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News Bulletin

July 6, 2010

Conference Committee Limits the SEC's Jurisdiction Over Certain Insurance Products

The Conference Committee bill passed by the joint House-Senate conferees on June 25, 2010 (the "Conference Bill"), contained an amendment limiting the Securities and Exchange Commission's (the "SEC") jurisdiction over certain insurance products—such as equity-indexed annuities, financial products that promise guaranteed returns and other similar products—effectively ending the jurisdictional fight that has been playing out since the SEC promulgated Rule 151A in December 2008. The inclusion in the Conference Bill of this amendment[1] (introduced by Senator Harkin and referred to below as the "Harkin Amendment") surprised some since the regulation of indexed annuities is not referenced in either the House or Senate versions of financial reform bills.

The Amendment

The Harkin Amendment attempts to clarify the types of insurance products that are covered under section 3(a)(8) of the Securities Act of 1933, as amended (the "Securities Act"), and to create a bright-line rule for when state insurance departments have jurisdiction over certain insurance products. Section 3(a)(8) of the Securities Act exempts "any insurance or endowment policy or annuity contract or optional annuity contract, 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" from the registration requirements of section 5 of the Securities Act. The broad language has led to legal skirmishes over the years as some insurance products were structured to more closely resemble securities than insurance. In fact, certain insurance products have been found by the courts to be "securities" subject to registration under section 5 of the Securities Act.

The SEC, in passing Rule 151A, and recently while defending adoption of the rule in a Delaware court, argued that indexed annuities were securities, rather than insurance, and therefore should not be afforded the section 3(a)(8) exemption. The Harkin Amendment would apply to any insurance or endowment policy or annuity contract or optional annuity contract if:

- the value of such policy or contract does not vary according to the performance of a separate account;
- it either (i) satisfies standard nonforfeiture laws or similar requirements of the applicable state at the time of issue; or (ii) in the absence of applicable standard nonforfeiture laws or requirements, satisfies the Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners; and

[1] H.R. 4173, Title IX, Subtitle I—Public Company Accounting Oversight Board, Portfolio Margining, and Other Matters, Section 989J—Further Promoting the Adoption of the NAIC Model Regulations that Enhance Protection of Seniors and Other Consumers.

- it is issued on and after June 16, 2013, in a state, or issued by an insurance company that is domiciled in a State, that adopts rules governing suitability requirements for the sale of an insurance or endowment policy or annuity contract or optional annuity contract, which shall substantially meet or exceed the minimum requirements established by the Suitability in Annuity Transactions Model Regulation adopted by the National Association of Insurance Commissioners (the "NAIC") in March 2010 (the "Model Annuity Suitability Regulation") and any successor modifications to the model regulations within five years of the adoption by the NAIC of any further successors thereto; or
- it is issued by an insurance company that adopts and implements practices nationwide for the sale of any insurance or endowment policy or annuity contract or optional annuity contract that meet or exceed the minimum requirements established by the Model Annuity Suitability Regulation, and any successor thereto, and is therefore subject to examination by the State of domicile of the insurance company, or by any other state where the insurance company conducts sales of such products.

The Harkin Amendment is limited to products that meet the above criteria that are regulated by state insurance departments under the Model Annuity Suitability Regulation or similar requirements. It does not opine on whether any other insurance or annuity product falls within the section 3(a)(8) exemption.

Rule 151A

Rule 151A provides that an indexed annuity is not an "annuity contract" under Section 3(a)(8) if certain conditions are met. Rule 151A, in its final form, defines annuity contracts as outside the scope of the Section 3(a)(8) if: (a) 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 (b) the amounts payable by the insurer under the contract are "more likely than not" to exceed the amounts guaranteed under the contract. Annuity contracts that fall within this definition would be treated as "securities" not eligible for an exemption from registration.

If an insurer relies on the Section 3(a)(8) exemption when issuing an annuity contract, the burden of proof will rest with the insurer to demonstrate that the annuity contract does not meet this test. An insurer can rely on its determination that the annuity contract does not meet the two-pronged test if the insurer can demonstrate that its: (a) methodology, including its assumptions, are reasonable; (b) computations were materially accurate; and (c) determination was made at or prior to the issuance of the annuity contract (no more than six months prior to the date that the form of contract is first offered). Rule 151A was to become effective for all applicable annuity products issued on or after January 12, 2011.

The Ongoing Court Battle

On January 16, 2009, a group of insurance companies filed suit against the SEC requesting that the U.S. Court of Appeals for the District of Columbia Circuit (the "Court") (a) find that Rule 151A is unlawful under the Securities Act, (b) vacate the rule and its requirements, and (c) issue a permanent injunction barring the SEC from implementing and enforcing the rule. The petitioners argued that the SEC's actions contradict prior federal court precedent that holds that fixed indexed annuities are not securities,[2] and Supreme Court precedent that holds that allocation of risk is only one of three factors to consider when determining whether a product is an annuity or a security.[3]

On July 21, 2009, the Court held that the SEC acted reasonably when determining that indexed annuity products fall outside the definition of "annuity contract" under section 3(a)(8) and, therefore, should be treated as "securities." As SEC decisions are entitled to considerable deference, such a determination need only be reasonable in order to be upheld. The Court explained that the Securities Act is ambiguous and that the SEC's

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[2] *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1987). The Supreme Court denied the petition for a writ of certiorari.
[3] *See SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959). *See also SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

interpretation was reasonable because indexed annuities expose policyholders to significant investment risk. However, the Court found that the SEC is required to determine whether the action "is necessary or appropriate in the public interest" in order to protect investors and whether it promotes efficiency, competition and capital formation in the insurance industry under Section 2(b) of the Securities Act when adopting Rule 151A. Because the SEC failed to do so in its analysis, its determination was arbitrary and capricious. Because the Court found that the SEC acted reasonably, the Court did not void Rule 151A; instead, the Court remanded the matter for reconsideration. Since the order did not vacate the rule, the January 12, 2011 effective date remained in place.

This effective date prompted insurance industry participants to file petitions requesting that the Court vacate Rule 151A, so that they could avoid having to prepare for compliance prior to the conclusion of the SEC's study and a final SEC decision regarding the rule. On December 8, 2009, the SEC stated in a filing with the Court that it agreed to stay the effective date for "two years after completion of all proceedings on remand, to run from publication of a retained or reissued Rule 151A in the Federal Register." The SEC also stated that it anticipated a Staff recommendation on the rule's re-issuance or revision in spring 2010. The Court has not yet ruled on the vacatur request or the SEC's stay of the effective date.

Reaction

The SEC and consumer advocacy groups are concerned that legislation meant to increase investor protections and market integrity would limit SEC jurisdiction over products that the SEC feels require additional regulation. However, state insurance commissioners and insurers are pleased with the Harkin Amendment because indexed annuity products already are regulated by state insurance laws, which they believe adequate for investor protection. The Model Annuity Suitability Regulation was drafted to address concerns raised by consumers and the Financial Regulatory Authority. Given the amount of time that went into crafting the regulation and the fact that it was only adopted in March 2010, state insurance regulators believe that the SEC's reaction to their handling of these products is premature.

For insurers to benefit from the Harkin Amendment, the insurance company must be domiciled in a state that has passed regulations that meet or exceed the minimum requirements established by the Model Annuity Suitability Regulation, or the insurance company must adopt a nationwide internal policy that meets or exceeds the minimum requirements established by the Model Annuity Suitability Regulation. State insurance commissioners who want to maintain jurisdiction over such products will have to work with state legislators to ensure passage of legislation that meets these requirements.

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