Federal Register

NATIONAL ARCHIVES AND RECORDS ADMINISTRATION
LITTERA SCRIPTA MANET
1985

Tuesday,
July 1, 2008

Part VI

Securities and Exchange Commission

17 CFR Parts 230 and 240
Indexed Annuities and Certain Other Insurance Contracts; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230 and 240

[Release Nos. 33–8933, 34–58022; File No. S7–14–08]

RIN 3235–AK16

Indexed Annuities and Certain Other Insurance Contracts

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing a new rule that would define the terms ''annuity contract'' and ''optional annuity contract'' under the Securities Act of 1933. The proposed rule is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. The proposed rule would apply on a prospective basis to contracts issued on or after the effective date of the rule. We are also proposing to exempt insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, provided that the securities are regulated under state insurance law, the issuing insurance company and its financial condition are subject to supervision and examination by a state insurance regulator, and the securities are not publicly traded.

DATES: Comments should be received on or before September 10, 2008.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

• Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*);

• Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–14–08 on the subject line; or

• Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

• Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–14–08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Michael L. Kosoff, Attorney, or Keith E. Carpenter, Senior Special Counsel, Office of Disclosure and Insurance Products Regulation, Division of Investment Management, at (202) 551–6795, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–5720.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') is proposing to add rule 151A under the Securities Act of 1933 (''Securities Act'') [1] and rule 12h–7 under the Securities Exchange Act of 1934 (''Exchange Act'').[2]

Table of Contents

I. EXECUTIVE SUMMARY
II. BACKGROUND
A. Description of Indexed Annuities
B. Marketing of Indexed Annuities
C. Section 3(a)(8) Exemption
III. DISCUSSION OF THE PROPOSED AMENDMENTS
A. Definition of Annuity Contract
B. Exchange Act Exemption for Securities that Are Regulated as Insurance
IV. GENERAL REQUEST FOR COMMENTS
V. PAPERWORK REDUCTION ACT
VI. COST/BENEFIT ANALYSIS
VII. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION; CONSIDERATION OF BURDEN ON COMPETITION
VIII. INITIAL REGULATORY FLEXIBILITY ANALYSIS
IX. CONSIDERATION OF IMPACT ON THE ECONOMY
X. STATUTORY AUTHORITY
TEXT OF PROPOSED RULES

I. Executive Summary

We are proposing a new rule that is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption under the Securities Act for certain insurance contracts. The proposed rule would prospectively define certain indexed annuities as not being ''annuity contracts'' or ''optional annuity contracts'' under this insurance exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The proposed definition would hinge upon a familiar concept: The allocation of risk. Insurance provides protection against risk, and the courts have held that the allocation of investment risk is a significant factor in distinguishing a security from a contract of insurance. The Commission has also recognized that the allocation of investment risk is significant in determining whether a particular contract that is regulated as insurance under state law is insurance for purposes of the federal securities laws.

Individuals who purchase indexed annuities are exposed to a significant investment risk—*i.e.,* the volatility of the underlying securities index. Insurance companies have successfully utilized this investment feature, which appeals to purchasers not on the usual insurance basis of stability and security, but on the prospect of investment growth. Indexed annuities are attractive to purchasers because they promise to offer market-related gains. Thus, these purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.

When the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract, the majority of the investment risk for the fluctuating, equity-linked portion of the return is borne by the individual purchaser, not the insurer. The individual underwrites the effect of the underlying index's performance on his or her contract investment and assumes the majority of the investment risk for the equity-linked returns under the contract.

The federal interest in providing investors with disclosure, antifraud, and sales practice protections arises when individuals are offered indexed annuities that expose them to securities investment risk. Individuals who purchase such indexed annuities assume many of the same risks and rewards that investors assume when investing their money in mutual funds, variable annuities, and other securities. However, a fundamental difference

[1] 15 U.S.C. 77a *et seq.*

[2] 15 U.S.C. 78a *et seq.*

between these securities and indexed annuities is that—with few exceptions—indexed annuities historically have not been registered as securities. As a result, most purchasers of indexed annuities have not received the benefits of federally mandated disclosure and sales practice protections.

We have determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws would enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. Accordingly, we are proposing a new definition of ''annuity contract'' that, on a prospective basis, would define a class of indexed annuities that are outside the scope of section 3(a)(8). With respect to these annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections.

We are aware that many insurance companies, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this release. Under these circumstances, we do not believe that insurance companies should be subject to any additional legal risk relating to their past offers and sales of indexed annuities as a result of our proposal today or its eventual adoption. Therefore, we are also proposing that the new definition apply prospectively only—that is, only to indexed annuities that are issued on or after the effective date of our final rule.

Finally, we are proposing a new exemption from Exchange Act reporting that would apply to insurance companies with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors. Where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law, and where there is no trading interest in an insurance contract, the concerns that periodic and current financial disclosures are intended to address are generally not implicated. Rather, investors who purchase these securities are primarily affected by issues relating to the insurer's financial ability to satisfy its contractual obligations—issues that are addressed by state law and regulation.

II. Background

Beginning in the mid-1990s, the life insurance industry introduced a new type of annuity, referred to as an ''equity-indexed annuity,'' or, more recently, ''fixed indexed annuity'' (herein ''indexed annuity''). Amounts paid by the insurer to the purchaser of an indexed annuity are based, in part, on the performance of an equity index or another securities index, such as a bond index.

The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court.[3] Insurers have typically marketed and sold indexed annuities without complying with the federal securities laws, and sales of the products have grown dramatically in recent years. This growth has, unfortunately, been accompanied by growth in complaints of abusive sales practices. These include claims that the often-complex features of these annuities have not been adequately disclosed to purchasers, as well as claims that rapid sales growth has been fueled by the payment of outsize commissions that are funded by high surrender charges imposed over long periods, which can make these annuities particularly unsuitable for seniors and others who may need ready access to their assets.

We have observed the development of indexed annuities for some time, and we have become persuaded that guidance is needed with respect to their status under the federal securities laws. Today, we are proposing rules that are intended to provide greater clarity regarding the scope of the exemption provided by section 3(a)(8). We believe our proposed action is consistent with Congressional intent in that the proposed definition would afford the disclosure and sales practice protections of the federal securities laws to purchasers of indexed annuities who are more likely than not to receive payments that vary in accordance with the performance of a security. In addition, the proposed rules are intended to provide regulatory certainty and relief from Exchange Act reporting obligations to the insurers that issue these indexed annuities and certain other securities that are regulated as insurance under state law. We base our proposed exemption on two factors: First, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of these activities and assets under state insurance law; and, second, the absence of trading interest in the securities.

A. Description of Indexed Annuities

An indexed annuity is a contract issued by a life insurance company that generally provides for accumulation of the purchaser's payments, followed by payment of the accumulated value to the purchaser either as a lump sum, upon death or withdrawal, or as a series of payments (an ''annuity''). During the accumulation period, the insurer credits the purchaser with a return that is based on changes in a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. The insurer also guarantees a minimum value to the purchaser.[4]

Life insurance companies began offering indexed annuities in the mid-1990s.[5] Sales of indexed annuities for 1998 totaled $4 billion and grew each year through 2005, when sales totaled $27.2 billion.[6] Indexed annuity sales for 2006 totaled $25.4 billion and $24.8 billion in 2007.[7] In 2007, indexed annuity assets totaled $123 billion, 58 companies were issuing indexed annuities, and there were a total of 322 indexed annuities offered.[8] The specific features of indexed annuities vary from product to product. Some of the key features are as follows.

Computation of Index-Based Return

The purchaser's index-based return under an indexed annuity depends on the particular combination of features specified in the contract. Typically, an indexed annuity specifies all aspects of the formula for computing return in

[3] *SEC* v. *Variable Annuity Life Ins. Co.,* 359 U.S. 65 (1959) (''*VALIC*''); *SEC* v. *United Benefit Life Ins. Co.,* 387 U.S. 202 (1967) (''*United Benefit*'').

[4] Financial Industry Regulatory Authority, Inc. (''FINRA''), *Equity-Indexed Annuities—A Complex Choice* (updated Apr. 22, 2008), available at: *http://www.finra.org/InvestorInformation/InvestorAlerts/AnnuitiesandInsurance/Equity-IndexedAnnuities-AComplexChoice/P010614;* National Association of Insurance Commissioners, *Buyer's Guide to Fixed Deferred Annuities with Appendix for Equity-Indexed Annuities,* at 9 (2007); National Association for Fixed Annuities, *White Paper on Fixed Indexed Insurance Products Including 'Fixed Indexed Annuities' and Other Fixed Indexed Insurance Products,* at 1 (2006), available at: *http://www.nafa.us/pdfs/White%20Paper%20Final_11-10-06_All%20Inquiries.pdf;* Jack Marrion, *Index Annuities: Power and Protection,* at 13 (2004).

[5] *See* National Association for Fixed Annuities, *supra* note 4, at 4.

[6] NAVA, *2008 Annuity Fact Book,* 57 (2008).

[7] *Id.*

[8] *Id.*

advance of the period for which return is to be credited, and the crediting period is generally at least one year long.[9] The rate of the index-based return is computed at the end of the crediting period, based on the actual performance of a specified securities index during that period, but the computation is performed pursuant to a mathematical formula that is guaranteed in advance of the crediting period. Common indexing features are described below.

• *Index.* Indexed annuities credit return based on the performance of a securities index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index. Some annuities permit the purchaser to select one or more indices from a specified group of indices.

• *Determining Change in Index.* There are several methods for determining the change in the relevant index over the crediting period.[10] For example, the ''point-to-point'' method compares the index level at two discrete points in time, such as the beginning and ending dates of the crediting period. Another method, sometimes referred to as ''monthly point-to-point,'' combines both positive and negative changes in the index values from one month to the next during the crediting period and recognizes the aggregate change as the amount of index credit for the period, if it is positive. Another method compares an average of index values at periodic intervals during the crediting period to the index value at the beginning of the period. Typically, in determining the amount of index change, dividends paid on securities underlying the index are not included. Indexed annuities typically do not apply negative changes in an index to contract value. Thus, if the change in index value is negative over the course of a crediting period, no deduction is taken from contract value nor is any index-based return credited.[11]

• *Portion of Index Change to be Credited.* The portion of the index change to be credited under an indexed annuity is typically determined through the application of caps, participation rates, spread deductions, or a combination of these features.[12] Some contracts ''cap'' the index-based returns that may be credited. For example, if the change in the index is 6%, and the contract has a 5% cap, 5% would be credited. A contract may establish a ''participation rate,'' which is multiplied by index growth to determine the rate to be credited. If the change in the index is 6%, and a contract's participation rate is 75%, the rate credited would be 4.5% (75% of 6%). In addition, some indexed annuities may deduct a percentage, or spread, from the amount of gain in the index in determining return. If the change in the index is 6%, and a contract has a spread of 1%, the rate credited would be 5% (6% minus 1%).

Surrender Charges

Surrender charges are commonly deducted from withdrawals taken by a purchaser.[13] The maximum surrender charges, which may be as high as 15–20%,[14] are imposed on surrenders made during the early years of the contract and decline gradually to 0% at the end of a specified surrender charge period, which may be in excess of 15 years. Imposition of a surrender charge may have the effect of reducing or eliminating any index-based return credited to the purchaser up to the time of a withdrawal. In addition, a surrender charge may result in a loss of principal, so that a purchaser who surrenders prior to the end of the surrender charge period may receive less than the original purchase payments.[15] Many indexed annuities permit purchasers to withdraw a portion of contract value each year, typically 10%, without payment of surrender charges.

Guaranteed Minimum Value

Indexed annuities generally provide a guaranteed minimum value, which serves as a floor on the amount paid upon withdrawal, as a death benefit, or in determining the amount of annuity payments. The guaranteed minimum value is typically a percentage of purchase payments, accumulated at a specified interest rate, and may not be lower than a floor established by applicable state insurance law. Indexed annuities typically provide that the guaranteed minimum value is equal to at least 87.5% of purchase payments, accumulated at annual interest rate of between 1% and 3%.[16] Assuming a guarantee of 87.5% of purchase payments, accumulated at 1% interest compounded annually, it would take approximately 13 years for a purchaser's guaranteed minimum value to be 100% of purchase payments.

Registration

Insurers typically have concluded that the indexed annuities they issue are not securities. As a result, virtually all indexed annuities have been issued without registration under the Securities Act.[17]

B. Marketing of Indexed Annuities

In the years after indexed annuities were first introduced, sales volumes were relatively small. In 1998, when sales totaled $4 billion, the impact of these products on both purchasers and issuing insurance companies was limited. As sales have grown in more recent years, with sales of $24.8 billion and total indexed annuity assets of $123 billion in 2007, these products have affected larger and larger numbers of purchasers. They have also become an increasingly important business line for some insurers.[18] In addition, in recent

---

[9] National Association for Fixed Annuities, *supra* note 4, at 13.

[10] *See* FINRA, *supra* note 4; National Association of Insurance Commissioners, *supra* note 4, at 12–14; National Association for Fixed Annuities, *supra* note 4, at 9–10; Marrion, *supra* note 4, at 38–59.

[11] National Association of Insurance Commissioners, *supra* note 4, at 11; National Association for Fixed Annuities, *supra* note 4, at 5 and 9; Marrion, *supra* note 4, at 2.

[12] *See* FINRA, *supra* note 4; National Association of Insurance Commissioners, *supra* note 4, at 10–11; National Association for Fixed Annuities, *supra* note 4, at 10; Marrion, *supra* note 4, at 38–59.

[13] *See* FINRA, *supra* note 4; National Association of Insurance Commissioners, *supra* note 4, at 3–4 and 11; National Association for Fixed Annuities, *supra* note 4, at 7; Marrion, *supra* note 4, at 31.

[14] The highest surrender charges are often associated with annuities in which the insurer credits a ''bonus'' equal to a percentage of purchase payments to the purchaser at the time of purchase. The surrender charge may serve, in part, to recapture the bonus.

[15] FINRA, *supra* note 4; Marrion, *supra* note 4, at 31.

[16] National Association for Fixed Annuities, *supra* note 4, at 6.

[17] In a few instances, insurers have registered indexed annuities as securities as a result of particular features, such as the absence of any guaranteed interest rate or the absence of a guaranteed minimum value. *See, e.g.,* Pre-Effective Amendment No. 4 to Registration Statement on Form S–1 of PHL Variable Insurance Company (File No. 333–132399) (filed Feb. 7, 2007); Pre-Effective Amendment No. 1 to Registration Statement on Form S–3 of Allstate Life Insurance Company (File No. 333–105331) (filed May 16, 2003); Initial Registration Statement on Form S–2 of Golden American Life Insurance Company (File No. 333–104547) (filed Apr. 15, 2003).

