FINAL BRIEF

ORAL ARGUMENT SCHEDULED FOR FRIDAY, MAY 8, 2009

No. 09-1021 (Consolidated with No. 09-1056)

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

AMERICAN EQUITY INVESTMENT
LIFE INSURANCE COMPANY, *et al.*,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

Petition for Review of Final Rule of the
United States Securities and Exchange Commission

OPENING BRIEF OF PETITIONERS AMERICAN EQUITY INVESTMENT LIFE INSURANCE COMPANY, BHC MARKETING, MIDLAND NATIONAL LIFE INSURANCE COMPANY, NATIONAL WESTERN LIFE INSURANCE COMPANY, OM FINANCIAL LIFE INSURANCE COMPANY, AND TUCKER ADVISORY GROUP, INC. IN CASE NO. 09-1021

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CERTIFICATE AS TO PARTIES,
<u>RULINGS, AND RELATED CASES</u>

Pursuant to Circuit Rules 26.1 and 28(a)(1)(A), petitioners state as follows:

(A) <u>Parties and Amici</u>:

The parties in this case are American Equity Investment Life Insurance Company, BHC Marketing, Midland National Life Insurance Company, National Western Life Insurance Company, OM Financial Life Insurance Company, and Tucker Advisory Group, Inc. ("Industry Petitioners"); the National Association of Insurance Commissioners and the National Conference of Insurance Legislators ("State Petitioners"); the United States Securities and Exchange Commission (Respondent); and AARP (Amicus). Petitioner National Conference of Insurance Legislators has advised that it intends to seek to participate as an *amicus curiae* instead.

Industry Petitioners American Equity Investment Life Insurance Company, Midland National Life Insurance Company, National Western Life Insurance Company, and OM Financial Life Insurance Company are companies that issue fixed indexed annuities which they expect to be required to register with the Commission under the new rule in issue in this case. Industry Petitioners BHC Marketing and Tucker Advisory Group, Inc. are independent marketing organizations that market fixed indexed annuities and whose business models will be significantly affected by the rule.

All parent corporations and publicly-held companies that own 10 percent or more of petitioner American Equity are as follows: American Equity is a wholly-owned subsidiary of American Equity Investment Life Holding Company.

All parent corporations and publicly-held companies that own 10 percent or more of petitioner Midland National are as follows: Midland National is a wholly-owned subsidiary of Sammons Financial Group, Inc., which is a wholly-owned subsidiary of Consolidated Investment Services, Inc., which is a wholly-owned subsidiary of Sammons Enterprises, Inc.

National Western has no parent companies and no publicly-held corporations that hold 10 percent or more of its stock.

All parent corporations and publicly held companies that own 10 percent or more of petitioner OM Financial are as follows: OM Financial is a wholly-owned subsidiary of Old Mutual PLC.

BHC Marketing has no parent corporations and no publicly-held companies that own 10 percent or more of its stock.

Tucker Advisory Group, Inc. has no parent corporations and no publicly-held companies that own 10 percent or more of its stock.

(B) <u>Rulings Under Review</u>:

Under review in this case is a rule of the Securities and Exchange Commission establishing standards for determining when fixed indexed annuities are considered not to be "annuity contracts" within the meaning of the Securities Act of 1933. The rule was adopted by the Commission at an Open Meeting on December 17, 2008, and was published in the Federal Register on January 16, 2009. Indexed Annuities and Certain Other Insurance Contracts, 74 Fed. Reg. 3,138.

(C) <u>Related Cases</u>:

Petition No. 09-1056 is related to the current petition for review. The Court consolidated that case with this case in an order issued February 13, 2009.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

* Authorities upon which petitioners chiefly rely.

Statutes

Rules, Regulations and Federal Register Publications

<u>Other Authorities</u>

GLOSSARY

Adopting Release	Indexed Annuities and Certain Other Insurance Contracts, 74 Fed. Reg. 3,138 (January 16, 2009) (JA 25)
Commission, or SEC	Securities and Exchange Commission
FIAs	Fixed Indexed Annuities
NAIC	National Association of Insurance Commissioners
Proposing Release	Indexed Annuities and Certain Other Insurance Contracts, 73 Fed. Reg. 37,752 (July 1, 2008) (JA 1)
Rule 151	17 C.F.R. § 230.151
Rule 151A	17 C.F.R. § 230.151A
Securities Act or the Act	Securities Act of 1933, 15 U.S.C. § 77a, *et seq.*

JURISDICTIONAL STATEMENT

This case is before the Court on petitions to review a final rule of the Securities and Exchange Commission. Indexed Annuities and Certain Other Insurance Contracts, 74 Fed. Reg. 3,138 (January 16, 2009) ("Rule 151A").

The Commission adopted the rule pursuant to Sections 3(a)(8) and 19(a) of the Securities Act of 1933. 15 U.S.C. §§ 77c(a)(8) and 77s(a) (Add. 15, 19). This Court has jurisdiction pursuant to Section 9(a) of the Securities Act, *id.* § 77i(a) (Add. 18), and Section 706 of the Administrative Procedure Act, 5 U.S.C. § 706 (Add. 10). *Cf. Investment Co. Inst. v. Bd. of Governors of Fed. Reserve*, 551 F.2d 1270, 1276 (D.C. Cir. 1977); *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); 3 Richard J. Pierce, Jr., *Administrative Law Treatise* § 18.2, at 1329-33 (4th ed. 2002).

The rule was published in the Federal Register on January 16, 2009, and the Industry Petitioners filed their petition for review the same day. Petitioners National Association of Insurance Commissioners and National Conference of Insurance Legislators filed their petition for review on February 10. The petitions concern a final agency rule that disposes of all parties' claims and the matter is properly before the Court.

STATEMENT OF ISSUES

1. The Securities Act of 1933 exempts from the definition of security "any" "annuity contract" issued by a corporation "subject to the supervision of the insurance commissioner" of a State. Fixed indexed annuities are regulated by state insurance commissions as annuities, and are subject to the panoply of state laws that guarantee purchasers of annuities minimum contract values plus interest. Are fixed indexed annuities "annuities" exempt from the definition of security?

2. The Supreme Court has said that a defining characteristic of an insurance product, including an annuity, is that it protects the purchaser from risk in a manner commensurate with insurance. The Court has found it indicative that a product is a security, not an annuity, if it is marketed as an opportunity to place funds under the investment management of the issuer. Fixed indexed annuities are subject to all generally-applicable state insurance protections against investment risk, and do not place funds under the investment management of the issuer. Are fixed indexed annuities exempt from the definition of security?

3. The Securities and Exchange Commission based its rule on Supreme Court decisions that, the Commission said, make the "allocation of investment risk" and the marketing of a product the principal determinants of whether a product is an annuity. In adopting the rule, the Commission used a definition of "investment risk" that conflicts with common parlance and the Supreme Court's

use of the term, failed to assess the allocation of risk between purchaser and issuer, and omitted from the text of its rule a provision concerning how the product is marketed. Was this arbitrary, capricious, and otherwise not in accordance with law?

4. In rulemakings, the SEC is required to consider effects on efficiency, competition, and capital formation. When proposing the rule, the Commission said the rule would promote efficiency and competition because fixed indexed annuities are subject to abusive sales practices and SEC regulation would provide "disclosure" and "suitability" protections that state laws do not. In adopting the rule, the Commission retreated from the claim that abusive sales practices were occurring and declined to assess whether state laws already provided extensive suitability and disclosure protections, as many commenters claimed; the Commission concluded that the rule—and costs it estimated in the hundreds of millions of dollars—were warranted in any event because, it asserted, fixed indexed annuities are securities as a matter of law. Was this arbitrary, capricious, and in violation of the Commission's obligation to consider efficiency, competition, and capital formation?

STATUTES AND REGULATIONS

Section 3(a)(8) of the Securities Act of 1993 provides in pertinent part:

> Section 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> . . .
>
> (8) Any 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[.]

15 U.S.C. § 77c(a)(8) (Add. 15).

Rule 151A states in relevant part that

> (a) . . . [A] contract that is issued by a corporation subject to the supervision of the insurance commissioner . . . of any State . . . 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) The contract specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods 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.

17 C.F.R. § 230.151A(a)(1)-(2) (Add. 24); 74 Fed. Reg. at 3,175 (JA 63). The full text of these provisions, and of other relevant statutes and regulations, is set forth in the Addendum or Joint Appendix to this brief.

