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Securities and Exchange Commission Rule 151A and Annuities: Issues and Legislation

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Summary

In January 2011, a new rule from the Securities and Exchange Commission (SEC), Rule 151A, entitled "Indexed Annuities and Certain Other Insurance Contracts," is slated to go into effect. This rule would effectively reclassify indexed annuities as both security products and insurance products. Since insurance products generally are regulated solely by the states, this rule will expand federal authority over indexed annuities, putting them in a similar classification as variable annuities, which are already regulated by both the SEC and the individual states.

The SEC has cited as a primary reason for increased federal oversight numerous problems with improper marketing and sales of these annuity products. This proposal has been controversial, with nearly 5,000 comments received by the SEC. The SEC's final rule was adopted on December 17, 2008, and was published in the *Federal Register* on January 16, 2009. Although some changes were made from the initial proposed rule, the final rule retained the majority of the original language. The U.S. Court of Appeals considered a legal challenge to the SEC's rule, in *American Equity Investment Life Insurance Co. vs. SEC*. In July 2009, the court found that the SEC was not unreasonable in classifying indexed annuities as securities, but remanded the rule to the SEC for the SEC to provide a more thorough analysis of the effects of the rule upon competition, efficiency, and capital formation. More recently, on July 12, 2010, the United States Court of Appeals for the District of Columbia Circuit ordered that Rule 151A be vacated and that its 2009 decision be amended accordingly.

On June 4, 2009, Representative Gregory Meeks introduced the Fixed Indexed Annuities and Insurance Products Classification Act of 2009 (H.R. 2733). Senator Benjamin Nelson introduced an identical bill, S. 1389, in the Senate on June 25, 2009. The bills would specifically nullify SEC Rule 151A and return to the states sole regulatory authority over indexed annuities. Neither individual bill has been brought up for consideration by relevant committees.

During the conference committee on the Wall Street Reform and Consumer Protection Act (H.R. 4173), Senator Harkin offered an amendment, ultimately adopted as Section 989J, that directs the SEC to treat as exempt securities annuities that meet a number of conditions. This language has been generally interpreted as preventing SEC oversight of indexed annuities, although its precise impact may be clarified by future court or regulatory decisions. The House agreed to the H.R. 4173 conference report on June 30, 2010, by a vote of 237-192 and the Senate agreed to the conference report on July 15, 2010, by a vote of 60-39. President Obama signed the bill into law as P.L. 111-203 on July 21, 2010.

This report explains the different types of annuities, the taxation of annuities, and disentangles the federal and state roles in the regulation of annuities. It outlines the SEC rule, including practical considerations for implementation. It also discusses legal and congressional action in response to the SEC rule. The report will be updated as legislative or regulatory events warrant.

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Background on Annuities[1]

Types of Annuities[2]

In its most simple form, an annuity can be thought of as the opposite of life insurance. In a basic life insurance contract, a person pays an insurer a small sum for many years, and then upon the insured's death, a large payment is made to a beneficiary. In the simplest form of annuity, a large sum is paid to the insurer and then a smaller sum is paid out to the insured over his or her lifetime. More formally, an annuity can be defined as "a contract that provides an income for a specified period of time, such as a number of years, or for life."[3] As with life insurance, annuities can be more complex, with insurers offering a wide variety of both insurance and investment features in the annuity contracts that they sell.

Annuities can be classified as follows:

- *Immediate versus Deferred*—Under an immediate annuity, an individual pays an insurance company a sum of money and the insurance company begins making regular monthly payments to the individual immediately. Under a deferred annuity, an individual pays the insurance company a sum of money and the insurance company begins making regular monthly payments at some designated time after purchase. For example, an individual at age 45 might buy a 20-year deferred annuity that would start making monthly payments when the individual reaches age 65. Deferred annuities may also be funded over time, with a person making periodic payments into the annuity, as they might with a 401(k) account or other savings vehicle. After this "accumulation phase" is finished, the annuity would then make periodic payments based on the value of the final contributed amount.
- *Fixed versus Variable*—A fixed annuity pays a flat monthly amount for the life of the annuitant whereas a variable annuity pays a monthly payment amount tied to the performance of an investment portfolio containing assets such as corporate stocks or bonds. Under a variable annuity, the annuitant bears the risk that the monthly annuity payment could go down.
- *Level Payment versus Graded Payment*—In a level payment annuity, the monthly payments remain the same, whereas in a graded annuity the monthly payments increase each year. Depending on the terms of the annuity contract, the payments may increase at a specified rate, such as 2% per year, or may increase at the rate of inflation.
- *Single-Life versus Joint-and-Survivor*—A single-life annuity makes regular monthly payments for the life of one person. A joint-and-survivor annuity makes regular monthly payments for the lives of two people, the primary annuitant and a secondary annuitant, typically the spouse of the primary annuitant.

