

1 UNITED STATES COURT OF APPEALS
2 FOR THE DISTRICT OF COLUMBIA CIRCUIT

3 AMERICAN EQUITY INVESTMENT LIFE
4 INSURANCE COMPANY, ET AL,

5 Petitioners,

6 v.

No. 09-1021

7 SECURITIES AND EXCHANGE
8 COMMISSION,

9 Respondent.

10 Friday, May 8, 2009

11 Washington, D.C.

12 The above-entitled matter came on for oral
13 argument pursuant to notice.

14 BEFORE:

15 CHIEF JUDGE SENTELLE AND CIRCUIT
16 JUDGES GINSBURG AND ROGERS

17 APPEARANCES:

18 ON BEHALF OF THE PETITIONERS, AMERICAN EQUITY
19 INVESTMENT LIFE INSURANCE COMPANY, ET AL:

20 EUGENE SCALIA, ESQ.

21 ON BEHALF OF THE PETITIONER, NATIONAL
22 ASSOCIATION OF INSURANCE COMMISSIONERS:

23 RODNEY F. PAGE, ESQ.

24 ON BEHALF OF THE RESPONDENT:

25 MICHAEL H. CONLEY, ESQ.

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Michael H. Conley, Esq. On Behalf of the Respondent	21

1 claiming that these requirements must be imposed as a matter
2 of law. We ask this Court to recognize that fixed indexed
3 annuities are annuities exempt from SEC regulation as a matter
4 of law and to vacate this rule.

5 I would note that the SEC has not opposed the
6 vacating rule if the petition is granted. Indeed, we believe
7 that the reasons set forth in our emergency motion for
8 expedited review, which this Court granted, further warrant
9 vacating the rule in the event the petition is granted.

10 I'd like to begin by addressing the subject of
11 deference, but let me be clear at the outset. We believe this
12 rule should be invalidated under any standard, because it's an
13 impermissible encroachment on the, an area reserved to the
14 authority of the states, and it rests on theories hatched in
15 the SEC's offices about annuities that conflict with the
16 reality of those products and conflict, as well, with Supreme
17 Court precedent and rule making record.

18 As to deference, this case closely resembles the
19 American Bankers case, another instance in which this Court
20 invalidated an SEC rule because the agency attempted to expand
21 its jurisdiction by defining a term that by definition was
22 outside of its authority, and tried to use that as a mechanism
23 of encroaching on the authority of another regulatory body.
24 That's precisely what's occurred here. We've got the
25 extraordinary circumstance of 50 state insurance commissioners

1 saying that they know annuities, they're the expert at
2 annuities, and this is an encroachment.

3 JUDGE ROGERS: I don't understand. The Supreme
4 Court has made clear that the fact of state enforcement
5 doesn't provide necessarily the type of protections that the
6 1933 act is designed to protect. I don't think that's
7 disputed in the briefs before us. Some states do some things,
8 some states do other things.

9 MR. SCALIA: Actually, Judge Rogers, that's a
10 significant difference between this case and the VALIC, and
11 the United Benefit cases. In both of those cases, the Supreme
12 Court did take a look at state law. And in VALIC, it said,
13 well the states aren't in agreement on whether these are
14 annuities. And in United Benefit, it said, these products
15 exist by virtue of an exemption from state insurance laws.
16 It's exactly the opposite here. That's one of the things that
17 makes this case so extraordinary. These products meet every
18 requirement under the state insurance laws and they're
19 uniformly recognized to be regular annuities. And yet, the
20 SEC is attempting to regulate them, nonetheless. That's the
21 difference.

22 But, and true with the deference point, what I also
23 would add is that McCarran-Ferguson establishes what the
24 Supreme Court has recognized as a rule that a federal statute
25 should not be construed to impair or supercede state insurance

1 regulation, absent a clear statement to that fact. It's a
2 clear statement rule. It only follows that the SEC can't
3 seize on purported ambiguities to expand its jurisdiction. It
4 needs a clear statement. That's absent here.

5 JUDGE SENTELLE: If the SEC does exactly what
6 they're supposed to do under this rule, doesn't that still
7 leave the states a great deal of leeway for other regulations?

