

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 230 and 240**

**[Release Nos. 33-8996, 34-59221; File No. S7-14-08]**

**RIN 3235-AK16**

**INDEXED ANNUITIES AND CERTAIN OTHER INSURANCE CONTRACTS**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** We are adopting a new rule that defines the terms “annuity contract” and “optional annuity contract” under the Securities Act of 1933. The rule is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. The rule applies on a prospective basis to contracts issued on or after the effective date of the rule. We are also adopting a new rule that exempts insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, provided that certain conditions are satisfied, including that the securities are regulated under state insurance law, the issuing insurance company and its financial condition are subject to supervision and examination by a state insurance regulator, and the securities are not publicly traded.

**EFFECTIVE DATE:** The effective date of § 230.151A is January 12, 2011. The effective date of § 240.12h-7 is May 1, 2009. Sections III.A.3. and III.B.3. of this release discuss the effective dates applicable to rule 151A and rule 12h-7, respectively.

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Regulation, Division of Investment Management, at (202) 551-6795, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5720.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (“Commission”) is adding rule 151A under the Securities Act of 1933 (“Securities Act”)<sup>1</sup> and rule 12h-7 under the Securities Exchange Act of 1934 (“Exchange Act”).<sup>2</sup>

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<sup>1</sup> 15 U.S.C. 77a et seq.

<sup>2</sup> 15 U.S.C. 78a et seq.

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## I. EXECUTIVE SUMMARY

We are adopting new rule 151A under the Securities Act of 1933 in order to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index.<sup>3</sup> Section 3(a)(8) of the Securities Act provides an exemption under the Securities Act for certain “annuity contracts,” “optional annuity contracts,” and other insurance contracts. The new rule prospectively defines certain indexed annuities as not being “annuity contracts” or “optional annuity contracts” under this exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The definition hinges upon a familiar concept: the allocation of risk. Insurance provides protection against risk, and the courts have held that the allocation of investment risk is a significant factor in distinguishing a security from a contract of insurance. The Commission has also recognized that the allocation of investment risk is significant in determining whether a particular contract that is regulated as insurance under state law is insurance for purposes of the federal securities laws.

Individuals who purchase indexed annuities are exposed to a significant investment risk – *i.e.*, the volatility of the underlying securities index. Insurance companies have successfully utilized this investment feature, which appeals to purchasers not on the usual insurance basis of stability and security, but on the prospect of investment growth. Indexed annuities are attractive to purchasers because they offer the

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<sup>3</sup> 17 CFR 230.151A. Rule 151A was proposed by the Commission in June 2008. See Securities Act Release No. 8933 (June 25, 2008) [73 FR 37752 (July 1, 2008)] (“Proposing Release”).

promise of market-related gains. Thus, purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.

When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, this indicates that the majority of the investment risk for the fluctuating, securities-linked portion of the return is borne by the individual purchaser, not the insurer. The individual underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the securities-linked returns under the contract.

The federal interest in providing investors with disclosure, antifraud, and sales practice protections arises when individuals are offered indexed annuities that expose them to investment risk. Individuals who purchase such indexed annuities assume many of the same risks and rewards that investors assume when investing their money in mutual funds, variable annuities, and other securities. However, a fundamental difference between these securities and indexed annuities is that – with few exceptions – indexed annuities historically have not been registered as securities. As a result, most purchasers of indexed annuities have not received the benefits of federally mandated disclosure, antifraud, and sales practice protections.

In a traditional fixed annuity, the insurer bears the investment risk under the contract. As a result, such instruments have consistently been treated as insurance contracts under the federal securities laws. At the opposite end of the spectrum, the purchaser bears the investment risk for a traditional variable annuity that passes through

to the purchaser the performance of underlying securities, and we have determined and the courts have held that variable annuities are securities under the federal securities laws. Indexed annuities, on the other hand, fall somewhere in between -- they possess both securities and insurance features. Therefore, we have determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws will enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws.

Accordingly, we are adopting a new definition of “annuity contract” that, on a prospective basis, will define a class of indexed annuities that are outside the scope of Section 3(a)(8). We carefully considered where to draw the line, and we believe that the line that we have drawn, which will be applied on a prospective basis only, is rational and reasonably related to fundamental concepts of risk and insurance. That is, if more often than not the purchaser of an indexed annuity will receive a guaranteed return like that of a traditional fixed annuity, then the instrument will be treated as insurance; on the other hand, if more often than not the purchaser will receive a return based on the value of a security, then the instrument will be treated as a security. With respect to the latter group of indexed annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections.

We are aware that many insurance companies and sellers of indexed annuities, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to the proposal and adoption of rule 151A. Under

these circumstances, we do not believe that insurance companies and sellers of indexed annuities should be subject to any additional legal risk relating to their past offers and sales of indexed annuities as a result of the proposal and adoption of rule 151A.

Therefore, the new definition will apply prospectively only – that is, only to indexed annuities that are issued on or after the effective date of our final rule.

Finally, we are adopting rule 12h-7 under the Exchange Act, a new exemption from Exchange Act reporting that will apply to insurance companies with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors.

Where an insurer’s financial condition and ability to meet its contractual obligations are subject to oversight under state law, and where there is no trading interest in an insurance contract, the concerns that periodic and current financial disclosures are intended to address are generally not implicated.

The Commission received approximately 4,800 comments on the proposed rules. The commenters were divided with respect to proposed rule 151A. Many issuers and sellers of indexed annuities opposed the proposed rule. However, other commenters supported the proposed rule, including the North American Securities Administrators Association, Inc. (“NASAA”),<sup>4</sup> the Financial Industry Regulatory Authority, Inc. (“FINRA”),<sup>5</sup> several insurance companies, and the Investment Company Institute

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<sup>4</sup> NASAA is the association of all state, provincial, and territorial securities regulators in North America.

<sup>5</sup> FINRA is the largest non-governmental regulator for registered broker-dealer firms doing business in the United States. FINRA was created in July 2007 through the consolidation

(“ICI”).<sup>6</sup> A number of commenters, both those who supported and those who opposed rule 151A, suggested modifications to the proposed rule. Sixteen commenters addressed proposed rule 12h-7, and all of these commenters supported the proposal, with some suggesting modifications. We are adopting proposed rules 151A and 12h-7, with significant modifications to address the concerns of commenters.

## II. BACKGROUND

Beginning in the mid-1990s, the life insurance industry introduced a new type of annuity, referred to as an “equity-indexed annuity,” or, more recently, “fixed indexed annuity” (herein “indexed annuity”). Amounts paid by the insurer to the purchaser of an indexed annuity are based, in part, on the performance of an equity index or another securities index, such as a bond index.

The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s.<sup>7</sup> Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis

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of NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.

<sup>6</sup> ICI is a national association of investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts.

<sup>7</sup> See Securities Act Release No. 7438 (Aug. 20, 1997) [62 FR 45359, 45360 (Aug. 27, 1997)] (“1997 Concept Release”); NASD, Equity-Indexed Annuities, Notice to Members 05-50 (Aug. 2005), available at: [http://www.finra.org/web/groups/rules\\_regs/documents/notice\\_to\\_members/p014821.pdf](http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p014821.pdf) (“NTM 05-50”); Letter of William A. Jacobson, Esq., Associate Clinical Professor, Director, Securities Law Clinic, and Matthew M. Sweeney, Cornell Law School ’10, Cornell University Law School (Sept. 10, 2008) (“Cornell Letter”); Letter of FINRA (Aug. 11, 2008) (“FINRA Letter”); Letter of Investment Company Institute (Sept. 10, 2008) (“ICI Letter”).



of factors that have been articulated by the U.S. Supreme Court.<sup>8</sup> Insurers have typically marketed and sold indexed annuities without registering the contracts under the federal securities laws.

In the years after indexed annuities were first introduced, sales volumes and the number of purchasers were relatively small. Sales of indexed annuities for 1998 totaled \$4 billion and grew each year through 2005, when sales totaled \$27.2 billion.<sup>9</sup> Indexed annuity sales for 2006 totaled \$25.4 billion and \$24.8 billion in 2007.<sup>10</sup> In 2007, indexed annuity assets totaled \$123 billion, 58 companies were issuing indexed annuities, and there were a total of 322 indexed annuity contracts offered.<sup>11</sup> As sales have grown in more recent years, these products have affected larger and larger numbers of purchasers. They have also become an increasingly important business line for some insurers.<sup>12</sup>

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<sup>8</sup> 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”).

<sup>9</sup> NAVA, 2008 Annuity Fact Book, at 57 (2008).

<sup>10</sup> Id.

<sup>11</sup> Id.

<sup>12</sup> See, e.g., Allianz Life Insurance Company of North America (Best's Company Reports, Allianz Life Ins. Co. of N. Am., Dec. 3, 2007) (Indexed annuities represent approximately two-thirds of gross premiums written.); American Equity Investment Life Holding Company (Annual Report on Form 10-K, at F-16 (Mar. 14, 2008)) (Indexed annuities accounted for approximately 97% of total purchase payments in 2007.); Americo Financial Life and Annuity Insurance Company (Best's Company Reports, Americo Fin. Life and Annuity Ins. Co., Sept. 5, 2008) (Indexed annuities represent over 90% of annuity premiums and almost 60% of annuity reserves.); Aviva USA Group (Best's Company Reports, Aviva Life Insurance Company, July 14, 2008) (Indexed annuity sales represent more than 85% of total annuity production.); Investors Insurance Corporation (IIC) (Best's Company Reports, Investors Ins. Corp., July 10, 2008) (IIC's primary product has been indexed annuities.); Life Insurance Company of the Southwest (“LSW”) (Best's Company Reports, Life Ins. Co. of the Southwest, June 28, 2007) (LSW specializes in the sale of annuities, primarily indexed annuities.); Midland National Life Insurance Company (Best's Company Reports, Midland Nat'l Life Ins. Co., Jan. 24, 2008)

The growth in sales of indexed annuities has, unfortunately, been accompanied by complaints of abusive sales practices. These include claims that the often-complex features of these annuities have not been adequately disclosed to purchasers, as well as claims that rapid sales growth has been fueled by the payment of outsize commissions that are funded by high surrender charges imposed over long periods, which can make these annuities unsuitable for seniors and others who may need ready access to their assets.<sup>13</sup>

We have observed the development of indexed annuities for some time and have become persuaded that guidance is needed with respect to their status under the federal securities laws. Given the current size of the market for indexed annuities, we believe that it is important for all parties, including issuers, sellers, and purchasers, to understand, in advance, the legal status of these products and the rules and protections that apply.

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(Sales of indexed annuities in recent years have been the principal driver of growth in annuity deposits.).

<sup>13</sup> See Letter of Susan E. Voss, Commissioner, Iowa Insurance Division (Nov. 18, 2008) (“Voss Letter”) (acknowledging sales practice issues and “great deal” of concern about suitability and disclosures in indexed annuity market). See also FINRA, Equity Indexed Annuities – A Complex Choice (updated Apr. 22, 2008), available at: <http://www.finra.org/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/Equity-IndexedAnnuities-AComplexChoice/P010614> (“FINRA Investor Alert”) (investor alert on indexed annuities); Office of Compliance Inspections and Examinations, Securities and Exchange Commission, et al., Protecting Senior Investors: Report of Examinations of Securities Firms Providing ‘Free Lunch’ Sales Seminars, at 4 (Sept. 2007), available at: <http://www.sec.gov/spotlight/seniors/freelunchreport.pdf> (joint examination conducted by Commission, North American Securities Administrators Association (“NASAA”), and FINRA identified potentially misleading sales materials and potential suitability issues relating to products discussed at sales seminars, which commonly included indexed annuities); Statement of Patricia Struck, President, NASAA, at the Senior Summit of the United States Securities and Exchange Commission, July 17, 2006, available at: [http://www.nasaa.org/Issues\\_Answers/Legislative\\_Activity/Testimony/4999.cfm](http://www.nasaa.org/Issues_Answers/Legislative_Activity/Testimony/4999.cfm) (identifying indexed annuities as among the most pervasive products involved in senior investment fraud); NTM 05-50, supra note 7 (citing concerns about marketing of indexed annuities and the absence of adequate supervision of sales practices).

Today, we are adopting rules that will provide greater clarity regarding the scope of the exemption provided by Section 3(a)(8). We believe our action is consistent with Congressional intent in that the definition will afford the disclosure, antifraud, and sales practice protections of the federal securities laws to purchasers of indexed annuities who are more likely than not to receive payments that vary in accordance with the performance of a security. In addition, the rules will provide relief from Exchange Act reporting obligations to the insurers that issue these indexed annuities and certain other securities that are regulated as insurance under state law. We base the Exchange Act exemption on two factors: first, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of these activities and assets under state insurance law; and, second, the absence of trading interest in the securities.

**A. Description of Indexed Annuities**

An indexed annuity is a contract issued by a life insurance company that generally provides for accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser either as a lump sum, upon death or withdrawal, or as a series of payments (an "annuity"). During the accumulation period, the insurer credits the purchaser with a return that is based on changes in a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. The insurer also guarantees a minimum value to the purchaser.<sup>14</sup> The specific features of indexed annuities vary from

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<sup>14</sup> FINRA Investor Alert, supra note 13; National Association of Insurance Commissioners, Buyer's Guide to Fixed Deferred Annuities with Appendix for Equity-Indexed Annuities, at 9 (2007) ("NAIC Guide"); National Association for Fixed Annuities, White Paper on

product to product. Some key features, found in many indexed annuities, are as follows.

#### Computation of Index-Based Return

The purchaser's index-based return under an indexed annuity depends on the particular combination of features specified in the contract. Typically, an indexed annuity specifies all aspects of the formula for computing return in advance of the period for which return is to be credited, and the crediting period is generally at least one year long.<sup>15</sup> The rate of the index-based return is computed at the end of the crediting period, based on the actual performance of a specified securities index during that period, but the computation is performed pursuant to a mathematical formula that is guaranteed in advance of the crediting period. Common indexing features are described below.

- Index. Indexed annuities credit return based on the performance of a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. Some annuities permit the purchaser to select one or more indices from a specified group of indices.
- Determining Change in Index. There are several methods for determining the change in the relevant index over the crediting period.<sup>16</sup> For example, the "point-to-point" method compares the index level at two discrete points in time, such as

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Fixed Indexed Insurance Products Including 'Fixed Indexed Annuities' and Other Fixed Indexed Insurance Products, at 1 (2006), available at: <http://www.nafa.us/index.php?act=attach&type=post&id=68> ("NAFA Whitepaper"); Jack Marrion, Index Annuities: Power and Protection, at 13 (2004) ("Marrion").

<sup>15</sup> NAFA Whitepaper, supra note 14, at 13.

<sup>16</sup> See FINRA Investor Alert, supra note 13; NAIC Guide, supra note 14, at 12-14; NAFA Whitepaper, supra note 14, at 9-10; Marrion, supra note 14, at 38-59.

the beginning and ending dates of the crediting period. Typically, in determining the amount of index change, dividends paid on securities underlying the index are not included. Indexed annuities typically do not apply negative changes in an index to contract value. Thus, if the change in index value is negative over the course of a crediting period, no deduction is taken from contract value nor is any index-based return credited.<sup>17</sup>

- Portion of Index Change to be Credited. The portion of the index change to be credited under an indexed annuity is typically determined through the application of caps, participation rates, spread deductions, or a combination of these features.<sup>18</sup> Some contracts “cap” the index-based returns that may be credited. For example, if the change in the index is 6%, and the contract has a 5% cap, 5% would be credited. A contract may establish a “participation rate,” which is multiplied by index growth to determine the rate to be credited. If the change in the index is 6%, and a contract’s participation rate is 75%, the rate credited would be 4.5% (75% of 6%). In addition, some indexed annuities may deduct a percentage, or spread, from the amount of gain in the index in determining return. If the change in the index is 6%, and a contract has a spread of 1%, the rate credited would be 5% (6% minus 1%).

### Surrender Charges

Surrender charges are commonly deducted from withdrawals taken by a

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<sup>17</sup> NAIC Guide, supra note 14, at 11; NAFA Whitepaper, supra note 14, at 5 and 9; Marrion, supra note 14, at 2.

<sup>18</sup> See FINRA Investor Alert, supra note 13; NAIC Guide, supra note 14, at 10-11; NAFA Whitepaper, supra note 14, at 10; Marrion, supra note 14, at 38-59.

purchaser.<sup>19</sup> The maximum surrender charges, which may be as high as 15-20%,<sup>20</sup> are imposed on surrenders made during the early years of the contract and decline gradually to 0% at the end of a specified surrender charge period, which may be in excess of 15 years.<sup>21</sup> Imposition of a surrender charge may have the effect of reducing or eliminating any index-based return credited to the purchaser up to the time of a withdrawal. In addition, a surrender charge may result in a loss of principal, so that a purchaser who surrenders prior to the end of the surrender charge period may receive less than the original purchase payments.<sup>22</sup> Many indexed annuities permit purchasers to withdraw a portion of contract value each year, typically 10%, without payment of surrender charges.

#### Guaranteed Minimum Value

Indexed annuities generally provide a guaranteed minimum value, which serves as a floor on the amount paid upon withdrawal, as a death benefit, or in determining the amount of annuity payments. The guaranteed minimum value is typically a percentage of purchase payments, accumulated at a specified interest rate, and may not be lower than a floor established by applicable state insurance law. In the years immediately following their introduction, indexed annuities typically guaranteed 90% of purchase payments

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<sup>19</sup> See FINRA Investor Alert, supra note 13; NAIC Guide, supra note 14, at 3-4 and 11; NAFA Whitepaper, supra note 14, at 7; Marrion, supra note 14, at 31.

<sup>20</sup> The highest surrender charges are often associated with annuities in which the insurer credits a “bonus” equal to a percentage of purchase payments to the purchaser at the time of purchase. The surrender charge may serve, in part, to recapture the bonus.

<sup>21</sup> See A Producer's Guide to Indexed Annuities 2007, LIFE INSURANCE SELLING (June 2007), available at: [http://www.lifeinsuranceselling.com/Media/MediaManager/0607\\_IASurvey\\_1.pdf](http://www.lifeinsuranceselling.com/Media/MediaManager/0607_IASurvey_1.pdf); Equity Indexed Annuities, ANNUITYADVANTAGE, available at: <http://datafeeds.annuityratewatch.com/annuityadvantage/fixed-indexed-accounts.htm>.

<sup>22</sup> FINRA Investor Alert, supra note 13; Marrion, supra note 14, at 31.

accumulated at 3% annual interest.<sup>23</sup> More recently, however, following changes in state insurance laws,<sup>24</sup> indexed annuities typically provide that the guaranteed minimum value is equal to at least 87.5% of purchase payments, accumulated at annual interest rate of between 1% and 3%.<sup>25</sup> Assuming a guarantee of 87.5% of purchase payments, accumulated at 1% interest compounded annually, it would take approximately 13 years for a purchaser's guaranteed minimum value to be 100% of purchase payments.

### Registration

Insurers typically have concluded that the indexed annuities they issue are not securities. As a result, virtually all indexed annuities have been issued without registration under the Securities Act.<sup>26</sup>

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<sup>23</sup> 1997 Concept Release, supra note 7 (concept release requesting comments on structure of equity indexed insurance products, the manner in which they are marketed, and other matters the Commission should consider in addressing federal securities law issues raised by these products). See also Letter from American Academy of Actuaries (Jan. 5, 1998); Letter from Aid Association for Lutherans (Nov. 19, 1997) (comment letters in response to 1997 Concept Release). The comment letters on the 1997 Concept Release are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7-22-97). Those comment letters that were transmitted electronically to the Commission are also available on the Commission's Web site at <http://www.sec.gov/rules/concept/s72297.shtml>.

<sup>24</sup> See, e.g., CAL. INS. CODE § 10168.25 (West 2007) & IOWA CODE § 508.38 (2008) (current requirements, providing for guarantee based on 87.5% of purchase payments accumulated at minimum of 1% annual interest); CAL. INS. CODE § 10168.2 (West 2003) & IOWA CODE § 508.38 (2002) (former requirements, providing for guarantee for single premium annuities based on 90% of premium accumulated at minimum of 3% annual interest).

<sup>25</sup> NAFA Whitepaper, supra note 14, at 6.

<sup>26</sup> In a few instances, insurers have registered indexed annuities as securities as a result of particular features, such as the absence of any guaranteed interest rate or the absence of a guaranteed minimum value. See, e.g., Pre-Effective Amendment No. 4 to Registration Statement on Form S-1 of PHL Variable Insurance Company (File No. 333-132399) (filed Feb. 7, 2007); Pre-Effective Amendment No. 1 to Registration Statement on Form S-3 of Allstate Life Insurance Company (File No. 333-105331) (filed May 16, 2003);

## B. Section 3(a)(8) Exemption

Section 3(a)(8) of the Securities Act provides an exemption for any “annuity contract” or “optional annuity contract” issued by a corporation that is subject to the supervision of the insurance commissioner, bank commissioner, or similar state regulatory authority.<sup>27</sup> The exemption, however, is not available to all contracts that are considered annuities under state insurance law. For example, variable annuities, which pass through to the purchaser the investment performance of a pool of assets, are not exempt annuity contracts.

The U.S. Supreme Court has addressed the insurance exemption on two occasions.<sup>28</sup> Under these cases, factors that are important to a determination of an annuity’s status under Section 3(a)(8) include (1) the allocation of investment risk between insurer and purchaser, and (2) the manner in which the annuity is marketed.

With regard to investment risk, beginning with SEC v. Variable Annuity Life Ins. Co. (“VALIC”),<sup>29</sup> the Court has considered whether the risk is borne by the purchaser (tending to indicate that the product is not an exempt “annuity contract”) or by the insurer

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Initial Registration Statement on Form S-2 of Golden American Life Insurance Company (File No. 333-104547) (filed Apr. 15, 2003).

<sup>27</sup> The Commission has previously stated its view that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from the registration but not the antifraud provisions. Securities Act Release No. 6558 (Nov. 21, 1984) [49 FR 46750, 46753 (Nov. 28, 1984)]. See also Tcherepnin v. Knight, 389 U.S. 332, 342 n.30 (1967) (Congress specifically stated that “insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act,” (quoting H.R. Rep. 85, 73d Cong., 1st Sess. 15 (1933))).

<sup>28</sup> VALIC, supra note 8, 359 U.S. 65; United Benefit, supra note 8, 387 U.S. 202.

<sup>29</sup> VALIC, supra note 8, 359 U.S. at 71-73.



(tending to indicate that the product falls within the Section 3(a)(8) exemption). In VALIC, the Court determined that variable annuities, under which payments varied with the performance of particular investments and which provided no guarantee of fixed income, were not entitled to the Section 3(a)(8) exemption. In SEC v. United Benefit Life Ins. Co. (“United Benefit”),<sup>30</sup> the Court extended the VALIC reasoning, finding that a contract that provides for some assumption of investment risk by the insurer may nonetheless not be entitled to the Section 3(a)(8) exemption. The United Benefit insurer guaranteed that the cash value of its variable annuity contract would never be less than 50% of purchase payments made and that, after ten years, the value would be no less than 100% of payments. The Court determined that this contract, under which the insurer did assume some investment risk through minimum guarantees, was not an “annuity contract” under the federal securities laws. In making this determination, the Court concluded that “the assumption of an investment risk cannot by itself create an insurance provision under the federal definition” and distinguished a “contract which to some degree is insured” from a “contract of insurance.”<sup>31</sup>

In analyzing investment risk, Justice Brennan’s concurring opinion in VALIC applied a functional analysis to determine whether a new form of investment arrangement that emerges and is labeled “annuity” by its promoters is the sort of arrangement that Congress was willing to leave exclusively to the state insurance commissioners. In that inquiry, the purposes of the federal securities laws and state insurance laws are important. Justice Brennan noted, in particular, that the emphasis in the Securities Act is on

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<sup>30</sup> United Benefit, supra note 8, 387 U.S. at 211.

<sup>31</sup> Id. at 211.

disclosure and that the philosophy of the Act is that “full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.”<sup>32</sup> We agree with the concurring opinion’s analysis. Where an investor’s investment in an annuity is sufficiently protected by the insurer, state insurance law regulation of insurer solvency and the adequacy of reserves are relevant. Where the investor’s investment is not sufficiently protected, the disclosure protections of the Securities Act assume importance.

Marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to the Securities Act “annuity contract” exemption. In United Benefit, the U.S. Supreme Court, in holding an annuity to be outside the scope of Section 3(a)(8), found significant the fact that the contract was “considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of ‘growth’ through sound investment management.”<sup>33</sup> Under these circumstances, the Court concluded “it is not inappropriate that promoters’ offerings be judged as being what they were represented to be.”<sup>34</sup>

In 1986, given the proliferation of annuity contracts commonly known as “guaranteed investment contracts,” the Commission adopted rule 151 under the Securities Act to establish a “safe harbor” for certain annuity contracts that are not deemed subject

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<sup>32</sup> VALIC, *supra* note 8, 359 U.S. at 77.

<sup>33</sup> United Benefit, *supra* note 8, 387 U.S. at 211.

<sup>34</sup> *Id.* at 211 (quoting SEC v. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943)). For other cases applying a marketing test, see Berent v. Kemper Corp., 780 F. Supp. 431 (E.D. Mich. 1991), *aff'd*, 973 F.2d 1291 (6th Cir. 1992); Associates in Adolescent Psychiatry v. Home Life Ins. Co., 729 F.Supp. 1162 (N.D. Ill. 1989), *aff'd*, 941 F.2d 561 (7th Cir. 1991); and Grainger v. State Security Life Ins. Co., 547 F.2d 303 (5th Cir. 1977).

to the federal securities laws and are entitled to rely on Section 3(a)(8) of the Securities Act.<sup>35</sup> Under rule 151, an annuity contract issued by a state-regulated insurance company is deemed to be within Section 3(a)(8) of the Securities Act if (1) the insurer assumes the investment risk under the contract in the manner prescribed in the rule; and (2) the contract is not marketed primarily as an investment.<sup>36</sup> Rule 151 essentially codifies the tests the courts have used to determine whether an annuity contract is entitled to the Section 3(a)(8) exemption, but adds greater specificity with respect to the investment risk test. Under rule 151, an insurer is deemed to assume the investment risk under an annuity contract if, among other things,

- (1) the insurer, for the life of the contract,
  - (a) guarantees the principal amount of purchase payments and credited interest, less any deduction for sales, administrative, or other expenses or charges; and
  - (b) credits a specified interest rate that is at least equal to the minimum rate required by applicable state law; and
- (2) the insurer guarantees that the rate of any interest to be credited in excess of the guaranteed minimum rate described in paragraph 1(b) will not be

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<sup>35</sup> 17 CFR 230.151; Securities Act Release No. 6645 (May 29, 1986) [51 FR 20254 (June 4, 1986)]. A guaranteed investment contract is a deferred annuity contract under which the insurer pays interest on the purchaser's payments at a guaranteed rate for the term of the contract. In some cases, the insurer also pays discretionary interest in excess of the guaranteed rate.

<sup>36</sup> 17 CFR 230.151(a).

modified more frequently than once per year.<sup>37</sup>

Indexed annuities are not entitled to rely on the safe harbor of rule 151 because they fail to satisfy the requirement that the insurer guarantee that the rate of any interest to be credited in excess of the guaranteed minimum rate will not be modified more frequently than once per year.<sup>38</sup>

### **III. DISCUSSION OF THE AMENDMENTS**

The Commission has determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws will enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are adopting a new definition of “annuity contract” that, on a prospective basis, defines a class of indexed annuities that are outside the scope of Section 3(a)(8). With respect to these annuities, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections. We are also adopting a

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<sup>37</sup> 17 CFR 230.151(b) and (c). In addition, the value of the contract may not vary according to the investment experience of a separate account.

<sup>38</sup> Some indexed annuities also may fail other aspects of the safe harbor test.