STATEMENT OF THE FACTS

A. Fixed Indexed Annuities.

Fixed indexed annuities ("FIAs") are contracts under which purchasers are credited "interest" based upon the performance of equity or bond indices such as the S&P 500. 74 Fed. Reg. at 3,140 (JA 28). This interest is periodically locked in—typically on an annual basis—so that interest earned to date is protected against future declines. Only positive interest is credited; the contract is not debited if the relevant index declines. JA 198-99, 244.[1]

By crediting interest through a formula linked to financial markets, rather than at a purely fixed rate, FIAs address familiar limitations associated with traditional fixed-interest returns, particularly during inflationary times. *See Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.*, 941 F.2d 561, 565 (7th Cir. 1991) (Easterbrook, J.) ("*AIAP*") ("Traditional annuities in which the exact (monthly or total) amounts to be paid to the purchaser are fixed are not responsive to inflation."). FIA interest credits historically have averaged 1 to 2 percent higher than fixed annuities, JA 277, and FIAs have experienced no loss in

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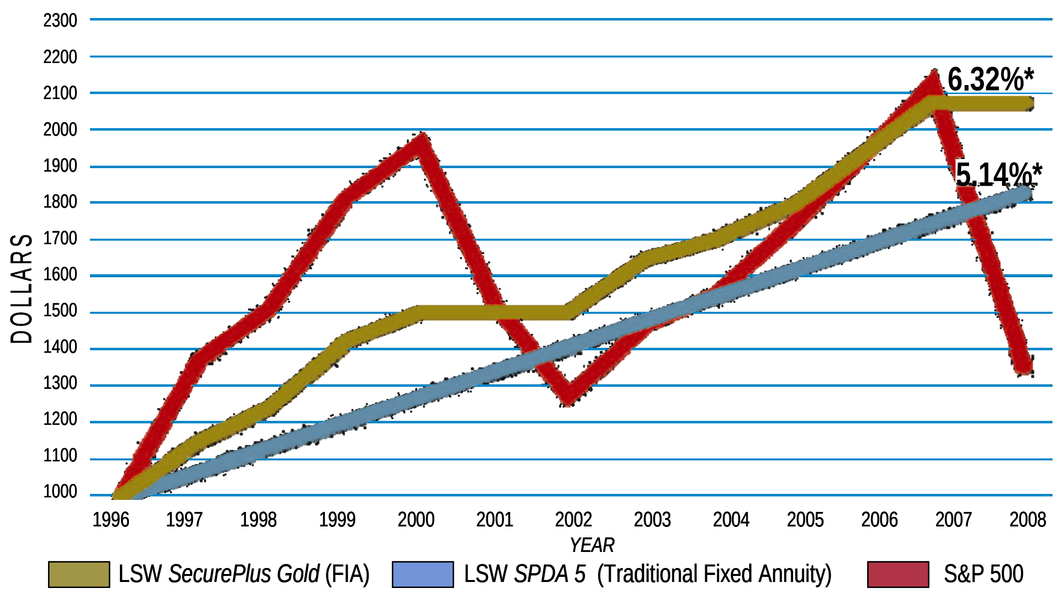
[1] The formula for calculating indexed interest is generally reset annually and by contract may include factors to modulate the impact of the index on the interest credit, such as an upper limit, or a "cap"; a "participation rate" to indicate the percentage of the change in the index to be credited; and a minimum interest credit, or "floor," which is never less than zero. JA 242.

contract value in the volatile markets of recent years, as reflected in the following chart in the rulemaking record that plots the performance of one FIA since 1996:



***The chart compares the 12-year accumulation value (premiums + interest credited) of LSW's Secure Plus Gold (Policy Form Nos. 7912 and 7918), an indexed annuity, and LSW's SPDA 5 (Policy Form No. 7682), a traditional fixed annuity. Both policy terms have a 10 year withdrawal charge period.**

The above illustration is reflective of a single premium payment into both LSW annuities, with an issue date of 10/21/1996. Past Interest credited results are no indication or guarantee of future interest credits. *Interest rate is annual effective rate.

JA 582.

Except for this interest crediting feature, the essential attributes of FIAs are identical to traditional fixed annuities. State insurance laws subject FIAs to "nonforfeiture" requirements under which they must have a guaranteed minimum contract value (at least 87.5 percent of premiums) after any costs and charges are applied. JA 242-43. State insurance laws also guarantee that the purchaser will be credited a minimum amount of interest, typically between 1 to 3 percent of the minimum contract value annually. FIA purchasers typically agree to hold the contract for a certain period of time and are assessed a "surrender" or "withdrawal" charge if they terminate early. JA 244. All of these features are characteristic of traditional fixed annuities also.[2]

Like all annuities, FIAs characteristically have two phases: an "accumulation" or "deferral" period in which the contract accrues value through payment of premiums and interest thereon, and a "payout" period in which the purchaser receives a stream of payments according to a selected payment option. JA 290, 294. FIAs and other annuities also provide for tax deferral, protect assets from creditors and fraud, avoid probate delays, and in some cases compensate purchasers for nursing home care. JA 277-82.

FIAs bear four important differences from variable annuities, whose value characteristically is determined ***entirely*** by the performance of an investment fund. First and most important, variable annuities are not subject to state nonforfeiture laws, and therefore are not required to guarantee either a minimum contract value or a minimum rate of return. *Infra* at 9. Second, variable annuities place premiums in a "separate account" on which the purchaser's return is based; FIA premiums are placed in the insurer's general account, essentially the insurer's

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[2] FIAs allow the customer to select, on an annual basis, whether to continue using the interest crediting component or to use a fixed rate instead. JA 199.

investment portfolio which is subject to special state requirements. Robert H. Rosenblum, *Investment Company Determination under the 1940 Act: Exemptions and Exceptions* § 14.4 (2003). Third and related, the value of variable annuities turns upon the issuer's ***investment management*** of the assets in the separate account; FIAs' value is calculated by reference to an exogenous index over which the issuer has no influence or control. Fourth, FIAs are subject to state guaranty fund laws that provide protections for purchasers if insurance companies become insolvent; variable annuities are not. *Infra* at 9.

B. State Regulation Of Fixed Indexed Annuities.

A range of state laws applies without distinction to fixed indexed annuities and other fixed annuities. Variable annuities, by contrast, are exempt from many of these requirements.

As noted, state nonforfeiture laws guarantee that purchasers receive a minimum amount of interest (typically from 1 to 3 percent annually), regardless of the performance of the relevant index. *See, e.g.*, Iowa Code Ann. § 508.37-.38 (Add. 40-52). An insurer's general account must consist of "permitted investments" as specified by state law; investments in common stocks are limited to publicly-traded securities, which may account for no more than 10 percent of the insurer's required reserve. JA 243; *see, e.g.*, Iowa Code Ann. § 511.8(18) (Add. 60-61). State law also requires insurers to maintain elevated levels of capital, and most States provide purchasers, through guaranty fund laws, $100,000 or more in insurance if the issuer becomes insolvent. *See, e.g., id.* § 521E *et seq.*; Md. Code Ann. Ins. § 9-401 *et seq.*

Variable annuities are generally exempt from these requirements. *See, e.g.*, Iowa Code Ann. § 508A.5 (Add. 27) (exempting variable contracts from state nonforfeiture law); Md. Code Ann. Ins. § 9-403(b)(2)(i)(2)(A) (Add. 68) (exemption from guaranty fund); Iowa Admin. Code. § 191-31.4(1) (exempting variable annuities from investment requirements applicable to fixed annuities) (Add. 25). Thus, variable annuities "ordinarily guarantee neither minimum contract values nor even any portion of premium payments." Clifford E. Kirsch, *Variable Annuities & Variable Life Insurance Regulation* § 2:2.4 (2006).

States also regulate the sale and marketing of FIAs and other annuities, as described at length in the brief of petitioner NAIC. NAIC Op. Br. at 2-8. States regulate ***disclosures*** regarding FIAs and other annuities, and require agents to consider the "***suitability***" of an annuity for a purchaser in light of the purchaser's financial circumstances. JA 259-66. States also require periodic "market conduct" examinations for insurance companies; through their unfair trade practice laws they prohibit misrepresentation of FIAs' terms and conditions; and they regulate agent licensing and training. JA 260.

C. Federal Securities Law: Section 3(a)(8) And The Supreme Court's Interpretation.

The federal securities laws extensively regulate the offering and sale of securities. *See generally* 1 Louis Loss *et al.*, *Securities Regulation* 801-09 (4th ed. 2006); 2 Loss *et al.*, *Securities Regulation* 72-510; 6 Loss *et al.*, *Securities Regulation* 2983-3009. SEC registration requirements for public offerings include requirements for audited financial statements and due diligence to determine and disclose material information about the company and the security being offered. Most public offers and sales of securities must be effected by a registered broker-dealer. Accordingly, if FIAs are regulated securities, an insurance company offering them would need to register itself or an affiliate as a broker-dealer, and the agents who sell the products would need to be licensed representatives of that broker-dealer. JA 216-17. Alternatively, the agents themselves would need to register as broker-dealers, or become registered representatives of a broker-dealer.