[18] *See, e.g.,* Allianz Life Insurance Company of North America (Best's Company Reports, Allianz Life Ins. Co. of N. Am., Dec. 3, 2007) (Indexed annuities represent approximately two-thirds of gross premiums written.); American Equity Investment Life Holding Company (Annual Report on Form 10–K, at F–16 (Mar. 14, 2008)) (Indexed annuities accounted for approximately 97% of total purchase payments in 2007.); Americo Financial Life and Annuity Insurance Company (Best's Company Reports, Americo Fin. Life and Annuity Ins. Co., Jul. 10, 2007) (Indexed annuities represent over eighty percent of annuity premiums and almost half of annuity reserves.); Aviva USA Group (Best's Company Reports, AmerUs Life Insurance Company, Nov. 6, 2007) (Indexed annuity sales represent more than 90% of total annuity production.); Conseco Insurance Group (CIG) (Best's Company Reports, Conseco Ins. Group, Nov. 7, 2008) (CIG's business was heavily weighted toward indexed annuities, which contributed approximately 77% of new first year premiums.); Investors Insurance Corporation (IIC) (Best's Company Reports, Investors Ins. Corp., Aug. 20, 2007) (IIC's primary product has been indexed

years, guarantees provided by indexed annuities have been reduced. In the years immediately following their introduction, indexed annuities typically guaranteed 90% of purchase payments accumulated at 3% annual interest.[19] More recently, however, following changes in state insurance laws,[20] guarantees in indexed annuities have been as low as 87.5% of purchase payments accumulated at 1% annual interest.[21]

At the same time that sales of indexed annuities have increased and guarantees within the products have been reduced, concerns about potentially abusive sales practices and inadequate disclosure have grown. In August 2005, NASD[22] issued a Notice to Members in which it cited its concerns about the manner in which persons associated with broker-dealers were marketing unregistered indexed annuities and the absence of adequate supervision of those sales practices.[23] The Notice to Members also expressed NASD's concern with indexed annuity sales materials that do not fully describe the features and risks of the products. Citing uncertainty as to whether indexed annuities are subject to the federal securities laws, NASD encouraged member firms to supervise transactions in these products as though they are securities.

At the Senior Summit held at the Commission in July 2006, at which securities regulators and others met to explore how to coordinate efforts to protect older Americans from abusive sales practices and securities fraud, concerns were cited about sales of indexed annuities to seniors.[24] Patricia Struck, then President of the North American Securities Administrators Association (''NASAA''), identified indexed annuities as among the most pervasive products involved in senior investment fraud.[25] In a joint examination conducted by the Commission, NASAA, and the Financial Industry Regulatory Authority, Inc. (''FINRA'') of ''free lunch'' seminars that are aimed at selling financial products, often to seniors, with a free meal as enticement, examiners identified potentially misleading sales materials and potential suitability issues relating to the products discussed at the seminars, which commonly included indexed annuities.[26]

C. Section 3(a)(8) Exemption

Section 3(a)(8) of the Securities Act provides an exemption for any ''annuity contract'' or ''optional annuity contract'' issued by a corporation that is subject to the supervision of the insurance commissioner, bank commissioner, or similar state regulatory authority.[27] The exemption, however, is not available to all contracts that are considered annuities under state insurance law. For example, variable annuities, which pass through to the purchaser the investment performance of a pool of assets, are not exempt annuity contracts.

The U.S. Supreme Court has addressed the insurance exemption on two occasions.[28] Under these cases, factors that are important to a determination of an annuity's status under section 3(a)(8) include (1) the allocation of investment risk between insurer and purchaser, and (2) the manner in which the annuity is marketed.

With regard to investment risk, beginning with *SEC* v. *Variable Annuity Life Ins. Co. (''VALIC''),*[29] the Court has considered whether the risk is borne by the purchaser (tending to indicate that the product is not an exempt ''annuity contract'') or by the insurer (tending to indicate that the product falls within the Section 3(a)(8) exemption). In *VALIC,* the Court determined that variable annuities, under which payments varied with the performance of particular investments and which provided no guarantee of fixed income, were not entitled to the section 3(a)(8) exemption. In *SEC* v. *United Benefit Life Ins. Co. (''United Benefit''),*[30] the Court extended the *VALIC* reasoning, finding that a contract that provides for some assumption of investment risk by the insurer may nonetheless not be entitled to the section 3(a)(8) exemption. The *United Benefit* insurer guaranteed that the cash value of its variable annuity contract would never be less than 50% of purchase payments made and that, after ten years, the value would be no less than 100% of payments. The Court determined that this contract, under which the insurer did assume some investment risk through minimum guarantees, was not an ''annuity contract'' under the federal securities laws. In making this determination, the Court concluded that ''the assumption of an investment risk cannot by itself create an insurance provision under the federal definition'' and distinguished a ''contract which to some degree is insured'' from a ''contract of insurance.''[31]

In analyzing investment risk, Justice Brennan's concurring opinion in *VALIC* applied a functional analysis to determine whether a new form of

annuities.); Life Insurance Company of the Southwest (''LSW'') (Best's Company Reports, Life Ins. Co. of the Southwest, Jun. 28, 2007) (LSW specializes in the sale of annuities, primarily indexed annuities.); Midland National Life Insurance Company (Best's Company Reports, Midland Nat'l Life Ins. Co., Jan. 24, 2008) (Sales of indexed annuities in recent years has been the principal driver of growth in annuity deposits.).

[19] Securities Act Release No. 7438 (Aug. 20, 1997) [62 FR 45359, 45360 (Aug. 27, 1997)] (concept release requesting comments on structure of equity indexed insurance products, the manner in which they are marketed, and other matters the Commission should consider in addressing federal securities law issues raised by these products) (''1997 Concept Release''). *See also* Letter from American Academy of Actuaries (Jan. 5, 1998); Letter from Aid Association for Lutherans (Nov. 19, 1997) (comment letters in response to 1997 Concept Release). The comment letters on the 1997 Concept Release are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC (File No. S7–22–97). Some of the comment letters are also available on the Commission's Web site at *http://www.sec.gov/rules/concept/s72297.shtml.*

[20] *See, e.g.,* Cal. Ins. Code § 10168.25 (West 2007) (current requirements, providing for guarantee based on 87.5% of purchase payments accumulated at minimum of 1% annual interest); Cal. Ins. Code § 10168.2 (West 2003) (former requirements, providing for guarantee for single premium annuities based on 90% of premium accumulated at minimum of 3% annual interest).

[21] *See A Producer's Guide to Indexed Annuities 2006,* Life Insurance Selling (Jun. 2006), available at: *http://www.lifeinsuranceselling.com/Media/MediaManager/6IAsurveyforweb3.pdf.*

[22] In July 2007, NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange were consolidated to create FINRA. The NASD materials cited in this release were issued prior to the creation of FINRA.

[23] *NASD, Equity-Indexed Annuities, Notice to Members 05–50* (Aug. 2005), available at: *http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p014821.pdf.*

See also FINRA, *supra* note 4 (investor alert on indexed annuities, stating that indexed annuities are ''anything but easy to understand'').

[24] The average age of issuance for indexed annuities has been reported to be 64. Advantage Compendium, *4th Quarter Index Annuity Sales Slip* (Mar. 2008), available at: *http://www.indexannuity.org/ic2008.htm#4q07.*

[25] Statement of Patricia Struck, President, NASAA, at the Senior Summit of the United States Securities and Exchange Commission, July 17, 2006, available at: *http://www.nasaa.org/IssuesAnswers/Legislative Activity/Testimony/4999.cfm.*

[26] Office of Compliance Inspections and Examinations, Securities and Exchange Commission, *et al., Protecting Senior Investors: Report of Examinations of Securities Firms Providing ''Free Lunch'' Sales Seminars,* at 4 (Sept. 2007), available at: *http://www.sec.gov/spotlight/seniors/freelunchreport.pdf.*

[27] The Commission has previously stated its view that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from the registration but not the antifraud provisions. Securities Act Release No. 6558 (Nov. 21, 1984) [49 FR 46750, 46753 (Nov. 28, 1984)]. *See also Tcherepnin* v. *Knight,* 389 U.S. 332, 342 n.30 (1967) (Congress specifically stated that ''insurance policies are not to be regarded as securities subject to the provisions of the [Securities] act,'' (*quoting* H.R. Rep. 85, 73d Cong., 1st Sess. 15 (1933)).

[28] *VALIC, supra* note 3, 359 U.S. 65; *United Benefit, supra* note 3, 387 U.S. 202.

[29] *VALIC, supra* note 3, 359 U.S. at 71–73.

[30] *United Benefit, supra* note 3, 387 U.S. at 211.

[31] *Id.* at 211.

investment arrangement that emerges and is labeled ''annuity'' by its promoters is the sort of arrangement that Congress was willing to leave exclusively to the state insurance commissioners. In that inquiry, the purposes of the federal securities laws and state insurance laws are important. Justice Brennan noted, in particular, that the emphasis in the Securities Act is on disclosure and that the philosophy of the Act is that ''full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.'' [32] Where an investor's investment in an annuity is sufficiently protected by the insurer, state insurance law regulation of insurer solvency and the adequacy of reserves are relevant. Where the investor's investment is not sufficiently protected, the disclosure protections of the Securities Act assume importance.

Marketing is another significant factor in determining whether a state-regulated insurance contract is entitled to the Securities Act ''annuity contract'' exemption. In *United Benefit,* the U.S. Supreme Court, in holding an annuity to be outside the scope of section 3(a)(8), found significant the fact that the contract was ''considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management.'' [33] Under these circumstances, the Court concluded ''it is not inappropriate that promoters' offerings be judged as being what they were represented to be.'' [34]

In 1986, given the proliferation of annuity contracts commonly known as ''guaranteed investment contracts,'' the Commission adopted rule 151 under the Securities Act to establish a ''safe harbor'' for certain annuity contracts that are not deemed subject to the federal securities laws and are entitled to rely on section 3(a)(8) of the Securities Act.[35] Under rule 151, an annuity contract issued by a state-regulated insurance company is deemed to be within section 3(a)(8) of the Securities Act if (1) the insurer assumes the investment risk under the contract in the manner prescribed in the rule; and (2) the contract is not marketed primarily as an investment.[36] Rule 151 essentially codifies the tests the courts have used to determine whether an annuity contract is entitled to the section 3(a)(8) exemption, but adds greater specificity with respect to the investment risk test. Under rule 151, an insurer is deemed to assume the investment risk under an annuity contract if, among other things,

(1) The insurer, for the life of the contract,

(a) guarantees the principal amount of purchase payments and credited interest, less any deduction for sales, administrative, or other expenses or charges; and

(b) credits a specified interest rate that is at least equal to the minimum rate required by applicable state law; and

(2) The insurer guarantees that the rate of any interest to be credited in excess of the guaranteed minimum rate described in paragraph 1(b) will not be modified more frequently than once per year.[37]

Indexed annuities are not entitled to rely on the safe harbor of rule 151 because they fail to satisfy the requirement that the insurer guarantee that the rate of any interest to be credited in excess of the guaranteed minimum rate will not be modified more frequently than once per year.[38]

III. Discussion of the Proposed Amendments

The Commission has determined that providing greater clarity with regard to the status of indexed annuities under the federal securities laws would enhance investor protection, as well as provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are proposing a new definition of ''annuity contract'' that, on a prospective basis, would define a class of indexed annuities that are outside the scope of section 3(a)(8). With respect to these annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections. We are also proposing a new exemption under the Exchange Act that would apply to insurance companies that issue indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law. We believe that this exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the presence of state oversight of insurance company financial condition and the absence of trading interest in these securities.

A. Definition of Annuity Contract

The Commission is proposing new rule 151A, which would define a class of indexed annuities that are not ''annuity contracts'' or ''optional annuity contracts'' [39] for purposes of section 3(a)(8) of the Securities Act. Although we recognize that these instruments are issued by insurance companies and are treated as annuities under state law, these facts are not conclusive for purposes of the analysis under the federal securities laws.

---

[32] *VALIC, supra* note 3, 359 U.S. at 77.

[33] *United Benefit, supra* note 3, 387 U.S. at 211.

[34] *Id.* at 211 (quoting *SEC* v. *Joiner Leasing Corp.,* 320 U.S. 344, 352–53 (1943)). For other cases applying a marketing test, see *Berent* v. *Kemper Corp.,* 780 F. Supp. 431 (E.D. Mich. 1991), *aff'd,* 973 F. 2d 1291 (6th Cir. 1992); *Associates in Adolescent Psychiatry* v. *Home Life Ins. Co.,* 729 F.Supp. 1162 (N.D. Ill. 1989), *aff'd,* 941 F.2d 561 (7th Cir. 1991); and *Grainger* v. *State Security Life Ins. Co.,* 547 F.2d 303 (5th Cir. 1977).

[35] 17 CFR 230.151; Securities Act Release No. 6645 (May 29, 1986) [51 FR 20254 (June 4, 1986)]. A guaranteed investment contract is a deferred annuity contract under which the insurer pays interest on the purchaser's payments at a guaranteed rate for the term of the contract. In some cases, the insurer also pays discretionary interest in excess of the guaranteed rate.

[36] 17 CFR 230.151(a).

[37] 17 CFR 230.151(b) and (c). In addition, the value of the contract may not vary according to the investment experience of a separate account.

[38] Some indexed annuities also may fail other aspects of the safe harbor test.

In adopting rule 151, the Commission declined to extend the safe harbor to excess interest rates that are computed pursuant to an indexing formula that is guaranteed for one year. Rather, the Commission determined that it would be appropriate to permit insurers to make limited use of index features, provided that the insurer specifies an index to which it would refer, no more often than annually, to determine the excess interest rate that it would guarantee for the next 12-month or longer period. For example, an insurer would meet this test if it established an ''excess'' interest rate of 5% by reference to the past performance of an external index and then guaranteed to pay 5% interest for the coming year. Securities Act Release No. 6645, *supra* note 35, 51 FR at 20260. The Commission specifically expressed concern that index feature contracts that adjust the rate of return actually credited on a more frequent basis operate less like a traditional annuity and more like a security and that they shift to the purchaser all of the investment risk regarding fluctuations in that rate.

The only judicial decision that we are aware of regarding the status of indexed annuities under the federal securities laws is a district court case that concluded that the contracts at issue in the case fell within the Commission's Rule 151 safe harbor notwithstanding the fact that they apparently did not meet the limited test described above, i.e., specifying an index that would be used to determine a rate that would remain in effect for at least one year. Instead, the contracts appear to have guaranteed the index-based formula, but not the actual rate of interest. *See Malone* v. *Addison Ins. Marketing, Inc.,* 225 F.Supp.2d 743, 751–754 (W.D. Ky. 2002).

[39] An ''optional annuity contract'' is a deferred annuity. *See United Benefit, supra* note 3, 387 U.S. at 204. In a deferred annuity, annuitization begins at a date in the future, after assets in the contract have accumulated over a period of time (normally many years). In contrast, in an immediate annuity, the insurer begins making annuity payments shortly after the purchase payment is made; *i.e.,* within one year. *See* Kenneth Black, Jr., and Harold D. Skipper, Jr., *Life and Health Insurance,* at 164 (2000).

1. Analysis

''Insurance'' and ''Annuity'': Federal Terms under the Federal Securities Laws

Our analysis begins with the well-settled conclusion that the terms ''insurance'' and ''annuity contract'' as used in the Securities Act are ''federal terms,'' the meanings of which are a ''federal question'' under the federal securities laws.[40] The Securities Act does not provide a definition of either term, and we have not previously provided a definition that applies to indexed annuities.[41] Moreover, indexed annuities did not exist and were not contemplated by Congress when it enacted the insurance exemption.

