

## Life and Health Insurance Industry Brief

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EQUITY  
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### SEC Staff Proposal: Index Annuities Should be Considered Securities

In what we view as an almost unbelievable development, yesterday, the SEC staff officially recommended to the Board of Governors that a new rule [so-called Safe Harbor Rule 151(A)] be adopted, which would basically deem any index annuity to be a security and require registration of both the product and the sellers of the product.

The SEC staff recommended a ruling, consisting of two “prongs.” If an annuity passes both prongs, it should be considered an investment, rather than an insurance, product:

- 1) If amounts payable by the insurance company are calculated, in whole or in part by reference to the performance of a security, including a group or index of securities.
- 2) Amounts payable by the insurance company, under the contract, are more likely than not to exceed the amounts guaranteed under the contract.

Index annuities, which base returns over and above guaranteed amounts on performance of an index and provide expected returns above those of minimum guaranteed amounts, clearly pass both prongs. We believe traditional fixed annuities with market value adjustment mechanisms may also pass both prongs. As traditional fixed annuities and other traditional fixed insurance products provide for amounts payable that are more likely than not to exceed the amounts guaranteed under the contract, we believe prong 1 is of most importance.

(As an aside, we even wonder if traditional fixed annuities without market value adjustments pass both prongs. Are not returns calculated in whole by reference to the general account – which is in fact a group of securities?)

#### Proposal Appears to Ignore Case Law

Concentrating solely on the index annuity question, we believe the proposal ignores existing case law surrounding the Securities Act of 1933, which exempts from registration products sold by insurance companies.

In *S.E.C. v. VALIC* (1959), Justice William Douglas (writing for the majority) states that variable annuities are investments because, “the holder of a variable annuity cannot look forward to a fixed monthly or yearly amount in his advancing years.” Mr. Douglas also writes “the difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interest reflects – which may be a lot, a little, or nothing.” Additionally, Douglas stated that, “...in common understanding ‘insurance’ involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts.”

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We believe index annuities meet all of Justice Douglas' criteria. First, investment risk is placed firmly on the issuer: if options backing the index annuity index value underperform, the insurer would have to dip into its own earnings to make up the difference. Additionally, if the insurer's general account assets underperform, it bears that risk.

Second, the index annuity policyholder can look forward to a fixed monthly or annual amount upon maturity (in fact well before maturity). The policyholder may get more, but is guaranteed a fixed amount.

And finally, there is a guarantee that some fraction of the benefits will be payable in fixed amounts.

In *SEC v. United Benefit Life* (1967), the court asked two key questions with regard to the accumulation phase of an annuity: 1) is a fixed amount of benefits stipulated and 2) is there "some shifting of risk from policyholder to insurer, but no pooling of risks among policyholders." Additionally, does the insurer have a "dollar target to meet." If the answer is yes to both, the product should be considered insurance.

Index annuities would again seem to meet the *United Benefit* tests. Index annuities stipulate a fixed amount of benefits (although the amount could be higher), significant risk is shifted to the insurer (there is no pooling of risks among policyholders), and the index annuity provider most definitely has a "dollar target to meet."

In *Malone v. Addison Insurance Marketing* (2002), the Western District Court of Kentucky found that the fact that a plaintiff's argument that her return from an index annuity over and above the minimum guarantee was variable, and thus did involve an element of risk and uncertainty, was inconclusive as the insurer was found to bear substantially more risk than the purchaser.

Finally, the original Safe Harbor Rule 151 (1986) clearly included index annuities in the exemption. The rule read:

Any annuity contract or optional annuity contract (a contract) shall be deemed to be within the [exemption] provisions of section 3(a)(8) of the Securities Act of 1933, provided,

- (1) The annuity or optional annuity contract is issued by a corporation (the insurer) subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;
- (2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this section; and
- (3) The Contract is not marketed primarily as an investment;

Criterion 2 is satisfied if:

- (1) the value of the contract does not vary according to the investment experience of a separate account;
- (2) The insurer for the life of the contract
  - (i) Guarantees the principal amount of the purchase payments and interest credited thereto, less any deduction (without regard to timing) for sales, administrative or other expenses or charges; and
  - (ii) Credits a specified rate of interest to... net purchase payments and interest credited thereto; and
- (3) The insurer guarantees that the rate of any interest to credited in excess of that described in paragraph (b)(2)(ii) of this section will not be modified more frequently than once per year.

