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REGULATORY REFORM

## Securities or Not: Uncertainties Remain For Fixed Insurance Products After Dodd-Frank

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When the Securities Act of 1933 was enacted 77 years ago, it was clear that annuity and life insurance products were not securities and were not subject to that Act. However, insurance products have evolved substantially since then, and one of the most significant changes has been the addition of investment components of varying type, scope and magnitude, with new types of products such as excess interest products, variable products, equity indexed products, and products with market value adjustments. This product evolution led to the creation of an analytic framework to determine whether certain types of products are or should be treated as securities under the federal securities laws. In some cases, however, that analy-

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sis involves some elements of uncertainty. Now, in the Dodd-Frank financial reform legislation enacted in July, Congress, for the first time since 1933, has provided a new statutory provision which expands the exemption for insurance products so that a new category of products meeting certain conditions will not be treated as securities. This article discusses that new statutory provision and identifies areas of uncertainty in its interpretation and application that will need to be addressed by product issuers, distributors and regulators alike.

## I. Background

Section 3(a)(8) of the Securities Act of 1933 (the ''1933 Act'') provides simply and in broad terms that ''any insurance or . . . annuity contract'' (issued by a regulated insurance company) is not subject to the provisions of that Act (except as otherwise specifically provided).[1] The legislative history of the 1933 Act states that ''insurance policies are not to be regarded as securities'' subject to that Act.[2] This was in the context of what we now think of as the 'traditional' fixed products that existed at that time.

Thereafter, the variable annuity product was developed and brought to market. In the traditional fixed annuity, the insurance company promised a fixed (or guaranteed rate of) return and bore the investment risk. In contrast, with a variable annuity the insurance company promises to 'pass through' the investment return (gains or losses) on a specified pool or group of assets, and thereby shifts the investment risk to the contract owner. Principally due to this shifting of investment risk to the contract owner, but also because such products are usually marketed with an emphasis on their investment management component, two seminal Supreme Court cases have led to the treatment of variable annuities as securities subject to all provisions of the 1933 Act[3] (absent an applicable exemption, *e.g.*, for contracts sold to qualified retirement plans or in private placements).

In the decades following those Supreme Court cases, various new types of fixed (or non-variable) insurance products have been developed, with different components that can impact the shifting or bearing of investment risk. These products can perhaps be grouped into three general categories: (a) products with a guaranteed minimum interest rate but with higher, current or 'excess' interest rates declared periodically by the insurance company (referred to as excess-interest or declared rate products); (b) products with fixed interest rates but with market value adjustments imposed on surrenders, withdrawals or other transactions (''MVAs''); and (c) products with the rate of interest determined at the end of stated periods and tied to the performance of a stock market or bond index (indexed products).[4]

These various types of fixed products, with lesser or greater degrees of investment orientation, have existed or even thrived despite, in some cases, a somewhat uncertain status under the federal securities laws. They are not variable products, where almost all of the investment risk is born by the purchaser; variable products are securities at one end of the securities-insurance spectrum. But nor are they ''traditional,'' 1933-era simple fixed products, where almost all of the investment risk is born by the issuer; these traditional products are clearly exempt insurance at the other end of the spectrum. With respect to many products between these ends of the spectrum there is no precise, clearly defined judicial test for determining 'how much' investment risk is born by the parties,[5] where along the investment risk spectrum a product falls, or where the line is between security and insurance.

Moreover, this imprecise and somewhat uncertain investment risk test is not the only criterion used to determine whether an insurance product is a security subject to the 1933 Act. As indicated above, how a product is marketed can also be a very important factor. The Securities and Exchange Commission (SEC or Commission) has said: ''Marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to'' the Section 3(a)(8) exemption.[6] Based primarily on the Supreme Court decision in the *United Benefit* case,[7] this marketing test has been summarized as requiring that, for a product to qualify for the Section 3(a)(8) exemption, an insurance company's marketing plan must be aimed at appealing to purchasers on the usual insurance basis of stability and security, and not promote the product primarily as an investment.[8] This marketing test, like the traditional investment risk test, is inherently vague and subjective.

In addition to the investment risk and marketing tests, the assumption of mortality risk by the insurer ''may be an appropriate factor to consider'' in determining whether a product qualifies under Section 3(a)(8).[9]

So a ''traditional'' determination of a product's status under Section 3(a)(8) is a fact and circumstances analysis based on a vague and imprecise investment risk test, a marketing test that is probably even more vague and

[1] Section 3(a)(8) states that ''Except as hereinafter expressly provided the provisions of this title 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'' or similar agency or officer of any state etc.

[2] H.R. Report No. 85, 73rd Cong., 1st Sess., 15 (1933). The Supreme Court, citing this legislative history, has stated that ''the exemption from registration for insurance policies was clearly supererogation.'' Tcherepnin v. Knight, 389 U.S. 332, 342 n. 30 (1967).

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

[4] These three product categories are not all-inclusive, and particular products can fall into more than one category (for example both excess interest and indexed products can also have an MVA).

[5] For certain declared rate annuities, there is a well-defined investment risk requirement in Rule 151, noted below.

[6] SEC Release No. 33-8996 (Jan. 8, 2009), 74 Fed. Reg. 3138, 3142 (Jan. 16, 2009) (''SEC Release No. 33-8996'') (adopting Rule 151A).

[7] *See* Note 3, *supra.*

[8] *See, e.g.*, Brief for the United States as Amicus Curiae, *VALIC*, *supra* note 3; SEC Release No. 33-6645 (May 29, 1986), 51 Fed. Reg. 20254, 20260 (June 4, 1986) (''SEC Release No. 33-6645'') (adopting Rule 151), (''the manner in which a contract is *primarily* marketed is a significant factor which must be considered in determining a contract's status under the federal securities laws.'') (emphasis in original). Commenters have criticized the marketing test because of its largely subjective nature. *Id*.

[9] SEC Release No. 33-6645, *supra* note 8, at 51 Fed. Reg. 20256.

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inexact, and a consideration of the assumption of mortality risk as well.

Against this backdrop the SEC, in two separate rulemaking proceedings, attempted to bring some clarity to the status under the 1933 Act of certain categories of annuity contracts. First, in the mid-1980's, the SEC adopted Rule 151, which is a 'safe harbor' for excess interest annuities. In grossly over-simplified terms, Rule 151 provides that an excess interest annuity qualifies for Section 3(a)(8) treatment if it is a state-regulated annuity contract, it meets a very specific investment risk test,[10] and it is not marketed primarily as an investment.

Second, more recently, the SEC adopted Rule 151A, which for all practical purposes would have established that indexed annuity products are securities and not covered by the Section 3(a)(8) exemption.[11] Rule 151A was based on a specific investment risk test (but a very different test than the Rule 151 test),[12] and Rule 151A did not include a marketing test. Rule 151A was successfully challenged in court and vacated (on procedural grounds) by the U.S. Court of Appeals for the D.C. Circuit.[13]

While Rule 151A was pending, legislation was introduced in Congress (the ''Meeks Bill'' was introduced in the House, and an identical bill was introduced in the Senate) that would have nullified Rule 151A and in effect provided that state-regulated indexed insurance products (both life and annuity products) that meet nonforfeiture standards are exempt under Section 3(a)(8).[14] This legislation, which would have amended Section 3(a)(8), never made it out of (or was even the subject of any hearings in) Congressional committees.