We therefore analyze indexed annuities under the facts and circumstances factors articulated by the U.S. Supreme Court in *VALIC* and *United Benefit.* In particular, we focus on whether these instruments are ''the sort of investment form that Congress was * * * willing to leave exclusively to the State Insurance Commissioners'' and whether they necessitate the ''regulatory and protective purposes'' of the Securities Act.[42]

Type of Investment

We believe that the indexed annuities that would be included in our proposed definition are not the sort of investment that Congress contemplated leaving exclusively to state insurance regulation. According to the U.S. Supreme Court, Congress intended to include in the insurance exemption only those policies and contracts that include a ''true underwriting of risks'' and ''investment risk-taking'' by the insurer.[43] Moreover, the level of risk assumption necessary for a contract to be ''insurance'' under the Securities Act must be meaningful—the assumption of an investment risk does not ''by itself create an insurance provision under the federal definition.''[44]

The annuities that ''traditionally and customarily'' were offered at the time Congress enacted the insurance exemption were fixed annuities that typically involved no investment risk to the purchaser.[45] These contracts offered the purchaser ''specified and definite amounts beginning with a certain year of his or her life,'' and the ''standards for investments of funds'' by the insurer under these contracts were ''conservative.''[46] Moreover, these types of annuity contracts were part of a ''concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.''[47] Thus, Congress exempted these instruments from the requirements of the federal securities laws because they were a ''form of 'investment' * * * which did not present very squarely the problems that [the federal securities laws] were devised to deal with,'' and were ''subject to a form of state regulation of a sort which made the federal regulation even less relevant.''[48]

In contrast, when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the amounts guaranteed under the contract, the purchaser assumes substantially different risks and benefits. Notably, at the time that such a contract is purchased, the risk for the unknown, unspecified, and fluctuating securities-linked portion of the return is primarily assumed by the purchaser.

By purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns. The value of such an indexed annuity reflects the benefits and risks inherent in the securities market, and the contract's value depends upon the trajectory of that same market. Thus, the purchaser obtains an instrument that, by its very terms, depends on market volatility and risk.

Such indexed annuity contracts provide some protection against the risk of loss, but these provisions do not, ''by [themselves,] create an insurance provision under the federal definition.''[49] Rather, these provisions reduce—but do not eliminate—a purchaser's exposure to investment risk under the contract. These contracts may to some degree be insured, but that degree may be too small to make the indexed annuity a contract of insurance.[50]

Thus, the protections provided by indexed annuities may not adequately transfer investment risk from the purchaser to the insurer when amounts payable by an insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. Purchasers of these annuities assume the investment risk for investments that are more likely than not to fluctuate and move with the securities markets. The value of the purchaser's investment is more likely than not to depend on movements in the underlying securities index. The protections offered in these indexed annuities may give the instruments an aspect of insurance, but we do not believe that these protections are substantial enough.[51]

Need for the Regulatory Protections of the Federal Securities Acts

We also analyze indexed annuities to determine whether they implicate the regulatory and protective purposes of the federal securities laws. Based on that analysis, we believe that the indexed annuities that would be included in our proposed definition present many of the concerns that Congress intended the federal securities laws to address.

Indexed annuities are similar in many ways to mutual funds, variable annuities, and other securities.

[40] *See VALIC, supra* note 3, 359 U.S. at 69.

[41] The last time the Commission formally addressed indexed annuities was in 1997. At that time, the Commission issued a concept release requesting public comment regarding indexed insurance contracts. The concept release stated that ''depending on the mix of features * * * [an indexed insurance contract] may or may not be entitled to exemption from registration under the Securities Act'' and that the Commission was ''considering the status of [indexed annuities and other indexed insurance contracts] under the federal securities laws.'' *See* Concept Release, *supra* note 19, at 4–5.

The Commission has previously adopted a safe harbor for certain annuity contracts that are entitled to rely on section 3(a)(8) of the Securities Act. However, as discussed in Part II.C., indexed annuities are not entitled to rely on the safe harbor.

[42] *See VALIC, supra* note 3, 359 U.S. at 75 (Brennan, J., concurring) (''* * * if a brand-new form of investment arrangement emerges which is labeled 'insurance' or 'annuity' by its promoters, the functional distinction that Congress set up in 1933 and 1940 must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners. In that inquiry, an analysis of the regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed becomes relevant.'').

[43] *Id.* at 71–73.

[44] *See United Benefit, supra* note 3, 387 U.S. at 211 (''[T]he assumption of investment risk cannot by itself create an insurance provision. * * * The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.'').

[45] *See VALIC, supra* note 3, 359 U.S. at 69.

[46] *Id.* (''While all the States regulate 'annuities' under their 'insurance' laws, traditionally and customarily they have been fixed annuities, offering the annuitant specified and definite amounts beginning with a certain year of his or her life. The standards for investment of funds underlying these annuities have been conservative.'').

[47] *Id.* (''Congress was legislating concerning a concept which had taken on its coloration and meaning largely from state law, from state practice, from state usage.'').

[48] *Id.* at 75 (Brennan, J., concurring).

[49] *See United Benefit, supra* note 3, 387 U.S. at 211 (finding that while a ''guarantee of cash value'' provided by an insurer to purchasers of a deferred annuity plan reduced ''substantially the investment risk of the contract holder, the assumption of investment risk cannot by itself create an insurance provision under the federal definition.'').

[50] *Id.* at 211 (''The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.'').

[51] *See VALIC, supra* note 3, 359 U.S. at 71 (finding that although the insurer's assumption of a traditional insurance risk gives variable annuities an ''aspect of insurance,'' this is ''apparent, not real; superficial, not substantial.'').

Although these contracts contain certain features that are typical of insurance contracts,[52] they also may contain ''to a very substantial degree elements of investment contracts.'' [53] Indexed annuities are attractive to purchasers precisely because they offer participation in the securities markets. Thus, individuals who purchase such indexed annuities are ''vitally interested in the investment experience.'' [54] However, indexed annuities historically have not been registered with us as securities. Insurers have treated these annuities as subject only to state insurance laws.

There is a strong federal interest in providing investors with disclosure, antifraud, and sales practice protections when they are purchasing annuities that are likely to expose them to market volatility and risk. We believe that individuals who purchase indexed annuities that are more likely than not to provide payments that vary with the performance of securities are exposed to significant investment risks. They are confronted with many of the same risks and benefits that other securities investors are confronted with when making investment decisions. Moreover, they are more likely than not to experience market volatility.

Accordingly, we believe that the regulatory objectives that Congress was attempting to achieve when it enacted the Securities Act are present when the amounts payable by an insurer under an indexed annuity contract are more likely than not to exceed the guaranteed amounts. Therefore, we are proposing a rule that would define such contracts as falling outside the insurance exemption.

2. Proposed Definition

Scope of the Proposed Definition

Proposed rule 151A would apply to a contract that is 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.[55] This language is the same language used in Section 3(a)(8) of the Securities Act. Thus, the insurance companies that will be covered by the proposed rule are the same as those covered by Section 3(a)(8). In addition, in order to be covered by the proposed rule, a contract must be subject to regulation as an annuity under state insurance law.[56] As a result, the proposed rule does 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, and it does not apply to any contract issued by an insurance company if the contract itself is not subject to regulation under state insurance law.

The proposed rule would expressly state that it does not apply to any contract whose value varies according to the investment experience of a separate account.[57] The effect of this provision is to eliminate variable annuities from the scope of the rule.[58] It has long been established that variable annuities are not entitled to the exemption under Section 3(a)(8) of the Securities Act, and, accordingly, we do not propose to cover them under the new definition or affect their regulation in any way.[59]

We request comment on the scope of the proposed definition and in particular on the following issues:

• Should the rule apply only to contracts that are issued by the same insurance companies that are covered by section 3(a)(8) of the Securities Act, or should the proposed definition apply with respect to contracts of different issuers than those covered by section 3(a)(8)?

• What contracts should be covered by the proposed definition? Should the scope of contracts covered be articulated by reference to state law? Should the proposed definition extend to all annuity contracts, or should any annuity contracts be excluded? Should variable annuity contracts be covered by the proposed definition? Should the proposed definition apply to forms of insurance other than annuities, such as life insurance or health insurance? Should the proposed definition apply to a contract issued by an insurance company if the contract is not itself regulated as insurance under state law?

• Should we permit insurance companies to register indexed annuities, as well as any other annuities that are securities, on Form N–4,[60] the form that is currently used by insurance companies to register variable annuities under the Securities Act? If so, should we modify Form N–4, which is also used by insurance company separate accounts to register under the Investment Company Act, in any way?

Definition of ''Annuity Contract'' and ''Optional Annuity Contract''

We are proposing that an annuity issued by an insurance company would *not* be an ''annuity contract'' or an ''optional annuity contract'' under section 3(a)(8) of the Securities Act if the annuity has the following two characteristics. First, amounts payable by the insurance company under the contract are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities. Second, amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The first characteristic, that amounts payable by the insurance company under the contract are calculated by reference to the performance of a security or securities, defines a class of contracts that we believe, in all cases, require further scrutiny because they implicate the factors articulated by the U.S. Supreme Court as important in determining whether the section 3(a)(8) exemption is applicable. When payments under a contract are calculated by reference to the performance of a security or securities, rather than being paid in a fixed amount, at least some investment risk relating to the performance of the securities is assumed by the purchaser. In addition, the contract may be marketed on the basis of the potential for growth offered by investments in the securities.

The proposed rule would define the class of contracts that is subject to scrutiny broadly. The rule would apply whenever any amounts payable under

[52] The presence of protection against loss does not, in itself, transform a security into an insurance or annuity contract. Like indexed annuities, variable annuities typically provide some protection against the risk of loss, but are registered as securities. Historically, variable annuity contracts have typically provided a minimum death benefit at least equal to the greater of contract value or purchase payments less any withdrawals. More recently, many contracts have offered benefits that protect against downside market risk during the purchaser's lifetime.

[53] *Id.* at 91 (Brennan, J., concurring).

[54] *Id.* at 89 (Brennan, J., concurring).

[55] Proposed rule 151A(a).

[56] *Id.* We note that the majority of states include in their insurance laws provisions that define annuities. *See, e.g.,* ALA. CODE *section* 27–5–3 (2008); CAL. INS. CODE *section* 1003 (West 2007); N.J. ADMIN. CODE tit. 11, *section* 4–2.2 (2008); N.Y. INS. LAW *section* 1113 (McKinney 2007). Those states that do not expressly define annuities typically have regulations in place that address annuities. *See, e.g.,* KAN. ADMIN. REGS. *section* 40–2–12 (2008); MISS. CODE ANN. § 83–1–151 (2008).

[57] Proposed rule 151A(c).

[58] The assets of a variable annuity are held in a separate account of the insurance company that is insulated for the benefit of the variable annuity owners from the liabilities of the insurance company, and amounts paid to the owner under a variable annuity vary according to the investment experience of the separate account. *See* Black and Skipper, *supra* note 39, at 174–77 (2000).

[59] *See, e.g., VALIC, supra* note 3, 359 U.S. 65; *United Benefit, supra* note 3, 387 U.S. 202. In addition, an insurance company separate account issuing variable annuities is an investment company under the Investment Company Act of 1940. *See Prudential Ins. Co. of Am.* v. *SEC,* 326 F.2d 383 (3d Cir. 1964).

[60] 17 CFR 239.17b and 274.11c.

the contract under any circumstances, including full or partial surrender, annuitization, or death, are calculated, in whole or in part, by reference to the performance of a security or securities. If, for example, the amount payable under a contract upon a full surrender is not calculated by reference to the performance of a security or securities, but the amount payable upon annuitization is so calculated, then the contract would need to be analyzed under the rule. As another example, if amounts payable under a contract are partly fixed in amount and partly dependent on the performance of a security or securities, the contract would need to be analyzed under the rule.

We note that the proposed rule would apply to contracts under which amounts payable are calculated by reference to a security, including a group or index of securities. Thus, the proposed rule would, by its terms, apply to indexed annuities but also to other annuities where amounts payable are calculated by reference to a single security or any group of securities. The federal securities laws, and investors' interests in full and fair disclosure and protection from abusive sales practices, are equally implicated, whether amounts payable under an annuity are calculated by reference to a securities index, another group of securities, or a single security.

The term ''security'' in proposed rule 151A would have the same broad meaning as in section 2(a)(1) of the Securities Act. Proposed rule 151A does not define the term ''security,'' and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Securities Act have the same meanings defined in the Act.[61]

The second characteristic, that amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract, sets forth the test that would define a class of contracts that are not ''annuity contracts'' or ''optional annuity contracts'' under the Securities Act and that, therefore, are not entitled to the section 3(a)(8) exemption. As explained above, by purchasing this type of indexed annuity, the purchaser assumes the risk of an uncertain and fluctuating financial instrument, in exchange for exposure to future, securities-linked returns.[62] As a result, the purchaser assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities. Our proposal is intended to provide the purchaser of such an annuity with the same protections that are provided under the federal securities laws to other investors who participate in the securities markets, including full and fair disclosure regarding the terms of the investment and the significant risks that he or she is assuming, as well as protection from abusive sales practices and the recommendation of unsuitable transactions.

Under proposed rule 151A, amounts payable by the insurance company under a contract would be more likely than not to exceed the amounts guaranteed under the contract if this were the expected outcome more than half the time. In order to determine whether this is the case, it would be necessary to analyze expected outcomes under various scenarios involving different facts and circumstances. In performing this analysis, the amounts payable by the insurance company under any particular set of facts and circumstances would be the amounts that the purchaser[63] would be entitled to receive from the insurer under those facts and circumstances. The facts and circumstances would include, among other things, the particular features of the annuity contract (*e.g.,* in the case of an indexed annuity, the relevant index, participation rate, and other features), the particular options selected by the purchaser (*e.g.,* surrender or annuitization), and the performance of the relevant securities benchmark (*e.g.,* in the case of an indexed annuity, the performance of the relevant index, such as the Dow Jones Industrial Average, Lehman Brothers Aggregate U.S. Index, Nasdaq 100 Index, or Standard & Poor's 500 Composite Stock Price Index). The amounts guaranteed under a contract under any particular set of facts and circumstances would be the minimum amount that the insurer would be obligated to pay the purchaser under those facts and circumstances without reference to the performance of the security that is used in calculating amounts payable under the contract. Thus, if an indexed annuity, in all circumstances, were to guarantee that, on surrender, a purchaser would receive 87.5% of purchase payments, plus 1% interest compounded annually, and that any additional payout would be based exclusively on the performance of a securities index, the amount guaranteed after 3 years would be 90.15% of purchase payments (87.5% $\times$ 1.01 $\times$ 1.01 $\times$ 1.01).

We request comment on the proposed definition and in particular on the following issues:

- Should we define a class of annuities that are not ''annuity contracts'' or ''optional annuity contracts'' under the Securities Act? If so, should we adopt the proposed definition or should the proposed definition be modified?
- Should we provide greater clarity with respect to the status under the Securities Act of annuities under which amounts payable by the insurance company are calculated, in whole or in part, by reference to the performance of a security, including a group or index of securities? Should we, as proposed, adopt a definitional rule that would apply to all such annuities? Or should we adopt a definitional rule that applies to a more limited subset of annuities, such as annuities under which amounts payable are calculated by reference to the performance of a securities index?
- Is the proposed test that defines a class of contracts that are not ''annuity contracts'' or ''optional annuity contracts,'' *i.e.,* that amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract, an appropriate test? Should the test be modified in any way, *e.g.,* should the threshold be higher or lower than ''more likely than not?'' Should we provide further clarification with respect to the meaning of any of the elements of that test, including ''amounts payable by the insurance company under the contract'' and ''amounts guaranteed under the contract?''
- Should we specify a particular point in time as of which ''amounts payable by the insurance company under the contract'' and ''amounts guaranteed under the contract'' should be determined under the rule? If so, what would be an appropriate time, *e.g.,* contract maturity, the point where the surrender charge period ends, a specified number of years (5 years, 10 years, 15 years, 20 years, or some other period), or a specified age of the annuitant or a joint annuitant under the contract (60 years, 65 years, 75 years, or some other age)?