[1] For more information on annuities, see CRS Report R40008, *Converting Retirement Savings into Income: Annuities and Periodic Withdrawals*, by Janemarie Mulvey and Patrick Purcell.

[2] This section is based on CRS Report RS22439, *The Market for Retirement Annuities*, by Neela K. Ranade.

[3] Emmett J. Vaughn and Therese Vaughn, *Fundamentals of Risk and Insurance*, 9th Ed. (Hoboken, NJ: John Wiley & Sons, 2003), p. 639.

Annuities and Indexed Annuities

Annuities as a class are a wide-ranging financial product: some annuities are relatively simple products designed to pay a set amount per month; some are complex products that may base payments on a variety of other investments combined with different forms of financial guarantees.

Indexed annuities are a relatively recent invention combining elements of fixed annuities, which offer returns based on a fixed interest rate, and variable annuities, which offer returns through investment holdings chosen by the annuitant. Indexed annuities have tended to be complex products with features that sometimes may be difficult to value. Specifically, a common form of indexed annuity offers an investment return based on the level of a specific securities index combined with a guaranteed minimum return should the securities market fall, limiting the downside risk to the purchaser. Unlike variable annuities in which the actual securities investments are held in segregated accounts, indexed annuities credit the annuity holder with a return based on a securities index, but the actual securities may or may not be held by the insurance company. The indexed annuity investment return typically does not include dividends that would have accrued had this amount been actually invested in the particular securities index. In addition, there are often insurance options, such as some death benefit upon the death of the annuitant, or a survivor benefit to base payment on the death of the second person in a couple rather than on one person. The various options available in indexed annuities, or other annuities, are often paid for through charges based on a percentage of the account value. There are also typically significant surrender charges should a purchaser wish to cancel the annuity contract early.

Annuities in general have been somewhat controversial, with opinions varying widely as to their suitability for many investors. Complaints about annuities include high fees on the investment funds, a lack of liquidity due to high surrender charges, and deceptive sales practices, particularly with regard to sales to senior citizens. These complaints, it should be noted, are not limited to indexed annuities, but include the variable annuity products that have been regarded as securities products under the Securities and Exchange Commission (SEC) regulation for decades. Defenders of annuity products point out that annuities can play an important role in retirement planning. They offer tax-deferred growth for investments and are the only product that can offer a lifetime guaranteed income.

Tax Treatment of Annuities[4]

One of the primary advantages of annuities compared to other financial products, such as mutual funds or certificates of deposit, is the deferral of tax on the investment earnings of the annuity contract. These earnings are taxed only when the annuitant actually receives the annuity payments, according to formulas specified in the law and in IRS regulations. Internal Revenue Code Section 72 provides that the taxable income from an annuity contract in a given year is the total amount received under the contract that year less that year's prorated share of the cost of (or investment in) the contract. This allows the investment income to compound tax-free for potentially several years before any tax is due. On the other hand, the tax due on annuity investment income is calculated at ordinary income rates, as with interest from savings accounts and certificates of deposits, rather than at the reduced rates that currently apply to capital gains

[4] For more specifics on the tax treatment of annuities, see CRS Report R40008, *Converting Retirement Savings into Income: Annuities and Periodic Withdrawals*, by Janemarie Mulvey and Patrick Purcell.

and dividends. Ordinary income tax rates are as high as 35%, while most long-term capital gains and dividends end up being taxed at 15%, although capital gains rates can be as low as 0%.[5] This potentially higher tax rate for annuity investment income can have a significant impact on the economic rationale prompting a consumer to purchase an annuity, and thus makes the annuity market, and the insurers offering annuities, very sensitive to tax proposals that might change rates on investment income.