## II. The Harkin Amendment

This brings us to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act'' or the ''Act''). When this legislation was first passed by the House and Senate and sent to the Conference Committee, it did not contain any provision addressing Section 3(a)(8) or the status of insurance products under the 1933 Act. However, when the Act finally emerged from the Conference Committee, it contained a provision that surprised many. Buried in a miscellaneous section of provisions (Subtitle I of Title IX) is Section 989J, known as the ''Harkin Amendment.''[15]

The Harkin Amendment has been referred to as providing an exemption for equity indexed annuities from regulation as securities, as a preservation of state insurance treatment for indexed annuities, and as a nullification of the SEC's Rule 151A under the 1933 Act for indexed annuities. However, Section 989J, the Harkin Amendment (sometimes referred to herein as simply ''Harkin''), is a new exemption that provides a 'safe harbor' from securities registration requirements (at least) that is not limited to indexed annuities; rather, it applies to any 'fixed' insurance product (life or annuity) that meets its conditions.

Those conditions may appear clear and simple, but on close examination each one, to different degrees, can present issues and uncertainties regarding the securities status of not only fixed or equity indexed deferred annuities but also of various other types of insurance products, such as group annuity contracts, modified guaranteed annuities or products with market value adjustments, immediate annuities, and particularly indexed life insurance policies. As of this writing, the SEC has not publicly reacted formally to the Harkin Amendment with any interpretive guidance or proposed rulemaking, and the authors are not aware of any informal interpretations or guidance being provided publicly by the SEC staff. Counsel for insurers and product distributors may face significant and unexpected challenges in designing products that qualify, and determining whether products qualify, for the Harkin Amendment.

Section 989J, the Harkin Amendment, provides that the Commission ''shall treat as exempt securities described under section 3(a)(8) of the Securities Act of 1933 . . . any insurance or endowment policy or annuity contract or optional annuity contract'' (collectively, any ''insurance product'' or ''contract'') that meets the following three requirements:

**(1) Separate Account —** the value of the insurance product does not vary according to the performance of a separate account;

**(2) Nonforfeiture —** the insurance product either-

(A) satisfies standard nonforfeiture laws or similar requirements at the time of issue; or

(B) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or the Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners (''NAIC''); and

**(3) Suitability —** the insurance product is issued either-

(A) on and 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

[10] The investment risk test of Rule 151 requires that a minimum rate (based on the rate in applicable nonforfeiture laws or, if none, the NAIC Model nonforfeiture laws) be guaranteed for the life of the contract, that principal and previously credited interest be guaranteed, and that excess interest (if any) be declared in advance and guaranteed for at least one year periods.

[11] The SEC proposed Rule 151A in June 2008 and adopted it in January 2009 (with an effective date of January 12, 2011). SEC Release No. 33-8996, *supra* note 6.

[12] Rule 151A specifies that a state-regulated annuity contract is not an ''annuity'' under Section 3(a)(8) if (1) the amounts payable ''are calculated . . . in whole or in part, by reference to the performance'' of an index of securities (at the end of the period), and (2) the amounts payable are ''more likely than not'' to exceed the amounts guaranteed.

[13] American Equity Inv. Life Ins. Co. v. SEC, No. 09-1021, 2009 WL 2152351 (D.C. Cir. July 21, 2009, reissued July 12, 2010). The Court held that the SEC's conclusion that fixed annuities were securities, including Rule 151A's investment risk test and lack of an explicit marketing test, were reasonable but vacated the Rule because of an insufficient analysis, under Section 2(b) of the 1933 Act, of the Rule's impact on competition, efficiency and capital formation. The SEC, in a ministerial action, withdrew Rule 151A on October 14, 2010. SEC Release No. 33-9152 (Oct. 14, 2010).

[14] Fixed Indexed Annuities and Insurance Product Classification Act, H.R. 2733, 111th Cong. (2009), and S. 1389, 111th Cong. (2009). In addition to meeting nonforfeiture standards, both bills required that the contract value not vary with the performance of a separate account. This requirement is discussed below in the context of the Harkin Amendment.

[15] Section 989J was introduced by Senator Tom Harkin (D-Iowa).

sale of an insurance product which substantially meet or exceed the minimum requirements established by the NAIC's Suitability in Annuity Transactions Model Regulation (''SATMR'') any successor thereto (within 5 years of the successor's adoption by the NAIC) (this can be referred to as the *mandatory* suitability test);[16] or

(B) by an insurance company that adopts and implements practices nationwide for the sale of any insurance product that meet or exceed the minimum requirements established by the SATMR (and any successor thereto) is therefore subject to examination (by the state of domicile of the insurance company, or by another other state where the insurance company sells insurance products), for the purpose of monitoring compliance ''under this section''(this can be referred to as the *voluntary* suitability test).

The new ''exemption'' included in Section 989J is written as a direction to the Commission, and does not actually amend, and therefore will not be codified in, Section 3(a)(8) (or any other section) of the 1933 Act. In addition, Section 989J does not by its terms specifically refer to indexed annuities (or Rule 151A).

As noted above, Section 989J operates as a safe harbor (although that term is not used). ***Importantly,*** Subsection (b) of 989J is a *rule of construction* that provides that nothing in the new provision shall be construed to affect whether any insurance product that is *not* described in that section is or is not exempt under Section 3(a)(8). Accordingly, if an insurance product does not satisfy the Section 989J requirements, then the product still may come within the Section 3(a)(8) exemption based on (a) judicial and Commission interpretations of Section 3(a)(8) of the 1933 Act, or (b) the Rule 151 safe harbor for certain fixed annuity contracts.

## III. Insurance Products Under the 1933 Act After Harkin

The practical impact of the Harkin Amendment can best be understood (and perhaps can only be understood) in the context of the larger picture of the securities law status of fixed insurance products. With the Harkin Amendment now law, there are essentially three avenues for insurance products to be treated as exempt insurance,[17] rather than securities, under Section 3(a)(8) of the 1933 Act.

*First*, certain fixed annuities might qualify for the 'safe harbor' exemption in Rule 151. This requires being an annuity that meets a strict, very well-defined and specific ''investment risk'' test,[18] and also meeting a vague and uncertain marketing test (that the product ''is not marketed primarily as an investment'').[19]

*Second*, insurance products of various types can qualify under the Harkin Amendment. As noted above, this requires that the product meet a 'no separate account' test, a nonforfeiture test, and a suitability test. However, the Harkin Amendment does not have a marketing component.

*Third*, in accordance with the 'rule of construction' in paragraph (b) of the Harkin Amendment, products that do not meet that provision can qualify under 'traditional' or pre-Harkin interpretations (from both the courts and the SEC) of Section 3(a)(8) of the 1933 Act. This requires meeting the vague and subjective investment risk test (is too much investment risk shifted to the policy owner? Does the insurer bear 'sufficient' investment risk?) as well as an even less clear marketing test.

The first two requirements of the Harkin Amendment (the value not varying with the performance of a separate account, and meeting nonforfeiture standards) together can be viewed as a type of investment risk test,[20] and the third part of Harkin is meeting a suitability requirement. There is no marketing test in the Harkin Amendment. Accordingly, at a very high level, and in general terms, the Harkin Amendment can be viewed, in part, as substituting a suitability requirement in place of the marketing test.

## IV. The Three Requirements of the Harkin Amendment

So where are the open issues and uncertainties in the Harkin Amendment that might hamper reliance on it and lead insurers and distributors to instead rely on a traditional Section 3(a)(8) analysis? They are actually in all three requirements of the Harkin Amendment, even those that appear clear, specific and unambiguous.