A broker-dealer generally must be a member of the Financial Industry Regulatory Authority ("FINRA"). 6 Loss *et al.*, *Securities Regulation* 2983-3009. Broker-dealers are subject to an array of regulatory requirements including requirements to maintain detailed books and records and preserve documents for specified periods of time, employ a chief compliance officer, maintain specified amounts of net capital, conduct annual training and audits, implement detailed supervisory and compliance procedures, pay annual fees to maintain membership in FINRA, and register with applicable States. *Id.* Representatives of a broker-dealer are required to obtain licenses through FINRA—by passing applicable license exams—and to obtain and maintain state registrations.

Section 3(a)(8) of the Securities Act of 1933 excludes from these requirements "any" "annuity contract" or "optional annuity contract" issued "by a corporation subject to the supervision of the insurance commissioner" of a State. 15 U.S.C. § 77c(a)(8) (Add. 15).[3]

The rule at issue is calculated to denominate FIAs as outside the Section 3(a)(8) exemption and, thus, as regulated securities. The Commission based the rule on two Supreme Court decisions interpreting Section 3(a)(8). *SEC v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65 (1959) ("*VALIC*"), and *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967) ("*United Benefit*").

In *VALIC*, the Court considered a variable annuity under which purchasers paid premiums that were invested in a fund consisting largely of common stock. Purchasers received a proportionate interest in the fund, and benefits were paid according to the fund's performance. In the Court's words, the contracts "guarantee[d] nothing to the annuitant except an interest in a portfolio of common

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[3] Products exempted by Section 3(a)(8) are exempt from all the requirements of the Securities Act. *VALIC*, 359 U.S. at 67-68; *Tcherepnin v. Knight*, 389 U.S. 332, 342-43 n.30 (1967).

stocks or other equities—an interest which has a ceiling but no floor." *VALIC*, 359 U.S. at 72 (footnote omitted). "Some states," the Court noted, "den[ied] these 'annuity' contracts any status as 'insurance' . . ." *Id.* at 69.

The Court held that the variable annuity fell outside the 3(a)(8) exemption because it "place[d] all the investment risks on the annuitant" and "none on the company." *Id.* at 71. There was thus no "true underwriting of risks, the one earmark of insurance . . . ." *Id.* at 73. "[T]he concept of 'insurance' involves some investment risk-taking on the part of the company," the Court said, and "absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant . . . ." *Id.* at 71. Because the variable annuity had "no element of a fixed return," its value depended entirely "on the wisdom of the investment policy" of the issuer and it was a regulated security. *Id.* at 70-71.

Justice Brennan filed a concurring opinion explaining that the federal interest in securities regulation was triggered because the purchaser was "a sharer in the investment experience of the company" that solicited her investment. *Id.* at 77. "[W]here the investor is asked to put his money in a scheme for managing it on an equity basis, it is evident that the Federal Act's controls become vital." *Id.* at 80.

In the second case, *United Benefit*, purchasers' premiums were placed in a "Flexible Fund" that was invested "with the object of producing capital gains as well as an interest return, and the major part of the fund [was] invested in common stocks." 387 U.S. at 205 & n.3. At any time before maturity the purchaser was entitled—in the Supreme Court's words—to withdraw "his proportionate share of the total fund." *Id.* at 205. Alternatively, the purchaser could demand cash payment of a "net premium guarantee" that rose from 50 percent of premium payments (less a deduction for expenses) in the first year, to 100 percent after 10 years. *Id.* at 205-06. However, the company's "risk of not being able to meet [the guarantee] through investment [was] insignificant," *id.* at 209, in part because the company had set the guarantee "by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so that it would not have become operable under any prior conditions." *Id*. at 209 n.12. At maturity, the purchaser's interest in the fund terminated, and he could receive the cash value of the policy—as measured by his interest in the fund or the net premium guarantee, "whichever [was] larger"—or he could convert his interest to a life annuity. *Id.* at 205-06.

The Court found the "Flexible Fund" to be a regulated security. While the issuer purported to bear a modicum of risk, the guarantee was essentially illusory and the Fund required special modification of state insurance laws. *Id.* at 211. Further, the Fund had been marketed on the basis of "the experience of United's management in professional investing," and appealed to consumers' interest in "growth through professionally managed investment," rather than in "stability and security" typically associated with insurance. *Id.* at 211 & n.15. The fact that the company purported to back-stop purchasers' investments with a guarantee did not change the essential character of the product: An investment contract that "to some degree is insured" was not at heart "a contract of insurance." *Id.*

D. A Related SEC Rule: Rule 151.

In 1986 the Commission relied upon *VALIC* and *United Benefit* to adopt a rule interpreting Section 3(a)(8) that bears a name similar to the rule at issue here: Rule 151. Definition of Annuity Contract or Optional Annuity Contract, 51 Fed. Reg. 20,254 (June 4, 1986) (Add. 1-9). The function of Rule 151 is the opposite of the rule here: it provides a safe harbor defining when products ***are*** annuities.

Under Rule 151, a product is exempt if it is (1) issued by a company subject to state insurance regulation; (2) the insurer "assumes the investment risk under the contract"; and (3) the product is not "marketed primarily as an investment." 17 C.F.R. § 230.151(a) (Add. 23). An insurer assumes investment risk for purposes of the rule when it guarantees the purchaser's principal less administrative charges (e.g., early withdrawal fees), and credits interest at a specified rate that is not changed more than once annually and "is at least equal to the minimum rate required . . . by the relevant nonforfeiture law in the jurisdiction where the contract is issued." *Id.* § 230.151(b), (c) (Add. 23).

In a section titled "Indexed Excess Interest Features," the preamble to the final rule said that it included a product that offered interest in excess of the state-required minimum which was "determined in accordance with an external formula or index . . . such as a composite bond index." 51 Fed. Reg. at 20,260 (Add. 7).

E. Adoption Of The Rule Under Review.

The rule at issue here—Rule 151***A—***was proposed in July 2008. Indexed Annuities and Certain Other Insurance Contracts, 73 Fed. Reg. 37,752 (July 1, 2008) ("Proposing Release") (JA 1-24). More than 4,800 comments were submitted. After an original comment deadline of September 10, 2008, the comment period was reopened until November 17, and the final rule was adopted exactly a month later. It was the second-to-last public meeting for the rule's most vocal proponent, the Chairman, who resigned a month later with the change in Administrations. *SEC Chairman Cox Resigns* (Jan. 20, 2009), *available at* http://abcnews.go.com/Business/Economy/wireStory?id=6694222.

The rule, which is brief, uses two central provisions to define when a contract is ***not*** an annuity. First, the rule inquires whether

> The contract specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities.

17 C.F.R. § 230.151A(a)(1) (Add. 24); 74 Fed. Reg. at 3,175 (JA 63).

> If so, the product is not an annuity if
>
> Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

17 C.F.R. § 230.151A(a)(2) (Add. 24).

By its terms the rule applies only to contracts that are issued by state-regulated insurance companies and ***are*** regulated as annuities by the States. 74 Fed. Reg. at 3,175 (JA 63). In adopting the rule, the Commission repeatedly referred to FIAs as annuities, and asserted an authority to regulate certain types of annuities. "Beginning in the mid-1990s," it said, "the life insurance industry introduced a new type of annuity, referred to as an 'equity-indexed annuity,' or, more recently, 'fixed indexed annuity' . . . ." *Id.* at 3,139 (JA 27). "We are adopting a new definition of 'annuity contract,'" the Commission announced, "that . . . defines a class of indexed annuities that are outside the scope of Section 3(a)(8). With respect to ***these annuities***, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections." *Id.* at 3,142 (emphasis added) (JA 30). There are circumstances, the Commission said elsewhere, "[w]here . . . an annuity contract is not entitled to the Section 3(a)(8) exemption"; "we have concluded [this] is the case with respect to certain indexed annuities . . . ." *Id.* at 3,147 (JA 35).

The Commission said it was basing the rule on "the facts and circumstances factors articulated by the U.S. Supreme Court in *VALIC* and *United Benefit*," *id.* at 3,143 (JA 31), and identified two key factors that distinguish annuities from regulated securities: "(1) the allocation of investment risk between insurer and purchaser, and (2) the manner in which the annuity is marketed." *Id.* at 3,141 (JA 29).

1. With respect to risk, the Commission stated that the purchaser of an FIA experiences investment risk to the extent he is likely to receive ***more*** than is guaranteed under the contract:

> 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, securities-linked portion of the return is borne by the individual purchaser, not the insurer.

Id. at 3,138 (JA 26) (emphasis added). The rule's "more likely than not to exceed" provision functions as the rule's central determinant of when an FIA poses so much risk to the purchaser that it constitutes a security. *Id.* at 3,175 (JA 63).