Regulation of Annuities

State Insurance Regulation[6]

As insurance products, all annuities are regulated by the individual states following the 1945 McCarran-Ferguson Act,[7] which identifies the states as the primary regulators of insurance. This state oversight generally includes regulation of insurer solvency, regulation of the content of insurance products, and regulation of the market conduct of insurers and those selling insurance products. Annuities, particularly variable annuities, have attracted attention for allegedly abusive sales tactics. States coordinate regulation of insurance through the National Association of Insurance Commissioners (NAIC), which has promulgated model laws and regulations on insurance. In order to be effective, however, NAIC models must be adopted by the individual states, which are free to adopt them "as is" or with modifications. This has led to variation among the states in the precise regulations applied to annuities and other insurance products.

Federal Securities Regulation[8]

Insurance products are primarily regulated at the state level, whereas securities products are generally regulated at the federal level, primarily by the SEC. SEC securities regulation related to annuities is typically less extensive than state insurance regulation. Companies that sell securities to the public are required to register with the SEC, as are brokers and others selling securities. In addition to SEC registration, securities brokers are required to be members of the Financial Industry Regulatory Authority (FINRA), a non-governmental self-regulatory organization for the securities industry. Much of the direct oversight of securities dealers occurs through FINRA rather than through the SEC, though the SEC retains authority over FINRA and may require it to adopt, or not adopt, certain policies or rules. There is little SEC oversight equivalent to state solvency requirements for insurers.

Federal securities regulations only apply to those financial products that are considered securities under the federal securities laws. For a number of years after the introduction of the variable annuity, some controversy existed as to whether or not these products are securities. The Supreme Court decided in 1959, however, that variable annuities were to be considered securities under

[5] For more information on capital gains and dividend taxes, see CRS Report 96-769, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle, and CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, by Jane G. Gravelle.

[6] See CRS Report R40771, *Insurance Regulation: Issues, Background, and Legislation in the 111th Congress*, by Baird Webel.

[7] 15 U.S.C. §§ 1011-1015; "Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest…." (15 U.S.C. § 1011).

[8] See CRS Report RL33235, *Banking and Securities Regulation and Agency Enforcement Authorities*, by Mark Jickling et al.

federal law.[9] Following that decision, variable annuities have been generally subject to SEC and FINRA requirements, while other types of annuities are not.

Consumer Protection

Both state and federal regulators have concluded that annuities in general present consumer protection issues and need particular regulatory attention. In proposing Rule 151A, the SEC cited the need to protect investors, particularly older investors, from fraudulent and abusive practices related to the sale of indexed annuities. Annuity sales practices have drawn complaints from consumers and various regulatory actions from state regulators and the SEC/FINRA over many years. The complexity of annuity products can allow unscrupulous sellers to take advantage of unsophisticated buyers, while high commissions on some annuities may give sellers a substantial financial incentive to sell these products. The alleged sales abuses seem to particularly affect older consumers. For example, a joint "Investor Alert" by the SEC, FINRA, and the North American Securities Administrators Association (NASAA) cites variable annuities as one of a number of products that are commonly used to defraud senior citizens.[10]

State regulators have also taken particular actions to protect consumers from abuses in annuity products. To help harmonize states' oversight efforts, the NAIC's model laws and regulations include an "Annuities Disclosure Model Regulation" and a "Suitability in Annuity Transactions Model Regulation." The NAIC Model Suitability language requires insurance companies to give objective financial information to potential purchasers, and it requires agents to use a standardized form to determine whether an annuity would be suitable for the potential purchaser. Some state laws ban the use of professional designations or titles—such as Senior Financial Advisor—that might mislead senior consumers into thinking that the advisor has special financial expertise related to the needs of older consumers.

The NAIC Annuity Disclosure Model Regulation requires certain information to be disclosed, including information about premiums and how they are charged, a summary of the options and restrictions for accessing money, and an outline of fees. NAIC models, however, must be adopted by the individual states before they can take effect. According to the NAIC, 32 states have adopted the NAIC model on annuity suitability and 16 have adopted the model on annuity disclosure in "a uniform and substantially similar manner."[11] In addition to the model laws and regulations, the NAIC addressed perceived abuses in annuity marketing with a "Buyer's Guide" for prospective purchasers of annuities. This guide includes a specific section on indexed annuities.

SEC Promulgation of Rule 151A

As insurance products, all annuities are regulated at the state level. Some annuity products, however, are also considered securities products and are regulated by the SEC. On June 26, 2008, the SEC announced a proposed rule regarding indexed annuities.[12] This rule was finalized on

[9] *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959).

[10] "Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line," available on SEC's website at http://www.sec.gov/spotlight/seniors/elderfraud.pdf.

