

Uncertainty Reigns: The Status of Indexed Universal Life Policies after Rule 151A

by Michael Berenson and Christopher Menconi

In a single sentence buried in the middle of the 155 page release adopting Rule 151A under the Securities Act of 1933,¹ a rule addressed at equity index annuities (EIAs),² the Securities and Exchange Commission (SEC) threw into a complete state of confusion the question of how indexed universal life (IUL) insurance policies should be analyzed under the federal securities laws. This article describes the key features of IUL, discusses certain characteristics IUL policies have in common with EIAs, and addresses the securities law analysis of IUL policies prior to the Adopting Release. It then explains the uncertainty created by the Adopting Release and suggests ways IUL policies might be analyzed in the future.

Indexed Universal Life Insurance

Simply put, an IUL policy is a variation on its older cousin, the universal life insurance (UL) policy. As with any life insurance policy, there is an insured party, a death benefit, and premium payments to be made. In contrast to a typical whole

life policy whose premiums are fixed, the owner of a UL policy has the flexibility, within broad limits, to make premium payments whenever and in whatever amounts chosen. The only requirement is that when the insurance company periodically, usually monthly, seeks to collect the cost of insurance and any other policy charges, there must be sufficient cash value in the policy to pay those charges. Otherwise, the policy goes into the grace period during which the owner has the choice of

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making additional premium payments or allowing the policy to lapse. While the insurance policy is in force, the insurance company pays interest on the policy's cash value. The insurance company periodically declares this interest rate. State insurance law sets a minimum declared rate.

Except for the interest crediting method, an IUL policy operates in exactly the same manner. Under an IUL policy, the actual interest rate credited to cash value is determined retrospectively, based on the performance of a specified securities index during a prior period, typically one year. The rate will never be negative and also is subject to state law establishing a minimum declared rate. The insurance company reserves the right each year to increase or decrease in advance certain factors that affect the amount of interest credited, including the participation rate, that is, the percentage of the index increase it will pay, and the maximum rate it will pay, no matter how much the index increases.

A contract owner looking at an EIA during the accumulation period and an IUL policy prior to the death of the insured or the policy's surrender would see two products operating very similarly from an investment perspective. Under both an EIA and an IUL policy, the owner makes premium payments, pays charges, receives insurance coverage, and is credited interest by the insurance company based on the performance of a securities index, subject to a minimum mandated by state law. While the insurance coverages provided largely are mirror images of each other—protection against outliving one's assets versus protecting one's dependents from early death—the investment elements of the two types of insurance operate in an identical manner.

Securities Law Analysis of Indexed Universal Life Policies Prior to the Adopting Release

Prior to the Adopting Release, there most likely would have been a consensus among practitioners on the criteria to be considered in determining whether an IUL policy is a security. While various routes might have been taken, there would have been agreement that the criteria referred to in footnote four in the release adopting Rule 151 under the 1933 Act³ are the appropriate ones, although there would be differences in how to evaluate and how much weight to be given to each factor. That footnote states:

[I]nsurers offering life insurance contracts are in the same position as those who seek

to offer annuity contracts in direct reliance upon section 3(a)(8). The securities law status of a life insurance contract may be analyzed by reference to the principles discussed in rule 151 and accompanying releases and by reference to relevant judicial interpretation of section 3(a)(8).

The principles discussed in Rule 151 to which the footnote refers are those underlying the three elements of Rule 151:

1. The issuer of the policy must be subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions;
2. The insurance company must assume the investment risk under the policy; and
3. The policy must not be marketed primarily as an investment.

Another factor that would have been considered is the extent to which the insurance company is bearing mortality risk under its policies. Although the SEC did not include mortality risk assumption as a separate element of Rule 151, the SEC did state as follows in the 151 Release:⁴

However, the [SEC] is not concluding by this action that consideration of mortality risk assumption has no place in a section 3(a)(8) analysis of annuity contracts outside the "safe harbor." The presence or absence of a mortality risk assumption may be an appropriate factor to consider in a general facts and circumstances analysis under section 3(a)(8).

While an insurance company bears mortality risk under both annuity contracts and life insurance policies, for the following reasons, that risk element is of greater significance to the insurance company issuing a life insurance policy. Under almost all annuity contracts, the insurance company bears mortality risk, more accurately, longevity risk, in that an annuity contract will include tables that guarantee a minimum amount of annuity payments that will be paid in the future when, and if, a life-contingent annuity payout is chosen. The insurance company makes these guarantees notwithstanding possible medical advances that could lengthen life expectancies. These annuity payment guarantees also impose risk on insurance companies because they expose insurers to adverse selection, that is, contract

owners who are descendants of Methuselah will select life annuities while those who have terminal diseases will take lump-sum settlements. Under most annuities, the insurance company also assumes mortality risk to the extent that a contract owner dies during the annuity's accumulation period and the annuity's account value is less than the guaranteed minimum death benefit promised in the annuity contract.