**A. Not Varying According to Separate Account Performance** The first requirement, that ''the value of [the contract] does not vary according to the performance of a separate account,'' seems clear and simple, but actually raises issues for certain product asset support designs or funding mechanisms. Separate accounts may be used *in connection with* certain insurance products, for funding or accounting purposes (such as for valuing assets or matching assets with liabilities), but where the contract value does not vary, at least directly and perhaps not at all negatively, with the account's performance. The use of such separate accounts certainly bears scrutiny with respect to complying with this requirement of Harkin, and exactly how this requirement will be or can be interpreted.

This requirement of the Harkin Amendment is almost identical to one of the investment risk requirements in

[16] ''Mandatory'' refers to the compulsory nature of suitability regulations adopted by the applicable state(s), as opposed to the company's ''voluntary'' implementation of nationwide suitability practices under the alternative suitability test of the Harkin Amendment. A company should have the option of relying on either test (subject to the effective date of the mandatory test, discussed below).

[17] This article uses the term ''exempt'' to refer to insurance products that are described in, or to be treated as described in, Section 3(a)(8) of the 1933 Act. Unless the context otherwise requires, ''exempt'' as used herein refers to *qualifying* under Section 3(a)(8), without regard to whether such qualification results in exemption from the registration requirements or exclusion from all provisions (including the antifraud provisions) of the 1933 Act. The exemption verses exclusion issue is addressed below.

[18] Paragraph (b) of Rule 151 under the 1933 Act. This includes a requirement that the value of the contract does not vary according to the investment experience of a separate account.

[19] Subparagraph (a)(3) of Rule 151 under the 1933 Act.

[20] This proposition is based on the notion that these two requirements function (at least in part) to limit or restrict the investment risk or loss that a contract owner can bear.


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Rule 151[21] and to one of the requirements in (now vacated) Rule 151A. In proposing the Rule 151 requirement (that the contract value ''not vary according to'' the investment experience of a separate account), the SEC used this requirement to distinguish 'qualifying' products that meet this requirement from variable annuities, saying that with variable products, where the contract value *does* vary according to the investment experience of a separate account, ''the insurer promises to pay the contract owner only his proportionate share of the account's income and gains (or deduct his share of losses), similar to a variable annuity contract.''[22] Similarly, in connection with the adoption of Rule 151, the SEC said that a contract that provides for the allocation of contributions to a separate account but does not provide for contract values that vary with the investment performance of the separate account would satisfy this test of Rule 151 (recognizing that insurers may utilize such ''non-unitized'' separate accounts to facilitate the matching of maturities of fixed-income securities and as a mechanism for complying with state law reserve requirements or statutory accounting standards).[23]

In addition, Rule 151A included a nearly identical requirement – it would not have applied to ''any contract whose value varies according to the investment experience of a separate account.''[24] In proposing and adopting this requirement in Rule 151A, the SEC explained it as follows: ''The effect of this provision is to eliminate variable annuities from the scope of the rule.''[25]

Accordingly, the SEC guidance on the nearly identical requirements in Rules 151 and 151A indicates that the requirement is intended to exclude variable insurance products, where the investment performance of the separate account is passed through to contract owners. This reading of the same requirement in the Harkin Amendment would permit the use of a separate account, in certain ways, while complying with this requirement. To what extent, if any, will the SEC guidance on this requirement of Rules 151 and 151A apply to the Harkin Amendment? In other words, is this requirement of the Harkin amendment limited to prohibiting the pass-through of investment performance of a separate account (as in variable products)? The plain language of Harkin permits the use of a separate account, it seems, if the contract value does not vary with the performance of the account.

Similarly, Section 2(a)(14) of the 1933 Act actually contains a definition of ''separate account'' that includes ''under which income, gains and losses . . . from assets allocated to such account are, in accordance with the applicable contract, credited to or charged against such account'' (emphasis added). This definition of separate account requires allocation of losses as well as gains, and requires that such allocation be in accordance with the terms of such contract. This also seems to limit the term ''separate account'' to variable contract separate accounts.

The Harkin Amendment's 'no separate account' requirement uses the phrase ''does not vary according to'' a separate account's performance, and Rule 151 and vacated Rule 151A also use ''vary according to'' terminology. In a different context, namely no-action letters addressing whether a separate account is an investment company under the Investment Company Act of 1940, different and much broader terminology was used.[26] In particular, in that correspondence, the request letters and the SEC staff's responses used terminology such as that amounts received by contract owners ''do not depend upon'' or are ''not affected by'' the investment experience of the separate account; that that company ''does not consider'' the investment performance in setting interest rates; that the contract owner's interest in the account ''is not determined by, and does not reflect'' the investment performance of the account.[27] How, if at all, does this broader language inform a proper interpretation of the Harkin Amendment language? Could the Harkin Amendment language be interpreted to be as broad as this other language? The better view would seem to be that the ''does not vary according to'' language in the Harkin Amendment is narrower than (and hence distinguishable from) this broader language, and this should further support the strict reading of the Harkin Amendment language suggested above.[28]

Finally, the issue of separate account 'asset insulation' should be considered. In many cases, and certainly for the typical variable product separate account, under applicable state insurance laws, the assets in the account are not chargeable with liabilities arising out of any other business the insurance company may deduct (at least to the extent of the reserves and other liabilities of the account). Would the insulation, or lack thereof, be a factor in determining whether the use of a separate account bars qualifying under the Harkin Amendment?[29]

Apart from actual separate accounts, in some cases there may be identifiable 'segments' of the insurance company's general account that are utilized in connection with fixed insurance products. Could an argument be made – could the SEC take the position that - a general account segment that is too closely tied to the interest credited to a product is the equivalent of a separate account that passes through investment performance to the contract value, and therefore bars the product from relying on the Harkin Amendment?

[21] The Rule 151 requirement uses the term ''investment experience'' whereas the Harkin Amendment uses the word ''performance.'' In this context, these terms appear to be synonymous.

[22] SEC Release No. 33-6558, (Nov. 21, 1985) 49 Fed. Reg. 46750, 46752 (Nov. 21, 1984).

[23] SEC Release No. 33-6645, *supra* note 8. Non-unitized separate accounts can be used to permit the assets in the account to be valued on a market value basis. Valley Forge Life Ins. Co., SEC No-Action Letter (Pub. Avail. Jan. 30, 1997).

[24] Rule 151A(c).

[25] SEC Release No. 33-8933 (June 25, 2008), 73 Fed. Reg. 37752, 37758 at note 58 (July 1, 2008); SEC Release No. 33-8996, *supra* note 6, at note 101.

[26] Valley Forge Life Ins. Co., SEC No-Action Letter (Pub. Avail. Jan. 30, 1997); The Equitable Life Assurance Society, SEC No-Action Letter (Pub. Avail. Dec. 22, 1995).

[27] *Id.* Those letters also stated that the separate accounts were not used to, and did not operate to, pass through the account's investment performance to contract owners.

[28] As those letters show, the use of such separate accounts could present issues as to their status as investment companies under the Investment Company Act of 1940 (the 1940 Act). It should be noted that the 1940 Act analysis could affect the 1933 Act analysis.

[29] In the Valley Forge and Equitable no-action letters cited in note 26 above, the separate account asset insulation by itself did not result in the accounts being viewed as separate 'issuers' or investment companies.

Accordingly, the use of separate accounts *in connection with* fixed products may, or should be, permitted under the Harkin Amendment, at least in certain circumstances, but nevertheless this requirement of Harkin raises interpretational issues that must be carefully considered.

**B. Satisfying Nonforfeiture Laws** The second requirement of the Harkin Amendment, satisfying state nonforfeiture law standards, may appear to be even more clear, specific and objective than the 'no separate account' requirement, but it too presents numerous uncertainties and interpretive issues.

