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Subject: **Appellate Court Upholds Challenge to SEC Regulation of Fixed Indexed Annuities (“FIAs”)**

Major References: [*American Equity Investment Life Insurance Company v. Securities And Exchange Commission, F.3d , No. 09-1021 \(D.C. Cir. July 12, 2010\)*](#)

Prior AALU Washington Reports: 09-06; 08-113; 08-59

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The U.S. Court of Appeals for the District of Columbia (here called the Court) has reversed a lower court ruling that had upheld the right of the Securities and Exchange Commission (SEC) to regulate fixed indexed annuities (FIAs). In its decision for the plaintiff insurance companies in American Equity Investment Life Insurance Company v. Securities And Exchange Commission, the Court determined that the SEC had failed properly to consider the effect of the rule upon efficiency, competition, and capital formation, as required by the Securities Act of 1933.

As previously reported (*see* our Bulletins Nos. 09-06, 08-113, and 08-59), the SEC, on January 8, 2009, issued a release adopting new Rule 151A under the Securities Act of 1933 (“the 1933 Act”). The rule, which had an effective date of January 12, 2011, would have required insurers to register as securities most indexed annuities being currently offered on or after that date. Therefore, producers selling these products would have to be securities-licensed once the products were registered as securities with the SEC. Importantly, the rule did not cover indexed life insurance products, although the rule likely would have had implications for the status of such products under the federal securities laws.

As background, the 1933 Act exempts from federal regulation annuity contracts issued by a corporation subject to regulation by state insurance laws. SEC Rule 151A states that fixed indexed annuities (FIAs) are not annuity contracts within the meaning of the 1933 Act. Because of this rule, FIAs would be subject to the full panoply of requirements set forth by the 1933 Act, instead of being subject solely to state insurance laws.

The Plaintiffs in the lawsuit made two main arguments against the validity of the rule, as follows:

1. That the Commission unreasonably interpreted the term “annuity contract” not to include FIAs; and
2. That the SEC failed to fulfill its statutory responsibility under the 1933 Act to consider the effect of the new rule on efficiency, competition, and capital formation.

1. ***Reasonableness of SEC’s Interpretation.*** The Court found against the Plaintiffs on their first contention, based principally on the difference between traditional fixed annuity contracts and indexed annuity contracts. This difference it described as follows:

“A traditional fixed annuity is a contract issued by a life insurance company, under which the purchaser makes a series of premium payments to the insurer in exchange for a series of periodic payments from the insurer to the purchaser at agreed upon later dates. In a fixed annuity, the insurance company guarantees that the purchaser will earn a minimum rate of interest over time. Fixed annuities are subject to state insurance law regulation, and are exempt from federal securities laws. . . . State insurance laws governing fixed annuity contracts require insurance companies to guarantee a minimum of the contract value after any costs and charges are applied. These state laws generally require the minimum guarantee be at least 87.5 percent of the premiums paid, accumulated at an annual interest rate of 1 to 3 percent. . . . The [state] laws also generally impose disclosure and suitability requirements, which vary from state to state. (Citations omitted.)

A fixed index annuity (FIA) is a hybrid financial product that combines some of the benefits of fixed annuities with the added earning potential of a security. Like traditional fixed annuities, FIAs are subject to state insurance laws, under which insurance companies must guarantee the same 87.5 percent of purchase payments. Unlike traditional fixed annuities, however, the purchaser’s rate of return is not based upon a guaranteed interest rate. In FIAs the insurance company credits the purchaser with a return that is based on the performance of a securities index, such as the Dow Jones Industrial Average, Nasdaq 100 Index, or Standard & Poor’s 500 Index. Depending on the performance of the securities index to which a particular FIA is tied, the return on an FIA might be much higher or lower than the guaranteed rate of return offered by a traditional fixed annuity. Due to the fact that the purchaser’s actual return is linked to the performance of a securities index, however, the purchaser’s return cannot be calculated until the end of the crediting period. Insurance companies typically apply an annual crediting period; that is, the index-linked interest of an FIA is typically calculated on an annual basis after each one-year period ends.”

The Court noted that the U.S. Supreme Court, in *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65 (1959) (VALIC) and *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) had determined variable annuity contracts and “flexible fund” annuity contracts to be securities because, like securities, the benefit payments of such contracts vary with the success of the investment management. The Supreme Court explained that a variable annuity did not fall within the 1933 Act’s exemption for traditional annuities because it placed “all the investment risks on the [purchaser], none on the company.” As the Supreme Court said, “the concept of ‘insurance’ involves some investment risk-taking on the part of the company.” (Citing *VALIC*, *supra*.)

In *United Benefit*, the company argued that, under *VALIC*, the existence *vel non* of substantial investment risk by the insurer ultimately determined whether a product fell within the 1933 Act exemption, but the Supreme Court disagreed that *VALIC* should be interpreted so narrowly. Rather, it explained, the critical inquiry under the 1933 Act was whether the product at issue “involve[d] considerations of investment not present in the conventional contract of insurance.”

In the instant case, the Court reasoned that the SEC could justifiably conclude that a FIA should be treated as a security applying the above precedents and the 1933 Act.

The standard for whether the SEC’s determination contravened the statute was set forth in *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). First, the Court must determine whether the statute being interpreted is ambiguous. In this case, the Court stated, “the 1933 Act is ambiguous, or at the very least silent, on whether the term “annuity contract” encompasses all forms of contracts that may be described as annuities.

Next, the Court must determine whether the SEC’s rule is a reasonable interpretation of the statute. It is irrelevant for this purpose that the Court might have reached a different—or better—conclusion than the SEC. The Court stated that the SEC could reasonably conclude that “considerations of investment not present in the conventional contract of insurance” are predominant in FIAs, and therefore that a FIA does not constitute an “annuity contract” under the 1933 Act.

2. *Effect on Efficiency, Competition and Capital Formation.* On this prong of the test, the Court found wanting the SEC’s compliance with the requirements of the 1933 Act.

Section 2(b) of the 1933 Act states that, for every rulemaking in which the SEC “is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”

The Court held that the SEC’s consideration of the effect of Rule 151A on efficiency, competition, and capital formation was “arbitrary and capricious,” in that it did not disclose a “reasoned basis for its conclusion that Rule 151A would increase competition.” The SEC’s efficiency analysis was similarly determined to be arbitrary and capricious in that it was an “incomplete” analysis of whether, under the existing [state law] regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors. Finally, the Court ruled, “the SEC’s flawed efficiency analysis also renders its capital formation analysis arbitrary and capricious,” in that the SEC’s conclusion that Rule 151A would promote capital formation was based significantly on the flawed presumption that the enhanced investor protections under Rule 151A would increase market efficiency.

The Court therefore granted the Plaintiffs’ petition to vacate the rule (prior to it’s having gone into effect) The Court noted that state regulations remain in place, and therefore that the potential for chaos in the regulation of FIAs would be significantly reduced or eliminated until such time as the SEC considers whether to reissue the rule.

Any AALU member who wishes to obtain a copy of *American Equity Investment Life Insurance Company v. Securities And Exchange Commission* may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at www.aalu.org, enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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