We believed, if anything, that the SEC staff would concentrate on Criterion 3, not basically amend Criterion (2), Sub-criterion (3) by adding that the sub-criterion is not effective if the excess interest credited is based on an index's performance.

But that is exactly what the SEC did, adding another hoop to crawl through on top of the question of which party to the contract bears a substantial amount of the risk.

#### **Where Does the SEC Go from Here?**

Following yesterday's proposal, the Commission will publish the proposed new rule. This may have already occurred by the time this note has been released, but will likely occur in no less than a few days.

A public comment period will follow, likely lasting 60 to 90 days.

At that time, the SEC staff will make its final recommendation to the Board of Governors. The staff may alter its proposal slightly, change its mind altogether and suggest that the Board of Governors refuse to make the official proposal into a rule, or recommend that the Board of Governors accept the proposal as originally proposed. Any substantial change to the proposal would necessitate a new Open Meeting.

The Board of Governors can accept the proposal and make it a rule, decline the proposal, or ignore the issue completely.

If the rule is accepted, Safe Harbor Rule 151 (A) will go into effect 12 months from the time it is published in the Federal Register.

### **Where Does the Life Industry Go from Here?**

Undoubtedly, industry groups and index annuity companies will launch a barrage of opposing comments (in fact, one SEC Governor stated publicly that he expected as much).

If this does not have the desired effect of either changing the staff's collective view or of persuading the Board of Governors to decline or ignore the staff's proposal, then we would expect a flurry of petitions to the Washington, D.C., Appellate Court for injunctive relief based on a lack of jurisdiction and violation of the Securities Act of 1933. This can occur once the rule appears in the Federal Register; the industry does not have to wait to file until the rule becomes effective.

Injunctive relief, if it is forthcoming, could take as long as a year. Eventually, we believe the matter would likely wend its way to the Supreme Court.

Meanwhile, we believe index annuity players will need to work with marketing organizations to ensure that the maximum number of agents become registered. This could be done through the life company's own broker/dealer unit or through an "index annuity friendly" broker/dealer. For those agents, who for one reason or another will not become registered, new products – likely some sort of fixed annuity with long-term care or enhanced benefits – will have to be developed.

### **The Net Effect?**

The proposal is the worst case scenario that could have come out of the SEC Open Meeting. If the proposal is accepted by the Board of Governors as is and becomes official, there will likely be one-time costs associated with the staffing of broker/dealers and the effort involved in getting agents registered. Costs in the \$5-10 million range would not seem unreasonable. While not the end of the world, no fun either. Ongoing costs will likely be considerably less.

The \$64,000 dollar question is the effect on sales. Last night, we were able to speak with the management of two large producer organizations. Although hardly a statistically significant sample, each indicated that while agents with substantial index annuity sales would likely get registered, those making just a few sales a year would not – which would add up. These marketing organizations estimated that as much as 20% to 50% of their index annuity production could be effectively eliminated.

### **Summary**

The SEC staff's decision to propose rules requiring the registration of index annuities based on an intrinsic part of the product design caught us, and we think most industry observers and participants, by surprise, as we expected the SEC to primarily concentrate on rules regarding how the product is marketed and/or limit the size and length of surrender charge periods.

We expect the industry defense to be spirited both during the public comment period and in the legal courts if the Board of Governors accepts the current proposal.

Ultimately, we expect the industry to prevail, as the SEC staff proposal appears to us to have no basis in the Securities Act of 1933 and its existing case law. This said, it is certain that the index annuity industry has entered into a period of substantial uncertainty.

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