[11] *Model Laws, Regulations, and Guidelines*, National Association of Insurance Commissioners, Update #90, January 2010, pp 245-24 and 275-11.

[12] The products in question are referred to by a variety of different terms including "equity indexed annuities," "fixed indexed annuities," and simply "indexed annuities." This report will generally use the term "indexed annuities."

January 8, 2009.[13] Specifically, Rule 151A removes an annuity contract from the insurance exemption in the Securities Act of 1933 if "the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract."[14] The same proposal also added Rule 12h-7, exempting state-regulated insurance companies from the requirements under the Securities Exchange Act of 1934 to file reports on such annuity contracts. The effective date of the rule is to be January 12, 2011. The primary impact of this rule change is that many, if not most, of the practices related to the sale of indexed annuities of those companies and individuals selling indexed annuities will be regulated by both the SEC and the states. This rule generated controversy, with several thousand comments to the SEC opposing it, including several written by Members of Congress. The SEC extended its comment period before promulgating its final Rule 151A.

In its final rule, the SEC stated that the nature of the investment risk posed by indexed annuities means that they should be regulated as securities, rather than solely as insurance products, as long as more than half the time the expected return of the indexed annuities is more likely than not greater than the minimum guaranteed return. In this case, the SEC stated, it is the purchaser of the annuity, rather than the insurance company, who would bear most of the investment risk. As a result, such purchasers should be entitled to the disclosure requirements, selling restrictions, and antifraud provisions of the federal securities laws, the SEC reasoned. The rule also cited a need to protect investors from fraudulent and abusive practices related to the sale of equity-indexed annuities.

Reaction to the Proposed Rule

The SEC received numerous public comments on the proposed rule, with most of them being either opposed to its adoption or requesting an extension of the time limit for filing comments.[15] Two complaints frequently made by those opposed to the rule were (1) equity-indexed annuities are fundamentally not securities, and thus should not be regulated as such; and (2) state regulation of insurance products is superior to SEC regulation of securities products, so the proposal would add a layer of complexity and duplicative regulation for little benefit.

Eighteen Members of Congress, led by Representative Gregory Meeks, sent a letter to the SEC calling for an extension of the comment period for an additional 90 days. The authors observed that the proposed rule would have a significant impact, imposing a layer of federal regulation on top of state regulation, and expressed concern that stakeholders, including state insurance regulators and the insurance industry, were not consulted in the development of the rule. [16] Several other Members of Congress wrote similar individual letters. Such concerns, and the request for delay, were also echoed in letters from various state insurance regulators and state legislators, as well as by individual comments made to the SEC.

Extension of Comment Period

In response to "numerous letters" requesting that the comment period be extended from its original September 10, 2008, closure, the SEC announced on October 10, 2008, that it was

[13] See the SEC website "SEC Final Rules" at http://www.sec.gov/rules/final.shtml.

[14] U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts," 73 *Federal Register* 37752, July 1, 2008.

[15] The full comments can be reviewed on the SEC website at http://www.sec.gov/comments/s7-14-08/s71408.shtml.

[16] Letter available on the SEC website at http://www.sec.gov/comments/s7-14-08/s71408-1008.pdf.

reopening the comment period for an additional 30 days. The official extension announcement was published in the *Federal Register* on October 17, 2008, and the comment period closed on November 17, 2008.[17] According to the SEC, more than 4,800 letters were received by the end of the second comment period.

Final SEC Rule

On December 17, 2008, the SEC approved the previously proposed rule, with one commissioner dissenting.[18] Prior to adoption, the language of the final rule was modified somewhat, particularly to address concerns that the types of annuities affected by it might be broader than intended by the SEC. It also extended the effective date from one year after adoption to approximately two years (January 12, 2011). The majority of the language in the final rule was, however, unchanged from that proposed in June 2008.[19] Some congressional concern was expressed over the SEC action at the time.[20]

SEC Regulation: What It Entails

To meet the requirements of SEC Rule 151A, companies offering indexed annuities will have to file registration statements with the SEC, prepare and distribute prospectuses to prospective purchasers, and comply with the anti-fraud provisions of the federal securities laws, such as Section 10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"). Becoming subject to the anti-fraud provisions of the federal securities laws means, among other things, that companies selling indexed annuities could be subject to liability—either via private lawsuits from purchasers of the annuities, or civil liability through the SEC's enforcement powers—under the Securities Act of 1933 ("the 1933 Act") for any material misstatements or omissions in the prospectuses they distribute to purchasers. The registration statements that insurance companies offering these products will have to file with the SEC must include a description of the securities to be offered for sale, information about the management of the issuer, information about the securities, and financial statements certified by independent accountants.