Determining Whether an Annuity Is Not an ''Annuity Contract'' or ''Optional Annuity Contract'' Under Proposed Rule 151A

Proposed rule 151A addresses the manner in which a determination would

[61] 17 CFR 230.100(b).

[62] *See supra* Part III.A.1.

[63] For simplicity, we are referring to payments to the purchaser. The proposed rule, however, references payments by the insurer without reference to a specified payee. In performing the analysis, payments to any payee, including the purchaser, annuitant, and beneficiaries would be included.

be made regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract. The proposed rule is principles-based, providing that a determination made by the insurer at or prior to issuance of a contract would be conclusive, provided that: (i) Both the insurer's methodology and the insurer's economic, actuarial, and other assumptions are reasonable; (ii) the insurer's computations are materially accurate; and (iii) the determination is made not earlier than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued.[64] The proposed rule would, however, specify the treatment of charges that are imposed at the time of payments under the contract by the insurer.[65]

We are proposing this principles-based approach because we believe that an insurance company should be able to evaluate anticipated outcomes under an annuity that it issues. Insurers routinely undertake such analyses for purposes of pricing and hedging their contracts.[66] In addition, we believe that it is important to provide reasonable certainty to insurers with respect to the application of the proposed rule and to preclude an insurer's determination from being second guessed, in litigation or otherwise, in light of actual events that may differ from assumptions that were reasonable when made.

As with all exemptions from the registration and prospectus delivery requirements of the Securities Act, the party claiming the benefit of the exemption—in this case, the insurer—bears the burden of proving that the exemption applies.[67] Thus, an insurer that believes an indexed annuity is entitled to the exemption under Section 3(a)(8) based, in part, on a determination made under the proposed rule would—if challenged in litigation—be required to prove that its methodology and its economic, actuarial, and other assumptions were reasonable, and that the computations were materially accurate.

The proposed rule provides that an insurer's determination under the rule would be conclusive only if it is made at or prior to issuance of the contract. Proposed rule 151A is intended to provide certainty to both insurers and investors, and we believe that this certainty would be undermined unless insurance companies undertake the analysis required by the rule no later than the time that an annuity is issued. The proposed rule also provides that, for an insurer's determination to be conclusive, the computations made by the insurance company in support of the determination must be materially accurate. An insurer should not be permitted to rely on a determination of an annuity's status under the proposed rule that is based on computations that are materially inaccurate. For this purpose, we intend that computations would be considered to be materially accurate if any computational errors do not affect the outcome of the insurer's determination as to whether amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

In order for an insurer's determination to be conclusive, both the methodology and the economic, actuarial, and other assumptions used would be required to be reasonable. We recognize that a range of methodologies and assumptions may be reasonable and that a reasonable methodology or assumption utilized by one insurer may differ from a reasonable assumption or methodology selected by another insurer. In determining whether an insurer's methodology is reasonable, it would be appropriate to look to methods commonly used for valuing and hedging similar products in insurance and derivatives markets.

An insurer will need to make assumptions in several areas, including assumptions about (i) insurer behavior, (ii) purchaser behavior, and (iii) market behavior, and will need to assign probabilities to various potential behaviors. With regard to insurer behavior, the insurer will need to make assumptions about discretionary actions that it may take under the terms of an annuity. In the case of an indexed annuity, for example, an insurer often has discretion to modify various features, such as guaranteed interest rates, caps, participation rates, and spreads. Similarly, the insurer will need to make assumptions concerning purchaser behavior, including matters such as how long purchasers will hold a contract, how they will allocate contract value among different investment options available under the contract, and the form in which they will take payments under the contract. Assumptions about market behavior would include assumptions about expected return, market volatility, and interest rates. In general, insurers will need to make assumptions about any feature of insurer, purchaser, or market behavior, or any other factor, that is material in determining the likelihood that amounts payable under the contract exceed the amounts guaranteed.

In determining whether assumptions are reasonable, insurers should generally be guided by both history and their own expectations about the future. An insurer may look to its own, and to industry, experience with similar or otherwise comparable contracts in constructing assumptions about both insurer behavior and investor behavior. In making assumptions about future market behavior, an insurer may be guided, for example, by historical market characteristics, such as historical returns and volatility, provided that the insurer bases its assumptions on an appropriate period of time and does not have reason to believe that the time period chosen is likely to be unrepresentative. As a general matter, assumptions about insurer, investor, or market behavior that are not consistent with historical experience would not be reasonable unless an insurer has a reasonable basis for any differences between historical experience and the assumptions used.

In addition, an insurer may look to its own expectations about the future in constructing reasonable assumptions. As noted above, insurers routinely analyze anticipated outcomes for purposes of pricing and hedging their contracts, and for similar purposes. We would expect that, in making a determination under proposed rule 151A, an insurer would use assumptions that are consistent with the assumptions that it uses for other purposes. Generally, assumptions that are inconsistent with the assumptions that an insurer uses for other purposes would not be reasonable under proposed rule 151A.

We note that an insurer may offer a particular form of contract over a significant period of time. Assumptions that are reasonable when a contract is originally offered may or may not continue to be reasonable at a subsequent time when the insurer continues to offer the contract. For this reason, the rule would provide that an insurer's determination would be conclusive if it is sufficiently current. Specifically, the determination must be made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which a particular contract is issued. For example, if a form of contract were first offered on January 1, 2011, the insurer

[64] Proposed rule 151A(b)(2).

[65] Proposed rule 151A(b)(1).

[66] *See generally,* Black and Skipper, *supra* note 39, at 26–47, 890–99.

[67] *See, e.g., SEC* v. *Ralston Purina,* 346 U.S. 119, 126 (1953) (an issuer claiming an exemption under section 4 of the Securities Act carries the burden of showing that the exemption applies).

would be required to make the determination not earlier than July 1, 2010. If the same form of contract were issued to a particular individual on January 1, 2014, the insurer's determination would be required to be made not earlier than January 1, 2011, in order to be conclusive for this transaction. This approach is intended to address the changing nature of reasonable assumptions, while permitting an insurer to rely on its determination for a significant period of time (three years) once made.

Proposed rule 151A would require that, in determining whether amounts payable by the insurance company under the contract are more likely than not to exceed the amounts guaranteed under the contract, amounts payable under the contract be determined without reference to any charges that are imposed at the time of payment. For example, the calculation of amounts payable upon surrender would be computed without deduction of any surrender charges, which typically decline over time. We are proposing this calculation methodology in order to eliminate the differential impact that such charges would have on the determination depending on the assumptions made about contract holding periods. However, the proposed rule would require that charges imposed at the time of payment be reflected in computing the amounts guaranteed under the contract. In many cases, amounts guaranteed under annuities are not affected by charges imposed at the time payments are made by the insurer under the contract.[68] However, in the case of an annuity where the amounts guaranteed are affected by charges imposed at the time payments are made,[69] the determination under proposed rule 151A would be made using the actual amounts guaranteed under the contract (which reflect the impact of these charges).

We request comment on the manner in which a determination would be made under proposed rule 151A regarding whether amounts payable by the insurance company under a contract are more likely than not to exceed the amounts guaranteed under the contract and, in particular, on the following issues:

- Should we, as proposed, adopt a principles-based approach to this determination? Would the principles-based approach facilitate our goal of providing certainty?
- Should the insurer's determination be conclusive? If so, are the conditions in the proposed rule (*i.e.,* determination at or prior to contract issuance, reasonable methodology and assumptions, materially accurate computation) appropriate, or should we modify these conditions in any way?
- Should we expressly specify the circumstances under which a computation is materially accurate? If so, should the rule, as proposed, provide that an insurer's computation is materially accurate if any computational errors do not affect the outcome of the insurer's determination as to whether amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract? Or should we provide a different guideline for determining whether the computation is ''materially accurate?'' For example, should the rule provide that an insurer's computation is materially accurate if any computational errors do not materially affect the insurer's determination of the likelihood that amounts payable by the insurer under the contract exceed the amounts guaranteed under the contract?
- Should the rule prescribe the assumptions to be used by an insurer in making its determination? What factors should affect a determination of whether an insurer's assumptions are reasonable? Should the rule specify how the determination should be made with respect to securities, including indices, that have little or no history?
- Should we, as proposed, provide that, in order for an insurer's determination to be conclusive, it must be made not more than six months prior to the date on which the form of contract is first offered? Should this period be shorter or longer, *e.g.,* 30 days, 3 months, 9 months, 1 year?
- Should we, as proposed, provide that, in order for an insurer's determination to be conclusive, it must not be made more than three years prior to the date on which a particular contract is issued? Should this period be shorter or longer, *e.g.,* 1 year, 2 years, or 5 years?
- Should an insurer's determination, once made for a particular form of contract, be conclusive with respect to every particular contract of that form that is sold provided that the determination meets the standards required for conclusiveness at the time of the insurer's original determination, *i.e.,* reasonable methodology and assumptions and materially accurate computation? Or should an insurer's determination only be conclusive with respect to any particular sale of a contract if the methodology and assumptions are reasonable at the time of the particular sale?
- How should surrender charges and other charges imposed at the time of payout under an annuity be treated in making the determination required under the proposed rule? Should amounts payable under the contract be determined with or without reference to such charges? Should amounts guaranteed under the contract be computed with or without reference to such charges? Should we define with greater specificity the concept of charges imposed at the time of payment under a contract?
- Should we provide any guidance with respect to the principles-based approach of the rule?
- Should we provide guidance on the circumstances under which it is reasonable to rely on historical experience? Would it be reasonable to use other asset prices (such as derivative prices) to form expectations about the future, as long as the use of these prices is supported by historical experience?
- Should we provide guidance about the circumstances under which it is reasonable to rely on insurer expectations about the future? Would it be reasonable to rely on these expectations for factors over which insurers have control (*e.g.,* changes in contract features) or about which they have particular expertise (*e.g.,* rates of annuitization, mortality rates)? Would it be reasonable to rely on these expectations for factors over which insurers do not have control, such as market behavior?
- Should we provide guidance that would specify how insurers should consider interactions between various factors that may affect the determination (such as interactions between market returns and surrender behavior)?
- Should the rule specify how the determination should be made in the case of contracts that offer more than one investment option, *e.g.,* multiple indices or multiple crediting formulas or the availability of a guaranteed interest rate option in addition to indexed investment options? In such a

---

[68] Guaranteed minimum value, as commonly defined in indexed annuity contracts, equals a percentage of purchase payments, accumulated at a specified interest rate, as explained above, and this amount is not subject to surrender charges.

[69] For example, a purchaser buys a contract for $100,000. The contract defines surrender value as the greater of (i) purchase payments plus index-linked interest minus surrender charges or (ii) the guaranteed minimum value. The maximum surrender charge is equal to 10%. The guaranteed minimum value is defined in the contract as 87.5% of premium accumulated at 1% annual interest. If the purchaser surrenders within the first year of purchase, and there is no index-linked interest credited, the surrender value would equal $90,000 (determined under clause (i) as $100,000 purchase payment minus 10% surrender charge), and this amount would be the guaranteed amount under the contract, not the lower amount defined in the contract as guaranteed minimum value ($87,500).

case, should we require a separate determination under each available option? If so, should we provide that the entire annuity is not an ''annuity contract'' or ''optional annuity contract'' if it is determined that the annuity would not be an ''annuity contract'' or ''optional annuity contract'' under any one or more of the available options?

• Should the rule require separate determinations with respect to the various benefits available under an annuity, such as lump sum payments, annuity payments, and death benefits? If so, should the rule prescribe that if the amounts payable under any one of these options are more likely than not to exceed the amounts guaranteed under that option, then the entire contract is not an ''annuity contract'' or ''optional contract''?

3. Effective Date

We propose to have the new definition apply prospectively—that is, only to indexed annuities issued on or after the effective date of a final rule. We are using our definitional rulemaking authority under Section 19(a) of the Securities Act, and the explicitly prospective nature of our proposed rule is consistent with similar prospective rulemaking that we have undertaken in the past when doing so was appropriate and fair under the circumstances.[70]

We are aware that many insurance companies, in the absence of definitive interpretation or definition by the Commission, have of necessity acted in reliance on their own analysis of the legal status of indexed annuities based on the state of the law prior to this release. Under these circumstances, we do not believe that insurance companies should be subject to any additional legal risk relating to their past offers and sales of indexed annuity contracts as a result of our proposal or its eventual adoption.

We also recognize that, if our proposal is adopted, the industry will need sufficient time to conduct the analysis required by the new definitional rule and comply with any applicable requirements under the federal securities laws. Therefore, we propose that if we adopt a final rule, the effective date of that rule would be a date that is 12 months after publication in the **Federal Register**.

We request comment on the proposed effective date of the rule and in particular on the following issue:

• Should the effective date of the new definitional rule, if adopted, be 12 months after publication in the **Federal Register**, or should it be effective sooner (*e.g.,* 60 days after publication, six months after publication) or later (*e.g.,* 18 months after publication, 2 years after publication)?

4. Annuities Not Covered by the Proposed Definition

Proposed rule 151A would apply to annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. The proposed rule would define certain of those annuities (annuities under which amounts payable by the issuer are more likely than not to exceed the amounts guaranteed under the contract) as not ''annuity contracts'' or ''optional annuity contracts'' under section 3(a)(8) of the Securities Act. The proposed rule, however, would not provide a safe harbor under section 3(a)(8) for any other annuities, including any other annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security. The status under the Securities Act of any annuity, other than an annuity that is determined under proposed rule 151A to be not an ''annuity contract'' or ''optional annuity contract,'' would continue to be determined by reference to the investment risk and marketing tests articulated in existing case law under section 3(a)(8) and, to the extent applicable, the Commission's safe harbor rule 151.[71]

We request comment on the proposal not to include a safe harbor in the proposal and in particular on the following issues:

• Should we provide a safe harbor under section 3(a)(8) of the Securities Act for any annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security? If so, what should the safe harbor be?

• Should we modify the Commission's existing safe harbor for certain annuities, rule 151, to address indexed annuities or other annuities under which amounts payable by the insurance company are calculated by reference to the performance of a security? If so, how?

B. Exchange Act Exemption for Securities That Are Regulated as Insurance

The Commission is also proposing new rule 12h–7, which would provide an insurance company with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities issued by the company that are registered under the Securities Act and regulated as insurance under state law.[72] We are proposing this exemption because we believe that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. We base that view on two factors: First, the nature and extent of the activities of insurance company issuers, and their income and assets, and, in particular, the regulation of those activities and assets under state insurance law; and, second, the absence of trading interest in the securities.[73] We are also proposing to impose conditions to the exemption that relate to these factors and that we believe are necessary or appropriate in the public interest and consistent with the protection of investors.

