

Litigation to Overturn SEC Index Annuity Rule

by Gary O. Cohen

The Securities and Exchange Commission (SEC) is in litigation¹ defending a new rule for the fourth time in four years.² This latest litigation is to overturn Rule 151A under the Securities Act of 1933 (1933 Act).³

The Rule, in effect, denies index annuities the statutory insurance exemption in the 1933 Act⁴ and requires index annuities to be registered as securities⁵ under that Act. The Rule also has the effect of requiring distributors of index annuities to register as broker-dealers under the Securities Exchange Act of 1934.

Timing of Decision

The US Court of Appeals for the District of Columbia (Court) heard oral arguments on May 8, 2009. The Rule's compliance date is January 12, 2011.⁶ This date can seem to be a long time off. However, both the industry and the SEC will be hard-pressed to be ready for compliance by that date.

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The industry will have to mount a mighty effort to revise its business methodologies and compliance procedures to meet SEC and the Financial Industry Regulatory Authority (FINRA) requirements, register the annuities as securities, and register distributors as broker-dealers.

The SEC will have to scramble to be in a position to process the expected influx of registrations. The SEC has estimated that "registration statements will be filed for 400 indexed annuities per year."⁷ The SEC also has said that it would consider how to tailor disclosure⁸ and accounting⁹ requirements for index annuities. This means that it is likely that the SEC will promulgate a new registration statement form.

Under these circumstances, petitioners asked the Court for an accelerated briefing schedule. The Court ordered a schedule that was even more accelerated than the one requested. This suggests that the Court is sensitive to the timeline and could move quickly to hand down a decision.

Participants in Litigation

One set of petitioners consists of four issuers and two distributors of index annuities.¹⁰ A second set of petitioners is a pair of state regulatory bodies: the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL).¹¹

The Court granted motions for two amici to file briefs in support of the petitioners: Allianz Life Insurance Company (Allianz), a major issuer of index annuities,¹² and Phillip R. Wasserman and Phillip Roy Financial Services, LLC, a distributor of index annuities.¹³ The Court granted motions for three amici to file briefs in support of the SEC: AARP, the membership organization for seniors, MetLife, a major issuer of variable annuities but not index annuities, and the North American Securities Administrators Association, Inc. (NASAA).¹⁴

Index Annuities

Index annuities¹⁵ are the latest form of annuities. Annuities, generally speaking, provide for various guaranteed minimums for various values or benefits. Insurance companies, beginning in the 1950s, have designed annuities that offer the owner the *possibility* of a return *greater* than any guaranteed minimum.

Variable annuities, which appeared in the 1950s, offer the possibility of a greater return based on the investment performance of an insurance company's separate account of investment securities. The US Supreme Court has held variable annuities to be registrable securities.¹⁶

Guaranteed interest annuities, which appeared in the 1980s, offer the possibility of greater return based on a rate of interest that an insurance company declares at the beginning of a year based on business and general account investment factors. The SEC has said that these annuities are not registrable securities, if the annuities meet specified conditions.¹⁷

Index annuities offer the possibility of greater return based on a securities market index, like the S&P 500 Stock Index. The SEC recently changed a long-held position and declared these annuities, as a product class, to be registrable securities, as explained below.

Industry and Regulator “Face-Offs”

The lead-up to the litigation and the litigation itself involve a number of provocative industry,

state regulator, and SEC face-offs outlined below.

Fund Industry versus Insurance Industry

The first “face-off” is the mutual fund industry versus the life insurance industry.

The Investment Company Institute (ICI) did not join the litigation. However, the ICI has submitted letters to the SEC, dating back to 1997, arguing that index annuities are securities that should be registered.¹⁸ The SEC brief echoes some of the ICI's arguments.¹⁹

The ICI argued, in part, as follows. Owners, not insurance companies, assume the principal investment risk under index annuities. The rate of return of an index varies like the investment performance of an insurance company separate account. A fair explanation of index annuities requires communication about the securities markets in order to differentiate index products from traditional insurance products. Offerees need SEC-type disclosure to understand not only limitations on the upside potential but the realities of the downside risks.

The ICI also pointed out that index annuities compete directly with mutual funds and the SEC has the responsibility to apply securities regulation uniformly.

The ICI, in a novel twist, originally argued that the Investment Company Act of 1940 may be applicable. The ICI said that the index measured investment experience and, therefore, constituted what it called a “virtual separate account.” The ICI argued that the assets in an insurer's general account that backed an insurance company's guarantee could be regulated by the SEC as an investment company.