The basic nonforfeiture requirement in the Harkin Amendment is to satisfy standard nonforfeiture laws "or similar requirements" of the applicable State. We are not aware of any guidance as to what is intended by "similar requirements." Could it refer to a state's nonforfeiture laws that are not "standard" but are similar to "standard" nonforfeiture laws? Or does it mean, as seems more probable if not likely, nonforfeiture "requirements" in a state that take the form of insurance department bulletins, office of general counsel opinions, or similar guidance that are not in the form of laws?

This raises the issue of determining which of the two nonforfeiture tests in Harkin is applicable. The language and structure of the Harkin Amendment is such that the first nonforfeiture test – satisfying standard nonforfeiture laws or similar requirements (subparagraph (a)(2)(A)) – is generally the applicable test. The second test – satisfying the NAIC model standard (life or annuity) nonforfeiture laws (subparagraph (a)(2)(B)) - only applies "in the absence of applicable standard nonforfeiture laws or requirements"[30] (that is, the second test only applies if the first test does not apply). So companies must first determine whether or not there are any 'standard nonforfeiture laws *or similar requirements*' in the applicable State. If there are, then the company is subject to the first test, and the second test (satisfying the NAIC model) is not an option.

Even after determining which test applies, and therefore which nonforfeiture laws (the laws of the applicable State or the NAIC model) must be satisfied, it seems that there still may be interpretational issues in applying the nonforfeiture standard. While it might appear that nonforfeiture standards are objective, mathematical, actuarial standards – either "the numbers" meet the standards or they do not – that may not be the case. While the authors are not actuaries, our understanding is that even for a particular product, there can be interpretive issues in measuring compliance with a specific nonforfeiture law as to which reasonable minds can differ. For example, with respect to individual deferred annuities, these points may involve matters such as maturity dates, the period for testing, prospective vs. retroactive testing, the discount rate used to calculate back a projected account value, the use of Actuarial Guideline 3, etc.[31] Therefore, while the reliance on state or NAIC model nonforfeiture laws may appear to be a very specific, objective, and well-defined requirement, there may be substantive uncertainties lurking below the surface.

Unfortunately, the Harkin Amendment does not provide any procedural mechanism or other guidance for determining compliance with the nonforfeiture requirement. And while a product's qualification as exempt under Section 3(a)(8) of the 1933 Act has been considered a federal question,[32] satisfaction of state law nonforfeiture standards has been a matter of state law, and generally treated as within the purview of appropriately licensed, qualified actuaries. [33] Given the substantive issues noted above (and others), and the lack of procedural guidance, perhaps some form of 'certification' procedure or other compliance mechanism could be established. State insurance department procedures and filing requirements certainly could play a role in establishing compliance with the Harkin Amendment's nonforfeiture requirement, and indeed it could be argued that submission of an actuarial certification to the state and subsequent state approval of the contract form should be definitive and determinative of compliance with the state's nonforfeiture law. Should the result be the same in a 'deemed approval' state?

A different type of uncertainty under the Harkin Amendment arises where there is no clearly applicable nonforfeiture law. The Harkin Amendment provides that "in the absence of applicable standard nonforfeiture laws or requirements," the contract must satisfy the NAIC Model Standard Nonforfeiture Law for Life Insurance or for Individual Deferred Annuities ("SNFL"). However, there are certain types of products to which the state nonforfeiture laws do not apply, and to which the NAIC model also is inapplicable. These types of products include group annuities, immediate annuities, payout options under deferred annuities, and stand-alone guaranteed living benefits. Some might argue that such products "satisfy" applicable nonforfeiture standards because there *are* no applicable standards. For example, an immediate annuity would not run afoul of applicable nonforfeiture (or SNFL) requirements, even if it provided a liquidity option (after annuity payments begin) that would yield a net surrender value substantially below the present or discounted value of the future payment stream (in effect, having the contract owner bear an investment loss on exercise of the liquidity feature, such as through an unlimited MVA). But if, as postulated above, this requirement of the Harkin Amendment is viewed as a type of invest-

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[30] This introductory phrase in subparagraph (2)(B) does not include the word "similar" to modify "requirements," but that obviously seems to be what it means.

[31] Due to these variables, different actuaries might calculate different maximum permissible surrender charges for the same product. For example, we understand that Actuarial Guideline 3, which permits the use of a 2% discount rate, may allow a surrender charge of nearly double that otherwise permitted, but that some states do not permit the use of Actuarial Guideline 3.

[32] *See VALIC, supra* note 3, 359 U.S. at 620-621; SEC Release No. 33-8996, *supra* note 6, 74 Fed. Reg. at 3142, text at note 40 (this was before Harkin was enacted). However, the Harkin Amendment relies heavily, and explicitly, on state insurance laws, not just with respect to nonforfeiture, but also with respect to suitability, and the heading of Section 989J begins "FURTHER PROMOTING THE ADOPTION OF THE NAIC MODEL REGULATIONS." Query, then, whether and to what extent qualification under the Harkin Amendment remains a federal question.

[33] With respect to reliance on actuaries, we note that the SEC requires an actuarial opinion in the context of variable life insurance illustrations included in a prospectus. *See* SEC Form N-6, Item 26(l).

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ment risk standard, then query whether actually meeting some nonforfeiture minimum is essential to meeting the spirit of Harkin.

Similarly, simply meeting the 'letter' of 'minimum' nonforfeiture standards could, for some product designs, be difficult or challenging for the SEC to accept, notwithstanding the plain language of the Harkin Amendment. For example, the SNFL does not actually require any surrender rights, and it does not actually mandate a minimum 'ongoing' cash value – it requires that if a surrender is permitted, it must meet minimum standards. And this minimum generally does not apply to death benefits or annuitization values. During periods prior to surrender, it appears that 'negative interest' is allowed under SNFL, and market value adjustments can significantly reduce cash values while the product is still in compliance with the SNFL. With these 'limits' of the SNFL (and specific state nonforfeiture laws) in mind, how are regulators likely to interpret this requirement of Harkin? Put another way, how comfortable should companies be with a narrow, literal compliance with nonforfeiture standards, regardless of the extent to which some investment risk is nevertheless born by the contract owner?

Another type of uncertainty that continues to exist under the Harkin Amendment is based on the question of what constitutes the ''contract.'' The Harkin Amendment, like Section 3(a)(8), simply refers to a ''policy'' or ''contract'' without defining the term. In the *United Benefit* case,[34] the Supreme Court bifurcated a deferred annuity, for Section 3(a)(8) analysis purposes, between its accumulation phase and its payout phase.[35] The Harkin Amendment (like Section 3(a)(8)) refers to an ''insurance . . . policy or annuity contract'' and does not differentiate between or specify a deferred or immediate annuity or the accumulation or payout phase of a deferred annuity. A deferred annuity could certainly comply with the terms of both of the investment risk requirements of Harkin (not varying according to the performance of a separate account, and satisfying SNFL) during the accumulation phase, but then allow the contract owner to bear considerable investment risk during the payout phase (by, for example, allowing surrenders at any time but subjecting them to an unlimited MVA; or perhaps by imposing a surrender charge after annuitization that would far exceed the maximum surrender charge permitted during the accumulation phase). Could such a product be bifurcated, with the accumulation phase qualifying under Harkin but the payout phase failing to qualify as exempt under Harkin (or under a traditional Section 3(a)(8) analysis)? Or does Harkin provide for 'single contract' treatment, with the Harkin-qualified accumulation phase carrying the payout phase with it?