In addition, under the new SEC rule, individual sellers of registered indexed annuities will be required to be registered broker-dealers and will become subject to oversight by FINRA. Alternatively, sellers of indexed annuities could become associated persons of an established broker-dealer through a networking arrangement. This provision will likely entail new compliance requirements for some firms selling indexed annuities, although it will offer some additional protection to buyers. Broker-dealers selling indexed annuities after Rule 151A's effective date of January 12, 2011, for instance, will fall under an obligation to make only suitable recommendations for the prospective buyer, and to comply with specific books and records, and supervisory and compliance requirements under the federal securities laws. This may arguably result in greater standardization of selling practices, which are currently subject to individual state oversight.

[17] U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts," 73 *Federal Register* 61753, October 17, 2008, available at http://sec.gov/rules/proposed/2008/33-8976fr.pdf.

[18] The dissenting commissioner was Troy A. Paredes; his speech outlining the reasons for the dissent can be found on the SEC website at http://www.sec.gov/news/speech/2008/spch121708tap.htm.

[19] The SEC final rule with background and explanation can be found on the SEC website at http://www.sec.gov/rules/final/2009/33-8996.pdf.

[20] See, for example, the statement issued by House Financial Services Committee Chairman Barney Frank at http://www.house.gov/apps/list/press/financialsvcs_dem/press121708.shtml.

Under the terms of Rule 151A's companion Rule 12h-7, companies would be exempt from the regular reporting requirements to the SEC mandated by the 1934 Act, which many other registered companies face, as long as the issuer of indexed annuities is already subject to state insurance regulation. The issuer must also file annual statements of its financial condition with its state regulator to qualify for this reporting exemption. Finally, to be exempt from reporting requirements, the insurance company selling the indexed annuities must also take steps to ensure that a secondary trading market for its indexed annuities does not emerge, since the provisions of the 1934 Act are aimed at issues surrounding the trading of securities.

Thus, while bringing companies offering indexed annuities under federal regulation, the SEC has at the same time chosen not to require additional regulatory updates such as the quarterly 10-Q and annual 10-K filings that other registered companies must submit to the SEC. The reasoning for this, according to the SEC in its final rule, is that, though the indexed annuities will be considered securities under the new rule, they will not be traded in a secondary market, and activities of the insurance companies issuing them, including the seller's assets and income, are already monitored and regulated at the state level. The SEC argues that this exemption from reporting requirements will lessen the burden and costs on the industry of implementing Rule 151A. However, critics of the rule have responded that the SEC has underestimated the costs and burden of implementing Rule 151A, and that the SEC has overstepped its statutory authority in attempting to regulate this product.[21]

Scope of Rule 151A

Only indexed annuities issued on or after the effective date of the rule—January 12, 2011—will need to register with the SEC and distribute prospectuses. Those issued and existing prior to January 12, 2011, would not be affected by the SEC's Rule 151A. One focus of critics' arguments has thus been on any potential future dampening effect on prospective competition or the offering of new indexed annuities products after that date.

The SEC Rule 151A would not automatically apply to all indexed annuities. Instead, indexed annuities will only be considered securities and thus be forced to register with the SEC if the expected payout of the annuity is more likely than not to exceed the minimum guaranteed amount under the annuity contract. The SEC would consider the payout to be more likely than not in excess of the minimum if that were the expected outcome more than half the time. However, it is up to the seller of the indexed annuities to analyze the expected outcomes under various scenarios, and to make that determination. Arguably, a buyer of annuities might infer that an unregistered annuity would fail that outcomes test—although some believe this would depend upon the sophistication of the prospective buyer. There is no particular disclosure requirement for sellers of indexed annuities who determine that their products are not more likely than not to pay more than the minimum outcome more than half the time, because such annuities would not be considered securities under Rule 151A.

[21] See Opening Remarks and Dissent of SEC Commissioner Troy A. Paredes Regarding Final Rule 151A: Indexed Annuities and Certain Other Insurance Contracts, at the Open Meeting of the Securities & Exchange Commission, December 17, 2008 in U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts; Final Rule," 74 *Federal Register* 3175, January 16, 2009.

