

**Opening Remarks and Dissent
by
Commissioner Troy A. Paredes**

**Regarding Final Rule 151A: Indexed Annuities
and Certain Other Insurance Contracts**

**Open Meeting of the
Securities & Exchange Commission**

December 17, 2008

Thank you, Chairman Cox.

I believe that proposed Rule 151A addressing indexed annuities is rooted in good intentions. For instance, at the time the rule was proposed, the Commission watched a television clip from *Dateline NBC* that described individuals who may have been misled by seemingly unscrupulous sales practices into buying these products. Part of our tripartite mission at the SEC is to protect investors, so there is a natural tendency to want to act when we hear stories like this.

However, our jurisdiction is limited; and thus our authority to act is circumscribed. Rule 151A is about this very question: the proper scope of our statutory authority.

In our effort to protect investors, we cannot extend our reach past the statutory stopping point. Section 3(a)(8) of the Securities Act of 1933 ('33 Act) provides a list of securities that are exempt from the '33 Act and thus, by design of the statute, fall beyond

the Commission's reach. The Section 3(a)(8) exemption includes, in relevant part, "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . of any State or Territory of the United States or the District of Columbia." I am not persuaded that Rule 151A represents merely an attempt to provide clarification to the scope of exempted securities falling within Section 3(a)(8). Instead, by defining indexed annuities in the manner done in Rule 151A, I believe the SEC will be entering into a realm that Congress prohibited us from entering. Therefore, I cannot vote in favor of the rule and respectfully dissent.

Rule 151A takes some annuity products (indexed annuities), which otherwise may be covered by the statutory exemption in Section 3(a)(8), and removes them from the exemption, thus placing them within the Commission's jurisdiction to regulate. If the Commission's Rule 151A analysis is wrong – which is to say that indexed annuities *do* fall within Section 3(a)(8) – then the SEC has exceeded its authority by seeking to regulate them. In other words, the effect of Rule 151A would be to confer additional authority upon the SEC when these products, in fact, are entitled to the Section 3(a)(8) exemption.

The Supreme Court has twice construed the scope of Section 3(a)(8) for annuity contracts in the *VALIC* and *United Benefit* cases.¹ I believe the approach embraced by Rule 151A conflicts with these Supreme Court cases. Although neither *VALIC* nor

¹ See generally *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

United Benefit deals with indexed annuities directly, the cases nevertheless are instructive in evaluating whether such a product falls within the Section 3(a)(8) exemption. And despite the adopting release's efforts to discount its holding, at least one federal court applying *VALIC* and *United Benefit* has held that an indexed annuity falls within the statutory exemption of Section 3(a)(8).²

When fixing the contours of Section 3(a)(8), the relevant features of the product at hand should be considered to determine whether the product falls outside the Section 3(a)(8) exemption. Rule 151A places singular focus on investment risk without adequately considering another key factor – namely, the manner in which an indexed annuity is marketed.

Moreover, I believe that Rule 151A misconceptualizes investment risk for purposes of Section 3(a)(8). The extent to which the purchaser of an indexed annuity bears investment risk is a key determinant of whether such a product is subject to the Commission's jurisdiction. Rule 151A denies an indexed annuity the Section 3(a)(8) exemption when it is "more likely than not" that, because of the performance of the linked securities index, amounts payable to the purchaser of the annuity contract will exceed the amounts the insurer guarantees the purchaser. This approach to investment risk gives short shrift to the guarantees that are a hallmark of indexed annuities. In other words, the central insurance component of the product eludes the Rule 151A test. More to the point, Rule 151A in effect treats the possibility of upside, beyond the guarantee of principal and the guaranteed minimum rate of return the purchaser enjoys, as investment

² See *Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

risk under Section 3(a)(8). I believe that it is more appropriate to emphasize the extent of downside risk – that is, the extent to which an investor is subject to a risk of loss – in determining the scope of Section 3(a)(8). When investment risk is properly conceived of in terms of the risk of loss, it becomes apparent why indexed annuities may fall within Section 3(a)(8) and thus beyond this agency’s reach, contrary to Rule 151A.

Not only does Rule 151A seem to deviate from the approach taken by courts, including the Supreme Court, but it also appears to depart from prior positions taken by the Commission. For example, in an amicus brief filed with the Supreme Court in the *Otto* case,³ the Commission asserted that the Section 3(a)(8) exemption applies when an insurance company, regulated by the state, assumes a “sufficient” share of investment risk and there is a corresponding decrease in the risk to the purchaser, such as where the purchaser benefits from certain guarantees. Yet Rule 151A denies the Section 3(a)(8) exemption to an indexed annuity issued by a state-regulated insurance company that bears substantial risk under the annuity contract by guaranteeing principal and a minimum return.

