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**INDEXED AND OTHER FIXED INSURANCE PRODUCTS:
SEC, FINRA AND STATE REGULATION AFTER
AMERICAN EQUITY OPINION AND DODD-FRANK ACT**

By

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INDEXED AND OTHER FIXED INSURANCE PRODUCTS: SEC, FINRA AND STATE REGULATION AFTER AMERICAN EQUITY OPINION AND DODD-FRANK ACT

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I. CURRENT SITUATION

President Obama signed the Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) into law on a very hot Wednesday afternoon, July 21, 2010.

Title IX., Section 989J, of the Dodd-Frank Act provides, in effect, that indexed life and annuity products that meet specified conditions are insurance and not securities. The Section thereby removes these products from regulation by the U.S. Securities and Exchange Commission (“SEC”) under the Securities Act of 1933 (“1933 Act”), leaving them subject to state insurance law.

Section 989J was introduced by Senator Tom Harkin, Democrat from Iowa. So, the Section is commonly referred to as the “Harkin Amendment.”

¹ The author and his law firm represent entities that supported, and entities that opposed, Rule 151A and the Harkin Amendment. He and his firm provided services to entities in actively opposing Rule 151A. The author’s law firm has represented and currently represents individual life insurance companies issuing indexed 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 indexed insurance products. The author and his firm wrote and filed the amicus brief for Allianz Life Insurance Company (“Allianz”), supporting Petitioners in the litigation against the SEC, *infra* notes 6 and 23. The firm wrote and filed NAFA’s comment letter to the SEC regarding the SEC’s so-called “concept release” on indexed annuities in 1997. Letter from Jordan Burt LLP, on behalf of NAFA, to Johnathan Katz, Secretary, SEC (Jan. 5, 1998) *available at* <http://www.sec.gov/rules/concept/s72297/boros1.htm>; Equity Index Insurance Products, SEC Securities Act Release No. 7438, 62 Fed. Reg. 45,359-01 (Aug. 27, 1997). The author and his 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> [hereinafter NAFA Comment Letter]. One of the author’s colleagues is a founder, and was a member of the board of directors, of NAFA. One of the author’s partners is currently a member of that board. The author and his firm also were responsible for the drafting of NAFA’s White Paper on indexed annuities, entitled “White Paper on Fixed Index Insurance Products Including ‘Fixed Indexed Annuities’ and Other Fixed Indexed Insurance Products” (2007), that the SEC cited in its release proposing Rule 151A, Indexed Annuities and Certain Other Insurance Contracts, SEC Securities Act Release No. 8933 and Securities Exchange Act Release No. 58022 (June 25, 2008) [hereinafter SEC Rule 151A Proposing Release]. For these and other reasons, the author, his partners and colleagues, and his law firm have been involved with matters that this Outline addresses. This Outline does not necessarily reflect the views of the author’s firm, the firm’s individual partners and other lawyers, NAFA, Allianz or any of the firm’s other clients.

A. Reaction to the Harkin Amendment

The Harkin Amendment has precipitated heated reactions from supporters and opponents of the Amendment. These comments have produced a contentious environment for the implementation of the Amendment.

The National Association for Fixed Annuities (“NAFA”), a significant force in winning the Harkin Amendment, said, by way of polite understatement, that it was “pleased.”²

Others were less restrained.

For example, The Wall Street Journal said that the SEC had been the deserved recipient of a “*smackdown*” and “legal *humiliation*” for what the Journal characterized as the SEC’s “latest *lunge for power*,” “*illegal . . . land grab*,” and “*illegal* overreach.”³

But there were, of course, voices on the other side.

For example, Senator Jack Reed, Democrat from Rhode Island, called the Harkin Amendment a “vast *loophole*.”⁴

The National Association of Personal Financial Advisors said that the Harkin Amendment is “quite simply, *dangerous*.”⁵

B. Where the Courts Stand

Enactment of the Dodd-Frank Act followed vacatur of the SEC’s Rule 151A by the U.S. Court of Appeals for the D.C. Circuit on July 12, 2010.⁶ The Court found the SEC’s adoption of Rule 151A to be reasonable, but vacated the Rule for lack of a sufficient

² Kim O’Brien, NAFA Executive Director, Letter to the Editor, Wall St. J., July 30, 2010 (responding to Christopher Cox Letter to Editor, cited *infra* note 63).

³ Editorial, *The SEC’s Annuity Smackdown*, Review and Outlook, Wall St. J., July 22, 2010. See accompanying table entitled, “Former SEC Chairman Christopher Cox Versus The Wall Street Journal.”

⁴ C-Span Video Library, Conference Committee on Financial Regulatory Reform: Financial Regs. Revision, June 22, 2010) (Day 5, Part 2).

⁵ William Baldwin, Chairman, quoted in *Mutual Funds*, July 19, 2010.

⁶ American Equity Inv. Life Ins. Co. v. SEC, No. 09-1021 (consolidated with No. 09-1056), 2009 WL 2152351 (DC Cir., decided, July 21, 2009; reissued July 12, 2010) [hereinafter American Equity]. There were two sets of Petitioners. The first set of Petitioners consisted of the American Equity Investment Life Insurance Company, BHC Marketing, Midland National Life Insurance Company, National Western Life Insurance Company, OM Financial Life Insurance Company, and Tucker Advisory Group, Inc. Brief of Petitioners, Am. Equity Inv. Life Ins. Co. v. SEC, No. 09-1021 (consolidated with 09-1056) (DC Cir. filed Feb. 17, 2009). The second set of Petitioners consisted of the National Association of Insurance Commissioners and the National Conference of Insurance Legislators. Brief of Petitioners, Nat’l Ass’n of Ins. Comm’rs v. SEC, No. 09-1056 (consolidated with 09-1021) (DC Cir. filed Feb. 17, 2009) [hereinafter Rule 151A litigation].

**FORMER SEC CHAIRMAN CHRISTOPHER COX
VERSUS THE WALL STREET JOURNAL**

Wall Street Journal: “The SEC’s Annuity Smackdown – The agency fails in its latest lunge for power”*	Christopher Cox: “It’s Right for the SEC to Regulate Annuity Products”**
<p>“Mr. Cox and his merry band argued that these annuity products ought to be considered ‘securities’ (and thus under SEC purview) because they involve <i>market ‘risk.’</i>”</p>	<p>“Investors with only a few years to live – and to whom these products are often peddled – can lose a big part of their investment in these ‘guaranteed’ products because of the <i>huge (and often inadequately disclosed) penalties</i> they must pay to get their money when they need it.”</p>
<p>“Lo, the D.C. Circuit Court of Appeals last week threw out the rule <i>in its entirety.</i>”</p>	<p>“[T]he agency’s interpretation was expressly upheld by the D.C. Circuit. In the clearest possible language, the court said, ‘we <i>hold</i> that the SEC’s interpretation of ‘annuity contract’ is <i>reasonable.</i>”</p>
<p>“[T]he <i>only risk</i> to investors is that they might make more money than expected.”</p>	<p>“If that were true, a <i>bipartisan commission</i> would not have taken the issue seriously. Nor would the SEC’s rule have been supported by all state, provincial and territorial securities regulators in North America – FINRA, several insurance companies and the Investment Company Institute.”</p>
<p>“Even Democrats decided this SEC <i>power grab</i> would <i>serve no purpose</i> other than to make fixed indexed annuities more expensive, and cost their home state insurance industry jobs.”</p>	<p>“Sales people whose securities licenses have been revoked, and even some who have been convicted of criminal securities fraud, are free to resurface in ‘insurance’ sales and push these products without the <i>full and fair disclosure, antifraud protections and suitability requirements</i> which investors get under the securities laws.”</p>
<p>“This kind of <i>illegal overreach</i> has become a pattern at the SEC.”</p>	<p>“The Court’s ‘procedural point is perfectly consistent with the SEC continuing to aggressively pursue its mission of <i>protecting older investors</i>, as it did in this case.”</p>

* Review and Outlook, July 22, 2010.

** Letter to the Editor, July 27, 2010. Mr. Cox, a Republican, was SEC Chairman from 2005 to 2009.

analysis of the impact of the Rule on competition, efficiency and capital formation under Section 2(b) of the 1933 Act. So, the Court did not reject the substance of the Rule, but vacated the Rule for a procedural reason.

The Court never expressed a view on the substance and even said that it might differ on the substance. The Court simply gave deference to the SEC as an agency. This essentially is a *procedural* disposition.

C. Where Congress Stands

The Harkin Amendment does not call for any study by the SEC. By its terms, the Amendment is immediately effective without any further action by the SEC. So, it appears that Congress has not anticipated follow-up regarding the Harkin Amendment.

There is very little substantive legislative history as to the purposes and parameters of the Harkin Amendment. This is because Senator Harkin introduced the Amendment on the Senate floor shortly before the final vote on the bill, but Senator Daniel K. Akaka, Democrat from Hawaii, opposed, thereby killing, the Amendment. Senator Harkin then introduced the Amendment during the Senate-House conference meeting, debated with Senator Jack Reed, Democrat from Rhode Island, and won on an 8-4 vote among Senate conferees and an 11-4 vote among House conferees.

D. Where the SEC Stands

1. SEC Process

The Harkin Amendment mandates the SEC to “treat” certain products as “exempt securities” under Section 3(a)(8) of the 1933 Act (“Section 3(a)(8”).⁷

It is not clear what Congress meant by the word “treat.”⁸ So, there is a question of what process the SEC will follow regarding the Harkin Amendment.

As discussed further below, current indications are that the SEC may conclude that no formal rulemaking on its part is necessary or appropriate to implement the Amendment. If that is the case, life insurance companies could rely on the Amendment without any such action by the SEC.

2. SEC Chairman Testimony

SEC Chairman Mary L. Schapiro, on July 20, 2010, testified before the House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. The title of her prepared testimony was “Testimony Concerning Oversight of the U.S. Securities and Exchange Commission:

⁷ All references to sections and rules are to sections of, and rules under, the 1933 Act, unless otherwise noted.

⁸ The author’s search located no comparable legislative approach.

Evaluating Present Reforms and Future Challenges.” The session lasted two hours and 15 minutes, during which Chairman Schapiro answered questions of the Subcommittee. Many, if not most, of the questions involved the SEC’s administration of the recently adopted Dodd-Frank Act.

Representative Judy Biggert, Democrat from Illinois, asked about the SEC’s view of the Harkin Amendment. Chairman Schapiro said that the SEC would not involve itself with indexed products, but would offer assistance and try to help the states in their regulation of indexed products. The questions and answers were as follows:

BIGGERT: OK, thank you, then one other. There’s a recent appellate court decision regarding indexed annuities, and that effectively means that the SEC will have to restart the rulemaking process for these products.

SCHAPIRO: Unfortunately, we won’t, because the Dodd-Frank Bill does prohibit the...

BIGGERT: Yes. Yes, and this was foreclosed by the amendment in.

SCHAPIRO: ... Yes. I’m sorry.

BIGGERT: ... Dodd-Frank (inaudible) in the conference that would classify indexed annuities as state regulated insurance products as long as they’re governed by NAIC standards.

SCHAPIRO: You’re exactly right.

BIGGERT: Does the Commission have any future plans related to indexed annuities?

SCHAPIRO: Well, *we haven’t really gone beyond the words* of the statute at this point. And I think, you know, there are *concerns*, and I’ve had these for many years, about how equity indexed annuities are sold.

We’re very *happy to work* with the state insurance commissioners, who clearly have a responsibility under this law, to see if we can be of *assistance* to them. They do have the model suitability rule. They are very focused also on sales practices. So we will *try to be helpful* to them in this process, but we *don’t have any plans to re-engage* on this issue, given the legislation.

BIGGERT: OK. Thank you very much.⁹

⁹ Transcript of author from C-Span Video Library, House Financial Services Subcommittee Hearing on SEC Oversight (July 20, 2010) (emphasis, other than for names, added) [hereinafter Chairman Schapiro’s testimony].

The SEC has not announced publicly how it will “be of assistance” and “helpful” to the state insurance commissioners. Conversely, the state insurance commissioners have not stated publicly whether and to what extent they would accept assistance and help from the SEC.

Chairman Schapiro did not describe the process that the SEC and the state insurance commissioners would follow in doing this. For example, she did not state whether the industry would be able to witness, or contribute to, the process. She also did not state whether the SEC would be in contact with state *insurance* commissioners. Her prepared testimony quoted above referred to working with state *securities* commissioners, but not in the context of insurance products.

3. SEC Invitation for Comments

Chairman Schapiro has announced an “open process for regulatory reform rulemaking”¹⁰ required under the Dodd-Frank Act. The announcement explains that, under this process, the public will be able to comment before the SEC proposes its regulatory reform rules and amendments.

The announcement refers to additional materials that invite public comment in this regard. The additional materials specify “various initiatives, including rulemaking and studies touching on many areas of financial regulation.”¹¹

As noted immediately below and elsewhere in this Outline, the Harkin Amendment appears to overtake Rule 151 in at least some respects. This may require or make it advisable for, the SEC to amend Rule 151, pronounce interpretive positions, and/or specify administrative procedures to answer questions that the Harkin Amendment raises. However, neither the announcement nor the additional materials refer to the Harkin Amendment or any initiative that the SEC might find necessary or appropriate to implement the Harkin Amendment.

4. SEC Rule 151 Amendment

Chairman Schapiro further testified that the SEC had not gone “beyond the words of the statute at this point” and “don’t have any plans to re-engage on the issue.”

The Harkin Amendment does not address any specific product. However, the Amendment, by its terms, covers products beyond indexed products and appears to cover certain products presently covered by Rule 151. It appears that the Harkin Amendment supersedes Rule 151 to the extent that these products rely upon the

¹⁰ Press Release, SEC, SEC Chairman Schapiro Announces Open Process for Regulatory Reform Rulemaking, No. 210-135 (July 27, 2010), *available at* <http://www.sec.gov/news/press/2010/2010-135.htm>.

¹¹ Materials, SEC, Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act (Aug. 3, 2010), *available at* <http://www.sec.gov/spotlight/regreformcomments.shtm>.

Amendment. The SEC could amend Rule 151 in this regard in order to comply with the mandate of the Harkin Amendment.

In a comparable situation, the SEC did not amend a rule that subsequent legislation superseded in part. Congress adopted legislation in 1996 that superseded some provisions of Rules 6e-2 and 6e-3(T) under the Investment Company Act of 1940. However, the SEC – 14 years later – has not amended the rules to reflect the legislation.