State insurance regulation is focused on insurance company solvency and the adequacy of insurers' reserves, with the ultimate purpose of ensuring that insurance companies are financially secure enough to meet their contractual obligations.[74] State insurance regulators require insurance companies to

[70] *See, e.g.,* Securities Act Release No. 4896 (Feb. 1, 1968) [33 FR 3142, 3143 (Feb. 17, 1968)] (''The Commission is aware that for many years issuers of the securities identified in this rule have not considered their obligations to be separate securities and that they have acted in reliance on the view, which they believed to be the view of the Commission, that registration under the Securities Act was not required. Under the circumstances, the Commission does not believe that such issuers are subject to any penalty or other damages resulting from entering into such arrangements in the past. Paragraph (b) provides that the rule shall apply to transactions of the character described in paragraph (a) only with respect to bonds or other evidence of indebtedness issued after adoption of the rule.''). *See also* Securities Act Release No. 5316 (Oct. 6, 1972) [37 FR 23631, 23632 (Nov. 7, 1972)] (''The Commission recognizes that the 'no-sale' concept has been in existence in one form or another for a long period of time. * * * The Commission believes, after a thorough reexamination of the studies and proposals cited above, that the interpretation embodied in Rule 133 is no longer consistent with the statutory objectives of the [Securities] Act. * * * Rule 133 is rescinded prospectively on and after January 1, 1973. * * *'').

[71] As noted in Part II.C., above, indexed annuities are not entitled to rely on the rule 151 safe harbor.

[72] The Commission has received a petition requesting that we propose a rule that would exempt issuers of certain types of insurance contracts from Exchange Act reporting requirements. Letter from Stephen E. Roth, Sutherland Asbill & Brennan LLP, on behalf of Jackson National Life Insurance Co., to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission (Dec. 19, 2007) (File No. 4–553) available at: *http://www.sec.gov/rules/petitions/2007/petn4–553.pdf.*

[73] *See* Section 12(h) of the Exchange Act [15 U.S.C. 78*l*(h)] (Commission may, by rules, exempt any class of issuers from the reporting provisions of the Exchange Act ''if the Commission finds, by reason of the number of public investors, *amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer,* or otherwise, that such action is not inconsistent with the public interest or the protection of investors.'') (emphasis added).

[74] Black and Skipper, *supra* note 39, at 949.

maintain certain levels of capital, surplus, and risk-based capital; restrict the investments in insurers' general accounts; limit the amount of risk that may be assumed by insurers; and impose requirements with regard to valuation of insurers' investments.[75] Insurance companies are required to file annual reports on their financial condition with state insurance regulators. In addition, insurance companies are subject to periodic examination of their financial condition by state insurance regulators. State insurance regulators also preside over the conservation or liquidation of companies with inadequate solvency.[76]

State insurance regulation, like Exchange Act reporting, relates to an entity's financial condition. We are of the view that, as a general matter, it may be unnecessary for both to apply in the same situation, which may result in duplicative regulation that is burdensome. Through Exchange Act reporting, issuers periodically disclose their financial condition, which enables investors and the markets to independently evaluate an issuer's income, assets, and balance sheet. State insurance regulation takes a different approach to the issue of financial condition, instead relying on state insurance regulators to supervise insurers' financial condition, with the goal that insurance companies be financially able to meet their contractual obligations. We believe that it would be consistent with our federal system of regulation, which has allocated the responsibility for oversight of insurers' solvency to state insurance regulators, to exempt insurers from Exchange Act reporting with respect to state-regulated insurance contracts.

Our conclusion in this regard is strengthened by the general absence of trading interest in insurance contracts. Insurance is typically purchased directly from an insurance company. While insurance contracts may be assigned in limited circumstances,[77] they typically are not listed or traded on securities exchanges or in other markets. As a result, outside the context of publicly owned insurance companies, there is little, if any, market interest in the information that is required to be disclosed in Exchange Act reports.

We request comment on whether we should provide insurance companies with exemptions from Exchange Act reporting with respect to securities that are regulated as insurance under state law and in particular on the following issues:

• Does the existence of state insurance regulation, and, in particular, state regulation of insurance company financial condition and solvency, support providing an exemption from Exchange Act reporting? Does Exchange Act reporting serve any purpose, in the context of insurance contracts that are also securities, that is not served by state insurance regulation?

• Does the lack of trading interest in insurance contracts support providing an exemption from Exchange Act reporting for securities that are regulated as insurance under state law? Should Exchange Act reporting be required notwithstanding the absence of trading interest and, if so, why? Are there any circumstances where trading interest in insurance contracts that are securities is significant enough that Exchange Act reporting should be required?

1. The Exemption

Proposed rule 12h–7 would provide an insurance company that is covered by the rule with an exemption from the duty under section 15(d) of the Exchange Act to file reports required by section 13(a) of the Exchange Act with respect to certain securities registered under the Securities Act.[78]

Covered Insurance Companies

The proposed Exchange Act exemption would apply to an issuer that is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state, including the District of Columbia, Puerto Rico, the Virgin Islands, and any other possession of the United States.[79] In the case of a variable annuity contract or variable life insurance policy, the exemption would apply to the insurance company that issues the contract or policy. However, the exemption would not apply to the insurance company separate account in which the purchaser's payments are invested and which is separately registered as an investment company under the Investment Company Act of 1940 and is not regulated as an insurance company under state law.[80]

Covered Securities

The proposed exemption would apply with respect to securities that do not constitute an equity interest in the insurance company issuer and that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.[81] The exemption does not apply with respect to any other securities issued by an insurance company. As a result, if an insurance company issues securities with respect to which the exemption applies, and other securities that do not entitle the insurer to the exemption, the insurer will remain subject to Exchange Act reporting obligations. For example, if an insurer that is a stock company[82] also issues insurance contracts that are registered securities under the Securities Act, the insurer generally

[75] *Id.* at 949 and 956–59.

[76] *Id.* at 949.

[77] Insurance contracts may be assigned either as a complete assignment or as collateral. Insurance contracts that are assignable typically provide that the insurer need not recognize the assignment until it receives written notice. *See* Black and Skipper, *supra* note 39, at 234.

[78] Introductory paragraph to proposed rule 12h–7. *Cf.* Rule 12h–3(a) under the Exchange Act [17 CFR 240.12h–3(a)] (suspension of duty under section 15(d) of the Exchange Act to file reports with respect to classes of securities held by 500 persons or less where total assets of the issuer have not exceeded $10,000,000); Rule 12h–4 under the Exchange Act [17 CFR 240.12h–4] (exemption from duty under Section 15(d) of the Exchange Act to file reports with respect to securities registered on specified Securities Act forms relating to certain Canadian issuers).

Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement that has become effective under the Securities Act to file reports and other information and documents required under section 13 of the Exchange Act [15 U.S.C. 78m] with respect to issuers registered under section 12 of the Exchange Act [15 U.S.C. 78l]. Section 13(a) of the Exchange Act [15 U.S.C. 78m(a)] requires issuers of securities registered under section 12 of the Act to file annual reports and other documents and information required by Commission rule.

[79] Proposed rule 12h–7(a). The Exchange Act defines " State" as any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. Section 3(a)(16) of the Exchange Act [15 U.S.C. 78c(a)(16)]. The term " State" in proposed rule 12h–7 has the same meaning as in the Exchange Act. Proposed rule 12h–7 does not define the term " State," and our existing rules provide that, unless otherwise specifically provided, the terms used in the rules and regulations under the Exchange Act have the same meanings defined in the Exchange Act. *See* rule 240.0–1(b) [17 CFR 240.0–1(b)].

[80] This approach is consistent with the historical practice of insurance companies that issue variable annuities and do not file Exchange Act reports. The associated separate accounts, however, are required to file Exchange Act reports. These Exchange Act reporting requirements are deemed to be satisfied by filing annual reports on Form N–SAR. 17 CFR 274.101. *See* Section 30(d) of the Investment Company Act [15 U.S.C. 80a–30(d)] and rule 30a–1 under the Investment Company Act [17 CFR 270.30a–1].

[81] Proposed rule 12h–7(b).

[82] A stock life insurance company is a corporation authorized to sell life insurance, which is owned by stockholders and is formed for the purpose of earning a profit for its stockholders. This is in contrast to another prevailing insurance company structure, the mutual life insurance company. In this structure, the corporation authorized to sell life insurance is owned by and operated for the benefit of its policyowners. Black and Skipper, *supra* note 39, at 577–78.

would be required to file Exchange Act reports as a result of being a stock company. Similarly, if an insurer raises capital through a debt offering, the proposed exemption would not apply with respect to the debt securities.

We are proposing that the exemption be available with respect to securities that are either subject to regulation under the insurance laws of the domiciliary state of the insurance company or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction.[83] We are proposing a broad exemption that would apply to any contract that is regulated under the insurance laws of the insurer's home state because we intend that the exemption apply to all contracts, and only those contracts, where state insurance law, and the associated regulation of insurer financial condition, applies. A key basis for the proposed exemption is that investors are already entitled to the financial condition protections of state law and that, under our federal system of regulation, Exchange Act reporting may be unnecessary. Therefore, we believe it is important that the reach of the exemption and the reach of state insurance law be the same.

The proposed Exchange Act exemption would apply both to certain existing types of insurance contracts and to types of contracts that are developed in the future and that are registered as securities under the Securities Act. The proposed exemption would apply to indexed annuities that are registered under the Securities Act. However, the proposed Exchange Act exemption is independent of proposed rule 151A and would apply to types of contracts in addition to those that are covered by proposed rule 151A. There are at least two types of existing insurance contracts with respect to which we intend that the proposed Exchange Act exemption would apply, contracts with so-called ''market value adjustment'' (''MVA'') features and insurance contracts that provide certain guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.

Contracts including MVA features have, for some time, been registered under the Securities Act.[84] Insurance companies issuing contracts with these features have also complied with Exchange Act reporting requirements.[85] MVA features have historically been associated with annuity and life insurance contracts that guarantee a specified rate of return to purchasers.[86] In order to protect the insurer against the risk that a purchaser may make withdrawals from the contract at a time when the market value of the insurer's assets that support the contract has declined due to rising interest rates, insurers sometime impose an MVA upon surrender. Under an MVA feature, the insurer adjusts the proceeds a purchaser receives upon surrender prior to the end of the guarantee period to reflect changes in the market value of its portfolio securities supporting the contract. As a result, if a purchaser makes a withdrawal at a time when interest rates are higher than at the time of contract issuance (and the market value of the insurer's assets has decreased), the proceeds payable upon surrender are adjusted downwards. By contrast, if interest rates are lower than at the time of contract issuance (and the market value of the insurer's assets has increased), the proceeds payable upon surrender are adjusted upwards.

More recently, some insurance companies have registered under the Securities Act insurance contracts that provide certain guarantees in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account.[87] As a result, the insurers become subject to Exchange Act reporting requirements if they are not already subject to those requirements. These contracts, often called ''guaranteed living benefits,'' are intended to provide insurance to the purchaser against the risk of outliving the assets held in the mutual fund, brokerage, or investment advisory account. An example of a guaranteed living benefit is a contract that guarantees regular income payments for the life of the purchaser to the extent that the value of the purchaser's investment in the relevant account is not sufficient to provide such payments. Such a contract could, for example, guarantee that if the purchaser withdraws no more than five percent per year of the amount invested, and if withdrawals and market performance reduce the account value to a zero balance, the insurer will thereafter make annual payments to the purchaser in an amount equal to five percent of the amount invested.

As noted above, the proposed Exchange Act exemption would also apply with respect to a guarantee of a security if the guaranteed security is subject to regulation under state insurance law.[88] We are proposing this provision because we believe that it would be appropriate to exempt from Exchange Act reporting an insurer that provides a guarantee of an insurance contract (that is also a security) when the insurer would not be subject to Exchange Act reporting if it had issued the guaranteed contract. This situation may arise, for example, when an insurance company issues a contract that is a security and its affiliate, also an insurance company, provides a guarantee of benefits provided under the first company's contract.[89]

Finally, the proposed exemption would be unavailable with respect to any security that constitutes an equity interest in the issuing insurance company. As a general matter, an equity interest in an insurer would not be covered by the proposed exemption because it would not be subject to regulation under state insurance law and often would be publicly traded. Nonetheless, we believe that the rule should expressly preclude any security that constitutes an equity interest in the issuing insurance company from being covered by the proposed exemption. Where investors own an equity interest in an issuing insurance company, and are therefore dependent on the financial condition of the issuer for the value of that interest, we believe that they have a significant interest in directly evaluating the issuers' financial condition for themselves on an ongoing basis and that Exchange Act reporting is appropriate.

---

[83] A domiciliary state is the jurisdiction in which an insurer is incorporated or organized. *See* National Association of Insurance Commissioners Model Laws, Regulations and Guidelines 555–1, § 104 (2007).

[84] Securities Act Release. No. 6645, *supra* note 35, 51 FR at 20256–58.

[85] *See, e.g.*, ING Life Insurance and Annuity Company (Annual Report on Form 10–K (Mar. 31, 2008)); Protective Life Insurance Company (Annual Report on Form 10–K (Mar. 31, 2008)); Union Security Insurance Company (Annual Report on Form 10–K (Mar. 3, 2008)).

[86] Some indexed annuities also include MVA features. *See, e.g.*, Pre-Effective Amendment No. 4 to Registration Statement on Form S–1 of PHL Variable Insurance Company (File No. 333–132399) (filed Feb. 7, 2007); Initial Registration Statement on Form S–1 of ING USA Annuity and Life Insurance Company (File No. 333–133153) (filed Apr. 7, 2006); Pre-Effective Amendment No. 2 to Registration Statement on Form S–3 of Allstate Life Insurance Company (File No. 333–117685) (filed Dec. 20, 2004).

[87] *See, e.g.*, PHL Variable Life Insurance Company, File No. 333–137802 (Form S–1 filed Feb. 25, 2008); Genworth Life and Annuity Insurance Company, File No. 333–143494 (Form S–1 filed Apr. 4, 2008).

[88] The Securities Act defines ''security'' in Section 2(a)(1) of the Act [15 U.S.C. 77b(a)(1)]. That definition provides that a guarantee of any of the instruments included in the definition is also a security.

[89] For example, an insurance company may offer a registered variable annuity, and a parent or other affiliate of the issuing insurance company may act as guarantor for the issuing company's insurance obligations under the contract.

We request comment on the proposed exemption and in particular on the following issues:

• Should we provide insurance companies with an exemption from the duty under Section 15(d) of the Exchange Act to file reports required by Section 13(a) of the Exchange Act with respect to certain securities that are also regulated as insurance? Should we modify the exemption in any way?

• What securities should be covered by the proposed exemption? Should the exemption, as proposed, only be available with respect to securities that are either subject to regulation under state insurance law or are guarantees of securities that are subject to regulation under state insurance law? Should the exemption apply to indexed annuities, contracts with MVA features, and insurance contracts that provide certain guaranteed benefits in connection with assets held in an investor's account, such as a mutual fund, brokerage, or investment advisory account? Should we limit the exemption to all or any of those three types of securities, or should we also make the exemption available to types of securities that may be issued by insurance companies in the future?

• If we adopt the proposed Exchange Act exemption, should the adopted rule expressly provide that the exemption is unavailable with respect to any security that constitutes an equity interest in the issuing insurance company? Should the rule expressly provide that the exemption is unavailable with respect to debt securities? If so, how should we define the term ''debt securities'' so that it does not cover insurance obligations?

2. Conditions to Exemption

As described above, we believe that the proposed exemption is necessary or appropriate in the public interest and consistent with the protection of investors because of the existence of state regulation of insurers' financial condition and because of the general absence of trading interest in insurance contracts. We are proposing that the Exchange Act exemption be subject to conditions that are designed to ensure that both of these factors are, in fact, present in cases where an insurance company is permitted to rely on the exemption.

