The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 23214

January 27, 2009

SEC Adopts Rules to Clarify Status of Indexed Annuities and Exempt Insurance Companies from Certain Reporting Requirements; Industry Coalition Files Legal Challenge

[23214]

January 27, 2009

TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 7-09
SEC RULES MEMBERS No. 9-09
SMALL FUNDS MEMBERS No. 7-09
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 3-09 RE: SEC ADOPTS RULES TO CLARIFY STATUS OF INDEXED ANNUITIES AND EXEMPT INSURANCE COMPANIES FROM CERTAIN REPORTING REQUIREMENTS; INDUSTRY COALITION FILES LEGAL CHALLENGE

The Securities and Exchange Commission has adopted Rule 151A under the Securities Act of 1933, which defines 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 rule, which effectively requires these indexed annuity contracts to be registered with the Commission as securities, applies prospectively to contracts issued on or after January 12, 2011. The Commission also has adopted Rule 12h-7 under the Securities Exchange Act of 1934 to exempt insurance companies from Exchange Act reporting requirements with respect to indexed annuities and certain other securities registered under the Securities Act and regulated as insurance under state law. [1] Rule 12h-7 becomes effective on May 1, 2009. The two rules are briefly summarized below.

On January 16, an industry coalition filed a petition in the U.S. Court of Appeals for the D.C. Circuit challenging the adoption of Rule 151A. The petition asks the Court to find the rule unlawful

under the Securities Act and the federal Administrative Procedure Act and to permanently enjoin the Commission from implementing and enforcing the rule's requirements. [2]

Rule 151A under the Securities Act

Section 3(a)(8) of the Securities Act provides an exemption from Securities Act registration 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. New Rule 151A under the Securities Act defines a class of annuity contracts that are outside the scope of the Section 3(a)(8) exemption. Specifically, the rule applies 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 at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods 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)).

Under paragraph (b) of Rule 151A, a determination by the issuer at or prior to issuance of the contract as to whether the amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed will be conclusive, provided that:

- 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.

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

The Release states that the Commission modified paragraph (a)(1) of Rule 151A to address

commenters' concerns that the rule, as proposed, was drafted too broadly and could apply to annuity contracts that are not indexed annuities. In particular, the Release clarifies that Rule 151A as adopted does not apply to: (1) traditional fixed annuities, even if the issuing insurance company looks to the performance of securities in its general account in establishing the rate of interest to be paid; (2) discretionary excess interest contracts, pursuant to which a specified interest rate may be established by reference to the past performance of a security or securities and applied on a prospective basis with respect to a future crediting period; and (3) annuity contracts that are covered by the Rule 151 safe harbor. [3] The "more likely than not" test of paragraph (a)(2) was adopted as proposed.

The Commission also modified paragraph (b) of the rule in response to commenters' concerns. As suggested by ICI and other commenters, the Commission eliminated the proposed requirement that the issuer's determination (of whether the amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract) be made not more than three years prior to the date on which the particular contract is issued. The Commission concluded that "the substantial uncertainties and potential costs introduced by this proposed requirement that a contract's status be redetermined every three years would be inconsistent with the intent of Rule 151A, which is to clarify the status of indexed annuities." The Commission further modified paragraph (b) to require that both the amounts payable under the contract and amounts guaranteed under the contract reflect all charges under the contract, including those imposed at the time of payment by the issuer. This change will ensure, for example, that the imposition of surrender charges under a contract will not affect the determination of whether that contract is a security.

The Release acknowledges that many commenters had significant concerns about the Commission's analysis of the proposal under Section 3(a)(8). Commenters asserted, among other things, that the purchaser of an indexed annuity does not assume investment risk in the sense contemplated by applicable legal precedent, and that the Commission failed to take into account the investment risk assumed by the issuer. [4] The Release responds at length to these and other concerns. [5] In particular, it rejects commenters' suggestion that investment risk should be viewed solely as the risk of loss of principal for purposes of Section 3(a)(8), stating that such a definition "fails to account for important forms of risk and leads to conclusions inconsistent with the contemporary understanding of investment risk." The Release states the Commission's view, for example, that the market would generally view an asset where the future payoff of the amount over the guaranteed principal return is uncertain (such as with an indexed annuity) to be more risky that a zero-coupon U.S. government bond maturing at the same date, which guarantees a return of principal but also has a nearly certain future payoff.