8 MR. SCALIA: It does leave --

9 JUDGE SENTELLE: Is it in fact preemptive, in other
10 words.

11 MR. SCALIA: Pardon?

12 JUDGE SENTELLE: Is it in fact preemptive Go ahead.

13 MR. SCALIA: Well, it does interfere directly and
14 conflict directly to an extent with state law, and one example
15 would be arbitration, which the, is required with broker
16 dealers under Sudoc (phonetic sp.) regulations and practices.
17 And the Federal Arbitration Act ordinarily would preempt a
18 state law that attempted to prohibit arbitration over those
19 products. But once you throw in McCarran-Ferguson, there's a
20 reverse preemption, and the insurance laws do require
21 litigation rather than arbitration in disputes with insurance
22 agents. This would defeat that, requiring the state law. And
23 I believe that Mr. Page representing the state insurance
24 commissioners would be prepared to talk about that more.

25 But additionally, Judge Sentelle, the court

1 recognized in VALIC that for the SEC to regulate these such
2 products would in fact impinge on the states. It said, we
3 begin with the reluctance to superimpose federal requirements
4 on state, on products that were tailored to satisfy state law.
5 That's precisely what's being done here. In fact, I think one
6 of the really extraordinary things about this rule is that one
7 of its very foundations is the existence and presence of state
8 regulation. You're not covered under this rule unless you are
9 an annuity recognized as such by the state and regulated as
10 such by the state. The rule's not even triggered absent that.
11 It's a very extraordinary use of state law as a pretext for
12 intruding in that area by the federal government.

13 Another interference, Chief Judge Sentelle, that I
14 would mention is simply that the states have extensive
15 requirements, themselves, already. If these federal
16 requirements are superimposed, as the record reflects, they
17 put an enormous additional cost on the insurance industry,
18 which is something the states have an interest in functioning
19 and offering affordable --

20 JUDGE SENTELLE: That's a different question. That
21 does not make it more interfering the state law than if it
22 didn't. It will impose more costs. That would seem to be a
23 given, that if you had two sets of regulations, there would be
24 some additional costs.

25 MR. SCALIA: And it will disenable the states from

1 requiring litigation with agents over disputes. And also, it
2 will disempower states' ability to assert their own authority
3 to the full extent and really assert control over these
4 products, because the SEC will be in the background as an
5 alternative regulatory authority. And insurance companies
6 naturally are going to give less deference to the states than
7 they do currently.

8 JUDGE GINSBURG: Excuse me. What is it about the
9 rule that, if I understood you correctly, that makes its
10 application dependent upon state recognition of the product as
11 an annuity?

12 MR. SCALIA: Judge Ginsburg, if you look at the very
13 first paragraph of the rule, a requirement of application of
14 this rule is that it involve a contract that --

15 JUDGE GINSBURG: Is the summary or --

16 MR. SCALIA: I'm sorry. It's at page A24 as the
17 statutory appendix, our brief. But the language is that a
18 contract that is subject to regulation under the insurance
19 laws of that jurisdiction as an annuity is nonetheless not an
20 annuity contract if certain conditions are met. The other
21 thing about this rule is that even if a product is an annuity
22 that the SEC ultimately is prepared to say, oh, yes, that's a
23 state law annuity and we don't have an interest in it,
24 nonetheless, the computation requirements at the tail end of
25 this very short rule require that a product, and even the SEC

1 would agree, oh, that's a state annuity, require that its
2 value be computed in advance, six months in advance, according
3 to a formula laid out in the rule. If you don't do that, even
4 though you're otherwise an annuity subject only to state
5 regulation, the SEC steps in. So this rule interferes
6 directly with state regulation in that manner, too.

7 Quickly on deference. You have the Board of
8 Governors, the American Bankers case which involved a very
9 similar circumstance where an agency was trying to expand its
10 jurisdiction based on a term outside of its authority. This
11 Court said no. Secondly, this Court's decision in York v.
12 EPA, in a decision written by Judge Rogers, you had statutory
13 language that said any physical, any physical change, and this
14 Court said, those words precluded interpreting discretion on
15 the part of the agency. It couldn't pick and choose which
16 products to regulate.

17 And another extraordinary thing about this rule,
18 where so little respect is shown to the states, their views,
19 and the regulatory system, is that the SEC actually said that
20 section 3(a)(8) exempts only quote, certain annuities, and I
21 believe that's on page 26 of the Joint Appendix. And it
22 repeatedly said that it was going to regulate products that
23 were indeed annuities.

24 Finally on deference, this Court has said repeatedly
25 that it will not defer to constructions of Supreme Court

1 decisions that are given by agencies, because this Court knows
2 just as well how to interpret a court decision as an agency
3 does. And yet, one of the very predicates of this rule was,
4 as the SEC put it, their risk analysis is based on an
5 application of the reasoning in the two Supreme Court
6 decisions.