In adopting rule 151, the Commission declined to extend the safe harbor to excess interest rates that are computed pursuant to an indexing formula that is guaranteed for one year. Rather, the Commission determined that it would be appropriate to permit insurers to make limited use of index features, provided that the insurer specifies an index to which it would refer, no more often than annually, to determine the excess interest rate that it would guarantee for the next 12-month or longer period. For example, an insurer would meet this test if it established an “excess” interest rate of 5% by reference to the past performance of an external index and then guaranteed to pay 5% interest for the coming year. Securities Act Release No. 6645, *supra* note 35, 51 FR at 20260. The Commission specifically expressed concern that index feature contracts that adjust the rate of return actually credited on a more frequent basis operate less like a traditional annuity and more like a security and that they shift to the purchaser all of the investment risk regarding fluctuations in that rate. See *infra* note 71 and accompanying text.

new exemption under the Exchange Act that applies to insurance companies that issue indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the presence of state oversight of insurance company financial condition and the absence of trading interest in these securities.

#### **A. Definition of Annuity Contract**

The Commission is adopting new rule 151A, which defines a class of indexed annuities that are not “annuity contracts” or “optional annuity contracts”<sup>39</sup> for purposes of Section 3(a)(8) of the Securities Act. Although we recognize that these instruments are issued by insurance companies and are treated as annuities under state law, these facts are not conclusive for purposes of the analysis under the federal securities laws.

#### **1. Analysis**

##### “Insurance” and “Annuity”: Federal Terms under the Federal Securities Laws

Our analysis begins with the well-settled conclusion that the terms “insurance” and “annuity contract” as used in the Securities Act are “federal terms,” the meanings of which are a “federal question” under the federal securities laws.<sup>40</sup> The Securities Act

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<sup>39</sup> An “optional annuity contract” is a deferred annuity. See United Benefit, *supra* note 8, 387 U.S. at 204. In a deferred annuity, annuitization begins at a date in the future, after assets in the contract have accumulated over a period of time (normally many years). In contrast, in an immediate annuity, the insurer begins making annuity payments shortly after the purchase payment is made, *i.e.*, within one year. See Kenneth Black, Jr., and Harold D. Skipper, Jr., Life and Health Insurance, at 164 (2000).

<sup>40</sup> See VALIC, *supra* note 8, 359 U.S. at 69. Although the McCarran-Ferguson Act, 15 U.S.C. 1012(b), provides that “No Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance,” the United States Supreme Court has stated that the question common to both the federal securities laws and the McCarran-Ferguson Act is whether

does not provide a definition of either term, and we have not previously provided a definition that applies to indexed annuities.<sup>41</sup> Moreover, indexed annuities did not exist and were not contemplated by Congress when it enacted the insurance exemption.

We therefore analyze indexed annuities under the facts and circumstances factors articulated by the U.S. Supreme Court in VALIC and United Benefit. In particular, we focus on whether these instruments are “the sort of investment form that Congress was . . . willing to leave exclusively to the State Insurance Commissioners” and whether they necessitate the “regulatory and protective purposes” of the Securities Act.<sup>42</sup>

### Type of Investment

We believe that the indexed annuities that will be included in our definition are not the sort of investment that Congress contemplated leaving exclusively to state

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the instruments are contracts of insurance. See VALIC, supra note 8. Thus, where a contract is not an “annuity contract” or “optional annuity contract,” which we have concluded is the case with respect to certain indexed annuities, we do not believe that such contract is “insurance” for purposes of the McCarran-Ferguson Act.

<sup>41</sup> The last time the Commission formally addressed indexed annuities was in 1997. At that time, the Commission issued a concept release requesting public comment regarding indexed insurance contracts. The concept release stated that “depending on the mix of features . . . [an indexed insurance contract] may or may not be entitled to exemption from registration under the Securities Act” and that the Commission was “considering the status of [indexed annuities and other indexed insurance contracts] under the federal securities laws.” See 1997 Concept Release, supra note 7, at 4-5.

The Commission has previously adopted a safe harbor for certain annuity contracts that are entitled to rely on Section 3(a)(8) of the Securities Act. However, as discussed in Part II.B., indexed annuities are not entitled to rely on the safe harbor.

<sup>42</sup> See VALIC, supra note 8, 359 U.S. at 75 (Brennan, J., concurring) (“ . . . if a brand-new form of investment arrangement emerges which is labeled ‘insurance’ or ‘annuity’ by its promoters, the functional distinction that Congress set up in 1933 and 1940 must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners. In that inquiry, an analysis of the regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed becomes relevant.”).

insurance regulation. According to the U.S. Supreme Court, Congress intended to include in the insurance exemption only those policies and contracts that include a “true underwriting of risks” and “investment risk-taking” by the insurer.<sup>43</sup> Moreover, the level of risk assumption necessary for a contract to be “insurance” under the Securities Act must be meaningful – the assumption of an investment risk does not “by itself create an insurance provision under the federal definition.”<sup>44</sup>

The annuities that “traditionally and customarily” were offered at the time Congress enacted the insurance exemption were fixed annuities that typically involved no investment risk to the purchaser.<sup>45</sup> These contracts offered the purchaser “specified and definite amounts beginning with a certain year of his or her life,” and the “standards for investments of funds” by the insurer under these contracts were “conservative.”<sup>46</sup> Moreover, these types of annuity contracts were part of a “concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.”<sup>47</sup> Thus, Congress exempted these instruments from the requirements of the federal securities laws because they were a “form of ‘investment’ . . . which did not present very

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<sup>43</sup> Id. at 71-73.

<sup>44</sup> See United Benefit, supra note 8, 387 U.S. at 211 (“[T]he assumption of investment risk cannot by itself create an insurance provision. . . . The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.”).

<sup>45</sup> See VALIC, supra note 8, 359 U.S. at 69.

<sup>46</sup> Id. (“While all the States regulate ‘annuities’ under their ‘insurance’ laws, traditionally and customarily they have been fixed annuities, offering the annuitant specified and definite amounts beginning with a certain year of his or her life. The standards for investment of funds underlying these annuities have been conservative.”).

<sup>47</sup> Id. (“Congress was legislating concerning a concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.”).

squarely the problems that [the federal securities laws] were devised to deal with,” and were “subject to a form of state regulation of a sort which made the federal regulation even less relevant.”<sup>48</sup>

In contrast, when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract, the purchaser assumes substantially different risks and benefits. Notably, at the time that such a contract is purchased, the risk for the unknown, unspecified, and fluctuating securities-linked portion of the return is primarily assumed by the purchaser.

By purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for participation in future securities-linked returns. The value of such an indexed annuity reflects the benefits and risks inherent in the securities market, and the contract’s value depends upon the trajectory of that same market. Thus, the purchaser obtains an instrument that, by its very terms, depends on market volatility and risk.

Such indexed annuity contracts provide some protection against the risk of loss, but these provisions do not, “by [themselves,] create an insurance provision under the federal definition.”<sup>49</sup> Rather, these provisions reduce – but do not eliminate – a purchaser’s exposure to investment risk under the contract. These contracts may to some degree be insured, but that degree may be too small to make the indexed annuity a

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<sup>48</sup> Id. at 75 (Brennan, J., concurring).

<sup>49</sup> See United Benefit, supra note 8, 387 U.S. at 211 (finding that while a “guarantee of cash value” provided by an insurer to purchasers of a deferred annuity plan reduced “substantially the investment risk of the contract holder, the assumption of investment risk cannot by itself create an insurance provision under the federal definition.”).



contract of insurance.<sup>50</sup>

Thus, the protections provided by indexed annuities may not adequately transfer investment risk from the purchaser to the insurer when amounts payable by an insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. Purchasers of these annuities assume the investment risk for investments that are more likely than not to fluctuate and move with the securities markets. The value of the purchaser's investment is more likely than not to depend on movements in the underlying securities index. The protections offered in these indexed annuities may give the instruments an aspect of insurance, but we do not believe that these protections are substantial enough.<sup>51</sup>

#### Need for the Regulatory Protections of the Federal Securities Acts

We also analyze indexed annuities to determine whether they implicate the regulatory and protective purposes of the federal securities laws. Based on that analysis, we believe that the indexed annuities that are included in the definition that we are adopting present many of the concerns that Congress intended the federal securities laws to address.

Indexed annuities are similar in many ways to mutual funds, variable annuities, and other securities. Although these contracts contain certain features that are typical of

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<sup>50</sup> Id. at 211 (“The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.”).

<sup>51</sup> See VALIC, supra note 8, 359 U.S. at 71 (finding that although the insurer's assumption of a traditional insurance risk gives variable annuities an “aspect of insurance,” this is “apparent, not real; superficial, not substantial.”).

insurance contracts,<sup>52</sup> they also may contain “to a very substantial degree elements of investment contracts.”<sup>53</sup> Indexed annuities are attractive to purchasers precisely because they offer participation in the securities markets. However, indexed annuities historically have not been registered with us as securities. Insurers have treated these annuities as subject only to state insurance laws.

There is a strong federal interest in providing investors with disclosure, antifraud, and sales practice protections when they are purchasing annuities that are likely to expose them to market volatility and risk. We believe that individuals who purchase indexed annuities that are more likely than not to provide payments that vary with the performance of securities are exposed to significant investment risks. They are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Moreover, they are more likely than not to experience market volatility because they are more likely than not to receive payments that vary with the performance of securities.

We believe that the regulatory objectives that Congress was attempting to achieve when it enacted the Securities Act are present when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the guaranteed amounts. Therefore, we are adopting a rule that will define such contracts as falling

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<sup>52</sup> The presence of protection against loss does not, in itself, transform a security into an insurance or annuity contract. Like indexed annuities, variable annuities typically provide some protection against the risk of loss, but are registered as securities. Historically, variable annuity contracts have typically provided a minimum death benefit at least equal to the greater of contract value or purchase payments less any withdrawals. More recently, many contracts have offered benefits that protect against downside market risk during the purchaser's lifetime.

<sup>53</sup> VALIC, supra note 8, 359 U.S. at 91 (Brennan, J., concurring).

outside the insurance exemption.

## **2. Commenters' Concerns Regarding Commission's Analysis**

Many commenters raised significant concerns regarding the Commission's analysis of indexed annuities under Section 3(a)(8). Commenters argued that the Commission's analysis is inconsistent with applicable legal precedent, particularly the VALIC and United Benefit cases. Specifically, the commenters argued that the purchaser of an indexed annuity does not assume investment risk in the sense contemplated by applicable precedent, that the Commission failed to take into account the investment risk assumed by the insurer, and that the Commission's analysis ignored the factors of marketing and mortality risk which have been articulated in applicable precedents. In addition, commenters questioned the need for federal securities regulation of indexed annuities, arguing that there is no evidence of widespread sales practice abuse in the indexed annuity marketplace, that state insurance regulators are effective in protecting purchasers of indexed annuities, and that the Commission's disclosure requirements would not result in enhanced information flow to purchasers of indexed annuities. We disagree with each of these assertions for the reasons outlined below.

### Commission's Analysis is Consistent with Applicable Precedents

We disagree with commenters who argued that the Commission's analysis is inconsistent with applicable legal precedents, particularly the VALIC and United Benefit cases.<sup>54</sup> These commenters asserted, first, that because of guarantees of principal and

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<sup>54</sup> See, e.g., Letter of Advantage Group Associates, Inc. (Nov. 16, 2008) ("Advantage Group Letter"); Letter of Allianz Life Insurance Company of North America (Sept. 10, 2008) ("Allianz Letter"); Letter of American Academy of Actuaries (Sept. 10, 2008) ("Academy Letter"); Letter of American Academy of Actuaries (Nov. 17, 2008) ("Second Academy Letter"); Letter of American Equity Investment Life Holding

minimum interest, the purchaser of an indexed annuity does not assume investment risk in the sense contemplated by applicable precedent which, in their view, is the risk of loss of principal. Second, the commenters argued that the Commission's analysis failed to take into account the investment risk assumed by the insurer, including the risk associated with guaranteeing principal and a minimum interest rate and with guaranteeing in advance the formula for determining index-linked return. Third, commenters argued that the Commission's analysis is inconsistent with precedent because it does not take into account the manner in which indexed annuities are marketed.<sup>55</sup> Fourth, commenters

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Company (Sept. 10, 2008) ("American Equity Letter"); Letter of American National Insurance Company (Sept. 10, 2008) ("American National Letter"); Letter of Aviva USA Corporation (Sept. 10, 2008) ("Aviva Letter"); Letter of Aviva USA Corporation (Nov. 17, 2008) ("Second Aviva Letter"); Letter of Coalition for Indexed Products (Sept. 10, 2008) ("Coalition Letter"); Letter of Committee of Annuity Insurers regarding proposed rule 151A (Sept. 10, 2008) ("CAI 151A Letter"); Letter of Lafayette Life Insurance Company (Sept. 10, 2008) ("Lafayette Letter"); Letter of Maryland Insurance Administration (Sept. 9, 2008) ("Maryland Letter"); Letter of the Officers of the National Association of Insurance Commissioners (Sept. 10, 2008) ("NAIC Officer Letter"); Letter of National Association for Fixed Annuities (Sept. 10, 2008) ("NAFA Letter"); Letter of National Association of Insurance and Financial Advisers (Sept. 10, 2008) ("NAIFA Letter"); Letter of National Conference of Insurance Legislators (Nov. 25, 2008) ("NCOIL Letter"); Letter of National Western Life Insurance Company (Sept. 10, 2008) ("National Western Letter"); Letter of Old Mutual Financial Network (Sept. 10, 2008) ("Old Mutual Letter"); Letter of Sammons Annuity Group (Sept. 10, 2008) ("Sammons Letter"); Letter of Transamerica Life Insurance Company (Sept. 10, 2008) ("Transamerica Letter"); Letter of Transamerica Life Insurance Company (Nov. 17, 2008) ("Second Transamerica Letter").

Other commenters, however, supported the Commission's interpretation of Section 3(a)(8) and applicable legal precedents. See, e.g., ICI Letter, supra note 7; Letter of K&L Gates on behalf of AXA Equitable Life Insurance Company, Hartford Financial Services Group, Inc., Massachusetts Mutual Life Insurance Company, MetLife, Inc., and New York Life Insurance Company (Oct. 7, 2008) ("K&L Gates Letter").

<sup>55</sup> See, e.g., Coalition Letter, supra note 54; Letter of The Hartford Financial Services Group, Inc. (Sept. 10, 2008) ("Hartford Letter"); NAFA Letter, supra note 54.

faulted the Commission’s analysis for ignoring mortality risk.<sup>56</sup>

Our investment risk analysis is an application of the Court’s reasoning in the VALIC and United Benefit cases, and rule 151A applies that analysis with a specific test to determine the status under the federal securities laws of indexed annuities. Indexed annuities are a relatively new product and are different from the securities considered in those cases. These very differences have resulted in the uncertain legal status of indexed annuities from their introduction in the mid-1990s. Like the contract at issue in United Benefit, indexed annuities present a new case that requires us to determine whether “a contract which to some degree is insured” constitutes a “contract of insurance” for purposes of the federal securities laws.<sup>57</sup> Indexed annuities offer to purchasers a financial instrument with uncertain and fluctuating returns that are, in part, securities-linked. We believe that whether such an instrument is a security hinges on the likelihood that the purchaser’s return will, in fact, be based on the returns of a securities index. In cases where the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract, the amount the purchaser receives will be dependent on market returns and will vary because of investment risk. In such a case, we have concluded that, on a prospective basis, the indexed annuity is not entitled to rely on the Section 3(a)(8) exemption. Though the contract may to some degree be insured, it is not a contract of insurance because of the substantial investment risk assumed by the purchaser.

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<sup>56</sup> See, e.g., CAI 151A Letter, supra note 54; Old Mutual Letter, supra note 54; Sammons Letter, supra note 54.

<sup>57</sup> See United Benefit, supra note 8, 387 U.S. at 211 (“The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.”).

A number of commenters equated investment risk with the risk of loss of principal for purposes of analysis under Section 3(a)(8) and argued that, because of guarantees of principal and minimum interest, the purchaser of an indexed annuity does not assume investment risk. We disagree. While the potential for loss of principal was important in the VALIC and United Benefit cases and helpful in analyzing the particular products at issue in those cases, it is by no means the only type of investment risk. Defining risk only as the possibility of principal loss or an approximate equivalent, as suggested by commenters, fails to account for important forms of risk and leads to conclusions inconsistent with the contemporary understanding of investment risk. Such a limited definition of risk would thus be incomplete.

One widely accepted definition of “risk” in financial instruments is the degree to which returns deviate from their statistical expectation.<sup>58</sup> Accordingly, even investments guaranteeing a positive minimum return over long investment horizons, such as indexed annuities, may have returns that meaningfully and unpredictably deviate from the expected return and therefore have investment risk under this definition.

For example, accepting the definition of risk suggested by commenters as a complete characterization of risk would lead to the conclusion that any two assets that both guarantee return of principal equally have no risk. However, we believe that the market would generally view an asset where the future payoff of the amount over the guaranteed principal return is uncertain to be more risky than a zero-coupon U.S. government bond maturing at the same date, which also guarantees principal return but

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<sup>58</sup> Zvi Bodie, Alex Kane and Alan J. Marcus, Investments, at 143 (2005) (“The standard deviation of the rate of return is a measure of risk.”).

has a nearly certain future payoff. Defining risk as the potential for loss of principal, or principal plus some minimal amount, misses important aspects of risk as commonly understood. While U.S. government bonds are commonly accepted as the standard benchmark of a nominally risk-free rate of return because their returns are considered to be nearly certain at specific horizons, the definition suggested by commenters fails to distinguish between these risk-free assets and assets that are protected against principal loss but that have uncertain payoffs above the guaranteed principal return.<sup>59</sup>

Additionally, under the definition of risk suggested by the commenters, most assets with positive expected returns would appear to have little to no risk over long horizons. As an example, using reasonable assumptions it can be estimated that a value-weighted portfolio of New York Stock Exchange (“NYSE”) stocks has approximately a 6% chance of returning less than principal in 10 years, and approximately a 1% chance of returning less than principal in 20 years.<sup>60</sup> Despite these relatively low probabilities of losing principal over long periods of time, we believe that it is generally understood that market participants, even those with long investment horizons, bear meaningful investment risk when investing in such a diversified portfolio of stocks. Indeed, investors generally consider modest long-term returns, even if greater than 0% or some minimal rate, to be undesirable outcomes when the expected return was substantially greater. We

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<sup>59</sup> Zvi Bodie, Alex Kane and Alan J. Marcus, Investments, at 144 (2005).

<sup>60</sup> Our Office of Economic Analysis conducted a simulation, in which annual returns from the Center for Research in Security Prices (“CRSP”) capitalization-weighted NYSE index, annually rebalanced, from 1926 through 2007, are drawn randomly and aggregated (a bootstrap procedure). This procedure replicates the observed mean, standard deviation, skewness, kurtosis, and other observed moments of returns, but assumes that returns are intertemporally independent. Realized 10-year returns in this period are negative 4% of the time, and there have been no 20-year negative returns.

therefore believe that the commenters' suggestion that such a portfolio is without risk is at odds both with the commonly accepted meaning of the term as well as with the definition of risk generally accepted by financial economists.

The purchaser of an indexed annuity assumes investment risk because his or her return is not known in advance and therefore varies from its expected value. When the amounts payable to the purchaser are more likely than not to exceed the guaranteed amounts, the investment risk assumed by the purchaser of an indexed annuity is substantial, and we believe that the contract should not be treated as an "annuity contract" for purposes of the federal securities laws. We also note that indexed annuities are not, in fact, without the risk of principal loss. An indexed annuity purchaser who surrenders the contract during the surrender charge period, which for some indexed annuities may be in excess of 15 years, may receive less than his or her original principal. Unlike a purchaser of a fixed annuity, a purchaser of an indexed annuity is dependent on favorable securities market returns to overcome the impact of the surrender charge and create a positive return rather than a loss.

We also disagree with commenters who argued that the Commission's analysis failed to take into account the investment risk assumed by the insurer, including the risk associated with guaranteeing principal and a minimum interest rate and with guaranteeing in advance the formula for determining securities-linked return. We agree with commenters that, in analyzing the status of indexed annuities under the federal securities laws, it is important to take into account the relative significance of the risks assumed by the insurer and the purchaser. In our analysis, the Commission does not ignore the risk assumed by the insurer as the commenters suggest. In fact, the rule, as proposed and



adopted, specifically contemplates different outcomes based on the relative risks assumed by the insurer and purchaser. When the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed, the contract loses the insurance exemption under rule 151A.

Unlike a traditional fixed annuity where the investment risk for the contract is assumed by the insurer, or a traditional variable annuity where the investment risk for the contract is assumed by the purchaser, the very mixed nature of indexed annuities led the Commission to carefully consider the relative risks assumed by both parties to the contract. The fact that the rule does not define all indexed annuities as outside Section 3(a)(8), but rather sets forth a test for analyzing these contracts, reflects the Commission's understanding that the status of these contracts under the federal securities laws hinges on the allocation of risk between both the insurer and the purchaser. Specifically, the rule recognizes that where the insurer is more likely than not to pay an amount that is fixed and guaranteed by the insurer, significant investment risks are assumed by the insurer and such a contract may therefore be entitled to the Section 3(a)(8) exemption. Conversely, where the purchaser is more likely than not to receive an amount that is variable and dependent on fluctuations and movements in the securities markets, rule 151A recognizes the significant investment risks assumed by the purchaser and specifies that such a contract would not be considered to fall within Section 3(a)(8). Moreover, both the guaranteed interest rate within an indexed annuity and the formula for crediting interest are typically reset on an annual basis. This provides insurers with a number of ways to reduce or eliminate their investment risks, including hedging market risk through the purchase of options or other derivatives and adjusting guarantees

downwards in subsequent years to offset losses in earlier years of a contract. For purposes of analysis under Section 3(a)(8), we do not consider these investment risks to be comparable to those of the indexed annuity purchaser, who bears the risk of a fluctuating and uncertain return based on the performance of a securities index.

Some commenters argued that the Commission's investment risk analysis is inconsistent with its own position in the Brief for the United States as Amicus Curiae in Variable Annuity Life Insurance Company, et al. v. Otto ("VALIC v. Otto").<sup>61</sup> That matter involved an annuity in which the insurer guaranteed principal and a minimum rate of interest and also could, in its discretion, credit excess interest above the guaranteed rate. The Commission argued that by guaranteeing principal and an adequate fixed rate of interest, and guaranteeing payment of all discretionary excess interest declared under the contract, the insurer assumed sufficient investment risk under the contract for it to fall within Section 3(a)(8), notwithstanding the assumption of the risk by the contract owner that the excess interest rate could be reduced or eliminated at the insurer's discretion.

We agree with commenters that our analysis is different from the position taken by the Commission in the VALIC v. Otto brief. However, this results from the fact that indexed annuity contracts are different from the contracts considered in VALIC v. Otto. Unlike the contracts in that case, which were annuity contracts that provided for wholly discretionary payment of excess interest, indexed annuities contractually specify that excess interest will be calculated by reference to a securities index. As a result, the

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<sup>61</sup> Brief for the United States as Amicus Curiae on Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit, VALIC v. Otto, No. 87-600, October Term, 1987. See, e.g., Aviva Letter, supra note 54; CAI 151A Letter, supra note 54; Coalition Letter, supra note 54; NAFA Letter, supra note 54.

purchaser of an indexed annuity is contractually bound to assume the investment risk for the fluctuations and movements in the underlying securities index. The contract in VALIC v. Otto did not impose this securities-linked investment risk on the purchaser. Moreover, we note that the Supreme Court did not grant certiorari in VALIC v. Otto. The final opinion in the case was rendered by the Seventh Circuit and was to the effect that, as a result of the insurer's discretion to declare excess interest under the contract, the insurer's guarantees were not sufficient to exempt the contract from the federal securities laws. Thus, the Commission's position in the case was not adopted by either the Seventh Circuit or the Supreme Court. We believe that the position articulated in the VALIC v. Otto brief is not relevant in the context of indexed annuities and, to the extent that the brief may imply otherwise, the position taken in the brief does not reflect the Commission's current position. Where the contractual return paid by an insurer under an annuity contract is retroactively determined based, in whole or in part, on the returns of a security in a prior period, we do not believe that fact – and the investment risk that it entails – can be ignored in determining whether the contract is an “annuity contract” that is entitled to the Section 3(a)(8) exemption.

Though rule 151A does not explicitly incorporate a marketing factor, we disagree with commenters who argued that the Commission's analysis is inconsistent with precedent, because it does not take into account the manner in which indexed annuities are marketed.<sup>62</sup> The very nature of an indexed annuity, where return is contractually linked to the return on a securities index, is, to a very substantial extent, designed to

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<sup>62</sup> See, e.g., Coalition Letter, supra note 54; NAFA Letter, supra note 54; Old Mutual Letter, supra note 54; Sammons Letter, supra note 54.

appeal to purchasers on the prospect of investment growth.<sup>63</sup> This is particularly true in the case of indexed annuities that rule 151A defines as not “annuity contracts” -- i.e., indexed annuities where the purchaser is more likely than not to receive securities-linked returns. It would be inconsistent with the character of such an indexed annuity, and potentially misleading, to market the annuity without placing significant emphasis on the securities-linked return and the related risks. We disagree with commenters who argued that purchasers do not buy indexed annuities on the basis of the prospect for investment growth, but rather on the basis of guarantees and stability of principal.<sup>64</sup> We agree with commenters that purchasers of indexed annuities, just like purchasers of variable annuities, have a blend of reasons for their purchase, including product guarantees and tax deferral.<sup>65</sup> However, we also believe that purchasers who are uninterested in the growth offered by securities-linked returns would opt for higher fixed returns in lieu of the lower fixed returns, coupled with the prospect of securities-linked growth, offered by indexed annuities. Indeed, data submitted by one indexed annuity issuer confirm that almost half (46.60%) of its 2008 indexed annuity purchasers identify the prospect for growth as a reason for their purchase.<sup>66</sup> Just as with variable annuities, the fact that

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<sup>63</sup> See, e.g., K&L Gates Letter, supra note 54. But see Letter of National Western Life Insurance Company (Nov. 17, 2008) (“Second National Western Letter”) (criticizing the K&L Gates position).

<sup>64</sup> See, e.g., Allianz Letter, supra note 54; American Equity Letter, supra note 54; Coalition Letter, supra note 54.

<sup>65</sup> See, e.g., Allianz Letter, supra note 54 (55.45% purchased indexed annuities because of guarantees and 54.88% because of tax deferral).

<sup>66</sup> See Allianz Letter, supra note 54. But see Coalition Letter, supra note 54 (sampling by some indexed annuity issuers reveals that a large majority of purchasers acquire fixed annuities for stability of premiums). We are not able to ascertain from the statement in

indexed annuities appeal to purchasers for a variety of reasons does not detract from the significant appeal of securities-linked growth. Accordingly, we have concluded that, in light of the nature of indexed annuities, it is unnecessary to include a separate marketing factor within rule 151A. The Supreme Court did not address marketing in VALIC. Similarly, we have concluded that a separate marketing analysis is unnecessary in the case of indexed annuities that are addressed by rule 151A.

Nor do we agree with commenters who argued that the Commission's analysis departs from precedent in that it does not take into account mortality risk.<sup>67</sup> In both VALIC and United Benefit, the Supreme Court found the investment risk test to be determinative (together with the marketing test in the case of United Benefit) that an insurance contract was not entitled to the Section 3(a)(8) exemption. While the Commission has stated, and we continue to believe, that the presence or absence of assumption of mortality risk may be an appropriate factor to consider in a Section 3(a)(8) analysis,<sup>68</sup> we do not believe that it should be given undue weight in determining the status of a contract under the federal securities laws, where it is clear from the nature of the investment risk that the contract is not an "annuity contract" for securities law purposes. We have concluded that this is the case for an indexed annuity where the amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

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the Coalition Letter the degree to which purchasers identified growth as a goal as the letter addressed only stability of premiums.

<sup>67</sup> See, e.g., CAI 151A Letter, supra note 54; Old Mutual Letter, supra note 54; Sammons Letter, supra note 54.

<sup>68</sup> Securities Act Release No. 6645, supra note 35.