The issue of what constitutes the ''contract'' under the Harkin Amendment, and how the nonforfeiture requirement is applied, is also presented by various types of insurance products with multiple 'buckets' or investment options. A ''combination'' variable annuity contract, for example, can include within it several types of investment options, such as (a) variable subaccount options (which clearly are securities), (b) a traditional fixed (or general account) option (which might clearly qualify for the Rule 151 safe harbor and not be a security), and (c) a fixed indexed subaccount option.[36] Even a ''simple'' fixed indexed annuity contract can offer multiple buckets – such as one tied to an equity index and one tied to a bond index (or different buckets with one, three, and five year maturity or reset dates, for example). Since SNFL (and specific state laws) generally apply to the contract as a whole, a contract owner could suffer very substantial losses in one bucket if such losses are sufficiently offset by gains in another bucket.[37] Therefore, and based on the general notion of limiting investment risk, should or could the nonforfeiture prong be applied separately to each bucket, notwithstanding that SNFL technically applies on an overall contract-wide basis?[38] On the other hand, and notwithstanding that what constitutes an ''annuity'' under Section 3(a)(8) has been said to be a federal question,[39] shouldn't satisfying state insurance law nonforfeiture standards be a state law question?

Overall, there may be numerous products and product designs and features that satisfy (or arguably sat-

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[34] *See United Benefit, supra* note 3.

[35] The fixed payout phase was viewed as qualifying under Section 3(a)(8) and was not at issue. The Court's analysis was focused on the accumulation phase.

More recently, the Supreme Court affirmed the viability of a ''bifurcation'' analysis in evaluating whether a ''deposit administration contract'' or ''participating group annuity'' issued by John Hancock Mutual Life Insurance Company, or a portion thereof, constituted ''plan assets'' (as opposed to a ''guaranteed benefit policy'') under the Employee Retirement Income Security Act of 1974 (ERISA). The Court ''[sought] guidance from [the] Court's decisions construing the insurance policy exemption'' in the 1933 Act, and stated that the bifurcation approach — or ''the division of the contract into its component parts and examination of risk allocation in each component'' — was ''well suited'' to an analysis of the Hancock annuity. The Supreme Court held that to determine whether a contract qualifies as a ''guaranteed benefit policy'' under ERISA, ''each component of the contract bears examination.'' *John Hancock Mutual Life Ins. Co. v. Harris Trust & Savings Bank*, 114 S. Ct. 517, 527 & 529 (1993).

[36] The Section 3(a)(8) analysis is typically applied to 'combination' products on a separate, bucket-by-bucket basis. A variable annuity typically has variable investment options that are registered, and a separate fixed account option that is analyzed separately under Section 3(a)(8) (and very frequently, treated as exempt under that section and hence unregistered).

[37] These losses can be 'unrealized' declines in the cash value of a bucket, or 'realized' losses on a cash withdrawal of all (or part) of a bucket, if the contract remains in force with respect to other bucket(s).

[38] The same question, of applicability on a bucket-by-bucket basis, can be asked of the 'no separate account' requirement of Harkin. In this context, however, the question might be viewed differently. For example, a typical variable annuity with a fixed account option, analyzed as a single contract, would fail the Harkin Amendment's 'no separate account' requirement because of the variable investment options even if the fixed account option, analyzed separately, would meet all of the Harkin Amendment requirements. In other words, under a single contract analysis, the separate account that supports the variable options would cause the entire contract, including the fixed account option, to fail to meet the Harkin Amendment. However, as noted above, a Section 3(a)(8) analysis generally has been applied to each bucket separately.

[39] *See VALIC, supra* note 3; SEC Release No. 33-8996, *supra* note 6, 74 Fed. Reg. at 3142, text at note 40. This 'federal question' position was pre-Harkin, and certainly its applicability to the nonforfeiture and suitability requirements of Harkin is open to question because those requirement are specifically based on state law requirements (or NAIC model state requirements).

isfy) the literal terms of the nonforfeiture requirement (and the 'no separate account' requirement) of Harkin, yet nevertheless allow the contract owner to bear very significant investment risks. This may provide greater latitude in (unregistered) product design than existed before Dodd-Frank was enacted; however, taking advantage of (or pushing the limits of) such latitude should be undertaken only after a careful analysis and understanding of the regulatory uncertainties and risks.

**C. The Suitability Requirement** As postulated above, the first two requirements of Harkin can be viewed as investment risk criteria, and in that broad sense they can at least perhaps be analyzed and applied in light of 'traditional' and other (Rule 151) investment risk analysis. But the third requirement, suitability, has no precedent in Section 3(a)(8) analysis or jurisprudence. Moreover, it appears to have been (and to our knowledge, clearly was) drafted very hastily. It has certain anomalies, and a literal reading or application can produce results that seem clearly unintended and unworkable. Applying this aspect of the Harkin Amendment will be particularly challenging for all parties (insurers, distributors, and regulators).

In interpreting and applying this requirement, it might be prudent to keep in mind the proposition suggested earlier that, in a 'big picture' way, the Harkin Amendment can be viewed as eliminating the marketing test and adding a suitability test – in effect, substituting a suitability requirement for the 'traditional' marketing test. Moreover, this 'substitution' hypothesis should be considered in light of the concept that at some level, both the marketing test and the suitability requirement, in perhaps similar but clearly different ways, are designed to protect investors from abusive, unfair, deceptive or just high-pressure sales tactics.[40]

**Alternative Suitability Tests; Different Effective Dates**. As noted above, there are two alternative suitability tests in Harkin, and only one or the other test must be met. What can be termed the 'mandatory' test, in subparagraph (a)(3)(A) of Section 989J, only applies to contracts issued on or after June 16, 2013 – in effect, this provision has an effective date of June 16, 2013.[41] The 'voluntary' test, in subparagraph (a)(3)(B), was available to be relied upon with the enactment of Dodd-Frank – in effect, it had an effective date of July 22, 2010.

**Contract vs. Company Suitability Test**. The first two requirements of the Harkin Amendment (not varying with separate account performance, and satisfying nonforfeiture), discussed above, are *contract* level requirements – (1) *the contract* must have a (cash) value that does not vary with the investment performance of a separate account, and (2) *the contract* must meet the nonforfeiture test. In contrast, however, both of the suitability tests are (or can be), in substance, *company* level tests – they both **can** be met if the contract is issued "by an insurance company that" meets the specified suitability requirement.

The first suitability test (subparagraph (A)) can be viewed as a 'mandatory' test because it depends on mandatory requirements of state law. This test can be met in two ways. It can be met, as indicated above, at the company level: if the contract is issued *by an insurance company* that *is domiciled* in a state that has adopted regulations that substantially meet or exceed the minimum requirements of the NAIC Suitability in Annuity Transactions Model Regulation ("SATMR"). (Alternatively, this test is met if *the contract* is issued in a state that has adopted those specified suitability requirements). This test can be met based solely on the adoption of regulations by the issuing company's state of domicile, even with respect to contracts issued in other states that have not adopted any such suitability requirements.[42]

The second suitability test (subparagraph (B)) can be viewed as 'voluntary' because it depends on voluntary actions by the insurance company, rather than mandatory requirements of state law. This test is met if the contract is issued *by an insurance company* "that adopts and implements practices on a nationwide basis" that meet certain suitability requirements. Those "practices"[43] must be "for the sale of any insurance *or* endowment policy *or* annuity contract *or* optional annuity contract" (emphasis added) and the practices must meet the NAIC model *annuity* suitability regulation.

