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A legal update from Dechert's Financial Services Group

SEC Proposes Rules to Clarify Status of Indexed Annuities under Federal Securities Laws and to Exempt Certain Securities from 1934 Act Reporting Requirements

On June 25, 2008, the U.S. Securities and Exchange Commission ("SEC") issued a release proposing a new rule under the Securities Act of 1933 (the "Securities Act") that would clarify that certain "indexed annuity contracts" do not qualify for the exclusion of insurance contracts from regulation as securities under the federal securities laws (the "Proposing Release").[1] Under the proposed rule, an annuity contract would be considered a security for purposes of the Securities Act if its performance is linked to that of one or more securities indices and the amounts payable by the insurer are "more likely than not to exceed the amounts guaranteed under the contract." As discussed in the Proposing Release, the proposed rule is intended to enhance investor protection and to provide increased certainty to the issuers and sellers of indexed annuity contracts with respect to their obligations under the federal securities laws. The SEC also proposes to exempt insurance company issuers of indexed annuity contracts and certain other securities that are registered under the Securities Act and regulated as insurance under state law from the reporting requirements under the Securities and Exchange Act of 1934 (the "1934 Act").

Proposed Rule 151A would apply prospectively to indexed annuity contracts that are issued on or after the effective date of the final rule. The comment period for the proposed new rules ends September 10, 2008.

Background

Definition of Annuity Contract under Securities Act

Section 3(a)(8) of the Securities Act excludes certain insurance, annuity, and optional annuity contracts issued by a corporation subject to an insurance commissioner, bank commissioner, or similar state regulatory authority from regulation under the federal securities laws (the "insurance contract exclusion").[2] The United States Supreme

1 1934 Act Release No. 34-50822 (June 25, 2008).

2 Section 3(a)(8) of the Securities Act provides that the provisions of the Securities Act shall not apply to "any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state or territory of the United States or the District of Columbia." Although stated as an exemption, Section 3(a)(8) in effect excludes certain insurance contracts from the definition of "security." This distinction is important, as the anti-fraud provisions of the federal securities laws apply to exempt securities but not to financial instruments that are excluded from the definition of security.

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Court has articulated a list of facts and circumstances that should be used in determining whether a particular insurance or annuity contract falls within the exclusion.[3] Based on certain of these factors, the SEC provided a safe harbor in 1986 in Rule 151 under the Securities Act for contracts issued by a state regulated insurance corporation (the "insurer") if the insurer assumes the investment risk imposed by the contract as specified in the safe harbor and the contract is not marketed primarily as an investment. An insurance contract that does not meet the above requirements may be considered to be a "security" and may be subject to the registration and other requirements of the Securities Act and related requirements under the 1934 Act.[4]

The following describes the basic features of an indexed annuity contract and discusses how the Proposing Release analyzes indexed annuity contracts in the context of Rule 151.

What Is an Indexed Annuity Contract?

Following the adoption of Rule 151 in 1986, many insurers continued to develop products that combine elements of insurance and those of securities, including the creation of the indexed annuity contract. An indexed annuity contract provides for the accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser in the form of a lump sum, upon death or withdrawal, or as a series of payments. In this respect, it is similar to a fixed annuity. However, unlike the fixed annuity, the return generated by an indexed annuity contract is linked to the performance of one or more securities indices. The SEC suggests that indexed annuity contracts therefore present many of the same risks (and potential rewards) that an investor assumes when purchasing a mutual fund, variable annuity, or other performance-driven investment. An insurer also typically guarantees a minimum value in an indexed annuity contract, which the release said is typically 87.5% of purchase payments accumulated at annual interest rates of between 1% and 3%.

3 *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

4 The Proposing Release states that indexed annuity contracts do not qualify for the Rule 151 safe harbor because they fail to satisfy the requirement that the issuer must guarantee that the rate of any interest to be credited in excess of the guaranteed minimum rate under the contract will not be modified more than once per year. (*See*, Proposing Release, *supra* note 1 at 20-21).

Although the guaranteed minimum value included under many indexed annuity contracts provides a certain level of insurance, the SEC states in the Proposing Release that the "risk for the unknown, unspecified, and fluctuating securities-linked portion of the return is primarily assumed by the purchaser,"[5] and that the federal securities laws are intended to provide disclosure, antifraud and sales practice protections to investors whose investments involve market volatility and risk. The SEC also notes in the Proposing Release that it has received complaints of abusive sales techniques and inadequate disclosure regarding the sale of these types of annuity contracts, including complaints of marketing to unsuitable purchasers (such as senior citizens) and failures to disclose features such as substantial early surrender charges. The SEC also states that studies have shown that the guarantees, or "insurance" portion, included in indexed annuity contracts have been gradually reduced.