Some commenters criticized the Commission for failing to adequately address a federal district court decision, Malone v. Addison Ins. Marketing, Inc. (“Malone”),<sup>69</sup> where the court determined that a particular indexed annuity was entitled to rely on Section 3(a)(8).<sup>70</sup> We disagree with the Malone court’s analysis of investment risk, which, we believe, understated the investment risk to the purchaser of an indexed annuity from the fluctuating and uncertain securities-linked return and therefore is inconsistent with applicable legal precedent. We also disagree with the court’s interpretation of the Commission’s rule 151 safe harbor, which does not apply to indexed annuities. As we discussed in the proposing release, in that case, the district court concluded that the contracts at issue fell within the Commission’s rule 151 safe harbor notwithstanding the fact that they apparently did not meet the test articulated by the Commission in adopting rule 151, *i.e.*, specifying an index that would be used to determine a rate that would remain in effect for at least one year.<sup>71</sup> Instead, the contracts appear to have guaranteed the index-based formula, but not, as required by rule 151, the actual rate of interest.

#### Need for Federal Securities Regulation

Some commenters agreed that federal securities regulation is needed with respect to indexed annuities.<sup>72</sup> Other commenters questioned the need for federal securities

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<sup>69</sup> 225 F.Supp. 2d 743 (W.D. Ky. 2002).

<sup>70</sup> See, e.g., Coalition Letter, supra note 54; NAFA Letter, supra note 54; Sammons Letter, supra note 54.

<sup>71</sup> See supra note 38.

<sup>72</sup> See, e.g., Letter of Joseph P. Borg, Director, Alabama Securities Commission (Aug. 5, 2008) (“Alabama Letter”); Cornell Letter, supra note 7; Letter of Financial Planning Association (Sept. 10, 2008) (“FPA Letter”); FINRA Letter, supra note 7; Hartford Letter,

regulation of indexed annuities, and we disagree with those commenters. These commenters argued, first, that there is no evidence of widespread sales practice abuse in the indexed annuity marketplace, which would suggest a need for federal securities regulation.<sup>73</sup> Second, commenters argued that state insurance regulators are effective in protecting purchasers of indexed annuities.<sup>74</sup> Third, commenters argued that the Commission’s disclosure requirements would not result in enhanced information flow to purchasers of indexed annuities.<sup>75</sup>

We believe that the commenters who argued that regulation of indexed annuities under the federal securities laws is unnecessary because there is no evidence of widespread sales abuse misunderstand the exemption under Section 3(a)(8) of the Securities Act as well as our purpose in proposing, and now adopting, rule 151A. Some of these commenters cited data that they argued demonstrated that the incidence of abuse

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supra note 55; ICI Letter, supra note 7; Letter of Max Maxfield, Secretary of State, State of Wyoming (Sept. 9, 2008) (“Wyoming Letter”).

<sup>73</sup> See, e.g., American Equity Letter, supra note 54; Coalition Letter, supra note 54; Letter of FBL Financial Group (Sept. 8, 2008) (“FBL Letter”); Lafayette Letter, supra note 54; Maryland Letter, supra note 54; NAIFA Letter, supra note 54; Sammons Letter, supra note 54.

<sup>74</sup> See, e.g., Allianz Letter, supra note 54; Academy Letter, supra note 54; Letter of American Bankers Insurance Association (Sept. 10, 2008) (“American Bankers Letter”); American Equity Letter, supra note 54; American National Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54; Letter of Connecticut Insurance Commissioner (Aug. 25, 2008) (“Connecticut Letter”); Letter of Iowa Insurance Commissioner (Sept. 10, 2008) (“Iowa Letter”); Maryland Letter, supra note 54; NAFA Letter, supra note 54; NAIC Officer Letter, supra note 54; NAIFA Letter, supra note 54; National Western Letter, supra note 54; Old Mutual Letter, supra note 54; Sammons Letter, supra note 54; Transamerica Letter, supra note 54.

<sup>75</sup> See, e.g., Allianz Letter, supra note 54; Aviva Letter, supra note 54.

in the indexed annuity marketplace is low.<sup>76</sup> Some of these commenters argued that the proposing release failed to present persuasive evidence of sales practice abuse.<sup>77</sup>

A vital aspect of the Commission’s mission is investor protection. As a result, reports of sales practice abuses surrounding a product, indexed annuities, whose status has long been unresolved under the federal securities laws, are a matter of grave concern to us. However, the presence or absence of sales practice abuses is irrelevant in determining whether an annuity contract is entitled to the exemption from federal securities regulation under Section 3(a)(8) of the Securities Act. Where an annuity contract is entitled to the Section 3(a)(8) exemption, the federal securities laws do not apply, and purchasers are not entitled to their protections, regardless of whether sales practice abuses may be pervasive. Where, however, an annuity contract is not entitled to the Section 3(a)(8) exemption, which we have concluded is the case with respect to certain indexed annuities, Congress intended that the federal securities laws apply, and purchasers are entitled to the disclosure and suitability protections under those laws without regard to whether there is a single documented incident of abuse.

This view is consistent with applicable precedent which makes clear that the necessity for federal regulation arises from the characteristics of the financial instrument

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<sup>76</sup> See, e.g., Advantage Group Letter, supra note 54; American Equity Letter, supra note 54; Maryland Letter, supra note 54; NAIFA Letter, supra note 54; Letter of Old Mutual Financial Network (Nov. 12, 2008) (“Second Old Mutual Letter”); Letter Type A (“Letter A”); Letter Type E (“Letter E”). “Letter Type” refers to a form letter submitted by multiple commenters, which is listed on the Commission’s Web site (<http://www.sec.gov/comments/s7-14-08/s71408.shtml>) as a single comment, with a notation of the number of letters received by the Commission matching that form type.

<sup>77</sup> See, e.g., American Equity Letter, supra note 54; FBL Letter supra note 73; Maryland Letter, supra note 54; NAIFA Letter, supra note 54; Old Mutual Letter, supra note 54; Sammons Letter, supra note 54; Second National Western Letter, supra note 63.



itself. This has been the approach of the United States Supreme Court in the two leading precedents. In those cases, the Court made a realistic judgment about the point at which a contract between a purchaser and an insurance company tips from being the sole concern of state regulators of insurance to also become the concern of the federal securities laws.

The United Benefit Court observed that the products at issue in that case were “considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of ‘growth’ through sound investment management.”<sup>78</sup> They were “pitched to the same consumer interest in growth through professionally managed investment,” and, as a result, the Court concluded that it seemed “eminently fair that a purchaser of such a plan be afforded the same advantages of disclosure which inure to a mutual fund purchaser under Section 5 of the Securities Act.”<sup>79</sup>

The United Benefit decision picked up and extended a theme previously discussed in Justice Brennan’s concurring opinion in VALIC. Justice Brennan examined the differing nature of state regulation of insurance and federal regulation of the securities markets. He looked at the nature of the obligation the insurer assumed and its connection to the regulation of investment policy. He concluded that there came a point when the “contract between the investor and the organization no longer squares with the sort of contract in regard to which Congress in 1933 thought its ‘disclosure’ statute was unnecessary.”<sup>80</sup>

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<sup>78</sup> United Benefit, supra note 8, 387 U.S. at 211.

<sup>79</sup> Id.

<sup>80</sup> VALIC, supra note 8, 359 U.S. at 72.

It is precisely this realistic judgment about identifying the appropriate circumstances in which to apply the disclosure and other regulatory protections of the federal securities laws that rule 151A makes. That is why the rule adopts the principle that an indexed annuity providing for a combination of minimum guaranteed payments plus a potentially higher payment dependent on the performance of a securities index does not qualify for the insurance exclusion in Section 3(a)(8) when the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

Our intent in adopting rule 151A is to clarify the status of indexed annuities under the federal securities laws, so that purchasers of these products receive the protections to which they are entitled by federal law and so that issuers and sellers of these products are not subject to uncertainty and litigation risk with respect to the laws that are applicable. We expect that clarity will enhance investor protection in the future, and indeed will help prevent future sales practice abuses, but rule 151A is not based on the perception that there are widespread sales abuses in the indexed annuity marketplace. Rather, the rule is intended to address an uncertain area of the law, which, because of the growth of the indexed annuity market and allegations of sales practice abuses, has become of pressing importance.

A number of commenters cited efforts by state insurance regulators to address disclosure and sales practice concerns with respect to indexed annuities as evidence that federal securities regulation is unnecessary and could result in duplicative or overlapping

regulation.<sup>81</sup> Commenters argued that state regulation extends beyond overseeing solvency and adequacy of the insurers' reserves, and that it is also addressed to investor protection issues such as suitability and disclosure.<sup>82</sup> Commenters cited, in particular, the NAIC Suitability in Annuity Transactions Model Regulation,<sup>83</sup> which has been adopted in 35 states,<sup>84</sup> and its adoption by the majority of states as evidence that states are addressing suitability concerns in connection with indexed annuity sales.<sup>85</sup> Commenters also noted that a number of states have adopted the NAIC Annuity Disclosure Model Regulation,<sup>86</sup> which has been adopted in 22 states and which requires delivery of certain disclosure documents regarding indexed annuity contracts.<sup>87</sup> Commenters also cited the existence of state market conduct examinations, the use of state enforcement and

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<sup>81</sup> See, e.g., Allianz Letter, supra note 54; American Bankers Letter, supra note 74; American Equity Letter, supra note 54; FBL Letter supra note 73; Maryland Letter, supra note 54; NAFA Letter, supra note 54; Letter of National Association of Health Underwriters (Sept. 10, 2008) (“Health Underwriters Letter”); National Western Letter, supra note 54; Letter of Vermont Department of Banking, Insurance, Securities and Health Care Administration (Nov. 17, 2008).

<sup>82</sup> See, e.g., Allianz Letter, supra note 54; American Equity Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54; Maryland Letter, supra note 54; NAFA Letter, supra note 54; NAIFA Letter, supra note 54; National Western Letter, supra note 54; Old Mutual Letter, supra note 54; Sammons Letter, supra note 54.

<sup>83</sup> NAIC SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION (Model 275-1) (2003).

<sup>84</sup> National Association of Insurance Commissioners, Draft Model Summaries, available at: [http://www.naic.org/committees\\_models.htm](http://www.naic.org/committees_models.htm).

<sup>85</sup> See, e.g., Letter A, supra note 76; American Bankers Letter, supra note 74; CAI 151A Letter, supra note 54; NAFA Letter, supra note 54; NAIC Officer Letter, supra note 54; NAIFA Letter, supra note 54.

<sup>86</sup> NAIC ANNUITY DISCLOSURE MODEL REGULATION (Model 245-1) (1998).

<sup>87</sup> See, e.g., Aviva Letter, supra note 54; CAI 151A Letter, supra note 54; NAFA Letter, supra note 54; NAIC Officer Letter, supra note 54; NAIFA Letter, supra note 54.

investigative authority, and licensing and education requirements applicable to insurance agents who sell indexed annuities.<sup>88</sup>

Commenters described a number of recent and ongoing efforts by state insurance regulators. Some commenters cited efforts being undertaken by individual states. For example, commenters cited an Iowa regulation which recently became effective requiring that agents receive indexed product training approved by the Iowa Insurance Division before they can sell indexed annuity products.<sup>89</sup> In addition, commenters stated that Iowa has partnered with the American Council of Life Insurers (“ACLI”) to operate a one-year pilot project with some ACLI members using templates developed for disclosure regarding indexed annuities, with the goal of assuring uniformity among insurers in the preparation of disclosure documents.<sup>90</sup> Commenters also noted recent efforts by state regulators addressed to annuities generally, such as the creation of NAIC working groups to review and consider possible improvements to the NAIC Suitability in Annuity Transactions Model Regulation and the NAIC Annuity Disclosure Model Regulation.<sup>91</sup>

We applaud the efforts in recent years of state insurance regulators to address sales practice complaints that have arisen with respect to indexed annuities, and it is not our intention to question the effectiveness of state regulation. Nonetheless, we do not believe that the states’ regulatory efforts, no matter how strong, can substitute for our

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<sup>88</sup> See, e.g., American Equity Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54; Maryland Letter, supra note 54; NAIC Officer Letter, supra note 54; NAFA Letter, supra note 54.

<sup>89</sup> See, e.g., Aviva Letter, supra note 54; Iowa Letter, supra note 74; NAIC Officer Letter, supra note 54.

<sup>90</sup> See, e.g., Iowa Letter, supra note 74; NAIC Officer Letter, supra note 54.

<sup>91</sup> See, e.g., NAIC Officer Letter, supra note 54.

responsibility to identify securities covered by the federal securities laws and the protections Congress intended to apply. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws. Indeed, at least one state insurance regulator acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts.<sup>92</sup> Where the purchaser of an indexed annuity assumes the investment risk of an instrument that fluctuates with the securities markets, and the contract therefore does not fall within the Section 3(a)(8) exemption, the application of state insurance regulation, no matter how effective, is not determinative as to whether the contract is subject to the federal securities laws.

Some commenters also cited voluntary measures taken by insurance companies, such as suitability reviews and the provision of plain English disclosures, as a reason why federal securities regulation of indexed annuities is unnecessary.<sup>93</sup> While these voluntary measures are commendable, they are not a substitute for the provisions of the federal securities laws that Congress mandated.

Finally, we note that some commenters argued that regulation of indexed annuities by the Commission would not enhance investor protection, in particular because

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<sup>92</sup> See Voss Letter, supra note 13 (proposing to accelerate NAIC efforts to strengthen the NAIC model laws affecting indexed annuity products and urge adoption by more of the member states).

<sup>93</sup> See, e.g., Allianz Letter, supra note 54; American Equity Letter, supra note 54; Letter of R. Preston Pitts (Sept. 10, 2008) (“Pitts Letter”); Sammons Letter, supra note 54; Karlan Tucker, Tucker Advisory Group, Inc. (Sept. 10, 2008) (“Tucker Letter”).

the Commission’s disclosure scheme is not tailored to these contracts.<sup>94</sup> Commenters cited a number of factors, including the lack of a registration form that is well-suited to indexed annuities, questions about the appropriate method of accounting to be used by insurance companies that issue indexed annuities, questions about advertising restrictions that may apply under the federal securities laws, and concerns about parity of the registration process vis-à-vis mutual funds. We acknowledge that, as a result of indexed annuity issuers having historically offered and sold their contracts without complying with the federal securities laws, the Commission has not created specific disclosure requirements tailored to these products. This fact, though, is not relevant in determining whether indexed annuities are subject to the federal securities laws. The Commission has a long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance.<sup>95</sup> We note that we are providing a two-year transition period for rule 151A, and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities. We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.

### **3. Definition**

#### Scope of the Definition

Rule 151A will apply, as proposed, to a contract that is issued by a corporation

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<sup>94</sup> See, e.g., Letter of American Council of Life Insurers (Sep. 19, 2008) (“ACLI Letter”); Allianz Letter, supra note 54; Aviva Letter, supra note 54; CAI 151A Letter, supra note 54; National Western Letter, supra note 54; Sammons Letter, supra note 54; Transamerica Letter, supra note 54.

<sup>95</sup> See Form N-4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N-6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

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.<sup>96</sup> This language is the same language used in Section 3(a)(8) of the Securities Act. Thus, the insurance companies covered by the rule are the same as those covered by Section 3(a)(8).

In addition, in order to be covered by the rule, a contract must be subject to regulation as an annuity under state insurance law.<sup>97</sup> The rule will not apply to contracts that are regulated under state insurance law as life insurance, health insurance, or any form of insurance other than an annuity, and it does not apply to any contract issued by an insurance company if the contract itself is not subject to regulation under state insurance law.<sup>98</sup> Thus, rule 151A itself will not apply to indexed life insurance policies,<sup>99</sup> in which the cash value of the policy is credited with a guaranteed minimum return and a securities-linked return. The status of an indexed life insurance policy under the federal securities laws will continue to be a facts and circumstances determination,

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<sup>96</sup> Rule 151A(a).

<sup>97</sup> Id. We note that the majority of states include in their insurance laws provisions that define annuities. See, e.g., ALA. CODE § 27-5-3 (2008); CAL. INS. CODE § 1003 (West 2007); N.J. ADMIN. CODE tit. 11, § 4-2.2 (2008); N.Y. INS. LAW § 1113 (McKinney 2008). Those states that do not expressly define annuities typically have regulations in place that address annuities. See, e.g., IOWA ADMIN. CODE § 191-15.70 (5078) (2008); KAN. ADMIN. REGS. § 40-2-12 (2008); MINN. STAT. § 61B.20 (2007); MISS. CODE ANN. § 83-1-151 (2008).

<sup>98</sup> One commenter was concerned that rule 151A might apply to a certain type of health insurance contract, where some portion of any favorable financial experience of the insurer is refunded to the insured.” Letter of America’s Health Insurance Plans (Sep. 10, 2008) (“AHIP Letter”). Rule 151A will not apply to contracts that are regulated under state insurance law as health insurance.

<sup>99</sup> See, e.g., Aviva Letter, supra note 54; Sammons Letter, supra note 54 (requesting clarification that rule 151A does not apply to indexed life insurance policies).

undertaken by reference to the factors and analysis that have been articulated by the Supreme Court and the Commission. We note, however, that the considerations that form the basis for rule 151A are also relevant in analyzing indexed life insurance because indexed life insurance and indexed annuities share certain features (e.g., securities-linked returns).

The adopted rule, like the proposed rule, expressly states that it does not apply to any contract whose value varies according to the investment experience of a separate account.<sup>100</sup> The effect of this provision is to eliminate variable annuities from the scope of the rule.<sup>101</sup> It has long been established that variable annuities are not entitled to the exemption under Section 3(a)(8) of the Securities Act, and, accordingly, the new definition does not cover them or affect their regulation in any way.<sup>102</sup>

#### Definition of “Annuity Contract” and “Optional Annuity Contract”

We are adopting, with modifications to address commenters’ concerns, the proposal that an annuity issued by an insurance company would not be an “annuity contract” or an “optional annuity contract” under Section 3(a)(8) of the Securities Act if the annuity has two characteristics. As adopted, those characteristics are as follows. First, the contract specifies that amounts payable by the insurance company under the

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<sup>100</sup> Rule 151A(d).

<sup>101</sup> The assets of a variable annuity are held in a separate account of the insurance company that is insulated for the benefit of the variable annuity owners from the liabilities of the insurance company, and amounts paid to the owner under a variable annuity vary according to the investment experience of the separate account. See Black and Skipper, supra note 39, at 174-77 (2000).

<sup>102</sup> See, e.g., VALIC, supra note 8, 359 U.S. 65; United Benefit, supra note 8, 387 U.S. 202. In addition, an insurance company separate account issuing variable annuities is an investment company under the Investment Company Act of 1940. See Prudential Ins. Co. of Am. v. SEC, 326 F.2d 383 (3d Cir. 1964).



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.<sup>103</sup> Second, amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.<sup>104</sup>

#### Annuities Subject to Rule 151A

The first characteristic, as proposed and as adopted, is intended to describe indexed annuities, which are the subject of the rule. As proposed, this characteristic would simply have required that amounts payable by the insurance company under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities.<sup>105</sup> We have modified this characteristic to address the concern expressed by many commenters that, as proposed, the first characteristic was overly broad and would reach annuities that were not indexed annuities.<sup>106</sup> Commenters were concerned that the rule could, for example, be interpreted as extending to traditional fixed annuities, where amounts payable under the contract accumulate at a fixed interest rate, or to discretionary excess interest contracts, where

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<sup>103</sup> Rule 151A(a)(1).

<sup>104</sup> Rule 151A(a)(2).

<sup>105</sup> Proposed rule 151A(a)(1).

<sup>106</sup> See, e.g., ACLI Letter, supra note 94; Allianz Letter, supra note 54; Aviva Letter, supra note 54; Letter of AXA Equitable Life Insurance Company (Sept. 10, 2008) (“AXA Equitable Letter”); Letter of Financial Services Institute (Sept. 10, 2008) (“FSI Letter”); CAI 151A Letter, supra note 54; Hartford Letter, supra note 55; NAFA Letter, supra note 54; NAIFA Letter, supra note 54; Letter of NAVA (Sept. 10, 2008) (“NAVA Letter”); Old Mutual Letter, supra note 54; Sammons Letter, supra note 54; Second Academy Letter, supra note 54; Transamerica Letter, supra note 54.

amounts payable under the contract may include a discretionary excess interest component over and above the guaranteed minimum interest rate offered under the contract.<sup>107</sup> With both traditional fixed annuities and discretionary excess interest contracts, the interest rates are often based, at least in part, on the performance of the securities held by the insurer's general account.

The modified language of the first characteristic addresses commenters' concerns in three ways. First, the language requires that the contract itself specify that amounts payable by the insurance company are calculated by reference to the performance of a security. Thus, a contract will not be covered by the proposed rule unless the insurance company is contractually bound to pay amounts that are dependent upon the performance of a security. While an insurance company may, in fact, look to the performance of the securities in its general account in, for example, establishing the rate to be paid under a traditional fixed annuity, such a contract does not itself obligate the insurer to do so or undertake in any way that the purchaser will receive payments that are linked to the performance of any security. Second, the language requires that the amounts payable by the insurance company be calculated at or after the end of one or more specified crediting periods by reference to the performance during the crediting period of a security. That is, in order to be covered by the rule, an annuity contract must provide that the amount to be paid with respect to a crediting period is determined retrospectively, by reference to the performance during the period of a security. This retrospective determination of amounts to be paid is characteristic of indexed annuities and eliminates from the scope of the rule

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<sup>107</sup> See, e.g., Letter of Association for Advanced Life Underwriting (Oct. 31, 2008); AXA Equitable Letter, supra note 106.

discretionary excess interest contracts, pursuant to which a specified interest rate may be established by reference to the past performance of a security or securities and applied on a prospective basis with respect to a future crediting period. Third, limiting the rule to contracts where the amount payable is determined retrospectively addresses the concerns of the commenters that the rule, as proposed, could reach annuity contracts covered by the rule 151 safe harbor.<sup>108</sup> As explained above, contracts where the amount payable is determined retrospectively do not fall within rule 151.<sup>109</sup>

Rule 151A, like the proposed rule, will apply whenever any amounts payable under the contract under any circumstances, including full or partial surrender, annuitization, or death, satisfy the first characteristic of the rule. If, for example, a contract specifies that the amount payable under a contract upon a full surrender is not calculated at or after the end of one or more specified crediting periods by reference to the performance during the period or periods of a security, but the amount payable upon annuitization is so calculated, then the contract would need to be analyzed under the rule. As another example, if a contract specifies that amounts payable under the contract are partly fixed in amount and partly dependent on the performance of a security in the manner specified by the rule, the contract would need to be analyzed under the rule.

We note that, like the proposal, rule 151A applies to contracts under which amounts payable are calculated by reference to the performance of a security, including a group or index of securities. Thus, the rule, by its terms, applies to indexed annuities but

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<sup>108</sup> AXA Equitable Letter, supra note 106; Hartford Letter, supra note 55; ICI Letter, supra note 7; K&L Gates Letter, supra note 54.

<sup>109</sup> See supra note 38 and accompanying text.

also to other similar annuities where the contract specifies that amounts payable are retrospectively calculated by reference to a single security or any group of securities.<sup>110</sup> The federal securities laws, and investors' interests in full and fair disclosure and sales practice protections, are equally implicated, whether amounts payable under an annuity are retrospectively calculated by reference to a securities index, another group of securities, or a single security.

The term "security" in rule 151A has the same broad meaning as in Section 2(a)(1) of the Securities Act. Rule 151A does not define the term "security," and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Securities Act have the same meanings defined in the Act.<sup>111</sup>

#### "More Likely Than Not" Test

The second characteristic sets forth the test that would define a class of indexed annuity contracts that are not "annuity contracts" or "optional annuity contracts" under the Securities Act and that, therefore, are not entitled to the Section 3(a)(8) exemption. As adopted, the second characteristic defines that class to include those contracts where the amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

We are adopting the second characteristic as proposed. As explained above, by

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<sup>110</sup> A commenter inquired whether an annuity product whose returns were indexed to the consumer price index, a real estate index, or a commodities index would be considered a security. Letter of Meaghan L. McFadden (Aug. 13, 2008). Rule 151A, by its terms, does not apply to such an annuity.

<sup>111</sup> 17 CFR 230.100(b).

purchasing such an indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns. As a result, the purchaser assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities. The rule that we are adopting will provide the purchaser of such an annuity with the same protections that are provided under the federal securities laws to other investors who participate in the securities markets, including full and fair disclosure regarding the terms of the investment and the significant risks that he or she is assuming, as well as protections from abusive sales practices and the recommendation of unsuitable transactions. Some commenters raised concerns about the proposed rule's treatment of de minimis amounts of securities-linked returns.<sup>112</sup> These commenters suggested that the smaller the amount of securities-linked return, the less investment risk is assumed by the purchaser, and the more is assumed by the insurer. In particular, commenters suggested that where the securities-linked return is de minimis, the purchaser does not assume the primary investment risk under the contract.<sup>113</sup> However, based on our current understanding, we believe that almost all current indexed annuity contracts provide for securities-linked returns that are more likely than not to exceed a de minimis amount in excess of the guaranteed return. Nevertheless, in the case of an indexed annuity contract that is more likely than not to provide only a de minimis securities-linked return in excess of the guaranteed return, the Commission and the staff would be prepared to consider a request for relief, if

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<sup>112</sup> See, e.g., CAI 151A Letter, supra note 54; National Western Letter, supra note 54; Sammons, supra note 54.

<sup>113</sup> See, e.g., CAI 151A Letter, supra note 54; National Western Letter, supra note 54; Sammons, supra note 54.

appropriate.

Under rule 151A, amounts payable by the insurance company under a contract will be more likely than not to exceed the amounts guaranteed under the contract if this is the expected outcome more than half the time. In order to determine whether this is the case, it will be necessary to analyze expected outcomes under various scenarios involving different facts and circumstances. In performing this analysis, the amounts payable by the insurance company under any particular set of facts and circumstances will be the amounts that the purchaser<sup>114</sup> would be entitled to receive from the insurer under those facts and circumstances. The facts and circumstances include, among other things, the particular features of the annuity contract (e.g., the relevant index, participation rate, and other features), the particular options selected by the purchaser (e.g., surrender or annuitization), and the performance of the relevant securities benchmark (e.g., in the case of an indexed annuity, the performance of the relevant index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index). The amounts guaranteed under a contract under any particular set of facts and circumstances will be the minimum amount that the insurer would be obligated to pay the purchaser under those facts and circumstances without reference to the performance of the security that is used in calculating amounts payable under the contract. Thus, if an indexed annuity, in all circumstances, guarantees that, on surrender, a purchaser will receive 87.5% of an initial

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<sup>114</sup> For simplicity, we are referring to payments to the purchaser. The rule, however, references payments by the insurer without reference to a specified payee. In performing the analysis, payments to any payee, including the purchaser, annuitant, and beneficiaries, must be included.

purchase payment, plus 1% interest compounded annually, and that any additional payout will be based exclusively on the performance of a securities index, the amount guaranteed after 3 years will be 90.15% of the purchase payment (87.5% x 1.01 x 1.01 x 1.01).

Determining Whether an Annuity is not an “Annuity Contract” or “Optional Annuity Contract” under Rule 151A

We are adopting, with modifications to address commenters’ concerns, the provisions of proposed rule 151A that address the manner in which a determination will be made regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract. Rule 151A is principles-based, providing that a determination made by the insurer at or prior to issuance of a contract will be conclusive, provided that: (i) both the insurer’s methodology and the insurer’s economic, actuarial, and other assumptions are reasonable; (ii) the insurer’s computations are materially accurate; and (iii) the determination is made not earlier than six months prior to the date on which the form of contract is first offered.<sup>115</sup> We have eliminated the proposed requirement that the insurer’s determination be made not more than three years prior to the date on which a particular contract is issued. The rule specifies the treatment of charges that are imposed at the time of payments under the contract by the insurer, and we have modified the proposal in order to provide for consistent treatment of these charges in computing both amounts payable by the insurance company and amounts guaranteed under the contract.<sup>116</sup>

We are adopting this principles-based approach because we believe that an

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<sup>115</sup> Rule 151A(b)(2).

<sup>116</sup> Rule 151A(b)(1).

insurance company should be able to evaluate anticipated outcomes under an annuity that it issues. We believe that many insurers routinely undertake similar analyses for purposes of pricing and valuing their contracts.<sup>117</sup> In addition, we believe that it is important to provide reasonable certainty to insurers with respect to the application of the rule and to preclude an insurer's determination from being second guessed, in litigation or otherwise, in light of actual events that may differ from assumptions that were reasonable when made.

