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Major References: ***Securities Act Release No. 33-8996***

Prior AALU Washington Reports: *08-113; 08-59*

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The U.S. Securities and Exchange Commission ("SEC" or "Commission") has released the language of recently adopted Rule 151A, which has an effective date of January 12, 2011. The rule will require insurers to register as securities most indexed annuities that are offered on or after that date. Producers selling these products will need to be securities licensed once the products are registered as securities with the SEC.

Importantly, in response to comments submitted by AALU and others, the SEC narrowed the scope of the rule so that it does not cover the vast majority of general account life insurance and annuity products. The rule does not cover indexed life insurance products, although the rule likely will have implications for the status of such products under the federal securities laws.

On January 8, 2009, the SEC issued the release adopting new Rule 151A under the Securities Act of 1933 (the "1933 Act") that defines a specified class of "annuity" and "optional annuity" contracts as being outside the scope of the exemption in Section 3(a)(8) of the 1933 Act.[1] The rule, which has an effective date of January 12, 2011, is intended to clarify the status under the federal securities laws of

[1] "Indexed Annuities and Certain Other Insurance Contracts," Securities Act Release No. 33-8996 (Jan. 8, 2009) (the "Adopting Release") available at http://www.sec.gov/rules/final/2009/33-8996.pdf.

indexed annuity contracts, which by their terms credit interest by reference to a security, or group or index of securities, retrospectively at the end of one or more crediting periods.

BACKGROUND

As previously reported, at an open meeting held on December 17, 2008, by a 4 - 1 vote over the objection of Commissioner Paredes, the SEC adopted Rule 151A under the 1933 Act that in effect will require the registration of typical equity indexed annuities. The SEC issued a press release on December 17 announcing its action.[2] This followed the SEC's consideration of approximately 4,800 comments which were received on a proposed rule that the SEC published on June 25.[3] The comment period initially ended on September 10, 2008, and then was re-opened for an additional 30 day period in mid-October.

The Commission also adopted Rule 12h-7 under the Securities Exchange Act of 1934 (the "1934 Act") that will exempt issuers of registered indexed annuities and certain other registered insurance products from 1934 Act periodic reporting requirements. Rule 12h-7 was adopted in substantially the same form as proposed, except that insurers will not be required to take steps to prevent the development of a market in these securities, such as limitations on and prior approval of assignments, to the extent that those actions would be prohibited by state law.

NEW DEFINITION OF AN ANNUITY

Proposed Rule 151A prospectively defines certain indexed annuity contracts that will not be able to rely on the exemption from registration for annuity or optional annuity contracts in Section 3(a)(8) of the 1933 Act. Absent another exemption, indexed annuities that meet this definition and that are issued on or after the January 12, 2011 effective date, will be required to be registered as securities. The definition has two parts.

Under Rule 151A, an annuity is subject to registration if:

(1) The contract specifies that amounts payable by the issuer under the contract are calculated, at or after 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.[4]

The final rule narrows the scope of the proposed rule in two ways. First, it only applies where ***the contract specifies*** that amounts payable are based, in whole or in part, on the performance of a security or securities index (i.e., a contract will not be covered unless the insurer is contractually bound to pay amounts based on the performance of a security, group of securities or securities index). Second, the final rule only applies to contracts that, by their terms, calculate interest ***at the end of*** one or more crediting periods ***retroactively***, in whole or in part, by reference to the performance of a security, including an index or group

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[2] The SEC's press release is available at http://www.sec.gov/news/press/2008/2008-298.htm.
[3] Securities Act Release No. 33-8933 (June 25, 2008) available at http://www.sec.gov/rules/proposed/2008/33-8933.pdf.

[4] Adopting Release at 152.

of securities, during the crediting period. These modifications are intended to address comments from AALU and others that the proposed rule could have been interpreted as applying to traditional fixed annuities or discretionary excess interest contracts where interest rates are often based, in part, on the performance of the securities held in the insurer's general account.[5] The new language in Rule 151A was also intended to clarify that the new rule does not reach contracts covered by the Rule 151 safe harbor, since contracts that credit interest retrospectively "do not fall within rule 151."[6] As a result of these changes, the rule does not apply to discretionary excess interest contracts where insurers declare the current rate of interest in advance, nor should it apply to traditional participating policies where insurers declare and pay dividends at their discretion based in part on the investment return of the insurer's general account portfolio.

The "more likely than not" determination is principles based, and would be made by the insurance company. The Adopting Release states that the amounts payable by an insurer under a contract would more likely than not exceed the amounts guaranteed under the contract if this were expected to occur more than half of the time.[7] The Commission states that analysis made by the insurer would be facts and circumstances based and would include, among other things, an analysis of the features of the contract, the options selected by the owner (*e.g.,* surrender or annuitization), and performance of the benchmark index.