Insurance Companies versus Insurance Companies

The second “face-off” is insurance companies versus insurance companies.

Some of the largest insurance companies have faced off against each other, some opposing the Rule and some supporting it. For example, as noted above, Allianz opposes the Rule, and MetLife supports it.

The insurance companies that support the Rule do so for a number of reasons. One reason is that they issue registered products, such as variable annuities, which compete with index annuities and believe that the competition should be on a level playing field.

Other companies oppose the Rule, but believe that legislation would be more effective than litigation in overturning the Rule. They point to the SEC's regulation of insurance products over the years that has involved uncertain positions and, in a number of instances, reversals of position.²⁰

The split among insurance companies meant that the industry was not able to present a united front to the SEC. So, when the SEC asked for comments on the proposed Rule, industry groups like the American Council of Life Insurers, NAVA, and Committee of Annuity Insurers were not able to either support or oppose the Rule.

Federal Regulation versus State Regulation

The third “face-off” is federal regulators versus state regulators.

On the state side, regulators are seeking to keep exclusive jurisdiction over index annuities, perhaps for revenue purposes and/or pride of regulatory authority.

However, there's a further “face-off” between state *insurance* regulators and state *securities* regulators. As noted above, state insurance regulators NAIC and NCOIL oppose the Rule, while state securities regulator NASAA supports it. This “face-off” could be, again, because of revenue purposes and/or pride of regulatory authority.

On the federal side, the election of President Barack Obama, of course, meant that the SEC switched from a Republican to Democratic majority and from a Republican to Democratic Chairman. However, this is not expected to result in a change in the SEC's support of the Rule. The new SEC Chairman Mary Schapiro, while she was NASD Vice Chairman, stated²¹ that index annuities were securities subject to FINRA, and presumably SEC, regulation. Also, another new Commissioner, Ms. Elise Walter, came to the SEC from FINRA.

SEC versus SEC

The fourth “face-off” is the SEC versus itself—actually, the current or immediate past SEC versus previous SECs.

The SEC, over the years, has reversed itself twice on the issue of whether indexing evidences securities.

The SEC, in 1984, said that an index feature “shifts all the investment risk” of fluctuations in the excess interest rate to the owner, and, therefore, index features did not fit the “safe harbor” of Rule 151 under the 1933 Act.²² But two years later, in

1986, the SEC changed its mind and said that an index feature could qualify under the “safe harbor.”²³

A decade passed, and, in 1997, the SEC more or less confirmed its 1986 position and said that index annuities, “depending upon the mix of features,” could qualify as insurance and not securities.²⁴ Then, another decade passed, and, at the end of last year, the SEC changed its mind again and decided that index annuities, as a product class, are registrable securities.

In adopting Rule 151A, the SEC ignored years of SEC and judicial pronouncements and changed the analytical standard. Traditionally, the SEC has said that annuities are not securities where an insurance company “assumes all risk with respect to principal,” a “fixed rate of [minimum] interest,” and “all” “excess interest declared.”²⁵ However, under the SEC's new standard,²⁶ an annuity would be a security if it is “more likely than not” that the owner would receive amounts that exceed the guaranteed amounts.²⁷

SEC versus Courts

The fifth “face-off” is the SEC versus the courts or at least one court.

A federal court has held that index annuities issued by American Equity Investment Life Insurance Company (a member of the coalition suing the SEC) were *not* securities.²⁸ The court analyzed the index annuities separately under the Rule 151 “safe harbor” and the statutory insurance exemption, based on the SEC's traditional standard.

The court said that the owner “did bear an element of risk and uncertainty” regarding the amount of the index interest. But the court went on to say that the insurance company “actually bore as much or more” of the investment risk in guaranteeing payment to the owner regardless of how poorly the market performed. The court said that the owner “had no risk” that she would lose the value of her initial investment.”

The SEC has said that it disagrees with the court's analysis of investment risk.²⁹

Commissioner versus Commissioner

The sixth “face-off” is Commissioner versus Commissioner.

