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News Bulletin

December 17, 2009

SEC Agrees to 2-Year Stay of Rule 151A

On December 8, 2009, the Securities and Exchange Commission (the "SEC") stated in a filing with the U.S. Court of Appeals for the District of Columbia Circuit (the "Court") that it agreed to stay of 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." Compliance with Rule 151A is therefore postponed. Companies would have two years from that new publication date to comply with Rule 151A, or any reissued version of the rule. The filing was made in response to petitions filed by various insurance industry participants requesting the Court to reconsider its remand order that it issued on July 21, 2009 and void Rule 151A. The Court had previously ruled that the SEC failed to properly consider the effects of Rule 151A on efficiency, competition and capital formation in the insurance industry and remanded the issue to the SEC for reconsideration.[1]

For a detailed discussion of Rule 151A, please see our client alerts "SEC Regulation of Indexed Annuities" and "Update - SEC Regulation of Indexed Annuities."

The Rule

On December 17, 2008, the SEC approved Rule 151A granting the SEC the authority to regulate certain indexed annuity products, effective for all applicable annuity products issued on or after January 12, 2011. At such time, all indexed annuity products within the scope of Rule 151A would have to be registered with the SEC, sold via a prospectus, and sold only by those who are registered with the Financial Industry Regulatory Authority ("FINRA") as broker-dealers.

Rule 151A provides that an indexed annuity is not an "annuity contract" under Section 3(a)(8) of the Securities Act of 1933, as amended (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
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> (b) amounts payable by the insurer under the contract are "more likely than not" to exceed the amounts guaranteed under the contract.

Annuity contracts that fall within this definition would not be entitled to the exemption afforded "annuity contracts" under the securities laws and would thus be classified "securities." If an insurer relied on the Section 3(a)(8) exemption from registration when issuing an annuity contract, the burden of proof would rest with the insurer to demonstrate that the annuity contract does not meet the above test. An insurer could rely on its

[1] *American Equity Investment Life Insurance Company et al. v. SEC*, 41 SRLR 1385, (July 27, 2009).

determination that the annuity contract does not meet the two-pronged test if the insurer could demonstrate that its (a) methodology, including its assumptions, are 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).

Rule 151A does not provide a safe harbor under Section 3(a)(8) for annuity contracts that do not meet the "more likely than not" test. If an insurer wishes to sell an annuity contract that does not fall within the definition created by the rule, the insurer must perform its own analysis to determine if the annuity contract (a) is exempt from the federal securities laws under Section 3(a)(8), (b) is subject to federal securities laws based on the investment risk and marketing tests established under federal case law, or (c) falls within the safe harbor created under existing Rule 151.

The Reaction

Opponents argued that the sale of indexed annuities was already adequately regulated by state insurance departments and guidance had been provided to those selling the products through releases by state insurance departments and FINRA. In addition to emphasizing the existence of legislation and guidance regarding the sale of indexed annuities, opponents of the rule questioned the SEC's authority to regulate such products, given the language of Section 3(a)(8) of the Securities Act and existing case law from the U.S. Supreme Court. Given the thousands of commenters who opposed the rule prior to its adoption, it was not surprising that a legal challenge questioning the SEC's authority and the cost-effectiveness of the rule was brought the same day the final rule was published in the Federal Register.

The Litigation

On January 16, 2009, a group of insurance companies filed suit against the SEC requesting that the Court (a) find that Rule 151A is 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. The petitioners argued that the SEC's actions contradict prior federal court precedent that holds that fixed indexed annuities are not securities,[2] and Supreme Court precedent that holds that allocation of risk is only one of three factors to consider when determining whether a product is an annuity or a security.[3]

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) of the Securities Act 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 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 is required to determine whether the action "is 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 in its analysis, 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 for reconsideration. Since the order did not vacate the rule, the effective date of January 12, 2011 remained in place.

The standing effective date caused insurance industry participants to file petitions requesting that the Court vacate Rule 151A to avoid having to prepare for its effective date prior to the conclusion of the SEC's study and a final decision by the SEC whether to revise or vacate Rule 151A.

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[2] *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1987). The Supreme Court denied the petition for a *writ of certiorari*.
[3] *See SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959). *See also SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

Next Steps

Based on the SEC's response to the recent petitions filed with the Court, Rule 151A most likely will not be vacated. In response to a Court order requesting additional briefing resulting from the SEC's failure to examine the effects of Rule 151A under Section 2(b), the SEC is currently studying the effects of the rule and plans to furnish a final report on the impact of Rule 151A on the insurance industry by spring 2010. The SEC admitted that an additional notice and comment period will be required, suggesting that changes to the rule are forthcoming; however, the SEC has shown no signs that it intends to abandon Rule 151A.

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