As with all exemptions from the registration and prospectus delivery requirements of the Securities Act, the party claiming the benefit of the exemption – in this case, the insurer – bears the burden of proving that the exemption applies.<sup>118</sup> Thus, an insurer that believes an indexed annuity is entitled to the exemption under Section 3(a)(8) based, in part, on a determination made under the rule will – if challenged in litigation – be required to prove that its methodology and its economic, actuarial, and other assumptions

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<sup>117</sup> See generally Black and Skipper, *supra* note 39, at 26-47, 890-99. Several commenters who issue indexed annuities disputed that insurers undertake these analyses. See, e.g., American Equity Letter, *supra* note 54; National Western Letter, *supra* note 54; Sammons Letter, *supra* note 54. Other commenters, however, confirmed that these analytical methods exist and are used by insurers for internal purposes. See, e.g., Aviva Letter, *supra* note 54; Academy Letter, *supra* note 54. We give substantial weight to the views of the American Academy of Actuaries (“Academy”) on this point, given their expertise in this type of analysis, and are not persuaded that the contrary comments of several issuers are representative of industry practice. See BLACK’S LAW DICTIONARY 39 (8th ed. 2004) (An actuary is a statistician who determines the present effects of future contingent events and who calculates insurance and pension rates on the basis of empirically based tables.); American Academy of Actuaries, Mission, available at: <http://www.actuary.org/mission.asp> (The mission of the Academy is to, among other things, provide independent and objective actuarial information, analysis, and education for the formation of sound public policy.).

<sup>118</sup> See, e.g., *SEC v. Ralston Purina*, 346 U.S. 119, 126 (1953) (an issuer claiming an exemption under Section 4 of the Securities Act carries the burden of showing that the exemption applies).



were reasonable, and that the computations were materially accurate.

The rule provides that an insurer's determination under the rule will be conclusive only if it is made at or prior to issuance of the contract. Rule 151A is intended to provide certainty to both insurers and investors, and we believe that this certainty will be undermined unless insurance companies undertake the analysis required by the rule no later than the time that an annuity is issued. The rule also provides that, for an insurer's determination to be conclusive, the computations made by the insurance company in support of the determination must be materially accurate. An insurer should not be permitted to rely on a determination of an annuity's status under the rule that is based on computations that are materially inaccurate. For this purpose, we intend that computations will be considered to be materially accurate if any computational errors do not affect the outcome of the insurer's determination as to whether amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

In order for an insurer's determination to be conclusive, both the methodology and the economic, actuarial, and other assumptions used must be reasonable. We recognize that a range of methodologies and assumptions may be reasonable and that a reasonable methodology or assumption utilized by one insurer may differ from a reasonable assumption or methodology selected by another insurer. In determining whether an insurer's methodology is reasonable, it is appropriate to look to methods commonly used for pricing, valuing, and hedging similar products in insurance and derivatives markets.

An insurer will need to make assumptions in several areas, including assumptions

about (i) insurer behavior, (ii) purchaser behavior, and (iii) market behavior, and will need to assign probabilities to various potential behaviors. With regard to insurer behavior, the insurer will need to make assumptions about discretionary actions that it may take under the terms of an annuity. In the case of an indexed annuity, for example, an insurer often has discretion to modify various features, such as guaranteed interest rates, caps, participation rates, and spreads. Similarly, the insurer will need to make assumptions concerning purchaser behavior, including matters such as how long purchasers will hold a contract, how they will allocate contract value among different investment options available under the contract, and the form in which they will take payments under the contract. Assumptions about market behavior will include assumptions about expected return, market volatility, and interest rates. In general, insurers will need to make assumptions about any feature of insurer, purchaser, or market behavior, or any other factor, that is material in determining the likelihood that amounts payable under the contract exceed the amounts guaranteed.

In determining whether assumptions are reasonable, insurers should generally be guided by both history and their own expectations about the future. An insurer may look to its own, and to industry, experience with similar or otherwise comparable contracts in constructing assumptions about both insurer behavior and investor behavior. In making assumptions about future market behavior, an insurer may be guided, for example, by historical market characteristics, such as historical returns and volatility, provided that the insurer bases its assumptions on an appropriate period of time and does not have reason to believe that the time period chosen is likely to be unrepresentative. As a general matter, assumptions about insurer, investor, or market behavior that are not consistent

with historical experience would not be reasonable unless an insurer has a reasonable basis for any differences between historical experience and the assumptions used.

In addition, an insurer may look to its own expectations about the future in constructing reasonable assumptions. As noted above, insurers routinely analyze anticipated outcomes for purposes of pricing and valuing their contracts. We expect that, in making a determination under rule 151A, an insurer will use assumptions that are consistent with the assumptions that it uses for other purposes, such as pricing and valuation. In addition, an insurer generally should use assumptions that are consistent with its marketing materials. In general, assumptions that are inconsistent with the assumptions that an insurer uses for other purposes will not be reasonable under rule 151A.

As noted above, we are adopting a principles-based approach because we believe that it will provide reasonable certainty to insurers with respect to the application of the rule. We recognize, however, that a number of commenters expressed concern that the principles-based approach provides insufficient guidance regarding implementation and the methodologies and assumptions that are appropriate and could result in inconsistent determinations by different insurance companies and present enforcement and litigation risk.<sup>119</sup> Some commenters suggested that the Commission address these concerns by providing guidance as to how to make the determination under the rule, which, they asserted, could result in greater uniformity and consistency in the application of the

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<sup>119</sup> See, e.g., Academy Letter, supra note 54; ACLI Letter, supra note 94; Aviva Letter, supra note 54; AXA Equitable Letter, supra note 106; CAI 151A Letter, supra note 54; FINRA Letter, supra note 7; Letter of Genesis Financial Products, Inc. (Aug. 29, 2008) (“Genesis Letter”); Letter of Janice Hart (Aug. 15, 2008) (“Hart Letter”); ICI Letter, supra note 7; National Western Letter, supra note 54; Sammons Letter, supra note 54.

rule.<sup>120</sup> While we believe that further guidance may, indeed, be helpful in response to specific questions of affected insurance companies, we note that commenters generally did not articulate with specificity the areas where they believe that further guidance is required. As a result, in order to provide guidance in the manner that would be most helpful, we encourage insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance, which we will consider during the two-year period between adoption of rule 151A and its effectiveness.<sup>121</sup>

Like the proposal, rule 151A requires that, in order for an insurer's determination to be conclusive, the determination must be made not more than six months prior to the date on which the form of contract is first offered.<sup>122</sup> For example, if a form of contract were first offered on January 1, 2012, the insurer would be required to make the determination not earlier than July 1, 2011. We are not adopting the proposed requirement that the insurer's determination be made not more than three years prior to the date on which the particular contract is issued.<sup>123</sup> We were persuaded by the commenters that if the status of a form of contract under the federal securities laws were to change, over time, from exempt to non-exempt and vice versa, this would present practical difficulties resulting from the possibility that an annuity could be exempted from registration at one time but be required to be registered subsequently and vice versa,

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<sup>120</sup> See, e.g., FINRA Letter, supra note 7; Hart Letter, supra note 119; ICI Letter, supra note 7; NAIC Officer Letter, supra note 54.

<sup>121</sup> See infra text accompanying notes 129 and 130.

<sup>122</sup> Rule 151A(b)(2)(iii).

<sup>123</sup> Proposed rule 151A(b)(2)(C).

as well as heightened litigation and enforcement risk.<sup>124</sup> We believe that the substantial uncertainties and resulting potential costs introduced by the proposed requirement that a contract's status be redetermined every three years would be inconsistent with the intent of rule 151A, which is to clarify the status of indexed annuities.

Rule 151A, as adopted, requires that, in determining whether amounts payable by the insurance company are more likely than not to exceed the amounts guaranteed, both amounts payable and amounts guaranteed are to be determined by taking into account all charges under the contract, including, without limitation, charges that are imposed at the time that payments are made by the insurance company.<sup>125</sup> For example, surrender charges would be deducted from both amounts payable and amounts guaranteed under the contract. This is a change from the proposal, which would have required that, in determining whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract, amounts

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<sup>124</sup> See, e.g., Aviva Letter, supra note 54; Sammons Letter, supra note 54. See also ICI Letter, supra note 7 (possibility that indexed annuity's status under the federal securities laws could change is not consistent with the purposes of the federal securities laws).

<sup>125</sup> Rule 151A(b)(1). In many cases, amounts guaranteed under annuities are not affected by charges imposed at the time payments are made by the insurer under the contract. This is a result of the fact that guaranteed minimum value, as commonly defined in indexed annuity contracts, equals a percentage of purchase payments, accumulated at a specified interest rate, as explained above, and this amount is not subject to surrender charges. However, under some indexed annuity contracts, the amounts guaranteed are affected by charges imposed at the time payments are made. For example, a purchaser buys a contract for \$100,000. The contract defines surrender value as the greater of (i) purchase payments plus index-linked interest minus surrender charges or (ii) the guaranteed minimum value. The maximum surrender charge is equal to 10%. The guaranteed minimum value is defined in the contract as 87.5% of premium accumulated at 1% annual interest. If the purchaser surrenders within the first year of purchase, and there is no index-linked interest credited, the surrender value would equal \$90,000 (determined under clause (i) as \$100,000 purchase payment minus 10% surrender charge), and this amount would be the guaranteed amount under the contract, not the lower amount defined in the contract as guaranteed minimum value (\$87,500).

payable be determined without reference to any charges that are imposed at the time of payment, such as surrender charges, while those charges would be reflected in computing the amounts guaranteed under the contract.<sup>126</sup>

We are making the foregoing change because we are persuaded by commenters who argued that the proposed provision could result in contracts being determined not to be entitled to the Section 3(a)(8) exemption irrespective of the likelihood of securities-linked return being included in the amount payable.<sup>127</sup> Specifically, commenters argued that as long as the surrender charge is in effect, the amount payable would always exceed the amount guaranteed if the surrender charge were subtracted from the latter but not the former. The commenters further argued that bona fide surrender charges should not result in a contract being deemed a security, since a surrender charge is an expense and does not represent a transfer of risk from insurer to contract purchaser. Because the rule, as adopted, requires surrender charges to be subtracted from both amounts payable and amounts guaranteed, the surrender charges will not affect the determination of whether a contract is a security (i.e., the determination of whether amounts payable are more likely than not to exceed the amounts guaranteed).

#### Effective Date

The effective date of rule 151A is January 12, 2011. We originally proposed that rule 151A, if adopted, would be effective 12 months after publication in the Federal Register. We are persuaded by commenters, however, that additional time is required

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<sup>126</sup> Proposed rule 151A(b)(1).

<sup>127</sup> See, e.g., Aviva Letter, supra note 54; CAI 151A Letter, supra note 54; Coalition Letter, supra note 54.

for, among other things, making the determinations required by the rule, preparing registration statements for indexed annuities that are required to be registered, and establishing the needed infrastructure for distributing registered indexed annuities.<sup>128</sup>

Based on the comments, we believe that a January 12, 2011 effective date will provide the time needed to accomplish these tasks.<sup>129</sup> We note that, during this period, the Commission intends to consider how to tailor disclosure requirements for indexed annuities and will also consider any requests for additional guidance that we receive concerning the determinations required under rule 151A.<sup>130</sup>

The new definition in rule 151A will apply prospectively as we proposed – that is, only to indexed annuities issued on or after January 12, 2011. We are using our definitional rulemaking authority under Section 19(a) of the Securities Act, and the explicitly prospective nature of our rule is consistent with similar prospective rulemaking that we have undertaken in the past when doing so was appropriate and fair under the circumstances.<sup>131</sup>

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<sup>128</sup> Letter of American International Group (Sept. 10, 2008) (“AIG Letter”); Aviva Letter, supra note 54; CAI 151A Letter, supra note 54; NAVA Letter, supra note 106; Letter of New York Life Insurance Company (Sept. 18, 2008) (“NY Life Letter”); Sammons Letter, supra note 54.

<sup>129</sup> AIG Letter, supra note 128 (recommending transition period of 2 years); Aviva Letter, supra note 54 (at least 24 months); CAI 151A Letter, supra note 54 (24 months); Letter of NAVA (Nov. 17, 2008) (“Second NAVA Letter”) (at least 24 months); NY Life Letter, supra note 128 (at least 24 months).

<sup>130</sup> See supra text accompanying notes 95 and 121.

<sup>131</sup> See, e.g., Securities Act Release No. 4896 (Feb. 1, 1968) [33 FR 3142, 3143 (Feb. 17, 1968)] (“The Commission is aware that for many years issuers of the securities identified in this rule have not considered their obligations to be separate securities and that they have acted in reliance on the view, which they believed to be the view of the Commission, that registration under the Securities Act was not required. Under the circumstances, the Commission does not believe that such issuers are subject to any

We are aware that many insurance companies and sellers of indexed annuities, such as insurance agents, broker-dealers, and registered representatives of broker-dealers, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this rulemaking. Under these circumstances, we do not believe that issuers and sellers of indexed annuities should be subject to any additional legal risk relating to their past offers and sales of indexed annuity contracts as a result of the proposal and adoption of rule 151A.<sup>132</sup>

Several commenters requested clarification of the statement that rule 151A will apply prospectively to indexed annuities issued on or after the rule's effective date (*i.e.*, January 12, 2011).<sup>133</sup> As a result, we are clarifying that if an indexed annuity has been issued to a particular individual purchaser prior to January 12, 2011, then that specific contract between that individual and the insurance company (including any additional purchase payments made under the contract on or after January 12, 2011) is not subject to

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penalty or other damages resulting from entering into such arrangements in the past. Paragraph (b) provides that the rule shall apply to transactions of the character described in paragraph (a) only with respect to bonds or other evidence of indebtedness issued after adoption of the rule.”). See also Securities Act Release No. 5316 (Oct. 6, 1972) [37 FR 23631, 23632 (Nov. 7, 1972)] (“The Commission recognizes that the ‘no-sale’ concept has been in existence in one form or another for a long period of time. . . . The Commission believes, after a thorough reexamination of the studies and proposals cited above, that the interpretation embodied in Rule 133 is no longer consistent with the statutory objectives of the [Securities] Act. . . . Rule 133 is rescinded prospectively on and after January 1, 1973 . . .”).

<sup>132</sup> See FSI Letter, supra note 106 (asking for clarification that, like insurance company issuers, independent broker-dealers and their affiliated financial advisers are not subject to any additional legal risk relating to past offers and sales of indexed annuities as a result of rule 151A).

<sup>133</sup> See, e.g., AIG Letter, supra note 128; Hartford Letter, supra note 55; Letter of North American Securities Administrators Association (Sept. 10, 2008) (“NASAA Letter”).



rule 151A, and its status under the federal securities laws is to be determined under the law as it existed without reference to rule 151A. By contrast, if an indexed annuity is issued to a particular individual purchaser on or after January 12, 2011, then that specific contract between that individual and the insurance company is subject to rule 151A, even if the same form of indexed annuity was offered and sold prior to January 12, 2011, and even if the individual contract issued on or after January 12, 2011, is issued under a group contract that was in place prior to January 12, 2011.

The Commission believes that permitting new sales of an existing form of contract (as opposed to additional purchase payments made under a specific existing contract between an individual and an insurance company) after the rule's effective date without reference to the rule is contrary to the purpose of the rule. If the rule were not applicable to all contracts issued on or after the effective date without regard to when the forms of the contracts were originally sold, then two substantially similar contracts could be sold after the effective date, one not subject to the rule and one subject to the rule, even though they present the same level of risk to the purchaser and present the same need for investor protection. The fact that one was designed and released into the marketplace prior to January 12, 2011, and the other was designed and released into the marketplace after that date should not be a determining factor as to the availability of the protections of the federal securities laws. We note that, because we have extended the effective date to January 12, 2011, insurers should have adequate time to prepare for compliance with rule 151A.

Some commenters raised concerns that the registration of an indexed annuity as required by rule 151A could cause offers and sales of the same annuity that occurred on

an unregistered basis after adoption but prior to the effective date of the rule, January 12, 2011, to be unlawful under Section 5 of the Securities Act.<sup>134</sup>

We reiterate that nothing in this adopting release is intended to affect the current analysis of the legal status of indexed annuities until the effective date of rule 151A.

Therefore, after the adoption of rule 151A but prior to the effective date of the rule:

- An indexed annuity issuer making unregistered offers and sales of a contract that will not be an “annuity contract” or “optional annuity contract” under rule 151A may continue to do so until the effective date of rule 151A without such offers and sales being unlawful under Section 5 of the Securities Act as a result of the pending effectiveness of rule 151A; and
- An indexed annuity issuer that wishes to register a contract that will not be an “annuity contract” or “optional annuity contract” under rule 151A may continue to make unregistered offers and sales of the same annuity until the earlier of the effective date of the registration statement or the effective date of the rule without such offers and sales being unlawful under Section 5 of the Securities Act as a result of the pending effectiveness of rule 151A.

#### Annuities not Covered by the Definition

Rule 151A applies to annuities where the contract specifies that amounts payable by the insurance company 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. The rule defines certain of those annuities (annuities under which amounts

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<sup>134</sup> See, e.g., Aviva Letter, supra note 54; CAI 151A Letter, supra note 54; Sammons Letter, supra note 54.

payable by the issuer are more likely than not to exceed the amounts guaranteed under the contract) as not “annuity contracts” or “optional annuity contracts” under Section 3(a)(8) of the Securities Act. The rule, however, does not provide a safe harbor under Section 3(a)(8) for any other annuities, including any other indexed annuities. The status under the Securities Act of any annuity, other than an annuity that is determined under rule 151A to be not an “annuity contract” or “optional annuity contract,” continues to be determined by reference to the investment risk and marketing tests articulated in existing case law under Section 3(a)(8) and, to the extent applicable, the Commission’s safe harbor rule 151.<sup>135</sup>

Some commenters suggested that the Commission, instead of adopting a rule that defines certain indexed annuities as not being “annuity contracts” under Section 3(a)(8), should instead define a safe harbor that would provide that indexed annuities that meet certain conditions are entitled to the Section 3(a)(8) exemption.<sup>136</sup> We are not adopting this approach for two reasons. First, such a rule would not address in any way the federal interest in providing investors with disclosure, antifraud, and sales practice protections that arise when individuals are offered indexed annuities that expose them to investment risk. A safe harbor would address circumstances where purchasers of indexed annuities are **not** entitled to the protections of the federal securities laws; one of our primary goals is to address circumstances where purchasers of indexed annuities **are** entitled to the

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<sup>135</sup> As noted in Part II.B., above, indexed annuities are not entitled to rely on the rule 151 safe harbor.

<sup>136</sup> See, e.g., Academy Letter, supra note 54; AIG Letter, supra note 128; Aviva Letter, supra note 54; Second Academy Letter, supra note 54; Second Aviva Letter, supra note 54; Second Transamerica Letter, supra note 54; Letter of Life Insurance Company of the Southwest (Sept. 10, 2008) (“Southwest Letter”); Voss Letter, supra note 13.

protections of the federal securities laws. We are concerned that many purchasers of indexed annuities today should be receiving the protections of the federal securities laws, but are not. Rule 151A addresses this problem; a safe harbor rule would not. Second, we believe that, under many of the indexed annuities that are sold today, the purchaser bears significant investment risk and is more likely than not to receive a fluctuating, securities-linked return. In light of that fact, we believe that is far more important to address this class of contracts with our definitional rule than to address the remaining contracts, or some subset of those contracts, with a safe harbor rule.

**B. Exchange Act Exemption for Securities that are Regulated as Insurance**

The Commission is also adopting new rule 12h-7 under the Exchange Act, which provides an insurance company with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities issued by the company that are registered under the Securities Act and regulated as insurance under state law.<sup>137</sup> Sixteen commenters supported the exemption.<sup>138</sup> No commenters opposed the exemption. We are adopting this exemption, with changes to the proposal that address commenters' concerns, because we believe that the exemption is necessary or appropriate in the public

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<sup>137</sup> The Commission received a petition requesting that we propose a rule that would exempt issuers of certain types of insurance contracts from Exchange Act reporting requirements. Letter from Stephen E. Roth, Sutherland Asbill & Brennan LLP, on behalf of Jackson National Life Insurance Co., to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Dec. 19, 2007) (File No. 4-553) available at: <http://www.sec.gov/rules/petitions/2007/petn4-553.pdf>.

<sup>138</sup> See, e.g., ACLI Letter, *supra* note 94; Allianz Letter, *supra* note 54; AXA Equitable Letter, *supra* note 106; Letter of Committee of Annuity Insurers regarding proposed rule 12h-7 (Sept. 10, 2008) (“CAI 12h-7 Letter”); FSI Letter, *supra* note 106; Letter of Great-West Life & Annuity Insurance Company (Sept. 10, 2008) (“Great-West Letter”); ICI Letter, *supra* note 7; Letter of MetLife, Inc. (Sept. 11, 2008) (“MetLife Letter”); NAVA Letter, *supra* note 106; Sammons Letter, *supra* note 54.

interest and consistent with the protection of investors. We base that view on two factors: first, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of those activities and assets under state insurance law; and, second, the absence of trading interest in the securities.<sup>139</sup> The new rule imposes conditions to the exemption that relate to these factors and that we believe are necessary or appropriate in the public interest and consistent with the protection of investors.

State insurance regulation is focused on insurance company solvency and the adequacy of insurers' reserves, with the ultimate purpose of ensuring that insurance companies are financially secure enough to meet their contractual obligations.<sup>140</sup> State insurance regulators require insurance companies to maintain certain levels of capital, surplus, and risk-based capital; restrict the investments in insurers' general accounts; limit the amount of risk that may be assumed by insurers; and impose requirements with regard to valuation of insurers' investments.<sup>141</sup> Insurance companies are required to file annual reports on their financial condition with state insurance regulators. In addition, insurance companies are subject to periodic examination of their financial condition by state insurance regulators. State insurance regulators also preside over the conservation

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<sup>139</sup> See Section 12(h) of the Exchange Act [15 U.S.C. 78l(h)] (Commission may, by rules, exempt any class of issuers from the reporting provisions of the Exchange Act "if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.") (emphasis added).

<sup>140</sup> Black and Skipper, supra note 39, at 949.

<sup>141</sup> Id. at 949 and 956-59.

or liquidation of companies with inadequate solvency.<sup>142</sup>

State insurance regulation, like Exchange Act reporting, relates to an entity's financial condition. We are of the view that, in appropriate circumstances, it may be unnecessary for both to apply in the same situation, which may result in duplicative regulation that is burdensome. Through Exchange Act reporting, issuers periodically disclose their financial condition, which enables investors and the markets to independently evaluate an issuer's income, assets, and balance sheet. State insurance regulation takes a different approach to the issue of financial condition, instead relying on state insurance regulators to supervise insurers' financial condition, with the goal that insurance companies be financially able to meet their contractual obligations. We believe that it is consistent with our federal system of regulation, which has allocated the responsibility for oversight of insurers' solvency to state insurance regulators, to exempt insurers from Exchange Act reporting with respect to state-regulated insurance contracts. Commenters asserted that, in light of the protections available under state insurance regulation, periodic reporting under the Exchange Act by state-regulated insurers does not enhance investor protection with respect to the securities covered under the rule.<sup>143</sup>

Our conclusion is strengthened by the general absence of trading interest in insurance contracts. Insurance is typically purchased directly from an insurance company. While insurance contracts may be assigned in some circumstances, they typically are not listed or traded on securities exchanges or in other markets. As a result,

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<sup>142</sup> Id. at 949.

<sup>143</sup> CAI 12h-7 Letter, supra note 138; ICI Letter, supra note 7; MetLife Letter, supra note 138.

outside the context of publicly owned insurance companies, there is little, if any, market interest in the information that is required to be disclosed in Exchange Act reports.

### **1. The Exemption**

Rule 12h-7 provides an insurance company that is covered by the rule with an exemption from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of the Exchange Act with respect to certain securities registered under the Securities Act.<sup>144</sup>

#### Covered Insurance Companies

The Exchange Act exemption applies to an issuer that is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States.<sup>145</sup> In the case of

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<sup>144</sup> Introductory paragraph to rule 12h-7. Cf. Rule 12h-3(a) under the Exchange Act [17 CFR 240.12h-3(a)] (suspension of duty under Section 15(d) of the Exchange Act to file reports with respect to classes of securities held by 500 persons or less where total assets of the issuer have not exceeded \$10,000,000); Rule 12h-4 under the Exchange Act [17 CFR 240.12h-4] (exemption from duty under Section 15(d) of the Exchange Act to file reports with respect to securities registered on specified Securities Act forms relating to certain Canadian issuers).

Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement that has become effective under the Securities Act to file reports and other information and documents required under Section 13 of the Exchange Act [15 U.S.C. 78m] with respect to issuers registered under Section 12 of the Exchange Act [15 U.S.C. 78j]. Section 13(a) of the Exchange Act [15 U.S.C. 78m(a)] requires issuers of securities registered under Section 12 of the Act to file annual reports and other documents and information required by Commission rule.

<sup>145</sup> Rule 12h-7(a). The Exchange Act defines “State” as any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. Section 3(a)(16) of the Exchange Act [15 U.S.C. 78c(a)(16)]. The term “State” in rule 12h-7 has the same meaning as in the Exchange Act. Rule 12h-7 does not define the term “State,” and our existing rules provide that, unless otherwise specifically

a variable annuity contract or variable life insurance policy, the exemption applies to the insurance company that issues the contract or policy. However, the exemption does not apply to the insurance company separate account in which the purchaser's payments are invested and which is separately registered as an investment company under the Investment Company Act of 1940 and is not regulated as an insurance company under state law.<sup>146</sup>

### Covered Securities

The exemption applies with respect to securities that do not constitute an equity interest in the insurance company issuer and that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.<sup>147</sup> The exemption does not apply with respect to any other securities issued by an insurance company. As a result, if an insurance company issues securities with respect to which the exemption applies, and other securities that do not entitle the insurer to the exemption, the insurer will remain subject to Exchange Act reporting obligations. For example, if an insurer that is a publicly held stock company<sup>148</sup> also issues insurance contracts that are

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provided, the terms used in the rules and regulations under the Exchange Act have the same meanings defined in the Exchange Act. See rule 240.0-1(b) [17 CFR 240.0-1(b)].

<sup>146</sup> The separate account's Exchange Act reporting requirements are deemed to be satisfied by filing annual reports on Form N-SAR. 17 CFR 274.101. See Section 30(d) of the Investment Company Act [15 U.S.C. 80a-30(d)] and rule 30a-1 under the Investment Company Act [17 CFR 270.30a-1].

<sup>147</sup> Rule 12h-7(a)(2).

<sup>148</sup> A stock life insurance company is a corporation authorized to sell life insurance, which is owned by stockholders and is formed for the purpose of earning a profit for its stockholders. This is in contrast to another prevailing insurance company structure, the mutual life insurance company. In this structure, the corporation authorized to sell life



registered securities under the Securities Act, the insurer generally would be required to file Exchange Act reports as a result of being a publicly held stock company. Similarly, if an insurer raises capital through a debt offering, the exemption does not apply with respect to the debt securities.

The exemption is available with respect to securities that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.<sup>149</sup> Rule 12h-7 is a broad exemption that applies to any contract that is regulated under the insurance laws of the insurer's home state because we intend that the exemption apply to all contracts, and only those contracts, where state insurance law, and the associated regulation of insurer financial condition, applies. A key basis for the exemption is that investors are already entitled to the financial condition protections of state law and that, under our federal system of regulation, Exchange Act reporting may be unnecessary. Therefore, we believe it is important that the reach of the exemption and the reach of state insurance law be the same. A single commenter addressed the scope of securities with respect to which the proposed exemption would apply, supporting the Commission's approach and noting that limiting the exemption to enumerated types of securities would require the Commission to revisit the rule every few years, or would

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insurance is owned by and operated for the benefit of its policy owners. Black and Skipper, supra note 39, at 577-78.