The SEC's vote adopting Rule 151A was not unanimous. The Commissioners split four to one, with Commissioner Troy A. Paredes vigorously dissenting.³⁰

Commissioner Paredes argued that the SEC lacked jurisdiction to adopt Rule 151A, as follows. The SEC “will be entering into a realm that Congress prohibited . . . [the SEC] from entering.” The approach taken in Rule 151A “conflicts with . . . Supreme Court cases.” At least “one federal court . . . has held that an indexed annuity falls within the statutory exemption.” Rule 151A not only seems “to deviate from the approach taken by courts, including the Supreme Court, but it also appears to depart from prior positions taken by the Commission.”

Commissioner Paredes argued against the approach taken by Rule 151A, as follows. Rule 151A “gives short shrift to the guarantees that are the hallmark of indexed annuities.” The Rule’s “‘more likely than not test’ does not provide insurers with proper notice of whether their products fall within the federal securities laws or not.” Rule 151A “may sweep up other insurance products that otherwise should fall within” the statutory insurance exemption.

Commissioner Paredes addressed state insurance regulation, as follows. The “rule and adopting release make an implicit judgment that state insurance regulators are inadequate to regulate these products.” Such “a judgment is beyond our mandate or our expertise.”

The SEC filed Commissioner Paredes’ dissent with its brief. So, the dissent is in the hands of the judges.

Former Chairman Cox versus Himself

The last “face-off” can be characterized, without any intended disrespect, as former SEC Chairman Christopher Cox versus himself.

One side of Chairman Cox was a conservative Republican deregulator. He put into place policies that are said to “have had a number of effects at odds with the SEC goals or objectives.”³¹

But another side of Chairman Cox was a principal activist initiator of the Rule. He caused the SEC to reverse a long-held position and impose regulation on an insurance product where Congress, at least in the first instance, has left the regulation of insurance products to the states.

There are two theories that possibly reconcile these opposing sides of Chairman Cox.

One theory is that Chairman Cox, rightly or wrongly, was under fire for not regulating in accordance with the SEC’s goals or objectives. Even Senator John McCain, the Republican Presidential candidate at the time, publicly called for Chairman Cox’s ouster.³² So, some observers

believe that Chairman Cox seized on index annuities as something to regulate to counter criticism that he and the SEC were not doing their jobs. Index annuities were a good target, because they were backed by only a small constituency and disfavored by many big insurance companies and wirehouses and by FINRA.

A second theory is that Chairman Cox championed the Rule for personal reasons. This is suggested in a high-profile speech that Chairman Cox made at the SEC’s Senior Summit last September.³³

Chairman Cox said that “the work all the SEC [S]taff is doing here to protect seniors, is very personal to me.” Chairman Cox talked about salespersons who “pestered” his mother during her last days. He said that “even while she was suffering from throat cancer and could barely speak, the scoundrels pursued my mother with unsolicited sales pitches over the phone and in person” for products that “weren’t just unsuitable, but they were affirmatively harmful to any senior in her circumstances.”

Chairman Cox did *not* specify that indexed annuities were involved. However, Chairman Cox made his speech in a context that related, in part, to index annuities.

Conclusion

The industry, state regulator and SEC “face-offs” outlined above are so convoluted that it is difficult to predict with reasonable certainty what the Court will do.

Observers think that the losing parties, depending on the rationale of the Court’s decision, may well appeal the decision to the Court *en banc* and then to the US Supreme Court.

A circumstance not favoring such an appeal by the SEC is the fact that litigation has overturned three SEC rules in the last four years. The SEC did not appeal any of those decisions.

A circumstance favoring such an appeal by any party is the fact that the US Supreme Court has not ruled on the status of annuities under the federal securities laws since 1967³⁴ and 1959³⁵—42 to 50 years ago.

NOTES

1. *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1021 (consolidated with No. 09-1056) (D.C. Cir. filed Jan. 16, 2009) [hereinafter *American Equity*].

2. The first three litigations, and the common name of the SEC rule overturned by each, were: *Fin. Planning Ass’n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) (Merrill Lynch rule); *Goldstein v.*

SEC, 451 F.3d 890 (D.C. Cir. 2006) (hedge fund rule); and Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006) (independent fund chair rule).