Regulation of Insurer's Financial Condition

In order to rely on the proposed exemption, an insurer must file an annual statement of its financial condition with, and the insurer must be supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or any officer performing like functions, of the insurer's domiciliary state.[90] This condition is intended to ensure that an insurer claiming the exemption is, in fact, subject to state insurance regulation of its financial condition. Absent satisfaction of this condition, Exchange Act reporting would not be duplicative of state insurance regulation, and the proposed exemption would not be available.

Absence of Trading Interest

The proposed Exchange Act exemption would be subject to two conditions intended to insure that there is no trading interest in securities with respect to which the exemption applies. First, the securities may not be listed, traded, or quoted on an exchange, alternative trading system,[91] inter-dealer quotation system,[92] electronic communications network, or any other similar system, network, or publication for trading or quoting.[93] This condition is designed to ensure that there is no established trading market for the securities. Second, the issuing insurance company must take steps reasonably designed to ensure that a trading market for the securities does not develop, including requiring written notice to, and acceptance by, the insurance company prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers of the securities at any time on a non-discriminatory basis.[94] This condition is designed to ensure that the insurer takes reasonable steps to ensure the absence of trading interest in the securities. We recognize that insurance contracts typically permit assignment in some circumstances. The proposed condition is intended to permit these assignments to continue while requiring the insurer to monitor assignments and, if it observes development of trading interest in the securities, to step in and refuse assignments related to this trading interest. We understand that it is commonplace for insurers today to include restrictions on assignments in their contracts similar to those that would be required by the proposed rule.[95]

We request comment generally on the proposed conditions to the Exchange Act exemption and specifically on the following issues:

• Are the proposed conditions appropriate? Will they help to ensure that the proposed exemption is necessary or appropriate in the public interest and consistent with the protection of investors?

• Should we, as proposed, condition the exemption on the insurer filing an annual statement of its financial condition with its home state insurance regulator? Should we require more or less frequent filings relating to financial condition, *e.g.*, quarterly, semi-annually, every two years, etc.?

• Should we require, as a condition to the exemption, any public disclosure of the insurer's financial condition, either through filing with us or by posting on the insurer's Web site? Should we require that an insurer post on its Web site, or make available to investors on request, any reports of financial condition that it files with state insurance regulators or any third-party ratings of its claims-paying ability? Should we require, as a condition to the exemption, an insurer to report to the Commission, disclose to its contract owners, and/or publicly disclose any material disciplinary action undertaken, or material deficiency identified by, a state insurance regulator that relates to the insurer's financial condition or any other matter?

• Should we require, as a condition to the exemption, that the insurer be subject to supervision and periodic examination of its financial condition by its home state regulator, as proposed? Is the proposed condition consistent with state insurance regulation? Are there other conditions that should be imposed relating to supervision by the state insurance regulator?

• Should the Exchange Act exemption include conditions designed to limit trading interest in the securities? If so, are the proposed conditions appropriate? Does the proposed rule place appropriate restrictions on transfers of securities with respect to which the exemption is claimed without unduly restricting transfers in a manner that would be harmful to investors' interests?

IV. General Request for Comments

The Commission requests comment on the rules proposed in this release,

[90] Proposed rule 12h–7(c). *Cf.* Section 26(f)(2)(B)(ii) and (iii) of the Investment Company Act [15 U.S.C. 80a–26(f)(2)(B)(ii) and (iii)] (using similar language in requirements that apply to insurance companies that sell variable insurance products).

[91] For this purpose, ''alternative trading system'' would have the same meaning as in Regulation ATS. *See* 17 CFR 242.300(a) (definition of ''alternative trading system'').

[92] For this purpose, ''inter-dealer quotation system'' would have the same meaning as in Exchange Act rule 15c2–11. *See* 17 CFR 240.15c2–11(e)(2) (definition of ''inter-dealer quotation system'').

[93] Proposed rule 12h–7(d).

[94] Proposed rule 12h–7(e).

[95] *See* Roth, *supra* note 72, at 4 n. 4.

whether any further changes to our rules are necessary or appropriate to implement the objectives of our proposed rules, and on other matters that might affect the proposals contained in this release.

V. Paperwork Reduction Act

A. Background

Proposed rule 151A contains no new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[96] However, we believe that proposed rule 151A would, if adopted, result in an increase in the disclosure burden associated with existing Form S–1 as a result of additional filings that would be made on Form S–1.[97] Form S–1 contains ''collection of information'' requirements within the meaning of the PRA. Although we are not proposing to amend Form S–1, we are submitting the Form S–1 ''collection of information'' (''Form S–1 (OMB Control No. 3235–0065)), which we estimate would increase as a result of proposed rule 151A, to the Office of Management and Budget (''OMB'') for review and approval in accordance with the PRA.[98]

We adopted existing Form S–1 pursuant to the Securities Act. This form sets forth the disclosure requirements for registration statements that are prepared by eligible issuers to provide investors with the information they need to make informed investment decisions in registered offerings. We anticipate that indexed annuities that register under the Securities Act would generally register on Form S–1.[99]

The hours and costs associated with preparing disclosure, filing forms, and retaining records constitute reporting and cost burdens imposed by the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The information collection requirements related to registration statements on Form S–1 are mandatory. There is no mandatory retention period for the information disclosed, and the information disclosed would be made publicly available on the EDGAR filing system.

B. Summary of Information Collection

Because proposed rule 151A would affect the number of filings on Form S–1 but not the disclosure required by this form, we do not believe that the amendments will impose any new recordkeeping or information collection requirements. However, we expect that some insurance companies will register indexed annuities in the future that they would not previously have registered. We believe this will result in an increase in the number of annual responses expected with respect to Form S–1 and in the disclosure burden associated with Form S–1. At the same time, we expect that, on a per response basis, proposed rule 151A would decrease the existing disclosure burden for Form S–1. This is because the disclosure burden for each indexed annuity on Form S–1 is likely to be lower than the existing burden per respondent on Form S–1. The decreased burden per response on Form S–1 would partially offset the increased burden resulting from the increase in the annual number of responses on Form S–1. We believe that, in the aggregate, the disclosure burden for Form S–1 would increase if proposed rule 151A were adopted.

C. Paperwork Reduction Act Burden Estimates

For purposes of the PRA, we estimate that our proposal will result in an annual increase in the paperwork burden for companies to comply with the Form S–1 collection of information requirements of approximately 60,000 hours of in-house company personnel time and approximately $72,000,000 for the services of outside professionals. These estimates represent the combined effect of an expected increase in the number of annual responses on Form S–1 and a decrease in the expected burden per response. These estimates include the time and the cost of preparing and reviewing disclosure, filing documents, and retaining records. Our methodologies for deriving the above estimates are discussed below.

We are proposing a new definition of ''annuity contract'' that, on a prospective basis, would define a class of indexed annuities that are not ''annuity contracts'' or ''optional annuity contracts'' for purposes of section 3(a)(8) of the Securities Act, which provides an exemption under the Securities Act for certain insurance contracts. These indexed annuities would, on a prospective basis, be required to register under the Securities Act on Form S–1.[100]

Increase in Number of Annual Responses

For purposes of the PRA, we estimate that there would be an annual increase of 400 responses on Form S–1 as a result of the proposal. In 2007, there were 322 indexed annuity contracts offered.[101] For purposes of the PRA analysis, we assume that 400 indexed annuities will be offered each year. This allows for some escalation in the number of contracts offered in the future over the number offered in 2007. Our Office of Economic Analysis has considered the effect of the proposed rule on indexed annuity contracts with typical terms and has determined that these contracts would not meet the definition of ''annuity contract'' or ''optional annuity contract'' if they were to be issued after the effective date of the proposed rule, if adopted as proposed. Therefore, we assume that all indexed annuities that are offered will be registered, and that each of the 400 registered indexed annuities would be the subject of one response per year on Form S–1,[102] resulting in the estimated annual increase of 400 responses of Form S–1.

[96] 44 U.S.C. 3501 *et seq.*

[97] 17 CFR 239.11.

[98] 44 U.S.C. 3507(d); 5 CFR 1320.11.

[99] Some Securities Act offerings are registered on Form S–3 [17 CFR 239.13]. We do not believe that proposed rule 151A would have any significant impact on the disclosure burden associated with Form S–3 because we believe that very few insurance companies that issue indexed annuities would be eligible to register those contracts on Form S–3. In order to be eligible to file on Form S–3, an issuer, must, among other things, have filed Exchange Act reports for a period of at least 12 calendar months. General Instruction I.A.3. of Form S–3. Very few insurance companies that issue indexed annuities today are currently eligible to file Form S–3. Further, if we adopt the proposed Exchange Act reporting exemption, insurance companies that issue indexed annuities and rely on the exemption would not meet the eligibility requirements for Form S–3.

We also do not believe that the proposed rules would have any significant impact on the disclosure burden associated with reporting under the Exchange Act on Forms 10–K, 10–Q, and 8–K. As a result of proposed rule 12h–7, insurance companies would not be required to file Exchange Act reports on these forms in connection with indexed annuities that are registered under the Securities Act. While proposed rule 12h–7 would permit some insurance companies that are currently required to file Exchange Act reports as a result of issuing insurance contracts that are registered under the Securities Act to cease filing those reports, the number of such companies is insignificant compared to the total number of Exchange Act reporting companies.

[100] Some Securities Act offerings are registered on Form S–3, but we believe that very few, if any, insurance companies that issue indexed annuities would be eligible to register those contracts on Form S–3. *See supra* note 99.

[101] NAVA, *supra* note 6, at 57.

[102] Annuity contracts are typically offered to purchasers on a continuous basis, and as a result, an insurer offering an annuity contract that is registered under the Securities Act generally would be required to update the registration statement once a year. *See* section 10(a)(3) of the Securities Act [15 U.S.C. 77j(a)(3)] (when prospectus used more than 9 months after effective date of registration statement, information therein generally required to be not more than 16 months old).

Decrease in Expected Hours per Response

For purposes of the PRA, we estimate that there would be a decrease of 265 hours per response on Form S–1 as a result of our proposal. Current OMB estimates and recent Commission rulemaking estimate the hours per response on Form S–1 as 1,176.[103] The current hour estimate represents the burden for all issuers, both large and small. We believe that registration statements on Form S–1 for indexed annuities would result in a significantly lower number of hours per response, which, based on our experience with other similar contracts, we estimate as 600 hours per indexed annuity response on Form S–1. We attribute this lower estimate to two factors. First, the estimated 400 indexed annuity registration statements will likely be filed by far fewer than 400 different insurance companies,[104] and a significant part of the information in each of the multiple registration statements filed by a single insurance company will be the same, resulting in economies of scale with respect to the multiple filings. Second, many of the 400 responses on Form S–1 each year will be annual updates to registration statements for existing contracts, rather than new registration statements, resulting in a significantly lower hour burden than a new registration statement.[105] Combining our estimate of 600 hours per indexed annuity response on Form S–1 (for an estimated 400 responses) with the existing estimate of 1,176 hours per response on Form S–1 (for an estimated 471 responses),[106] our new estimate is 911 hours per response $(((400 \times 600) + (471 \times 1{,}176))/871)$.

Net Increase in Burden

To calculate the total effect of the proposed rules on the overall compliance burden for all issuers, large and small, we added the burden associated with the 400 additional Forms S–1 that we estimate will be filed annually in the future and subtracted the burden associated with our reduced estimate of 911 hours for each of the current estimated 471 responses. We used current OMB estimates in our calculation of the hours and cost burden associated with preparing, reviewing, and filing Form S–1.

Consistent with current OMB estimates and recent Commission rulemaking,[107] we estimate that 25% of the burden of preparation of Form S–1 is carried by the company internally and that 75% of the burden is carried by outside professionals retained by the issuer at an average cost of $400 per hour.[108] The portion of the burden carried by outside professionals is reflected as a cost, while the burden carried by the company internally is reflected in hours.

The tables below illustrate our estimates concerning the incremental annual compliance burden in the collection of information in hours and cost for Form S–1.

INCREMENTAL PRA BURDEN DUE TO INCREASED FILINGS

Estimated increase in annual responses	Hours/response	Incremental burden (hours)
400	911	364,400

INCREMENTAL DECREASE IN PRA BURDEN DUE TO DECREASE IN HOURS PER RESPONSE

Estimated decrease in hours/response	Current estimated number of annual filings	Incremental decrease in burden (hours)
(265)	471	(124,800)

SUMMARY OF CHANGE IN INCREMENTAL COMPLIANCE BURDEN

Incremental burden (hours)	25% Issuer (hours)	75% Professional (hours)	$400/hr. Professional cost
240,000	60,000	180,000	$72,000,000

D. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comments to: (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information would have practical utility; (2) evaluate the accuracy of our estimate of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. We note that the PRA burden will depend on the number of indexed annuity contracts that, under any rule we adopt, are not ''annuity contracts,'' and therefore will be required to register under the Securities Act. We have assumed, for purposes of the PRA, that all indexed annuities would not be ''annuity contracts'' under the rule and that, if the proposed rule were adopted, they would be required to be registered under the Securities Act. We request comment regarding this assumption and, more generally, on the percentage, or number, of indexed annuities that would be required to register under the Securities Act if the proposed rule were adopted.

Persons submitting comments on the collection of information requirements should direct the comments to OMB,

[103] *See* Securities Act Release No. 8878 (Dec. 19, 2007) [72 FR 73534, 73547 (Dec. 27, 2007)].

[104] The 322 indexed annuities offered in 2007 were issued by 58 insurance companies. *See* NAVA, *supra* note 6, at 57.

[105] *See supra* note 102.

[106] *See* Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8878, available at: *http://www.reginfo.gov/public/do/DownloadDocument?documentID=61283&version=1.*

[107] *See* Securities Act Release No. 8878, *supra* note 103, 72 FR at 73547.

[108] *Id.* at n. 110 and accompanying text.

Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of the comments to Office of the Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–9303, with reference to File No. S7–14–08. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–14–08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE., Washington, DC 20549–1110. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VI. Cost/Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. Proposed rule 151A is intended to clarify the status under the federal securities laws of indexed annuities, under which payments to the purchaser are dependent on the performance of a securities index. Section 3(a)(8) of the Securities Act provides an exemption for certain insurance contracts. The proposed rule would prospectively define certain indexed annuities as not being ''annuity contracts'' or ''optional annuity contracts'' under this insurance exemption if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. With respect to these annuities, investors would be entitled to all the protections of the federal securities laws, including full and fair disclosure and sales practice protections. We are also proposing new rule 12h–7 under the Exchange Act, which would exempt certain insurance companies from Exchange Act reporting with respect to indexed annuities and certain other securities that are registered under the Securities Act and regulated as insurance under state law.

A. Benefits

Possible benefits of the proposed amendments include the following: (i) Enhanced disclosure of information needed to make informed investment decisions about indexed annuities; (ii) sales practice protections would apply with respect to those indexed annuities that are outside the insurance exemption; (iii) greater regulatory certainty with regard to the status of indexed annuities under the federal securities laws; (iv) enhanced competition; and (v) relief from Exchange Act reporting obligations to insurers that issue certain securities that are regulated as insurance under state law.

Disclosure

Proposed rule 151A would extend the benefits of full and fair disclosure under the federal securities laws to investors in indexed annuities that, under the proposed rule, fall outside the insurance exemption. Without such disclosure, investors face significant obstacles in making informed investment decisions with regard to purchasing indexed annuities that expose investors to securities investment risk. Extending the federal securities disclosure regime to such indexed annuities that impose securities investment risk should help to provide investors with the information they need.