Cost of SEC Regulation

In its proposed rulemaking, the SEC offered a cost estimate of complying with the rule. This drew a number of comments, particularly from industry groups, arguing that the costs of implementing the registration requirement would exceed the SEC estimate.

The SEC estimated that the total cost savings to insurance companies that will be spared having to otherwise file regular quarterly and annual reports as a result of Rule 151A's companion Rule 12h-7—the voluntary exemption from 1934 Act reporting requirements—would be $15,414,600. This calculation was based on the SEC's analysis that approximately 24 insurance companies currently offer products with "market-value adjustment" features and other types of guaranteed benefits in connection with assets held in an investor's account, and those insurance companies currently file regular reports such as the annual Form 10-K, quarterly 10-Q, and Form 8-K. However, these companies would be entitled to the 12h-7 exemption, according to the SEC.

The SEC calculated its $15,414,600 cost savings based on the number of filings it receives from the 24 insurance companies offering these products; a total of 49,994 burden hours for preparing the reports; and an hourly rate of $175 for the work of preparation by in-house staff, with 16,664 hours at $400 per hour for the work of preparation by outside professionals.[22] The SEC then estimated the total cost of preparing the new registration statements that would be required under Rule 151A for insurance companies at $82,500,000, based on 60,000 burden hours estimated of in-house work at $175 per hour and an additional $72,000,000 cost estimate for outside professionals' work.

Several commentators disagreed with the SEC's cost estimates. Some stated that consumers would face added costs, because the costs of preparing prospectuses and registering as broker-dealers would be passed along to the consumer; others stated the new rule would place a disproportionate burden on small insurance distributors. Others wrote that the hourly rates used by the SEC in its estimations were too low.[23]

Legal Challenge[24]

On the day the SEC published its final Rule 151A, a coalition of insurance companies and insurance trade groups filed a Petition for Review in the U.S. Court of Appeals for the District of Columbia Circuit challenging the rule.[25] The petitioners challenging the rule included American Equity Life Insurance Co. and the National Association of Insurance Commissioners. The Association of American Retired Persons provided briefs supporting the SEC rule. The petitioners made two arguments: (1) The SEC unreasonably interpreted the term "annuity contract" not to include fixed indexed annuities (FIAs),[26] and (2) the SEC did not fulfill its statutory duty under

[22] U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts; Final Rule," 74 *Federal Register* 3164, January 16, 2009, also available at http://www.sec.gov/rules/final/2009/33-8996.pdf.

[23] Full SEC discussion of costs can be found in its final rule at U.S. Securities and Exchange Commission, "Indexed Annuities and Certain Other Insurance Contracts; Final Rule," 74 *Federal Register* 3138-3176, January 16, 2009, also available at http://www.sec.gov/rules/final/2009/33-8996.pdf.

[24] This section authored by Michael V. Seitzinger, legislative attorney in the American Law Division.

[25] *American Equity Investment Life Insurance Company vs. SEC*, 09-1021 (D.C. Cir. 2009), filed on January 16, 2009.

[26] The court's judgment adopted the term "fixed indexed annuity" so this will be used in this section.

Section 2(b) of the 1933 Act[27] to consider the effect of the rule upon efficiency, competition, and capital formation.

On July 21, 2009, the United States Court of Appeals for the District of Columbia decided the case.[28] The court, after a thorough analysis of whether the SEC's Rule 151A was reasonable under the two-step test set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc. (Chevron)*,[29] held that the rule's interpretation of "annuity contract" was reasonable and therefore that FIAs could be treated as securities rather than insurance products. However, the court also held that the Commission did not adequately consider the effect of the rule upon efficiency, competition, and capital formation. The court therefore remanded the rule for reconsideration and a more complete analysis of the impact of the rule upon competition, efficiency, and capital formation.

Analysis of Argument

Petitioners first argued that the SEC improperly excluded FIAs from the Section 3(a)(8) exemption of the 1933 Act and that this argument could be supported by the text of the exemption; by two Supreme Court decisions, *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America (VALIC)*[30]and *Securities and Exchange Commission v. United Benefit Life Insurance Company (United Benefit)*;[31] and by the language of the SEC's earlier rule, Rule 151.