Discussion of Proposed Rules

Rule 151a

The Proposing Release states that an annuity contract whose amounts payable by the insurer are more likely than not to exceed the amounts guaranteed by the contract involves a certain level of investment-risk on behalf of the insured. In the absence of specific SEC guidance regarding the classification of these contracts, issuers have, according to the SEC, relied on their own analysis of the legal status of these instruments, which has generally resulted in their not being registered under the Securities Act and therefore not governed by the federal securities laws. The SEC therefore proposes to adopt Rule 151A which would establish standards for determining when an annuity contract should be considered a "security" and therefore subject to the protection of the federal securities laws. In the Proposing Release, the SEC stated its belief that purchasers of indexed annuity contracts who are exposed to risks similar to those experienced by investors in traditional "securities" are entitled to the protection of the federal securities laws, including disclosure, antifraud, and sales practice protections.

Proposed Rule 151A provides that a contract issued by an insurance company is not entitled to the exclusion provided by Section 3(a)(8) if (1) amounts payable by

5 *Id.* at 25.

the issuer under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities; and (2) amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.[6]

The amounts guaranteed under the contract are the minimal amounts that the insurer would be required to pay the purchaser, without reference to the performance of the security used in calculating amounts payable under the contract. Proposed Rule 151A(b) provides that determinations made by the issuer with respect to amounts payable and guaranteed shall be made "without reference to any charges that are imposed at the time of payment, but those charges shall be taken into account in computing the amounts guaranteed under the contract."[7]

The Proposing Release explains that amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract if this were the expected outcome more than half the time. The SEC notes in the Proposing Release that the amounts payable determination will require the issuer to analyze expected outcomes under various scenarios involving different facts and circumstances. The SEC has therefore proposed a facts and circumstances test for insurance companies to utilize when analyzing this prong of the equation and suggests the issuer take into account the particular features of the annuity contract, the particular options selected by the purchaser, and the performance of the relevant securities benchmark.

Because the methodology and assumptions required to determine whether amounts payable under the contract will more likely than not exceed the amounts guaranteed will vary among issuers, the proposed rule affords a safe harbor which provides that a determination by the issuer at or prior to issuance of the contract will be considered conclusive if: (a) both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable; (b) the computations made by the issuer in support of the determination are materially accurate; and (c) the determination is made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued. Accordingly, an issuer offering a form of contract over an extended period of time may have to periodically revisit this determination.

1934 Act Exemption for Securities That Are Regulated as Insurance

Proposed Rule 12h-7 would exempt an insurance company from the duty to file reports required by Section 13(a) of the 1934 Act with respect to securities registered under the Securities Act, provided that (i) the securities are subject to state insurance regulation, do not constitute an equity interest in the insurance company issuer, and are not listed, traded or quoted on an exchange, alternative trading system, electronic communications network or similar system; and (ii) the insurance company issuer files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or similar regulatory body of the issuer's state of domicile. The insurance company issuer would also be required to take steps reasonably designed to ensure that a trading market for the securities does not develop. Accordingly, proposed Rule 12h-7 would cover indexed annuity contracts as described in proposed Rule 151A.

In the Proposing Release, the SEC states it believes that the proposal is "necessary or appropriate in the public interest and consistent with the protection of investors" given "the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of those activities and assets under state insurance law, and second, the absence of trading interest in the securities."[8] The SEC believes that state insurance regulation, like the 1934 Act reporting laws, is primarily concerned with ensuring that reporting companies are adequately equipped to meet their financial obligations. The Proposing Release explains that because both bodies of law impose similar reporting requirements, the application of both state regulatory laws and 1934 Act rules may result in duplicative regulation.

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6 *Id*. at 93-94. It should be noted that the proposed rule makes clear that it would not apply to a contract "whose value varies according to the investment experience of a separate account." Accordingly, Rule 151A will not apply to typical variable annuity contracts, which will continue to be regulated as securities and subject to securities registration unless otherwise exempted from registration.

7 *Id*. at 40.

8 *Id*. at 47, *citing* Section 12(h) of the 1934 Act [15 U.S.C. 78l(h)].