In the rulemaking, numerous commenters objected to the Commission's designation of the likelihood of financial gain as "investment risk." JA 198, 253-55, 476, 590. The Commission responded in the Adopting Release that deviation from expected return is a widely accepted definition of risk in financial instruments. 74 Fed. Reg. at 3,145 (JA 33). A single authority was cited for this proposition. Zvi Bodie, Alex Kane, and Alan J. Marcus, *Investments* 143-44 (6th ed. 2005). That treatise states that such a definition of risk is appropriate only when the deviation has a normal distribution, and that even then the definition has limited utility, since:

> Clearly, what would trouble potential investors . . . is the downside risk of a [negative] return, not the upside potential of a [positive] return. The standard deviation of the rate of return does not distinguish between these two; it treats both simply as deviations from the mean.

Id. at 143-44. In the comment period, a 12-page expert report had been submitted which explained these points at greater length. JA 271-82. "'Upside risk' measures have not gained traction," the report stated, and instead measures that concentrate on downside risk "represent the state of art on risk measurement in the field of financial economics." JA 273-74. The Commission did not cite or otherwise respond to this submission, nor to a criticism of its risk definition by the American Academy of Actuaries. JA 130-34.

While the Commission said that it was basing its proposal on the "familiar concept [of] [t]he ***allocation*** of risk," 73 Fed. Reg. at 37,752 (JA 2) (emphasis added), it did not weigh the overall risk borne by the insurer against the risk putatively borne by the purchaser. Specifically, it did not weigh the purchaser's "risk" of earning interest against the insurer's risk of having to ***pay*** that interest, plus the risk associated with paying the state-required guarantees of premium and interest. It did not discuss the insurer's risk that its financial performance (including contract sales, revenues, and the performance of its portfolio) might not enable it to earn a profit after crediting the equity-related interest due the purchaser. 74 Fed. Reg. at 3,144-45 (JA 32-33).

The Commission repeatedly likened FIAs to mutual funds and variable annuities, which under the law are not required to provide protection against total loss of principal. *See*, *e.g.*, *id.* at 3,138, 3,150, 3,161 (JA 26, 38, 49). It did not respond to the rulemaking comments which stated that comparison to traditional annuities was more apt, including the statement of the American Academy of Actuaries that the "regulatory capital requirements for an issuer of [FIAs] are similar to those for fixed-rate annuities because the risk profiles are similar." JA 189; *see also* JA 193, 221, 241-44, 396-97.

Numerous commenters noted that treating FIAs as regulated securities conflicted with related Rule 151, which the Commission had said covered products with "indexed excess interest." 51 Fed. Reg. at 20,260 (Add. 7); JA 399-400. They noted that the only court to consider the issues held that FIAs fell within the 151 safe harbor. *Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d 743, 752-54 (W.D. Ky. 2002). The Commission responded that FIAs "fail to satisfy [151's] 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." 74 Fed. Reg. at 3,142 (JA 30). The Commission did not explain how this was consistent with Rule 151's adopting release, which stated that "while the rate of interest calculated under a particular index or formula may fluctuate upward or downward on a daily basis, the excess interest rate actually credited may not fluctuate more than once a year." 51 Fed. Reg. at 20,260 (Add. 7).

2. As noted, the Commission identified marketing as the other principal determinant of a security. 74 Fed. Reg. at 3,141-42 (JA 29-30). Related Rule 151—which designates when a product ***is*** an annuity—uses marketing as one part of what is essentially a two-part test. *Supra* at 14. However, the Commission included no marketing test in the new rule. It explained:

> The very nature of an indexed annuity, where return is contractually linked to the return on a securities index, is, to a very substantial extent, designed to appeal to purchasers on the prospect of investment growth. . . . ***It 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 returns and the related risks.

Id. at 3,146 (emphasis added) (JA 34). Numerous comments had been submitted in the rulemaking to demonstrate that FIAs are marketed with emphasis on the guarantee of principal, minimum interest, and other features that further financial stability and security, and that promotional materials emphasize that the interest crediting feature is not a means of participating in the stock market. *See, e.g.,* JA 203-04, 258, 299-330. The Commission did not discuss these materials in any way. It also did not address the *Malone* case, where a federal court examined an FIA's marketing materials and found that they did not market the product "primarily as an investment" within the meaning of Rule 151. 225 F. Supp. 2d at 753.

3. In rulemakings under the Securities Act, the Commission must consider effects on "efficiency, competition, and capital formation." 15 U.S.C. § 77b(b) (Add. 13). In proposing the rule, the Commission asserted that there were widespread abuses in the sale of FIAs and that the rule would further efficiency and competition by preventing those abuses. 73 Fed. Reg. at 37,755 (JA 5). State regulation, the Commission said, was focused primarily on insurer solvency, *id.* at 37,762 (JA 12), whereas federal regulation would deliver significant benefits by imposing disclosure and suitability requirements, *id.* at 37,771 (JA 21).

State insurance regulators and others challenged both of these premises of the proposed rule. They submitted evidence disputing that sales abuses involving FIAs were widespread. For example, the Maryland Insurance Administration stated: "Complaints about equity indexed annuities represent less than 1/2 of 1% of the complaints received by the MIA's Life and Health Unit." JA 118 (emphasis omitted); *see also* JA 204-07, 265. State insurance commissioners and others also disputed the Commission's characterization of state law, submitting evidence of States' regulation of disclosure, "suitability," and other sales practices. JA 82-84, 114-19, 379-81. *See* the further discussion of state regulation in the brief of petitioner NAIC at 2-8.

In the Adopting Release, the Commission responded to these comments by stating that the prevalence of sales abuses, and the scope of state regulation, were not important to its decision to adopt the rule. "[T]he presence or absence of sales practice abuses is ***irrelevant***" to its decision to act, it said, because FIAs are securities as a matter of law and therefore the rule was appropriate "without regard to whether there is ***a single documented incident of abuse***." 74 Fed. Reg. at 3,147 (JA 35) (emphases added). Similarly, the Commission did not dispute commenters' correction of its earlier characterization of state law. In its view FIAs were securities under the terms of the statute, and "it is not the Commission's role to reevaluate the efficiencies of [the federal] regulatory structure for each particular instrument that is a security." *Id.* at 3,170 (JA 58). The Commission therefore declined to "undertake a comprehensive consideration of the existing state law regulatory regime," *id.*, or even to compare state disclosure and suitability requirements with federal requirements. *Id.* at 3,148 (JA 36). However, it continued to claim increased efficiency and competition from federal regulation of those products. *Id.* at 3,169-70 (JA 57-58).

While finding neither significant FIA abuses nor gaps in state law that federal regulation would fill, the Commission acknowledged that the rule's costs would be considerable. These included costs to register FIAs with the SEC and associated administrative and legal expenses, *id.* at 3,165-67 (JA 53-55), and the dissolution of the current, prevailing network for marketing and selling FIAs through state-regulated insurance agents who are not registered representatives. JA 216, 267. Commenters predicted that a majority of unlicensed agents would cease selling FIAs because of the costs of being licensed and regulated as registered representatives, *id.*, and that some smaller companies would exit the market entirely, JA 411, 477. In response, the Commission acknowledged that the rules' costs could exceed $1.8 billion in lost revenue and $82.5 million in registration costs, but asserted that this was justified because "where ***an annuity contract*** is not entitled to the Section 3(a)(8) exemption, which we have concluded is the case with respect to certain indexed annuities, the federal securities laws apply." 74 Fed. Reg. at 3,166, 3,168-69 (JA 54, 56-57) (emphasis added).

While adopting Rule 151A despite extensive evidence of a thorough state regulatory system, the Commission in the same release adopted a separate rule to provide that an insurance company's issuance of FIAs would not trigger the reporting requirements of the Securities Exchange Act of 1934. *Id.* at 3,139, 3,154 (JA 27, 42). There is "no trading interest in an insurance contract," the Commission explained, and there already is "state regulation of insurers' financial condition." *Id.* at 3,156, 3,172 (JA 44, 60). It appeared "unnecessary for both [state and federal requirements] to apply in the same situation, which may result in duplicative regulation that is burdensome." *Id.* at 3,154 (JA 42).

Commissioner Paredes dissented from adoption of Rule 151A, stating that the Commission was "entering into a realm that Congress prohibited us from entering." *Id.* at 3,175 (JA 63). He charged the Commission with departing from *VALIC* and *United Benefit*, and stated that it had "misconceptualize[d] investment risk" by treating the likelihood of financial ***gains***—rather than losses—as a risk borne by the purchaser. *Id*. at 3,176 (JA 64). Rule 151A "gives short shrift to the guarantees that are a hallmark of indexed annuities," he said, and "place[s] singular focus on investment risk without adequately considering . . . the manner in which an indexed annuity is marketed." *Id.* The rule also "seems to diverge from the analysis embedded in Rule 151." *Id.*

STANDARD OF REVIEW

This Court should review Rule 151A with a "reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements." *VALIC*, 359 U.S. at 68. *Accord* 15 U.S.C. § 1012(b) (McCarran-Ferguson Act) ("No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . .") (Add. 22). The Court shall "hold unlawful and set aside agency action . . . found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law [or] in excess of statutory jurisdiction." 5 U.S.C. § 706(2)(A) & (C) (Add. 10).