Disclosures that would be required for registered indexed annuities include information about costs (such as surrender charges); the method of computing indexed return (*e.g.,* applicable index, method for determining change in index, caps, participation rates, spreads); minimum guarantees, as well as guarantees, or lack thereof, with respect to the method for computing indexed return; and benefits (lump sum, as well as annuity and death benefits). We think there are significant benefits to the disclosures provided under the federal securities laws. This information will be public and accessible to all investors, intermediaries, third party information providers, and others through the SEC's EDGAR system. Public availability of this information would be helpful to investors in making informed decisions about purchasing indexed annuities. The information would enhance investors' ability to compare various indexed annuities and also to compare indexed annuities with mutual funds, variable annuities, and other securities and financial products. The potential liability for materially false and misleading statements and omissions under the federal securities laws would provide additional encouragement for accurate, relevant, and complete disclosures by insurers that issue indexed annuities and by the broker-dealers who sell them.[109]

In addition, we believe that potential purchasers of indexed annuities that an insurer determines do not fall outside the insurance exemption under the proposed rule may benefit from enhanced information available as a result of the proposed rule. An indexed annuity that is not registered under the Securities Act after the adoption of proposed rule 151A would reflect the insurer's determination that investors in the annuity would not receive more than the amounts guaranteed under the contract at least half the time. This information would help a purchaser to evaluate the value of the index-based return.

Sales Practice Protections

Investors would also benefit because, under the federal securities laws, persons effecting transactions in indexed annuities that fall outside the insurance exemption under proposed rule 151A would be required to be registered broker-dealers or become associated persons of a broker-dealer through a networking arrangement. Thus, the broker-dealer sales practice protections would apply to transactions in registered indexed annuities. As a result, investors who purchase these indexed annuities after the effective date of proposed rule 151A would receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities would be subject to supervision by the broker-dealer with which they are associated. Both the selling broker-dealer and its registered representatives would be subject to the oversight of FINRA.[110] The registered broker-dealers would also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as be subject to the Commission's general inspections and, where warranted, enforcement powers.

[109] *See, e.g.,* Section 12(a)(2) of the Securities Act [15 U.S.C. 77l(a)(2)] (imposing liability for materially false or misleading statements in a prospectus or oral communication, subject to a reasonable care defense). *See also* Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)]; rule 10b–5 under the Exchange Act [17 CFR 240.10b–5]; Section 17 of the Securities Act [15 U.S.C. 77q] (general antifraud provisions).

[110] *Cf.* NASD Rule 2821 (recently adopted rule designed to enhance broker-dealers' compliance and supervisory systems and provide more comprehensive and targeted protection to investors regarding deferred variable annuities). *See* Order Approving FINRA's NASD Rule 2821 Regarding Members' Responsibilities for Deferred Variable Annuities (Approval Order), Securities Exchange Act Release No. 56375 (Sept. 7, 2007), 72 FR 52403 (Sept. 13, 2007) (SR–NASD–2004–183); Corrective Order, Securities Exchange Act Release No. 56375A (Sept. 14, 2007), 72 FR 53612 (September 19, 2007) (SR–NASD–2004–183) (correcting the rule's effective date).

Regulatory Certainty

Proposed rule 151A would provide the benefit of increased regulatory certainty to insurance companies that issue indexed annuities and the distributors who sell them, as well as to purchasers of indexed annuities. The status of indexed annuities under the federal securities laws has been uncertain since their introduction in the mid-1990s. Under existing precedents, the status of each indexed annuity is determined based on a facts and circumstances analysis of factors that have been articulated by the U.S. Supreme Court. Proposed rule 151A would bring greater certainty into this area by defining a class of indexed annuities that are outside the scope of the insurance exemption and by providing that an insurer's determination, in accordance with the proposed rule, would be conclusive.

Enhanced Competition

Proposed rule 151A may result in enhanced competition among indexed annuities, as well as between indexed annuities and other competing financial products, such as mutual funds and variable annuities. Proposed rule 151A would result in enhanced disclosure, and, as a result, more informed investment decisions by potential investors, which may enhance competition among indexed annuities and competing products. The greater clarity that results from proposed rule 151A may enhance competition as well because insurers who may have been reluctant to issue indexed annuities while their status was uncertain may now decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities. Further, we believe that the proposed Exchange Act exemption may enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption would reduce the regulatory costs associated with doing so. Increased competition may benefit investors through improvements in the terms of insurance products and other financial products, such as reductions of direct or indirect fees.

Relief from Reporting Obligations

In addition, the proposed exemption from Exchange Act reporting requirements with respect to certain securities that are regulated as insurance under state law would provide a cost savings to insurers. We have identified approximately 24 insurance companies that currently are subject to Exchange Act reporting obligations solely as a result of issuing insurance contracts that are securities and that we believe would, if we adopt proposed rule 12h–7, be exempted from Exchange Act reporting obligations.[111] We estimate that, each year, these insurers file an estimated 24 annual reports on Form 10–K, 72 quarterly reports on Form 10–Q, and 26 reports on Form 8–K.[112] Based on current cost estimates, we believe that the total estimated annual cost savings to these companies would be approximately $15,414,600.[113]

B. Costs

While our proposal would result in significant cost savings for insurers as a result of the proposed exemption from Exchange Act reporting requirements, we believe that there would be costs associated with the proposal. These would include costs associated with: (i) Determining under proposed rule 151A whether amounts payable by the insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under the contract; (ii) preparing and filing required Securities Act registration statements with the Commission; (iii) printing prospectuses and providing them to investors; (iv) entering into a networking arrangement with a registered broker-dealer for those entities that are not currently parties to a networking arrangement or registered as broker-dealers and that intend to distribute indexed annuities that are registered as securities;[114] (v) loss of revenue to insurance companies that determine to cease issuing indexed annuities; and (vi) diminished competition that may result if some insurance companies cease issuing indexed annuities.

Determination Under Proposed Rule 151A

Insurers may incur costs in performing the analysis necessary to determine whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts guaranteed under the contract. This analysis calls for the insurer to analyze expected outcomes under various scenarios involving different facts and circumstances. Insurers routinely undertake such analyses for purposes of pricing and hedging their contracts.[115] As a result, we believe that the costs of undertaking the analysis for purposes of the proposed rule may not be significant. However, the determinations necessary under the proposed rule may result in some additional costs for insurers that issue indexed annuities, either because the timing of the determination does not coincide with other similar analyses undertaken by the insurer or because the level or type of actuarial and legal analysis that the insurer would determine is appropriate under the proposed rule is different or greater than that undertaken for other purposes, or for other reasons. These costs, if any, could include the costs of software, as well as the costs of internal personnel

[111] In addition, if we adopt both proposed rules 151A and 12h–7, insurers that currently are not Exchange Act reporting companies and that would be required to register indexed annuities under the Securities Act could avail themselves of the Exchange Act exemption and obtain the benefits of the exemption. We have not included potential cost savings to these companies in our computation because they are not currently Exchange Act reporting companies.

[112] These estimates are based on the requirement to file one Form 10–K each year and three Forms 10–Q each year, and on our review of the actual number of Form 8–K filings by these insurers in calendar year 2007.

[113] This consists of $8,748,950 attributable to internal personnel costs, representing 49,994 burden hours at $175 per hour, and $6,665,600 attributable to the costs of outside professionals, representing 16,664 burden hours at $400 per hour. Our estimates of $175 per hour for internal time and $400 per hours for outside professionals are consistent with the estimates that we have used in recent rulemaking releases.

Our total burden hour estimate for Forms 10–K, 10–Q, and 8–K is 66,658 hours, which, consistent with current OMB estimates and recent Commission rulemaking, we have allocated 75% (49,994 hours) to the insurers internally and 25% (16,664 hours) to outside professional time. *See* Supporting Statement to the Office of Management and Budget under the PRA for Securities Act Release No. 8819, available at: *http://www.reginfo.gov/public/do/DownloadDocument?documentID=42924&version=1*. The total burden hour estimate was derived as follows. The burden attributable to Form 10–K is 52,704 hours, representing 24 Forms 10–K at 2,196 hours per Form 10–K. The burden attributable to Form 10–Q is 13,824 hours, representing 72 Forms 10–Q at 192 hours per Form 10–Q. The burden attributable to Form 8–K is 130 hours, representing 26 Forms 8–K at 5 hours per Form 8–K. The burden hours per response for Form 10–K (2,196 hours), Form 10–Q (192 hours), and Form 8–K (5 hours) are consistent with current OMB estimates.

[114] While some distributors may register as broker-dealers or cease distributing indexed annuities that would be required to be registered as a result of proposed rule 151A, based on our experience with insurance companies that issue insurance products that are also securities, we believe that the vast majority would continue to distribute those indexed annuities via networking arrangements with registered broker-dealers, as discussed below.

[115] *See generally* Black and Skipper, *supra* note 39, at 26–47, 890–899.

and external consultants (*e.g.* , actuarial, accounting, legal).

Securities Act Registration Statements

Insurers will incur costs associated with preparing and filing registration statements for indexed annuities that are outside the insurance exemption as a result of proposed rule 151A. These include the costs of preparing and reviewing disclosure, filing documents, and retaining records. As noted above, our Office of Economic Analysis has considered the effect of the proposed rule on indexed annuity contracts with typical terms and has determined that these contracts would not meet the definition of ''annuity contract'' or ''optional annuity contract'' if they were issued after the effective date of the proposed rule, if adopted as proposed. For purposes of the PRA, we have estimated an annual increase in the paperwork burden for companies to comply with the proposed rules to be 60,000 hours of in-house company personnel time and $72,000,000 for services of outside professionals. We estimate that the additional burden hours of in-house company personnel time would equal total internal costs of $10,500,000 [116] annually, resulting in aggregate annual costs of $82,500,000 [117] for in-house personnel and outside professionals. These costs reflect the assumption that filings will be made on Form S–1 for 400 contracts each year, which we made for purposes of the PRA.

Costs of Printing Prospectuses and Providing Them to Investors

Insurers will also incur costs to print and provide prospectuses to investors for indexed annuities that are outside the insurance exemption as a result of proposed rule 151A. For purposes of the PRA, we have estimated that registration statements would be filed for 400 indexed annuities per year. We estimate that it would cost $0.35 to print each prospectus and $1.21 to mail each prospectus,[118] for a total of $1.56 per prospectus.[119] These estimates would be reduced to the extent that prospectuses are delivered in person or electronically, or to the extent that Securities Act prospectuses are substituted for written materials used today, rather than being delivered in addition to those materials.

Networking Arrangements With Registered Broker-Dealers

Proposed rule 151A may impose costs on indexed annuity distributors that are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer. Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement would impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor would incur legal costs in connection with entering into a networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement.[120]

Possible Loss of Revenue

Insurance companies that determine that indexed annuities are outside the insurance exemption under proposed rule 151A could either choose to register those annuities under the Securities Act or to cease selling those annuities. If an insurer ceases selling such annuities, the insurer may experience a loss of revenue. The amount of lost revenue would depend on actual revenues prior to effectiveness of the proposed rules and to the particular determinations made by insurers regarding whether to continue to issue registered indexed annuities. The loss of revenue may be offset, in whole or in part, by gains in revenue from the sale of other financial products, as purchasers' need for financial products will not diminish. These gains could be experienced by the same insurers who exit the indexed annuity business or they could be experienced by other insurance companies or other issuers of securities or other financial products.

Possible Diminished Competition

There could be costs associated with diminished competition as a result of our proposed rules. In order to issue indexed annuities that are outside the insurance exemption under proposed rule 151A, insurers would be required to register those annuities as securities. If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by proposed rule 151A and register those annuities that are outside the insurance exemption under the proposed rule, there will be fewer issuers of indexed annuities, which may result in reduced competition. Any reduction in competition may affect investors through potentially less favorable terms of insurance products and other financial products, such as increases in direct or indirect fees. Any reduction in competition must be considered in conjunction with the potential enhancements to competition that are described in the Benefits section, above.

C. Request for Comments

We request comments on all aspects of this cost/benefit analysis, including identification of any additional costs or benefits that may result from the proposed amendments. We also solicit comment on any alternatives to the proposal in light of the cost-benefit analysis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible. In particular, we request comment on the following issues:

• Are our quantitative estimates of benefits and costs correct? If not, how should they be adjusted?

• What are the costs associated with determining whether amounts payable under an indexed annuity would be more likely than not to exceed the amounts guaranteed under the contract? Are valuation and hedging models currently in use readily adaptable for the purposes of this calculation? How much, if any, additional cost would this represent for insurers over and above the costs they routinely incur for the

[116] This cost increase is estimated by multiplying the total annual hour burden (60,000 hours) by the estimated hourly wage rate of $175 per hour. Consistent with recent rulemaking releases, we estimate the value of work performed by the company internally at a cost of $175 per hour.

[117] $10,500,000 (in-house personnel) + $72,000,000 (outside professionals).

[118] These estimates reflect estimates provided to us by Broadridge Financial Solutions, Inc., in connection with our recent proposal to create a summary prospectus for mutual funds. The estimates depend on factors such as page length and number of copies printed and not on the content of the disclosures. Because we believe that these factors may be reasonably comparable for indexed annuity and mutual fund prospectuses, we believe that it is reasonable to use these estimates in the context of indexed annuities. *See* Memorandum to File number S7–28–07 regarding October 27, 2007 meeting between Commission staff members and representatives of Broadridge Financial Solutions, Inc. (Nov. 28, 2007). The memorandum is available for inspection and copying in File No. S7–28–07 in the Commission's Public Reference Room and on the Commission's Web site at *http://www.sec.gov/comments/s7-28-07/s72807-5.pdf.*

[119] We note that we solicit specific comment on the average number of prospectuses that would be provided each year to offerees and/or purchasers of a registered indexed annuity. This information may assist us in estimating an aggregate cost for printing and providing prospectuses.

[120] We note that we solicit specific comment on the number of entities that are distributors of indexed annuities, and on how many are parties to a networking arrangement.

analysis necessary for pricing and hedging contracts, or for other purposes?

• We have estimated that 400 indexed annuity contracts would be registered on Form S–1 each year. Is this an accurate estimate, or is it too high or too low? What percentage of indexed annuities currently offered would not be considered ''annuity contracts'' or ''optional annuity contracts'' under proposed rule 151A?

• What would the costs of printing and providing prospectuses be for indexed annuities that are outside the insurance exemption under proposed rule 151A? What would the per prospectus printing and mailing costs be? On average, how many prospectuses would be provided each year for a registered indexed annuity to offerees and/or purchasers? To what degree would prospectuses be delivered by mail, in person, or electronically? To what degree would Securities Act prospectuses be provided in lieu of written materials used today?

• What are the costs of entering into a networking arrangement with a registered broker-dealer? How many entities currently distribute indexed annuities? Of those, how many have entered into a networking arrangement to sell other insurance products that are also securities (*i.e.,* variable annuities)? How many have registered as broker-dealers to sell other insurance products that are also securities?

• How much revenue would be lost by insurers that determine to cease issuing indexed annuities? Would this lost revenue be offset by revenue gains of these insurance companies or by revenue gains of others? If so, by how much?

VII. Consideration of Promotion of Efficiency, Competition, and Capital Formation; Consideration of Burden on Competition

Section 2(b) of the Securities Act [121] and section 3(f) of the Securities Exchange Act [122] require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act [123] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe that proposed rule 151A would promote efficiency by extending the benefits of the disclosure and sales practice protections of the federal securities laws to indexed annuities that are more likely than not to provide payments that vary with the performance of securities. The required disclosures would enable investors to make more informed investment decisions, and investors would receive the benefits of the sales practice protections, including a registered representative's obligation to make only recommendations that are suitable. We believe that these investor protections would provide better dissemination of investment-related information, enhance investment decisions by investors, and, ultimately, lead to greater efficiency in the securities markets.