<sup>149</sup> A domiciliary state is the jurisdiction in which an insurer is incorporated or organized. See National Association of Insurance Commissioners Model Laws, Regulations and Guidelines 555-1, § 104 (2007).

provide a significant barrier to the introduction of new investment products.<sup>150</sup>

The Exchange Act exemption applies both to certain existing types of insurance contracts and to types of contracts that are developed in the future and that are registered as securities under the Securities Act. The exemption applies to indexed annuities that are registered under the Securities Act. However, the Exchange Act exemption is independent of rule 151A and applies to types of contracts in addition to those that are covered by rule 151A. There are at least two types of existing insurance contracts with respect to which the Exchange Act exemption applies, contracts with so-called “market value adjustment” (“MVA”) features and insurance contracts that provide certain guaranteed benefits in connection with assets held in an investor’s account, such as a mutual fund, brokerage, or investment advisory account.

Contracts including MVA features have, for some time, been registered under the Securities Act.<sup>151</sup> Insurance companies issuing contracts with these features have also complied with Exchange Act reporting requirements.<sup>152</sup> MVA features have historically been associated with annuity and life insurance contracts that guarantee a specified rate of return to purchasers.<sup>153</sup> In order to protect the insurer against the risk that a purchaser

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<sup>150</sup> Great-West Letter, supra note 138.

<sup>151</sup> Securities Act Release No. 6645, supra note 35, 51 FR at 20256-58.

<sup>152</sup> See, e.g., ING Life Insurance and Annuity Company (Annual Report on Form 10-K (Mar. 31, 2008)); Protective Life Insurance Company (Annual Report on Form 10-K (Mar. 31, 2008)); Union Security Insurance Company (Annual Report on Form 10-K (Mar. 3, 2008)).

<sup>153</sup> Some indexed annuities also include MVA features. See, e.g., Pre-Effective Amendment No. 4 to Registration Statement on Form S-1 of PHL Variable Insurance Company (File No. 333-132399) (filed Feb. 7, 2007); Initial Registration Statement on Form S-1 of ING

may make withdrawals from the contract at a time when the market value of the insurer's assets that support the contract has declined due to rising interest rates, insurers sometime impose an MVA upon surrender. Under an MVA feature, the insurer adjusts the proceeds a purchaser receives upon surrender prior to the end of the guarantee period to reflect changes in the market value of its portfolio securities supporting the contract.<sup>154</sup>

More recently, some insurance companies have registered under the Securities Act insurance contracts that provide certain guarantees in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.<sup>155</sup> As a result, the insurers become subject to Exchange Act reporting requirements if they are not already subject to those requirements. These contracts, often called "guaranteed living benefits," are intended to provide insurance to the purchaser against the risk of outliving the assets held in the mutual fund, brokerage, or investment advisory account.<sup>156</sup>

As noted above, the Exchange Act exemption also applies with respect to a guarantee of a security if the guaranteed security is subject to regulation under state

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USA Annuity and Life Insurance Company (File No. 333-133153) (filed Apr. 7, 2006); Pre-Effective Amendment No. 2 to Registration Statement on Form S-3 of Allstate Life Insurance Company (File No. 333-117685) (filed Dec. 20, 2004).

<sup>154</sup> See Proposing Release, supra note 3, 73 FR at 37764 (describing MVA features).

<sup>155</sup> See, e.g., PHL Variable Life Insurance Company, File No. 333-137802 (Form S-1 filed Feb. 25, 2008); Genworth Life and Annuity Insurance Company, File No. 333-143494 (Form S-1 filed Apr. 4, 2008).

<sup>156</sup> See Proposing Release, supra note 3, 73 FR at 37764 (describing guaranteed living benefits).

insurance law.<sup>157</sup> We are adopting this provision because we believe that it is appropriate to exempt from Exchange Act reporting an insurer that provides a guarantee of an insurance contract (that is also a security) when the insurer would not be subject to Exchange Act reporting if it had issued the guaranteed contract. This situation may arise, for example, when an insurance company issues a contract that is a security and its affiliate, also an insurance company, provides a guarantee of benefits provided under the first company's contract.<sup>158</sup>

Finally, the exemption is not available with respect to any security that constitutes an equity interest in the issuing insurance company. As a general matter, an equity interest in an insurer is not covered by the exemption because it is not subject to regulation under state insurance law and often is publicly traded. Nonetheless, we believe that the rule should expressly preclude any security that constitutes an equity interest in the issuing insurance company from being covered by the exemption. Where investors own an equity interest in an issuing insurance company, and are therefore dependent on the financial condition of the issuer for the value of that interest, we believe that they have a significant interest in directly evaluating the issuers' financial condition for themselves on an ongoing basis and that Exchange Act reporting is appropriate.

## **2. Conditions to Exemption**

As described above, we believe that the exemption is necessary or appropriate in

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<sup>157</sup> The Securities Act defines "security" in Section 2(a)(1) of the Act [15 U.S.C. 77b(a)(1)]. That definition provides that a guarantee of any of the instruments included in the definition is also a security.

<sup>158</sup> For example, an insurance company may offer a registered variable annuity, and a parent or other affiliate of the issuing insurance company may act as guarantor for the issuing company's insurance obligations under the contract.

the public interest and consistent with the protection of investors because of the existence of state regulation of insurers' financial condition and because of the general absence of trading interest in insurance contracts. The Exchange Act exemption that we are adopting, like the proposal, is subject to conditions that are designed to ensure that both of these factors are, in fact, present in cases where an insurance company is permitted to rely on the exemption. We have modified the conditions related to trading interest in one respect to address the concerns of commenters. We have also added a condition to the proposed rule in order to address a commenter's concern.

#### Regulation of Insurer's Financial Condition

In order to rely on the exemption, an insurer must file an annual statement of its financial condition with, and the insurer must be supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or any officer performing like functions, of the insurer's domiciliary state.<sup>159</sup> Commenters did not address this condition, and we are adopting this condition as proposed. This condition is intended to ensure that an insurer claiming the exemption is, in fact, subject to state insurance regulation of its financial condition. Absent satisfaction of this condition, Exchange Act reporting would not be duplicative of state insurance regulation, and the exemption would not be available.

#### Absence of Trading Interest

The Exchange Act exemption is subject to two conditions intended to insure that there is no trading interest in securities with respect to which the exemption applies, and

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<sup>159</sup> Rule 12h-7(c). Cf. Section 26(f)(2)(B)(ii) and (iii) of the Investment Company Act [15 U.S.C. 80a-26(f)(2)(B)(ii) and (iii)] (using similar language in requirements that apply to insurance companies that sell variable insurance products).

we are modifying the proposed conditions in one respect to address the concerns of commenters. First, the securities may not be listed, traded, or quoted on an exchange, alternative trading system,<sup>160</sup> inter-dealer quotation system,<sup>161</sup> electronic communications network, or any other similar system, network, or publication for trading or quoting.<sup>162</sup> This condition is designed to ensure that there is no established trading market for the securities. Second, the issuing insurance company must take steps reasonably designed to ensure that a trading market for the securities does not develop.<sup>163</sup> This includes, except to the extent prohibited by the law of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States,<sup>164</sup> or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any state, requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis. This condition is designed to ensure that the insurer takes reasonable steps to ensure the absence of trading interest in the securities.

We are adopting the first condition, relating to the absence of listing, trading, and quoting on any exchange or similar system, network, or publication for trading or

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<sup>160</sup> For this purpose, “alternative trading system” would have the same meaning as in Regulation ATS. See 17 CFR 242.300(a) (definition of “alternative trading system”).

<sup>161</sup> For this purpose, “inter-dealer quotation system” would have the same meaning as in Exchange Act rule 15c2-11. See 17 CFR 240.15c2-11(e)(2) (definition of “inter-dealer quotation system”).

<sup>162</sup> Rule 12h-7(d).

<sup>163</sup> Rule 12h-7(e).

<sup>164</sup> See supra note 145 for a discussion of the term “State” as used in rule 12h-7.

quoting, as proposed. We are not adopting the suggestion of a commenter that the Commission limit this condition to exchanges and other similar systems, networks, and publications for trading or quoting that are registered with, or regulated by, the Commission or a self-regulatory organization.<sup>165</sup> The commenter argued that, absent this limitation, insurance companies would be placed in the position of enforcing the Commission's requirements by identifying any exchanges and other similar systems, networks, and publications for trading or quoting that may arise from time to time and operate in violation of the Commission's rules and regulations. We disagree that this limitation is appropriate. We have determined that the exemption provided by rule 12h-7 is necessary or appropriate in the public interest and consistent with the protection of investors, in part, because of the absence of trading interest in the insurance contracts covered by the exemption. We do not believe that there would be an absence of trading interest where an insurance contract trades on an exchange or similar system, network, or publication for trading or quoting, whether regulated by the Commission or not.

We are modifying the second condition, which requires the issuing insurance company to take steps reasonably designed to ensure that a trading market for the securities does not develop. As the condition was proposed, this would have included requiring written notice to, and acceptance by, the insurance company prior to any assignment or transfer of the securities and reserving the right to refuse assignments or other transfers of the securities at any time on a non-discriminatory basis.<sup>166</sup> Under the adopted rule, these particular steps will continue to be required, except to the extent that

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<sup>165</sup> CAI 12h-7 Letter, supra note 138.

<sup>166</sup> Proposed rule 12h-7(e).

they are prohibited by the law of any state or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any state.

This modification addresses the concern expressed by several commenters that the proposed condition could, in some circumstances, be inconsistent with applicable state law.<sup>167</sup> The commenters stated that some states may not permit restrictions on transfers or assignments and, indeed, that some states specifically grant contract owners the right to transfer or assign their contracts. In proposing the condition relating to restrictions on assignment, it was not our intent to require restrictions that are inconsistent with applicable state law. Our modification to rule 12h-7 clarifies this and, accordingly, addresses the commenters' concern.

Three commenters requested that the second condition be removed in its entirety.<sup>168</sup> These commenters stated that the second condition is unnecessary, because the first should give sufficient comfort that a trading market will not arise. The commenters also stated that this condition would be difficult to apply. One of the commenters stated that the condition is ambiguous, and that there is no clear definition of "trading market" in the federal securities laws.<sup>169</sup> We continue to believe that the second condition is important because it will ensure that the issuer takes steps reasonably designed to preclude the development of a trading market. We do not believe that, as modified to address concerns about inconsistency with state law, the second condition

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<sup>167</sup> Allianz Letter, supra note 54; CAI 12h-7 Letter, supra note 138; ICI Letter, supra note 7; NAVA, supra note 106; Sammons Letter, supra note 54.

<sup>168</sup> CAI 12h-7 Letter, supra note 138; Sammons Letter, supra note 54; Transamerica Letter, supra note 54; Second Transamerica Letter, supra note 54.

<sup>169</sup> CAI 12h-7 Letter, supra note 138.



will be unduly difficult to be apply.

Two commenters requested that rule 12h-7 include a transition period for filing required reports under the Exchange Act for any insurance company previously relying on the rule that no longer meets its conditions.<sup>170</sup> We do not believe that it would be appropriate to include such a transition period because, if an insurer no longer meets the conditions, this generally would mean that either the securities are not regulated as insurance under state law or the securities are traded or may become traded. In such a case, the very basis on which we are granting the exemption would no longer exist. Therefore, we have determined not to include such a transition period in rule 12h-7. If an issuer no longer meets the conditions of the rule, it will immediately become subject to the filing requirements of the Exchange Act. We would, in any event, expect situations where an insurance company ceases to meet the conditions of rule 12h-7 to be extremely rare. In such a case, at an insurer's request, we would consider, based on the particular facts and circumstances, whether individual exemptive relief to provide for a transition period would be appropriate.

#### Prospectus Disclosure

We are adding a condition to proposed rule 12h-7 to require that, in order for an insurer to be entitled to the Exchange Act exemption provided by the rule with respect to securities, the prospectus for the securities must contain a statement indicating that the issuer is relying on the exemption provided by the rule.<sup>171</sup> This addresses a commenter's

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<sup>170</sup> Letter of Committee of Annuity Insurers regarding proposed rule 12h-7 (Nov. 17, 2008) ("Second CAI 12h-7 Letter"); Second Transamerica Letter, supra note 54.

<sup>171</sup> Rule 12h-7(f).

request that the Commission clarify that reliance on the exemption is optional because some insurers may conclude that the benefits that flow from the ability to incorporate by reference Exchange Act reports may outweigh any costs associated with filing those reports.<sup>172</sup> The new condition will permit an insurance company that desires to remain subject to Exchange Act reporting requirements to do so by omitting the required statement from its prospectus. The new provision also has the advantage of providing notice to investors of an insurer's reliance on the exemption. An insurer who does not include this statement will be subject to mandatory Exchange Act reporting.<sup>173</sup>

### **3. Effective Date**

The effective date of rule 12h-7 is May 1, 2009.

## **IV. PAPERWORK REDUCTION ACT**

### **A. Background**

Rule 151A contains no new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>174</sup> However, we believe that rule 151A will result in an increase in the disclosure burden associated with existing

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<sup>172</sup> CAI 12h-7 Letter, supra note 138. See Form S-1, General Instruction VII.A. (incorporation by reference permitted only if, among other things, registrant subject to Exchange Act reporting requirements); Form S-3, General Instruction I.A.2. (Form S-3, which permits incorporation by reference, available to registrant that, among other things, is required to file Exchange Act reports).

<sup>173</sup> As described above, the exemption applies to an insurance company that issues a variable annuity contract or variable life insurance policy, but not to the associated separate account. See supra note 146 and accompanying text. On or after the effective date of rule 12h-7, the prospectus for a variable insurance contract with respect to which the insurer does not file Exchange Act reports (and therefore is relying on rule 12h-7) will be required to include the statement that the insurer is relying on rule 12h-7.

<sup>174</sup> 44 U.S.C. 3501 et seq.

Form S-1 as a result of additional filings that will be made on Form S-1.<sup>175</sup> Form S-1 contains “collection of information” requirements within the meaning of the PRA.

Although we are not amending Form S-1, we have submitted the Form S-1 “collection of information” (“Form S-1 Registration Statement” (OMB Control No. 3235-0065)), which we estimate will increase as a result of rule 151A, to the Office of Management and Budget (“OMB”) for review and approval in accordance with the PRA.<sup>176</sup> We published notice soliciting comment on the increase in the collection of information requirements in the release proposing rule 151A and submitted the proposed collection of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 C.F.R. 1320.11.

We adopted Form S-1 pursuant to the Securities Act. This form sets forth the disclosure requirements for registration statements that are prepared by eligible issuers to provide investors with the information they need to make informed investment decisions in registered offerings. We anticipate that, absent amendments to our disclosure requirements to specifically address indexed annuities, indexed annuities that register under the Securities Act would generally register on Form S-1.<sup>177</sup> As a result, we have

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<sup>175</sup> 17 CFR 239.11.

<sup>176</sup> 44 U.S.C. 3507(d); 5 CFR 1320.11.

<sup>177</sup> Some Securities Act offerings are registered on Form S-3 [17 CFR 239.13]. We do not believe that rule 151A will have any significant impact on the disclosure burden associated with Form S-3 because we believe that very few, if any, insurance companies that issue indexed annuities will be eligible to register those contracts on Form S-3. In order to be eligible to file on Form S-3, an issuer, must, among other things, have filed Exchange Act reports for a period of at least 12 calendar months. General Instruction I.A.3. of Form S-3. Very few insurance companies that issue indexed annuities are currently eligible to file Form S-3. Further, any insurance companies that issue indexed annuities and rely on the Exchange Act reporting exemption that we are adopting will not meet the eligibility requirements for Form S-3. We believe that very few, if any, issuers

assumed, for purposes of our PRA analysis, that this would be the case. We note, however, that we are providing a two-year transition period for rule 151A and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities.<sup>178</sup>

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The information collection requirements related to registration statements on

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of indexed annuities will choose to be subject to the reporting requirements of the Exchange Act because of the costs that this would impose. In any event, the number of indexed annuity issuers that choose to be subject to the reporting requirements of the Exchange Act would be insignificant compared to the total number of Exchange Act reporting companies, which is approximately 12,100. The number of indexed annuity issuers in 2007 was 58. NAVA, supra note 9, at 57.

We also do not believe that the rules will have any significant impact on the disclosure burden associated with reporting under the Exchange Act on Forms 10 K, 10 Q, and 8 K. As a result of rule 12h-7, insurance companies will not be required to file Exchange Act reports on these forms in connection with indexed annuities that are registered under the Securities Act, and, as noted in the prior paragraph, we believe that very few, if any, issuers of indexed annuities will choose to be subject to the reporting requirements of the Exchange Act because of the costs that this would impose. While rule 12h 7 will permit some insurance companies that are currently required to file Exchange Act reports as a result of issuing insurance contracts that are registered under the Securities Act, to cease filing those reports, the number of such companies is insignificant compared to the total number of Exchange Act reporting companies. Likewise, we do not believe that the prospectus statement required under rule 12h-7 for insurers relying on that rule will have any significant impact on the disclosure burden associated with registration statements for insurance contracts that are securities (Forms S-1, S-3, N-3, N-4, and N-6). We do not believe that the currently approved collections of information for these forms will change based on the rule 12h-7 prospectus statement.

<sup>178</sup> As noted above, some commenters expressed concern about what they believed to be a lack of a registration form that is well-suited to indexed annuities. See supra text accompanying notes 94 and 95.

Form S-1 are mandatory. There is no mandatory retention period for the information disclosed, and the information disclosed will be made publicly available on the EDGAR filing system.

#### **B. Summary of Information Collection**

Because rule 151A will affect the number of filings on Form S-1 but not the disclosure required by this form, we do not believe that the rules will impose any new recordkeeping or information collection requirements. However, we expect that some insurance companies will register indexed annuities in the future that they would not previously have registered. We believe this will result in an increase in the number of annual responses expected with respect to Form S-1 and in the disclosure burden associated with Form S-1. At the same time, we expect that, on a per response basis, rule 151A will decrease the existing disclosure burden for Form S-1. This is because the disclosure burden for each indexed annuity on Form S-1 is likely to be lower than the existing burden per respondent on Form S-1. The decreased burden per response on Form S-1 will partially offset the increased burden resulting from the increase in the annual number of responses on Form S-1. We believe that, in the aggregate, the disclosure burden for Form S-1 will increase as a result of the adoption of rule 151A.

#### **C. Paperwork Reduction Act Burden Estimates**

For purposes of the PRA, we estimate that the rule will result in an annual increase in the paperwork burden for companies to comply with the Form S-1 collection of information requirements of approximately 60,000 hours of in-house company personnel time and approximately \$72,000,000 for the services of outside professionals. These estimates represent the combined effect of an expected increase in the number of

annual responses on Form S-1 and a decrease in the expected burden per response. These estimates include the time and the cost of preparing and reviewing disclosure, filing documents, and retaining records. Our methodologies for deriving the above estimates are discussed below.

We are adopting a new definition of “annuity contract” that, on a prospective basis, defines a class of indexed annuities that are not “annuity contracts” or “optional annuity contracts” for purposes of Section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities will, on a prospective basis, be required to register under the Securities Act on Form S-1.<sup>179</sup>

We received numerous comment letters on the proposal, and we have revised proposed rule 151A in response to the comments. However, we do not believe that any of the modifications affect the estimated reporting and cost burdens discussed in this PRA analysis. These modifications include:

- Revising the proposed definition so that the rule will apply to a contract that specifies that 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;<sup>180</sup>

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<sup>179</sup> Some Securities Act offerings are registered on Form S-3, but we believe that very few, if any, insurance companies that issue indexed annuities will be eligible to register those contracts on Form S-3. See supra note 177.

<sup>180</sup> Rule 151A(a)(1).

- Eliminating the provision in proposed rule 151A that the issuer's determination as to whether amounts payable under the contract are more likely than not to exceed the amounts guaranteed under the contract be made not more than three years prior to the date on which the particular contract is issued,<sup>181</sup> and
- Adopting a requirement that amounts payable by the issuer and amounts guaranteed are to be determined by taking into account all charges under the contract, including, without limitation, charges that are imposed at the time that payments are made by the issuer.<sup>182</sup>

We do not believe that any of these changes will affect the annual increase in the number of responses on Form S-1 or the hours per response required. As we state below, we assume that all indexed annuities that are offered on or after January 12, 2011, will be registered, and that each of the 400 registered indexed annuities will be the subject of one response per year on Form S-1. We do not expect the changes in the rule, as adopted, to affect our estimates of the increase in the number of annual responses required on Form S-1. The first change, revising the scope of the rule, addresses commenters' concerns that the rule was overly broad and would reach annuities that were not indexed annuities, such as traditional fixed annuities and discretionary excess interest contracts. While the revision clarifies the intended scope of the rule to address these concerns, our PRA estimates with respect to the proposed rule were based on the intended scope of the

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<sup>181</sup> Proposed Rule 151A(b)(2)(iii).

<sup>182</sup> Rule 151A(b)(1).

proposed rule, which did not extend to these other types of annuities. As a result, this change has no effect on our estimates of the number of responses required on Form S-1. Our PRA estimates assume that all indexed annuities that are offered will be registered, and we do not believe that this assumption is affected by the elimination of the requirement that an insurer's determination under rule 151A be made not more than three years prior to the date on which a particular contract is issued or the change to the manner of taking charges into account under the rule. In addition, the changes in the rule will not affect the information required to be disclosed by Form S-1, or the time required to prepare and file the form.

#### Increase in Number of Annual Responses

For purposes of the PRA, we estimate that there will be an annual increase of 400 responses on Form S-1 as a result of the rule. In 2007, there were 322 indexed annuity contracts offered.<sup>183</sup> For purposes of the PRA analysis, we assume that 400 indexed annuities will be offered each year. This allows for some escalation in the number of contracts offered in the future over the number offered in 2007. Our Office of Economic Analysis has considered the effect of the rule on indexed annuity contracts with typical terms and has determined that these contracts would not meet the definition of "annuity contract" or "optional annuity contract" if they were to be issued after the effective date of the rule. Therefore, we assume that all indexed annuities that are offered will be registered, and that each of the 400 registered indexed annuities will be the subject of one

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<sup>183</sup> See NAVA, supra note 9, at 57.



response per year on Form S-1,<sup>184</sup> resulting in the estimated annual increase of 400 responses on Form S-1.

#### Decrease in Expected Hours Per Response

For purposes of the PRA, we estimate that there will be a decrease of 120 hours per response on Form S-1 as a result of the rule. Current OMB approved estimates and recent Commission rulemaking estimate the hours per response on Form S-1 as 950.<sup>185</sup> The current hour estimate represents the burden for all issuers, both large and small. We believe that registration statements on Form S-1 for indexed annuities will result in a significantly lower number of hours per response, which, based on our experience with other similar contracts, we estimate as 600 hours per indexed annuity response on Form S-1. We attribute this lower estimate to two factors. First, the estimated 400 indexed annuity registration statements will likely be filed by far fewer than 400 different insurance companies,<sup>186</sup> and a significant part of the information in each of the multiple registration statements filed by a single insurance company will be the same, resulting in economies of scale with respect to the multiple filings. Second, many of the 400

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<sup>184</sup> Annuity contracts are typically offered to purchasers on a continuous basis, and as a result, an insurer offering an annuity contract that is registered under the Securities Act generally will be required to update the registration statement once a year. See Section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)] (when prospectus used more than 9 months after effective date of registration statement, information therein generally required to be not more than 16 months old).

<sup>185</sup> These estimates have been revised by other rules that the Commission has adopted, and OMB approval is pending. See Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8876, available at: <http://www.reginfo.gov/public/do/DownloadDocument?documentID=90204&version=0> (“33-8876 Supporting Statement”).

<sup>186</sup> The 322 indexed annuities offered in 2007 were issued by 58 insurance companies. See NAVA, supra note 9, at 57.

responses on Form S-1 each year will be annual updates to registration statements for existing contracts, rather than new registration statements, resulting in a significantly lower hour burden than a new registration statement.<sup>187</sup> Combining our estimate of 600 hours per indexed annuity response on Form S-1 (for an estimated 400 responses) with the existing estimate of 950 hours per response on Form S-1 (for an estimated 768 responses),<sup>188</sup> our new estimate is 830 hours per response  $((400 \times 600) + (768 \times 950))/1168$ .

#### Net Increase in Burden

To calculate the total effect of the rules on the overall compliance burden for all issuers, large and small, we added the burden associated with the 400 additional Forms S-1 that we estimate will be filed annually in the future and subtracted the burden associated with our reduced estimate of 830 hours for each of the current estimated 768 responses. We used current OMB approved estimates in our calculation of the hours and cost burden associated with preparing, reviewing, and filing Form S-1.

Consistent with current OMB approved estimates and recent Commission rulemaking,<sup>189</sup> we estimate that 25% of the burden of preparation of Form S-1 is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of \$400 per hour.<sup>190</sup> The portion of the burden

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<sup>187</sup> See supra note 184.

<sup>188</sup> See 33-8876 Supporting Statement, supra note 185.

<sup>189</sup> See Securities Act Release No. 8878 (Dec. 19, 2007) [72 FR 73534, 73547 (Dec. 27, 2007)].

<sup>190</sup> Id. at note 110 and accompanying text.

carried by outside professionals is reflected as a cost, while the burden carried by the company internally is reflected in hours.

The tables below illustrate our estimates concerning the incremental annual compliance burden in the collection of information in hours and cost for Form S-1.

Incremental PRA Burden Due to Increased Filings

Estimated Increase in Annual Responses	Hours/Response	Incremental Burden (hours)
400	830	332,000

Incremental Decrease in PRA Burden Due to Decrease in Hours Per Response

Estimated Decrease in Hours/Response	Current Estimated Number of Annual Filings	Incremental Decrease in Burden (hours)
(120)	768	(92,200)

Summary of Change in Incremental Compliance Burden

Incremental Burden (hours)	25% Issuer (hours)	75% Professional (hours)	\$400/hr. Professional Cost
240,000	60,000	180,000	\$72,000,000

**D. Response to Comments on Commission’s Paperwork Reduction Act Analysis**

A few commenters commented on the Commission’s Paperwork Reduction Act analysis in the Proposing Release.<sup>191</sup> One commenter stated that external costs of registering indexed annuities on Form S-1 will vary considerably depending on whether the insurer has previously prepared a Form S-1.<sup>192</sup> The commenter stated that, for

<sup>191</sup> See, e.g., Allianz Letter, supra note 54; Second Aviva Letter, supra note 54; Letter of National Association for Fixed Annuities (Nov. 17, 2008) (“Second NAFA Letter”); Transamerica Letter, supra note 54.

<sup>192</sup> Allianz Letter, supra note 54.

insurers that have not previously prepared a Form S-1 registration statement, external legal costs could be as high as \$250,000-\$500,000 for each registration statement. The same commenter estimated external legal costs for an issuer that has previously filed a Form S-1 at \$50,000-\$100,000. Another commenter estimated external legal costs for preparation and filing of a Form S-1 registration statement with the SEC at \$350,000 for the first few years, which, the commenter stated, would decrease over time as the insurer gained more expertise.<sup>193</sup> However, these commenters did not specify the sources of these cost estimates or how they were made.

As stated above, we estimate the average burden per indexed annuity response on Form S-1 to be 600 hours. We further estimate that 75% of that burden will be carried by outside professionals retained by the issuer at an average cost of \$400 per hour.

Accordingly, we estimate the cost for outside professionals for each indexed annuity registration statement on Form S-1 to be on average \$180,000 ((600 X .75) x \$400). We do not believe that it is necessary to change our estimate of outside professional costs based on the commenters' estimated costs. The \$250,000-\$500,000 range cited by the commenters is for an issuer that has not previously filed a Form S-1, with commenters acknowledging that the costs to an experienced filer would be lower (as low as \$50,000-\$100,000). Our \$180,000 estimate reflects outside professional costs incurred not only by first-time Form S-1 filers, but also the costs of preparing Form S-1 for contracts offered by experienced Form S-1 filers, as well as annual updates to existing Form S-1

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<sup>193</sup> Second Aviva Letter, supra note 54.

registration statements, which we expect to be significantly lower than costs incurred by first-time filers.

One commenter cites a cost of \$255,000 for the insurer to prepare a registration statement.<sup>194</sup> It is not clear whether this cost represents only external costs or total costs. The commenter also estimates the cost of preparing a registration statement for certain types of carriers at \$62,500<sup>195</sup> and further indicates that there are 27 such carriers issuing indexed annuities, which is approximately half the number of insurers currently issuing indexed annuities.<sup>196</sup> Because the commenter does not provide information as to the basis for the \$255,000 figure, and because the \$62,500 figure is substantially below the Commission's estimate of \$180,000, we are not revising our estimate of the burden of registering an indexed annuity on Form S-1 to reflect these estimates.