E. Where the States Stand

The National Association of Insurance Commissioners (“NAIC”) appears to have recognized that the Harkin Amendment shifts the principal regulatory burden from the SEC to the states and, in doing so, raises a number of questions. These questions relate, at least in part, to the conditions for falling within the scope of the Harkin Amendment, particularly the references to state law.

State insurance regulators began raising these questions shortly after the Dodd-Frank Act became law. The author understands that the NAIC has committees scheduled to look into questions raised.

F. Where the Industry Stands

Individual life insurance companies have been cautious about relying on the Harkin Amendment in offering products covered by the Amendment without further guidance from the SEC and the states. They have not known whether the SEC or other regulators will propose rulemaking or issue statements that would contradict positions the companies might take early on.

Part of this hesitancy might have been attributable to the fact that other provisions of the Dodd-Frank Act increase the risk of being wrong. For example, the Dodd-Frank Act expressly provides for the standard for aiding and abetting to be recklessness (as well as knowingly) and encourages whistle-blowing.

G. Questions Raised

The lack of legislative history¹² and the peculiar language of the Harkin Amendment raise a number of questions, such as the following:

¹² The background, as it developed, is set out in the following conference papers and articles by the author:

- *SEC Rule 151A Under the Securities Act of 1933: Aftermath for Analysis of Status of Insurance Company Products Under Section 3(a)(8) of the Act*, in ALI-ABA Conference on Life Insurance Company Products, Current SEC, FINRA, Insurance, Tax and ERISA Regulatory and Compliance Issues, Course of Study Materials 439 (Nov. 2009);
- *Rule 151A Litigation and the Battle over Suitability Standards*, in *The Investment Lawyer*, Vol. 16, No. 10 at 3 (co-author with James F. Jorden) (Oct. 2009);
- *Litigation to Overturn SEC Index Annuity Rule*, in *The Investment Lawyer*, Vol. 16, No. 7 at 3 (July 2009);

1. How do we determine what products fall *within* the Harkin Amendment and therefore within Section 3(a)(8)? *See III.*, below.

2. How do we determine the status, under Section 3(a)(8), of any product that falls *outside* of the Harkin Amendment and outside Rule 151 under the 1933 Act? *See IV.*, below.

3. Is there some way the SEC can still regulate the *marketing* of indexed and other exempted fixed products? *See V.*, below.

4. Is there some way the SEC can still regulate the *disclosure* of indexed and other exempted fixed products? *See VI.*, below.

5. Is there some way that FINRA can regulate indexed and other exempted fixed products? *See VII.*, below.

6. What is the likelihood that the SEC will exercise any authority to regulate indexed and other exempted fixed products? *See VIII.*, below.

It remains to be seen how the SEC, FINRA, state regulators and the courts will respond to such questions. It might be thought that Congress' enactment of the Harkin Amendment and the Court of Appeals' vacatur of Rule 151A would make the SEC and FINRA reluctant to assert any jurisdiction with respect to index annuities and, perhaps, certain other insurance products. Nevertheless, as indicated in the balance of this Outline, the SEC and FINRA, in theory, could seek to interpret the Harkin Amendment narrowly in various respects and to assert at least a degree of jurisdiction over many such products.

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- *SEC Regulation of Index Annuities Versus Index Mutual Funds*, in PLI Investment Management Institute 2009 at 699 (Apr. 2009);
 - *Index Insurance Products: Twists and Turns of SEC Regulation*, in ALI-ABA Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, and State Regulatory and Compliance Issues, Course of Study Materials 39 (Nov. 2008);
 - *Indexed Insurance Products Versus Index Mutual Funds; Status Under the Federal Securities Laws 2007*, in PLI Investment Management Institute 2009 at 507 (Apr. 2007); and
 - *Fixed Indexed Insurance Products: Perspective on Their Status as Insurance or Securities Under the Federal Securities Laws*, in ALI-ABA Conference on Life Insurance Company Products: Current Securities, Tax, ERISA, and State Regulatory and Compliance Issues, Course of Study Materials 381 (Nov. 2006).

II. HARKIN AMENDMENT

The Harkin Amendment has little legislative history, because it was adopted during the Senate-House Conference Committee and without any hearing. Arguably, the preceding Meeks Bill provides some information regarding legislative purpose. However, the Harkin Amendment differs from the Meeks Bill in significant ways.

A. Congressional Purpose

The legislative history of the Harkin Amendment is sketchy, because the Amendment was not part of the original bill, but was added during conference.

Representative Gregory M. Meeks, Democrat from New York, sponsored a bill to nullify Rule 151A.¹³ Senator Ben Nelson, Democrat from Nebraska introduced an identical bill in the Senate.¹⁴

The Meeks Bill states, as findings, that:

- primary jurisdiction for regulating life insurance and annuities is vested with the states;
- indexed insurance and annuity products offered by life insurance companies are subject to a wide array of laws and regulations enforced by the states, including nonforfeiture requirements that provide for minimum guaranteed values, thereby protecting consumers against market related losses; and
- any perceived benefits of Rule 151A are outweighed by the fact that the Rule:
 - interferes with state insurance regulation,
 - harms the insurance industry,
 - reduces competition,
 - restricts consumer choice,
 - creates unnecessary and excessive regulatory burdens, and
 - diverts SEC resources.

¹³ Fixed Indexed Annuities and Insurance Products Classification Act of 2009, H.R. 2733, 111th Cong. (2009) [hereinafter Meeks Bill]. The Meeks Bill is set out on an accompanying page. The Meeks Bill never came to a vote in either the House or the Senate, and was overtaken by the Harkin Amendment.

¹⁴ Fixed Indexed Annuities and Insurance Products Classification Act of 2009, S. 1389, 111th Cong. (2009).

H.R. 2733 (THE “MEEKS BILL”)

To clarify the exemption for certain annuity contracts and insurance policies from Federal regulation under the Securities Act of 1933.

Be it enacted by the Senate and House of Representatives of the United States of American in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ‘Fixed Indexed Annuities and Insurance Products Classification Act of 2009’.

SECTION 2. FINDINGS AND PURPOSE.

(a) Findings – The Congress makes the following findings:

(1) Primary jurisdiction for regulating life insurance and annuities is vested with the States and Territories of the United States and the District of Columbia.

(2) Indexed insurance and annuity products offered by insurance companies are subject to a wide array of laws and regulations enforced by States and applicable jurisdictions, including nonforfeiture requirements that provide for minimum guaranteed values, thereby protecting consumers against market related losses.

(3) Adoption of Rule 151A by the Securities and Exchange Commission, entitled ‘Indexed Annuities and Certain Other Insurance Products’, 74 Fed. Reg. 3138 (January 16, 2009), interferes with State insurance regulation, harms the insurance industry, reduces competition, restricts consumer choice, creates unnecessary and excessive regulatory burdens, and diverts Commission resources, all of which outweighs any perceived benefits.

(b) Purpose – The purpose of this Act is to nullify rule [sic] 151A and clarify the scope of the exemption for annuities and insurance contracts from Federal regulation under the Securities Act of 1933.

SECTION 3. SCOPE OF EXEMPTION FROM FEDERAL SECURITIES REGULATION.

Section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)) is amended by inserting before the semicolon the following: ‘, and 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 of the applicable State, Territory, or District of Columbia at time of issue, or in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners.’.

SECTION 4. NULLIFICATION OF CERTAIN FEDERAL SECURITIES REGULATIONS.

Rule 151A promulgated by the Securities and Exchange Commission and entitled ‘Indexed Annuities and Certain other Insurance Contracts’, 74 Fed. Reg. 3138 (January 16, 2009), shall have no force or effect.

DODD-FRANK ACT / HARKIN AMENDMENT

SEC. 989J. FURTHER PROMOTING THE ADOPTION OF THE NAIC MODEL REGULATIONS THAT ENHANCE PROTECTION OF SENIORS AND OTHER CONSUMERS.

(a) **IN GENERAL.** – The Commission shall treat as exempt securities described under section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)) any insurance or endowment policy or annuity contract or optional annuity contract –

(1) the value of which does not vary according to the performance of a separate account;

(2) that –

(A) satisfies standard nonforfeiture laws or similar requirements of the applicable State at the time of issue; or

(B) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners; and

(3) that is issued –

(A) on an after June 16, 2013, in a State, or issued by an insurance company that is domiciled in a State, that –

(i) adopts rules that govern suitability requirements in the sale of an insurance or endowment policy or annuity contract or optional annuity contract, which shall substantially meet or exceed the minimum requirements established by the Suitability in Annuity Transactions Model Regulation adopted by the National Association of Insurance Commissioners in March 2010; and

(ii) adopts rules that substantially meet or exceed the minimum requirements of any successor modifications to the model regulations described in subparagraph (A) within 5 years of the adoption by the Association of any further successors thereto; or

(B) by an insurance company that adopts and implements practices on a nationwide basis for the sale of any insurance or endowment policy or annuity contract or optional annuity contract that meet or exceed the minimum requirements established by the National Association of Insurance Commissioners Suitability in Annuity Transactions Model Regulation (Model 275), and any successor thereto, and is therefore subject to examination by the State of domicile of the insurance company, or by any other State where the insurance company conducts sales of such products, for the purpose of monitoring compliance under this section.

(b) **RULE OF CONSTRUCTION.** – Nothing in this section shall be construed to affect whether any insurance or endowment policy or annuity contract or optional annuity contract that is not described in this section is or is not an exempt security under section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)).

On the other hand, one could argue that these findings do not underlie the Harkin Amendment, because they are not set out in the Harkin Amendment and were not made after any formal Congressional hearing. Indeed, there is no evidence that the SEC had any opportunity to state its views on these matters.

B. Harkin Amendment

There may be more than one version¹⁵ of how the Harkin Amendment came to replace the Meeks Bill.

It seems clear, however, that there were at least three principal influences that led Senator Harkin to push his Amendment. First, NAFA, with executive director Kim O'Brien, had laid a foundation by getting Representative Meeks and Senator Nelson to introduce bills nullifying Rule 151A and lining up multiple co-sponsors in both the House and Senate. Second, state regulators, with Iowa insurance commissioner Susan Voss, spoke up for continued state, rather than new federal, regulation. Third, issuers of indexed products, including issuers in Iowa like American Equity Investment Life Insurance Company and issuers outside Iowa like OM Financial Life Insurance Company, lobbied for legislation.

C. Comparison of Harkin Amendment with Meeks Bill

1. Title

The title of the Harkin Amendment, "Further Promoting the Adoption of the NAIC Model Regulations that Enhance Protection of Seniors and Other Consumers," refers specifically to state insurance law.

The title of the Meeks Bill was more matter-of-fact, referring to "Fixed Annuities and Insurance Products Classification Act."

2. Findings

The Meeks Bill specified three findings: (i) primary jurisdiction for regulating life insurance and annuities is vested with the states; (ii) indexed insurance and annuity products are subject to a wide array of state law, including nonforfeiture requirements that provide for minimum guaranteed values, thereby protecting consumers against market related losses; and (iii) the SEC's adoption of Rule 151A interferes with state insurance regulation, harms the insurance industry, reduces competition, restricts consumer choice, creates unnecessary and excessive regulatory burdens, and diverts SEC resources, all of which outweighs any perceived benefits.

¹⁵ One version is reported by Steven A. Morelli, *The Story Behind the Story How SEC Ruling [sic] 151A Was Overturned*, InsuranceNewsNet Magazine, August 2010, at 10.

**COMPARISON OF HARKIN AMENDMENT WITH
MEEKS BILL**

Feature	Harkin Amendment	Meeks Bill
1. Title refers to state law	Yes	No
2. Specifies findings	No	Yes
3. Amends Section 3(a)(8)	No	Yes
4. Refers expressly to indexed products	No	Yes
5. Covers products other than indexed products	Yes	Yes
6. Requires no value varying with separate account performance	Yes	Yes
7. Requires satisfaction of state or NAIC nonforfeiture law	Yes	Yes
8. Requires satisfaction of state or NAIC suitability requirements	Yes	No
9. Nullifies Rule 151A	Yes, impliedly	Yes, expressly
10. Provides rule of construction	Yes	No

In contrast, the Harkin Amendment specifies no findings.

3. Amendment of Section 3(a)(8)

The Meeks Bill amended Section 3(a)(8) to insert additional language into the 1933 Act.

The Harkin Amendment does not technically amend Section 3(a)(8). Instead, it imposes a mandate on the SEC “to treat [specified products] as exempt securities described under section 3(a)(8).”

4. Requirement Regarding No Separate Account Performance

Both the Harkin Amendment and the Meeks Bill provided, as a condition for exemption, that product values not vary according to the performance of a separate account.

5. Requirement Regarding Satisfaction of Nonforfeiture Laws

Both the Harkin Amendment and the Meeks Bill provided, as a condition for exemption, that products must satisfy (i) state standard nonforfeiture laws or similar requirements, or (ii) in the absence of state standard nonforfeiture laws or requirements, the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the NAIC.

6. Requirement Regarding Satisfaction of Suitability Requirements

The Harkin Amendment, in essence, requires, as a condition for exemption, that products must be issued by a company that (i) satisfies state suitability requirements that substantially meet or exceed the minimum requirements established by the Suitability in Annuity Transactions Model Regulation adopted by the NAIC or (ii) adopts and implements practices on a nationwide basis that meet or exceed those requirements.

The Meeks Bill had no such requirement.

7. Nullification of Rule 151A

The Meeks Bill expressly nullified Rule 151A by providing that the Rule “shall have no force or effect.”

The Harkin Amendment has no such language. However, it impliedly nullifies Rule 151A by mandating the SEC to treat described products as exempt securities.

**ARGUMENTS FOR AND AGAINST HARKIN AMENDMENT
DURING SENATE-HOUSE CONFEREES MEETING ON JUNE 22, 2010***

<p align="center">Senator Tom Harkin Arguments For</p>	<p align="center">Senator John Reed Arguments Against</p>
<p>“This is an insurance product.” “It always has been and still is today.”</p>	<p>These are complex instruments that guarantee an income that is linked to a securities index.</p>
<p>Past problems with the marketing of the annuities have been addressed by a suitability standard developed by the NAIC. The model regulation requires that any agent selling the product obtain information about a customer’s age, income, financial experience, investment horizon and liquidity needs, among other factors.</p>	<p>“There have been repeated abuses of this product.” These instruments are too often sold to vulnerable customers, such as elderly investors, who lose access to their money for many years unless they pay huge penalties.</p>
<p>The U.S. District Court of Appeals for the DC Circuit recently held that the <i>SEC does not have authority to regulate the annuities.</i></p>	<p>Senator Harkins misinterprets the Court’s decision. The court <i>upheld SEC oversight</i> but remanded the rule to the SEC, because it didn’t take into account how it would affect market efficiency, competition and capital formation. “The Harkin amendment would effectively trump the court’s decision.”</p>
<p>“The SEC’s got a lot of other things to do than regulate what is now an insurance market.”</p>	<p>“This is a major amendment of securities law without any hearings or debate.” “I don’t think this is the proper place to make such a change.”</p>
<p>* The quotes and paraphrases were reported in “Senate conferees approve Harkin amendment on equity-indexed annuities,” Investment News, June 23, 2010.</p>	

8. Rule of Construction

The Harkin Amendment provides that its provisions shall not be construed to effect whether any product that is not described is or is not an exempt security under Section 3(a)(8).