Section 3(a)(8) is to be interpreted without deference to the Commission, for several reasons. First, no deference is warranted when an agency has not purported to invoke interpretative discretion. *United States v. Mead Corp.*, 533 U.S. 218, 237 (2001). That is the case here: The SEC characterized FIAs as securities as a matter of law and on that basis declined to address certain matters raised by commenters. Second, the Commission based the rule on its interpretation of Supreme Court caselaw; this Court is "not obliged to defer to an agency's interpretation of Supreme Court precedent under *Chevron* or any other principle." *Akins v. FEC*, 101 F.3d 731, 740 (D.C. Cir. 1997) (en banc). Third, *Chevron* does not command deference to an agency on a "pure question of statutory construction." *INS v. Cardoza-Fonseca*, 480 U.S. 421, 446 (1987); *Nat'l Ass'n of Mfrs. v. U.S. Dep't of Interior*, 134 F.3d 1095 (D.C. Cir. 1998). Fourth, Section 3(a)(8) exempts "any" annuity contract from regulation as a security: "[W]hen Congress places the word 'any' before a phrase with several common meanings, the statutory phrase encompasses each of those meanings [and] the agency may not pick and choose among them." *New York v. EPA*, 443 F.3d 880, 888 (D.C. Cir. 2006) (Rogers, J.). Rather, "the word 'any' has an expansive meaning'" which, applying "the usual tools of statutory construction," renders the terms that follow it broad and clear so as to preclude agency interpretive discretion. *Id.* at 885, 886 (citation omitted). Finally, "[t]he SEC cannot use its definitional authority to expand its own jurisdiction and to invade the jurisdiction of other agencies," *American Bankers Ass'n v. SEC*¸ 804 F.2d 739, 755 (D.C. Cir. 1986), nor, in this case, to invade the jurisdiction of the States that is protected by the McCarron-Ferguson interpretive presumption.

Deference also will not be accorded an agency's interpretation where the statutory language is "clear," or where the agency interpretation is not "based on a permissible construction of the statute." *Chevron, U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 842-43 (1984).

With respect to the separate inquiry required by the APA, "an agency rule would be arbitrary and capricious if the agency . . . entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or it is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). A rule may not be sustained on a basis not previously advanced by the agency. *PDK Labs., Inc. v. DEA*, 362 F.3d 786, 798 (D.C. Cir. 2004).

In proceedings to review agency regulations, a rule is to be vacated without remand where—among other circumstances—the text of the rule is irreconcilable with the governing statute, and remand would therefore serve no purpose. *NRDC v. EPA*, 489 F.3d 1250, 1260-61 (D.C. Cir. 2007).

SUMMARY OF ARGUMENT

Fixed indexed annuities—as described in the Commission's Proposing and Adopting Releases and as reflected in the rulemaking record—are annuities, not regulated securities. They are uniformly recognized as such by the States and are subject without exception to the state laws that exist to assure that insurance products provide protections against risk commensurate with the name. Unlike *VALIC*, *United Benefit*, variable annuities, and mutual funds, FIAs are not marketed or valued according to the investment management of the issuer.

For these reasons FIAs are exempt from regulation as securities according to the plain terms of a statute that exempts "any" annuity contract, and there is no need to deploy the analysis used in *VALIC* and *United Benefit*. But FIAs plainly satisfy that analysis, while the terms of Rule 151A conflict with the Supreme Court's decisions and the statutory text. The rule's invalid terms result from the Commission's use of a definition of investment risk that conflicts with the governing caselaw and common parlance, and from its failure to apply either part of the two-part test that it said was determinative and that it deployed in a fundamentally different manner in another, closely-related rule. In its haste to finalize the rule—which issued only a month after the comment deadline and shortly before the resignation of the rule's principal proponent—the Commission ignored record evidence about the meaning of investment risk and the marketing of indexed products. And, when comments showed that the Commission had premised its proposal on mistaken beliefs about state insurance regulation and abusive sales of FIAs, the Commission did not reconsider its premises, but simply jettisoned them, claiming that it was compelled as a matter of law to issue a rule that will cost hundreds of millions of dollars without bringing any identifiable improvement upon the existing state regulatory regime with which it will interfere.

The rule should be vacated.

STANDING

Petitioners are insurance companies and independent marketing organizations that issue and market FIAs and that will be subject to SEC regulation as a consequence of the rule. In such circumstances, where the petitioner is the "object of the action" under review, there is "little question" about standing. *Sierra Club v. EPA*, 292 F.3d 895, 900 (D.C. Cir. 2002) (citation omitted). The Commission has acknowledged that its rule will impose costs on entities such as petitioners. 74 Fed. Reg. at 3,166-68 (JA 54-56).

ARGUMENT

I. FIXED INDEXED ANNUITIES ARE ANNUITIES AS A MATTER OF LAW.

A. Under The Plain Meaning Of Section 3(a)(8), Fixed Indexed Annuities Are Annuities Exempt From SEC Regulation.

Section 3(a)(8) of the Securities Act excludes from the definition of security "any . . . annuity contract" that is "issued by a corporation subject to the supervision of the insurance commissioner . . . of any State." As annuities subject to the full panoply of state insurance protections applied to traditional fixed annuities, FIAs are annuity contracts within the plain meaning of Section 3(a)(8). The facts-and-circumstances test of *VALIC* and *United Benefit* need not be reached.

In *VALIC* and *United Benefit*, the Supreme Court was presented with two threshold facts that are absent here: (1) the value of the contracts in question depended on the issuer's management of a fund in which the purchaser was a shareholder; and (2) the protections of state insurance laws did not fully apply. Indeed, in *VALIC* the Court noted that "[s]ome States deny these 'annuity' contracts any status as 'insurance.'" 359 U.S. at 69.

In these circumstances, the Court undertook a more searching inquiry to determine whether products that bore the investment management characteristics of regulated securities; were marketed as such; and were not subject to state guarantees against risk, nonetheless bore risk characteristics that corresponded with the prevailing conception of insurance and annuities. Such an inquiry is not necessary when, as here, the products in question are not subject to the insurer's investment management, and state insurance protections against risk apply by their terms and are fully satisfied.

1. In *VALIC* and *United Benefit*, the issuer's management of the purchaser's investment was crucial to the Court's decision to undertake a facts-and-circumstances analysis. "It was implied in the majority opinion in *VALIC* and made explicit by the two concurring Justices," the Court wrote in *United Benefit*, that the securities laws address "a form of 'investment'" that is different than insurance (and annuities)—namely, because its value depends on the "investment management" of the issuer. 387 U.S. at 210-11 (citation omitted). Justice Brennan's concurring opinion in *VALIC*—which this passage of *United Benefit* cited approvingly—spoke at length about the federal securities interest when the purchaser is "a sharer in the investment experience of the company" that solicited her investment. 359 U.S. at 77. "[W]here the investor is asked to put his money in a scheme for managing it on an equity basis, it is evident that the Federal Act's controls become vital." *Id.* at 80. In this Court's words, *VALIC* "concluded that Congress, in exempting insurance-type contracts from SEC regulation, did not intend to exempt what were essentially equity shares, however labeled," with no

"'guarantee of fixed income.'" *American Bankers Ass'n v. SEC*, 804 F.2d 739, 751 (D.C. Cir. 1986) (citation omitted).

Likewise in *United Benefit*, it was in the context of observing that the promoters of the Flexible Fund offered "sound investment management" and their "experience . . . in professional investing," that the Court asserted that the Fund was at its heart an investment contract: It was "a contract which to some degree is insured" rather than "a contract of insurance." 387 U.S. at 211 & n. 15. A contract whose essence was "take my money and manage it," did not become an insurance contract because some nominal insurance was offered.[4]

2. The absence of generally-applicable state annuity laws was also important in *VALIC* and *United Benefit*. In *VALIC* there was no minimum guarantee at all and many States did not regard the product as an annuity or insurance product. 359 U.S. at 69. In *United Benefit* the products existed by virtue of a state insurance law exemption. 387 U.S. at 211. In the absence of applicable

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[4] Most other cases applying *VALIC* and *United Benefit* to determine whether contracts are annuities or securities involved an arrangement where the contract's value depended on the issuer's management of a pool of assets in which purchaser was invested. *See, e.g.*, *AIAP*, 941 F.2d at 566 (excess interest rate based on rate of return that insurer earned on its own portfolio); *Peoria Union Stock Yards Co. Retirement Plan v. Penn Mutual Life Ins. Co.*, 698 F.2d 320, 325 (7th Cir. 1983) ("Until money is withdrawn from the deposit account to purchase annuity for a retiring employee, the insurance company is offering the pension plan a chance to share in the insurance company's investment experience.").

state insurance protections against risk, the Court undertook to consider for itself whether the degree of risk borne by the purchaser was consistent with prevailing notions of insurance.