Rule 151A continues to be characterized as "principles-based" and to provide that an insurer's determinations regarding the "more likely than not" test are conclusive if:

(1) Both the insurer's methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;

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

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

The Commission dropped the requirement that the determination be made not more than three years prior to the date on which the particular contract is issued. The Commission was persuaded by commenters that if the status of a contract were to change from exempt to non-exempt and vice versa, it would present practical difficulties.[8]

EFFECTIVE DATE AND PROSPECTIVE APPLICATION

The effective date of Rule 151A is January 12, 2011, thus extending the 12 month period in the proposed rule to 24 months. Therefore, the new definition in Rule 151A will apply prospectively only. The Adopting Release makes clear that nothing in the release is intended to affect the current legal status of indexed annuities until January 12, 2011, and states that "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."[9] The SEC notes that during the period between the adoption of Rule 151A and the effective date:

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[5] Id. at 49-50.
[6] Id. at 51.
[7] Id. at 54.
[8] Id. at 60.
[9] Id. at 64.

- 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 January 12, 2011 without such offers being unlawful under Section 5 of the 1933 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 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.[10]

The Commission also clarified that insurers may continue to receive additional premium payments after the rule's effective date under individual indexed annuity contracts previously issued without registration, but new sales of an existing form of an indexed annuity contract will not be permitted.[11] Similarly, a group indexed annuity contract offered and sold prior to January 12, 2011 cannot be sold to an individual on or after January 12, 2011 without reference to Rule 151A.

The SEC has indicated that it intends to work during the 2-year transition period to develop a tailored disclosure form that would address such issues as appropriate financial statements and filing fees, and would also consider other regulatory changes to level the playing field with variable annuities and other investment products.

IMPLICATIONS FOR LIFE INSURANCE PRODUCTS

The SEC had requested comment on whether Rule 151A should apply to not just indexed annuities but also to indexed life insurance. The Adopting Release states that 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. In general, the final rule is confirmatory of clarification sought by AALU from the SEC to try to assure that unwarranted questions would not be raised about the vast majority of general account life insurance products. It does this not only by restating that the final rule only applies by its terms to certain annuities, but by narrowing (as described above) the scope of the final rule even with regard to annuities—to exclude discretionary excess interest contracts where insurers declare the current rate of interest in advance; and to exclude traditional contracts where insurers declare and pay dividends at their discretion based in part on the investment return of the insurer's general account portfolio. The Adopting Release does have specific language with respect to indexed life insurance. The Adopting Release states that:

> "…rule 151A itself will not apply to indexed life insurance policies [footnote omitted], 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, 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)."[12]

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[10] Id. at 66.
[11] Id. at 64-65.
[12] Id. at 47-48.

Because Rule 151A is prospective – that is, it will not be effective until January 12, 2011 -- it is likely that until 2011 insurers will evaluate the securities status of indexed life insurance in a manner not inconsistent with how they will assess their ability to continue to offer indexed annuities without SEC registration prior to the 2011 effective date. As noted above, the SEC has explicitly stated that indexed annuities generally can continue to be offered on an unregistered basis until January 12, 2011, without violating the 1933 Act's prohibition on the sale of unregistered securities.

With respect to sales of indexed life insurance after the effective date of Rule 151A, given the SEC's statements quoted above, it is likely that insurers will be evaluating the securities status of the indexed life insurance products they offer by considering not only prior Supreme Court and Commission precedent but also the analysis in the Adopting Release and the "more likely than not" determination specified in Rule 151A. Depending on the conclusions insurers reach after conducting such an analysis, indexed life insurance products could also be registered as securities with the SEC. This, in turn, would require that producers selling such products be securities licensed once the registration statements are declared effective by the SEC.

CONCLUSION

AALU will continue to monitor and report on any additional developments on this matter. For now, the picture is as clear as it may be for some time. Concerns expressed by AALU and other groups were important in narrowing the rule to make clear that it does not apply to, nor should it impact or raise questions about, the vast majority of general account life insurance products and annuities. Indexed annuities which are covered by the rule generally may be sold without securities registration until the January 12, 2011 effective date and thereafter such products generally would require securities registration and producers who sell them would need securities licenses. For indexed life insurance, carriers have between now and the January 12, 2011 effective date to determine whether or how products after that date could be structured and sold without securities registration. As AALU previously noted, it is possible that some groups could challenge the rule in court. The prospects for successful court challenge are not clear. In the interim, it is possible, but currently appears very unlikely, that the SEC will make meaningful changes to the final rule during the two year pendency before the rule's effective date. In light of the above, there appears to be a fair measure of closure on this issue at the present time. AALU does not have any current plans for further engagement on this issue, but welcomes your questions or concerns and will keep you informed of further information or developments.

Any AALU member who wishes to obtain a copy of any of the items discussed in this Washington Report may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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