The Meeks Bill had no such provision.

D. Observations: Ironies

1. Focus on State Regulation

The caption for the Harkin Amendment, as it appears in the Dodd-Frank Act is “Further Promoting the Adoption of the NAIC Model Regulations that Enhance Protection of Seniors and Other Consumers.”

This title shifts the focus from denying *federal* regulation to enhancing *state* regulation.

The title of the Meeks Bill was more matter-of-fact: “Fixed Indexed Annuities and Insurance Products Classification Act of 2009.”

2. Reference to State Nonforfeiture Laws

It always has been ironic that the SEC, in implementing *federal* jurisdiction over annuity products referenced a *state* insurance law requirement, namely, the interest rate provision of state nonforfeiture law.

The Harkin Amendment refers to the same state insurance law, but in order to *deny* federal jurisdiction over annuity (and life insurance) products.

3. Less and More Federal Regulation of Insurance

The Harkin Amendment *removes* federal regulation of insurance while other provisions of the Dodd-Frank Act, in other respects, *add* federal regulation of insurance.

The Dodd-Frank Act imposes a degree of federal regulation on insurance in a number of ways.

For example, Title V., Section 502, creates a new Federal Insurance Office (“FIO”) within the Treasury Department.

The FIO will:

- monitor the U.S. insurance industry,
- coordinate federal efforts and policy relating to international insurance matters,

- determine which state insurance measures are preempted by international agreements,
- report to Congress annually on the state of the insurance industry, and
- identify insurers that could pose a threat to U.S. financial stability.

The FIO has authority over all lines of insurance, except health insurance, long-term care insurance and crop insurance. The FIO Director has authority to determine when state insurance measures are inconsistent with international agreements relating to prudential measures for insurance or reinsurance.¹⁶

¹⁶ See *infra* VI.E., for further discussion of the FIO.

III. HOW DO WE DETERMINE WHAT PRODUCTS FALL *WITHIN* THE HARKIN AMENDMENT AND THEREFORE WITHIN SECTION 3(a)(8)?

The Harkin Amendment conditions exemption from Section 3(a)(8) on satisfaction of three prongs. The second prong requires satisfaction of state nonforfeiture laws and the third prong requires satisfaction of state suitability requirements for annuities. It is not entirely clear whether certain products will be deemed by the states and the SEC to satisfy these prongs.

A. Question Raised

The Harkin Amendment conditions eligibility on satisfying designated state insurance laws. Questions arise regarding what products satisfy those laws. These are important questions, because products that do not satisfy state insurance law as the Harkin Amendment provides can be subject to SEC jurisdiction.

A question arises as to the role of the SEC in policing what course of action a life insurance company follows in this regard.

The following is not intended to be a technical discussion of the issues raised, but rather a general overview of interpretive issues that the Harkin Amendment raises.

1. Indexed Life

The Harkin Amendment covers (with emphasis added) a product that is issued:

by an insurance company that adopts and implements practices on a nationwide basis for the sale of any *insurance* or endowment policy or annuity contract or optional annuity contract that meet or exceed the minimum requirements established by the National Association of Insurance Commissioners Suitability in *Annuity* Transactions Model Regulation (Model 275), and any successor thereto, and is therefore subject to examination by the State of domicile of the insurance company, or by any other State where the insurance company conducts sales of such products, for the purpose of monitoring compliance under this section.

So, the language of the Harkin Amendment can be read to provide, in effect, that a life insurance company issuing indexed life *insurance*, in reliance on the Amendment, must comply with suitability requirements adopted for *annuities*.

To the extent that requirements for annuities may be an ill fit for life insurance, there have been suggestions that life insurance companies have two options other than registering as a security or relying on Section 3(a)(8) or another applicable exemption:

**ANNUITY GUARANTEES:
COMPARISON OF RULE 151 UNDER THE SECURITIES ACT OF 1933 WITH
NAIC MODEL STANDARD NONFORFEITURE LAW FOR
INDIVIDUAL DEFERRED ANNUITIES**

Rule 151	Nonforfeiture Law
<p>Assumed Base of at Least 90%</p> <p>Guarantees principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges. SEC Staff is understood to assume a deduction of no more than 10% for these expenses or charges, leaving a net principal amount of no less than 90%.</p>	<p>Specified Base of 87½%</p> <p>The net considerations for a given contract year used to define the minimum nonforfeiture amount shall be an amount equal to 87½% of the gross considerations (including credited interest) credited to the contract during the contract year, permitting an annual contract charge of \$50 and any premium tax paid by the insurer.</p>
<p>Specified Interest Rate Same as State Law</p> <p>The insurer, for the life of the contract, credits a specified rate of interest, which rate is at least equal to the minimum rate required to be credited by the relevant nonforfeiture law in the jurisdiction in which the contract is issued or, if that jurisdiction does not have an applicable nonforfeiture law at the time the contract is issued (or if the minimum rate applicable to an existing contract is no longer mandated in that jurisdiction), the specified rate under the contract must at least be equal to the minimum rate then required for individual annuity contracts by the NAIC Standard Nonforfeiture Law.</p>	<p>Specified Interest Rate of 1% to 3%</p> <p>At the time the SEC adopted Rule 151, state standard nonforfeiture law required a minimum interest rate of 3%. The NAIC Model was subsequently amended to provide for the lesser of (i) 3% per year and (ii) the following, if the interest rate will be reset: the five-year Constant Maturity Treasury Rate reported by the Federal Reserve as specified, reduced by 125 basis points (with a conditioned additional reduction for index annuities), but not less than 1%.</p>
<p>Excess Interest Rate for at Least One Year</p> <p>The insurer guarantees that the rate of any interest to be credited in excess of the specified rate of interest will not be modified more frequently than once per year.</p>	<p>No Excess Interest Rate Requirement</p> <p>The nonforfeiture law has no provision for excess interest.</p>

- consider this requirement of the Harkin Amendment to be inapplicable to life insurance company products on the ground that state law applicable to annuities is *per se* inapplicable to life insurance or
- adopt and implement practices that build off state law applicable to annuities with appropriate adjustments that reflect the differences between life insurance and annuities.

If indexed life insurance does not fall within the Harkin Amendment, a question arises as to how the status of indexed life insurance under Section 3(a)(8) is to be determined. The SEC has said that the considerations underlying Rule 151A would be relevant, as follows:

The status of an indexed life insurance policy under the federal securities laws will continue to be a facts and circumstances determination, undertaken by reference to the factors and analysis that have been articulated by the Supreme Court and the Commission. We note, however, that the ***considerations that form the basis for rule 151A are also relevant*** in analyzing indexed life insurance because indexed life insurance and indexed annuities share certain features (e.g., securities-linked returns).¹⁷

Although the court in *American Equity* vacated Rule 151A, the court, in effect, found those considerations to be reasonable. It follows that those considerations could be deemed to be reasonable even though Rule 151A has been vacated.

2. Modified Guaranteed Annuities

The Harkin Amendment was intended to address indexed products. The predecessor Meeks bill, in fact, contained language expressly addressing indexed products. The debates about the Harkin Amendment, both on the floor of the Senate and during the Conference Meeting, focused on indexed products.

However, the language of the Harkin Amendment does not refer to indexed products *per se*. The language refers (with emphasis added) to:

any insurance or endowment policy or annuity contract or optional annuity contract –

(1) the value of which does not vary according to the performance of a separate account;

(2) that –

¹⁷ Indexed Annuities and Certain Other Insurance Contracts, SEC Securities Act Release No. 8996 and Securities Exchange Act Release No. 59221 at 47-48 (Jan. 8, 2009) (adopting Rule 151A) (emphasis added) [hereinafter SEC Rule 151A Adopting Release].

(A) satisfies standard nonforfeiture laws or *similar requirements* of the applicable State at the time of issue; or

(B) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners.

So, the language of the Harkin Amendment is sufficiently broad to apply to not only indexed products, but also to annuity products that Rule 151 addresses, such as so-called excess interest or declared rate products.

Such products may include modified guaranteed annuities (“MGAs”) that may not meet standard nonforfeiture laws. To the extent that MGAs do not meet standard nonforfeiture laws, it has been suggested that life insurance companies issuing MGAs have certain options other than registering as a security or relying on Section 3(a)(8) (or another available exemption):

- claim (although most may dispute this claim) that MGAs can still qualify under the Harkin Amendment by meeting the requirements of the NAIC Modified Guaranteed Annuity Model Regulation (or similar requirements adopted in the applicable state), which provides for detailed nonforfeiture requirements for MGAs that are distinct from the NAIC Model Standard Nonforfeiture Law for Individual Deferred Annuities, or
- perhaps qualify under Rule 151.

3. Group Annuity Contracts

Group annuity contracts may not be required to meet standard nonforfeiture laws. However, group contracts may be required to meet modified guarantee annuity laws.

The Harkin Amendment requires, as a condition for eligibility, that a product meet either “standard nonforfeiture laws or similar requirements.” The question arises whether modified guarantee annuity laws fall within the category of “similar requirements.”

4. Synthetics

Synthetics have no cash value and, therefore, cannot satisfy standard nonforfeiture laws.

To the extent that synthetics cannot meet standard nonforfeiture laws, it has been suggested that the only option that life insurance companies issuing synthetics have – other than registering as a security or relying on Section 3(a)(8) (or another applicable

exemption) – is to claim that the condition of the Harkin Amendment is inapplicable to synthetics.

B. SEC Residual Authority

The SEC continues to have a statutory mandate to regulate the offer and sale of any product that falls outside of the Harkin Amendment, Rule 151 and Section 3(a)(8).

So, it's important to establish what products meet the Harkin Amendment's condition of satisfying, at the time of issue:

- standard nonforfeiture laws,
- similar requirements of the applicable state, or
- in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Individual Deferred Annuities.

There could be much uncertainty here. The form of state nonforfeiture laws varies. For example, in at least one state, the MGA law is part of the state's nonforfeiture law.

The NAIC appears to be addressing questions raised regarding the parameters of state law, compliance with which would satisfy the conditions of the Harkin Amendment. Query whether Chairman Schapiro's testimony indicates that the SEC stands by to render assistance and help to the states in this regard, as distinguished from the marketing area.

IV. HOW DO WE DETERMINE THE STATUS, UNDER SECTION 3(a)(8), OF ANY PRODUCT THAT FALLS OUTSIDE OF THE HARKIN AMENDMENT AND OUTSIDE RULE 151?

The Harkin Amendment provides that it does not affect the status of products – other than those addressed – under Section 3(a)(8). The SEC’s traditional tests for purposes of analyzing a product under Section 3(a)(8) have been, in order of importance, investment risk, marketing and mortality risk. However, SEC statements made in the context of indexed annuities suggest that, in the future, the SEC could grant relatively more weight to investment risk than to marketing and mortality risk, and the investment risk test may not be the traditional test.

A. Question Raised

The question arises as to the standards or tests to be used in determining the status, under Section 3(a)(8), of any life insurance company product that falls outside of the Harkin Amendment and Rule 151.

There are two new circumstances.

First, the Court of Appeals has found that, at least in the context of indexed products, the SEC’s analytical approach is “reasonable” and the SEC’s new “more-likely-than-not” test is not “arbitrary and capricious.”¹⁸

Second, the Harkin Amendment, provides as follows:

(b) RULE OF CONSTRUCTION. – Nothing in this section shall be construed to affect whether any insurance or endowment policy or annuity contract or optional annuity contract that is not described in this section is or is not an exempt security under section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)).

The question arises whether the investment risk standard or test to be used is:

- the traditional test that the courts and the SEC have pronounced in the past or
- a new test that includes, to any extent, the “more-likely-than-not” test that the SEC pronounced in adopting Rule 151A.

The question also arises to what extent the marketing test and the mortality risk test survive.

¹⁸ See *infra* notes 30-32 and 37.

B. Investment Risk Test

1. SEC Traditional and New Positions on Investment Risk Test

The SEC's traditional position has been that a life insurance company assumes a sufficient investment risk under a product for purposes of Section 3(a)(8) where the insurer guarantees:

- the principal (purchase payments less expenses);
- an adequate minimum rate of interest for the life of the product;
- any excess rate of interest for at least a year; and
- credited interest.

The SEC stated its traditional position in a brief to the U.S. Supreme Court, as follows:

At least where . . . a state-regulated insurer assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the *investment-risk criterion is satisfied*.¹⁹

But in proposing Rule 151A, the SEC backed away from its traditional position and articulated a different standard, namely, the “more-likely-than-not” test:

The second characteristic, that amounts payable by the insurance company under the contract are *more likely than not* to exceed the amounts guaranteed under the contract, sets forth the test that would define a class of contracts that are not “annuity contracts” or “optional annuity contracts” under the Securities Act and that, therefore, are not entitled to the Section 3(a)(8) exemption. As explained above, by purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns. As a result, the purchaser assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities. Our proposal is intended to provide the purchaser of such an annuity with the same protections that are provided under the federal securities laws to other investors who participate in the securities markets, including full and fair disclosure regarding the terms of the investment and the significant

¹⁹ Brief for the United States as *Amicus Curiae* Supporting Writ of Certiorari at 8-9, Variable Annuity Life Ins. Co. v. Otto, 486 U.S. 1026 (1988) (No. 87-600) (emphasis added) (citing *Marine Bank v. Weaver*, 455 U.S. 551 (1982)) (the brief bears the names of SEC staff officials) [hereinafter SEC Otto Brief].

risks that he or she is assuming, as well as protection from abusive sales practices and the recommendation of unsuitable transactions.²⁰

NAFA pointed out the SEC's contradictory statements during the public comment period for the proposal, as follows:

The Commission takes an approach that is *at odds* with the approach that the Commission took in the “safe harbor” of Rule 151 under Section 3(a)(8). In that Rule, the Commission provided that an annuity could rely on the “safe harbor” if the insurer guaranteed principal, a minimum interest rate and previously credited interest. The rationale has been that an insurer assumes a sufficiently substantial investment risk in guaranteeing principal, a minimum interest rate and previously credited interest. This is because the owner assumes only the less significant risk that the insurer will declare, for the following year, no excess rate of interest or a rate of excess interest that is different (higher or lower) from that declared for the past year.

