

The Fate of Fixed Indexed Annuities and Rule 151A

August 3, 2009

On July 21, the U.S. Court of Appeals for the District of Columbia Circuit issued its opinion in *American Equity Investment Life Insurance Company, et al.*¹ v. *Securities and Exchange Commission*.²

The issue before the court was whether the Securities and Exchange Commission (SEC) was acting in an arbitrary and capricious manner when it adopted Rule 151A under the Securities Act of 1933 (Securities Act), which precludes certain Fixed Indexed Annuity (FIA)³ contracts from relying on the exclusion from the definition of a security in Section 3(a)(8) of the Securities Act. The petitioners also asserted that the SEC had failed to meet its obligation under Section 2(b) of the Securities Act to “properly consider the effect of the rule upon efficiency, competition, and capital formation.”

The court ruled that the SEC was within its authority and jurisdiction when it adopted Rule 151A to regulate FIAs, but remanded the matter to the SEC to give it an opportunity to meet its Section 2(b) responsibilities.

The court began its review of the SEC’s interpretation of Section 3(a)(8) by conducting a two-step analysis as required by *Chevron*.⁴ First, the court undertook to determine whether the statute being interpreted was ambiguous. The court noted that Section 3(a)(8) had previously been at issue in two Supreme Court decisions (*VALIC* and *United Benefit*) and reasoned that if the statute was unambiguous, the Supreme Court would not have analyzed the products at issue in those cases. The court explained that, as the statute was silent on “whether the term ‘annuity contract’ encompasses all forms of contracts that may be described as annuities,” it was therefore open for interpretation and ambiguous.

The petitioners argued that an annuity could fall outside of Section 3(a)(8) if the annuity product is not subject to state insurance laws. The court rejected this argument and stated that this was not the only factor and that petitioners’ argument “misses the mark because it interprets *VALIC* and *United Benefit* too restrictively.”

Second, the court undertook to determine whether Rule 151A is a reasonable interpretation of the statute. The court said, “We cannot hold that this interpretation [Rule 151A] is unreasonable.” It further stated, “It is irrelevant that this court might have reached a different—or better—conclusion than the SEC.” The court did not wholeheartedly endorse each of the SEC’s policy decisions or rationales for the rule, and indeed acknowledged that the petitioners’ arguments were not unreasonable. For example, while the court regarded as reasonable the petitioners’ view that investment risk exists only where the purchaser of a security faces the possibility of a loss of principal, the court noted that that this was not sufficient to establish that Rule 151A was arbitrary or capricious.

1. The petitioners included American Equity Investment Life Insurance Co., Midland National Life Insurance Co., National Western Life Insurance Co., OM Financial Life Insurance Co., Tucker Advisory Group Inc., and BHC Marketing, an insurance marketing organization.

2. *Am. Equity Inv. Life Ins. Co., et al. v. Securities and Exchange Commission*, No. 09-1021, slip op. (D.C. Cir. July 21, 2009).

3. An FIA is an annuity that provides a minimum guaranteed interest rate with the possibility of additional earnings tied to the performance of a market index or indexes. The court explained that an FIA is a “hybrid financial product that combines some of the benefits of fixed annuities with the added earning potential of a security.”

4. *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

Similarly, while acknowledging that the SEC's failure to include a marketing test was inconsistent with prior SEC rulemaking, the court found that this failure was not "unreasonable."

The petitioners also argued that the SEC contravened Section 2(b) of the Securities Act because it failed to consider the efficiency, competition, and capital formation effects of Rule 151A. Section 2(b) of the Securities Act requires the SEC, when it engages in rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." The petitioners argued that the high costs and inefficiency of implementing the rule contravened the meaning of Section 2(b).

The SEC adopted a two-pronged defense on this point. First, it argued that it had met its Section 2(b) obligation. Alternatively, the SEC argued that although it had provided a Section 2(b) analysis, it had done so voluntarily, as it was not required to do so. The court rejected the latter argument, in essence saying that because the SEC had initially presented the Section 2(b) analysis without a disclaimer that it was not required to provide such information, the SEC was required to defend the record it had created.

As to Rule 151A's impact on competition, the SEC had argued in the adopting release that the rule would "enhance competition because insurers who may have been reluctant to issue indexed annuities [may now] decide to enter the market." In the same vein, the SEC also reasoned that broker-dealers would now be more willing to sell FIAs because there would be a more certain regulatory status. The court, however, was not persuaded, and said the SEC's reasoning is flawed. "The lack of clarity resulting from the 'uncertain legal status' of the financial product is only another way of saying that there was not a regulation in place prior to the adoption of Rule 151A."

The court ultimately sent the rulemaking back to the SEC requiring that it do one of the following: (i) complete a presumably more thoughtful Section 2(b) analysis or (ii) despite the court's insistence in the decision that the SEC provide a more thoughtful Section 2(b) analysis, explain why Section 2(b) does not govern the SEC rulemaking in this instance. Giving the SEC an opportunity to convince the court that the Section 2(b) analysis was not required increases the likelihood that Rule 151A will take effect in January 2011, as scheduled.

The interested industry parties are likely to increase their focus on Congress, where bills have been introduced in both the Senate and the House of Representatives that would nullify Rule 151A.

Read the full text of the decision at <http://pacer.cadc.uscourts.gov/docs/common/opinions/200907/09-1021-1197327.pdf>.

Morgan Lewis & Bockius LLP will continue to monitor this situation and will update you with any new information as it becomes available. If you have any questions about any of the issues raised in this Morgan Lewis Investment Management FYI, please contact:

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