In contrast, immediately upon issuance of life insurance, the insurance company is exposed to the risk that the insured might die. In addition, to qualify as life insurance under the Internal Revenue Code, a policy's death benefit must exceed the policy value by an amount based on the insured's age at death and the tax test chosen.

Future Securities Law Analysis of Indexed Universal Life Policies

In discussing IUL policies, the Adopting Release repeats the statement from the release proposing Rule 151A⁵ that Rule 151A will not apply to life insurance policies. It goes on to state that:

The status of an indexed life insurance policy under the federal securities laws will continue to be a facts and circumstances determination, undertaken by reference to the factors and analysis that have been articulated by the Supreme Court and the Commission. We note, however, that the considerations that form the basis for rule 151A are also relevant in analyzing indexed life insurance because indexed life insurance and indexed annuities share certain features (*e.g.*, securities-linked returns).⁶

It is the second sentence that has created uncertainty at several levels of the analysis. One approach would be to measure an IUL policy against the three factor test of Rule 151 (state regulation of the issuing insurance company; bearing of investment risk by the issuing insurance company; and marketing), supplemented by assumption of mortality risk that the SEC in the 151 Release recognized as an element of a facts and circumstances test. Presumably, the investment risk test of Rule 151 would be replaced by the test in Rule 151A(a)(2) (the Amounts Payable Test), which precludes an EIA from relying on the exclusion in Section 3(a)(8) of the 1933 Act if "[a]mounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract."

Leaving for later discussion how the Amounts Payable Test would be applied to an IUL policy, the relevant facts and circumstances could be read more narrowly in light of public comments made, but rejected, as part of the Rule 151A rulemaking process. The Proposing Release acknowledged that marketing is a significant factor in determining whether an insurance contract can rely on the Section 3(a)(8) exclusion. Notwithstanding this acknowledgement and commenters who questioned the absence of an explicit marketing test in Rule 151A,⁷ the SEC concluded in the Adopting Release that a separate marketing test was unnecessary because "[i]t would be inconsistent with the character of such an indexed annuity, and potentially misleading, to market the annuity without placing significant emphasis on the securities-linked return and the related risks."⁸ Similarly, the SEC did not make any change in Rule 151A in response to comments suggesting inclusion of a mortality risk test.⁹ In light of the SEC's decision not to include marketing and mortality risk tests in Rule 151A, the question exists whether these factors would continue to be relevant in a Section 3(a)(8) facts and circumstances analysis of an IUL policy.

Whether or not how the policy is marketed and the amount of mortality risk the insurer is assuming are relevant tests, it is not completely clear how the Amounts Payable Test should be applied to an IUL policy. What are the amounts payable and the amounts guaranteed under an IUL policy? Do the amounts payable include death benefits? Because the application of the Amounts Payable Test to an IUL policy was not raised in the Proposing Release, there were no public comments or statements in the Adopting Release on these points.¹⁰ There is, however, a footnote in the Adopting Release that suggests that death benefits should be considered as amounts payable. Footnote 114 states:

For simplicity, we are referring to payments to the purchaser. The 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, must be included.

Of course, death benefits would be payments to beneficiaries as referenced in footnote 114, but there is nothing specifically tying the footnote's language to the earlier discussion of how an IUL policy should be analyzed.

Conclusion

The Adopting Release has left a number of unanswered questions concerning how to analyze the availability of the Section 3(a)(8) exclusion to IUL policies. Having created the confusion with a single sentence in the Adopting Release, it behooves the SEC to provide some clarification before Rule 151A becomes effective on January 12, 2011. This assumes the SEC's adoption of Rule 151A survives the current challenge in the US Court of Appeals for the District of Columbia Circuit.¹¹

NOTES

1. Securities Act Release No. 8996 (Jan. 8, 2009) (the Adopting Release), text following n.99.
2. Rule 151A defines which EIAs cannot rely on the exclusion for "annuity contracts," "optional annuity contracts" and

other insurance contracts contained in Section 3(a)(8) of the Securities Act of 1933.

3. Securities Act Release No. 6645 (May 29, 1986) (the 151 Release).
4. 151 Release, n.4.
5. Securities Act Release No. 8933 (June 25, 2008) (the Proposing Release).
6. Adopting Release, at text following n.99.
7. Adopting Release at n.62.
8. *Id.* at text following n.63.
9. *Id.* at text accompanying n.67 and n.68.
10. Indeed, the Proposing Release said Rule 151A would not apply to life insurance policies. Although technically true, it is a somewhat disingenuous statement, given that the Adopting Release states that the Amounts Payable Test should be incorporated into the facts and circumstances test for an IUL policy.
11. *American Equity Investment Life Insurance Company, et al. v. US Securities and Exchange Commission*, No. 09-1021 (D.C. Cir.).

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