3. The author's law firm has represented and currently represents individual life insurance companies issuing index insurance products, including annuities and life insurance products. The firm also has represented the National Association for Fixed Annuities (NAFA), a trade association whose members include issuers and distributors of index insurance products. The firm wrote and filed the amicus brief for Allianz Life Insurance Company (Allianz), supporting petitioners in the current litigation against the SEC, *supra* n.1. The firm wrote and filed NAFA's comment letter to the SEC regarding the SEC's so-called "concept release" on index annuities in 1997. Letter from Jordan Burt LLP, on behalf of the National Association for Fixed Products (now, NAFA), to Johnathan Katz, Secretary, SEC (Jan. 5, 1998) available at <http://www.sec.gov/rules/concept/s72297/boros1.htm>; *Equity Index Insurance Products*, Securities Act Release No. 7438, 62 Fed. Reg. 45,359-01 (Aug. 27, 1997) [hereinafter SEC's Concept Release]. The firm also wrote NAFA's comment letter to the SEC regarding Rule 151A. Letter from Jordan Burt LLP, on behalf of NAFA, to Florence E. Harmon, Acting Secretary, SEC (Sept. 10, 2008) available at <http://www.sec.gov/comments/s>. One of the author's partners is a founder, and was a member, of the board of directors of NAFA. Another of the author's partners is currently a member of that board. The firm also was responsible for the drafting of NAFA's White Paper on index annuities entitled "White Paper on Fixed Index Insurance Products Including 'Fixed Indexed Annuities' and Other Fixed Indexed Insurance Products" (2007), that the SEC cites in its release proposing Rule 151A, *Indexed Annuities and Certain Other Insurance Contracts*, Securities Act Release No. 8933 and Securities Exchange Act Release No. 58022, 73 Fed. Reg. 37,752-01, beginning at 37,753 n.4 (proposed July 1, 2008). For these and other reasons, the author, his partners and colleagues, and his law firm have been involved with matters that this article addresses. Generally speaking, this article presents arguments against the SEC's regulation of index annuities. This article does not necessarily reflect the views of the author's law firm, the law firm's individual partners and other lawyers, NAFA, Allianz or any of the law firm's other clients.

4. Section 3(a)(8) of the Securities Act provides an exemption for:

Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state or territory of the United States or the District of Columbia.

5. Technically, the 1933 Act requires *offerings* of securities to be registered. For readability, this article refers to the registration of *securities*.

6. *Indexed Annuities and Certain Other Insurance Contracts*, Securities Act Release No. 8996, Securities Exchange Act Release No. 59,221, 74 Fed. Reg. 3138-01, at 3138 (Jan. 16, 2009) (adopting Rule 151A) [hereinafter SEC Rule 151A Adopting Release].

7. *Id.* at 3166.

8. *Id.* at 3148–3149.

9. *Id.* at 3166.

10. Brief of Petitioners, *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1021 (consolidated with 09-1056) (D.C. Cir. filed Feb. 17, 2009) (Petitioners are American Equity Investment Life Ins. Co., BHC Marketing, Midland National Life Ins. Co., National Western Life Ins. Co., OM Financial Life Ins. Co., and Tucker Advisory Group, Inc.).

11. Brief of Petitioners, *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1056 (consolidated with 09-1021) (D.C. Cir. filed Feb. 17, 2009) (Petitioners are National Association of Insurance Commissioners and National Conference of Insurance Legislators).

12. Corrected Brief of Allianz Life Ins. Co. of N. Am. as Amicus Curiae Supporting Petitioners, *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1021 (consolidated with 09-1056) (D.C. Cir. filed Mar. 5, 2009).

13. Brief of Phillip R. Waserman and Phillip Roy Fin. Services, LLC as amici curiae in Supporting Petitioners, *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1021 (consolidated with 09-1056) (D.C. Cir. filed Apr. 10, 2009).

14. These participants filed a joint brief. Brief of AARP, *et al.* as amici curiae Supporting Respondent, *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1021 (consolidated with 09-1056) (D.C. Cir. filed Apr. 10, 2009).

15. Background for this article is set out in Gary O. Cohen, "Indexed Insurance Products: Are They Securities?," *The Investment Lawyer*, Vol. 14, No. 2 at 3 (Feb. 2007) and Gary O. Cohen, "SEC Regulation of Index Annuities Versus Index Mutual Funds," PLI Investment Management Institute 2009, Materials at 699 (Apr. 2-3, 2009).

16. *See SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) [hereinafter *United Benefit*]; *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) [hereinafter *VALIC*].

17. *See* Rule 151 under the 1933 Act.