The analysis undertaken in *VALIC* and *United Benefit* therefore addressed the circumstance of products that did ***not*** fall within States' insurance protections against risk, and which functioned like investment contracts. The cases are not general license for the Commission and courts—under a statute that exempts "any" annuity—to sit in judgment of the protections from risk provided by generally-applicable state insurance laws, such that federal authorities may ordain that a product poses "risk" incompatible with insurance (or an annuity) even though the product meets all generally-applicable state requirements that exist to ensure protections against risk commensurate with insurance. "When the States speak in the field of 'insurance,' they speak with the authority of a long tradition." *VALIC*, 359 U.S. at 68.[5]

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[5] To be sure, the Court went on to state in *VALIC* that the meaning of "insurance" and "annuity" under the Securities Act "is a federal question." 359 U.S. at 69. But when the answer to a question turns on what is ***characteristic*** of a heavily-state regulated product such as insurance, States' prescription of those characteristics carries enormous weight—unless, as in *VALIC* and *United Benefit*, relevant state insurance requirements do not apply.

Accordingly, in this case, where neither of the exceptional threshold facts in *VALIC* and *United Benefit* is present, this Court should recognize FIAs as annuities exempt from SEC regulation under the plain terms of Section 3(a)(8) without further analysis. *VALIC* and *United Benefit* make plain that slapping the name "annuity" on a security does not exempt it under Section 3(a)(8). But the re-appraisal of state insurance protections against risk that would be involved here are different in kind. Indeed, there would be ***no basis*** for the Court to conclude that FIAs do not offer the protections against risk characteristic of insurance, given that FIAs satisfy the generally-applicable state laws that are the embodiment and definition of insurance protections against risk.

B. Fixed Indexed Annuities Are Also Annuities Under The Test Applied In *VALIC* and *United Benefit.*

FIAs do, however, easily satisfy the facts-and-circumstances analysis of *VALIC* and *United Benefit*.

It bears noting at the outset that a correlation with the performance of the financial markets is ***not*** inconsistent with classification as an annuity. If that were the rule, *VALIC* and *United Benefit* would simply have ordained that the value of the products in issue varied with the market and therefore were securities, not annuities. Instead, the Court conducted a more sensitive analysis and spoke caution not to "freeze the concepts of 'insurance' or 'annuity' into the mold they fitted when" Congress passed the Securities Act. 359 U.S. at 71. Consistent with this, the Commission has recognized in related Rule 151 and elsewhere that annuity contracts' value may be calculated by reference to a stock index. *Supra* at 15.

The Adopting Release states that "[i]ndexed annuities are similar in many ways to mutual funds, variable annuities, and other securities," and that the purchaser of an indexed annuity "assumes many of the same risks that investors assume when investing in mutual funds, variable annuities, and other securities." 74 Fed. Reg. at 3,143, 3,150 (JA 31, 38). That is incorrect, obviously, and it is incorrect for two reasons at the heart of the analysis in *VALIC* and *United Benefit.* First, FIA premiums are invested in insurers' general account—which are subject to special state investment requirements—and contract values are not based on insurers' investment management. Second, investment risk is fundamentally ***risk of loss to one's investment***—the risk borne by purchasers of mutual funds and variable annuities that their capital will be lost or plummet in value with a decline in the underlying securities. "Funds of variable annuity contract owners are held in the separate account, and the contract owners participate fully in the investment results. Thus, in theory, the account could fall to zero." Kenneth Black, Jr., and Harold D. Skipper, *Life and Health Insurance* 175 (2000). FIAs, by contrast, are subject to the full panoply of state insurance laws whose function is to protect against risk of loss, guaranteeing that a contract owner receives no less than 87.5

percent of premiums even if the contract is surrendered in the first year, and assuring that the minimum contract value will increase at a rate of at least 1 to 3 percent annually for the life of the contract. These are identical to the guarantees for traditional fixed annuities. JA 241-44. For such reasons, the American Academy of Actuaries—in a comment the Commission ignored—said the "the risk profiles [for FIAs and traditional annuities] are similar." JA 189.[6]

The decisions of other courts confirm that FIAs are annuities. *Malone* squarely held that the issuer of an FIA assumed as much or more investment risk than the purchaser. 225 F. Supp. 2d at 750. In *Olpin v. Ideal Nat'l Ins. Co.*, 419 F.2d 1250 (10th Cir. 1969), purchasers of insurance participated in a "Bonus Fund" whose value was credited 2.5 percent annually plus an annual variable contribution determined by the insurer. *Id.* at 1252. The insurer "no doubt" considered its own investment "earnings" in setting the discretionary rate, and the value of the purchaser's contract was therefore linked to the investment performance of the insurer and the markets. *Id.* at 1261. But the excess interest was a risk ***borne by***

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[6] It is to be noted that annuities are not identical to insurance—Section 3(a)(8) separately refers to "annuity contracts" and "insurance"—and therefore displaying ***all*** the features of an insurance contract, and none of an investment, cannot be the measure of whether the Section 3(a)(8) exemption is met. Rather, all annuities possess certain investment characteristics. *Cf. Nationsbank of N.C. v. VALIC*, 513 U.S. 251, 259 (1995) ("Annuity contracts must . . . be recognized as investments rather than insurance.").

the company, the court said, because the crediting formula was locked in and if the insurer's "forecast as to the future returns from [its] investments was greater than the actual returns realized, because of lapsed policies, unwise investments, changed economic conditions, or any other reason," the purchaser nonetheless remained entitled to his proportionate share of the Fund. *Id.* So here, an FIA purchaser who holds his contract to term is entitled to his premiums plus indexed interest, and the insurer bears the risk of ensuring that its business performance and investment success enable it to satisfy that obligation while earning a profit.

In *Otto v. Variable Annuity Life Insurance Co.*, 814 F.2d 1127 (7th Cir. 1986), *rev'd on rehearing* 814 F.2d 1140 (7th Cir. 1987), the court initially held that a product with a fixed interest rate and discretionary rate was an annuity. After a petition for rehearing the court reversed itself, but only because the issuer had "unfettered discretion" to change the excess interest rate on past deposits, as well as "the absolute right to stop all excess interest payments on all deposits, past or present." *Id.* at 1141. With FIAs, by contrast, the interest-crediting formula is stated in advance, subject to statutorily prescribed minimums and, once set, may not be changed by the insurer during the stated period. Similarly, in a subsequent case, the Seventh Circuit addressed a "Flexible Annuity" that had a guaranteed minimum interest rate and an excess rate that was declared at the beginning of each year and was "derived from the rate of return [the insurer] earned on its general investment portfolio." *AIAP*, 941 F.2d at 566, 567. Because the company there—like *Olpin*, but unlike *Otto*—committed to a crediting formula in advance of knowing its own performance in the period, it bore sufficient investment risk for the product to be an annuity. *Id.* at 567.

For all of these reasons, FIAs are annuities. As shown below, it was only through an analysis that defies Supreme Court precedent, common parlance, and prior pronouncements of the SEC itself that the agency was able to arrogate to itself the power to regulate FIAs as securities.

II. THE REASONING AND TEXT OF RULE 151A ARE ARBITRARY AND CAPRICIOUS AND IRRECONCILABLE WITH SECTION 3(a)(8), WITH THE SUPREME COURT CASES ON WHICH THE COMMISSION PURPORTED TO RELY, AND WITH RELATED COMMISSION RULE 151.

Rule 151A rests on the Commission's mistaken interpretation of its authority and of applicable Supreme Court precedent. The consequence is that both the reasoning and the ***text*** of the rule are arbitrary, capricious, and contrary to law. The rule must be vacated.

A. The Commission Has No Authority To Regulate "Certain" Annuities, As This Rule Supposes.

In adopting Rule 151A, the Commission repeatedly referred to FIAs as annuities, while declaring its intent to regulate them as securities. There are circumstances, it pronounced, "[w]here . . . an ***annuity contract*** is not entitled to the Section 3(a)(8) exemption"; "we have concluded [this] is the case with respect to certain indexed annuities . . . ." 74 Fed. Reg. at 3,147 (emphasis added) (JA 35). This rule, it said, "defin[es] a class of indexed annuities that are outside the scope of Section 3(a)(8). With respect to ***these annuities***, investors will be entitled to all the protections of the federal securities laws, including full and fair disclosure and antifraud and sales practice protections." *Id.* at 3,142 (emphasis added) (JA 30). *Accord* 73 Fed. Reg. at 37,758 (JA 8). Indeed, by its very terms the rule singles out for treatment as securities those products that are "subject to regulation under the insurance laws of that [state] jurisdiction as an annuity." 17 C.F.R. § 230.151A(a) (Add. 24). A product not regulated by a state as an annuity—or not issued by "a corporation subject to the supervision of the [state] insurance commissioner," *id.*—would not be identified as a security under the rule. *Compare VALIC*, 359 U.S. at 68 (counseling "reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by ***superimposing*** federal requirements on transactions that are ***tailored*** to meet state requirements") (emphases added).