Furthermore, because insurance contracts may only be assigned under very limited circumstances, a public trading market does not exist for them. Thus, there is little need or interest for the information that is required to be disclosed in 1934 Act reports.

The scope of proposed Rule 12h-7 would include the same companies that are covered by Section 3(a)(8) of the Securities Act.[9] However, the exemption would not apply to insurance company separate accounts. Proposed Rule 12h-7 would apply to contracts falling within the umbrella of proposed Rule 151A, including annuity contracts with "market value adjustment" ("MVA") features, as well as to insurance contracts that provide certain guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account. Thus, the SEC clarified in the Proposing Release that the 1934 Act exemption is independent of proposed Rule 151A and would apply to not only the securities covered by proposed Rule 151A, but also to these types of contracts.

Practical Implications

If adopted, Rule 151A will impose registration requirements on numerous indexed products that may not have otherwise required registration. While the proposed rule is not retroactive, if insurers want to continue to offer products similar to existing indexed products, they will need to register some of these products if Rule 151A is adopted as proposed. Registration brings along with it numerous obligations, which may include yearly updating of the registration statement depending on the structure of the product. Another effect of the proposed rule would be that equity indexed product sales practices would become subject to the antifraud provisions of the securities laws, including Rule 10b-5 under the 1934 Act. Additionally, under proposed Rule 151A, anyone selling registered indexed annuities generally would be required to be a registered broker-dealer.[10] Registered broker-dealers and their registered representatives are subject to the oversight of Financial Industry Regulatory Authority. This may entail new compliance requirements for certain firms.

The breadth of the proposal appears to have captured products other than equity-indexed products. Many insurers offer products they consider "fixed," under which interest rates are specified as a function of a prevailing interest rate, such as the rate on a U.S. Treasury security, LIBOR, or a benchmark of securities with a specified rating. The status of these products would be in question under the proposed rule.

Interestingly, the SEC seems to have shifted its focus in the analysis of securities status in this proposal—with less emphasis on protection of principal that is evident in Rule 151 and more emphasis on the nature of the return. The release states: "Notably, at the time that such a contract is purchased, the risk for the unknown, unspecified, and fluctuating securities-linked portion of the return is primarily assumed by the purchaser." The proposal seems to imply that an indexed product would not be in the safe harbor even if principal is fully protected.

Proposed Rule 12h-7 would excuse issuers of indexed annuity contracts, products with MVA features, and insurance contracts that provide certain guaranteed benefits from the burdensome reporting requirements imposed by the 1934 Act, including the filing of Forms 10K and 10Q. Additionally, when an issuer is subject to 1934 Act reporting, it also becomes subject to the accompanying Sarbanes-Oxley Act ("SOX") requirements. Presumably, relief from SOX will be welcomed by most. However, this proposed rule will not eliminate the requirement for inclusion of an insurance company's financial statements in a contract's registration statement.

Conclusion

Proposed Rule 151A would apply to annuity contracts whose payments are linked to the performance of a security or a group or index of securities. If an annuity contract has the characteristics set forth in proposed Rule 151A, its issuer will be required to register it under

9 Equity interests in insurance companies would not be included in the exclusion because they are not regulated by state insurance law and are often publicly traded. Absent 1934 Act reporting, purchasers of these types of securities would not be given the type of information necessary to make an informed investment decision. Therefore, these securities are not included in the proposed exclusion.

10 Or such person would need to become an associated person of a broker-dealer through a networking arrangement.

the Securities Act. As the party claiming the benefit of the exemption, the insurer would bear the burden of proving that the exemption is applicable. Proposed Rule 12h-7 will provide an exemption from 1934 Act reporting requirements for issuers of indexed annuity contracts (covered by Rule 151A) and certain other securities that are registered under the Securities Act and regulated as insurance under state law. However, if the insurance company issues both securities that *are* covered by proposed Rule 151A and publicly-traded securities, the issuer will not be entitled to the exemption. For example, if an insurance company issues indexed annuity contracts and also raises capital through a debt offering, the proposed exemption would not apply with respect to the debt securities and the issuer would be subject to 1934 Act reporting requirements.

The Proposing Release also states that insurance companies will not be subject to any additional legal risk relating to past offers and sales of indexed annuities as a result of the proposed rules, and notes that the new rules, if adopted, would apply prospectively to indexed annuity contracts issued on or after the effective date of the final rule release.

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