18. *See* Letter from Karrie McMillan, General Counsel, ICI, to Florence E. Harmon, Acting Secretary, SEC (Sept. 10, 2008), available at <http://www.sec.gov/comments/s7-14-08-171408-1712.pdf>. The ICI Letter stated that "the [ICI] developed its positions on this rulemaking with input from, among others, members of the [ICI's] Variable Insurance Products Advisory Committee." Letter from Craig S. Tyle, General Counsel, ICI, to Johnathan G. Katz, Secretary, SEC (Dec. 30, 1997) available at http://www.ici.org/statements/cmltr/97_sec_eq_insure_com.html#TopOfPage. The discussion in the text below summarizes the two letters in the aggregate.

19. Final Brief of the Respondent Securities and Exchange Commission, *Am. Equity Inv. Life Ins. Co. v. SEC*, No. 09-1021 (consolidated with 09-1056) (D.C. Cir. filed Apr. 6, 2009).

20. *See infra* n.22, n.23 and n.25 and accompanying text.

21. Ms. Schapiro stated:

Equity-indexed annuities are only one example of a financial product that a firm might erroneously treat as a non-security NASD considers all of these products to be securities, subject to firm supervision.

Speech by Mary L. Schapiro, Vice Chairman, NASD, Spring Securities Conference (May 25, 2005).

Later, the NASD backed off Ms. Schapiro's statement as follows:

As discussed above, NASD is not taking a position on whether a particular EIA [equity indexed annuity] is a security, nor are we attempting to describe the circumstances in which an EIA would be deemed a security.

NASD Notice to Members 05-50, "Equity-Indexed Annuities, Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities," at 5 (Aug. 2005).

22. The SEC originally stated that it intended to exclude from the "safe harbor" any annuity providing for excess interest to be determined in accordance with an external formula or index, such as a composite bond index or Treasury bill rate. The SEC's rationale was that, "an insurer which 'externalizes' its discretionary excess interest rate shifts to the contract owner all of the investment risk regarding fluctuations in that rate." *Definition of "Annuity Contract for Optional Annuity Contract,"* Securities Act Release No. 6558, 49 Fed. Reg. 46,750, at 46,753 n.19 (proposed Nov. 21, 1984).

23. *Definition of Annuity Contract or Optional Annuity Contract,* Securities Act Release No. 6645, 51 Fed. Reg. 20,254-01 (June 4, 1986) (adopting Rule 151). The SEC, based on the comments received, determined that it would be appropriate to extend Rule 151 to "permit insurers to make limited use of index features in determining the excess interest rate, so long as the excess rate is not modified more frequently than once per year." However, as a practical matter, most index annuities do not guarantee an interest rate for a following year. Therefore, these index annuities are not eligible for the Rule 151 "safe harbor."

24. SEC's Concept Release *supra* n.3, at 45,359-60.

25. Brief for the United States as Amicus Curiae Supporting Writ of Certiorari at 11, *Variable Annuity Life Ins. Co. v. Otto*, 486 U.S. 1026, at 6 and 5, respectively (1988) (No. 87-600). The names of Staff members of the SEC appear on the Brief.

26. Thus, the SEC, not without some irony, created a test for registration based on a speculation, or "forward looking statement," that would call for compliance with limitations required of registrants by Section 27A of the 1933 Act.

27. SEC Rule 151A Adopting Release, *supra* n.6, at 3150-3154, 3175.

28. *Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

29. SEC Rule 151A Adopting Release, *supra* n.6, at 3147.

30. Opening Remarks and Dissent by Commissioner Troy A. Paredes Regarding Final Rule 151A: Indexed Annuities and Certain Other Insurance Contract, Open Meeting of the SEC (Dec. 17, 2008), attached to SEC Rule 151A Adopting Release, *supra* n.6, following page 3174. The quotations in the text below are from the cited dissent.

31. U.S. Gov't Accountability Office Report to Congressional Requesters, Securities and Exchange Commission, Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement 49 (GAO-09-358, March 2009), available at <http://www.gao.gov/new.items/d09358.pdf>.

32. *E.g.*, Catherine Dodge & Kim Chipman, "McCain Says He Would Fire SEC's Cox If President," *Bloomberg News* (Sept. 18, 2009), http://www.bloomberg.com/apps/news?pid=20601070&sid=a_byXT9uKJEW&refer=home#.

33. Speech of Chairman Christopher Cox Regarding Protecting Senior Investors in Today's Markets, SEC Senior Summit, Washington, DC (Sept. 22, 2008) available at <http://www.sec.gov/news/speech/2008/spch092208cc.htm>. The Senior Summit was open to the public and webcast.

34. *United Benefit*, *supra* n.16.

35. *VALIC*, *supra* n.16.

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