A possible uncertainty with both of these company level suitability tests is that they can be met, literally, even if there are no suitability requirements applicable to the sale of the particular type of product at issue. For example, this would seem to mean that a company's sale of *life* insurance policies could literally meet this company level suitability test if the company is domiciled in a state that has adopted suitability rules that only apply to the sale of *annuities* (thus meeting the first suitability test). (The treatment of life products under the Harkin Amendment is discussed more fully below). Although it is less clear, it also could be argued, because the company practices must be for the sale of life insurance policies "or" annuity contracts, that the second suitability test literally is met with respect to the sale of life insurance policies if the company has adopted and implemented nationwide practices for the sale of annuity contracts that meet the specified standard. That is, based on the peculiar wording of the statute, it could be argued that the state rules or the company 'practices' do not have to be applicable to the par-

[40] The suitability and marketing considerations are both "outside" of the four corners of the insurance policy or annuity contract itself. In contrast, the investment risk tests are all based on the specific terms of the contract itself. This is true of all of the different investment risk tests – the traditional test based on the *VALIC* and *United Benefit* cases, the requirements embodied in Rule 151, the 'more likely than not' test in (now vacated) Rule 151A, and now (at least arguably) in the separate account and nonforfeiture requirements of the Harkin Amendment.

[41] It has been suggested that the 'delayed' effectiveness of this test and its June 2013 date are intended to allow the states time (and influence them) to adopt regulations that would in effect provide for a largely uniform 'nationwide' suitability standard.

[42] Interestingly, as noted in the text, this requirement is based solely on certain rules being 'on the books.' The requirement is, on its face, met even if the insurance company does not comply with, or even make an effort to comply with, those requirements.

[43] What, exactly, are "practices"? Are they written policies and procedures? Do such policies and procedures constitute "practices" or not, depending on the extent to which they are enforced – vigorously, lightly, or not at all? Is 100% compliance with the policies and procedures necessary in order for them to constitute "practices" that are implemented "on a nationwide basis"?

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ticular insurance product for this requirement, at least literally, to be met.[44]

However, especially if, as postulated above, the Harkin Amendment in effect substitutes a suitability standard for the traditional marketing test, then it would seem problematic to rely on the Harkin Amendment for a *particular contract* that is not subject to *any* suitability requirement (*and* no marketing test), simply because the *company* meets Harkin's suitability requirement. Fundamentally, if the question is the qualification of a contract for the exemption, then shouldn't the suitability requirement (and other requirements) of Harkin be applied to that contract? As indicated above, applying the suitability test at the company level may, in certain circumstances, ultimately leave one with an uneasy feeling. It seems that suitability simply should be a contract level requirement, notwithstanding the structure and wording of the Harkin Amendment.

**Applying the Suitability Tests: "Meets" and "Substantially Meets"**. Even assuming that the insurance product at issue is an annuity contract, and that suitability requirements (either mandatory or voluntary) apply or are applied at the contract (rather than the company) level, there remain issues and uncertainties in determining if the suitability requirement is met. The mandatory suitability test is met (after June 16, 2013) if satisfactory suitability regulations have been adopted[45] in either the insurer's state of domicile, or ''in a State'' (read: in *the* State?) in which the contract is issued. If the state of domicile prong is relied on, then the Harkin exempt status applies on a nationwide basis.[46] However, if the state of issue prong is utilized, then the exemption would apply on a state by state basis, depending on if and when each state adopts satisfactory suitability rules.[47]

The mandatory and the voluntary suitability tests of Harkin differ in that the June 2013 mandatory test requires that the state rules ''*substantially* meet or exceed'' (emphasis added) the minimum requirements of the NAIC Suitability in Annuity Transactions Model Regulation (''SATMR''), while the voluntary test requires the company adoption and implementation of practices ''that meet or exceed'' the minimum requirements of SATMR (with no 'substantially' qualification).[48]

The concept of ''substantially'' meeting or exceeding ''minimum'' requirements obviously presents a degree of ambiguity and uncertainty, with numerous substantive issues. But there are also procedural issues, and the Harkin Amendment provides no procedural guidelines. Theoretically at least, a state insurance commissioner could declare (through a bulletin or otherwise), or its general counsel could issue an opinion concluding, that the state's rules substantially meet or exceed the SATMR requirements; what effect would this have? Would it be conclusive, influential, or could it be disregarded by the SEC? The NAIC is not itself a regulatory body with interpretive or enforcement authority, but the Harkin Amendment relies on the NAIC's model suitability regulations so perhaps the NAIC could provide some guidance or assistance to address whether specific states' rules satisfy this standard. Another possibility is that the SEC could provide some guidance regarding this standard.

**Adopting and Implementing Practices**. Although the voluntary suitability test, based on a company's ''practices,'' is simply 'meets or exceeds' with no 'substantially' qualification, it may present more significant challenges in practical application. How can a company be assured that its practices meet the minimum SATMR requirements? Other regulatory 'compliance' requirements are based on written policies and procedures,[49] and certainly insurance companies that intend to rely on this test will have written policies and procedures, manuals, requirements, etc., and they will undoubtedly address, point by point, everything in SATMR. But the requirement to ''implement[s] practices'' seems to require something more. What can, or must, a company do to 'adopt and implement practices' that meet or exceed SATMR requirements? The assistance of independent third parties in establishing, or reviewing and

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[44] This reading of the Harkin Amendment would apply the separate account and nonforfeiture requirements at the contract level, and the suitability requirement at the company level. Applying certain tests or requirements at the contract level and another requirement at the company level is not uncommon with respect to the status of insurance products under the 1933 Act. Section 3(a)(8) itself has both types of requirements – the product (1) must be a life or annuity product, (2) that is issued *by a corporation* that is subject to state insurance regulation. Rules 151 and 151A both apply, by their explicit terms, only (1) to contracts that meet certain conditions, and (2) where the issuing corporation meets a company level test (specifically, being a state regulated insurance company).

[45] Common sense would seem to dictate that the rules need to have been adopted before the date the contract is sold (putting aside any distinction between the date sold or applied for and date of issuance). But is the requirement met with respect to contracts sold after the rules have been adopted, but before the effective date of the rules?

[46] This seems to be the result under the Harkin Amendment even though generally, an insurer's state of domicile does not enforce its regulations with respect to a domiciliary company's nationwide (*i.e.*, out-of-state) sales or market conduct activities.

[47] Making the applicability of a federal exemption, from the 'nationwide' 1933 Act, depend on if (and when) an individual state adopts satisfactory rules, may present practical problems. Can a registration statement be filed under the 1933 Act that treats a particular class of contract (*e.g.*, a contract form) as a security in some states, but not others? Can that status be changed in a particular state, from a federal security to qualifying as exempt under Harkin, after the effective date of the registration statement under the 1933 Act, if and when the state adopts satisfactory regulations after the 1933 Act effective date?

Similarly, what is the 1933 Act status of a contract whose owner buys the contract in one state (where it qualifies under Harkin) but then moves to another state (where it does not qualify) and then the owner makes additional premium payments? The suitability requirement of Harkin (paragraph (3)) refers to a contract ''that is issued'' in a state, so presumably the contract's original status on the date of issue carries forward for the life of the contract. But does this square with the commonly accepted notion that each premium payment is a new 'sale'' under Section 5 of the 1933 Act?

[48] The subparagraph (A) mandatory test refers to the SATMR adopted by the NAIC in March 2010, while the subparagraph (B) voluntary test refers to the NAIC SATMR (Model 275). This difference seems to be meaningless, although theoretically the NAIC could amend or change ''Model 275'' while the version adopted in March 2010 cannot be changed (since the clock cannot be turned back).

