



SEC Adopts New Registration Rule for Indexed Annuities and Periodic Reporting Exemption for Certain Insurance Products

December 17, 2008 -- By a vote of 4 to 1, the SEC today adopted new Rule 151A under the Securities Act, which is aimed at removing indexed annuity contracts from the scope of the registration exclusion of Section 3(a)(8) of the Securities Act. The SEC also adopted new Rule 12h-7 under the Exchange Act, which provides issuers of indexed and certain other annuities with an optional exemption from the periodic reporting requirements of the Exchange Act. Commissioner Troy Paredes was the sole dissenter.

Copies of the adopting release were not publicly available as of this writing. Accordingly, the following is based on statements made by the Commissioners and SEC staff at today's open meeting.

RULE 151A

Although the SEC received over 4800 comments on proposed Rule 151A, including many that raised significant legal and practical issues, the SEC offered no new or additional rationale or support in adopting the Rule. Chairman Cox noted in his opening remarks that Rule 151A is a matter of great interest to "senior investors."

Compliance Date: Rule 151A would apply on a prospective basis to index annuity contracts issued on or after **January 12, 2011**. According to the SEC staff, this timeframe would allow for a two-year "transition" period.

Modifications from Proposal: The SEC adopted Rule 151A with three modifications recommended by the SEC staff. First, the SEC limited the application of the Rule to index annuity contracts that specify that:

(1) Amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities.

The underscored language was added to address many commenters' concerns that the Rule, as proposed, was overly broad and would reach traditional fixed annuities and other annuities that are not indexed annuities.

Second, the SEC eliminated the proposed requirement that would have required an issuer to determine not more than three years prior to the date on which a particular contract is issued whether the amounts payable under the contract are more likely than not to exceed the amounts guaranteed under the contract. As adopted, the Rule will only require that such determination be made not more than six months prior to the date on which the form of contract is first offered.

Third, the SEC adopted a modification to permit surrender and other charges to be reflected both in amounts payable and amounts guaranteed in determining whether the former are more likely than not to exceed the latter.

Disclosure, Marketing, and Other Issues: In response to questions from Commissioner Casey regarding disclosure, financial statement presentation, advertising and marketing requirements, and filing fees, Associate Director Susan Nash noted that the Rule provides for a two-year transition period during which the SEC staff would consider how to tailor the disclosure regime and address GAAP versus statutory accounting issues as it had for variable insurance products. Regarding competition, Ms. Nash stated that concerns had been expressed in terms of the regulatory regime being more appropriate for variable insurance products and mutual funds than the regime that would apply to indexed annuities under the Rule, and that that would be "looked at" with a view to putting indexed annuities in "parity" with the sorts of products to which they are similar.

"Sabre Rattling": In response to questions from Commissioner Aguilar, SEC General Counsel Brian Cartwright stated that he had heard some "sabre rattling" from the industry regarding Rule 151A and that as general counsel, he was "very confident" of the SEC's position. Mr. Cartwright stated that there were a "couple of" Supreme Court cases that were "fairly old" that do not directly address these products, and that the SEC's approach was "completely consistent" with those cases. (Mr. Cartwright was presumably referring to the Supreme Court's decisions in *United Benefit* and *VALIC*.)

Commissioner Paredes' Dissent: In a highly critical dissent, Commissioner Troy Paredes expressed the view that Rule 151A, while "rooted in good intentions," nonetheless exceeded the proper scope of the SEC's statutory authority.

Commissioner Paredes began by observing that Rule 151A removes from the statutory exemption of Section 3(a)(8) of the Securities Act indexed annuity contracts 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 is wrong, and indexed annuities fall 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 also expressed the view that the approach of Rule 151A conflicts with both *United Benefit* and *VALIC* and noted that at least one federal court has held that an indexed annuity falls within the Section 3(a)(8) exemption.