Another commenter stated that the Commission's estimate of outside professional costs of \$400 per hour does not reflect market rates for securities counsel.<sup>197</sup> However, the commenter did not cite a different rate and did not explain the basis for its disagreement with the \$400 per hour rate cited by the Commission. Our estimate of \$400 per hour for outside professionals retained by the issuer is consistent with recent rulemakings and is based on discussions between our staff and several law firms.<sup>198</sup>

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<sup>194</sup> Second NAFA Letter, supra note 191.

<sup>195</sup> This estimate is for carriers "without variable authority." The commenter does not explain the meaning of the phrase "without variable authority."

<sup>196</sup> NAVA, supra note 9, at 57 (58 companies issued indexed annuities in 2007).

<sup>197</sup> Transamerica Letter, supra note 54.

<sup>198</sup> See, e.g., Securities Act Release No. 8909 (Apr. 10, 2008) [73 FR 20512, 20515 (Apr. 15, 2008)] ("Revisions to Form S-11 Release").

Accordingly, we are not changing our estimate of the cost per hour of outside professional costs. The commenter further stated that the estimates of time involved are low for persons unfamiliar with the process of registration of securities under the federal securities laws and the anticipated need for interaction with Commission staff.

However, as discussed, our estimate of time required to prepare a registration statement reflects time needed not only by first-time Form S-1 filers, but also the time involved in preparing Form S-1 for contracts offered by experienced Form S-1 filers, as well as annual updates to the existing Form S-1 registration statement, which we expect to be significantly less than time needed by first-time filers. We are not revising our estimate of time involved in preparing registration statements on Form S-1.

#### **V. COST-BENEFIT ANALYSIS**

The Commission is sensitive to the costs and benefits imposed by its rules. Rule 151A is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption for certain insurance contracts. The rule prospectively defines certain indexed annuities as not being “annuity contracts” or “optional annuity contracts” under this insurance exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. With respect to these annuities, investors are entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections. We are also adopting new rule 12h-7 under the Exchange Act, which exempts certain insurance companies from Exchange Act

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reporting with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law.

In the Proposing Release, we identified certain costs and benefits and requested comment on our cost-benefit analysis, including identification of any costs and benefits not discussed. We also requested that commenters provide empirical data and factual support for their views.

Discussed below is our analysis of the costs and benefits of rules 151A and 12h-7, as well as the issues raised by commenters. As noted above, we are sensitive to the costs imposed by our rules and we have estimated the costs associated with adoption of rule 151A. We emphasize, however, that the burdens of complying with the federal securities laws apply to all market participants who issue or sell securities under the federal securities laws. Rule 151A, by defining those indexed annuities that are not entitled to the Section 3(a)(8) exemption, does not impose any greater or different burdens than those imposed on other similarly situated market participants. Rather, the effect of rule 151A is that issuers and sellers of indexed annuities that are not entitled to the Section 3(a)(8) exemption are treated in the same manner under the federal securities laws as issuers and sellers of other registered securities, and that investors purchasing these instruments receive the same disclosure, antifraud, and sales practice protections that apply when they are offered and sold other securities that pose similar investment risks.

#### **A. Benefits**

We anticipate that the rules will benefit investors and covered institutions by:

- (i) creating greater regulatory certainty with regard to the status of indexed annuities under the federal securities laws;
- (ii) enhancing disclosure of information needed to make

informed investment decisions about indexed annuities; (iii) applying sales practice protections to those indexed annuities that are outside the insurance exemption; (iv) enhancing competition; and (v) relieving from Exchange Act reporting obligations insurers that issue certain securities that are regulated as insurance under state law.

### Regulatory Certainty

Rule 151A will provide the benefit of increased regulatory certainty to insurance companies that issue indexed annuities and the distributors who sell them, as well as to purchasers of indexed annuities. The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court. Rule 151A will bring greater certainty into this area by defining a class of indexed annuities that are outside the scope of the insurance exemption and by providing that an insurer's determination, in accordance with the rule, will be conclusive.

Indexed annuities possess both insurance and securities features, and fall somewhere between traditional fixed annuities, which are clearly insurance falling within Section 3(a)(8), and variable annuities, which are clearly securities. We have carefully considered where to draw the line, and we believe that the line that we have drawn is rational and reasonably related to fundamental concepts of risk and insurance.

Some commenters agreed that the proposal would provide greater regulatory certainty.<sup>199</sup> One commenter stated that current uncertainty regarding the status of

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<sup>199</sup> See, e.g., Advantage Group Letter, supra note 54; Cornell Letter, supra note 7; FINRA Letter, supra note 7; ICI Letter, supra note 7; Letter of State of Washington Department of Financial Institutions Securities Division (Nov. 17, 2008) (“Washington State Letter”).



indexed annuities has impeded the ability of regulators to protect indexed annuity consumers,<sup>200</sup> and another stated that it is apparent that clarification is needed and will set a clear national standard of regulatory oversight for indexed annuities.<sup>201</sup> Some commenters, however, expressed concern that the principles-based approach provides insufficient guidance regarding implementation and the methodologies and assumptions that are appropriate and could result in inconsistent determinations by different insurance companies and present enforcement and litigation risk.<sup>202</sup> While we believe that further guidance may be helpful in response to specific questions from affected insurance companies, commenters generally did not articulate with specificity the areas where they believe that further guidance is required. As a result, in order to provide guidance in the manner that would be most helpful, we encourage insurance companies, sellers of indexed annuities, and other affected parties to submit specific requests for guidance, which we will consider during the two-year period between adoption of rule 151A and its effectiveness.

### Disclosure

Rule 151A extends the benefits of full and fair disclosure under the federal securities laws to investors in indexed annuities that, under the rule, fall outside the insurance exemption. Without such disclosure, investors face significant obstacles in making informed investment decisions with regard to purchasing indexed annuities that expose them to investment risk. Indexed annuities are similar in many ways to mutual

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<sup>200</sup> FINRA Letter, supra note 7;

<sup>201</sup> Washington State Letter, supra note 199.

<sup>202</sup> See supra note 119.

funds, variable annuities, and other securities. Investors in indexed annuities are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Extending the federal securities disclosure regime to indexed annuities under which amounts payable by the insurer are more likely than not to exceed the amounts guaranteed should help to provide investors with the information they need.

Disclosures required for registered indexed annuities include information about costs (such as surrender charges); the method of computing indexed return (e.g., applicable index, method for determining change in index, caps, participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits). We think there are significant benefits to the disclosures provided under the federal securities laws. This information will be public and accessible to all investors, intermediaries, third party information providers, and others through the Commission's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system. Public availability of this information will be helpful to investors in making informed decisions about purchasing indexed annuities. The information will enhance investors' ability to compare various indexed annuities and also to compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. The potential liability for materially false and misleading statements and omissions under the federal securities laws will provide additional encouragement for accurate and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell

them.<sup>203</sup>

In addition, we believe that potential purchasers of indexed annuities that an insurer determines do not fall outside the insurance exemption under the rule may benefit from enhanced information that will help a purchaser to evaluate the value of the contract and, specifically, the index-based return. Specifically, an indexed annuity that is not registered under the Securities Act after the effective date of rule 151A would reflect the insurer's determination that investors in the annuity will not receive more than the amounts guaranteed under the contract at least half the time.

A number of commenters acknowledged the need for improved disclosures and agreed that indexed annuity purchasers will benefit from disclosures required under the federal securities laws.<sup>204</sup> These commenters noted that indexed annuities are complicated products that can confuse experienced investment professionals and consumers, and strongly supported rule 151A as improving critical disclosures about these products. One commenter expressed strong support for enhanced disclosures regarding critical costs of indexed annuities, such as surrender charges, and the method of computing indexed returns, as well as guaranteed interest rates.<sup>205</sup> Another commenter noted that the Commission could greatly improve consumer protection by subjecting

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<sup>203</sup> See, e.g., Section 12(a)(2) of the Securities Act [15 U.S.C. 77](a)(2)] (imposing liability for materially false or misleading statements in a prospectus or oral communication, subject to a reasonable care defense). See also Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)]; rule 10b-5 under the Exchange Act [17 CFR 240.10b-5]; Section 17 of the Securities Act [15 U.S.C. 77q] (general antifraud provisions).

<sup>204</sup> See, e.g., Alabama Letter, supra note 72; Cornell Letter, supra note 7; FPA Letter, supra note 72; Hartford Letter, supra note 55.

<sup>205</sup> FPA Letter, supra note 72.

indexed annuities that are not “annuity contracts” under rule 151A to the “thorough, standardized, accessible, and transparent disclosure requirements and antifraud rules of the federal securities laws.”<sup>206</sup>

However, some commenters argued that the proposed rule would not result in enhanced disclosure, in particular because the Commission’s disclosure scheme is not tailored to indexed annuities and Form S-1 is not well-suited to indexed annuities.<sup>207</sup> We acknowledge that, as a result of indexed annuity issuers having historically offered and sold their contracts without complying with the federal securities laws, the Commission has not created specific disclosure requirements tailored to these products. This fact, though, is not relevant in determining whether indexed annuities are subject to the federal securities laws. The Commission has a long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance.<sup>208</sup> We note that we are providing a two-year transition period for rule 151A, and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities. We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.

Some commenters also cited recent efforts by state insurance regulators to address disclosure concerns with respect to indexed annuities as evidence that federal securities

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<sup>206</sup> Hartford Letter, supra note 55.

<sup>207</sup> See supra note 94 and accompanying text.

<sup>208</sup> See Form N-4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N-6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

regulation is unnecessary.<sup>209</sup> However, as we state above, we disagree. We do not believe that the states' regulatory efforts, no matter how strong, can substitute for our obligation to identify securities covered by the federal securities laws and the protections Congress intended to apply. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws.

We have carefully considered the concerns raised by commenters, and we continue to believe that rule 151A will greatly enhance disclosures regarding indexed annuities. In addition to the specific benefits described above, we anticipate that these enhanced disclosures will also benefit the overall financial markets and their participants.

We anticipate that the disclosure of terms of indexed annuities will be broadly beneficial to investors, enhancing the efficiency of the market for indexed annuities through increased competition. Disclosure will make information on indexed annuity contracts, including terms, publicly available. Public availability of terms will better enable investors to compare indexed annuities and may focus attention on the price competitiveness of these products. It will also improve the ability of third parties to price contracts, giving purchasers a better understanding of the fees implicit in the products. We anticipate that third-party information providers may provide services to price or compare terms of different indexed annuities. Analogously, we note that public disclosure of mutual fund information has enabled third-party information aggregators to

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<sup>209</sup> See supra note 81 and accompanying text.

facilitate comparison of fees.<sup>210</sup> We believe that increasing the level of price transparency and the resulting competition through enhanced disclosure regarding indexed annuities would be beneficial to investors. It could also expand the size of the market, as investors may have increased confidence that indexed annuities are competitively priced.

### Sales Practice Protections

Investors will also benefit because, under the federal securities laws, persons effecting transactions in indexed annuities that fall outside the insurance exemption under rule 151A will be required to be registered broker-dealers or become associated persons of a broker-dealer through a networking arrangement. Thus, the broker-dealer sales practice protections will apply to transactions in registered indexed annuities. As a result, investors who purchase these indexed annuities after the effective date of rule 151A will receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities will be subject to supervision by the broker-dealer with which they are associated. Both the selling broker-dealer and its registered representatives will be subject to the oversight of FINRA.<sup>211</sup> The registered broker-dealers will also be required

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<sup>210</sup> See, e.g., FINRA, Fund Analyzer, available at: <http://www.finra.org/fundanalyzer> ("FINRA Fund Analyzer").

<sup>211</sup> Cf. NASD Rule 2821 (rule designed to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities). See Order Approving FINRA's NASD Rule 2821 Regarding Members' Responsibilities for Deferred Variable Annuities (Approval Order), Securities Exchange Act Release No. 56375 (Sept. 7, 2007), 72 FR 52403 (Sept. 13, 2007) (SR-NASD-2004-183); Corrective Order, Securities Exchange Act Release No. 56375A (Sept. 14, 2007), 72 FR 53612 (September 19, 2007) (SR-NASD-2004-183) (correcting the rule's effective date).

to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as be subject to the Commission's general inspections and, where warranted, enforcement powers.

A number of commenters agreed that indexed annuity purchasers will benefit from the sales practice protections accorded by the federal securities laws.<sup>212</sup> These commenters indicated that sales practice protections accorded by the federal securities laws are the most effective means of preventing abusive sales practices. Some commenters specifically stated that the protections of the federal securities laws are needed for the protection of seniors in the indexed annuity marketplace.<sup>213</sup>

As stated above, however, a number of commenters argued that, because of efforts by state insurance regulators to address sales practice concerns with respect to indexed annuities, federal securities regulation is unnecessary and could result in duplicative or overlapping regulation.<sup>214</sup> Commenters cited, in particular, the adoption by the majority of states of the NAIC Suitability in Annuity Transactions Model Regulation.<sup>215</sup> Commenters also cited the existence of state market conduct examinations, the use of state enforcement and investigative authority, licensing and

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<sup>212</sup> See, e.g., Alabama Letter, supra note 72; Cornell Letter, supra note 7; FPA Letter, supra note 72; FINRA Letter, supra note 7; Hartford Letter, supra note 55; Wyoming Letter, supra note 72.

<sup>213</sup> Alabama Letter, supra note 72; Wyoming Letter, supra note 72.

<sup>214</sup> See supra note 81 and accompanying text.

<sup>215</sup> NAIC SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION (Model 275-1) (2003). National Association of Insurance Commissioners, Draft Model Summaries, available at: [http://www.naic.org/committees\\_models.htm](http://www.naic.org/committees_models.htm). See, e.g., Letter A, supra note 76; American Bankers Letter, supra note 74; CAI 151A Letter, supra note 54; NAFA Letter, supra note 54; NAIC Officer Letter, supra note 54; NAIFA Letter, supra note 54.

education requirements applicable to insurance agents who sell indexed annuities, and a number of recent and ongoing efforts by state insurance regulators.<sup>216</sup> Commenters also noted recent efforts by state regulators addressed to annuities generally, such as the creation of NAIC working groups to review and consider possible improvements to the NAIC Suitability in Annuity Transactions Model Regulation.<sup>217</sup>

However, for the same reasons that we do not believe recent state disclosure efforts can substitute for federally required disclosures, we do not believe that the state's efforts to address sales practice concerns, no matter how strong, can substitute for our responsibility to identify securities covered by the statutes and the protections Congress intended to apply. State insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws.<sup>218</sup> Where the purchaser of an indexed annuity assumes the investment risk of an instrument that fluctuates with the securities markets, and the contract therefore does not fall within the Section 3(a)(8) exemption, the application of state insurance regulation, no matter how effective, is not determinative as to whether the contract is subject to the federal securities laws.

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<sup>216</sup> See, e.g., American Equity Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54; Iowa Letter, supra note 74; Maryland Letter, supra note 54; NAIC Officer Letter, supra note 54; NAFA Letter, supra note 54.

<sup>217</sup> See, e.g., NAIC Officer Letter, supra note 54.

<sup>218</sup> Indeed, at least one state regulator acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts. See Voss Letter, supra note 13.



## Enhanced Competition

Rule 151A may result in enhanced competition among indexed annuities, as well as between indexed annuities and other competing financial products, such as mutual funds and variable annuities. Rule 151A will result in enhanced disclosure, and, as a result, more informed investment decisions by potential investors, which may enhance competition among indexed annuities and competing products. The greater clarity that results from rule 151A may enhance competition as well because insurers who may have been reluctant to issue indexed annuities while their status was uncertain may now decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities. Further, we believe that the Exchange Act exemption may enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption will reduce the regulatory costs associated with doing so. Increased competition may benefit investors through improvements in the terms of insurance products and other financial products, such as reductions of direct or indirect fees.

We anticipate that the disclosure of terms of indexed annuities will be broadly beneficial to investors, enhancing the efficiency of the market for indexed annuities through increased competition. Disclosure will make information on indexed annuity contracts, including terms, publicly available. Public availability of terms will better

enable investors to compare indexed annuities and may focus attention on the price competitiveness of these products. It will also improve the ability of third parties to price contracts, giving purchasers a better understanding of the fees implicit in the products. We anticipate that third-party information providers may provide services to price or compare terms of different indexed annuities. Analogously, we note that public disclosure of mutual fund information has enabled third-party information aggregators to facilitate comparison of fees.<sup>219</sup> We believe that increasing the level of price transparency and the resulting competition through enhanced disclosure regarding indexed annuities would be beneficial to investors. It could also expand the size of the market, as investors may have increased confidence that indexed annuities are competitively priced.

A number of commenters argued that proposed rule 151A would hinder competition, citing a number of factors that they argued would result in indexed annuities becoming less available.<sup>220</sup> Commenters indicated that they did not believe that broker-dealers would become more willing to sell indexed annuities.<sup>221</sup> They stated that broker-

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<sup>219</sup> See, e.g., FINRA Fund Analyzer, supra note 210.

<sup>220</sup> See, e.g., Advantage Group Letter, supra note 54; Allianz Letter, supra note 54; American Equity Letter, supra note 54; American National Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54; FBL Letter, supra note 73; National Western Letter, supra note 54; Old Mutual Letter, supra note 54; Southwest Letter, supra note 136.

We note that a number of commenters supporting the proposal are industry participants, such as insurers, see, e.g., Hartford letter, supra note 55, and industry groups, see, e.g., ICI letter, supra note 7.

<sup>221</sup> See, e.g., Allianz Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54.

dealers have limited “shelf space” for new products.<sup>222</sup> One commenter stated that a broker-dealer would incur start-up costs in selling indexed annuities, such as becoming familiar with the products, performing due diligence, setting up supervisory systems, introducing appropriate technology, and becoming licensed to sell insurance, and these costs would deter a broker-dealer from selling indexed annuities.<sup>223</sup> A number of commenters stated that many agents currently selling indexed annuities would stop selling them, rather than incur the costs of becoming licensed to sell securities and becoming associated with a broker-dealer.<sup>224</sup> Two commenters stated that some agents would not be able to associate with a broker-dealer due to remote locations of the agents, so that rural areas would be underserved.<sup>225</sup> Commenters further pointed to obstacles to distributors networking with registered broker-dealers.<sup>226</sup> Commenters also stated that some insurance companies may stop issuing indexed annuities, because of the rule’s adverse impact on distribution and because of the costs that the rule would impose on insurers, such as the cost of registering indexed annuities.<sup>227</sup>

The Commission believes that there could be costs associated with diminished competition as a result of rule 151A. As the commenters note, some insurance

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<sup>222</sup> See, e.g., Allianz Letter, supra note 54; Aviva Letter, supra note 54.

<sup>223</sup> Allianz Letter, supra note 54.

<sup>224</sup> See, e.g., Allianz Letter, supra note 54; American Equity Letter, supra note 54; Aviva Letter, supra note 54; Coalition Letter, supra note 54.

<sup>225</sup> Second Old Mutual Letter, supra note 76; Southwest Letter, supra note 136.

<sup>226</sup> See, e.g., American Equity Letter, supra note 54; Coalition Letter, supra note 54; Old Mutual Letter, supra note 54.

<sup>227</sup> See, e. g., Aviva Letter, supra note 54; National Western Letter, supra note 54; Old Mutual Letter, supra note 54.

companies may stop issuing indexed annuities, and some broker-dealers and agents may determine not to sell indexed annuities. We recognize that the impact of rule 151A on competition may be mixed, but, on balance, we continue to believe that rule 151A will provide the benefits described above and has the potential to increase competition. In this regard, the demand for financial products is relatively fixed, in the aggregate. Any potential reduction in indexed annuities sold under the rule would likely correspond with an increase in the sale of other financial products, such as mutual funds or variable annuities. Thus, total reductions in competition may not be significant, when effects on the financial industry as a whole, including insurance companies together with other providers of financial instruments, are considered. Within the insurance industry, if some insurers cease selling indexed annuities, it is also likely that these insurers will sell other products through the same distribution channels, such as annuities with fixed interest rates.

#### Relief from Reporting Obligations

The exemption from Exchange Act reporting requirements with respect to certain securities that are regulated as insurance under state law will provide a cost savings to insurers. We have identified approximately 24 insurance companies that currently are subject to Exchange Act reporting obligations solely as a result of issuing insurance contracts that are securities and that we believe will be entitled to an exemption from Exchange Act reporting obligations under rule 12h-7.<sup>228</sup> We estimate that, each year,

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<sup>228</sup> In addition, because we are adopting both rules 151A and 12h-7, insurers that currently are not Exchange Act reporting companies and that will be required to register indexed annuities under the Securities Act will be entitled to rely on the Exchange Act exemption and obtain the benefits of the exemption. We have not included potential cost savings to

these insurers file an estimated 24 annual reports on Form 10-K, 72 quarterly reports on Form 10-Q, and 26 reports on Form 8-K.<sup>229</sup> Based on current cost estimates, we believe that the total estimated annual cost savings to these companies will be approximately \$15,414,600.<sup>230</sup>

One commenter estimated a higher cost savings.<sup>231</sup> The commenter estimated costs of \$1.5 - \$2 million annually for an issuer to comply with Exchange Act reporting obligations. Under our current cost estimates, we estimate that it costs \$642,275 per

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these companies in our computation because they are not currently Exchange Act reporting companies.

<sup>229</sup> These estimates are based on the requirement to file one Form 10-K each year and three Forms 10-Q each year, and on our review of the actual number of Form 8-K filings by these insurers in calendar year 2007.

<sup>230</sup> This consists of \$8,748,950 attributable to internal personnel costs, representing 49,994 burden hours at \$175 per hour, and \$6,665,600 attributable to the costs of outside professionals, representing 16,664 burden hours at \$400 per hour. Our estimates of \$175 per hour for internal time and \$400 per hour for outside professionals are consistent with the estimates that we have used in recent rulemaking releases.

Our total burden hour estimate for Forms 10-K, 10-Q, and 8-K is 66,658 hours, which, consistent with current OMB estimates and recent Commission rulemaking, we have allocated 75% (49,994 hours) to the insurers internally and 25% (16,664 hours) to outside professional time. See Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8819, available at: <http://www.reginfo.gov/public/do/DownloadDocument?documentID=42924&version=1>. The total burden hour estimate was derived as follows. The burden attributable to Form 10-K is 52,704 hours, representing 24 Forms 10-K at 2,196 hours per Form 10-K. The burden attributable to Form 10-Q is 13,824 hours, representing 72 Forms 10-Q at 192 hours per Form 10-Q. The burden attributable to Form 8-K is 130 hours, representing 26 Forms 8-K at 5 hours per Form 8-K. The burden hours per response for Form 10-K (2,196 hours), Form 10-Q (192 hours), and Form 8-K (5 hours) are consistent with current OMB estimates.

<sup>231</sup> Great-West Letter, supra note 138.

issuer<sup>232</sup> to comply with these obligations. We are not revising our estimate, however, because the commenter did not explain how it arrived at its estimate and we have no basis for determining whether or not it is accurate.

## **B. Costs**

While the rules we are adopting will result in significant cost savings for insurers as a result of the exemption from Exchange Act reporting requirements, we believe that there will be costs associated with the rules. These include costs associated with: (i) determining under rule 151A whether amounts payable by the insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract; (ii) preparing and filing required Securities Act registration statements with the Commission; (iii) printing prospectuses and providing them to investors; (iv) entering into a networking arrangement with a registered broker-dealer for those entities that are not currently parties to a networking arrangement or registered as broker-dealers and that intend to distribute indexed annuities that are registered as securities;<sup>233</sup> (v) loss of revenue to insurance companies that determine to cease issuing indexed annuities; and (vi) diminished competition that may result.

Some commenters opined that the benefits of the proposal to indexed annuity

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<sup>232</sup> The \$642,275 cost was derived by dividing the total annual cost savings for all insurance companies that we believe will be entitled to the rule 12h-7 exemption (\$15,414,600) by the number of such companies (24). See supra text accompanying notes 228 and 230.

<sup>233</sup> While some distributors may register as broker-dealers or cease distributing indexed annuities that will be required to be registered as a result of rule 151A, based on our experience with insurance companies that issue insurance products that are also securities, we believe that the vast majority will continue to distribute those indexed annuities via networking arrangements with registered broker-dealers, as discussed below.

purchasers would outweigh any costs to the indexed annuity industry.<sup>234</sup> One commenter, for example, recognized that the proposal would impose some compliance costs on the indexed annuity industry, but stated that these costs are minimal relative to the gains to investors in regulatory oversight.<sup>235</sup> The commenter stated that the rule would bring clarity regarding the status of indexed annuities under the federal securities laws and would subject indexed annuity sales to the application of suitability and antifraud protections under the federal securities laws.

A number of other commenters, however, stated that the Commission significantly underestimated the costs of the proposal.<sup>236</sup> As discussed below, these commenters stated that the proposal would impose substantial costs throughout the industry, affecting insurers, agents, marketing organizations. Commenters also stated that consumers would face additional costs as a result of the proposal, as the costs of product development and offering and selling registered securities are passed on to consumers.<sup>237</sup> We also received a number of comments specifically stating that the proposal would have an adverse impact on small entities, such as small insurance distributors.<sup>238</sup>

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<sup>234</sup> See, e.g., Cornell Letter, supra note 7; NASAA Letter, supra note 133.

<sup>235</sup> Cornell Letter, supra note 7.

<sup>236</sup> See, e.g., Allianz Letter, supra note 54; ACLI Letter, supra note 94; American Equity Letter, supra note 54; Coalition Letter, supra note 54; Old Mutual Letter, supra note 54; Second Aviva Letter, supra note 54. Southwest Letter, supra note 136; Transamerica Letter, supra note 54.

<sup>237</sup> See, e.g., American National Letter, supra note 54; National Western Letter, supra note 54; Old Mutual Letter, supra note 54; Southwest Letter, supra note 136.

<sup>238</sup> See infra Section VII.

The following is a more detailed discussion of specific costs that we believe will be associated with the rule. We specifically identified and discussed each of these costs in the Proposing Release. We received comments on each identified cost.

#### Determination Under Rule 151A

Insurers may incur costs in performing the analysis necessary to determine whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts guaranteed under the contract. This analysis calls for the insurer to analyze expected outcomes under various scenarios involving different facts and circumstances. Insurers routinely undertake such analyses for purposes of pricing and valuing their contracts.<sup>239</sup> As a result, we believe that the costs of undertaking the analysis for purposes of the rule may not be significant. However, the determinations necessary under the rule may result in some additional costs for insurers that issue indexed annuities, either because the timing of the determination does not coincide with other similar analyses undertaken by the insurer or because the level or type of actuarial and legal analysis that the insurer determines is appropriate under the rule is different or greater than that undertaken for other purposes, or for other reasons. These costs, if any, could include the costs of software, as well as the costs of internal personnel and external consultants (e.g., actuarial, accounting, legal).

Several commenters who issue indexed annuities disputed that insurers undertake these analyses.<sup>240</sup> Other commenters, however, confirmed that these analytical methods

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<sup>239</sup> See generally Black and Skipper, supra note 39, at 26-47, 890-99.

<sup>240</sup> See, e.g., American Equity Letter, supra note 54; National Western Letter, supra note 54; Sammons Letter, supra note 54. The commenters did not provide cost estimates for performing the analysis necessary under the rule.



exist and are used by insurers for internal purposes.<sup>241</sup> We continue to believe that because insurers routinely undertake these types of analyses, the costs of doing so for purposes of the rule may not be significant.

### Securities Act Registration Statements

As noted above, we believe that significant benefits arise from the registration of indexed annuities, including enhanced disclosures of critical information regarding these products. Without such disclosure, investors face significant obstacles in making informed investment decisions with regard to purchasing indexed annuities that expose investors to securities investment risk. Investors in indexed annuities are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Extending the federal securities disclosure regime to indexed annuities that impose investment risk should help to provide investors with the information they need. The costs of preparing and filing registration statements are not unique to indexed annuities that are outside the scope of the Section 3(a)(8) exemption for annuities as a result of rule 151A, but apply to all issuers of registered securities. However, we are sensitive to these costs and discuss them below, along with comments that we received on this analysis.