The court began its analysis with a discussion of the two-step process for reviewing the authority of an agency's interpretation of a statute as set forth in *Chevron*.[32] The first step under *Chevron* is to determine whether the statute being interpreted is ambiguous. The court found that *Chevron* Step One is satisfied because the 1933 Act is ambiguous or at least silent concerning whether "annuity contract" includes every form of contract that may be described as an annuity. The court buttressed this analysis by referring to the Supreme Court decisions in *VALIC* and *United Benefit*. In *VALIC*, the Supreme Court decided that a variable annuity did not fall within the Section 3(a)(8) exemption because it places all of the investment risks upon the purchaser and no risks upon the insurance company. In *United Benefit*, the Court found that a flexible fund annuity did not fall within the Section 3(a)(8) exemption because the flexible fund appealed to a purchaser primarily for the possibility of growth and not significantly for the qualities of stability and security associated with insurance.

The second step under *Chevron* is whether an agency's interpretation of a statute is permissible. The court discussed the *United Benefit* case in describing that one may reasonably believe that risk based upon the prospect of growth attaches to the purchase of a fixed indexed annuity.[33]

The court went on to state that, as in securities, there can be a wide variation in a purchaser's return on a fixed indexed annuity, resulting in risk to a purchaser. Because of this and other

[27] 15 U.S.C. § 77b(b).

[28] *American Equity Investment Life Insurance Company v. Securities and Exchange Commission*, No. 09-1021, 2009 U.S. App. LEXIS 16097 (D.C. Cir. 2009).

[29] 467 U.S. 837 (1984).

[30] 359 U.S. 65 (1959).

[31] 387 U.S. 202 (1967).

[32] The court begins its analysis in *American Equity* at *17. Our discussion of the analysis follows the language and rationale used by this particular court in its interpretation of the *Chevron* case.

[33] *Id.* at *20-*21.

characteristics of FIAs, the court found that the Commission's interpretation that an FIA is not an annuity contract under Section 3(a)(8) of the 1933 Act was reasonable.

As for petitioners' argument that the language of the SEC's earlier Rule 151 supported its position and that Rules 151 and 151A were inconsistent, the court responded that the SEC was consistent in its position on investment risk. The earlier rule provided a safe harbor under Section 3(a)(8) for some annuity contracts based upon an investment index. However, only those products with index-based interest rates calculated in advance were allowed the safe harbor. In the instant case, involving FIAs, the interest rate was determined only at the end of the investment year, resulting in significant risk to a purchaser.

Based upon all of these reasons, the court held that the Commission's interpretation of "annuity contract" was reasonable and that the second step as set forth in *Chevron* was also satisfied.

In its second argument, petitioners stated that the SEC did not meet the requirements of Section 2(b)[34] of the 1933 Act because it did not adequately consider the effects of Rule 151A upon efficiency, competition, and capital formation. The court first rejected the SEC's argument that it was not required by the 1933 Act to perform a Section 2(b) analysis. Because the SEC did in fact conduct a Section 2(b) analysis, the SEC, according to the court, was required to defend the basis of the analysis that it used.[35]

In discussing the merits of the SEC's analysis, the court stated that the Administrative Procedure Act[36] requires a court to set aside an agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[37] The court held that the SEC's consideration of the effects of Rule 151A upon efficiency, competition, and capital formation was arbitrary and capricious.

The court went on to state that the competition analysis failed because the SEC did not make any finding on the level of marketplace competition under state law. In addition, the court, for a variety of reasons, found that the Commission's efficiency analysis and capital formation analysis were arbitrary and capricious. The court therefore remanded the rule to the SEC to address the deficiencies of the section 2(b) analysis.

On July 12, 2010, the United States Court of Appeals for the District of Columbia Circuit ordered that Rule 151A be vacated and that its 2009 decision be amended accordingly.[38]

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[34] This provision, codified at 15 U.S.C. section 77b(b), states:

Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[35] *American Equity*, at *31, referencing and quoting from *Securities and Exchange Commission v. Chenery* Corporation, 318 U.S. 80 (1943).

[36] 5 U.S.C. §§ 551 *et seq*.

[37] *Id*., quoting 5 U.S.C. § 706.

[38] *American Equity Investment Life Insurance Company v. Securities and Exchange Commission*, No. 09-1021 Consolidated with 09-1056, 2010 U.S. App. LEXIS 14249 (D.C. Cir. 2010).