[49] *E.g.*, Rule 38a-1 under the Investment Company Act of 1940 requires written policies and procedures reasonably designed to ensure compliance with the federal securities laws.

evaluating, a company's practices would certainly be helpful in this regard, and should carry some or even considerable weight, but in the final analysis this test seems to have inherent ambiguities and uncertainties so that meeting this test will always be subject to second-guessing by state or federal regulators. At the very least, however, a single isolated instance of an unsuitable sale that is clearly contrary to and violative of the company's policies and procedures (and assuming vigorous efforts to implement and enforce those policies and procedures), should not be sufficient to show that the company has not adequately ''implemented'' practices that meet the *minimum* requirements of SATMR. Well-designed and solid policies, practices and procedures, that fully address all of the SATMR requirements, and that are effectively implemented and enforced, should satisfy this requirement notwithstanding an isolated, occasional or minor failure.

The voluntary company practices must be adopted and implemented on a ''nationwide'' basis. There is no guidance as to what ''nationwide'' means, other than perhaps common sense and the purposes of the suitability requirement. First, if a company is licensed in less than 50 states, then it should only need practices that apply and are implemented in those states in which it is licensed, and arguably only in those states in which it is doing business or even just in those states in which it is selling the applicable type of product. Second, it is by its terms a nationwide requirement, so it would seem that if the practices are not applicable in all states in which the company is selling the products, then this requirement would not be met in any state.[50]

**Subject to Examination**. The voluntary 'company practices' test also includes a provision that the company ''is therefore subject to examination'' by the states (of domicile or sale of such products) ''for the purpose of monitoring compliance with this section.'' It is not entirely clear whether this ''therefore'' clause is merely a statement of fact (the consequences of adopting nationwide suitability practices) or if it is an additional requirement. But assuming the latter, it raises numerous questions, both procedural and substantive. To what extent will state insurance departments examine an insurance company to 'monitor compliance' with voluntary practices adopted by the company? More particularly, will any state – particularly a state that has adopted its own suitability requirements – actually examine or monitor for compliance with the NAIC model regulation? That could be what this requires, with respect to a company that relies on the voluntary (subparagraph (B)) suitability test. But it should be sufficient, in accordance with the plain language of the statute, that the company is merely ''subject to'' such examination.[51]

**Successor Regulations**. In different ways, both the mandatory and voluntary suitability test refer to compliance with 'successor' model regulations. The mandatory test requires the applicable states (i) to adopt rules that substantially meet or exceed the minimums of the NAIC SATMR adopted in March 2010 (as noted above), *and* (ii) to adopt rules that substantially meet or exceed the minimums ''of any successor modifications thereto'' within five years of the adoption by the NAIC of any successors. This seems clear enough. However, assume that a state adopts rules that substantially meet or exceed the NAIC SATMR, and thereafter the NAIC adopts what arguably are minor or technical modifications to its SATMR, and after five years the state has not adopted any comparable modifications to its suitability regulation. Should that state's rules still be considered to ''substantially'' meet or exceed the modified (*i.e.*, successor) SATMR?

The voluntary suitability test simply requires a company to adopt and implement practices that meet or exceed the minimums in the NAIC SATMR (Model 275) ''or any successor thereto.'' There is a potential, or real, ''timing'' glitch in this provision. Consider whether it is possible that if a company is relying on practices that meet the NAIC SATMR (Model 275) for qualification of products as exempt under Harkin, and then the NAIC adopts ''any successor'' regulation, could the company then *instantly* – at the moment of adoption by the NAIC – lose its qualification as exempt, until it adopts and implements new or revised practices that comply with the successor model regulation? Surely this was not intended, but it seems to be the literal result. How much time does the company have to adopt and implement new practices in accordance with the successor regulation? In this situation, it would certainly be appropriate, at least, for the SEC to provide some guidance with respect to a reasonable period for compliance with the successor model regulation.

## V. Life Insurance Products

In addition to virtually all of the issues and uncertainties noted above, life insurance products present a special type of problem under the Harkin Amendment. Although as noted above, the focus and intent of the Harkin Amendment was indexed annuity products, it clearly encompasses life insurance products as well. Two things in the Amendment itself compel this conclusion. First, it uses the full phrase from Section 3(a)(8), ''any insurance or endowment policy or annuity contract or optional annuity contract,''[52] which clearly encompasses life insurance policies as well as annuity contracts. Second, subparagraph (a)(2)(B) specifically refers to complying with the Model Standard Nonforfeiture Law for Life Insurance.

The issue is that the third requirement of the Harkin Amendment (subparagraph (a)(3)), the suitability test), only refers to the NAIC Suitability in *Annuity* Transactions Model Regulation – in both the mandatory test and the voluntary test – and does not mention any similar or

[50] ''State'' as used herein is intended to include territories and the District of Columbia.

[51] The state examination factor may be further complicated by the language in Section 989J that refers to examinations for compliance ''under this section.'' Technically and literally, ''this section'' means Section 989J – the entire Harkin Amendment. This would mean state examination for compliance with all three of the Harkin Amendment requirements, including the first requirement that the contract value not vary with the performance of a separate account, and the second or nonforfeiture requirement. Can state market conduct, or other, examinations be said to or will they monitor for compliance with these parts of Section 989J? The better reading of this ''under this section'' language may be that it really refers to only the suitability requirement of Harkin (or actually just the voluntary suitability test in which this language appears).

[52] The Harkin amendment uses this full phrase twice, in the opening clause of paragraph (a) and again in paragraph (b), the Rule of Construction (addressed below).

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comparable requirement or standard for life insurance products. With regard to the mandatory test, this depends on whether the applicable state has adopted rules that govern suitability in the sale of an insurance policy (*or* annuity contract) that meet or exceed the NAIC model *for annuities*. Literally, this requirement would be met with respect to life insurance products if the state adopts satisfactory rules for annuity contracts, even though there would or could be no suitability rules applicable to life policies. This result would seem to be troublesome, as a practical matter, for an insurance company to rely upon.

It is certainly plausible, however, for a company to rely on state rules for suitability in the sale of life insurance products, if such rules are adopted, but here the challenge is how to get comfortable that rules for life insurance policy sales substantially meet or exceed the requirements of rules for annuity sales.

The voluntary suitability test also presents daunting challenges with respect to life insurance policies. Can an insurance company adopt and implement suitability practices for life insurance products that meet or exceed the minimum standards in SATMR for annuities? Remember, this test does not have a ''substantially'' qualification in it.

Since Congress clearly intended the Harkin Amendment to apply to life insurance, and although the Harkin Amendment does not direct the SEC to engage in rulemaking, it would certainly be helpful, and consistent with the spirit of the Harkin Amendment, for the SEC to provide some guidance on how to comply with the Harkin Amendment's suitability requirement with respect to life products.

## VI. The Meaning or Effect of Qualifying Under Harkin

Notwithstanding the uncertainties noted above (and perhaps others), there are certainly classes or categories of insurance products that will clearly qualify as exempt under the Harkin Amendment – for example, excess interest annuities that are not connected to a separate account, that are subject to and meet the state's nonforfeiture law, and that are issued by an insurance company domiciled in a state that has adopted the NAIC SATMR verbatim. So what, exactly, does it mean to qualify as 'exempt' under the Harkin Amendment? Unfortunately, that is another area of some uncertainty.

The Harkin Amendment does not amend Section 3(a)(8) or any other section of the 1933 Act, or any other federal securities law.[53] Instead, the Harkin Amendment is written as a direction or order to the SEC – it states that ''[t]he Commission shall treat as exempt securities described under section 3(a)(8)'' of the 1933 Act, any insurance product that meets its requirements (hereafter, products that qualify under the Harkin Amendment are referred to as ''Harkin Products''). At a minimum, Harkin Products are exempt from the registration provisions of the 1933 Act.

