

FS Regulatory Briefs*

Is It An Insurance Product? Or a Security? The SEC Adopts Indexed Annuity Governance Rule

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Target Audience: Manufacturers and distributors of indexed annuities

The longstanding debate between insurance regulators and the Securities Exchange Commission (SEC) regarding jurisdiction of indexed annuities came to a head on December 17, 2008 as the SEC adopted Rule 151A under the Securities Act of 1933 governing indexed annuities.

SEC Rule 151A requires that, as of January 12, 2011, all indexed annuities, as defined by the SEC, must be registered as a securities product. The intention of the new rule is to protect investors, especially seniors, from improper fraudulent sales practices and unsuitable sales of indexed annuities.

Rule 151A defines the terms "annuity contract" and "optional annuity contract" which are both exempted from the scope of SEC Rule 151A. Contracts for which the amounts payable are more likely than not to exceed the guaranteed contract amounts do not meet these definitions and are therefore subject to the rule.

However, not all parties are in agreement that federal oversight of indexed annuities is necessary or legal. The Proposing Release on SEC Rule 151A generated approximately 4,800 comment letters and according to the SEC, commenters were divided on the issue. Further, there is currently an ongoing court challenge on behalf of the indexed annuity industry to appeal SEC Rule 151A. On April 6, 2009 the SEC filed a brief, in response to the January lawsuit filed by industry associations in connection with three of the largest indexed annuity carriers, reiterating its belief that it has regulatory authority over the annuities. Oral arguments began on May 8.

Background

Indexed annuities earn interest rates tied to the performance of the underlying securities index (e.g. S&P 500). This is in contrast to the traditional fixed

annuity, where fixed interest rates are earned. Indexed annuities have grown significantly since they were initially introduced in the mid-90s, prompting the need for further scrutiny.

Points to consider

While there is an appeal process in place, currently SEC Rule 151A stands with an effective date of January 12, 2011 and leaves manufacturers and distributors of indexed annuities with much to consider regarding compliance with the Rule and the associated costs. We encourage you to consider the following points going forward.

- SEC Rule 151A is a principles based requirement, leaving room for some interpretation. Companies must observe prescribed guidance and develop assumptions to determine whether 151A is applicable to its indexed annuities.
- In order to comply with SEC Rule 151A, companies may be forced to make several changes to its distribution platform. For instance, all indexed annuities within the scope of Rule 151A would be required to be registered as securities products and companies selling the products would be required to register as a broker-dealer (if not already registered as such). The producers selling these annuities would need to obtain / maintain applicable securities licenses and broker-dealer affiliations as a registered representative.
- The distribution platform changes must not only be considered for their organizational impact, but also the impact they would have on compliance requirements. Once the broker-dealer and representatives are registered,

proper supervisory controls and a supervisory structure would need to be implemented (including branch visits, written supervisory procedures, firm element training and a host of other controls in compliance with FINRA requirements).

- There would be a number of costs associated with complying with Rule 151A, including:
 - registering the indexed annuities;
 - preparing and filing indexed annuity registration statements;
 - registering representatives and registering as a broker-dealer; and
 - printing and providing prospectuses to investors for the indexed annuities.

- There still remains an almost 2 year grace period from today until the rule becomes effective. Companies need to begin to deliberate on the following:
 - What is the appropriate timeline to implement changes to ensure compliance ahead of the effective date?
 - How can we remain competitive while implementing changes and incurring costs to do so?
 - Do we have the processes and data necessary to comply with the rigorous supervision and monitoring requirements for the sales of securities products?
 - Are we currently registered as a broker-dealer or is that an additional set of costs to incur?
 - Should we continue to sell indexed annuities? How profitable are they to our company? How significant are they to our company's revenue? What does a comprehensive cost-benefit analysis reveal?
 - If we remain in the indexed annuity market, what will others within the industry do? How will this change our competitive landscape?

Additional Information

If you would like additional information about the topic discussed in this FS Regulatory Brief, please call:

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