Will SEC Rustle Insurers' Cash Cow?

By Editor Test *Wed, Jul 29, 2009*

A federal appeals court has ruled that index annuities are risky enough to be called securities, but it also gave insurance forces time to pursue a legislative remedy in this regulatory turf war.

Not much was permanently resolved last week by a federal appellate court's decision in the matter of *American Equity Investment Life et al. v. the Securities and Exchange Commission*, in which the fixed indexed annuity (FIA) industry is challenging the SEC's right to regulate its product.

Yet the ruling, which sent the case back—"remanded" it, in legalese—to the SEC for revision, was significant.

On the one hand, the D.C. Court of Appeals affirmed the SEC's primary contention that FIAs are too risky not to be regulated as securities. But the court rejected as "flawed" the SEC's contention that Rule 151A will stimulate rather than reduce competition in the FIA space.

The decision could push back the anticipated January 2011 start date for Rule 151A indefinitely—and give insurance companies and the National Association of Insurance Commissioners (NAIC) more time to pursue legislation that would put FIAs beyond the SEC's reach.

For now, the status quo prevails. Insurance agents without security licenses can sell FIAs, which are structured products consisting of bonds and S&P Index options. Insurance-licensed registered reps can sell them too, but must submit their sales to their broker-dealers for approval.

There's upwards of $1 billion in commissions at stake. The insurance industry maintains that FIAs are legally its cash cow. It accuses broker dealers and the SEC—privately, not publicly—of using regulatory reform as a pretext to rustle that cow.

Hence the court's focus on economic factors. "In June of 2008 I wrote, 'the proposal could result in a loss of $852 million to insurance industry distribution channels," said Jack Marrion, a behavioral finance consultant and author of *Index Annuities: Power and Protection*.

"'Most of this loss would be incurred by small entities, and it would result in a major increase in costs for insurance agents.' It was on this basis that 151A was sent back for SEC to assess the economic damage 151A might cause," he added.

The July 21 ruling "is a setback for the SEC," said Sheryl Moore, president and CEO of AnnuitySpecs.com, which compiles index annuity product profiles and other data. "They are going to have extreme difficulty attempting to prove that Rule 151A improves 'competition, efficiency, and capital formation.' Regarding competition specifically, the number of carriers and products in this market has steadily declined since FINRA issued the Notice to Members 05-50 in August of 2005.

"This is not a victory for the indexed annuity industry, but it has given us time," she added. "Now, it is more important than ever for the indexed annuity distribution to get face time with their legislators; call and write in support of HR 2733 and S 1389. These bills will ensure that indexed annuities continue to be regulated as fixed insurance products."

Meeting the court's demand for a demonstration that Rule 151A doesn't restrain trade will be "a formidable and time-consuming task, and there is no assurance that the court will find that the SEC's follow-up meets the statutory standard," agreed securities and insurance law expert Joan Boros, of the Washington law firm, Jorden Burt, said in a prepared statement.

"The task, among other things, may require the SEC to subject its review to still another round of public comment. In view of the current pressures on the SEC regarding proposed financial regulatory reform, it is quite uncertain whether (and when) the SEC will choose to assume these tasks," she wrote.

Marrion expressed the same doubts. "The SEC could revisit this area and conduct a thorough analysis on the economic effects and try this again, but I don't think they will," he said.

"First, the SEC plate is a little fuller than it was last summer with other regulatory needs—since the lack of SEC oversight has been blamed for billions of dollars in securities losses it is harder to justify attacking an instrument that protects against loss. Second, there are active bills in Congress that, if passed, would mandate index annuities are not securities, so SEC could wind up simply wasting their time in an area they may not control.

"Third, the issue that was the real reason 151A was passed—that index annuity sellers are unregulated cowboys—is being handled. FINRA has effectively back-doored putting supervision on index annuities by making broker dealers responsible for supervising rep sales of *all* products, whether securities or not.

"In addition, NAIC is quickly moving forward on new suitability regulations that could cause the agent and supervising marketing company to lose their insurance license for an unsuitable annuity sale. The unregulated sales issue is being addressed," he added.

As the FIA industry tries to persuade Congress to protect its product from the securities industry, it's unclear what weight the appellate court's ruling that index annuities are risky assets will carry, if any. In their ruling, the three-judge panel of the D.C. Court of Appeals offered the following reasoning.

"In petitioners' view, investment risk exists only where the purchaser of a security faces the possibility of a loss of principal. Petitioners' view is certainly a defensible one. However, that is not sufficient to establish that the SEC's rule is arbitrary or capricious.

"As the SEC points out, comparing two slightly different annuity products—one with a 5% interest rate guaranteed ahead of time; one with an interest rate that could be between one and 10% determined at the end of the year—the second product is riskier than the first product because its potential return could be lower than the rate of return from the first product, even though it guarantees a minimum return rate of at least one percent.

“Indeed,” the ruling continued, “the key characteristic of FIAs is that they offer a wide range of potential yearly return interest rates based on the performance of a securities index. This potential for a greater rate of return is what makes FIAs potentially more enticing than those exempt annuities that guarantee an interest rate ahead of time but at a lower rate. As we have noted above, this key distinction between these two products shows that FIAs are more like securities from a risk perspective than other annuity contracts.”