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<sup>241</sup> See, e.g., Aviva Letter, *supra* note 54; Academy Letter, *supra* note 54. We give substantial weight to the views of the Academy on this point, given their expertise in this type of analysis, and are not persuaded that the contrary comments of several issuers are representative of industry practice. See BLACK'S LAW DICTIONARY 39 (8th ed. 2004) (An actuary is a statistician who determines the present effects of future contingent events and who calculates insurance and pension rates on the basis of empirically based tables.); American Academy of Actuaries, Mission, available at: <http://www.actuary.org/mission.asp> (The mission of the Academy is to, among other things, provide independent and objective actuarial information, analysis, and education for the formation of sound public policy.).

Insurers will incur costs associated with preparing and filing registration statements for indexed annuities that are outside the insurance exemption as a result of rule 151A. These include the costs of preparing and reviewing disclosure, filing documents, and retaining records. Our Office of Economic Analysis has considered the effect of the rule on indexed annuity contracts with typical terms and has determined that, more likely than not, these contracts would not meet the definition of “annuity contract” or “optional annuity contract” if they were issued after the effective date of the rule. For purposes of the PRA, we have estimated an annual increase in the paperwork burden for companies to comply with the rules to be 60,000 hours of in-house company personnel time and \$72,000,000 for services of outside professionals.<sup>242</sup> We estimate that the additional burden hours of in-house company personnel time will equal total internal costs of \$10,500,000<sup>243</sup> annually, resulting in aggregate annual costs of \$82,500,000<sup>244</sup> for in-house personnel and outside professionals. These costs reflect the assumption that filings will be made on Form S-1 for 400 contracts each year, which we made for purposes of the PRA.

As indicated in our analysis for purposes of the PRA, we received several comments questioning our estimate of the costs of registering an indexed annuity on

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<sup>242</sup> See supra Part IV.C.

<sup>243</sup> This cost increase is estimated by multiplying the total annual hour burden (60,000 hours) by the estimated hourly wage rate of \$175 per hour. Consistent with recent rulemaking releases, we estimate the value of work performed by the company internally at a cost of \$ 175 per hour.

<sup>244</sup> \$10,500,000 (in-house personnel) + \$72,000,000 (outside professionals).

Form S-1.<sup>245</sup> One commenter stated that, for insurers that have not previously prepared a Form S-1 registration statement, external legal costs could be as high as \$250,000-\$500,000 for each registration statement.<sup>246</sup> However, the commenter did not specify the source of this range of cost estimates or how it was made. The \$250,000-\$500,000 range cited by the commenter is for an issuer that has not previously filed a Form S-1, with the commenter acknowledging that the costs to an experienced filer would be lower (as low as \$50,000 to \$100,000).<sup>247</sup> Another commenter estimated external legal costs for preparation and filing of a Form S-1 registration statement with the SEC at \$350,000 for the first few years, which, the commenter stated, would decrease over time as the insurer gained more expertise.<sup>248</sup> Our average \$180,000 estimate reflects outside professional costs incurred not only by first-time Form S-1 filers, but also the costs of preparing Form S-1 for contracts offered by experienced Form S-1 filers, as well as annual updates to existing Form S-1 registration statements, which we expect to be significantly lower than costs incurred by first-time filers. Therefore, we do not believe that it is necessary to change our estimate of outside professional costs based on the commenters' estimated costs.

One commenter cites a cost of \$62,500 per insurance company for "Registration Statement Preparation" but also appears to assume a cost of \$255,000 per contract for

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<sup>245</sup> See, e.g., Allianz Letter, supra note 54; Second Aviva Letter, supra note 54; Second NAFA Letter, supra note 191.

<sup>246</sup> Allianz Letter, supra note 54.

<sup>247</sup> Id.

<sup>248</sup> Second Aviva Letter, supra note 54.

registration statement preparation.<sup>249</sup> It is unclear how these estimates should be reconciled, and we are not revising our estimate of the burden of preparation of registration statement on the basis of the commenter's estimates.

Another commenter stated that the Commission's estimate of outside professional costs of \$400 per hour does not reflect market rates for securities counsel.<sup>250</sup> However, the commenter did not cite a different rate and did not explain the basis for its disagreement with the \$400 per hour rate cited by the Commission. Our estimate of \$400 per hour for outside professionals retained by the issuer is consistent with recent rulemakings and is based on discussions between our staff and several law firms.<sup>251</sup> Accordingly, we are not changing our estimate of the cost per hour of outside professional costs.

The commenter further stated that the estimates of time involved are low for persons unfamiliar with the process of registration of securities under the federal securities laws and the anticipated need for interaction with Commission staff. However, our estimate of time required to prepare a registration statement reflects time needed not only by first-time Form S-1 filers, but also the time involved in preparing Form S-1 for contracts offered by experienced S-1 filers, as well as annual updates to the existing Form S-1 registration statement, which we expect to be significantly less than time needed by first-time filers. Therefore, we are not revising our estimate of time involved in preparing registration statements on Form S-1.

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<sup>249</sup> Second NAFA Letter, supra note 191.

<sup>250</sup> Transamerica Letter, supra note 54.

<sup>251</sup> See, e.g., Securities Act Release No. 8909 (Apr. 10, 2008) [73 FR 20512, 20515 (Apr. 15, 2008)] ("Revisions to Form S-11 Release").

Commenters stated that insurers will be subject to significant additional costs as a result of having to register on Form S-1.<sup>252</sup> These include required registration fees for securities sold. One commenter estimated Commission registration fees, assuming sales of \$5 billion annually, as \$196,500.<sup>253</sup> Commenters also stated that the due diligence necessary to verify disclosures in the registration statement will require significant resources.<sup>254</sup> We acknowledge that these are additional costs associated with registration. However, these costs are not unique to indexed annuities, but are incurred by all issuers of registered securities.

Commenters also cited other costs of registration on Form S-1, such as preparation of financial statements in accordance with generally accepted accounting principles (“GAAP”), which, according to the commenters, many insurers currently do not do.<sup>255</sup> One commenter estimated a cost of at least several million dollars for an insurer to develop GAAP financial statements.<sup>256</sup> We acknowledge that if an indexed annuity issuer that did not currently prepare GAAP financial statements were required to do so in order to register its indexed annuities, the one-time start-up costs could be significant. We note that, during the two-year transition period for rule 151A, the Commission intends to consider how to tailor accounting requirements for indexed

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<sup>252</sup> See, e.g., Allianz Letter, supra note 54; American Equity Letter, supra note 54; Old Mutual Letter, supra note 54; Transamerica Letter, supra note 54.

<sup>253</sup> Allianz Letter, supra note 54.

<sup>254</sup> National Western Letter, supra note 54; Old Mutual Letter, supra note 54.

<sup>255</sup> See, e.g., Allianz Letter, supra note 54. See Second Aviva Letter, supra note 54.

<sup>256</sup> Second Aviva Letter, supra note 54.

annuities.<sup>257</sup>

Based on the foregoing analysis, our estimates of the costs of registration for indexed annuities include the costs of preparing Form S-1 registration statements, totaling \$82,500,000 annually, or \$206,250 per contract, and, based on a commenter's estimate, registration fees of \$196,000 assuming sales by an insurer of \$5 billion annually. If the insurer does not already prepare financial statements in accordance with GAAP, the insurer will also incur costs of developing GAAP financials, which one commenter estimated to involve one-time start-up costs of at least several million dollars per insurer. Commenters also mentioned due diligence as a cost of registration, but did not separately break out its cost.

#### Costs of Printing Prospectuses and Providing them to Investors

Insurers will incur costs to print and provide prospectuses to investors for indexed annuities that are outside the insurance exemption as a result of rule 151A. For purposes of the PRA, we have estimated that registration statements will be filed for 400 indexed annuities per year. In the Proposing Release, we estimated that it would cost \$0.35 to print each prospectus and \$1.21 to mail each prospectus,<sup>258</sup> for a total of \$1.56 per

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<sup>257</sup> See *supra* note 95 and accompanying text.

<sup>258</sup> These estimates reflect estimates provided to us by Broadridge Financial Solutions, Inc. ("Broadridge"), in connection with our recent proposal to create a summary prospectus for mutual funds. The estimates depend on factors such as page length and number of copies printed and not on the content of the disclosures. Because we believe that these factors may be reasonably comparable for indexed annuity and mutual fund prospectuses, we believe that it is reasonable to use these estimates in the context of indexed annuities. See Memorandum to File number S7-28-07 regarding October 27, 2007 meeting between Commission staff members and representatives of Broadridge Financial Solutions, Inc. (Nov. 28, 2007) ("Broadridge Memo"). The memorandum is available for inspection and copying in File No. S7-28-07 in the Commission's Public Reference Room and on the Commission's Web site at <http://www.sec.gov/comments/s7-28-07/s72807-5.pdf>.

prospectus. These estimates would be reduced to the extent that prospectuses are delivered in person or electronically, or to the extent that Securities Act prospectuses are substituted for written materials used today, rather than being delivered in addition to those materials.

One commenter questioned whether the cost of printing an indexed annuity prospectus on Form S-1 would be roughly equivalent to that of printing a mutual fund prospectus on Form N-1A, as we were assuming for purposes of our estimate in the proposing release.<sup>259</sup> The commenter, based on its internal projections of prospectus printing and mailing costs, stated that the indexed annuity prospectus would cost twice as much as the mutual fund prospectus. The commenter estimated printing costs for an indexed annuity prospectus on Form S-1 as \$1.50 and the cost of mailing as \$1.38 for a total cost of \$2.88. In making its cost projections, the commenter assumed that the mutual fund prospectus would be 25 pages long, while the indexed annuity prospectus (including financial statements) would be 100 pages long. Our estimate of the cost of printing and mailing a mutual fund prospectus was based on an assumed page length of 45 pages.<sup>260</sup> We believe that the commenter's estimate of page length may be more realistic for a prospectus prepared on Form S-1.<sup>261</sup> Accordingly, we are revising our estimate of the costs of printing and mailing the prospectus to the costs cited by the

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<sup>259</sup> Allianz Letter, supra note 54.

<sup>260</sup> Broadridge Memo, supra note 258.

<sup>261</sup> See Pre-effective Amendment No. 4 to Registration Statement on Form S-1 of PHL Variable Insurance Company (File No. 333-132399) (filed Feb. 7, 2007) (67-page prospectus); 257 Pre-effective Amendment No. 1 to Registration Statement on Form S-1 of Golden America Life Insurance Company (File No. 333-67660) (filed Feb. 8, 2002) (170-page prospectus).

commenter; i.e., \$1.50 for printing the prospectus and \$1.38 for mailing for a total cost of \$2.88.<sup>262</sup> Though we have revised our estimate as described above, we believe that the revised estimate is conservative because some indexed annuity issuers who file Exchange Act reports and incorporate their financial statements from their Exchange Act reports by reference may have significantly shorter prospectuses as a result.<sup>263</sup>

Another commenter estimated the cost per insurance company of “printing prospectuses/supply chain”<sup>264</sup> at \$20,000 per insurance company for a combined total of \$880,000. The commenter does not explain how it arrived at this estimate. Moreover, because the commenter’s estimate is for total cost per insurance company and does not specify the number of prospectuses printed by each insurance company, and our estimate is a per prospectus cost, we are not able to compare the two estimates. Thus, we are not revising our estimate of the cost of printing prospectuses and providing them to investors.

#### Networking Arrangements with Registered Broker-Dealers and Other Related Costs

Rule 151A may impose costs on indexed annuity distributors that are not currently parties to a networking arrangement or registered as broker-dealers. These costs are not unique to indexed annuity distributors but apply to all distributors of

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<sup>262</sup> Allianz Letter, supra note 54. This revision does not affect our estimate of the cost burden for Form S-1 under the Paperwork Reduction Act. Printing and mailing costs are not “collections of information” for purposes of the Paperwork Reduction Act.

<sup>263</sup> See Pre-effective Amendment No. 4 to Registration Statement on Form S-1 of PHL Variable Insurance Company (File No. 333-132399) (filed Feb. 7, 2007) (20 pages of the prospectus are attributable to financial statements); Pre-effective Amendment No. 1 to Registration Statement on Form S-1 of Golden America Life Insurance Company (File No. 333-67660) (filed Feb. 8, 2002) (63 pages of the prospectus are attributable to financial statements).

<sup>264</sup> Second NAFA Letter, supra note 191. It is not fully clear what the commenter intends by “supply chain,” but we are citing the estimate, because it references printing of prospectuses.



federally registered securities that are not registered broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors will likely enter into a networking arrangement with a registered broker-dealer. Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement will impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor will incur legal costs in connection with entering into a networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement. However, while there are costs of entering into a networking arrangement and monitoring compliance with the terms of the arrangement, distributors in networking arrangements will not be subject to the full range of costs associated with obtaining and maintaining broker-dealer registration.

One commenter estimated that the cost of registering as a broker-dealer, taking into account only the legal and regulatory work of initial setup,<sup>265</sup> licensing, and staffing could be between \$250,000-\$500,000.<sup>266</sup> Another commenter estimated the cost of

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<sup>265</sup> Allianz Letter, supra note 54. Initial setup includes registering the broker-dealer with the Commission, developing extensive written policies and procedures tailored to its business, obtaining a fidelity bond, registering its offices as branch offices, and setting up a procedure for a principal review of all applications, as well as review of advertisements, business cards, letterhead, office signage, correspondence, and e-mails.

<sup>266</sup> Allianz Letter, supra note 54.

forming a registered broker-dealer at \$800,000.<sup>267</sup> The same commenter cites a cost of \$3 million for “BD startup” in a separate comment.<sup>268</sup> As we discuss above, however, we believe it is more likely that distributors will enter into networking arrangements with registered broker-dealers, rather than register as broker-dealers.

Some commenters disagreed that distributors would enter into networking arrangements with registered broker-dealers, stating that the cost of networking would be too high.<sup>269</sup> One of these commenters stated that networking would be inordinately expensive.<sup>270</sup> The commenter stated that under current industry practice, a distributor would bear expenses when using a networking arrangement that include examination fees, state registration fees, and possibly a pro rata share of the associated broker-dealer’s increased compliance costs, and would have to share a portion of his commissions with the registered broker-dealer.<sup>271</sup> Commenters did not provide estimates of the cost of

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<sup>267</sup> Memorandum from the Division of Investment Management Regarding a November 10, 2008 Meeting with Representatives of the National Association for Fixed Annuities (Nov. 26, 2008). One commenter stated that the costs of registering and operating as a broker-dealer include FINRA registration and examination fees of up to \$4,000. The commenter further stated that the legal cost associated with registering and applying for membership with FINRA, the cost of completing the necessary forms, and the costs of ongoing compliance could result in start-up costs of \$25,000 and between \$50,000 to \$100,000 annually to maintain the registration. Coalition Letter, supra note 54.

<sup>268</sup> Second NAFA Letter, supra note 191.

<sup>269</sup> See, e.g., American Equity Letter, supra note 54; Coalition Letter, supra note 54.

<sup>270</sup> Coalition Letter, supra note 54.

<sup>271</sup> Coalition Letter, supra note 54. One commenter indicated its belief that insurance agencies are only permitted to enter into networking arrangements with affiliated broker-dealers. Therefore, the commenter stated that insurance agencies without an affiliated broker-dealer would not appear to be able to take advantage of networking arrangements. We disagree with the commenter’s interpretation and note that, in our view, insurance agencies may enter into networking arrangements with unaffiliated broker-dealers.

networking. We recognize that a distributor will incur costs in entering into networking arrangement. We estimate the upper bound of entering into a networking agreement to be the equivalent of the cost of establishing a registered broker-dealer. Commenters provided a range of cost estimates for establishing a registered broker-dealer from \$250,000 to \$3 million. However, these costs are not unique to indexed annuities. For example, issuers of insurance products registered as securities, such as variable annuities, may incur networking costs, as do banks involved in networking arrangements. Moreover, while we would expect networking to be generally more cost-effective than registration as a broker-dealer, to the extent that it is not, broker-dealer registration remains an option for indexed annuity distributors.

Commenters also cited additional costs that agents will incur as a result of the rule.<sup>272</sup> For example, commenters cited annual securities registration and licensing fees, including FINRA fees and state securities fees, that agents would be required to pay. With regard to state registration fees, one commenter estimated that an agent selling in all 50 states would pay approximately \$3,100 in initial state securities registration fees and nearly \$3,000 annually in ongoing state securities fees.<sup>273</sup> We recognize that agents may incur additional registration and licensing costs and are sensitive to the impact of such costs. However, these fees are paid by all sellers of securities and are not unique to those selling indexed annuities. The fees are a product of the regulatory structure mandated by Congress under the federal securities laws, which is intended to provide sales practice

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<sup>272</sup> See, e.g., Allianz Letter, supra note 54; Coalition Letter, supra note 54; Southwest Letter, supra note 136.

<sup>273</sup> Allianz Letter, supra note 54.

and other protections to investors.

Several commenters cited an industry source that estimated loss to distributors as a result of the rule as approximately \$800 million.<sup>274</sup> This source estimates that agents would lose about \$200 million in income by having to share commissions with the broker-dealers with which the agent is associated. The source estimates that fees charged by the broker-dealer and by FINRA would amount to another \$22.5 million. The sharing of commissions, as well as the fees charged by the broker-dealer and by FINRA are necessary expenses of selling registered securities. For marketing organizations, the source estimates that indexed annuity sales would drop by 60% and marketing organization compensation would be reduced from around \$500 million-\$700 million a year today to \$60 million-\$200 million as a result of the rule. However, the source does not explain the basis for the estimate of the decline in sales. Moreover, if the marketing organization registers as, or enters into a networking arrangement with, a broker-dealer, it would have opportunities to sell other types of securities, and may be able to compensate for any declines in sales of indexed annuities that may occur. We believe that even at the high end of costs suggested by commenters, given the imperative of the federal securities laws and the size of the industry, these costs are nonetheless justified.

#### Possible Loss of Revenue

Insurance companies that determine that indexed annuities are outside the

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<sup>274</sup> Letter of Advisors Excel (Aug. 20, 2008); Coalition Letter, *supra* note 54; Letter of Courtney A. Juhl (Aug. 15, 2008), citing Jack Marrion, The Proposed Rule Will Sock it to Index Annuity Distributors, NATIONAL UNDERWRITER LIFE & HEALTH/FINANCIAL SERVICES EDITION, Aug. 4, 2008, at 13, available at: <http://www.lifeandhealthinsurancenews.com/cms/nulh/Weekly%20Issues/issues/2008/29/Focus/L29cover2>.

insurance exemption under rule 151A could either choose to register those annuities under the Securities Act or to cease selling those annuities. If an insurer ceases selling such annuities, the insurer may experience a loss of revenue. Commenters agreed that some insurers may stop selling indexed annuities as a result of the rule and that they would experience a loss of revenue.<sup>275</sup> One commenter estimated a total first year loss to insurance companies of approximately \$300,000,000 as a result of the rule.<sup>276</sup> The commenter argued that industry experts state indexed annuity sales will drop from approximately \$30 billion of premium per year (projected for 2008) to \$10 billion per year as a result of the rule.<sup>277</sup> However, the commenter does not explain how this estimate was determined. We believe that even at the high end of costs suggested by commenters, given the imperative of the federal securities laws and the size of the industry, these costs are nonetheless justified.

The amount of lost revenue for insurance companies would depend on actual revenues prior to effectiveness of the rules and to the particular determinations made by insurers regarding whether to continue to issue registered indexed annuities. However, the loss of revenue may be offset, in whole or in part, by gains in revenue from the sale of other financial products, as purchasers' need for financial products will not diminish. These gains could be experienced by the same insurers who exit the indexed annuity business or they could be experienced by other insurance companies or other issuers of

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<sup>275</sup> See, e.g., Allianz Letter, supra note 54; National Western, supra note 54.

<sup>276</sup> Second NAFA Letter, supra note 191.

<sup>277</sup> Id., citing "The Advantage Compendium, Jack Marrion, President." The commenter does not provide a specific citation, and we have been unable to find the source of the estimate provided by the commenter.

securities or other financial products.

Commenters also stated that sellers of indexed annuities may lose revenue because rule 151A may cause them to cease selling these products.<sup>278</sup> One commenter estimated a first-year income loss to distributors of \$1.5 billion, based on an estimated decline in indexed annuity sales from approximately \$30 billion (projected for 2008) to \$10 billion per year, as a result of the rule.<sup>279</sup>

The amount of lost revenue for sellers of indexed annuities would depend on actual revenues prior to effectiveness of the rules and to the particular determinations made by distributors regarding whether to continue to sell registered indexed annuities. The loss of revenue may be offset, in whole or in part, by gains in revenue from the sale of other financial products, as purchasers' need for financial products will not diminish.

Commenters also cited indirect or collateral costs associated with the rule.<sup>280</sup> For example, if insurers exit the indexed annuities business; this will result in a reduction in personnel of those who are no longer needed to administer the products.<sup>281</sup> Commenters also stated that if insurers chose to stop offering indexed annuities because of the rule, third-party service providers who helped support the administration and/or sale of the insurer's indexed annuities may also incur costs.<sup>282</sup>

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<sup>278</sup> See, e.g., Second Old Mutual Letter, supra note 76; Southwest Letter, supra note 136.

<sup>279</sup> Second NAFA Letter, supra note 191. This commenter also estimated a first-year income loss of \$300 million for independent marketing organizations.

<sup>280</sup> Allianz Letter, supra note 54; Aviva Letter, supra note 54; National Western Letter, supra note 54.

<sup>281</sup> See, e.g., Allianz Letter, supra note 54.

<sup>282</sup> See, e.g., Allianz Letter, supra note 54.

A number of commenters cited job loss as a consequence of the rule. Loss of employment, these commenters argued, would affect current employees of insurance companies, agents, and others.<sup>283</sup> Demand for financial products is relatively fixed in the aggregate. Within the insurance industry, some employees of insurance companies and agents will likely find employment in other areas of the insurance industry.

#### Possible Diminished Competition

There could be costs associated with diminished competition as a result of our rules. In order to issue indexed annuities that are outside the insurance exemption under rule 151A, insurers would be required to register those annuities as securities. If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by rule 151A and register those annuities that are outside the insurance exemption under the rule, there will be fewer issuers of indexed annuities, which may result in reduced competition. Any reduction in competition may affect investors through potentially less favorable terms of insurance products and other financial products, such as increases in direct or indirect fees. A number of commenters agreed that diminished competition would result in indexed annuity purchasers receiving less favorable terms. However, the commenters did not provide data in this regard.<sup>284</sup>

It is currently unknown whether new providers will enter the market for indexed annuities. We note, however, that the possibility for new entrants created by this rule is

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<sup>283</sup> E.g., Letter of Todd F. Gregory (Aug. 5, 2008); Letter of Terry R. Lucas (Sept. 9, 2008); National Western Letter, supra note 54; Letter of Randall L. Whittle (Aug. 8, 2008).

<sup>284</sup> See, e.g., American Equity, supra note 54; American National, supra note 54; National Western, supra note 54.

beneficial to competition, even if they do not enter the market. If the indexed annuity market becomes sufficiently uncompetitive and economic profits increase, new entrants will likely arrive, putting downward pressure on prices. Thus, any reduction in regulatory barriers to entry created by increased regulatory certainty can have the effect of increasing competition and reducing prices, a direct benefit to investors. It is currently unknown whether new providers will enter the market for indexed annuities. We note, however, that the possibility for new entrants created by this rule is beneficial to competition, even if they do not enter the market. If the indexed annuity market becomes sufficiently uncompetitive and economic profits increase, new entrants will likely arrive, putting downward pressure on prices. Thus, any reduction in regulatory barriers to entry created by increased regulatory certainty can have the effect of increasing competition and reducing prices, a direct benefit to investors.

#### Additional Costs

Commenters provided further information on costs for insurance companies. One commenter estimated a total first-year cost to insurance companies of \$237,000,000.<sup>285</sup> Components of this cost are identified as broker-dealer startup, broker-dealer annual maintenance, new compliance costs, legal start-up costs, FINRA implementation, FINRA maintenance, state fees, Form S-1 fees, including registration statement preparation, state filing, annual audit, operations/administration/systems, printing prospectus supply chain, and additional fees paid to FINRA impacting product pricing. Much of these costs appear to be the attributable to setting up a broker-dealer. As note above, however, we do not believe that insurers would need to establish a broker-dealer to continue to sell

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<sup>285</sup> Second NAFA Letter, supra note 191.



indexed annuities. An insurer could make use of existing broker-dealers and avoid the costs of starting a broker-dealer. If those costs are avoided, the commenter's estimate could be reduced by at least \$135,727,000 (the total cost attributable to the costs of starting a broker-dealer as estimated by the commenter). This still leaves a total first-year cost to insurance companies of over \$100,000,000. We recognize this is a substantial cost. However, these costs are not unique to indexed annuities but are the costs of offering and selling any registered securities. All issuers of securities must incur such costs, and issuers of indexed annuities will not incur higher costs as a result of the rule than any other issuer of securities.

One commenter cited the cost that may be incurred if the insurer needs to find additional distributors as a result of existing distributors dropping out of the indexed annuity market because of the costs they would incur under the rule.<sup>286</sup> However, this is no different from any securities issuer, all of whom must use distribution channels subject to the federal securities laws.

The Commission has carefully considered the costs cited by the commenters. These include the costs that the commenters state will be incurred by insurers, distributors, and agents. We have also considered the collateral costs cited by the commenters, and the possibility of loss of employment cited by the commenters. While we have taken the costs of the rule into account, we also continue to believe that the rule will result in substantial benefits to indexed annuity purchasers, in the form of enhanced disclosure and sales practice protections, greater regulatory certainty for issuers and sellers of indexed annuities, enhanced competition, and relief from reporting obligations.

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<sup>286</sup> See, e.g., American Equity Letter, supra note 54.

While the costs of the rule may be significant, where an annuity contract is not entitled to the Section 3(a)(8) exemption, which we have concluded is the case with respect to certain indexed annuities, the federal securities laws apply, and participants in the indexed annuity market will need to bear the costs of compliance with the federal securities laws, as do any other participants in the securities markets. Furthermore, notwithstanding these costs, our rule imposes no greater costs than those imposed on other market participants who issue or sell securities.

**VI. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION; CONSIDERATION OF BURDEN ON COMPETITION**

Section 2(b) of the Securities Act<sup>287</sup> and Section 3(f) of the Securities Exchange Act<sup>288</sup> require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act<sup>289</sup> requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

**A. Efficiency**

For the following reasons, we believe that rule 151A will promote efficiency by

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<sup>287</sup> 15 U.S.C. 77b(b).

<sup>288</sup> 15 U.S.C. 78c(f).

<sup>289</sup> 15 U.S.C. 78w(a)(2).

extending the benefits of the disclosure and sales practice protections of the federal securities laws to indexed annuities that are more likely than not to provide payments that vary with the performance of securities.

The required disclosures will enable investors to make more informed investment decisions. As discussed above, disclosures that will be required for registered indexed annuities include information about costs (such as surrender charges); the method of computing indexed return (e.g., applicable index, method for determining change in index, caps participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits). This information will be public and accessible to all investors, intermediaries, third party information providers, and others through the SEC's EDGAR system. Public availability of this information will be helpful to investors in making informed decisions about purchasing indexed annuities. The enhancement of investor decision-making that will result from the public availability of information about indexed annuities will ultimately lead to more efficient capital allocation in the securities markets.

Investors will also receive the benefits of the sales practice protections, including a registered representative's obligation to make only recommendations that are suitable. Under the federal securities laws, persons effecting transactions in indexed annuities that fall outside the insurance exemption under rule 151A will be required to be registered broker-dealers or become associated persons of a broker-dealer. As a result, investors who purchase these indexed annuities after the effective date of rule 151A will receive the benefits associated with a registered representative's obligation to make only

recommendations that are suitable. The registered representatives who sell registered indexed annuities will be subject to supervision by the broker-dealer with which they are associated. Both the selling broker-dealer and its registered representatives will be subject to the oversight of FINRA. The registered broker-dealers will also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as be subject to the Commission's general inspections and, where warranted, enforcement powers. These sales practice protections will promote suitable recommendations to investors, which will lead to enhanced decision-making by investors and, ultimately, to greater efficiency in the securities markets.

