

MEMO# 24499

August 18, 2010

Unanimous D.C. Court of Appeals Vacates Rule 151A

[24499]

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TO: SEC RULES MEMBERS No. 82-10

SMALL FUNDS MEMBERS No. 45-10

CLOSED-END INVESTMENT COMPANY MEMBERS No. 43-10

VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 6-10 RE: UNANIMOUS D.C.
COURT OF APPEALS VACATES RULE 151A

On January 16, 2009, the Securities and Exchange Commission (“Commission”) adopted Rule 151A to define the term “annuity contract” to exclude certain index annuities (“index annuities”) from the insurance exemption of the Securities Act of 1933 (“Securities Act”), effectively requiring such annuities to be registered with the Commission as securities. [\[1\]](#) On July 21, 2010, as a result of a challenge to Rule 151A, the United States Court of Appeals for the District of Columbia issued a unanimous opinion vacating the rule. The Court found the Commission’s interpretation of “annuity contract” reasonable but held that the Commission had failed to properly analyze the effects of Rule 151A upon efficiency, competition and capital formation under Section 2(b) of the Securities Act. [\[2\]](#)

I. Commission’s Interpretation of Annuity Contract Reasonable

Although the Court vacated Rule 151A, the Court found the Commission’s interpretation of “annuity contract” reasonable on the basis that the index annuities do “involve considerations of investment not present in the conventional contract of insurance.” [\[3\]](#) In reaching this conclusion, the Court rejected the petitioners’ arguments. First, the Court rejected arguments that the Commission erred when it excluded certain index annuities from the definition of “annuity contract” under Section 3(a)(8) of the Securities Act which exempts “annuity contracts” that are subject to state insurance laws. The Court found the petitioners’ interpretation too restrictive and asserted that although the index annuities were subject to state insurance regulation, it did not, without more, place them within the

Section 3(a)(8) exemption. Second, the Court rejected their arguments that Rule 151A was in conflict with the text of Section 3(a)(8), prior decisions of the court, [\[4\]](#) and the text of the Commission's prior rule, Rule 151.

II. Commission's Improper Analysis of Rule 151A Under Section 2(b)

Even though the Court concluded that the Commission's interpretation of "annuity contract" was reasonable, the Court supported the petitioners' argument that the Commission had contravened Section 2(b) of the Securities Act and vacated Rule 151A. Under Section 2(b), the Commission "is required to consider or determine whether an action is necessary or appropriate in the public interest, [and shall also consider], in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

The Court first rejected the Commission's argument that a challenge to its Section 2(b) analysis had to fail because that analysis was not required by the Securities Act. The Court stated that "the grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based." [\[5\]](#) As a result, because the Commission conducted a Section 2(b) analysis when it adopted Rule 151A, but did not assert that the analysis was done voluntarily, the Court concluded that the Commission was required to defend the analysis.

The Court then conducted a review of the Commission's Section 2(b) analysis under the Administrative Procedure Act ("APA"). Under the APA, the Court must set aside agency actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." [\[6\]](#) After evaluating the merits of the Commission's analysis, the Court concluded that the Commission's consideration of the effect of Rule 151A on efficiency, competition, and capital formation was arbitrary and capricious. [\[7\]](#)

A. Competition

The Court first rejected the Commission's assertion that implementation of Rule 151A would enhance competition because it brought clarity to the uncertain legal status of index annuities. The Court stated that the Commission could not justify adoption of a rule simply because it provided clarity to an area that is without regulation. The Court contended that any rule adopted by the Commission could equally be said to make a previously unregulated market clearer. It stated that under Section 2(b) of the Securities Act, the test is not whether any rule would have an effect on competition, but rather, whether the specific rule promotes competition. The Court asserted that the Commission would have achieved a similar clarity if it declined outright to regulate the index annuities. Furthermore, it stated that the Commission's reasoning at most supported the notion that any Commission action in this area could promote competition.

Second, the Court rejected the Commission's contention that Rule 151A would increase competition through enhanced disclosure requirements and increased price transparency. The Court stated that these claims were flawed because a baseline level of disclosure and price transparency was never assessed under existing state law. Without a starting point, the Court argued that it was impossible to accurately calculate any increase in competition. Accordingly, because the Commission neither considered the economic implications of the rule it proposed nor the existing level of competition, the Court

concluded that the Commission's analysis was arbitrary and capricious.

B. Efficiency

The Court also rejected the Commission's contention that Rule 151A would promote efficiency by allowing investors to make more informed decisions and enabling sellers to make more suitable recommendations. Like its analysis of competition, the Court found the Commission's analysis of efficiency insufficient; the Commission failed to examine whether adequate protections were already in place to enable investors to make informed investment decisions and sellers to make suitable recommendations. The Court found the Commission's failure to analyze the efficiency of the existing state law regime rendered arbitrary and capricious the Commission's judgment that applying the federal securities laws would increase efficiency.

C. Capital Formation

As a result of the Commission's flawed efficiency analysis, the Court also found the Commission's capital formation assessment unsatisfactory. Because the Commission grounded its assertion that Rule 151A would promote capital formation on the mistaken presumption that enhanced investor protections would increase market efficiency, the capital formation analysis "fails with the failure of its underlying premise." [8] The Court therefore deemed this analysis arbitrary and capricious, as well.

* * * *

Although the Court vacated Rule 151A, it did note that, after a more complete examination, the Commission may determine that Rule 151A has a positive effect on efficiency, competition, and capital formation. Nevertheless, on July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. This law contains an annuity regulation provision known as the Harkin Amendment, which places new limitations on the Commission's ability to regulate indexed annuities.

If you have specific questions, please contact Susan Olson at (202)326 5813 (solson@ici.org) or Heather Traeger at (202)326-5920 (htraeger@ici.org).

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endnotes

[1] Indexed Annuities and Certain Other Insurance Contracts, SEC Rel. Nos. 33-8996, 34-59221 (Jan. 8, 2009).

[2] American Equity v. SEC, No. 09-1021, July 12, 2010 ("American Equity"). Full opinion available at: <http://pacer.cadc.uscourts.gov/docs/common/opinions/201007/09-1021-1254636.pdf>.

[3] Id. at 15.

[\[4\]](#) See VALIC, 359 U.S. 65 (1959), SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

[\[5\]](#) American Equity at 20.

[\[6\]](#) 5 U.S.C. §706(2)(A)(2010).

[\[7\]](#) See generally American Equity at 20-24.

[\[8\]](#) American Equity at 24.

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