7 JUDGE ROGERS: Let me ask you. In the Supreme Court
8 cases where basically the court instructed that a functional
9 approach is the way to look at these offerings to determine
10 whether or not federal regulations is appropriate, given that
11 structure and the Court would look to Supreme Court
12 instruction in that regard, and then look at what the SEC had
13 done. I understand your point about refrains in the rule
14 about it doesn't really matter what the state law might
15 require. But ignoring that for the moment in terms of
16 responding to this question, what specifically do you think
17 that the SEC has failed to do? Ignoring the section 2(b)
18 argument, too, if you will for, in answering this question.

19 MR. SCALIA: What it's failed to do in this rule
20 making?

21 JUDGE ROGERS: Yes, to the extent that the Supreme
22 Court has said we want a functional approach. The SEC has
23 offered its expert judgment as to the nature of the investment
24 risk involved in these products and determined that there's a
25 significant enough risk to the purchaser, such that federal

1 law --

2 MR. SCALIA: First, Judge Rogers, I would say they
3 have failed to base this rule on the reality of annuities,
4 both these products and traditional annuities as they exist in
5 the market. This rule is based on theories that the SEC
6 developed in its offices, but they're incompatible with
7 reality in the rule making record. Let me mention --

8 JUDGE ROGERS: Is that a different response to you
9 just disagree with the SEC's definition of investment risk?

10 MR. SCALIA: Yes. That is one element of the
11 disagreement. There's much more. So as to their theory, one
12 part of their theory was that if there are uncertainties as to
13 the rate of return you'll get on a product, if there's a link
14 to the markets, that can't be an annuity. Those --

15 JUDGE SENTELLE: Counsel, you're not going to assert
16 that an agency cannot act based upon economic theories they've
17 worked out in his office, are you? I mean, this is I think
18 twice at least, maybe three times you've told us that, but I'm
19 not sure why that is disqualifying. That's what agencies do a
20 lot, is work out theories in their offices.

21 MR. SCALIA: Well what you had in this case was, let
22 me, first of all by saying, again, this is an unusual area
23 where this state lacks the expertise. These are products by
24 definition outside their authority, so their theorizing --

25 JUDGE SENTELLE: Whoa, whoa, whoa. That's the very

1 reason we're here. You're begging the question, then.

2 MR. SCALIA: But their theories --

3 JUDGE SENTELLE: You're saying we can't rely on it
4 because it's outside the authority.

5 MR. SCALIA: But my point is, is that they're --

6 JUDGE SENTELLE: We're here to find out if it's
7 within, to decide if it's within their authority.

8 MR. SCALIA: It's that the economic theories that
9 they identify have to be consistent with reality. And their
10 theory was essentially that if there's uncertainty as to the
11 amount of return, and if there's a link to the markets --

12 JUDGE SENTELLE: And there is investment risk, then
13 the question then becomes, who's risk, who's bearing the risk.

14 MR. SCALIA: Well but there's, even the predicate
15 that if there's uncertainty as to returns or there's a link to
16 the markets, that's incompatible with annuity, is simply
17 incorrect. This record showed and --

18 JUDGE SENTELLE: No, it's not correct or, correct or
19 incorrect is what we're here to decide, isn't it? You keep
20 begging the question, I think, when you say they're incorrect
21 on this.

22 MR. SCALIA: Well, I'm sorry, judge. I'm trying to
23 complete the sentence.

24 JUDGE SENTELLE: I know that your position is that
25 they're incorrect, but we can't decide they're incorrect just

1 because they're incorrect. We have to have your reasoning
2 along the way. And why isn't it their job to analyze
3 investment risk and see who's bearing the risk in order to
4 make that determination as to whether these are exempted
5 annuities within the meaning of the statute?

6 MR. SCALIA: The theory that they adopted is
7 inconsistent with the reality of these products in the rule
8 making record. Traditionally, traditional fixed annuities
9 also have uncertain rates of return. When you buy a product,
10 when you know your rate of return in year one, year two,
11 three, four, you don't know what your rate of return will be.
12 There is uncertainty with the traditional product.

13 Additionally, traditional products can be indexed to
14 the markets. In fact, what happened in this rule making was
15 that the traditional issuers came in and said, we like the
16 rule because we're imposing costs on our competitors by
17 subjecting them to the regulations we're not, but they said,
18 our products also vary your rate of return year to year based
19 on an index or based on our own portfolio. So that theory
20 that that supposed risk is incompatible with annuities is just
21 simply false. And the SEC hatched the theory in its offices
22 without any expertise on these products and ignored
23 significant rule making evidence.