Picking and choosing which annuities to regulate as securities was outside the Commission's authority. Section 3(a)(8) exempts "any" "annuity contract" from SEC regulation: "[W]hen Congress places the word 'any' before a phrase with several common meanings, the statutory phrase ***encompasses each of those meanings*** [and] the agency may not pick and choose among them." *New York v.*

EPA, 443 F.3d at 888 (Rogers, J.) (emphasis added). *Accord Financial Planning Ass'n v. SEC*, 482 F.3d 481, 488 (D.C. Cir. 2007) (Rogers, J.) (invalidating SEC rule for failing to give due weight to word "any," which "is usually understood to be all inclusive"). For this reason alone, the Commission's rule is arbitrary and capricious and should be vacated.

B. The Analysis And Justification For The Rule, And The Rule's Text, Are Inconsistent With *VALIC* and *United Benefit*.

The Commission purported to "analyze indexed annuities under the facts and circumstances factors articulated . . . in *VALIC* and *United Benefit*," in which—it said—"factors that are important . . . include (1) the allocation of investment risk between insurer and purchaser, and (2) the manner in which the annuity is marketed." 74 Fed. Reg. at 3,141, 3,143 (JA 29, 31). The Commission misconstrued and misapplied the first factor while ignoring the second.

1. Rule 151A contains and depends upon an insupportable definition of investment risk.

Under Rule 151A, a purchaser bears sufficient risk to treat an FIA as a security whenever "amounts payable by the issuer under the contract are more likely than not to ***exceed*** the amounts guaranteed under the contract." 17 C.F.R. § 230.151A(a)(2) (emphasis added) (JA 63). In the SEC's view, to the extent the purchaser is likely to get her minimum guarantee ***and more***, she bears "risk" that renders the product a security.

That analysis—and the provision of Rule 151A that embodies it—conflicts with *VALIC* and *United Benefit*, where the Court regarded a purchaser's primary investment risk as the ***risk*** to her ***investment***, i.e., the possibility her principal would be lost. An increased likelihood that a purchaser will get back a guaranteed amount and more is not risk at all. *Compare Webster's New World Dictionary*, Second College Edition (1976) (defining risk as "the chance of injury, damage, or loss; dangerous chance; hazard," or, in the insurance sense, "a) the chance of loss b) the degree of probability of loss c) the amount of possible loss to the insuring company").

In the Adopting Release the Commission asserted that "deviat[ion] from the expected return" is a "widely accepted definition of 'risk' in financial instruments," 74 Fed. Reg. at 3,145 (JA 33) (citing Bodie *et al.*, *Investments* 143-44). But that treatise only shows the error of the Commission's analysis: Such a definition of risk only applies, the treatise states, when the deviation has a normal distribution. Bodie at 143-44. Fixed indexed annuities do not have a normal distribution, because the purchaser is credited only with gains and not with losses. Moreover, the treatise goes on to explain that because of the limitations of this definition of risk, it has limited relevance to investors. "Clearly, what would trouble potential investors . . . is the downside risk of a [negative] return, not the upside potential of a [positive] return." *Id*. The Commission did not cite or address a 12-page expert report in the rulemaking record which explained the error of the Commission's new definition of risk and stated that measures considering "upside risk" are disfavored by financial economists. JA 271-82; *supra* at 18. It also ignored the statement of the American Academy of Actuaries that the "historic view of a security, as we have understood it, is that the uncertainty of return of principal is a true risk that defines security status, not the uncertainty of a dispersion of positive returns." JA 131.[7]

Even supposing the definition of investment risk seized upon by the Commission for purposes of this rule is meaningful in some contexts, it is a square peg in a round hole when applied under *VALIC* and *United Benefit*. As the Commission repeatedly acknowledged, those cases are concerned with the "place[ment]," "allocation," or "transfer" of risk between purchaser and insurer. *VALIC*, 359 U.S. at 71; 73 Fed. Reg. at 37,752, 37,757 (JA 2, 7). Risk that may be

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[7] At one point the Adopting Release appears to suggest that withdrawal charges—or "surrender" fees—also constitute investment risk. 74 Fed. Reg. at 3,145 (JA 33). However, later in the Release the Commission concurs that "bona fide surrender charges should not result in a contract being deemed a security, since a surrender charge is an expense and does not represent a transfer of risk from insurer to contract purchaser." *Id.* at 3,153 (JA 41). *Accord AIAP*, 941 F.2d at 567 (surrender charges do "nothing to throw investment risk on the investor"). *And see* the adopting release to Rule 151, where the Commission stated that a surrender charge "normally does not shift additional investment risk to the contractowner." Definition of Annuity Contract or Optional Annuity Contract, 51 Fed. Reg. 20,254, 20,257 n.20 (June 4, 1986) (Add. 4).

"placed, "allocated," or "transferred" is zero sum: as it rises for one party, it falls for the other. In the Commission's formulation, by contrast, risk rises for both parties: If—as the Commission maintains—the FIA purchaser "risks" getting additional returns, that plainly still presents risk to the insurer also, who must ***pay*** those returns "[r]egardless" whether its own resources are less than anticipated "because of lapsed policies, unwise investments, changed economic conditions, or any other reason." *Olpin*, 419 F.2d at 1261. Unsurprisingly, States consider an insurer's excess interest obligations when determining whether the insurer has sufficient reserves to satisfy state solvency requirements. *See, e.g.*, Iowa Code Ann. § 508.36(7) (Add. 38).

The Commission may not "accomplish its objective[s] by a manipulation of meaning." *Goldstein v. SEC*, 451 F.3d 873, 882 (D.C. Cir. 2006) (invalidating rule). That is what occurred here, and the rule should be vacated both because the ***reasoning*** underlying its adoption is mistaken, and because the rule's ***text*** embeds a definition that is arbitrary, capricious, and contrary to law. The text of Rule 151A is arbitrary and capricious for the further reason that it treats likely gains as excessive risk regardless of their magnitude or likelihood: ***any*** amount of likely gain above the guarantee is deemed "risk" that outweighs the insurer's; and even if the purchaser were certain or near-certain to realize index-related gains, this nonetheless would be treated as "risk" that predominates over the insurer's.[8]

2. The Commission failed to assess the relative risk borne by purchaser and insurer, as required by *VALIC* and *United Benefit*; the text of the rule also fails to account for the insurer's risk.

The Commission also did not assess the relative risk allocated to issuer and purchaser, as required by *VALIC* and *United Benefit*.

Every case to analyze whether a contract meets Section 3(a)(8) has balanced the investment risks assumed by the purchaser and insurer. *See, e.g.*, *VALIC*, 359 U.S. at 70-73; *United Benefit*, 387 U.S. at 209; *Malone*, 225 F. Supp. 2d at 750-51. The Commission inexplicably omitted this analysis. It designated the possibility of gain as "risk" borne by the purchaser, ignored the true risk of payment this presents to the insurer, and failed even to discuss the other risks borne by the insurer. These include (1) guarantees of principal; (2) guarantees reflected in the minimum nonforfeiture value or otherwise; (3) guarantees of previously credited interest; (4) the establishment of the precise terms of the index interest crediting method

[8] The Commission admitted that a contract with *de minimis* securities-linked gains would be covered by Rule 151A. 74 Fed. Reg. at 3,150 (JA 38). It committed that it "would be prepared to consider a request for relief, if appropriate" in such circumstances. *Id.* This is little comfort to insurers and agents, who must ensure securities compliance in advance, and the Commission's acknowledgement merely confirms the arbitrariness of the rule.

prospectively, at the beginning of each term; and (5) mortality risk, which was recognized to present risk to the insurer when the Commission adopted related Rule 151. *See* 51 Fed. Reg. at 20,256 (Add. 3); *and see VALIC*, 359 U.S. at 71; *Grainger v. State Sec. Life Ins. Co.*, 547 F.2d 303, 305 (5th Cir. 1977). Instead, the Commission merely pronounced that FIAs pose "too much" risk to the purchaser, 74 Fed. Reg. at 3,145, 3,150 (JA 33, 38), without explaining why it was "too much" under the "allocation of risk" test the Commission purported to apply.