Legislation

The Fixed Indexed Annuities & Insurance Products Classification Act of 2009 (H.R. 2733/S. 1389)

H.R. 2733 was introduced in the House on June 4, 2009, by Representative Gregory Meeks along with 21 cosponsors. It was referred to the House Financial Services Committee. Senator Benjamin Nelson introduced an identical bill, S. 1389, in the Senate on June 25, 2009. It was referred to the Senate Banking, Housing, and Urban Affairs Committee. Neither committee has held hearing or markup on the legislation.

H.R. 2733/S. 1389 would amend the Securities Act of 1933 to specify that this act's exemption from the definition of a securities product would include "any insurance or endowment policy or annuity contract or optional annuity contract (a) the value of which does not vary according to the performance of a separate account, and (b) which satisfies standard nonforfeiture laws or similar requirements." The bill would also specifically annul Rule 151A as promulgated by the SEC.

This bill would have the effect of returning the regulation of indexed annuities to the status quo before the SEC's promulgation of Rule 151A; namely, indexed annuities would be exempted from SEC regulation and solely subject to regulation by the state insurance regulators. Many opponents of the rule, who would presumably support the legislation, see the extra SEC regulatory layer as unnecessarily duplicative of the existing state insurance regulation. They may point out, for example, that the SEC has had authority over variable annuity products for many years, yet consumer complaints regarding these products continue to be heard. The SEC registration requirements that would be annulled by the legislation involve some cost. Because of the increasing cost for those offering indexed annuities, opponents of Rule 151A argue, some companies might choose to discontinue these products, or individual agents or brokers might choose to stop selling them. This could reduce the supply of what some see as an important retirement product.

The SEC and supporters of Rule 151A, who would presumably oppose the legislation, do not see the additional regulation for the indexed annuity market as duplicative. Rather, they characterize Rule 151A as providing necessary protection for consumers. The SEC also argues that because indexed annuities expose consumers to investment risk, these annuities should be treated as securities products, and consumers should have the same protections when they purchase indexed annuities as when they purchase securities. They agree that this regulation has some costs, and argue the costs are offset by consumer benefits such as enhanced disclosure and standardization of selling practices. The continued existence of abuses in variable annuities, despite both SEC and state regulation, may also be an argument for supporting additional oversight for indexed annuities, which share some similar characteristics.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173/P.L. 111-203) and the Restoring American Financial Stability Act (S. 3217)

H.R. 4173 and S. 3217 are broad bills reforming the financial regulatory system in the United States. As introduced, neither directly addressed SEC Rule 151A or the issue of SEC oversight of annuities. During floor consideration of S. 3217, Senator Tom Harkin submitted the language of S. 1389 as an amendment (S.Amdt. 3920), but this amendment was not called up or voted on

prior to the Senate finishing consideration of S. 3217. The Senate substituted the amended text of S. 3217 into H.R. 4173 and passed this amended bill on May 20, 2010. During the conference committee reconciling the differences between the House and Senate versions of H.R. 4173, Senator Harkin offered another annuities amendment, which was ultimately adopted as Section 989J of the conference report. Although not specifically addressing SEC Rule 151A, the section requires the SEC to treat certain annuities and insurance contracts as exempt securities. The requirements for this treatment include two conditions similar to H.R. 2733/S. 1389, namely that the value of the contract does not vary according to the performance of a separate account and that non-forfeiture standards are in place. In addition, Section 989J requires that consumer protections meeting or exceeding the requirements of the NAIC's Suitability in Annuity Transactions Model Regulation are in place either through state regulations or through implementation by the company itself.

During conference debate on Section 989J and after its passage, this language was generally interpreted as returning regulation of fixed index annuities to the status quo prior to SEC Rule 151A. Because the language does not directly nullify the rule, as H.R. 2733/S. 1389 would have done, additional regulation or litigation may occur, particularly with regard to the consumer protection requirements. As of January 2010, five states and the District of Columbia have taken no action with regard to the NAIC model regulation and 12 states have taken action on the issue but "have not adopted the NAIC model in a uniform and substantially similar manner" according to the NAIC.[39]

The House agreed to the H.R. 4173 conference report on June 30, 2010 by a vote of 237-192. The Senate agreed to the conference report on July 15, 2010 by a vote of 60-39. President Obama signed the bill into law as P.L. 111-203 on July 21, 2010.

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[39] National Association of Insurance Commissioners, *Model Laws, Regulations and Guidelines*, Update 90, January 2010, pp. 275-7 to 275-11.