24 And I'm going to emphasize particularly the comments
25 that were filed by the American Academy of Actuaries. This is

1 66 pages in the Joint Appendix. The SEC twice in footnotes in
2 its adopting release said this academy are experts. They're
3 objective, they're independent. They said, we give their
4 views substantial weight. But in these comments at pages 131,
5 127 and 128 and elsewhere, the academy said repeatedly, the
6 risk profile of these products is very similar to traditional
7 annuities. And they said, variable annuities are very, very
8 different. So here you have this expert body, 66 pages in the
9 Joint Appendix, wholly ignored by the SEC because again,
10 variable theory --

11 JUDGE SENTELLE: The SEC said nothing in response to
12 those comments?

13 MR. SCALIA: They say nothing whatsoever, Your
14 Honor. They do not address this comment except when it suits
15 their purpose in another point. They cite them and say, these
16 guys are real experts.

17 JUDGE SENTELLE: So except for, except for
18 mentioning them somewhere, they ignore them. Is that what
19 you're telling me?

20 MR. SCALIA: Pardon?

21 JUDGE SENTELLE: Except for mentioning them
22 somewhere, they ignored them? Is that what you're telling --

23 MR. SCALIA: Oh, worse than ignored. When it suited
24 their purpose, cited and said these guys are geniuses.

25 JUDGE SENTELLE: So they didn't ignore them.

1 MR. SCALIA: But --

2 JUDGE SENTELLE: So they didn't ignore them.

3 MR. SCALIA: They --

4 JUDGE SENTELLE: They liked part of it and disliked
5 part of it.

6 MR. SCALIA: Your Honor, on the central point in
7 this rule, that is whether these products are like traditional
8 annuities or like variables, they completely ignored them even
9 though they were aware of the comments. They said they were
10 experts. It's actually an extraordinary thing that agency on
11 the one hand say, this is a truly expert body, on the other
12 hand, not even acknowledge what they've said on the key
13 question of how these products function. The actuaries also
14 criticize the theory of investment annuities that the SEC had
15 used.

16 Also, the SEC repeatedly said that these products
17 are very like variable annuities or mutual funds. They said
18 that seven different times in the adopting release. They're
19 unlike traditional annuities. They're very like mutual funds
20 and variable annuities. The Academy of Actuaries said not,
21 not true. These are very like traditional annuities. The SEC
22 has abandoned that particular theory in its brief.

23 JUDGE SENTELLE: You are over your time now. So --

24 JUDGE ROGERS: Can I just ask one question, though?

25 JUDGE SENTELLE: Sure.

1 JUDGE ROGERS: In your reply brief, you offer an
2 example in the footnote on page 12, saying how a typical FIA's
3 value is calculated. As I understand it, the SEC is focusing
4 on the latter, the last paragraph. And I thought the argument
5 here was in part, and I know it's in your briefs, that in
6 allocating risk, the SEC by using its more likely than not
7 standard had ignored the risk that the issuer bears. And that
8 that's, and then you point to the guarantees that a purchaser
9 received in connection with the principle and the rate of
10 interest and the periodic interest. But it's that fourth
11 paragraph, isn't it, that the SEC has been looking at in terms
12 of defining whether or not there's a significant investment
13 risk to the purchaser?

14 MR. SCALIA: Your Honor, Chief Judge Sentelle, I'll
15 try to answer this briefly. But I think that fourth paragraph
16 is part of what they've attempted to address, but here's what
17 they've conceded. They've conceded that a principal is a risk
18 borne by the seller. They've conceded that the state required
19 minimum interest is a risk borne by the seller. And they've
20 conceded that this indexed interest, which is the subject
21 really of their rule, also is a risk borne by the seller.
22 They did concede that on page 10 of their brief. And it is a
23 risk borne by the seller.

24 JUDGE SENTELLE: Stated it where?

25 MR. SCALIA: On page 10 of their brief. Because if

1 the index goes up, the insurer indisputably bears the burden
2 of paying that interest. There is no case that has ever held
3 that when a piece of an annuity is a risk borne by an insurer,
4 it nonetheless must be treated as risk borne by the purchaser.
5 And what's an additional failing here is that the commission
6 purported to base this rule on a test of the allocation of
7 risk. But I urge you to read their brief at pages 54 to 55
8 where they explain why it is that when a seller bears all that
9 risk and a purchaser bears this small amount of hypothetical
10 risk, somehow, the allocation is disproportionately in favor
11 of the company. They never explain it, and that's the very
12 essence of arbitrary and capricious decision making.

13 JUDGE GINSBURG: Actually, I thought you denied that
14 that was even risk?

15 MR. SCALIA: Pardon?

16 JUDGE GINSBURG: I thought what you just referred to
17 as the small risk borne by the insured, elsewhere in your
18 brief, you denied was risk at all.

