News Bulletin

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DC Circuit Court Vacates Rule 151A

On July 12, 2010, the DC Circuit Court of Appeals (the "Court") reissued a prior opinion and vacated Rule 151A (the "Rule"), which was approved by the Securities Exchange Commission (the "SEC") on December 17, 2008, on the grounds that the SEC's efficiency, competition and capital formation analysis under Section 2(b) of the Securities Act of 1933, as amended (the "Securities Act") was arbitrary and capricious. The Rule would have brought indexed annuities within the definition of "security" under the Securities Act and within the SEC's jurisdiction. The decision to vacate the Rule came shortly after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") by the House of Representatives. The Act contained a provision granting jurisdiction over such products to state insurance commissioners.[1] The Court's decision also came a year after the first legal challenge relating to the Rule had been filed.[2]

Rule 151A would have become effective for all covered annuity products as of January 12, 2011. The Rule stated that an indexed annuity is not an "annuity contract" under Section 3(a)(8) if certain conditions are met. Rule 151A, in its final form, defined an annuity contract as outside the scope of the Section 3(a)(8) of the Securities Act if: (a) 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, and (b) the amounts payable by the insurer under the contract are "more likely than not" to exceed the amounts guaranteed under the contract. An annuity contract that fell within this definition would be treated as a "security" not eligible for an exemption from registration.

If an insurer relied on the Section 3(a)(8) exemption when issuing an annuity contract, the burden of proof would have rested with the insurer to demonstrate that the annuity contract did not meet this test. An insurer could rely on its determination that the annuity contract did not meet the two-pronged test if the insurer could demonstrate that its: (a) methodology, including its assumptions, were reasonable, (b) computations were materially accurate, and (c) determination was made at or prior to the issuance of the annuity contract (no more than six months prior to the date that the form of contract is first offered).

On January 16, 2009, a group of insurance companies filed suit against the SEC requesting that the Court (a) find Rule 151A unlawful under the Securities Act, (b) vacate the Rule and its requirements, and (c) issue a permanent injunction barring the SEC from implementing and enforcing the Rule and its requirements. On July 21, 2009, the Court held that the SEC acted reasonably when determining that indexed annuity products fall outside the definition of "annuity contract" under Section 3(a)(8) and, therefore, should be treated as "securities." Because decisions by the SEC are entitled to considerable deference, such a determination need only be reasonable in

[1] See our client alert: http://www.mofo.com//files//Uploads/Images/100706Jurisdiction.pdf.
[2] See our client alert: http://www.mofo.com/files/Publication/7ff88f64-6eab-408f-8abb-6a4562204d57/Presentation/PublicationAttachment/822b1787-f68c-4022-9f78-6a9c54beffb5/091217Rule_151A.pdf.

order to be upheld. The Court explained that the Securities Act is ambiguous and that the SEC's interpretation was reasonable because indexed annuities expose policyholders to significant investment risk. However, the Court found that the SEC was required to determine whether the action was "necessary or appropriate in the public interest" in order to protect investors and whether it promotes the efficiency, competition and capital formation effects in the insurance industry under Section 2(b) of the Securities Act when adopting Rule 151A. Because the SEC failed to do so, its determination was arbitrary and capricious. Because the Court found that the SEC acted reasonably, the Court did not void Rule 151A; instead, as a result of the SEC's flawed analysis, the Court remanded the matter to the SEC for further analysis. Since the order did not vacate the Rule, the effective date of January 12, 2011 remained in place.

The January 2011 effective date prompted insurance industry participants to file petitions requesting that the Court vacate Rule 151A to avoid having to prepare for the effective date before the SEC concluded its study and reached a final decision whether to revise or vacate the Rule. On December 8, 2009, the SEC stated in a filing with the Court that it agreed to stay the effective date of Rule 151A for "two years after completion of all proceedings on remand, to run from publication of a retained or reissued Rule 151A in the Federal Register."

On June 30, 2010, the date that the House of Representatives passed the Act containing an annuity regulation provision known as the Harkin Amendment, the SEC had not yet provided the Court with findings from the follow-up study nor had it requested that the Court vacate the Rule. The Court, awaiting study findings, had not yet issued a final ruling. Since the Harkin Amendment attempts to clarify the types of insurance products that are covered under Section 3(a)(8) and create a bright line rule for when state insurance departments have jurisdiction over certain insurance products, many industry participants and regulators were waiting to see how the Court would react to passage of the Act.

Under the Harkin Amendment, any insurance or endowment policy or annuity contract or optional annuity contract would be covered under Section 3(a)(8) if:

- the value of such policy or contract does not vary according to the performance of a separate account;
- it either (i) satisfies standard nonforfeiture laws or similar requirements of the applicable state at the time of issue; or (ii) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners; and
- it is issued on or after June 16, 2013, in a state, or issued by an insurance company that is domiciled in a state, that adopts rules that govern suitability requirements in the sale of an insurance or endowment policy or annuity contract or optional annuity contract, which shall substantially meet or exceed the minimum requirements established by the Suitability in Annuity Transactions Model Regulation adopted by the National Association of Insurance Commissioners (the "NAIC") in March 2010 (the "Model Annuity Suitability Regulation") and any successor modifications to the model regulations within five years of the adoption by the NAIC of any further successors thereto; or
- it is issued by an insurance company that adopts and implements practices on a nationwide basis for the sale of any insurance or endowment policy or annuity contract or optional annuity contract that meet or exceed the minimum requirements established by the Model Annuity Suitability Regulation, and any successor thereto, and is therefore subject to examination by the state of domicile of the insurance company, or by any other state where the insurance company conducts sales of such products.

The Harkin Amendment is limited to the types of products that meet the above criteria that are regulated by state insurance departments under the Model Annuity Suitability Regulation or similar requirements. It does not attempt to opine on whether any other type of insurance or annuity product falls within the Section 3(a)(8) exemption.

On July 12, 2010, less than two weeks after the passage of the Act in the House of Representatives, the Court reissued its July 21, 2009 opinion and vacated Rule 151A. On July 15, the Senate passed the Act, and on July 21, 2010, President Obama signed it into law. After 18 months, the future of Rule 151A is now known, and at least for the time being, indexed annuity products will remain under the jurisdiction of state insurance commissioners.

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