Commissioner Paredes next criticized Rule 151A for its "singular focus" on investment risk and failure to adequately consider the "key factor" of how an indexed annuity is marketed. He stated further that he believed that Rule 151A "misconceptualizes" investment risk for purposes of Section 3(a)(8) and observed that the more-likely-than-not test of Rule 151A gives "short shrift" to the insurance guarantees that are a "hallmark of indexed annuities." He also noted that while Rule 151A treats the possibility of upside beyond guaranteed principal and minimum rate of interest as an investment risk for purposes of Section 3(a)(8), he believed it more appropriate to emphasize the extent of downside risk, i.e., risk of loss, in determining the scope of Section 3(a)(8). When investment risk is viewed in terms of risk of loss, according to Commissioner Paredes, it becomes "apparent why indexed annuities may fall within Section 3(a)(8)" and thus beyond the reach of the SEC, contrary to Rule 151A.

Commissioner Paredes next identified three additional legal shortcomings with Rule 151A. First, he observed that the Rule appeared to depart from SEC's own approach taken in its amicus brief in *Otto v. VALIC*, in which the Commission asserted that Section 3(a)(8) applies when a state regulated insurance company assumes a sufficient share of investment risk and there is a corresponding decrease in the risk to the purchaser, such as where the purchaser benefits from certain guarantees. By contrast, Commissioner Paredes noted that "Rule 151A denies the Section 3(a)(8) exemption to an indexed annuity issued by a state-regulated insurance company that bears substantial risk under the annuity contract by guaranteeing principal and a minimum return."

Second, Commissioner Paredes noted that Rule 151A "seems to diverge" from the analysis required by the SEC's Rule 151 safe harbor, which sets out a variety of factors for consideration. He also noted that the adopting release for Rule 151 indicated that the Rule allows for certain indexed excess interest features without the annuity contract falling outside the safe harbor. In addition, he noted that a critical difference between Rule 151 and Rule 151A is the fact that Rule 151 is a safe harbor, while Rule 151A takes away the statutory exemption of Section 3(a)(8).

Third, 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 Securities Act even if the insurer 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 test 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.

Apart from legal frailties, Commissioner Paredes leveled three other criticisms at Rule 151A. First, he expressed disappointment that the Rule and the adopting release "make an implicit judgment that state insurance regulators are inadequate to regulate these products," which he described as being beyond the SEC's "mandate or expertise." Second, he expressed concern that the costs and burdens of Rule 151A could disproportionately impact small businesses and result in less competition to the detriment of consumers. Third, Commissioner Paredes stated his belief that there were more "effective and appropriate" ways to address the concerns underlying Rule 151A, such as amending Rule 151 to establish a more precise safe harbor in light of all the relevant facts and circumstances attendant to indexed annuities, including how they are marketed. He urged further exploration of alternative approaches and continued engagement with interested parties including state regulators.

In closing, he requested that his remarks be included in the Federal Register along with the final version of the adopting release, noting that his oral remarks did not give a full exposition of the shortcomings of Rule 151A.

RULE 12h-7

The SEC adopted Rule 12h-7 largely in the form proposed, with two modifications.

First, in response to concerns expressed by commenters, the SEC revised the proposed requirement that an issuer take steps reasonably designed to ensure that a trading market for the securities does not develop to include an exception for steps prohibited by state law.

Second, the SEC added a condition requiring that the prospectus for the securities with respect to which the Exchange Act exemption is being claimed contain a statement that the issuer is relying on the exemption. As a result, an issuer may choose to remain subject to Exchange Act reporting requirements by **omitting** the statement. Associate Director Susan Nash clarified that by omitting the statement, an issuer would be subject to **mandatory** Exchange Act reporting and subject to all requirements applicable to Exchange Act reporting companies.

We are continuing to consider the implications of the SEC's adoption of this Rule and will be furnishing additional comments and reactions in the future. For more information please contact any of our SEC/FINRA lawyers, listed [here](#).

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