19 MR. SCALIA: To the purchaser, that's correct.

20 JUDGE GINSBURG: Yes.

21 MR. SCALIA: We would. It's putatively treated as a
22 risk. And even supposing it were, the fact is, it is risk to
23 the seller as well, which pre-commits to a fixed amount or
24 rather pre-commits to an amount that he will have to pay at
25 the end of the term. Thank you.

1 JUDGE SENTELLE: Thank you, counsel. We'll hear
2 from, let's see. Do we have an intervenor scheduled for
3 argument? I've mislaid my court sheet here somewhere.

4 MR. PAGE: Yes. Yes.

5 JUDGE SENTELLE: Okay. We'll hear from whoever's
6 next. Do we have an extra copy of that court sheet?

7 JUDGE ROGERS: Here.

8 JUDGE SENTELLE: Okay, thank you. I'm sure it's
9 here in this stack of papers somewhere, but you all have
10 generated, generated entirely too much paper this morning.

11 ORAL ARGUMENT OF RODNEY F. PAGE, ESQ.

12 ON BEHALF OF THE PETITIONER,

13 NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

14 MR. PAGE: Sorry about that, Your Honor. May it
15 please the Court. I am Rodney Page, and I am appearing on
16 behalf of the National Association of Insurance Commissioners.
17 I have not reserved time for rebuttal.

18 We have petitioned this Court to vacate the Rule
19 151(a) because we believe that the rule is an impermissible
20 encroachment on the regulation of insurance by the states. It
21 is specifically we think contrary to statutory directives. We
22 think it's inconsistent with principles of federalism and we
23 submit that it was adopted in complete disregard for an
24 existing regulatory regime at the state level with respect to
25 FIAs.

1 This rule, we believe, is a solution in search of a
2 problem. When the rule was proposed, the SEC release stated
3 that it was needed because of the need to enhance investor
4 protection, and the proposing release described the marketing
5 of FIAs as being fraudulent and abusive, and it sought
6 comments with respect to how to regulate them. The proposing
7 release made very little reference to the existing state
8 regulatory scheme.

9 What happened is, in the comment period, that the
10 premise of the SEC turned out to be incorrect. The state
11 regulatory environment dealing with these products is robust.
12 There is regulation of a number of aspects of these products.
13 There is non-forfeiture protection. There is regulation of
14 the investment of funds, capital adequacy of the issuers. The
15 products themselves are filed with and reviewed by state
16 regulators. Advertising of the product is regulated.
17 Disclosures about the product are required when they are sold.
18 Suitability determinations have been incorporated at the state
19 level, and other protections of that nature exist.

20 Accordingly, the SEC in dealing with this shifted
21 ground, and in its final release, stated that whether or not
22 there was abuse and fraud in the marketplace was simply
23 irrelevant to their determination. They would proceed on the
24 assumption that there was a need for federal regulatory
25 protection in the sale of the product. And they dismissed as

1 irrelevant the existence of a state regulatory regime.

2 We submit that in doing that, they have violated
3 what we believe is a statutory commitment committing these
4 products to regulation of the states. And that in fact, it is
5 an unnecessary, inefficient rule.

6 Most of the FIAs, an important fact that we noted in
7 our reply brief, are actually regulated by a relatively small
8 number of states. Two states account for about two-thirds of
9 the premiums sold with respect to the FIAs. Those two states
10 are Iowa and Minnesota, and they have among the most robust
11 protection at the state level.

12 We believe that the SEC in proceeding with its rule
13 making essentially has misread the case law from the Supreme
14 Court with respect to the role that the state should play with
15 respect to regulation of these products. As counsel, as Mr.
16 Scalia also noted, the Supreme Court in VALIC stated that it
17 started with a reluctance to disturb state regulatory schemes
18 that are in place. A key difference between what existed in
19 the Supreme Court case in VALIC and the case here is that
20 unlike this case, there was not an extensive regulatory scheme
21 in place at the state level. We believe that VALIC stands
22 properly for the, for the proposition that the existence of
23 the state regulation is not dispositive to the federal
24 questions. But we believe the SEC has misread this case in
25 concluding that the state regulatory regime is irrelevant.