The Commission proposes a *radically different approach*. The Commission fragments or separates the excess interest element from the insurer's guarantee of the purchase payments, a minimum interest rate and credited interest. The proposed approach focuses on the investment risk posed by the former without weighing the floor on that risk guaranteed by the latter.²¹

However, the SEC, in adopting Rule 151A, stated that:

- the SEC's traditional position was not relevant to index annuities; and
- in any event, the SEC's traditional position was no longer the SEC's position.

The SEC said:

We believe that the position articulated in the *VALIC v. Otto* brief is *not relevant* in the context of indexed annuities and, to the extent that the brief may imply otherwise, the position taken in the brief *does not reflect the Commission's current position*. Where the contractual return paid by an insurer under an annuity contract is retroactively determined based, in whole or in part, on the returns of a security in a

²⁰ Fixed Annuities and Certain Other Insurance Contracts, SEC Securities Act Release No. 8933 and Securities Exchange Act Release No. 58022 at 32-33 (June 25, 2008) (proposing Rule 151) (footnote omitted; emphasis added) [hereinafter SEC Rule 151 Proposing Release].

²¹ NAFA Comment Letter, *supra* note 1, at 27-28.

prior period, we do not believe that fact – and the investment risk that it entails – can be ignored in determining whether the contract is an “annuity contract” that is entitled to the Section 3(a)(8) exemption.²²

During the Rule 151A litigation, an *amicus* pointed out to the Court that Rule 151A was not consistent with the SEC’s traditional position as stated to the U.S. Supreme Court, as follows:

The SEC has agreed and so stated to the Supreme Court, as follows:

At least where . . . a state-regulated insurer assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the *investment-risk criterion is satisfied*.

* * * *

Based on this history, it is plain that Rule 151A contradicts the Supreme Court’s *VALIC-United Benefit* standard as well as the SEC’s statement to the Supreme Court regarding the application of the *VALIC-United Benefit* standard.²³

The SEC, in response, told the Court that, as stated in the Release adopting Rule 151A and as quoted above, the SEC’s traditional position was not relevant to indexed annuities and, in any event, was no longer the SEC’s position, as follows:

In this rulemaking, the Commission stated that the position articulated in the *Otto* brief is *not relevant* in the context of indexed annuities and, to the extent that the brief may imply otherwise, the position taken in the brief *does not reflect the Commission’s current position*. RA181-82. *See generally Brand X*, 545 U.S. at 981 (“An initial agency interpretation is not instantly carved in stone. On the contrary, the agency . . . must consider varying interpretations and the wisdom of its policy on a continuing basis”) (quoting *Chevron*, 467 U.S. at 863-64).²⁴

The Court held that the SEC’s interpretation that an indexed annuity does not constitute an “annuity contract under § 3(a)(8) of the Act was reasonable.” The Court

²² SEC Rule 151A Adopting Release, *supra* note 17, at 35 (emphasis added).

²³ Corrected Brief of Allianz Life Ins. Co. as *Amicus Curiae* in Support of Petitioners, American Equity, *supra* note 6 (emphasis added). The author’s firm represented the amicus, and the author of this Outline was the principal author of the brief.

²⁴ Brief for the United States, American Equity, *supra* note 6, at 48 n.19 (italicized emphasis and deletions in original; bold emphasis added) (the brief bears the names of SEC staff officials).

determined that the “more-likely-than-not” test did not cause Rule 151A to be arbitrary and capricious, as follows:

Petitioners assert that the SEC based its analysis of Rule 151A on an “insupportable definition of investment risk.” The SEC determined that a purchaser bears sufficient risk to treat a product as a security when “[a]mounts payable to the issuer under the contract are more likely than not to *exceed* the amounts guaranteed under the contract.” 17 C.F.R. § 230.151A(a)(2) (emphasis added). In petitioners’ view, investment risk exists only where the purchaser of a security faces the possibility of a loss of principal. Petitioners’ view is certainly a defensible one. However, that is *not sufficient to establish that the SEC’s rule is arbitrary or capricious.*²⁵

So, the question arises whether the “more-likely-than-not” test expired with the Harkin Amendment and the vacatur of Rule 151A or whether the test survives, to any extent, with respect to products that do not fall within the Harkin Amendment.

2. Breadth of SEC Investment Risk Test

There are a number of indications that the SEC’s “more-likely-than-not test” was limited to indexed products. The SEC has said:

Proposed rule 151A would apply to annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. The proposed rule would define certain of those annuities (annuities under which amounts payable by the issuer are more likely than not to exceed the amounts guaranteed under the contract) as not “annuity contracts” or “optional annuity contracts” under Section 3(a)(8) of the Securities Act. The proposed rule, however, would not provide a safe harbor under Section 3(a)(8) for any other annuities, including any other annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. *The status under the Securities Act of any annuity, other than an annuity that is determined under proposed rule 151A to be not an “annuity contract” or “optional annuity contract,” would continue to be determined by reference to the investment risk and marketing tests articulated in existing case law under Section 3(a)(8) and, to the extent applicable, the Commission’s safe harbor rule 151.*²⁶

²⁵ American Equity, *supra* note 6, at 15 (italicized emphasis in original; bold emphasis added).

²⁶ SEC Rule 151A Proposing Release, *supra* note 1, at 46 (footnote omitted; emphasis added).

Furthermore, the SEC, in adopting Rule 151A, did not extend the “more-likely-than-not” test to non-indexed products. Indeed, the SEC explained that the investment risk analysis for indexed annuities differed from that for products like variable annuities. The SEC said that its investment risk test for indexed products, including the “more-likely-than-not” test, was an application of the traditional investment risk test, but differed because of the unique features of indexed annuities, as follows:

Our investment risk analysis is an application of the Court’s reasoning in the *VALIC* and *United Benefit* cases, and rule 151A applies that analysis with a specific test [*i.e.*, the “more-likely-than-not”] test to determine the status under the federal securities laws of indexed annuities. Indexed annuities are a relatively *new* product and are *different* from the securities considered in those cases.²⁷

However, there is some indication that the SEC – or a court – could extend the “more-likely-than-not” test to products other than indexed annuities.

To begin with, the SEC, in proposing Rule 151A, entertained the possibility of applying the “more-likely-than-not” test to products other than indexed annuities. The SEC said that it invited response to the following cluster of questions:

What contracts should be covered by the proposed definition? Should the scope of contracts covered be articulated by reference to state law? Should the proposed definition *extend to all annuity contracts*, or should any annuity contracts be excluded? Should variable annuity contracts be covered by the proposed definition? Should the proposed definition apply to forms of insurance other than annuities, such as *life insurance* or health insurance? Should the proposed definition apply to a contract issued by an insurance company if the contract is not itself regulated as insurance under state law?²⁸

Moreover, it is conceivable that the SEC or a court could extend the “more-likely-than-not” test to other products, such as excess interest or declared rate products. The SEC traditionally has taken the position that, under such products, an owner incurs an investment risk to the extent that a life insurance company can, at the end of a contract period, declare the same rate of excess interest for the ensuring period, a higher rate, a lower rate or no rate. The SEC, for example, has told the U.S. Supreme Court as follows:

Otto did have some investment risk under VALIC’s fixed annuity. One of the fixed annuity’s attractions undoubtedly was its excess-interest component. Indeed, the record shows that VALIC set a rate of

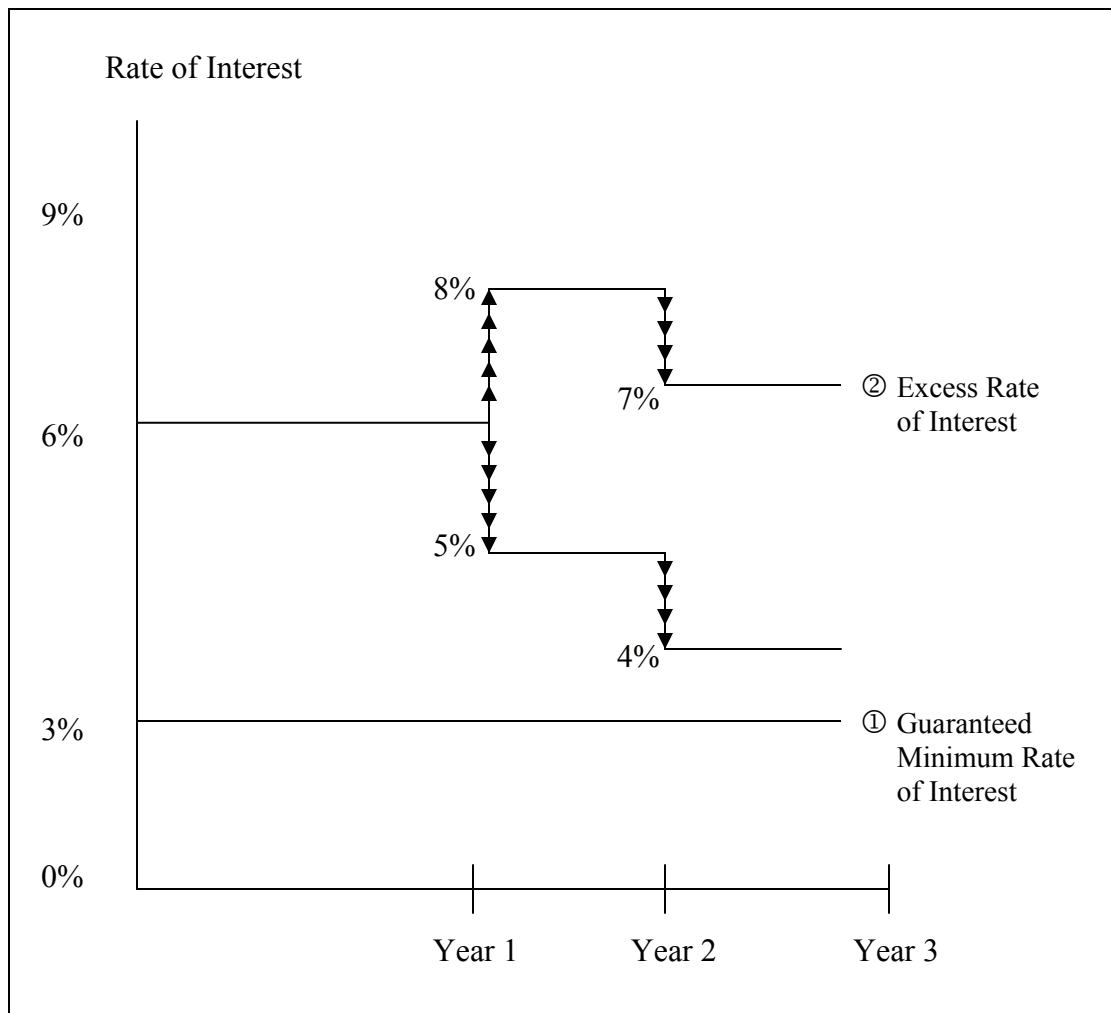
²⁷ SEC Rule 151A Adopting Release, *supra* note 17, at 29 (emphasis added).

²⁸ *Id.*, at 30 (emphasis added).

14-1/2% for deposits made in the third quarter of 1982. This rate was over ten points higher than the guaranteed minimum rate. Under the contract, Otto *bore the risk that this excess-interest rate – or any other declared excess-interest rate – could be reduced or eliminated at VALIC's discretion.*²⁹

The following graphic illustrates the point:

²⁹ SEC Otto Brief, *supra* note 19, at 8 (emphasis added).



One could, at least theoretically, argue that an owner’s investment risk regarding the *retrospective* declaration of an interest rate under indexed products is not essentially different from an owner’s investment risk regarding the *prospective* declaration of an interest rate under an excess interest or declared rate product.

Although the excess interest rate is not contractually linked to a securities index, an insurer declares that rate based in significant part on returns that the insurer recently realized from the performance of securities that the insurer owns and the return that the insurer anticipates receiving in the immediate future on those securities. This means that the owner assumes an investment rate that derives from the performance of securities. The SEC did not address this fact in justifying its “more-likely-than-not” test.

Furthermore, the traditional investment risk test has been premised on the insurer’s *shifting* an investment risk assumed by the insurer to an owner. Under indexed products, the insurer promises a return based on a defined and specified link to a securities index which does *not* involve the shifting of a risk *from* the insurer *to* the owner. The SEC did not address this distinction in justifying its “more-likely-than-not” test.

To the extent that these points are deemed valid, there is at least a possibility that the SEC or a court could apply the “more-likely-than-not” test to products other than indexed annuities.

The question would be: is it more likely than not that any excess interest rate that the life insurance company declares for an ensuring period will be

- the excess interest rate for the current period,
- a higher rate,
- a lower rate, or
- no excess interest rate.

3. **Breadth of Court Opinion**

The Court, in its *American Equity* opinion, upheld the reasonableness of the SEC’s rationale of Rule 151A and vacated the Rule only for the procedural reason that the SEC had failed to make the impact analysis required by Section 2(b) of the 1933 Act. This could be important in terms of whether the SEC seeks to impose the rationale of Rule 151A outside the context of indexed annuities in the future.

The Court specifically stated that it “must ... determine whether the SEC’s rule is a reasonable interpretation of the statute,” pointing out that “[i]t is irrelevant that this court might have reached a different – or better – conclusion than the SEC.”³⁰

The Court concluded that “the SEC has adopted an interpretation that is based in *reason*”;³¹ the “SEC’s interpretation that an FIA [indexed annuity] does not constitute an “annuity contract” under Section 3(a)(8) of the Act was *reasonable*”;³² and “the SEC’s interpretation of ‘annuity contract’ was *reasonable*.”³³

Significantly, the Court indicated that the SEC’s interpretation of Section 3(a)(8) was consistent with the Supreme Court’s doctrine pronounced in *United Benefit*.³⁴ There are three particular aspects of the Court’s analysis that could be relevant going forward:

³⁰ *American Equity*, *supra* note 6, at 14.

³¹ *Id.* (emphasis added).

³² *Id.* at 15 (emphasis added).

³³ *Id.* at 20 (emphasis added).

³⁴ *Id.* at 14.

