

SEC Proposes New Rule to Bring Equity Indexed Annuities under SEC's Jurisdiction

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The Securities and Exchange Commission ("SEC") has proposed a new rule, Proposed Rule 151A, that would, if adopted, require that offerings of indexed annuities be registered with the SEC under the Securities Act of 1933 (the "Securities Act"). An accompanying proposal, Proposed Rule 12h-7, would exempt from the reporting requirements under the Securities Exchange Act of 1934 (the "Exchange Act") any insurance company required to report solely because it has issued indexed annuities or other insurance products registered under the Securities Act.

An indexed annuity is a fixed annuity that credits interest according to either a formula based on returns on an index or, if greater, to a guaranteed contractual minimum interest rate. Since their introduction in the mid-1990's, according to the SEC's proposing release, total indexed annuity assets have grown to \$123 billion in 2007, with 58 companies issuing indexed annuity products.

The SEC cites several reasons for proposing the new rule. First, the SEC believes there is a need for greater clarity regarding the status of indexed annuities under the federal securities laws. Second, it views recent developments in the structure of indexed annuities as shifting more investment risk to purchasers. Third, it perceives growing suitability and sales practice problems. In an opening statement at the meeting at which publication of the proposed rule was approved, SEC Chairman Christopher Cox emphasized that the proposed rule was intended to contribute to state securities regulators' ongoing efforts to fight abusive sales practices aimed at senior citizens.

Proposed Rule 151A would carve out from the definition of annuity contracts under Section 3(a)(8) of the Securities Act products that fall within the Proposed Rule's scope. As a result, these products would be treated as securities subject to the registration and other requirements of the Securities Act. Under Proposed Rule 151A, an indexed annuity would be treated as a security if (1) amounts payable by the insurance company are calculated in whole or in part by reference to the performance of a security or a group or index of securities; and (2) amounts payable under the contract are more likely than not to exceed the amounts guaranteed under the contract. Under this test, it is likely that if the proposed rule is adopted, continued sales of many, if not all, equity index annuity products would require registration.

Absent from the proposed rule is a safe harbor provision. Indexed annuities that do not meet the rule's definition are not, by that reason alone, entitled to rely on Section 3(a)(8). Rather, the SEC states in the proposing release that the status of those annuity products would continue to be determined based on the investment risk and marketing tests in ex-

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isting precedents. Therefore, indexed annuities not covered by the rule might still be deemed securities. The proposed rule also does not address the status of life insurance products that, like indexed annuities, may credit interest based on a formula based on returns on an index.

Proposed Rule 151A would require fundamental changes in the indexed annuity business. The offer and sale of indexed annuities covered by the proposed definition would be required to be registered under the Securities Act. Sellers of registered indexed annuities would be required to register as broker-dealers or enter into a permissible networking arrangement with a broker-dealer. Individuals transacting registered indexed annuity sales would need to possess securities licenses and be associated persons of a broker-dealer. Sales of registered indexed annuities thus would be subject to suitability, anti-fraud and sales practice regulation by the SEC and FINRA. Further, registered indexed annuities might as a consequence also be treated as securities under state law, and thus be subject to additional supervision by state securities regulators.

Proposed Rule 151A would be prospective, applying only to indexed annuities issued 12 months after the final rule's adoption and publication in the Federal Register. This implies that insurance companies would not be subject to SEC enforcement actions for offering and selling unregistered indexed annuity offerings prior to the effective date of the final rule. The Proposed Rule, if adopted, would require registration for continuing sales of existing products as well as for sales of new products. The proposal, however, makes no clear statement on how the rule would apply to additional payments made under outstanding indexed annuity contracts.

The SEC has also proposed Rule 12h-7 to exempt insurance companies from Exchange Act reporting requirements, if those requirements would apply solely because they are issuers of registered indexed annuities or other insurance products registered under the Securities Act. The exemption is not limited to indexed annuity issuers, and would thus provide relief for issuers of other existing registered insurance products such as deferred fixed annuities with market value adjustment features. The SEC's rationales for this exemption are that sufficient state regulation of insurers' financial condition exists and that as a general matter there is no trading interest in insurance contracts. In order to ensure that these factors are present, however, under the proposed rule an insurer seeking to rely on the proposed exemption must meet the following conditions: (i) none of the issuer's registered securities may be equity securities or securities that are not either regulated under state insurance laws or guarantees of securities so regulated; (ii) the issuer must file an annual statement of its financial condition with, and have its financial condition periodically examined by, the insurance commissioner or like agency of its domiciliary state; (iii) the registered product may not be listed, traded, or quoted on an exchange or other trading network; and (iv) the insurer must take steps reasonably designed to ensure that a trading market for the registered products does not develop.

Comments on the proposal are due to the SEC by September 10, 2008.

We are continuing to analyze the proposed rules. Please contact us if you would like to discuss the results of our further analysis.

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