1 What it should have done, what it should have done
2 was look at the comments and evaluate the need for this
3 regulation in light of what the actual marketplace looks like
4 and what is actually going on in the market. Instead, what
5 the SEC has done, we believe, is adopt the very proposition
6 that the Supreme Court in VALIC rejected, and that is the
7 notion that concepts of insurance and insurance regulation are
8 static and frozen and do not evolve over time. The opinion in
9 VALIC made it clear that that is not the case. What the SEC
10 has done, itself, in this case is adopt exactly what the
11 Supreme Court rejected. It has chosen to treat state
12 insurance as being solely about the question of insolvency of
13 the companies and not recognizing that in fact, state
14 regulation has gone far beyond that.

15 What is required for this rule is a balancing of
16 state and federal interest, and the SEC failed to do that.
17 For that reason, we ask you to vacate this ruling.

18 JUDGE SENTELLE: You're not making a constitutional
19 federalism argument, are you?

20 MR. PAGE: No.

21 JUDGE SENTELLE: Okay, good. Thank you. Hear from
22 the respondent.

23 ORAL ARGUMENT OF MICHAEL H. CONLEY, ESQ.

24 ON BEHALF OF THE RESPONDENT

25 MR. CONLEY: Good morning and may it please the

1 Court. Michael Conley for the SEC.

2 I plan to address two main points this morning.

3 First, why this rule reflects precisely the sort of
4 interpretation of an ambiguous statutory term that's reviewed
5 for reasonableness under Chevron. And second, why the line
6 that the commission drew in this rule is in fact a reasonable
7 one, and therefore, should be upheld.

8 I'll first address why Chevron deference is
9 appropriate here. This rule making is just the latest in a
10 series of efforts by the commission and courts over the past
11 50 years to address how the exemption in section 3(a)(8) of
12 the Securities Act for annuity contracts applies to new forms
13 of annuities that didn't exist when that exemption was
14 enacted. The bottom line is this. Based on VALIC, United
15 Benefit and the cases that have followed them, we know that
16 there's a spectrum along which annuity contracts fall. At one
17 end is the traditional fixed annuity, which is clearly
18 insurance and clearly entitled to the exemption under 3(a)(8).
19 At the other end of the spectrum are variable annuities, which
20 are clearly securities and clearly not entitled to the, and
21 not entitled to the exemption under 3(a)(8).

22 But between these two goals is a gray area that's
23 occupied by products like the flexible fund annuity that the
24 court addressed in United Benefit and the indexed annuities
25 that are the subject of this rule. And the Supreme Court,

1 other courts, and the commission have all recognized that
2 these sorts of hybrid products which have aspects of both
3 insurance and securities, when you're talking about these
4 things, the application of the annuity contract exemption is
5 ambiguous. As Judge Easterbrook (phonetic sp.) said when he
6 wrote about this for the 7th Circuit in the Home Life
7 (phonetic sp.) case, neither the statute nor the Supreme Court
8 draw any bright line that tells us where these hybrid annuity
9 products fall, whether they're entitled to the exemption or
10 not.

11 Ultimately, then, whether such a product is entitled
12 to the exemption depends upon a judgment about the investment
13 risk that it presents, and whether it presents risk that
14 implicate the protections of the securities laws. That's what
15 courts have been doing since VALIC. That's what the Supreme
16 Court, it's what the commission did more than 20 years ago
17 when it adopted Rule 151, and it's exactly what the commission
18 did in this case, too. It made a judgment based on the
19 factors that the court identified in VALIC and United Benefit,
20 that the class of index annuity contracts that are addressed
21 by this rule present investment risk that Congress would not
22 have intended to leave solely to state insurance regulation.
23 The commission reasoned that the purchasers of these products
24 are exposed by definition to market volatility, and that that
25 implicates the securities laws protective purposes.

1 And it's based on that judgment that the commission
2 concluded that these products are not annuity contracts as
3 defined by section 3(a)(8). And under settled law, this is
4 exactly the kind of determination that is reviewed for
5 reasonableness, which is what I'll turn to now.

6 And basically here, the petitioners have made three
7 principal challenges to the reasonableness of the commission's
8 judgment. First, they say it's based on an understanding of
9 investment risk that's fundamentally flawed. Second, they say
10 that it doesn't account adequately for the amount of risk
11 that's borne by the insurance companies under these contracts.
12 And finally, they talk about the commission having failed
13 adequately to consider how these products are marketed. And
14 as Your Honors will see in the release, the commission dealt
15 with each of these arguments and explained why they don't have
16 merit.

17 I'm going to turn first now to the biggest argument,
18 which is with respect to whether in fact the commission has a
19 reasonable understanding of investment risk here. And the
20 petitioners argue, and they repeated this morning, that
21 investment risk exist or is cognizable for these purposes only
22 where there's the potential to lose principal. And the
23 problem with that, the commission explained how that's not an
24 adequate understanding of investment risk or a complete
25 understanding of investment risk, but it's also contrary to

1 the position that every single case has been decided since
2 United Benefit has taken.