Beyond that, in determining the effect of qualifying under Harkin, two parts of the wording of the Harkin Amendment's ''direction'' must be considered. The language of the Harkin Amendment directs that Harkin Products be treated *as exempt securities* under the 1933 Act, and the language directs that *the Commission* shall treat them as exempt. This language presents several questions.

The first question is whether such products are merely *exempted* from the registration requirements of the 1933 Act, or completely *excluded* from all provisions of that Act (including its antifraud provisions).[54] Prior to the Harkin Amendment, it was accepted doctrine that products that qualified under Section 3(a)(8) were not merely exempt from registration but excluded from all provisions of the 1933 Act, including its antifraud provisions. The SEC has said that ''there can be no serious question that Congress intended any insurance contract . . . falling within section 3(a)(8) of the [1933] Act to be excluded from all provisions of the Act, notwithstanding the plain language of the Act that section 3(a)(8) is an 'exemption' from the registration but not the antifraud provisions.''[55] However, the Harkin Amendment certainly expanded the scope of the Section 3(a)(8) exemption to include certain types of products (*e.g.*, fixed indexed annuities) that were not in existence when Congress enacted the 1933 Act. And while the Harkin Amendment does use the term ''exempt,'' that is the term that Section 3(a) has always used, and there is no indication that Congress intended it to have a different meaning in this context than it has previously been given. Accordingly, while it may not be entirely clear whether Harkin Products will be treated as excluded from all provisions of the 1933 Act, or merely exempt from its registration requirements,[56] and although arguably the Harkin Amendment may have reopened this question, there does not appear to be anything beyond what is noted above to suggest that Har-

[53] It does not appear that the Harkin Amendment, Section 989J of Dodd-Frank, will actually be codified or appear anywhere in the U.S. Statutes.

[54] The fraud provisions of Sections 12(2) and 17 of the 1933 Act are specifically made applicable to instruments that are exempted under Section 3 of that Act.

[55] SEC Release No. 33-6558, *supra* note 22, text at footnote 25 (footnote omitted). The Commission reiterated this view in proposing Rule 151A. *See* SEC Release No. 33-8933, note 27. This view of Section 3(a)(8) has been called ''supererogation.'' *See* footnote 2, *supra*.

[56] In addition, the Securities Exchange Act of 1934 (the ''1934 Act'') does not contain an express exemption or exclusion provision comparable or parallel to Section 3(a)(8) of the 1933 Act, and the Harkin Amendment says nothing about the 1934 Act or how the SEC should treat Harkin Products under the 1934 Act. This could possibly have implications with respect to licensing requirements for sellers of Harkin Products, and with respect to applicability of the fraud provisions under the 1934 Act, specifically Rule 10b-5.


## Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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kin Products should not be treated as excluded from all provisions of the Act.[57]

Second, since the Harkin Amendment is written as a direction *to the SEC*, its impact with respect to other parties remains to be seen. With respect to broker-dealers, in 2005 the NASD (now FINRA) addressed equity-indexed annuities, expressed significant concerns over their marketing and their treatment or status under the federal securities laws, and questioned whether broker-dealers should treat sales of such products as Outside Business Activities or Private Securities Transactions.[58] As of this writing, FINRA has not indicated (at least publicly) how it will treat, or how it expects its members to treat, Harkin Products.[59] Moreover, distributors of insurance products – whether registered broker-dealers or unregistered insurance marketers – will need to decide how they will treat products that insurers assert are Harkin Products.

Then, of course, there is the issue of private litigation. Will courts allow private litigants (purchasers of Harkin Products) to proceed with claims based on the securities status of Harkin Products, such as anti-fraud claims under the 1933 or 1934 Acts?[60] Or should they accept what seems to be the better view, that despite its wording, the Harkin Amendment really is a declaration of law that Harkin Products are simply not to be treated as securities?[61]

## VII. Traditional 3(a)(8) Analysis After Harkin

The Harkin Amendment includes a ''Rule of Construction,'' (paragraph (b)), as noted above, which provides that nothing in Section 989J ''shall be construed to affect whether'' a contract that does not meet its three conditions ''is or is not an exempt security under section 3(a)(8).'' This seems to mean that the Harkin Amendment should be ignored in analyzing whether a contract that does not meet its conditions is nevertheless exempt under Section 3(a)(8). This is in contrast to Rule 151, which has a 'penumbra' affecting Section 3(a)(8) generally, since ''[t]he rationale underlying the conditions set forth in [Rule151] is relevant to any section 3(a)(8) determination.''[62] As worded, the Rule of Construction seems to mean that the Harkin Amendment has no such penumbra.

Consequently, an insurance product that does not meet the Harkin Amendment's three conditions (or the Rule 151 safe harbor) should be analyzed under a traditional, pre-Harkin consideration of Section 3(a)(8) jurisprudence and Commission interpretations. As indicated above, this means a traditional analysis of investment risk, which would not be based on the significant reliance that Harkin places on meeting nonforfeiture standards. This also means that marketing must be carefully considered and could still have a very significant impact on the traditional Section 3(a)(8) analysis.[63]

## VIII. Conclusion

The Harkin Amendment may have been intended primarily for fixed indexed annuities, and in that regard, this legislation certainly seems to end the SEC's rulemaking effort, at least for now, with respect to requiring registration of such annuities as securities. More generally, however, the Harkin Amendment is not limited to that type of annuity product. The Harkin Amendment certainly expands the Section 3(a)(8) exemption, and could include a wide variety of both life and annuity products. But this new exemption does raise a number of areas and subjects of uncertainty, and interpreting and applying its provisions will undoubtedly present interesting challenges for insurance companies, product distributors, and regulators.

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[57] This issue could be analyzed and discussed at great length, but that discussion generally is beyond the scope of this article.

[58] *See* NASD Notice to Members 05-50 (August 2005).

[59] Harkin is a direction to the SEC only, at least on its face, not to FINRA. On the other hand, FINRA is a self-regulatory organization under the supervision of the SEC, so the SEC's treatment of Harkin Products as exempt should govern FINRA's treatment of such products. But FINRA does treat (and therefore its members treat) 'exempt' securities as subject to many of its rules. See FINRA General Standards, Rule 0150(c).

[60] It seems unlikely that private litigants could maintain claims based on the unregistered status of such products under Section 5 of the 1933 Act, given the Harkin Amendment's direction to the SEC to treat such products as exempt, but other claims could be more of an open question.

[61] In part, this argument could be based on the notion that the Harkin Amendment represents a congressional determination (in accordance with the Meeks bill and its findings; see footnote 14, *supra*) to overrule, vacate, and eliminate Rule 151A in its entirety.

[62] SEC Release No. 33-6645, *supra* note 8, 51 Fed. Reg. at 20261 (adopting Rule 151) (footnote omitted). The SEC made a similar statement that the considerations that form the basis for Rule 151A, which would have applied only to indexed annuity products, are also relevant to the consideration of indexed life insurance. *See* SEC Release No. 33-8996, *supra* note 6, 74 Fed. Reg. at 3149. The impact of the adoption of Rule 151A and the related litigation (that resulted in its vacature) on Section 3(a)(8) jurisprudence is beyond the scope of this article. It should be noted, however, that the ''more likely than not'' investment risk test, was held to be reasonable (for purposes of Rule 151A) by the U.S. Court of Appeals for the D.C. Circuit.

[63] It also means that meeting suitability standards should not be relevant to the Section 3(a)(8) analysis, and that assumption of mortality risk can be taken into consideration.

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