Some commenters argued that rule 151A, as proposed, would not promote efficiency, because it would be duplicative of state insurance regulation of indexed annuities.<sup>290</sup> These commenters argued that disclosure and suitability concerns in connection with indexed annuity sales are already addressed by state insurance regulation, and further indicated that state insurance regulation is more closely tailored to indexed annuities than federal securities regulation.

We do not believe that these efforts, no matter how strong, can substitute for the federal securities law protections that apply to instruments that are regulated as securities. The federal securities laws were designed to provide uniform protections, with respect to both disclosure and sales practices, to investors in securities. State insurance laws,

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<sup>290</sup> See e.g., Coalition Letter, supra note 54; NAFA Letter, supra note 54. But see Washington State Letter, supra note 199 (noting its experience with variable annuities and synergy of complementary regulation by the insurance regulator focused on solvency and the securities regulator focused on investor protection).

enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws. Indeed, at least one state insurance regulator acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts.<sup>291</sup> Where the purchaser of an indexed annuity assumes the investment risk of an instrument that fluctuates with the securities markets, and the contract therefore does not fall within the Section 3(a)(8) exemption, the application of state insurance regulation, no matter how effective, is not determinative as to whether the contract is subject to the federal securities laws, which provide uniform and enforceable protections for investors. In addition, during the transition period between adoption and the effective date of rule 151A, we intend to consider how to tailor disclosure requirements for indexed annuities.

One commenter stated that the Commission cannot claim further efficiencies without a comprehensive consideration of the existing state law regulatory regime, the efficiencies that regime already realizes, and the respects in which that state regime falls short and further gains may be achieved by the Commission.<sup>292</sup> The commenter further stated that the proposal would only impose further costs and burdens on efficiency with no compensating benefit, adding an unnecessary, largely duplicative layer of federal requirements that were developed for securities and have not been tailored to annuity

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<sup>291</sup> See Voss Letter, supra note 13 (proposing to accelerate NAIC efforts to strengthen the NAIC model laws affecting indexed annuity products and urge adoption by more of the member states).

<sup>292</sup> Coalition Letter, supra note 54.

products and purchasers generally.<sup>293</sup> We disagree that the Commission must undertake a comprehensive consideration of the existing state law regulatory regime and that there are no benefits from the federal securities laws. Congress has determined that securities investors are entitled to the disclosure, antifraud, and sales practice protections of the federal securities laws. The burdens that are uniformly imposed on issuers and sellers of all types of securities are part of those laws, and it is not the Commission's role to reevaluate the efficiencies of that regulatory structure for each particular instrument that is a security.

### **B. Competition**

We also anticipate that, because rule 151A will improve investors' ability to make informed investment decisions, it will lead to increased competition between issuers and sellers of indexed annuities, mutual funds, variable annuities, and other financial products, and increased competitiveness in the U.S. capital markets. The greater clarity that results from rule 151A also may enhance competition because insurers who may have been reluctant to issue indexed annuities, while their status was uncertain, may decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities.

We have carefully considered the concerns raised by commenters, and we continue to believe that rule 151A will greatly enhance disclosures regarding indexed annuities. In addition to the specific benefits described above, we anticipate that these

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<sup>293</sup> Id.

enhanced disclosures will also benefit the overall financial markets and their participants.

We anticipate that the disclosure of terms of indexed annuities will be broadly beneficial to investors, enhancing the efficiency of the market for indexed annuities through increased competition. Disclosure will make information on indexed annuity contracts, including terms, publicly available. Public availability of terms will better enable investors to compare indexed annuities and may focus attention on the price competitiveness of these products. It will also improve the ability of third parties to price contracts, giving purchasers a better understanding of the fees implicit in the products. We anticipate that third-party information providers may provide services to price or compare terms of different indexed annuities. Analogously, we note that public disclosure of mutual fund information has enabled third-party information aggregators to facilitate comparison of fees.<sup>294</sup> We believe that increasing the level of price transparency and the resulting competition through enhanced disclosure regarding indexed annuities would be beneficial to investors. It could also expand the size of the market, as investors may have increased confidence that indexed annuities are competitively priced.

The Commission believes that there could be costs associated with diminished competition as a result of rule 151A. As the commenters note, some insurance companies may stop issuing indexed annuities, and some broker-dealers and agents may determine not to sell indexed annuities. We recognize that the impact of rule 151A on competition may be mixed, but, on balance, we continue to believe that rule 151A will

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<sup>294</sup> See, e.g., FINRA, Fund Analyzer, available at: <http://www.finra.org/fundanalyzer> (“FINRA Fund Analyzer”).

provide the benefits described above and has the potential to increase competition. In this regard, the demand for financial products is relatively fixed, in the aggregate. Any potential reduction in indexed annuities sold under the rule would likely correspond with an increase in the sale of other financial products, such as mutual funds or variable annuities. Thus, total reductions in competition may not be significant, when effects on the financial industry as a whole, including insurance companies together with other providers of financial instruments, are considered. Within the insurance industry, if some insurers cease selling indexed annuities, it is also likely that these insurers will sell other products through the same distribution channels, such as annuities with fixed interest rates.

We conclude, in any event, that the importance of providing the protections of the federal securities laws to indexed annuity purchasers is significant notwithstanding any burden on competition that may result from the operation of the rule. In addition, the rule will provide other benefits. It will bring about clarity in what has been an uncertain area of law. In addition, issuers and sellers of these products will no longer be subject to uncertainty and litigation risk with respect to the laws that are applicable.

Some commenters argued that regulation under the federal securities laws of indexed annuities will place them at a competitive disadvantage to variable annuities and mutual funds because the Commission's disclosure scheme is not tailored to these contracts.<sup>295</sup> Commenters cited a number of supposed defects, including the lack of a registration form that is well-suited to indexed annuities, questions about the appropriate

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<sup>295</sup> Allianz Letter, supra note 54; Sammons Letter, supra note 54; Second Aviva Letter, supra note 54.



method of accounting to be used by insurance companies that issue indexed annuities, and concerns about parity of the registration process vis-a-vis mutual funds.

We acknowledge that, as a result of indexed annuity issuers having historically offered and sold their contracts without complying with the federal securities laws, the Commission has not created specific disclosure requirements tailored to these products. This fact, though, is not relevant in determining whether indexed annuities are subject to the federal securities laws. The Commission has a long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance.<sup>296</sup> We note that we are providing a two-year transition period for rule 151A, and, during this period, we intend to consider how to tailor disclosure requirements for indexed annuities. We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.

One commenter indicated that the rule creates a competitive disadvantage for indexed annuities to the advantage of fixed annuities and suggests that that the Commission improperly failed to consider competition between indexed and fixed annuities.<sup>297</sup> Fixed annuities do not involve assumption of significant investment risks by purchasers. By contrast, indexed annuities that fall outside the insurance exemption under rule 151A do impose significant investment risk on purchasers, and, like other securities, they require the protections of the federal securities laws. Securities and non-

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<sup>296</sup> See Form N-4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N-6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

<sup>297</sup> NAFA Letter, supra note 54.

securities are subject to different regulatory regimes as a result of Congressional action; it is not the Commission's role to revisit that determination by Congress.

### **C. Capital Formation**

We also anticipate that the increased market efficiency resulting from enhanced investor protections under rule 151A could promote capital formation by improving the flow of information among insurers that issue indexed annuities, the distributors of those annuities, and investors. Public availability of this information will be helpful to investors in making informed decisions about purchasing indexed annuities. The information will enhance investors' ability to compare various indexed annuities and also to compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. The potential liability for materially false and misleading statements and omissions under the federal securities laws will provide additional encouragement for accurate, relevant, and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell them.<sup>298</sup>

Some commenters criticized the Commission's consideration of whether the rule will promote capital formation.<sup>299</sup> One commenter specifically questioned whether the proposed rule would improve the flow of information with regard to indexed annuities, suggesting that the Commission should delineate where the states' current disclosure regime falls short, and how the rule would improve upon it, as well as how the benefits of

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<sup>298</sup> See, e.g., Section 12(a)(2) of the Securities Act [15 U.S.C. 77](a)(2)] (imposing liability for materially false or misleading statements in a prospectus or oral communication, subject to a reasonable care defense). See also Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)]; rule 10b-5 under the Exchange Act [17 CFR 240.10b-5]; Section 17 of the Securities Act [15 U.S.C. 77q] (general antifraud provisions).

<sup>299</sup> See, e.g., Coalition Letter, supra note 54; NAFA Letter, supra note 54.

the rule would exceed its costs.<sup>300</sup> We disagree. It is not our intention to question the effectiveness of state regulation. We continue to believe that applying the federal securities disclosure scheme to indexed annuities will enhance disclosure of information needed to make informed investment decisions. The information will enhance investors' abilities to compare various indexed annuities and also compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. We believe that state insurance laws, enforced by multiple regulators whose primary charge is the solvency of the issuing insurance company, cannot serve as an adequate substitute for uniform, enforceable investor protections provided by the federal securities laws. At least one state regulator has acknowledged the developmental nature of state efforts and the lack of uniformity in those efforts.<sup>301</sup> Congress has prescribed a uniform federal regulatory scheme for securities having already weighed whether the federal securities laws are well-suited to securities. In addition, the courts have recognized that labeling a product as insurance does not remove it from the federal regulatory scheme.

The federal securities laws will further improve upon the state structure because of the Commission's long history of creating appropriate disclosure requirements for different types of securities, including securities issued by insurance companies, such as variable annuities and variable life insurance,<sup>302</sup> the federal regulatory scheme's

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<sup>300</sup> Coalition Letter, supra note 54.

<sup>301</sup> See Voss Letter, supra note 13.

<sup>302</sup> See e.g., Form N-4 [17 CFR 239.17b and 274.11c] (registration form for variable annuities); Form N-6 [17 CFR 239.17c and 274.11d] (registration form for variable life insurance).

uniformity in application, the suitability requirements enforced by FINRA, as well as the Commission and FINRA's robust enforcement powers and the private remedies allowed under the federal securities laws.

Another commenter stated that the proposed rule would only promote capital formation if it resulted in increased sales of indexed annuities, and that the Commission has not analyzed the rule to the point where it can determine whether or not it will increase indexed annuity sales.<sup>303</sup> We strongly disagree that the correct measure of whether the rule will promote capital formation is if it results in increased sales of indexed annuities. We believe that capital formation would be enhanced through increased competition among indexed annuities and among indexed annuities and other financial products, such as variable annuities and mutual funds, and the innovation and better terms in indexed annuities for investors that may result from this competition. Better information leads to increased competition and greater investor confidence in markets which will in turn lead to willingness to invest and facilitate capital formation. Moreover, it is not possible to predict with certainty whether indexed annuity sales will themselves increase or decrease as a result of the rule. The Commission has taken both possibilities into account. In any event, we believe, first, that the importance of protecting purchasers of these products under the federal securities laws is significant notwithstanding any reduction in capital formation that may result from fewer sales of indexed annuities and second, that any such reduction is likely to be offset by an increase in capital formation through sales of other financial products.

Rule 12h-7 provides insurance companies with an exemption from Exchange Act

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<sup>303</sup> NAFA Letter, supra note 54.

reporting with respect to indexed annuities and certain other securities that are regulated as insurance under state law. We are adopting this exemption because the concerns that Exchange Act financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract. Accordingly, we believe that the exemption will improve efficiency by eliminating potentially duplicative and burdensome regulation relating to insurers' financial condition. Furthermore, we believe that rule 12h-7 will not impose any burden on competition. Rather, we believe that the rule will enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption will reduce the regulatory costs associated with doing so. We also anticipate that the innovations in product development could promote capital formation by providing new investment opportunities for investors.

## **VII. FINAL REGULATORY FLEXIBILITY ANALYSIS**

This Final Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act.<sup>304</sup> It relates to the Commission's rule 151A that defines the terms "annuity contract" and "optional annuity contract" under the Securities Act of 1933 and rule 12h-7 that exempts insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities

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<sup>304</sup> 5 U.S.C. 604 et seq.

that are registered under the Securities Act, subject to certain conditions, both of which we are adopting in this Release. The Initial Regulatory Flexibility Analysis (“IRFA”) which was prepared in accordance with 5 U.S.C. 603 was published in the Proposing Release.

**A. Need For and Objectives of Rules**

We are adopting the definition of the terms “annuity contract” and “optional annuity contract” to provide greater clarity with regard to the status of indexed annuities under the federal securities laws. We believe this will enhance investor protection and provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are adopting the exemption from Exchange Act reporting because we believe that the concerns that periodic financial disclosures are intended to address are generally not implicated where an insurer’s financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract.

**B. Significant Issues Raised By Public Comment**

In the Proposing Release, we requested comment on the number of small entity insurance companies, small entity distributors of indexed annuities, and any other small entities that may be affected by the rules, the existence or nature of the potential impact and how to quantify the impact of the rules. A number of commenters stated that costs and burdens arising from rule 151A would have a significant and adverse impact on small entities, such as small insurance distributors.<sup>305</sup> Commenters have estimated the number

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<sup>305</sup> See, e.g., Letter A, supra note 76; Letter of Dennis Absher (Jul. 25, 2008) (“Absher Letter”); Letter of James Brenner (Jul. 7, 2008) (“Brenner Letter”); Letter E, supra note 76; Letter of Dustin R. Montgomery (Sep. 11, 2008) (“Montgomery Letter”); Letter of

of small entities to be adversely affected by this rule to range from thousands to tens of thousands of small entities.<sup>306</sup> Insurance distributors that would be affected by the rule are not registered with the Commission. For that reason, we do not have information pertaining to the number of such distributors, or the number of small distributors. While commenters provided a range of numbers of small entities, they did not explain the basis for their estimates.

Some commenters stated that the estimate of the burden on small entities in the proposing release is understated.<sup>307</sup> In particular, one commenter stated that small entities among distributors who network with registered broker-dealers will incur not only legal and monitoring costs, as the Proposing Release recognized, but will also have to share commissions that they earn from the sales of indexed annuities.<sup>308</sup> While we did not specifically address sharing of commissions in the Proposing Release, we recognize that networking may cause small distributors to share commissions with registered broker-dealers. However, we continue to believe that networking may be more cost-effective than registering as a broker-dealer. We recognize that a distributor will incur costs in entering into networking arrangement. However, these costs are not unique to indexed annuities. For example, issuers of insurance products registered as securities,

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Raymond J. Ohlson, The Ohlson Group, Inc. (Jul. 22, 2008) (“Ohlson Letter”); Letter of Steven A Sewell (Aug. 25, 2008) (“Sewell Letter”); Letter of Donna Tupper (Sept. 11, 2009) (“Tupper Letter”).

<sup>306</sup> See, e.g., Letter of Matthew Coleman (Jul. 11, 2008) (“Coleman Letter”); Letter of Bruce E. Dickes (Jul. 16, 2008) (“Dickes Letter”); Letter Type K (“Letter K”); Letter of Larry A. Kaufman (Aug. 27, 2008) (“Kaufman Letter”); Letter of Dejah F. LaMonte (Sep. 3, 2008) (“LaMonte Letter”); Letter of Kyle Mann (Sep. 9, 2008) (“Mann Letter”).

<sup>307</sup> See, e.g., Coalition Letter, supra note 54.

<sup>308</sup> Coalition Letter, supra note 54

such as variable annuities, may incur networking costs, as do banks involved in networking arrangements. Moreover, while we would expect networking to be generally more cost-effective than registration as a broker-dealer, to the extent that it is not more efficient, broker-dealer registration remains an option for indexed annuity distributors. We believe that the upper bound of the cost of entering into a networking agreement is the equivalent of the costs of establishing a registered broker-dealer. Commenters provided a range of cost estimates for establishing a registered broker-dealer, ranging from \$250,000 to \$3 million.

As discussed below, it is the view of the Commission that, despite any adverse impact to small entities that may result, rule 151A is a necessary measure for the protection of purchasers of indexed annuities. Rule 151A will result in significant benefits to indexed annuity purchasers, including federally mandated disclosure and sales practice protections. Moreover, rule 151A offers benefits to all entities, large and small, such as greater regulatory certainty with regard to the status of indexed annuities under the federal securities laws and enhance competition. We do not anticipate that rule 151A will impose different or additional burdens on small entities than those imposed on other small entities who issue or distribute securities. Commenters generally supported rule 12h-7 and did not raise any issues regarding the effect of rule 12h-7 on small entities.

### **C. Small Entities Subject to the Rules**

The Commission's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by



the Commission.<sup>309</sup> Rule 0-10(a)<sup>310</sup> defines an issuer, other than an investment company, to be a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year.<sup>311</sup> No insurers currently issuing indexed annuities are small entities.<sup>312</sup> In addition, no other insurers that would be covered by the Exchange Act exemption are small entities.<sup>313</sup>

While there are no small entities among the insurers who are subject to the new

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<sup>309</sup> See rule 157 under the Securities Act [17 CFR 230.157]; rule 0-10 under the Exchange Act [17 CFR 240.0-10].

<sup>310</sup> 17 CFR 240.0-10(a).

<sup>311</sup> Securities Act rule 157(a) [17 CFR 157(a)] generally defines an issuer, other than an investment company, to be a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year and it is conducting or proposing to conduct a securities offering of \$5 million or less. For purposes of our analysis, however, we use the Exchange Act definition of “small business” or “small entity” because that definition includes more issuers than does the Securities Act definition and, as a result, assures that the definition we use would not itself lead to an understatement of the impact of the amendments on small entities.

<sup>312</sup> The staff has determined that each insurance company that currently offers indexed annuities has total assets significantly in excess of \$5 million. The staff compiled a list of indexed annuity issuers from four sources: AnnuitySpecs, Carrier List, <http://www.annuityspecs.com/Page.aspx?s=carrierlist>; Annuity Advantage, Equity Indexed Annuity Data, <http://www.annuityadvantage.com/annuitydataequity.htm>; Advantage Compendium, Current Rates, [http://www.indexannuity.org/rates\\_by\\_carrier.htm](http://www.indexannuity.org/rates_by_carrier.htm); and a search of BEST'S COMPANY REPORTS (available on LEXIS) for indexed annuity issuers. The total assets of each insurance company issuer of indexed annuities were determined by reviewing the most recent BEST'S COMPANY REPORTS for each indexed annuity issuer.

<sup>313</sup> The staff has determined that each insurance company that currently offers contracts that are registered under the Securities Act and that include so-called market value adjustment features or guaranteed benefits in connection with assets held in an investor's account has total assets significantly in excess of \$5 million. The total assets of each such insurance company were determined by reviewing the Form 10-K of that company and, in some cases, BEST'S COMPANY REPORTS (available on LEXIS).

rules 151A and 12h-7, we note that there may be a substantial number of small entities among distributors of indexed annuities.<sup>314</sup> Rule 0-10(c)<sup>315</sup> states that the term “small business” or “small organization,” when referring to a broker-dealer that is not required to file audited financial statements prepared pursuant to rule 17a-5(d) under the Exchange Act,<sup>316</sup> means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. Rule 0-10(a)<sup>317</sup> states that the term “small business” or “small organization,” when used with reference to a “person,” other than an investment company, means a “person” that, on the last day of its most recent fiscal year, had total assets of \$5 million or less.

#### **D. Reporting, Recordkeeping, and Other Compliance Requirements**

Rule 151A will result in Securities Act filing obligations for those insurance companies that, in the future, issue indexed annuities that fall outside the insurance exemption under rule 151A, and rule 12h-7 will result in the elimination of Exchange Act reporting obligations for those insurance companies that meet the conditions to the exemption. As noted above, no insurance companies that currently issue indexed annuities or that would be covered by the exemption are small entities.

However, rule 151A may affect indexed annuity distributors that are small entities

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<sup>314</sup> See supra note 306 and accompanying text.

<sup>315</sup> 17 CFR 240.0-10(c).

<sup>316</sup> 17 CFR 240.17a-5(d).

<sup>317</sup> 17 CFR 240.0-10(a).

and that are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer. Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement would impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor will incur legal costs in connection with entering into a networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement.<sup>318</sup> Entities that enter into such networking arrangements would not be subject to ongoing reporting, recordkeeping, or other compliance requirements imposed by the federal securities laws. If any of these entities were to choose to register as broker-dealers as a result of rule 151A,<sup>319</sup> they would be subject to ongoing reporting, recordkeeping, and other compliance requirements applicable to registered broker-dealers. Compliance with these requirements, if applicable, would impose costs associated with accounting, legal, and other professional personnel, and the design and operation of automated and other

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<sup>318</sup> See discussion supra Part V.B. The costs borne by distributors entering into networking arrangements will be borne by both large and small distributors of registered indexed annuities.

<sup>319</sup> See, e.g., Submission for OMB Review; Comment Request, OMB Control No. 3235-0012 [72 FR 39646 (Jul. 19, 2007)] (discussing the total annual burden imposed by Form BD).

compliance systems.<sup>320</sup>

**E. Commission Action to Minimize Effect on Small Entities**

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the adoption of rule 151A and rule 12h-7, we considered the following alternatives:

- establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- further clarifying, consolidating, or simplifying the requirements for small entities;
- using performance standards rather than design standards; and
- providing an exemption from the requirements, or any part of them, for small entities.

Because no insurers that currently issue indexed annuities or that will be covered by the Exchange Act exemption are small entities, consideration of these alternatives for those insurance companies is not applicable. Small distributors of indexed annuities that choose to enter into networking arrangements with registered broker-dealers, which we believe will be likely once rule 151A is adopted, would not be subject to ongoing reporting, recordkeeping, or other compliance requirements. However, because some small distributors may choose to register as broker-dealers, we did consider the alternatives above for small distributors.

Commenters did not suggest any alternatives specifically addressed to small

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<sup>320</sup> See supra notes 265-268 and accompanying text.

entities. Some commenters suggested that the Commission, instead of adopting a rule that defines certain indexed annuities as not being “annuity contracts” under Section 3(a)(8), should instead define a safe harbor that would provide that indexed annuities that meet certain conditions are entitled to the Section 3(a)(8) exemption.<sup>321</sup> We are not adopting this approach for two reasons. First, such a rule would not address in any way the federal interest in providing investors with disclosure, antifraud, and sales practice protections that arise when individuals are offered indexed annuities that expose them to investment risk. A safe harbor would address circumstances where purchasers of indexed annuities are **not** entitled to the protections of the federal securities laws; one of our primary goals is to address circumstances where purchasers of indexed annuities **are** entitled to the protections of the federal securities laws. We are concerned that many purchasers of indexed annuities today should be receiving the protections of the federal securities laws, but are not. Rule 151A addresses this problem; a safe harbor rule would not. Second, we believe that, under many of the indexed annuities that are sold today, the purchaser bears significant investment risk and is more likely than not to receive a fluctuating, securities-linked return. In light of that fact, we believe that is far more important to address this class of contracts with our definitional rule than to address the remaining contracts, or some subset of those contracts, with a safe harbor rule.

The Commission believes that different registration, compliance, or reporting requirements or timetables for small entities that distribute registered indexed annuities

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<sup>321</sup> See, e.g., Academy Letter, supra note 54; AIG Letter, supra note 128; Aviva Letter, supra note 54; Second Academy Letter, supra note 54; Second Aviva Letter, supra note 54; Second Transamerica Letter, supra note 54; Letter of Life Insurance Company of the Southwest (Sept. 10, 2008) (“Southwest Letter”); Voss Letter, supra note 13.

would not be appropriate or consistent with investor protection. The rules will provide investors with the sales practice protections of the federal securities laws when they purchase indexed annuities that are outside the insurance exemption. These indexed annuities would be required to be distributed by a registered broker-dealer. As a result, investors who purchase these indexed annuities after the effective date of rule 151A would receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities would be subject to supervision by the broker-dealer with which they are associated, and the selling broker-dealers would be subject to the oversight of FINRA. The registered broker-dealers would also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as to be subject to the Commission's general inspections and, where warranted, enforcement powers.

Different registration, compliance, or reporting requirements or timetables for small entities that distribute indexed annuities may create the risk that investors will receive lesser sales practice and other protections when they purchase a registered indexed annuity through a distributor that is a small entity. We believe that it is important for all investors that purchase indexed annuities that are outside the insurance exemption to receive equivalent protections under the federal securities laws, without regard to the size of the distributor through which they purchase. For those same reasons, the Commission also does not believe that it would be appropriate or consistent with investor protection to exempt small entities from the broker-dealer registration requirements when those entities distribute indexed annuities that fall outside of the

insurance exemption under our rules.

Through our existing requirements for broker-dealers, we have endeavored to minimize the regulatory burden on all broker-dealers, including small entities, while meeting our regulatory objectives. Small entities that distribute indexed annuities that are outside the insurance exemption under our rule should benefit from the Commission's reasoned approach to broker-dealer regulation to the same degree as other entities that distribute securities. In our existing broker-dealer regulatory framework, we have endeavored to clarify, consolidate, and simplify the requirements applicable to all registered broker-dealers, and the rules do not change those requirements in any way. Finally, we do not consider using performance rather than design standards to be consistent with investor protection in the context of broker-dealer registration, compliance, and reporting requirements.

## **VIII. STATUTORY AUTHORITY**

The Commission is adopting the amendments outlined above under Sections 3(a)(8) and 19(a) of the Securities Act [15 U.S.C. 77c(a)(8) and 77s(a)] and Sections 12(h), 13, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78l(h), 78m, 78o, 78w(a), and 78mm].

### **List of Subjects**

#### **17 CFR Parts 230 and 240**

Reporting and recordkeeping requirements, Securities.

### **TEXT OF RULES**

For the reasons set forth in the preamble, the Commission amends Title 17, Chapter II, of the Code of Federal Regulations as follows:

**PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933**

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll (d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

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2. Add § 230.151A to read as follows:

**§ 230.151A Certain contracts not “annuity contracts” or “optional annuity contracts” under section 3(a)(8).**

(a) General. Except as provided in paragraph (c) of this section, a contract that is issued by a corporation 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, and that is subject to regulation under the insurance laws of that jurisdiction as an annuity is not an “annuity contract” or “optional annuity contract” under Section 3(a)(8) of the Securities Act (15 U.S.C. 77c(a)(8)) if:

(1) The contract specifies that 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

(2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

(b) Determination of amounts payable and guaranteed. In making the determination under paragraph (a)(2) of this section:



(1) Amounts payable by the issuer under the contract and amounts guaranteed under the contract shall be determined by taking into account all charges under the contract, including, without limitation, charges that are imposed at the time that payments are made by the issuer; and

(2) A determination by the issuer at or prior to issuance of the contract shall be conclusive, provided that:

(i) Both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;

(ii) The computations made by the issuer in support of the determination are materially accurate; and

(iii) The determination is made not more than six months prior to the date on which the form of contract is first offered.

(c) Separate accounts. This section does not apply to any contract whose value varies according to the investment experience of a separate account.

#### **PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

3. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

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4. Add § 240.12h-7 to read as follows:

**§ 240.12h-7 Exemption for issuers of securities that are subject to insurance regulation.**

An issuer shall be exempt from the duty under section 15(d) of the Act (15 U.S.C. 78o(d)) to file reports required by section 13(a) of the Act (15 U.S.C. 78m(a)) with respect to securities registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.), provided that:

(a) The issuer is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State;

(b) The securities do not constitute an equity interest in the issuer and are either subject to regulation under the insurance laws of the domiciliary State of the issuer or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction;

(c) The issuer files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of the issuer's domiciliary State;

(d) The securities are not listed, traded, or quoted on an exchange, alternative trading system (as defined in §242.300(a) of this chapter), inter-dealer quotation system (as defined in § 240.15c2-11(e)(2)), electronic communications network, or any other similar system, network, or publication for trading or quoting;

(e) The issuer takes steps reasonably designed to ensure that a trading market for the securities does not develop, including, except to the extent prohibited by the law of any State or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any State, requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis; and

(f) The prospectus for the securities contains a statement indicating that the issuer is relying on the exemption provided by this rule.

By the Commission.

Elizabeth M. Murphy  
Secretary

January 8, 2009