- First, the Court said that it was not “arbitrary and capricious” for the SEC to take the position that investment risk could be present even where a purchase does not face “the possibility of loss of principal.”³⁵
- Second, the Court said that it was not “unreasonable” for the SEC to take the position that a purchaser bore investment risk, even when the product “guarantees a minimum return rate” if the excess return rate is not declared in advance.³⁶
- Third, the Court said that it was not “arbitrary and capricious” for the SEC to “treat a product as a security when ‘[a]mounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.’”³⁷

The Court made it clear that it vacated Rule 151A for procedural reasons distinct from the substance of the Rule. The Court explained that “[t]he SEC’s obligations under § 2(b) are distinct from the questions posed in *VALIC* and *United Benefit*.³⁸ The Court went on to “hold that the Commission’s consideration of the effect of Rule 151A on efficiency, competition, and capital formation was arbitrary and capricious.”³⁹

The fact that the Court did not raise any substantive objection to Rule 151A could make it more likely that the SEC or a court may, in the future, seek to apply the Rule’s investment risk test to products that do not fall within the Harkin Amendment, including (at least in theory) annuities not based on any index.

C. Marketing Test

1. SEC Traditional and New Positions on Marketing Test

The SEC’s traditional position has been that, for purposes of determining whether a product falls within Section 3(a)(8), it is important to determine whether the product is marketed primarily as insurance or an investment.

The SEC stated its traditional position in a brief to the U.S. Supreme Court, as follows:

³⁵ *Id.* at 15.

³⁶ *Id.* at 15-16.

³⁷ *Id.* at 15.

³⁸ *Id.* at 23.

³⁹ *Id.* at 21.

Investment risk is only one of the interrelated criteria for judging whether a contract is an “annuity contract” under Section 3(a)(8). Another factor *is the manner in which the contract is marketed*. See *United Benefit*, 387 U.S. at 211. To qualify for the exemption, the insurance company’s marketing plan must be aimed at *appealing* to purchasers ““on the usual insurance basis of stability and security.”” 51 Fed. Reg. at 20261 (quoting *United Benefit*, 387 U.S. at 211). A contract most likely will not qualify under Section 3(a)(8) if it is marketed “with discretionary *primary* emphasis on current excess interest, and the possibility of future interest” rather than “the product’s usefulness as a long-term insurance device for retirement or income security purposes.” 51 Fed. Reg. at 20261 & n.47 (emphasis in original).⁴⁰

But in adopting Rule 151A, the SEC backed away from its traditional position of looking to a marketing test, as follows:

The *very nature* of an indexed annuity, where return is contractually linked to the return on a securities index, is, to a very substantial extent, designed to *appeal* to purchasers on the prospect of investment growth. This is particularly true in the case of indexed annuities that rule 151A defines as not “annuity contracts” – *i.e.*, indexed annuities where the purchaser is more likely than not to receive securities-linked returns. It would be inconsistent with the character of such an indexed annuity, and potentially misleading, to market the annuity without placing *significant emphasis* on the securities-linked return and the related risks.⁴¹

Commentators had pointed out,⁴² during the public comment period for the proposal, that the proposal’s failure to include a marketing test was inconsistent with SEC precedent. But the SEC answered the commenters as follows:

We disagree with commenters who argued that purchasers do not buy indexed annuities on the basis of the *prospect for investment growth*, but rather on the basis of guarantees and stability of principal. We agree with commenters that purchasers of indexed annuities, just like purchasers of variable annuities, have a blend of reasons for their purchase, including product guarantees and tax deferral. However, we also believe that purchasers who are uninterested in the growth offered by securities-linked returns would opt for higher fixed returns in lieu of

⁴⁰ SEC Otto Brief, *supra* note 19, at 9 (italicized emphasis in original; bold emphasis added).

⁴¹ SEC Rule 151A Adopting Release, *supra* note 17, at 35-36 (emphasis added).

⁴² *Id.*

the lower fixed returns, coupled with the prospect of securities-linked growth, offered by indexed annuities.⁴³

2. Analysis of Marketing Test

The SEC has attempted to base its refusal to include a marketing test for analyzing indexed products on the U.S. Supreme Court's approach to analyzing the status of products under Section 3(a)(8). In adopting Rule 151A, the SEC stated, without discussion, that "[t]he Supreme Court did not address marketing in VALIC."⁴⁴

However, the Supreme Court *did* address marketing in *United Benefit*. But the SEC, curiously, mentions this fact only parenthetically⁴⁵ and without discussion. The SEC's approach here in the context of indexed products starkly contrasts with the SEC's approach in adopting Rule 151 for excess interest or declared rate products. There, the SEC relied heavily on *United Benefit* and the statements made by the Supreme Court about the significance of marketing in analyzing products under Section 3(a)(8). Indeed, the SEC said:

The Commission cited the *United Benefit* case as its **principal support** for the application of a marketing test as an element in determining whether or not a contract is within the scope of rule 151.⁴⁶

The industry finds itself in a peculiar position. In 1986, the industry opposed⁴⁷ the marketing test that the SEC adopted as part of Rule 151. The industry's opposition was principally based on the subjective nature of the test.⁴⁸ However, in the decades since the adoption of Rule 151, at least some life insurance companies have come to regard the marketing test as helpful in analyzing the status of products under Section 3(a)(8). Accordingly, some commenters criticized⁴⁹ the SEC for omitting a marketing test from Rule 151A.

Based on what the SEC said about the marketing test in the context of Rule 151A, one could arguably conclude that the SEC has departed from its traditional position and downplayed the importance of the marketing test in relation to the investment risk test.

⁴³ *Id.* at 36 (footnotes omitted; emphasis added).

⁴⁴ *Id.* at 37.

⁴⁵ *Id.*

⁴⁶ Adoption of rule [sic], SEC Securities Act Release No. 6645 at 30 (adopting Rule 151) (footnote omitted; emphasis added) (May 29, 1986).

⁴⁷ *See id.* at 30-31.

⁴⁸ *Id.*

⁴⁹ *See* SEC Rule 151A Adopting Release, *supra* note 17, at 35.

It is unclear what effect, if any, this will have on future positions that the SEC or the courts may take.

D. Mortality Risk Test

1. SEC Traditional and New Positions on Mortality Risk Test

The SEC’s traditional position has been that, for purposes of determining whether a product falls within Section 3(a)(8), mortality risk is an appropriate, but not essential, factor.

The SEC stated its traditional position in a brief to the Supreme Court, as follows:

Another factor in a Section 3(a)(8) analysis is whether the insurance company assumes a meaningful *mortality or longevity risk*. See *VALIC I*, 359 U.S. at 71. At a minimum, to assume a mortality risk the insurance company must guarantee in the contract that the purchaser may buy an annuity at specified rates. The mortality risk is meaningful, however, only if there is a reasonable possibility that a purchaser reaching retirement age would choose to annuitize at those rates.

* * * *

The lack of a meaningful mortality risk is not necessarily a disqualifying feature. See 51 Fed. Reg. at 20256. But if VALIC’s marketing tactics place the status of its fixed-annuity contract in doubt, VALIC’s assumption of a meaningful mortality risk might nonetheless *tip the balance* in favor of a conclusion that the contract is an “annuity contract” under Section 3(a)(8).⁵⁰

2. Analysis of Mortality Risk Test

The SEC, in adopting Rule 151A, hewed to its traditional position that mortality risk is not a weighty factor in analyzing the status of a product under Section 3(a)(8). Indeed, the SEC came close to stating that the investment risk test was determinative, as follows:

While the Commission has stated, and we continue to believe, that the presence or absence of assumption of *mortality risk* may be an appropriate factor to consider in a Section 3(a)(8) analysis, we do not believe that it *should be given undue weight* in determining the status of a contract under the federal securities laws, where it is clear from the

⁵⁰ SEC Otto Brief, *supra* note 19, at 9-10 (emphasis added).

nature of the investment risk that the contract is not an “annuity contract” for securities law purposes.⁵¹

Based on what the SEC has said in the context of indexed products, one could arguably conclude that the SEC has downplayed the mortality risk test (along with the marketing test) in relation to the investment risk test.

⁵¹ *Id.* at 37.

V. CAN THE SEC STILL REGULATE THE MARKETING OF INDEXED AND OTHER EXEMPTED FIXED PRODUCTS?

Conceivably, there are at least two ways the SEC can still regulate the marketing of these products.⁵² If the Harkin Amendment, despite precedent, is deemed to be an exemption, rather than an exclusion, antifraud provisions would apply and sales would be required to be made through SEC-registered broker-dealers. In addition, the SEC might be able to influence FINRA suitability standards which, in turn, could influence NAIC suitability standards.

A. Question Raised

The Harkin Amendment, as noted in II., above, does not actually amend Section 3(a)(8). The statutory language is that “[t]he Commission shall treat [the indexed and other products addressed] as exempt securities described under section 3(a)(8).” The approach of the Harkin Amendment differs from that under the Meeks Bill which actually amended Section 3(a)(8) to include indexed products.

The Harkin Amendment doesn’t specifically state that persons other than the SEC must treat indexed and other fixed products addressed as “exempt securities.” However, it seems likely that a court would do so. So, the Harkin Amendment may, in fact, be the functional equivalent of an amendment of the language of Section 3(a)(8), although this is not entirely clear.

Moreover, the Harkin Amendment specifically speaks in terms of “exempt securities,” after decades of SEC and court pronouncements that deem Section 3(a)(8) to provide an “exclusion” from status as a security, rather than merely an exemption from most of the 1933 Act’s provisions. Although Congress had notice of this interpretive gloss, it nevertheless used “exempt” rather than “exclude” language.

So, the question arises whether the Harkin Amendment is intended to:

- supersede the interpretive pronouncements of the SEC and the courts and establish Section 3(a)(8) as an exemption (rather than an exclusion) for products that the Amendment covers, or
- fit under the traditional interpretive gloss that Section 3(a)(8) is an exclusion rather than an exemption.

Stated another way, the question arises whether a product covered by the Harkin Amendment is:

⁵² This is in addition to the potential disclosure regulation discussed *infra* VI.

- a security *exempted* from the registration and other provisions of the 1933 Act, but nevertheless subject to the anti-fraud provisions and broker-dealer requirements of the federal securities laws, or
- an instrument *excluded* from the definition of “security” under Section 2(a)(1) and therefore not subject to any (including the anti-fraud) provisions of the federal securities laws.

A second question arises whether the SEC could influence state suitability standards by influencing FINRA suitability standards on which the NAIC’s suitability standards are based.⁵³

B. SEC Regulation Through Anti-Fraud and Broker-Dealer Provisions

1. Applicable Law

Section 3(a) of the 1933 Act is captioned “Exempted Securities” and provides that “the provisions of [the 1933 Act] shall not apply to any of the . . . classes of securities” referred to in the Section, “except as hereinafter expressly provided.”

The anti-fraud provisions of Sections 12(a)(2) and 17(a) expressly apply to exempted securities.⁵⁴ Consequently, Section 3(a)(8) can be read to provide that insurance and annuity products falling within its parameters are securities exempted from the 1933 Act, including registration, but subject to the anti-fraud provisions.

a. Section 12

Section 12 is entitled “Civil Liabilities Arising in Connection with Prospectuses and Communications.”

⁵³ This is, of course, in addition to the possibility that the SEC may *directly* influence state regulation of the marketing of indexed and other products, *e.g.*, through what Chairman Schapiro referred to as “assistance” to state regulators as discussed *supra* I.D.

⁵⁴ The SEC has said:

The fraud provisions of sections 12(2) [now, 12(a)(2)] and 17 of the [1933] Act (15 U.S.C.) 771(2) and 779) are specifically made applicable to instruments exempted by section 3.

SEC Rule 151 Proposing Release, *supra* note 20, at 14 n.25.

Section 12(a)(2)⁵⁵ provides that any person who offers or sells a security – “whether or not exempted by the provisions of Section 3” – in interstate commerce and by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made not misleading, shall be liable to the person purchasing the security. Section 2(a)(10), generally and as applicable here, defines “prospectus” to mean any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale.

Section 12(a)(2) provides that the purchaser has the right to recover (i) the consideration paid for the security with interest, less the amount of any income received thereon, upon the tender of the security, or (ii) damages if the purchaser no longer owns the security.

b. Section 17

Section 17 is entitled “Fraudulent Interstate Transactions.”

Sections 17(a) and (c)⁵⁶ read together makes it unlawful for any person in the offer or sale of any securities – including securities subject to the “exemptions

⁵⁵ Section 12(a)(2), with emphasis added, provides as follows:

Any person who:

* * * *

(2) Offers or sells a security (*whether or not exempted by the provisions of Section 3*, other than paragraphs (2) and (14) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

⁵⁶ Section 17(a) provides as follows:

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in Section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly –

- (1) To employ any device, scheme, or artifice to defraud, or
- (2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

provided in Section 3” – in interstate commerce, directly or indirectly, to employ any device, scheme or artifice to defraud, make any untrue or misleading statement, or engage in any transaction, practice or course of business that operates as a fraud or deceit on the purchaser.

c. Rights of Action

So, if indexed annuities (or other insurance products) are *exempted* securities, they would be subject to the foregoing anti-fraud provisions. But if indexed annuities (or other insurance products) are *excluded* from the definition of “securities,” they would not be.

The SEC, of course, could conceivably decide to bring actions under the foregoing sections.

In addition, Section 12(a)(2) expressly provides for a private right of action.

Unlike Section 12(a)(2), Section 17 does not expressly provide for a private right of action. The courts of appeal are split on whether a private right of action lies under Section 17(a).⁵⁷

d. 1934 Act Provisions

The Harkin Amendment refers expressly to the 1933 Act and not to the 1934 Act. Accordingly, this Outline focuses on the Harkin Amendment’s impact in the context of the 1933 Act. However, the Harkin Amendment also raises questions regarding its impact in the context of the 1934 Act and, consequently, in the context of FINRA rules. For example, would the anti-fraud provisions of Section 10(b) of, and Rule 10b-5 under, the 1934 Act apply and would products covered by

Section 17(c), with emphasis added, provides as follows:

The *exemption provided in Section 3 shall not apply* to the provisions of this section.

⁵⁷ A recent law review article summarizes the uncertain legal situation as follows:

Although similar in language to Section 10 of the Securities Exchange Act of 1934 (“1934 Act”), see § 10, 48 Stat. at 891, lower federal courts are split as to whether or not there is an implied private right of action for violations of Section 17(a) of the 1933 Act, Securities Act of 1933, Pub. L. No. 73-22, tit. I, § 17, 48 Stat. 74, 84-85 (codified as amended at 15 U.S.C. § 77q (2006)). The United States Supreme Court has yet to address the issue. For a thorough examination of the legislative history surrounding the Acts, as well as an argument as to why there is no private right of action, see *CPC Int’l, Inc. v. McKesson Corp.*, 514 N.E.2d 116 (N.Y. 1987). But see, e.g., *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978), cert. denied, 442 U.S. 909 (1979) (holding that a private cause of action does exist under section 17(a)). See also Choudhary, *supra* note 18, at 35-44 (examining potential federal causes of action for ARS investors).

