contract. [14]

Proposed Exemption from Exchange Act Reporting

The Commission also is proposing new Rule 12h-7 under the Exchange Act, which would exempt insurance companies from reporting requirements under that Act with respect to securities that are registered under the Securities Act and regulated as insurance under state law. The Proposing Release explains that state insurance regulation, like Exchange Act reporting, relates to an entity's financial condition and that the Commission believes that, as a general matter, applying both in the same situation may result in duplicative regulation that is burdensome. [15]

As proposed, Rule 12h-7 would exempt an insurance company from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of that Act with respect to securities registered under the Securities Act, provided that:

- the securities are subject to regulation under the insurance laws of the state in which the insurance company issuer is domiciled (or are guarantees of securities subject to such regulation), and do not constitute an equity interest in the insurance company issuer;
- the insurance company files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or similar regulatory authority in the company's state of domicile;
- the securities are not listed, traded, or quoted on an exchange, alternative trading system, electronic communications network, or similar system; and
- the insurance company takes steps reasonably designed to ensure that a trading market for the securities does not develop.[16]

According to the Proposing Release, Rule 12h-7 would apply to indexed annuities covered by proposed Securities Act Rule 151A (as described above), as well as to other types of contracts satisfying the rule's requirements. These would include, for example, contracts with "market value adjustment" features and contracts that provide certain guaranteed benefits in connection with assets held in an investor's account, such as mutual fund, brokerage or advisory account. In the case of a variable annuity contract, the exemption would apply to the insurance company issuer but not to the separate account in which the purchaser's payments are invested. If the insurance company issues securities to which the exemption would not apply (e.g., through an offering of debt securities to raise capital), the company would remain subject to Exchange Act reporting requirements with respect to those securities. [17]

The Proposing Release seeks comment on a range of issues regarding proposed Rule 12h-7, particularly with respect to whether the Commission should provide such an exemption from Exchange Act reporting requirements, the scope of the proposed exemption, and the appropriateness of the conditions to be included in the rule. [18]

Rachel H. Graham
Associate Counsel

Attachment

endnotes

[1] See Indexed Annuities and Certain Other Insurance Contracts, SEC Rel. Nos. 33-8933 and 34-58022 (June 25, 2008) (the "Proposing Release"). Page numbers in this memorandum refer to the Proposing Release as posted on the Commission's website, which is available at http://www.sec.gov/rules/proposed/2008/33-8933.pdf.

[2] Proposing Release at 9-10.

[3] An "optional annuity contract" is a deferred annuity.

[4] Proposing Release at 8, 17-20.

[5] Proposing Release at 20-21.

[6] See Equity Index Insurance Products, SEC Rel. No. 33-7438 (Aug. 27, 1997). The Commission stated that it was considering the status of these insurance products under the federal securities laws and that both purchasers and insurers could benefit from greater clarity in this area. The Institute filed a comment letter in response to the concept release. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Dec. 30, 1997. A copy of the Institute's letter is attached.

[7] Proposing Release at 14-16.

[8] Proposing Release at 8.

[9] For purposes of this calculation, amounts payable under the contract would be determined without reference to any charges imposed at the time of payment (e.g.,

surrender charges), while amounts guaranteed under the contract would be required to reflect such charges.

[10] Proposing Release at 31-33, 36.

[11] Proposing Release at 38.

[12] Proposing Release at 39.

[13] Proposing Release at 45.

[14] See Proposing Release at 29-30, 34-35, 41-44, 45 for the specific questions posed.

[15] Proposing Release at 48.

[16] Section 12(h) of the Exchange Act authorizes the Commission to adopt rules exempting any class of issuer from the reporting requirements of the Exchange Act if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.

[17] Proposing Release at 51-53.

[18] See Proposing Release at 49-50, 56-57, 59-60 for the specific questions posed.