Rule 151A After the American Equity Decision: Not Only Isn't It Dead; It Wasn't Even Needed

By John L. Olsen *Tue, Aug 4, 2009*

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Last week, the U.S. Court of Appeals for the 2nd District decided *American Equity Investment Life Insurance Co. et al. v. SEC. (*No. 09-1021). For some observers, this was a "victory" for those who insist that fixed index annuities are not, and should not be considered, "securities," subject to regulation by the SEC (which Rule 151A asserted).

It was not a victory. Rule 151A was not overturned. The Court remanded it to the SEC for "reconsideration," solely because it found that the SEC had not given proper consideration to the rule's effect on "efficiency, competition, and capital formation" in the annuity industry, as required by Sect. 2(b) of the Securities Act of 1933. The SEC is free to re-submit Rule 151A, provided it supplies a "Sect. 2(b) analysis" that satisfies the Court.

Most observers understand this. Curiously, however, few who have written about this case seem to have noticed that *the SEC didn't really need Rule 151A at all!* If its goal was to declare that fixed index annuities are "securities," subject to its authority, it's had the authority to do so for more than two decades—in Rule 151.

Rule 151, which has been on the books for 23 years, and is clarified in SEC Release 33-6645 (May 29, 1986), offers a "safe harbor." Contracts which meet its tests will be deemed to qualify for the Sect. 3(a)(8) exclusion of the Securities Act of 1933 and, thus, will *not* be "securities" (subject to SEC authority). Release 33-6645 includes the following:

> *After reviewing the comments, the Commission has determined that it would be appropriate to extend the rule to permit insurers to make limited use of index features in determining the excess interest rate, so long as the excess rate is not modified more frequently then once per year. The insurer, therefore, would be permitted to specify an index to which it will refer, no more often than annually, to determine the excess rate that it will guarantee under the contract for the next 12-month or longer period. Once determined, the rate of excess interest credited to a particular purchase payment or to the value accumulated under the contract must remain in effect for at least the one-year time period established by the rule.*

In the author's judgment, NO index annuity can pass that test, as ALL index annuities credit interest *retrospectively*. They *can't* credit interest *prospectively* because the index performance on which interest will be based has not happened yet. But that won't satisfy the test cited above, which clearly states that, to qualify for the Rule 151 "safe harbor," an annuity *must* calculate "excess interest" (over and above the

interest rate contractually guaranteed), declare that interest, and *guarantee to credit that rate for at least "the next 12-month or longer period."* The operative word here is "next."

Why, then, did the SEC feel the need to declare, in Rule 151A (over two decades later), that any annuity in which the "excess" interest credited will, "more likely than not," exceed the *guaranteed* rate, will fail to meet the Rule 151 tests and will, therefore, be a "security"?

Why didn't the SEC simply assert the "must calculate interest in advance" test and declare that all fixed index annuities fail it?

I don't know for certain. I haven't met anyone (yet) who does. But I can speculate. Is it possible that the SEC realized that a strict interpretation of the "calculate interest in advance" test would not only leave index annuities outside its safe harbor, but some *non-indexed* contracts as well?

The SEC developed that test because (as it said in Release 33-6645) it believed that retroactive interest declarations shift "investment risk" to the purchaser, and that vehicles that do that are more like "securities" than "insurance." Might it have realized, belatedly, that *checking accounts* that pay interest based on fluctuating money market rates (and that do not guarantee the current rate for an entire year) work the same way, and that declaring those instruments to be "securities" would be going altogether too far?

Whatever its reasons, the SEC hasn't asserted the 151 test (to this author's knowledge). But now that 151A has been remanded to it for a reconsideration that will probably require considerable time, effort, and expense to do properly, might it now decide to do so?

I wouldn't be at all surprised.

So, where's that leave those who don't want to have to satisfy SEC rules (whatever they'll be)—and FINRA rules (whatever they'll be)—in offering fixed index annuities to their clients?

It leaves us with a *lot* of work to do.

The task for those who oppose SEC regulation of index annuities is, in my opinion, not a firm resistance to a "reconsidered" Rule 151A, but an *overturning* of the 23-year-old Rule 151 (at least, to the extent of the interest rate crediting provision cited above). Congress might produce that result if HR 2733 or S 1389, or something similar, becomes law. But I won't hold my breath waiting for that to happen.

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