In addition, Rule 151A seems to diverge from the analysis embedded in Rule 151. Rule 151 establishes a true safe harbor under Section 3(a)(8) and provides that a variety of factors should be considered, such as marketing techniques and the availability of guarantees. The Rule 151 adopting release even indicates that the rule allows for certain “indexed excess interest features” without the product falling outside the safe harbor.

³ *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127 (7th Cir. 1987). The Supreme Court denied the petition for a writ of certiorari.

An even more critical difference between Rule 151 and Rule 151A is the effect of failing to meet the requirements under the rule. If a product does not meet the requirements of Rule 151, there is no safe harbor, but the product nevertheless may fall within Section 3(a)(8) and thus be an exempted security. But if a product does not pass muster under the Rule 151A “more likely than not” test, then the product is deemed to fall outside Section 3(a)(8) and thus is under the SEC’s jurisdiction. In essence, while Rule 151 provides a safe harbor, Rule 151A takes away the Section 3(a)(8) statutory exemption.

I am not aware of another instance in the federal securities laws where a “more likely than not” test is employed, and for good reason. A “more likely than not” test does not provide insurers with proper notice of whether their products fall within the federal securities laws or not. If an insurer applies the test in good faith and gets it wrong, the insurer nonetheless risks being subject to liability under Section 5 of the Securities Act, even if the insurer had no intent to run afoul of the federal securities laws. In addition, under the “more likely than not” test, the availability of the Section 3(a)(8) exemption turns on the insurer’s own analysis. Accordingly, it is at least conceivable that the same product could receive different Section 3(a)(8) treatment depending on how each respective insurer modeled the likely returns.

Further, I am concerned that Rule 151A, as applied, reveals that the “more likely than not” test, despite its purported balance, leads to only one result: the denial of the

Section 3(a)(8) exemption. In practice, Rule 151A appears to result in blanket SEC regulation of the entire indexed annuity market. The adopting release indicates that over 300 indexed annuity contracts were offered in 2007 and explains that the Office of Economic Analysis has determined that indexed annuity contracts with typical features would not meet the Rule 151A test. Indeed, the adopting release elsewhere expresses the expectation that almost all indexed annuity contracts will fail the test. If everyone is destined to fail, what is the purpose of a test? Further, there is at least some risk that in sweeping up the index annuity market, the rule may sweep up other insurance products that otherwise should fall within Section 3(a)(8).

The rule has other shortcomings, aside from the legal analysis that underpins it. These include, but are not limited to, the following.

First, a range of state insurance laws govern indexed annuities. I am disappointed that the rule and adopting release make an implicit judgment that state insurance regulators are inadequate to regulate these products. Such a judgment is beyond our mandate or our expertise. In any event, Section 3(a)(8) does not call upon the Commission to determine whether state insurance regulators are up to the task; rather, the section exempts annuity contracts subject to state insurance regulation.

Second, as a result of Rule 151A, insurers will have to bear various costs and burdens, which, importantly, could disproportionately impact small businesses. Some even have predicted that companies may be forced out of business if Rule 151A is

adopted. Such an outcome causes me concern, especially during these difficult economic times. Even when the economy is not strained, such an outcome is disconcerting because it can lead to less competition, ultimately to the detriment of consumers.

Third, the Commission received several thousand comment letters since Rule 151A was proposed in June 2008. Consistent with comments we have received, I believe that there are more effective and appropriate ways to address the concerns underlying this rulemaking. One possible alternative to Rule 151A would be amending Rule 151 to establish a more precise safe harbor in light of all the relevant facts and circumstances attendant to indexed annuities and how they are marketed. A more precise safe harbor would provide better clarity and certainty in this area – regulatory goals the Commission has identified – and would preserve the ability of insurers to find an exemption outside the safe harbor by relying directly on Section 3(a)(8) and the cases interpreting it. I believe further exploration of alternative approaches is warranted, as is continued engagement with interested parties, including state regulators.

In closing, I request that my remarks be included in the Federal Register with the final version of the release. My remarks today do not give a full exposition of the rule's shortcomings, but rather highlight some of the key points that lead me to dissent. I wish to note that these dissenting remarks just given represent my view after giving careful consideration to the range of arguments presented by the Commission's staff, particularly the Office of General Counsel, the commenters, and my own counsel, as well as those of

my fellow Commissioners. Although I cannot support the rule, I nonetheless thank the staff for the hard work they have devoted to its preparation.