Stephanie Myers, *Blue Skies Ahead: Auction Rate Securities and the Need For a Private Right of Action For New York Investors*, 30 Pace L. Rev. 1109, 1121 n.73 (2010).

the Harkin Amendment be required to be offered and sold through registered broker-dealers?

If indexed annuities (or other insurance products) are exempted securities, the question arises whether such products would have to be sold through SEC-registered broker-dealers and would be subject to the anti-fraud provisions under the 1934 Act. This is because the literal terms of Section 3(a)(8) and the Harkin Amendment do not provide an exemption from any 1934 Act requirements, and there is no exemption under the 1934 Act that is analogous to Section 3(a)(8). See Section 3(a)(12) of the 1934 Act and FINRA Rule 0150.

However, if indexed annuities (or other insurance products) are *excluded* from the definition of “security,” the question arises whether the exclusion would apply for 1934 Act purposes, as well as 1933 Act purposes. If so, the requirement that products be sold through registered broker-dealers and the anti-fraud provisions under the 1934 Act would not apply. See *Malone v. Addison Insurance Marketing, Inc.*, 225 F. Supp. 2d 743 (W.D. Ky 2002) (“In sum, because the American Equity [indexed] annuities at issue are exempt from federal securities laws both under Section 3(a)(8) and Rule 151, there is no legal basis for Plaintiff’s complaints under [Section 10(b) of and Rule 10b-5 under] the Securities and Exchange Act of 1934”); *Berent v. Kemper Corp.*, 973 F.2d 1291 (6th Cir. 1992) (“Insurance policies that come within Section 3(a)(8) are excluded from the anti-fraud provisions of all federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934,” citing precedents).

2. Gloss on Applicable Law

Even though the 1933 Act provides that Section 3(a)(8) is an exemption, the SEC and the Courts have deemed Section 3(a)(8) to be an exclusion. A legal result is that any product falling within Section 3(a)(8) is not subject to the anti-fraud provisions of the federal securities laws.

The basis for deeming Section 3(a)(8) to be an exclusion rather than an exemption lies in the legislative history of the 1933 Act. A House report at the time stated that:

insurance policies are *not to be regarded as securities* subject to the provisions of the [1933] act.⁵⁸

The U.S. Supreme Court has referred to this legislative history in stating that insurance products under Section 3(a)(8) are not securities, as follows:

Congress specifically stated that “insurance policies are *not to be regarded as securities* subject to the provisions of the act,” H.R.Rep.

⁵⁸ H.R.Rep. No. 85, 73d Cong., 1st Sess., 15 (1933) (emphasis added).

No. 85, 73d Cong., 1st Sess., 15 (1933), and the exemption from registration for insurance policies was clearly supererogation.⁵⁹

Thereafter, the SEC has made several statements to the effect that Section 3(a)(8) is an exclusion rather than an exemption.

The SEC, for example, stated, in the context of excess interest or declared rate annuities, as follows:

In the Commission's view, there can be no serious question that Congress intended any insurance contract (including any annuity contract or optional annuity contract) falling within section 3(a)(8) of the Act to be ***excluded from all provisions of the Act***, notwithstanding the plain language of the Act that section 3(a)(8) is an "exemption" from the registration but not the antifraud provisions.⁶⁰

The District Court, in the *Otto v. VALIC* case, stated:

Indeed, although the statute refers to insurance policies and annuities as "exempted securities," they are probably more accurately considered ***not to be securities*** at all.⁶¹

The SEC has also stated its view in the context of indexed annuities, pointing out:

The Commission has previously stated its view that Congress intended any insurance contract falling within Section 3(a)(8) to be ***excluded*** from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an ***exemption*** from the registration but not the antifraud provisions.⁶²

3. Breadth of Harkin Amendment

It is not clear whether the Harkin Amendment fits into the interpretive gloss addressed in 1. and 2., immediately above.

Former SEC Chairman Christopher Cox seems to view the Harkin Amendment as having the effect of rendering the products covered as excluded, rather than exempted,

⁵⁹ *Tcherepnin v. Knight*, 389 U.S. 332, 342 n.30 (1967) (emphasis added).

⁶⁰ Rule 151 Proposing Release, *supra* note 20, at 14 (footnote omitted; emphasis added).

⁶¹ *Otto v. VALIC*, 611 F. Supp. 83, 84 n.1 (D.C. Ill. 1985) (emphasis added). The brief of the United States to the U.S. Supreme Court to support a petition for certiorari in that case, 486 U.S. 1026 (1988), called attention to the District Court's opinion.

⁶² SEC Rule 151A Proposing Release, *supra* note 1, at 17 n.27 (emphasis added); *see* virtually the same language in Report to SEC of SEC Staff Life Settlements Task Force at 21 n.88 (July 22, 2010) (emphasis added).

securities. In his letter to the editors of the Wall Street Journal, he stated that indexed annuities would not be subject to antifraud protections, as follows:

Sales people whose securities licenses have been revoked, and even some who have been convicted of criminal securities fraud, are free to resurface in “insurance” sales and push these products *without* the full and fair disclosure, *antifraud protections* and suitability requirements which investors get under the securities laws.⁶³

C. SEC Regulation Through Influencing State Suitability Laws

1. SEC Influence of FINRA

The SEC conceivably can influence the NAIC Suitability in Annuity Transactions Model Regulation (“Suitability Regulation”) and even the suitability laws of individual states through FINRA. This influence would be indirect and tenuous. Nevertheless there may be a path for the SEC to influence state insurance law in this regard.

The history of the Suitability Regulation shows that the NAIC adopted the revised 2010 Regulation to provide for suitability standards consistent with those of FINRA. The statement was made that the Suitability Regulation was adopted to:

where feasible and rational, to make these suitability standards *consistent* with the suitability standards imposed by the Financial Industry regulatory Authority (*FINRA*).⁶⁴

FINRA, of course, is subject to the oversight of the SEC. It possibly follows that the SEC could influence FINRA’s suitability rules with a view toward influencing the Suitability Regulation and the suitability laws of individual states.

2. Analysis of NAIC Suitability in Annuity Transaction Model

The following is a summary of, and comment on, certain provisions of the 2010 NAIC Model Suitability in Annuity Transaction Model (“Model”).

⁶³ Christopher Cox, former SEC Chairman, Letter to the Editor, Wall St. J., July 27, 2010 (emphasis added) [hereinafter Cox Letter to Editor]. See table entitled “Former SEC Chairman Cox Versus the Wall Street Journal,” *supra* II.

⁶⁴ Thomas R. Sullivan and Adam Hamm, Revised Executive Summary regarding the Suitability in Annuity Transactions Model Regulation (undated) (emphasis added). At the time, Mr. Sullivan was the insurance commissioner of Connecticut, and Mr. Hamm was the insurance commissioner of North Dakota, and they were the respective chair and vice chair of the Life Insurance and Annuities (A) Committee of the NAIC.

a. Basic Duty

An insurance producer or insurer (“seller”) must have reasonable grounds for believing that the recommendation to buy or exchange an annuity is suitable for the consumer (“suitability duty”).

This requirement is couched in relative terms of what the seller *believes* is suitable, rather than absolute terms of what *is* suitable. However, the Model goes on to provide for insurer review of each recommendation. *See h.*, below.

b. Suitability Belief

The seller’s suitability belief must be based on facts disclosed by the consumer as to the consumer’s (i) investments and other insurance products and (ii) financial situation and needs (including “suitability information” as defined by the Model).

This provision has the possible drawback of (i) permitting the seller to rely only on a consumer’s *oral* disclosure but (ii) not requiring the seller to obtain *written* documentation (bank statements, brokers statements, etc.). However, the *insurer* is required to maintain procedures to review each recommendation and detect those that are not suitable. These procedures may, but are not required to, include such processes as confirmation of consumer suitability information, interviews and confirmation letters. *See h.*, below.

c. Suitability Information

The Model defines “suitability information” to include: age; annual income; financial situation and needs, including financial resources used to buy the annuity; financial experience, objectives and time horizon; intended use of the annuity existing assets, including investment and life insurance holdings; liquidity needs, liquid net worth, risk tolerance, and tax status.

This provision has the possible drawback of requiring the seller to consider the consumer’s (i) “financial experience,” but (ii) not – to the extent it can be distinguished – the consumer’s level of financial sophistication.

d. Suitability Scope

The seller’s suitability belief must relate specifically to: (i) the particular annuity as a whole, (ii) the underlying subaccounts to which the consumer’s purchase payments are allocated, (iii) riders and similar product enhancements, and (iv) in the case of an exchange or replacement, the transaction as a whole for the particular consumer.

This provision has the possible drawback of relating to the suitability of the underlying subaccounts (i) only “at the time of purchase or exchange” and (ii) not at other times when the consumer transfers between or among subaccounts.

e. Consumer Benefit

The suitability belief includes the belief that the consumer would benefit from certain features of the annuity, such as tax-deferred growth, annuitization or death or living benefit.

Query what is or will be the standard for establishing the seller's belief of a benefit.

f. Disclosure

The seller's suitability belief includes the belief that the consumer has been reasonably informed of various features of the annuity, such as the (i) potential surrender period and surrender charge, (ii) potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity, (iii) mortality and expense fees, (iv) investment advisory fees, (v) potential charges for and features of riders, (vi) limitations on interest returns, insurance and investment components, and (vii) market risk.

Query whether the disclosure requirements of the Model protect the consumer to the same extent as would the disclosure requirements of the 1933 Act.

g. Exchanges

The suitability belief, in the case of an exchange or replacement, must take into consideration whether the consumer (i) will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death or living benefits), or be subject to increased fees, investment advisory fees or charges for riders and similar product enhancements, (ii) would benefit from product enhancements and improvement, and (iii) has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 36 months.

Again, query the standard for establishing the seller's belief of a benefit.

h. Allocation of Duties

The insurance producer has the suitability duty. If there is no insurance producer, the insurer has the suitability duty.

This means that, where an insurance producer is involved, the insurance producer, and not the insurer, has the *primary* duty to have a reasonable belief of suitability.

However, the insurer has *secondary* duties to maintain procedures to (i) review each recommendation prior to issuance of an annuity, (ii) detect recommendations that are not suitable, and (iii) assess the effectiveness of the supervision system annually. The review procedures may apply a screening system for the purpose of

identifying selected transactions for additional review based on selection criteria. The detection procedures may, but are not required to, include confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters and programs of internal monitoring. The assessment process must provide for a report to senior management, including senior management responsible for audit function, detailing the assessment review, with appropriate testing.

The insurer also has *secondary* duties to establish a supervisory system reasonably designed to achieve compliance by insurance producers, including informing, training, providing training manuals to, and requiring compliance by, insurance producers.

The Model identifies certain procedures that could benefit the consumer, but does not *require* the insurer to adopt the procedures.

VI. IS THERE SOME WAY THE SEC CAN STILL REGULATE THE DISCLOSURE OF INDEXED AND OTHER EXEMPTED FIXED PRODUCTS?

The SEC might be able to influence the disclosure⁶⁵ of indexed and other exempted fixed products through its authority to regulate disclosure of combination annuities with an indexed investment option and of point-of-sale investment product materials. Looking further out, query whether the Federal Insurance Office will address the question of disclosure in these regards.

A. Question Raised

The SEC has authority now to regulate some degree of disclosure in the marketing of indexed products and excess interest or declared-rate products excluded from regulation under the Harkin Amendment.

This authority is not articulated in express terms of indexed and excess interest or declared rate products, but rather arises in connection with more general SEC authority, as set out below.

The question arises whether, and to what extent, the SEC will exercise this authority.

B. Assisting State Insurance Commissioners

The SEC has said that it would offer to work with the states in their regulation of indexed products.

As noted above, Chairman Schapiro testified⁶⁶ before Congress shortly after the Dodd-Frank Bill became law. She testified that the SEC was “very happy to work with the state insurance commissioners . . . to see if we can be of assistance to them” and “will try to be helpful to them in this process.”

The SEC has not announced publicly how it will “be of assistance” and “helpful” to the state insurance commissioners. Conversely, the state insurance commissioners have not stated publicly whether and to what extent they would accept assistance and help from the SEC.

⁶⁵ The potential disclosure regulation discussed below is in addition to the disclosure aspects of the potential marketing regulation discussed *supra* V.

⁶⁶ Chairman Schapiro’s testimony is set out and cited *supra* I.D.2.

C. Prospectus Disclosure of Index Investment Options

On information and belief, the SEC staff has requested or encouraged further disclosure regarding unregistered indexed investment options under registered combination variable annuity contracts.

Traditionally, the SEC staff has required that prospectuses related to combination variable annuity contracts set out a statement that the SEC staff has not reviewed prospectus disclosure regarding fixed investment options.

However, there is some indication that the SEC staff may request or, at least, encourage: (i) further disclosure, outside of a prospectus, regarding an unregistered indexed investment option; (ii) prospectus reference to such disclosure; and (iii) delivery of such disclosure with the prospectus.

D. Broker-Dealer Disclosure

The SEC, under the Dodd-Frank Act, may have authority to regulate point-of-sale disclosure for indexed products⁶⁷ offered and sold by SEC-registered broker-dealers, even if broker-dealer registration is not necessarily a prerequisite to sell a product in question. However, the SEC's authority depends on an interpretive issue.

1. SEC Rulemaking Authority

Section 919 of the Dodd-Frank Act clarifies the SEC's authority to require investor disclosures before purchase of investment products and services. The Act authorizes the SEC to adopt rules designating disclosure documents or information. It grants this authority to the SEC notwithstanding any other provision of the federal securities laws.

The Section provides as follows:

Notwithstanding any other provision of the securities laws, the Commission may issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an *investment product or service* by the retail investor.

The Dodd-Frank Act does not require the SEC to conduct and publish a study prior to adopting point-of-sale disclosure rules. However, the Act does require the SEC to consider whether the rules will promote investor protection, efficiency, competition and capital formation.

⁶⁷ This section of the Outline is drafted in terms of indexed products, but applies to other products that the Harkin Amendment exempts.

