



Rule 151A Litigation Oral Argument

The U.S. Court of Appeals for the D.C. Circuit, on May 8, 2009, heard oral argument in the case of *American Equity Investment Life Insurance Co. v. SEC*.

In this case, a coalition of life insurance companies and independent marketing organizations sued the SEC to vacate Rule 151A under the Securities Act. The Rule, in effect, requires index annuities to be registered as securities. The NAIC and NCOIL together also sued the SEC to vacate the Rule. The court consolidated the two lawsuits.

The judges' questions focused on investment risk and state insurance regulation.

The Coalition's brief had argued against judicial deference to the SEC's administrative authority. SEC counsel said that, pursuant to the doctrine of deference under *Chevron*, the line that the SEC drew was reasonable. However, the judges did not explore the deference point, except indirectly in the context of investment risk and state regulation.

Coalition counsel stated that the Rule was not consistent with precedent. The judges asked questions about how the Rule fit with the precedent of *VALIC* and *United Benefit*. There were some exchanges regarding *Home Life*. Coalition counsel tried to argue *Olpin*, but the judges did not pursue it.

NAIC counsel stated that state regulation went beyond the protection of solvency and was sufficiently comprehensive to protect the public.

There was no direct reference to Commissioner Paredes' dissent.

Investment Risk

The judges' principal questions related to the bearing of investment risk.

There was much discussion of the nature of investment risk, the different kinds of investment risk, the allocation of investment risk between the insurance company and owner, the need for SEC-type disclosure of investment risk, and the protections offered by federal and state law regarding the assumption of investment risk by an owner.

The principal thrust of the judges' questions was whether the key factor under Section 3(a)(8) was

- an insurance company's investment risk in guaranteeing principal, a minimum interest rate and credited interest or
- an owner's investment risk regarding the uncertainty of a return linked to a securities market index.

SEC counsel said as follows. The SEC has acknowledged that the guarantees of principal, minimum interest and credited interest involve investment risks that the insurer assumes. However, every case under Section 3(a)(8) has involved such guarantees. In some of those cases, the courts found the product to be a security. So, the issue to be decided does not relate to these factors, but rather to the factor of the investment risk regarding the excess return.

One judge asked SEC counsel why an SEC-type prospectus was needed. SEC counsel replied as follows. An owner needs to make an "investment decision" each year whether to hold on to an index annuity or surrender it. The guaranteed minimum interest rate is "irrelevant" for this purpose. Accordingly, owners need SEC-type disclosure to help gauge the investment risk arising from the index methodology. SEC counsel seemed to support the SEC's position by referring to surrenders and surrender charges, but the reference wasn't clear.

Coalition counsel pointed out, in light of the judges' questions, that, under index annuities, the insurance company discloses, in advance, the formula for determining the excess return.

The judges did not ask about either mortality risk assumption or marketing.

State Insurance Regulation

The judges asked questions about the relationship of federal law to state insurance law, in terms of "leaving leeway to the states."

Coalition counsel argued that state insurance regulation today is quite different from the situation at the time of *VALIC* and *United Benefit*. He pointed to the McCarran-Ferguson Act, which bars the SEC from interfering with state insurance regulation. He also gave two examples of federal regulation's interference with state regulation: first, arbitration regarding disputes involving sales persons, and, second, methodology of setting the value of an annuity.

SEC counsel stated that, under the *VALIC* majority opinion, the existence of state insurance regulation was not, in and of itself, "dispositive" of the legal issue raised. The SEC was bound to determine whether federal regulation is also necessary.

NAIC counsel described the wide scope of state insurance law and made a number of arguments against federal regulation. One judge asked NAIC counsel if he was raising a "Constitutional issue." NAIC counsel said no.

Another judge picked up on the points made by NAIC counsel about the wide scope of state insurance law. The judge asked SEC counsel whether the SEC

acknowledged that the scope of state insurance law had widened since the *VALIC* and *United Benefit* decisions.

SEC counsel gave two answers. First, he said that there is no support in the record that state insurance law is comprehensive and uniform. Second, he said that the federal securities laws are relevant to the protection of investors, regardless of state insurance law. SEC counsel said that state insurance law is "helpful," but does not "replace" federal regulation.

The Court gave no indication when it would hand down its decision.

If you have any questions, please contact Gary Cohen at (202) 965-8152 or goc@jordenusa.com.

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