3 All of those cases, every one, involved contracts in
4 which there was a guarantee of principle, plus a guaranteed
5 return of interest. What those cases all dealt with was
6 whether uncertainties with respect to payments beyond
7 principle and interest were such that it made the contract
8 ineligible for the section 3(a)(8) exemption.

9 JUDGE GINSBURG: These are not Supreme Court cases
10 then.

11 MR. CONLEY: Those are not Supreme Court cases, Your
12 Honor. However, I'll note also that in the United Benefit
13 case, the contract that was at issue there also provided for,
14 after a 10-year period of time, a full return of premiums paid
15 or net premiums paid. But these, but the cases that followed
16 it were addressing contracts that the insurance industry
17 developed in response to Supreme Court decisions. And yet in
18 each of those cases, the court was looking at whether this
19 extra component, whether it's extra, I'm sorry, excess
20 interest, which is sometimes referred to, whether there's
21 enough uncertainty about that, that investment risk was
22 presented, that made these things ineligible for section
23 3(a)(8). And some cases found that it did, and some cases
24 found that it didn't, depending on the nature of the --

1 JUDGE GINSBURG: Excuse me. But the United Benefit
2 is the case in which the Supreme Court said the return, the
3 risk component was dependent upon the insurance company's
4 management of a portfolio, didn't it?

5 MR. CONLEY: It's true, Your Honor, that in the, in
6 the VALIC case, the particular kind of contract that was
7 presented was a variable annuity. And the way that that
8 contract functions, the Supreme Court did identify that there
9 were many ways in which it looked like an investment company.
10 And but what the Supreme Court didn't say was that the only
11 kind of risk that was relevant would be if a contract
12 presented that particular kind of risk. Instead, the position
13 was taken, the broader position that was taken was, is there
14 something about the contract that, are the risks that are
15 presented there that make the securities laws relevant, that
16 make the protections of the securities laws relevant. And
17 then the court went on to actually analyze the particular
18 contract and identify that as one of the risk.

19 JUDGE SENTELLE: Looking at this contract, is it
20 conceded, I think it is, that there is no risk on the investor
21 as to principal.

22 MR. CONLEY: That's correct.

23 JUDGE SENTELLE: That if there is a fixed return, it
24 is not at risk. It's over and above, is all that is at risk.

25 MR. CONLEY: Well the way these --

1 JUDGE SENTELLE: If that's risk.

2 MR. CONLEY: I'm sorry, Your Honor. The way these
3 contracts work is that there is a minimum guarantee that's
4 provided, and then there's the potential to participate in its
5 market-related returns. And we tried to explain in our brief.
6 These are very complicated instruments.

7 JUDGE SENTELLE: Yes. We got that part.

8 MR. CONLEY: Okay. Yes, that's clear. And the
9 guaranteed return only kicks in if at the point that the
10 person leaves the contract, either by surrendering it or
11 coming to the end of the term, if the returns from the market
12 component don't exceed what the minimum guarantee is. So it's
13 slightly different than these traditional excess interest
14 contacts, contracts.

15 JUDGE SENTELLE: I'm not sure how that is different
16 in kind.

17 MR. CONLEY: Well --

18 JUDGE SENTELLE: I mean, if it's a guaranteed
19 return, the fact that you can only grow it at the end as
20 opposed to, or can only be computed at the end.
21 Incrementally, you've been getting it all the time, perhaps.
22 But nonetheless, it is a guaranteed return.

23 MR. CONLEY: That's correct. It's a guarantee --

24 JUDGE SENTELLE: The only thing that can be called
25 risk at all is the over and above what's guaranteed.

1 MR. CONLEY: That's correct. And as --

2 JUDGE SENTELLE: That's not real risky? What's
3 the --

4 MR. CONLEY: Well as I said, Your Honor, that is,
5 that's actually the exact way that all of these other cases,
6 every contract that was dealt with in these cases work.
7 Because really, all --

8 JUDGE SENTELLE: Did you not also say some of them
9 had gone one way, some had gone the other way?

10 MR. CONLEY: Well that's, that's with respect to how
11 the particular, and that's where we come in to the thing
12 that's critical here. What, in the Home Life case, Judge
13 Easterbrook explained why some cases went one way and why some
14 cases went the other. And what he said is, that the way to
15 understand and to rationalize these decisions, basically, is
16 to pay attention to how the, the determination is made about
17 what the rate to be paid will be. And in the cases where the
18 determination was made prospectively, where the investor knew
19 in advance what he or she was going to receive over the
20 period, that was a sufficient assumption of risk by the
21 insurance company, and those cases were found to satisfy the
22 requirements of 3(a)(8). Where, however, the determination of
23 the rate was not made until after a period elapsed,
24 retrospectively, which is exactly how these contracts work in
25 this case, then the courts concluded that the purchaser bore

1 the risk, too much of the investment risk, and the contracts
2 were ineligible for section 3(a)(8).