2. “Investment Product or Service”

The SEC would have authority to designate disclosure documents or information for indexed products if indexed products were deemed to be an “investment product or service.” The Act does not define the term “investment product or service.” Therefore, it is not clear whether the SEC has authority to designate point-of-sale disclosure documents or information for indexed products.

There are, of course, arguments against interpreting the term “investment product or service” to include an indexed product, such as the following. First, the Harkin Amendment reflects a Congressional intention that the SEC not regulate indexed products. Second, where Congress intended the Dodd-Frank Act to apply to fixed insurance products, the Act does not use the term “investment product,” but rather “financial product.”⁶⁸

On the other hand, there are arguments supporting the interpretation of the term “investment product or service” to include indexed products, such as the following. First, if Congress had intended indexed products to be excluded, the Dodd-Frank Act could have referred to fixed insurance products as it does elsewhere.⁶⁹ Second, the Court in the *American Equity* case held that the SEC was reasonable in determining that indexed products fell outside the references to insurance products in Section 3(a)(8).

The authority granted to the SEC, although not a tight fit, could be deemed to apply to indexed products. The authority granted is to designate that documents or information:

- be in summary format
- contain clear and concise information about
 - investment objectives, strategies, cost, and risks; and
 - any compensation or other financial incentive received by a broker, dealer, or other intermediary in connection with the purchase of retail investment products.

3. SEC View

The SEC has made statements to the effect that it considers indexed annuities to be investment products.

⁶⁸ See Section 989A(a)(2) of the Dodd-Frank Act which defines the term “financial product” to mean, with emphasis added, “a security, an *insurance* product (including an insurance product that pays a *return*, whether *fixed* or variable), a bank product, and a loan product.”

⁶⁹ *Id.* In addition, Section 989A (e)(1)(B) and (C), refer, respectively, to “insurance products” and “annuities.”

For example, the SEC, in adopting Rule 151A, stated as follows:

The very nature of an indexed annuity, where return is contractually linked to the return on a securities index, is, to a very substantial extent, *designed* to appeal to purchasers on the prospect of *investment* growth.⁷⁰

The SEC further stated that it believes that purchasers “buy indexed annuities on the basis of the prospect for *investment* growth.”⁷¹

The SEC based these statements on pronouncements that the U.S. Supreme Court has made that non-traditional annuities involve investment aspects. The SEC noted as follows:

In *United Benefit*, the U.S. Supreme Court, in holding an annuity to be outside the scope of Section 3(a)(8), found significant the fact that the contract was “considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of ‘growth’ through sound *investment* management.”⁷²

The SEC also referred to Justice Brennan’s concurring opinion in *VALIC* stating that, while annuities were exempted from the 1933 Act under Section 3(a)(8), they were investment products, as follows:

Thus, Congress exempted these instruments from the requirements of the federal securities laws, because they were a “**form of ‘investment’** . . . which did not present very squarely the problems that [the federal securities laws] were devised to deal with.”⁷³

More recently, former SEC Chairman Christopher Cox seemed to view indexed annuities as “investment products.” In his letter to the editors of the Wall Street Journal, he refers to purchasers as “investors” and their stake in the annuities as “their investment,” and downplays the insurance aspects of the annuities by putting the words “guaranteed” and “insurance” in quotation marks, as follows:

Investors with only a few years to live – and to whom these products are often peddled – can lose a big part of their *investment* in these “*guaranteed*” products because of the huge (and often inadequately disclosed) penalties they must pay to get their money when they need

⁷⁰ SEC Rule 151A Adopting Release, *supra* note 17, at 35-36 (footnote omitted; emphasis added).

⁷¹ *Id.* at 36 (footnote omitted; emphasis added).

⁷² *Id.* at 18 (emphasis added), citing *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967).

⁷³ *Id.* at 23-24 (emphasis added), citing *SEC v. VALIC*, 359 U.S. 69, 71 (1959).

it. Sales people whose securities licenses have been revoked, and even some who have been convicted of criminal securities fraud, are free to resurface in “*insurance*” sales and push these products without the full and fair disclosure, antifraud protections and suitability requirements which investors get under the securities laws.⁷⁴

E. Establishment of the Federal Insurance Office

Title V., Section 502, of the Dodd-Frank Act creates a new Federal Insurance Office (“FIO”) within the Treasury Department.

As noted in II.,D.,3., above, the FIO will: (i) monitor the U.S. insurance industry, (ii) coordinate federal efforts and policy relating to international insurance matters, (iii) determine which state insurance measures are preempted by international agreements, (iv) report to Congress annually on the state of the insurance industry, and (v) identify insurers that could pose a threat to financial stability.

The FIO has authority over all lines of insurance, except health, long-term care and crop insurance. The FIO Director will have the authority to determine when state insurance measures are inconsistent with international agreements relating to prudential measures for insurance or reinsurance. Additionally, the Act contains reforms to nonadmitted insurance and reinsurance.

Of particular relevance here is the fact that the Dodd-Frank Act requires the FIO Director to conduct a study within 18 months after the passage of the Act on how to modernize and improve the system of insurance regulation in the United States. The study is to explore the possibility of subjecting insurance (other than health insurance) to federal regulation and the impact that federal regulation could have on the operation of state guarantee funds, policyholder protection, the possible loss of life insurance special separate account status, and the international competitiveness of insurance companies.

⁷⁴ Cox Letter to Editor, *supra* note 63 (emphasis added). See table entitled “Former SEC Chairman Cox Versus the Wall Street Journal,” *supra* II.

VII. IS THERE SOME WAY THAT FINRA CAN REGULATE INDEXED AND OTHER EXEMPTED FIXED PRODUCTS?

FINRA has attempted to “regulate” indexed annuities sold through member broker-dealers through two concepts: outside business activities and use of proceeds or source of income. Query whether FINRA will continue to do so after the Harkin Amendment.

A. Question Raised

There is an argument against FINRA’s⁷⁵ having authority to regulate the offer and sale of indexed and other exempted fixed products by broker-dealers. The argument is that FINRA is a self-regulatory body, but subject to SEC oversight. It arguably follows that, if the Harkin Amendment mandates that the SEC treat indexed and other products as *excluded* securities, the Amendment mandates that FINRA do the same.⁷⁶

On the other hand, FINRA has asserted itself regarding the role of associated persons of member registered broker-dealers in offering and selling indexed products.

B. Outside Business Activity

FINRA has attempted to assert some degree of regulation over the offer and sale of indexed products through its regulation of member registered broker-dealers, notwithstanding that the products might be covered by the Section 3(a)(8) exclusion.

1. NASD Rule

NASD Rule 3030 requires, in effect, that an associated person of a registered broker-dealer and FINRA member report that person’s offer and sale of indexed products outside the business activity of the broker-dealer. The Rule provides as follows:

No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt *written notice to the member*. Such notice shall be in the form required by the member.

⁷⁵ A predecessor of FINRA was the National Association of Securities Dealers, Inc., and the discussion below refers to the history of NASD regulation during the periods cited.

⁷⁶ On the other hand, if an indexed annuity or other insurance product was deemed to be merely *exempt* from most of the provisions of the 1933 Act, FINRA would have direct jurisdiction over those products. See *supra* V.A., and B.

The NASD, as described below, has pointed out to its member that a broker-dealer's compliance with Rule 3030 could involve such approaches as a broker-dealer's requirement that an associated person:

- get the broker-dealer's prior approval to sell indexed products, and/or
- offer and sell only indexed products that the broker-dealer has vetted and placed on an improved product list.

2. Historical Context

The history set out below, of course, covers a period when the status of an indexed product under Section 3(a)(8) was uncertain. However, the history would still seem to be relevant even for those products that the Harkin Amendment has now mandated that the SEC (and, presumably, FINRA) treat indexed products as insurance and not securities.

The NASD, in August 2005, issued a notice⁷⁷ to its members addressing members' responsibilities for supervising sales of unregistered indexed annuities, in which the NASD referred to indexed annuities as "equity-indexed annuities," or "EIAs."

The Notice described the principal features of indexed annuities, and characterized them as "complex investments."⁷⁸

The Notice expressed the NASD's concern "about the manner in which associated persons are marketing and selling unregistered EIAs, and the absence of adequate supervision of these sales practices." One NASD concern was "sales material for unregistered EIAs that do [sic] not fully describe the features and risks of the product" and, therefore, "could confuse or mislead investors." Another NASD concern was that, "because of the product's complexity, some associated persons might have difficulty understanding all of the features of the product and determining the extent to which those features meet the needs of the customer."

⁷⁷ NASD Notice to Members 05-50, Equity-Indexed Annuities, Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities (Aug. 2005) [hereinafter NASD Notice to Members 05-50]. All quotations in this section of the Outline are from the cited Notice, some with emphasis added.

⁷⁸ *Id.* The Notice set out a discussion of the status issue. The Notice first stated as follows:

Some EIAs are not registered under the Securities Act of 1933 . . . based on a determination that they are insurance products that fall within that statute's Section 3(a)(8) exemption and therefore are not considered to be securities.

This statement was somewhat misleading, because it could be read to say that more indexed annuities were registered than not registered. The fact was that virtually all indexed annuities were not registered and only a handful of indexed annuities were registered.

The Notice went on to refer to the definition of "security" in Section 2(a)(1) of the 1933 Act and the exemption from the definition for insurance and annuity contracts in Section 3(a)(8). The Notice also referred to Rule 151, summarized its provisions and explained that the Rule is "relevant to any Section 3(a)(8) analysis."

The Notice then stated that “[m]any firms assume that EIAs that are not registered under the Securities Act are insurance products and not securities” and “treat the sale of unregistered EIAs by associated persons in their capacity as insurance agents as an outside business activity under Rule 3030, beyond the mandated purview of the firm’s supervision.” The Notice stated that “[a] broker-dealer runs certain risks in applying Rule 3030 to the sale of an unregistered EIA on the assumption that the product is not a security . . . , [because] [i]t is often unclear whether a particular EIA qualifies for the exemption under Section 3(a)(8), since the analysis is made on a case-by-case basis and may turn on the particular features and marketing materials associated with the product.” The Notice warned that “if a particular EIA did not qualify for the exemption, a firm might incorrectly treat the EIA transaction as an outside business activity under Rule 3030 rather than a private securities transaction under Rule 3040 and thereby fail to supervise sales of the product as required by NASD rules.”

The Notice concluded that, “[p]erhaps for these reasons,” some firms:

- require that associated persons obtain firm approval to sell exempt insurance products;
- require that their associated persons obtain more specific approval to sell unregistered indexed annuities; or
- maintain a list of approved indexed annuities and prohibit the sale of all others.

3. Current Situation

FINRA has not made any public statement regarding the impact of the *American Equity* opinion and the Harkin Amendment on its historical position.

A recent report refers to the issue raised as follows:

But a Financial Industry Regulatory Authority notice that was issued in 2005 has led broker-dealers to continue to exercise tougher oversight of sales of indexed annuities products than is warranted in light of Dodd-Frank and the appeals court decision, according to sources.⁷⁹

C. Use of Proceeds

FINRA also has attempted to assert some degree of regulation over the offer and sale of indexed products through its regulation of recommendations of member registered broker-dealers to sell securities to buy other products.

⁷⁹ Peter Ortiz, *Finra [sic] Notice Hampers Indexed Annuity Sales: Providers*, Ignites, September 9, 2010.

This approach is sometimes referred to as “use of proceeds” or “source of funds.” FINRA has followed this approach notwithstanding that the indexed annuities might be covered by the Section 3(a)(8) exclusion.

1. NASD Assertion of Jurisdiction

The NASD had asserted some degree of jurisdiction over indexed annuities in an indirect manner. The NASD asserted jurisdiction over the use of proceeds from a customer’s sale of registered securities to buy indexed annuities based on the following rationale:

[A]ll recommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender [sic] are for the purpose of funding the purchase of an unregistered EIA.

The financial press had reported this development as follows:

Not waiting around to find out whether equity-indexed annuities will ever be labeled a security, Wall Street enforcers are zeroing in on sales of these increasingly popular investment products.

Saying it’s particularly “troubled” by brokers aggressively moving customers from investment securities to these instruments, the National Association of Securities Dealers is probing situations where brokers appear to be pushing transactions that it believes are “unsuitable” for clients.

In essence, the NASD is asserting its authority by looking at both sides of the transaction, even though the customer’s purchase of the equity-indexed product may or may not be a security.⁸⁰

The NASD had indicated what it might deem to be an unsuitable use of proceeds from the sale of a registered security, as follows:

Importantly, I should point out here that we’re committed to making sure investors get a fair shake when they buy EIAs, despite our limited jurisdiction. Last August, we advised our 5,200 member firms that they would do well to treat EIAs as securities, even though it’s not clear that they are. And we’re investigating some situations where

⁸⁰ “Regulators Target Equity-Indexed Annuities,” Financial Advisor Magazine (Sept. 23, 2005).

brokers *switched older investors from variable annuities into EIAs* with high costs and long surrender periods.⁸¹

An industry publication has described and analyzed the matter, in terms of investment advisers rather than broker-dealers, as follows:

The next big issue to face our industry is called “Source of Funds”. [sic] Source of Funds [sic] means where are you getting the money to put into the annuity? There are many options that insurance agents use to fund annuities. They range from CDs, cash, replacements of existing annuities (both variable and fixed), mutual funds, stocks, bonds, brokerage accounts, and others. There is no issue with insurance agents using non-securities related products to fund annuity contracts. The issue arises from non-securities licensed individuals liquidating securities to fund fixed annuity contracts.

The Investment Advisory [sic] Act of 1940 states the following three things:

- You recommend the buying or selling of a securities product.
- You do it on a regular basis.
- You make a commission.

Agents in the fixed annuity world have always stated they were not giving securities advice because they didn’t make a commission when someone liquidated their [sic] mutual fund, so they didn’t qualify under all three statements. Today many states and regulators have developed the opinion that when an insurance agent makes a commission from selling a fixed annuity with the proceeds of a securities transaction, they [sic] are in fact being compensated and therefore deemed to be giving securities advice. Not all states view these transactions as giving unregistered securities advice, but more and more states are adopting this line of thinking.

