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SEC Again in Controversial Territory by Voting to Regulate Indexed Annuities

The Securities and Exchange Commission (“SEC”), in a 4-to-1 decision on December 17, 2008, adopted Rule 151A under the Securities Act of 1933 (“Securities Act”) governing index annuities.¹ Unlike traditional fixed annuities that earn fixed rates of interest, indexed annuities tie contract values to the performance of a securities index. Under Rule 151A, indexed annuities that satisfy the rule’s definition and are issued on or after January 12, 2011 will need to be registered under the Securities Act.

The rule purports to clarify the SEC’s position on the regulatory status of indexed annuities, which had remained open since their introduction. The debate over whether indexed annuities need to be registered under the Securities Act may not have ended with the adoption of Rule 151A, however. As with many other issues tackled by the SEC recently, the regulatory status of indexed annuities has drawn a surprising degree of heated focus from persons on both sides of the question. The Proposing Release generated about 4,800 comment letters, and the lone dissenter, Commissioner Paredes, took the unusual step of requesting that his dissenting remarks be published in the Federal Register. It is rumored that some issuers of indexed annuities may be considering taking the debate to court.

The final version of Rule 151A has not yet been published, but comments by the SEC and its staff at the December 17 open meeting shed light on the scope of the final rule, as well as potential legal challenges to it. The following summary is based on these comments.

Background

Section 3(a)(8) of the Securities Act provides that “annuity contract[s]” or “optional annuity contract[s]” are not subject to regulation under the Securities Act. This exemption, however, is not available to all contracts that are “annuities” under state law (e.g., variable annuities), and it has long been unclear if indexed annuities are within its scope. The dramatic increase in the popularity of indexed annuities since their introduction in the mid-1990s, together with reports of abusive sales practices and improper sales to seniors, prompted the SEC to provide additional guidance on their status under Section 3(a)(8).

Key Provisions of Rule 151A

As explained by presenters at the December 17 open meeting, Rule 151A defines certain contracts as outside the Section 3(a)(8) definition, and thus subject to Securities Act regulation, if (i) amounts payable by the insurer 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(s) of a security, including a group or index of securities; and (ii) the amounts

¹Rule 151A was proposed in Securities Act Rel. No. 8933 (Jun. 25, 2008) (“Proposing Release”).

payable by the insurer under the contract are “more likely than not” to exceed the amounts guaranteed under the contract.

Furthermore, an insurance company’s determination, at or before the issuance of a contract, that the amounts payable under the contract are (or are not) “more likely than not” to exceed contractual guarantees will be conclusive, provided that (i) the insurance company’s methodology and economic, actuarial and other assumptions are reasonable, (ii) the insurance company’s computations are materially accurate; and (iii) the determination is made not earlier than six months prior to the date on which the form of contract is first offered. In making this determination, surrender and other charges should be reflected in both the amounts payable and the amounts guaranteed under the contract. The SEC staff noted at the open meeting that this provision is intended to be “principles-based,” suggesting an intention that it be open to interpretation.

The staff further indicated that Rule 151A as adopted differs from the proposed version in two respects: It does not contain the requirement that the insurance company re-assess the status of each indexed annuity every three years. Also, the scope of the rule was narrowed and clarified to address concerns raised by commenters that, as originally proposed, it could have been interpreted to apply to traditional fixed annuities, which was not the intent.

Commissioner Paredes’s Dissent

In his dissent, Commissioner Paredes presented the legal analysis reflected in a number of comment letters opposing the rule. Among other things, he asserted that Rule 151A exceeds the SEC’s statutory authority and interpreted the precedents of the SEC and the courts to not support regulation of indexed annuities under the Securities Act. He noted that the approach taken in Rule 151A is contrary to the seminal Supreme Court cases interpreting Section 3(a)(8), *SEC v. Variable Annuity Life Ins. Co. of*

Am. (359 U.S. 65 (1959)) and *SEC v. United Benefit Life Ins. Co.* (387 U.S. 202 (1967)), as well as a federal court that concluded certain indexed annuities are not securities (see *Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002)). He also stated that Rule 151A is inconsistent with the position taken by the SEC itself in an amicus brief it submitted in a petition for certiorari before the Supreme Court in the case of *Otto v. Variable Annuity Life Ins. Co.* (814 F.2d 1127 (7th Cir. 1987)). Commissioner Paredes also took issue with Rule 151A’s concept of investment risk (which in his view focuses on upside, rather than downside, risk) and other practical concerns such as the uncertainty caused by a “more likely than not” test.

Adoption of Rule 12h-7

The SEC also voted to adopt Rule 12h-7, a companion rule to Rule 151A. Rule 12h-7 exempts insurance companies from certain reporting requirements under the Securities Exchange Act of 1934 (“Exchange Act”) with respect to securities that are either subject to regulation under the insurance laws of the insurer’s home state or are guarantees of securities subject to such regulation. To qualify for Rule 12h-7, the following conditions must also be satisfied:

- An insurer claiming the exemption must file an annual statement of financial condition with, and be supervised and examined by, the insurance regulator in the insurer’s home state;
- The securities to which the exemption relates may not be listed, traded, or quoted on an exchange, alternative trading system, inter-dealer quotation system, electronic communications network, or any similar system;
- The insurer must take steps reasonably designed to ensure that a trading market does not develop for the securities to which the exemption applies; and

- The prospectus for the relevant securities must contain an express statement that the issuing insurance company is relying on the exemption.

Commenters at the December 17 open meeting noted two differences between the rule as adopted and that as proposed. First, to address some commenters' concerns that the requirement to restrict transferability was inconsistent with state law, the staff stated that nothing had to be done that was inconsistent with state law requirements. Second, the provision regarding prospectus notice regarding an insurer's reliance on the exemption was added to permit an insurer to choose to continue to be an Exchange Act reporting company rather than to rely on the exemption. If the requisite language is not included in the prospectus, the insurer must continue to comply with Exchange Act reporting requirements. The effective date of Rule 12h-7 was not discussed at the open meeting.

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