The Release also describes the Commission's reasons for rejecting the assertions of some commenters that federal regulation of indexed annuities is not needed because, for example, there is no evidence of widespread sales practice abuse and state insurance regulators are effective in protecting purchasers of indexed annuities. The Release states that, while reports of sales practices abuses surrounding indexed annuities are "a matter of grave concern" to the Commission, the presence or absence of such abuses is irrelevant in

determining whether an annuity contract is covered by the Section 3(a)(8) exemption. Rather, in accordance with applicable precedent, the necessity for federal regulation arises "from the characteristics of the financial instrument itself." On the issue of state regulation, the Release applauds recent efforts by state insurance regulators to address sales practice complaints, but says the Commission does "not believe that states' regulatory efforts, no matter how strong, can substitute for [the Commission's] responsibility to identify securities covered by the federal securities laws and the protections Congress intended to apply."

According to the Release, during the two-year transition period for Rule 151A, the Commission intends to consider how to tailor disclosure requirements for indexed annuities. Issuers are encouraged to work with the Commission during the transition period to address their concerns. Issuers and other affected parties also are encouraged to submit, for the Commission's consideration during the transition period, specific requests for guidance concerning the determinations required by Rule 151A(b). [6]

Rule 12h-7 under the Exchange Act

The Commission also adopted a rule to exempt insurance companies from reporting requirements under the Exchange Act with respect to securities that are registered under the Securities Act and regulated as insurance under state law. Specifically, Rule 12h-7 exempts 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:

Rule 12h-7 applies to indexed annuities covered by Securities Act Rule 151A (as described above), as well as to other types of contracts satisfying the rule's requirements. These include 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 a mutual fund, brokerage or advisory account. In the case of a variable annuity contract or variable life insurance policy, the exemption applies 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 remains subject to Exchange Act reporting requirements with respect to those securities.

In response to comments from ICI and others that the condition in paragraph (e) of the rule could potentially conflict with state law in some circumstances, the Commission modified that condition to clarify that an issuer would not be required restrict assignments or other transfers of securities to the extent that such restrictions would be inconsistent with applicable state law. The Commission also added the prospectus disclosure requirement in paragraph (f) to clarify that reliance on Rule 12h-7 is optional. The Release makes clear

that, if an insurer does not state in its prospectus that it is relying on the exemption provided by Rule 12h-7, the insurer will be subject to mandatory Exchange Act reporting.

Dissent of Commissioner Paredes

Commissioner Paredes voted against the adoption of Rule 151A. [7] His dissent takes issue with the Commission's legal analysis, stating that it conflicts with applicable Supreme Court precedent. In particular, Commissioner Paredes suggests that Rule 151A misconceptualizes investment risk for purposes of Section 3(a)(8) by focusing on the "possibility of upside," beyond the guarantee of principal and the guaranteed minimum rate of return instead of emphasizing the extent of downside risk, or the extent to which an investor is subject to a risk of loss. He further questions the rule's use of a "more likely than not" test, suggesting that the test, as applied, would result in "blanket SEC regulation of the entire indexed annuity market."

Commissioner Paredes suggests that Rule 151A has additional shortcomings, including that: (1)the rule, together with the Release, makes an implicit judgment that state insurance regulation of indexed annuities is inadequate; (2) the rule will impose various costs and burdens on insurers that could disproportionately impact small businesses; and (3) there are "more effective and appropriate" ways to address the concerns underlying this rulemaking, including by amending Rule 151 to establish a more precise safe harbor under Section 3(a)(8).

Rachel H. Graham
Senior Associate Counsel

endnotes

[1] See Indexed Annuities and Certain Other Insurance Contracts, SEC Rel. Nos. 33-8996, 34-59221 (Jan. 8, 2009), 74 Fed. Reg. 3138 (Jan. 16, 2009) ("Release"). Page numbers in this memorandum refer to the Release as posted on the Commission's website, which is available at http://www.sec.gov/rules/final/2009/33-8996.pdf. For a discussion of the background to this rulemaking, see Institute Memorandum 22676, dated July 10, 2008.

[2] See Coalition of Insurance Companies and Independent Marketing Organizations File Lawsuit Against the SEC Over New Annuities Regulation (press release dated Jan. 16, 2009). The press release and accompanying press kit, which includes a copy of the petition filed with the Court, is available at http://media.corporate-ir.net/media_files/irol/14/147784/Press-Kit_1-16-09.pdf.

[3] Release at 49-51. 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.

[4] Under applicable Supreme Court precedent, factors that are important to a determination of an annuity's status under Section 3(a)(8) include the allocation of investment risk between insurer and purchaser and the manner in which the annuity is marketed. Release at 16.

[5] Release at 27-46.

[6] The Release acknowledges the concerns of some commenters that the "principles based approach" outlined in paragraph (b) of the rule provides insufficient guidance regarding the methodologies and assumptions that are appropriate and could result in inconsistent determinations by different insurance companies. It notes, however, that commenters generally did not articulate with specificity the areas where they believe that further guidance is required.

[7] The text of Commissioner Paredes' dissent is available at http://www.sec.gov/rules/final/2009/33-8996-dissent.pdf.