In September 2009, The [sic] Arkansas Insurance Department issued Bulletin Number 14-2009 to all licensed life and health insurance producers and other groups. The subject was sales or investment advice related to securities products by insurance producers. To summarize: “The recommendation to replace securities such as mutual funds, stocks, bonds, and various other investment vehicles defined as securities under the Arkansas Securities Act is the offering

⁸¹ Speech by Robert Glauber, Chairman and Chief Executive Officer, NASD, NASAA Enforcement Conference, Miami Beach, Fl. (Jan. 9, 2006) (emphasis added) [hereinafter Glauber Miami Beach speech].

of investment advice. It is unlawful to offer investment advice unless one is registered with the Arkansas Securities Department as an investment adviser or investment advisor [sic] representative. The insurance and securities commissioner [sic] intend to take action against insurance producers who improperly engage in transactions involving securities. This includes, but is not limited to, an order for cease and desist of your business and fines up [sic] \$20,000 per violation.”

In short, if the regulation continues down the path we see today, fixed annuity producers will be required to have some form of securities license to produce index annuity business and not be limited in how you will fund the policy. If you don't become securities licensed, regulators could limit your funding options to cash, CDs, or 1035's from existing fixed annuity contracts.⁸²

2. Court Pronouncement

It is beyond the scope of this Outline to discuss the validity of FINRA regulation of indexed products through regulation of use of proceeds or source of funds.

So, the author simply notes, in passing, that, in the context of Rule 10b-5 under the 1934 Act, one federal district court has stated that “the actual source of funds is not determinative of 10b-5 standing. . . . The crux of a Rule 10b-5 violation is fraud in connection with the purchase or sale of a security.”⁸³

⁸² Anthony Compton, *The Aftermath of 151A – What's next for annuity advisors?*,” 2-4 (emphasis in original), avail. July, 2010 from Gradient Ins. Brokerage, Inc., at (800) 407-4137. Mr. Compton is President of Gradient Ins. Brokerage, Inc.

⁸³ *Medline Industries, Inc. Employee Profit Sharing and Retirement Trust v. Blunt, Ellis, & Loewi, Inc.*, 1993 WL 13436 at 2 (N.D. Ill. Jan. 21, 1993); *see also* *Seippel v. Sidley, Austin, Brown, & Wood LLP*, 399 F.Supp. 2d 283 (S.D.N.Y. June 16, 2005).

**VIII. WHAT IS THE LIKELIHOOD THAT THE SEC WILL EXERCISE
ANY AUTHORITY TO REGULATE INDEXED AND
OTHER COVERED FIXED PRODUCTS**

Public statements by SEC Chairman Schapiro suggest that she may be inclined to exercise whatever authority the SEC still has to “regulate” indexed products. Three other Commissioners would seem to be inclined to support the Chairman. On the other hand, Commissioner Paredes dissented from the adoption of Rule 151A and could oppose the exercise of any such authority.

A. Question Raised

To the extent that the SEC has any authority, however marginal or indirect, in the regulation of indexed annuities and other products that may be covered by the Harkin Amendment, how likely is it that the SEC will take a proactive or passive approach?

B. SEC Chairman Congressional Testimony

SEC Chairman Schapiro testified⁸⁴ before a Congressional committee in July and made what some observers have viewed as equivocal statements.

On the one hand, she flatly stated that “we don’t have any plans to re-engage on this issue, given the legislation.”

On the other hand, she stated that “we’re very happy to work with the state insurance commissioners” and “will try to be helpful to them in this process.”

Perhaps more significantly, Chairman Schapiro stated that, so far as marketing and disclosure are concerned, “there are concerns, and I’ve had these for many years, about how equity-indexed annuities are sold.”

C. SEC Commissioners

Of the current five Commissioners, all but Chairman Schapiro participated in the adoption of Rule 151A at a Commission meeting on December 17, 2008. Three of the four Commissioners, Kathleen L. Casey, Luis A. Aguilar and Elisse B. Walter, voted for adoption of the Rule, but Commissioner Troy A. Paredes dissented.⁸⁵

⁸⁴ Chairman Schapiro’s complete testimony in this regard is set out *supra* I.D.2.

⁸⁵ SEC Commissioner Paredes’ dissent, SEC Rule 151A Adopting Release, *supra* note 17, at 3175-76 [hereinafter Commissioner Paredes’ Dissent].

Chairman Schapiro is formerly of FINRA and, before FINRA, the NASD. Another new Commissioner, Elise Walter, is also formerly of FINRA.

Chairman Schapiro and Commissioner Paredes may represent two contending positions regarding the SEC's exercise of any remaining authority to regulate indexed products. Chairman Schapiro, based on the background outlined in D., below, seems more likely to favor such exercise of any authority. Commissioner Paredes, based on the background outlined in E., below, seems more likely to oppose such exercise of any authority, especially any regulation that would overlap or burden state regulation. The other three Commissioners supported then SEC Chairman Cox in the adoption of Rule 151A. So, the Commission's current composition would seem to favor the exercise of any authority the SEC still may have to regulate indexed products, however marginal or indirect.

D. Background of SEC Commissioner Who May Favor SEC Exercise of Any Regulatory Authority

Chairman Schapiro has broad and deep experience and expertise in the area of federal regulation of securities. She served as an SEC Commissioner for almost six years, from December 1988 to October 1994. In 1993, she served as Acting Chairman. She left the SEC to serve as Chairman of the Commodity Futures Trading Commission until 1996. She then joined the NASD in 1996 as President of NASD Regulation, and became Vice Chairman in 2002. About four years later, in 2006, she became the NASD's Chairman and CEO.

During Ms. Schapiro's tenure at the NASD, the NASD mounted an initiative to protect investors against unsuitable sales of indexed annuities.⁸⁶ The NASD strongly encouraged the SEC to harmonize federal regulation of fixed (including indexed) annuities and variable annuities.

In the process, the NASD, however well-intentioned its objective, made what some industry observers believe are certain inaccurate, incomplete and/or unnecessarily provocative statements. Statements made by Ms. Schapiro are quoted in 2., below.

1. Harmonizing Regulation of Annuities

The NASD had pursued a goal of harmonizing the regulation of variable and fixed annuities, including indexed annuities. The NASD had described its goal, in a number of separate statements, aggregated here as follows:

Why should brokers have to follow one set of rules when they sell fixed annuities, another when they sell variable annuities and yet another when they sell equity-indexed annuities? And why should investors

⁸⁶ The NASD's regulatory efforts regarding outside business activities and use of proceeds (or source of funds) are addressed *supra* VII.

receive one level of protection for one of these products and a different level for another?⁸⁷

What the three annuity types do have in common is that they are arguably among the most complicated retail investment products out there. And they are frequently marketed to senior citizens, to whom they all look very much the same. And why shouldn't they? Annuities really are one product that's been carved in thirds for regulatory purposes. That may be OK for regulators, but it's a bum deal for investors, who have every right to expect the same degree of protection when they buy what they think is the same product. An investor shouldn't get one level of disclosure and protection if he's looking at a fixed annuity, another level if he's looking at a variable annuity, and yet another if he's looking at an EIA. It is simply not fair to investors that the level of disclosure and protection should vary depending on what agency regulates the product.

So what we're proposing is this: a concerted effort by all interested parties to **harmonize the rules** governing sales of these three versions of the same product. And we propose to get the process started with a summit conference, where regulators and senior representatives of the securities and insurance industries can meet to discuss the best ways to level the investor protection playing field among and between these products.⁸⁸

The three annuity types are really three versions of the same product. It simply is not fair to investors that the level of disclosure and protection they receive should vary depending on which agency regulates the version of the product they're buying.⁸⁹

Thus, the degree of protection that investors get when buying annuities is far from equal. For example, sales of variable annuities are covered by extensive suitability rules, but the sales of fixed annuities are not. These disparities are indefensible, and the only way to erase them is for the various regulators to work together on **harmonizing the rules** covering the three annuity types. NASD recently took the first step in

⁸⁷ Glauber Miami Beach speech, *supra* note 81, at 4.

⁸⁸ *Id.* (emphasis added).

⁸⁹ NASD, Minnesota Department of Commerce Annuity Roundtable, Washington, D.C. (May 5, 2006).

this direction by convening a summit meeting of securities and insurance regulators to start discussing how to achieve this goal. The meeting was encouraging and I hope we can all make meaningful progress in the near future. Investors deserve nothing less.⁹⁰

2. NASD Assertion of Jurisdiction

Some industry observers believed that the NASD and its spokespersons, during the course of the NASD's initiative, made certain inaccurate, incomplete and/or unnecessarily provocative statements. These observers wryly noted that the NASD would have objected to these kinds of statements if the statements had appeared in insurer sales materials that the NASD reviewed.

The author found it difficult to document this industry belief definitively. However, certain industry participants in the NASD, Minnesota Department of Commerce Annuity Roundtable publicly took issue with certain statements made by NASD spokespersons. Moreover, the NASD has tacitly corrected or clarified a number of statements by subsequently making other statements on the same points that were more accurate or clearer.

In terms of SEC regulation, the NASD began by, in *effect*, equating indexed annuities with VAs and VLI, where the SEC had determined that VAs and VLI as *categories* were securities under Section 3(a)(8). Later, the NASD changed its position by, in *effect*, equating indexed annuities with excess interest or declared rate annuities, where the SEC had determined that particular products could be annuities under Section 3(a)(8).

Early on, Ms. Schapiro boldly declared that all indexed annuities were securities as follows:

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.⁹¹

However, the NASD, only a few months later, declared a quite different position that was consistent with the SEC's view at the time, as follows:

⁹⁰ Speech by Robert Glauber, Chairman and Chief Executive Officer, NASD, Harvard Business School Global Leadership Forum (June 21, 2006) (emphasis added).

⁹¹ Speech by Mary L. Schapiro, Vice Chairman, NASD President, Regulatory Policy & Oversight, NASD Spring Securities Conference (May 25, 2005) (emphasis added).

The question of whether a *particular* EIA is an insurance product or a security is complicated and *depends upon the particular facts and circumstances* concerning the instrument offered or sold.⁹²

The NASD went on to state in what some industry observers regarded as a *mea culpa* for its spokesperson's having stated that the NASD considers "all" index annuities to be securities, as follows:

NASD does not seek to resolve that [status] issue in this *Notice*; nor is this *Notice* intended to describe those circumstances in which an EIA might be deemed to be a security.⁹³

Indeed, the NASD repeated the point, as follows:

As discussed above, *NASD is not taking a position* on whether a particular EIA is a security, nor are we attempting to describe the circumstances in which an EIA would be deemed a security.⁹⁴

Ms. Schapiro, who originally stated that index annuities were securities, retreated from her statement, but expressed what some observers regarded as an element of frustration in having to do so:

Variable annuity sales compete with equity-indexed and plain vanilla annuities. Variable annuities are securities, *equity-indexed annuities may not be securities, yet the subject of another long and tortuous story*, and plain vanilla annuities are not securities.⁹⁵

Subsequently, the NASD reflected the SEC's view, such as the following:

Depending on the mix of features, an indexed annuity may or may not be a security. The typical indexed annuity is not registered with the SEC.⁹⁶

⁹² NASD Notice to Members 05-50, *supra* note 77, at 3 (emphasis added).

⁹³ *Id.* (emphasis in original).

⁹⁴ *Id.* at 5 (emphasis added).

⁹⁵ Remarks by Mary L. Schapiro, Vice Chairman, NASD President, Regulatory Policy & Oversight, SIA Compliance & Legal Division Annual Conference, Hollywood, FL 8 (March 20, 2006) *available at* <http://www.finra.org/Newsroom/Speeches/Schapiro/P016200> (emphasis added).

⁹⁶ NASD Discussion Paper 3, NASD, Minnesota Department of Commerce Annuity Roundtable, Washington, D.C. (May 5, 2006) (footnote omitted, but including a "see" citation to "Equity Index Annuities, SEC Investor Information," *available at* <http://www.sec.gov/investor/pubs/equityidxannuity.htm>.").

E. Background of SEC Commissioner Who May Oppose SEC Exercise of Any Regulatory Authority

Commissioner Troy A Paredes had been a tenured professor at Washington University School of Law in St. Louis. He taught and researched in the areas of securities regulation and corporate governance. He also taught at the University's business school. Before that, he practiced law at certain national law firms.

Commissioner Paredes has been a co-author of later editions of the well-known and respected securities law treatise, *Securities Regulation*, begun by Harvard Law School Professor Louis Loss. Professor Loss spent several years on the SEC staff. The SEC's library is named after him.

At the SEC meeting adopting Rule 151A, Commissioner Paredes vigorously dissented.⁹⁷ The dissent was highly critical of the adoption of Rule 151A. Essentially, he said that Rule 151A, while "rooted in good intentions," nonetheless exceeded the proper scope of the SEC's statutory authority.

The dissent was wide-ranging.⁹⁸ Many of Commissioner Paredes' points have been overtaken by the Harkin Amendment. Set out below are the points that Commissioner Paredes made that might color his thinking going forward.

1. State Regulation

Commissioner Paredes began by observing that Rule 151A removes from the statutory exemption of Section 3(a)(8) of the 1933 Act indexed annuities that otherwise may be covered by the exemption, thereby placing them under the SEC's jurisdiction. He noted, however, that if the SEC's analysis was wrong, and indexed annuities fell within Section 3(a)(8), "then the SEC has exceeded its authority by seeking to regulate them. In other words, the effect of Rule 151A would be to confer additional authority upon the SEC when these products, in fact, are entitled to the Section 3(a)(8) 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."

⁹⁷ Commissioner Paredes' Dissent, *supra* note 85. All quotations in this section of the Outline are from Commissioner Paredes' dissent.

⁹⁸ A full summary of Commissioner Paredes' Dissent is set out in the author's conference paper, SEC Rule 151A Under the Securities Act of 1933: Aftermath for Analysis of Status of Insurance Company Products Under Section 3(a)(8) of the Act, in ALI-ABA Conference on Life Insurance Company Products, Current SEC, FINRA, Insurance, Tax and ERISA Regulatory and Compliance Issues, Course of Study Materials, at 439, 503-506 (Nov. 2009).

2. “More-Likely-Than-Not” Test

Commissioner Paredes observed that he was not aware of another instance in the federal securities laws where a more-likely-than-not test was employed. He noted that such a test does not provide insurers with “proper notice” of whether their products fall within the ambit of the federal securities laws. In this regard, he noted that an insurer that applies such a test in good faith and gets it “wrong” nonetheless risks being subject to liability under the 1933 Act even if the life insurance company had no intent of violating the federal securities laws.

In addition, Commissioner Paredes noted that under such a test, the availability of the Section 3(a)(8) exemption would turn on the insurer’s own analysis, with the possibility that the same product could receive different treatment by different insurers. Furthermore, Commissioner Paredes expressed concern that in practice, the more-likely-than-not standard of Rule 151A leads to only one result, namely, denial of the Section 3(a)(8) exemption and blanket SEC regulation of the entire indexed annuity industry.

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