* * *

In *VALIC* the Supreme Court said that a product is not an annuity when the issuer bears "no" risk, and *United Benefit* said that a "slight" risk to the issuer was insufficient also. *AIAP*, 941 F.2d at 566. The text of Rule 151A turns that law on its head, requiring that the risk to the issuer of an FIA be total: The insurer must guarantee the minimum contract value plus interest as required by state law, but—to the extent the purchaser is "more likely than not" to experience market-related gains—the issuer must guarantee those anticipated gains also, in advance. Otherwise, by operation of Section 230.151A(a)(2), the product is not an annuity. This "definition" of annuity is in effect a mandate that in offering products uniformly recognized as annuities by the States, insurers must provide a "guarantee" higher than required by the States or risk SEC enforcement action and penalties for purportedly offering an unregistered security. Such a regulatory requirement intrudes on States' own regulation of FIAs.

3. The rule's failure to account for marketing is contrary to precedent of the courts and the Commission.

In determining whether a product is a security or annuity, the courts repeatedly have inquired whether the product is marketed on the basis of the investment acumen of the issuer. *Supra* at 14, 21. The SEC, in turn, identified how a product is marketed as second only to "investment risk" in determining when a product is a regulated security. *Id.*

Numerous commenters showed that insurers and the States take precautions to ensure that FIAs are marketed primarily for their safety and guarantees, rather than as an invitation to share in the "investment experience" of the issuer. *Supra* at 20-21. Yet marketing is excluded altogether from the test under Rule 151A.   In pure *ipse dixit* and without referring to the rulemaking record, the Commission said in its Adopting Release:

> The very nature of an indexed annuity, where return is contractually linked to the return on a securities index, is, to a very substantial extent, designed to appeal to purchasers on the prospect of investment growth . . . It 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 returns and the related risks.

74 Fed. Reg. at 3,146 (JA 34).

This reasoning by the Commission eliminates what the Supreme Court and the Commission itself have previously regarded as an important, ***independent*** factor in identifying securities. It is irreconcilable with the Commission's own statements about the importance of marketing in interpreting Section 3(a)(8), and conflicts squarely with related SEC Rule 151, which makes a product "not [being] marketed primarily as an investment" one of two substantive criteria distinguishing a regulated security from an annuity. 17 C.F.R. § 230.151(a)(3) (Add. 23).

Because it omits any consideration of marketing, Rule 151A is flawed on its face and must be vacated.

C. The Rule Conflicts With Related Commission Rule 151, And Arbitrarily Treats Similar Products Differently.

As noted, related Commission Rule 151 provides a "safe harbor" in which products will be recognized as annuities. In adopting that rule, the Commission said it included "limited use of index features in determining the excess interest rate, so long as the excess interest rate is not modified more frequently than once per year." 51 Fed. Reg. at 20,260 (Add. 7). "The insurer, therefore, would be permitted to specify an index to which it will refer, no more often than annually, to determine the excess interest it will guarantee for the next 12-month or longer period." *Id.* FIAs do exactly that, by referring to an index on an annual basis and crediting that amount to the purchaser. The only court to decide whether FIAs are annuities held that they satisfied the Rule 151 safe harbor. *Malone*, 225 F. Supp. 2d at 752-54.

The Commission asserts that FIAs cannot claim the Rule 151 safe harbor 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 a year." 74 Fed. Reg. at 3,142 (JA 30). But that statement contradicts the Rule 151 adopting release, which states that, "while the rate of interest calculated under a particular index or formula may fluctuate upward or downward on a daily basis, the excess interest rate actually credited may not fluctuate more than once a year." 51 Fed. Reg. at 20,260 (Add. 7). That is how FIAs function: the crediting method is determined annually and interest is credited annually, though the index itself fluctuates daily.

It is the quintessence of arbitrary and capricious agency rulemaking to declare a "security" a product that another rule denominates an "annuity." *AT&T v. FCC*, 836 F.2d 1386, 1391 (D.C. Cir. 1988) (invalidating rule that "constitutes a self-contradiction" with agency's previous statements).

The Commission drew similar distinctions without a difference in establishing the parameters of Rule 151A itself. In finalizing the rule, the Commission made changes to its text in order to exclude traditional fixed annuities and "discretionary excess interest contracts," under which the insurer may declare "discretionary 'excess interest' rates . . . from time to time." These periodic changes in the excess rate enable the insurer to offer rates that "adjust in response to prevailing market rates." Kirsch, *Variable Annuities* § 2:2.2. The Commission admitted in the Adopting Release: "With both traditional fixed annuities and discretionary excess interest contracts, the interest rates are often based, at least in part, on the performance of the securities held by the insurer's general account." 74 Fed. Reg. at 3,149 (JA 37). Rather than pausing to reconsider whether the securities-related component of FIAs was an appropriate ground for singling them out for treatment as securities, however, the Commission revised the second paragraph of the rule to state that covered contracts were only those where "[t]he contract [itself] specifies" that amounts payable are calculated with reference to securities. 17 C.F.R. § 230.151A(a)(1) (Add. 24).

There is no basis in reason why the supposed "risk" of additional securities-related returns is greater when that feature of a product is identified in the contract. Rather, at least one commenter has suggested that FIAs place ***more*** investment risk on the insurer than discretionary excess interest contracts because the insurer commits itself in advance to pay a rate of interest in accordance with a formula. *See* Kirsch, *Variable Annuities* § 2:2.3[B]. The Commission's action to carve these products out of the rule is characteristic, however, of a rule that is said in the first sentence of the Adopting Release to "define[ ] the terms 'annuity contract' and 'optional annuity contract' under the Securities Act of 1933," 74 Fed. Reg. at 3,138 (JA 26), but which in fact whittles and sculpts language to denominate a single type of annuity a regulated security, without providing or resting upon any generally-applicable definition of what distinguishes annuities from securities.

III. THE COMMISSION FAILED TO FULFILL ITS STATUTORY RESPONSIBILITY TO CONSIDER EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.

In rulemakings under the Securities Act, the Commission is required to consider a proposed rule's effects on "efficiency, competition, and capital formation." 15 U.S.C. § 77b(b) (Add. 13); *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006) (invalidating, for the second time, rule for failure to properly consider costs).

The Commission estimated that the rule's costs could exceed $100 million in the first year alone, 74 Fed. Reg. at 3,169 (JA 57), and did not dispute commenters' estimates of lost revenues of $1.5 billion for independent marketing organizations and their agents and $300 million for insurance companies. *Id.* at 3,168 (JA 56). "[G]iven the imperative of the federal securities laws and the size of the industry," it said, even these higher-end costs were "justified." *Id.* To commenters' objections that the Commission had erred both in asserting widespread abusive sales of FIAs, and in positing that state laws were not designed to address them, the Commission responded that this was immaterial ("the presence or absence of sales practice abuse is ***irrelevant***”) because “Congress has determined that securities investors are entitled” to the rule’s requirements; “it is not the Commission’s role to reevaluate the efficiencies of that regulatory structure for each particular instrument that is a security.” *Id.* at 3,170 (emphasis added) (JA 58).[9]

The Commission’s assertions that it need not weigh costs against benefits because it was following the clear dictates of Section 3(a)(8) dispose of any claim on the agency’s part to be entitled to *Chevron* deference. *See* the discussion of standard of review *supra* at 24-27. To the extent the Commission had any interpretive discretion to exercise, however, its effective refusal to consider whether a costly rule was needed—that is, whether a problem existed, and if so whether States were addressing it—was a complete abandonment of the obligation to consider effects on efficiency, competition, and capital formation.

“[U]ncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed

[9] The Commission also asserted that the requirement to file a prospectus would enhance competition by making price and product publicly available, *id.* at 3,169-70 (JA 57-58), but it made no finding that there was not already robust competition through the usual market mechanisms, and filed rate requirements are not generally considered hallmarks of efficient competition.

regulation before it decides whether to adopt the measure." *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005). The Commission's failure to weigh the costs of duplicative regulation of disclosure, suitability, and other market practices is particularly striking given its statement—in the same section of the Adopting Release—that exempting insurance companies from certain Exchange Act requirements would "improve efficiency by eliminating potentially burdensome and duplicative regulation," and would "enhance competition" because it would "reduce . . . regulatory costs." 74 Fed. Reg. at 3,172 (JA 60).

Accordingly, even assuming this rule did lie within the Commission's discretion to adopt—and it did not—a remand would be necessary for the Commission to appropriately exercise that discretion.

CONCLUSION

For the foregoing reasons, petitioners request that the petition for review be granted and that Rule 151A be vacated.

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 12,087 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word using 14-point Times New Roman font.

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CERTIFICATE OF SERVICE

I hereby certify that on this 17th day of February, 2009, I have caused to be served two true and correct copies of this Opening Brief of Petitioner and one copy of the Joint Appendix upon the following, by the method indicated below:

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