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## SEC Regulation of Indexed Annuities

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### Court of Appeals Remands Rule 151A for Reconsideration, But Leaves Open the Possibility of SEC Regulation of Indexed Annuities

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#### SUMMARY

In *American Equity Investment Life Insurance Company et al. v. SEC*, No. 09-1021, decided on July 21, 2009, the U.S. Court of Appeals for the District of Columbia Circuit ordered the SEC to reconsider Rule 151A, finding that the SEC had failed to properly consider the effects of the Rule on efficiency, competition and capital formation in the insurance industry. Rule 151A would have treated most indexed annuities issued on or after January 12, 2011 as securities subject to federal regulation under the Securities Act.

However, the Court left open the possibility of future federal regulation of indexed annuities. The Court rejected the argument that the SEC exceeded its authority under the Securities Act, holding that classifying indexed annuities as securities subject to federal regulation rather than as insurance products subject to state regulation was a reasonable statutory interpretation. The Court agreed with the SEC's reasoning that, as compared to traditional insurance products, indexed annuities place an investment risk on the policyholders. This leaves open the possibility that the SEC will again adopt Rule 151A or a similar rule.

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#### BACKGROUND

##### Securities Regulation: Section 3(a)(8) Exemption

Section 3(a)(8) of the Securities Act exempts from federal securities regulation “[a]ny insurance or endowment policy or annuity contract or optional annuity contract” issued by an insurer that is subject to the supervision of an insurance commissioner, bank commissioner or similar state regulatory authority. The Securities Act does not define “annuity contract.” Instead, the analysis of whether insurance

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products fall under the scope of the Section 3(a)(8) exemption has focused on (a) whether the insurer assumed sufficient investment risk with the product and (b) whether the product was marketed as an investment. This analysis was first employed by the Supreme Court in *SEC v. Variable Annuity Life Insurance Company*, where the Court held that a pure variable annuity was a security rather than an insurance product because it placed all the investment risk on the policyholder.<sup>1</sup> Similarly, in *SEC v. United Benefit Life Ins. Co.*, the Court held that a product similar to a variable annuity was a security, because it “appeal[ed] to the purchaser not on the usual insurance basis of stability and security but on the prospect of ‘growth’ through sound investment management.”<sup>2</sup>

The SEC promulgated Rule 151 in 1986 as a safe harbor for application of the Section 3(a)(8) exemption, codifying the earlier judicial principles in response to the introduction and proliferation of guaranteed investment contracts. Rule 151 states that a contract falls within the Section 3(a)(8) insurance exemption if (a) the annuity or optional annuity contract is issued by an insurer subject to the supervision of an insurance commissioner, bank commissioner or similar state regulatory authority; (b) the insurer assumes the investment risk under the contract in the manner prescribed in the Rule; and (c) the contract is not marketed primarily as an investment.

### **Indexed Annuities and Rule 151A**

In the mid-1990s, life insurance companies began to offer indexed annuities (also known as fixed index annuities, classified index annuities or equity-linked annuities). Indexed annuities are insurance products which provide the greater of either a guaranteed minimum return or a return derived from the performance of an underlying securities index such as the Dow Jones Industrial Average, Nasdaq 100 Index or Standard & Poor’s 500 Composite Stock Price Index. Essentially, a policyholder of an indexed annuity has limited downside risk while realizing a rate of return that may be greater or lesser than the fixed rates in a traditional annuity, depending on the rate of return of the underlying index.

In June of 2008, the SEC proposed to classify these indexed annuities as securities subject to federal regulation under the Securities Act in order to clarify the treatment of indexed annuities and to extend Securities Act protections to purchasers. The final text of Rule 151A was released on January 8, 2009. Rule 151A carves out certain indexed annuities from the Section 3(a)(8) insurance exemption and was to apply prospectively to all indexed annuities issued on or after January 12, 2011.

**Key Provisions of Rule 151A.** For purposes of the Section 3(a)(8) insurance exemption, indexed annuities would not be “annuity contracts” or “optional annuity contracts” if they meet two criteria:

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<sup>1</sup> See 359 U.S. 65, 71 (1959).

<sup>2</sup> See 387 U.S. 202, 211 (1967).

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- Amounts payable by the insurance company 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; and
- Amounts payable by the insurance company under the contract are “more likely than not” to exceed the amounts guaranteed under the contract.

An insurer can rely on its determination that the indexed annuity does not meet these two criteria if:

- The methodology and assumptions used are reasonable;
- The underlying computations are materially accurate; and
- The determination is made no more than six months prior to the initial offer of the form of the indexed annuity contract.

**Effect of Rule 151A.** Under the “more likely than not” test, the issuance of most indexed annuities would require registration with the SEC under the Securities Act. In addition, an insurance agent dealing with indexed annuities would be required to be an associated person of a registered broker-dealer, either as employee or principal, or as an independent contractor in a broker-dealer networking arrangement. Under Rule 12h-7, which was adopted at the same time as Rule 151A, regulated insurance companies would be exempted from filing reports under the Exchange Act with respect to indexed annuities and certain other securities registered under the Securities Act, provided that certain conditions are met, including that the securities are regulated as insurance under state insurance law, the issuing insurance company and its financial condition are subject to supervision and examination by a state insurance regulator, and the securities are not publicly traded.

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## COURT OF APPEALS DECISION

The Court of Appeals in *American Equity Investment Life Insurance Company et al. v. SEC*, No. 09-1021, held that while the SEC’s interpretation in defining indexed annuities as securities was reasonable, the agency failed to determine if Rule 151A would “promote efficiency, competition and capital formation” as required by Section 2(b) of the Securities Act. In a unanimous decision, the matter was remanded to the SEC for reconsideration of the Rule.

The Court found that the SEC did not err in excluding indexed annuities from the definition of “annuity contract” under the § 3(a)(8) insurance exemption. The Court determined that the Securities Act is ambiguous on whether the term “annuity contract” encompasses indexed annuities and that the SEC’s interpretation of “annuity contract” in Rule 151A to exclude such annuities was a reasonable interpretation of the statute. The exclusion of indexed annuities from the insurance exemption “is based in reason,” the Court stated, because indexed annuities expose policyholders to a significant investment risk, since their value depends on the performance of the market.

The Court also found that the SEC failed to adequately consider the efficiency, competition, and

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capital formation effects of Rule 151A. Section 2(b) of the Securities Act requires the SEC to consider “in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” The Court remanded Rule 151A for reconsideration, finding that the SEC’s competition, efficiency and capital formation analyses were arbitrary and capricious in the following respects:

- The SEC’s reasoning that Rule 151A increases competition by providing clarity into the regulatory status of indexed annuities is flawed, because any rule that the SEC chooses to adopt could equally be said to clarify the status of a previously unregulated market;
- The SEC failed to determine the existing level of competition in the insurance industry under the current state law regime; and
- The SEC failed to determine whether policyholders were receiving adequate protection and suitable recommendations under the current state law regime.

However, the decision leaves room for the SEC to adopt Rule 151A or a similar rule in the future. The Court stated that “[i]t is obvious that the SEC believes imposing a federal framework on [indexed annuities] would be superior to the existing patchwork of state insurance laws. Indeed, after a more thorough review of the existing state law regime, the Commission may decide ultimately that Rule 151A will promote competition, efficiency and capital formation.”

It is uncertain whether and when the SEC will reconsider Rule 151A or propose a new rule seeking to regulate indexed annuities. At this time, insurance industry trade groups are also seeking legislative support for the House-sponsored bill, H.R. 2733, and the Senate-sponsored bill, S. 1389, to prevent federal regulation of indexed annuities.

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