We also anticipate that, because proposed rule 151A would improve investors' ability to make informed investment decisions, it would lead to increased competition between issuers and sellers of indexed annuities, mutual funds, variable annuities, and other financial products, and increased competitiveness in the U.S. capital markets. The greater clarity that results from proposed rule 151A also may enhance competition because insurers who may have been reluctant to issue indexed annuities, while their status was uncertain, may decide to enter the market. Similarly, registered broker-dealers who currently may be unwilling to sell unregistered indexed annuities because of their uncertain regulatory status may become willing to sell indexed annuities that are registered, thereby increasing competition among distributors of indexed annuities.

Proposed rule 151A might have some negative effects on competition. In order to issue indexed annuities that are outside the insurance exemption under proposed rule 151A, insurers would be required to register those annuities as securities. If some insurers determine to cease issuing indexed annuities rather than undertake the analysis required by proposed rule 151A and register those annuities that are outside the insurance exemption under the proposed rule, there will be fewer issuers of indexed annuities, which may result in reduced competition. Any reduction in competition must be considered in conjunction with the potential enhancements to competition that are described in the preceding paragraph.

We also anticipate that the increased market efficiency resulting from enhanced investor protections under proposed rule 151A could promote capital formation by improving the flow of information between insurers that issue indexed annuities, the distributors of those annuities, and investors.

Proposed rule 12h–7 would provide insurance companies with an exemption from Exchange Act reporting with respect to indexed annuities and certain other securities that are regulated as insurance under state law. We have proposed this exemption because the concerns that Exchange Act financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract. Accordingly, we believe that the proposed exemption would improve efficiency by eliminating potentially duplicative and burdensome regulation relating to insurers' financial condition. Furthermore, we believe that proposed rule 12h–7 would not impose any burden on competition. Rather, we believe that the proposed rule would enhance competition among insurance products and between insurance products and other financial products because the exemption may encourage insurers to innovate and introduce a range of new insurance contracts that are securities, since the exemption would reduce the regulatory costs associated with doing so. We also anticipate that the innovations in product development could promote capital formation by providing new investment opportunities for investors.

We request comment on whether the proposed amendments, if adopted, would promote efficiency, competition, and capital formation. We also request comment on any anti-competitive effects of the proposed rules. Commenters are requested to provide empirical data and other factual support for their views.

VIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act.[124] It relates to the Commission's proposed rule 151A that would define the terms ''annuity contract'' and ''optional annuity contract'' under the Securities Act of

[121] 15 U.S.C. 77b(b).

[122] 15 U.S.C. 78c(f).

[123] 15 U.S.C. 78w(a)(2).

[124] 5 U.S.C. 603 *et seq.*

1933 and proposed rule 12h–7 that would exempt insurance companies from filing reports under the Securities Exchange Act of 1934 with respect to indexed annuities and other securities that are registered under the Securities Act, subject to certain conditions.

A. Reasons for, and Objective of, Proposed Amendments

We are proposing the definition of the terms ''annuity contract'' and ''optional annuity contract'' to provide greater clarity with regard to the status of indexed annuities under the federal securities laws. We believe this would enhance investor protection and would provide greater certainty to the issuers and sellers of these products with respect to their obligations under the federal securities laws. We are proposing the exemption from Exchange Act reporting because we believe that the concerns that periodic financial disclosures are intended to address are generally not implicated where an insurer's financial condition and ability to meet its contractual obligations are subject to oversight under state law and where there is no trading interest in an insurance contract.

B. Legal Basis

The Commission is proposing rules 151A and 12h–7 pursuant to the authority set forth in sections 3(a)(8) and 19(a) of the Securities Act [15 U.S.C. 77c(a)(8) and 77s(a)] and sections 12(h), 13, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78*l*(h), 78m, 78o, 78w(a), and 78mm].

C. Small Entities Subject to the Proposed Rules

The Commission's rules define ''small business'' and ''small organization'' for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission.[125] Rule 0–10(a)[126] defines an issuer, other than an investment company, to be a ''small business'' or ''small organization'' for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year.[127] No insurers currently issuing indexed annuities are small entities.[128] In addition, no other insurers that would be covered by the proposed Exchange Act exemption are small entities.[129]

While there are no small entities among the insurers who are subject to the proposed rules, we note that there may be small entities among distributors of indexed annuities. Proposed rule 151A, if adopted as proposed, may affect indexed annuity distributors who are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer.[130] Under these arrangements, an affiliated or third-party broker-dealer provides brokerage services for an insurance agency's customers, in connection with transactions in insurance products that are also securities. Entering into a networking arrangement would impose costs associated with contracting with the registered broker-dealer regarding the terms, conditions, and obligations of each party to the arrangement. We anticipate that a distributor would incur legal costs in connection with entering into a networking arrangement with a registered broker-dealer, as well as ongoing costs associated with monitoring compliance with the terms of the networking arrangement.

Rule 0–10(c)[131] states that the term ''small business'' or ''small organization,'' when referring to a broker-dealer that is not required to file audited financial statements prepared pursuant to rule 17a–5(d) under the Exchange Act,[132] means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. Rule 0–1(a)[133] states that the term ''small business'' or ''small organization,'' when used with reference to a ''person,'' other than an investment company, means a ''person'' that, on the last day of its most recent fiscal year, had total assets of $5 million or less.

D. Reporting, Recordkeeping, and Other Compliance Requirements

Proposed rule 151A would result in Securities Act filing obligations for those insurance companies that, in the future, issue indexed annuities that fall outside the insurance exemption under proposed rule 151A, and proposed rule 12h–7 would result in the elimination of Exchange Act reporting obligations for those insurance companies that meet the conditions to the proposed exemption. As noted above, no insurance companies that currently issue indexed annuities or that would be covered by the proposed exemption are small entities.

However, proposed rule 151A may affect indexed annuity distributors that are small entities and that are not currently parties to a networking arrangement or registered as broker-dealers. While these entities may choose to register as broker-dealers, in order to continue to distribute indexed annuities that are registered as securities, these distributors would likely enter into a networking arrangement with a registered broker-dealer. Entities that enter into such networking arrangements would not be subject to ongoing reporting, recordkeeping, or other compliance requirements. If any of these entities were to choose to register as broker-dealers as a result of proposed rule 151A,[134] they would be subject to

[125] *See* rule 157 under the Securities Act [17 CFR 230.157]; rule 0–10 under the Exchange Act [17 CFR 240.0–10].

[126] 17 CFR 240.0–10(a).

[127] Securities Act rule 157(a) [17 CFR 157(a)] generally defines an issuer, other than an investment company, to be a ''small business'' or ''small organization'' for purposes of the Regulatory Flexibility Act if it had total assets of $5 million or less on the last day of its most recent fiscal year and it is conducting or proposing to conduct a securities offering of $5 million or less. For purposes of our analysis, however, we use the Exchange Act definition of ''small business'' or ''small entity'' because that definition includes more issuers than does the Securities Act definition and, as a result, assures that the definition we use would not itself lead to an understatement of the impact of the amendments on small entities.

[128] The staff has determined that each insurance company that currently offers indexed annuities has total assets significantly in excess of $5 million. The staff compiled a list of indexed annuity issuers from four sources: AnnuitySpecs, Carrier List, *http://www.annuityspecs.com/Page.aspx?s=carrierlist;* Annuity Advantage, Equity Indexed Annuity Data, *http://www.annuityadvantage.com/annuitydataequity.htm;* Advantage Compendium, Current Rates, *http://www.indexannuity.org/rates_by_carrier.htm*; and a search of BEST'S COMPANY REPORTS (available on LEXIS) for indexed annuity issuers. The total assets of each insurance company issuer of indexed annuities were determined by reviewing the most recent BEST'S COMPANY REPORTS for each indexed annuity issuer.

[129] The staff has determined that each insurance company that currently offers contracts that are registered under the Securities Act and that include so-called market value adjustment features or guaranteed benefits in connection with assets held in an investor's account has total assets significantly in excess of $5 million. The total assets of each such insurance company were determined by reviewing the Form 10–K of that company and, in some cases, BEST'S COMPANY REPORTS (available on LEXIS).

[130] We note that we solicit specific comment on the number of entities that are distributors of indexed annuities, and on how many are parties to a networking arrangement. *See* Part VI., above.

[131] 17 CFR 240.0–10(c).

[132] 17 CFR 240.17a–5(d).

[133] 17 CFR 240.10(a).

[134] *See, e.g.,* Submission for OMB Review; Comment Request, OMB Control No. 3235–0012 [72 FR 39646 (Jul. 19, 2007)] (discussing the total annual burden imposed by Form BD).

ongoing reporting, recordkeeping, and other compliance requirements applicable to registered broker-dealers. Compliance with these requirements, if applicable, would impose costs associated with accounting, legal, and other professional personnel, and the design and operation of automated and other compliance systems.

E. Duplicative, Overlapping, or Conflicting Federal Rules

We believe that the proposed rules would not duplicate, overlap, or conflict with other federal rules.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Further clarifying, consolidating, or simplifying the proposed requirements for small entities;
- Using performance standards rather than design standards; and
- Providing an exemption from the proposed requirements, or any part of them, for small entities.

Because no insurers that currently issue indexed annuities or that would be covered by the proposed Exchange Act exemption are small entities, consideration of these alternatives for those insurance companies is not applicable. Small distributors of indexed annuities that choose to enter into networking arrangements with registered broker-dealers, which we believe would be likely if proposed rule 151A were adopted, would not be subject to ongoing reporting, recordkeeping, or other compliance requirements. However, because some small distributors may choose to register as broker-dealers, we did consider the alternatives above for small distributors.

The Commission believes that different registration, compliance, or reporting requirements or timetables for small entities that distribute registered indexed annuities would not be appropriate or consistent with investor protection. The proposed rules would provide investors with the sales practice protections of the federal securities laws when they purchase indexed annuities that are outside the insurance exemption. These indexed annuities would be required to be distributed by a registered broker-dealer. As a result, investors who purchase these indexed annuities after the effective date of proposed rule 151A would receive the benefits associated with a registered representative's obligation to make only recommendations that are suitable. The registered representatives who sell registered indexed annuities would be subject to supervision by the broker-dealer with which they are associated, and the selling broker-dealers would be subject to the oversight of FINRA. The registered broker-dealers would also be required to comply with specific books and records, supervisory, and other compliance requirements under the federal securities laws, as well as to be subject to the Commission's general inspections and, where warranted, enforcement powers.

Different registration, compliance, or reporting requirements or timetables for small entities that distribute indexed annuities may create the risk that investors would receive lesser sales practice and other protections when they purchase a registered indexed annuity through a distributor that is a small entity. We believe that it is important for all investors that purchase indexed annuities that are outside the insurance exemption to receive equivalent protections under the federal securities laws, without regard to the size of the distributor through which they purchase. For those same reasons, the Commission also does not believe that it would be appropriate or consistent with investor protection to exempt small entities from the broker-dealer registration requirements when those entities distribute indexed annuities that fall outside of the insurance exemption under our proposed rules.

Through our existing requirements for broker-dealers, we have endeavored to minimize the regulatory burden on all broker-dealers, including small entities, while meeting our regulatory objectives. Small entities that distribute indexed annuities that are outside the insurance exemption under our proposed rule should benefit from the Commission's reasoned approach to broker-dealer regulation to the same degree as other entities that distribute securities. In our existing broker-dealer regulatory framework, we have endeavored to clarify, consolidate, and simplify the requirements applicable to all registered broker-dealers, and the proposed rules do not change those requirements in any way. Finally, we do not consider using performance rather than design standards to be consistent with investor protection in the context of broker-dealer registration, compliance, and reporting requirements.

G. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- Whether there are any small entity insurance companies that would be affected by the proposed rules and, if so, how many and the nature of the potential impact of the proposed rules on these insurance companies;
- The number of small entity distributors of indexed annuities that may be affected by proposed rule 151A and the potential effect of the rule on these small entities; and
- Any other small entities that may be affected by the proposed rules.

Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules themselves.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ''SBREFA'',[135] a rule is ''major'' if it results or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a ''major rule'' for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

X. Statutory Authority

The Commission is proposing the amendments outlined above under sections 3(a)(8) and 19(a) of the Securities Act [15 U.S.C. 77c(a)(8) and 77s(a)] and Sections 12(h), 13, 15, 23(a), and 36 of the Exchange Act [15 U.S.C. 78*l*(h), 78m, 78o, 78w(a), and 78mm].

[135] Pub. L. 104–21, Title II, 110 Stat. 857 (1996).

List of Subjects in 17 CFR Parts 230 and 240

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rules

For the reasons set forth in the preamble, the Commission proposes to amend title 17, Chapter II, of the Code of Federal Regulations as follows:

PART 230—GENERAL RULES AND REGULATONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z–3, 77sss, 78c, 78d, 78j, 78*l*, 78m, 78n, 78o, 78t, 78w, 78*ll*(d), 78mm, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

2. Add § 230.151A to read as follows:

§ 230.151A Certain contracts not ''annuity contracts'' or ''optional annuity contracts'' under section 3(a)(8).

(a) *General.* Except as provided in paragraph (c) of this section, a contract that is 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, and that is subject to regulation under the insurance laws of that jurisdiction as an annuity is not an ''annuity contract'' or ''optional annuity contract'' under Section 3(a)(8) of the Securities Act (15 U.S.C. 77c(a)(8)) if:

(1) Amounts payable by the issuer under the contract are calculated, in whole or in part, by reference to the performance 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.

(b) *Determination of amounts payable and guaranteed.* In making the determination under paragraph (a)(2) of this section:

(1) Amounts payable by the issuer under the contract shall be determined without reference to any charges that are imposed at the time of payment, but those charges shall be taken into account in computing the amounts guaranteed under the contract; and

(2) A determination by the issuer at or prior to issuance of the contract shall be conclusive, provided that:

(i) Both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable;

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

(iii) The determination is made not more than six months prior to the date on which the form of contract is first offered and not more than three years prior to the date on which the particular contract is issued.

(c) *Separate accounts.* This section does not apply to any contract whose value varies according to the investment experience of a separate account.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

4. Add § 240.12h–7 to read as follows:

§ 240.12h–7 Exemption for issuers of securities that are subject to insurance regulation.

An issuer shall be exempt from the duty under section 15(d) of the Act (15 U.S.C. 78o(d)) to file reports required by section 13(a) of the Act (15 U.S.C. 78m(a)) with respect to securities registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), provided that:

(a) The issuer is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State;

(b) The securities do not constitute an equity interest in the issuer and are either subject to regulation under the insurance laws of the domiciliary State of the issuer or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction;

(c) The issuer files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of the issuer's domiciliary State;

(d) The securities are not listed, traded, or quoted on an exchange, alternative trading system (as defined in § 242.300(a) of this chapter), inter-dealer quotation system (as defined in § 240.15c2–11(e)(2)), electronic communications network, or any other similar system, network, or publication for trading or quoting; and

(e) The issuer takes steps reasonably designed to ensure that a trading market for the securities does not develop, including requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis.

June 25, 2008.

By the Commission.

Florence E. Harmon,

Acting Secretary.

[FR Doc. E8–14845 Filed 6–30–08; 8:45 am]

BILLING CODE 8010–01–P