3 JUDGE SENTELLE: In those, does the purchaser here
4 have, have the ability to calculate that minimum return that
5 is guaranteed at the time of purchase?

6 MR. CONLEY: That is a calculation that presumably
7 could go forward. But remember --

8 JUDGE SENTELLE: That is a yes.

9 MR. CONLEY: Yes. But that's true, that was true in
10 all these other contracts, as well.

11 JUDGE GINSBURG: I think that's in the sales
12 materials.

13 MR. CONLEY: I'm sorry?

14 JUDGE GINSBURG: I believe that would be in the
15 sales material.

16 MR. CONLEY: That's true. That's true. They would,
17 the sales materials presumably would talk about --

18 JUDGE GINSBURG: So the insured, the insured doesn't
19 have to calculate it. It's part of the --

20 JUDGE SENTELLE: Right.

21 JUDGE GINSBURG: -- part of the policy.

22 JUDGE SENTELLE: Prospectively, it's been
23 calculated.

24 MR. CONLEY: But what the, what the purchaser of the
25 contract cannot do, which is exactly what all the cases that

1 found 3(a)(8) not being satisfied concluded, they can't tell
2 what the potential, what the return will be from the, in the
3 coming period, because it's linked to the uncertain
4 performance of a security or a securities index.

5 JUDGE GINSBURG: Well the excess return, as what
6 it's calling it. In other words, they can look and say, well,
7 we'll give whatever state gives us 1 to 3 percent. Whether
8 we'll get any more is uncertain.

9 MR. CONLEY: That's true. That's true. But again,
10 that's exactly the same as all these other contracts.

11 JUDGE GINSBURG: Now if the --

12 MR. CONLEY: The contracts that were at issue in,
13 and that the court described in Home Life.

14 JUDGE GINSBURG: Let me pick up there. But Home
15 Life's the Easterbrook opinion?

16 MR. CONLEY: Yes, that's Easterbrook.

17 JUDGE GINSBURG: Yes. Starting there. If the, if
18 the rate of return for the coming year on this fluctuating
19 tranche is determined retrospectively based on the performance
20 of the market or some index of the prior year, and during the
21 first 10 years or so, it's impractical for the insured to
22 abandon the policy because of the surrender charge, what, what
23 difference does it make whether the calculation is
24 prospective, instead made prospective?

25 MR. CONLEY: Well the difference that it makes is

1 that the purchaser of the contract simply lacks the
2 information to be able to make the judgment that you're
3 talking about.

4 JUDGE GINSBURG: About whether to abandon?

5 MR. CONLEY: About whether to abandon.

6 JUDGE GINSBURG: Well the surrender charge, I mean,
7 they haven't earned, they're starting at about 87 percent --

8 MR. CONLEY: That's correct.

9 JUDGE GINSBURG: -- invested and they haven't earned
10 back the other 13 percent for some years.

11 MR. CONLEY: Well it depends on the performance of
12 the index prior to that time. Because as soon as the index
13 performs positively, and this is materials we cited in our
14 brief and were cited in the release, under most of these
15 contracts, under all of these contracts that we know of, then
16 what essentially happens is the minimum guarantee almost
17 becomes irrelevant. Because once there's a positive return,
18 the surrender charge dropped from that, under a relatively
19 short period of time, would be in excess of the minimum. So
20 there are circumstances in which it's going to be extremely
21 relevant for the purchaser to be able to know what the return
22 is going to be in the coming year, and be able to make a
23 judgment, a realistic judgment based on all the information
24 that he or she has about whether to stay in the contract or
25 not.

1 This isn't just a hypothetical thing that could
2 never be meaningful. It really can be meaningful in exactly
3 the way that Judge Easterbrook talked about. Because when you
4 have prospective setting of rates, what happens effectively is
5 that the contract becomes a series of one-year fixed
6 annuities. The purchaser or whatever the particular period
7 happens to be, we're using one year as an example, but then at
8 the start of each period, the purchaser is free at that time,
9 has sufficient information to decide whether to stay in the
10 contract or not. When the purchaser doesn't have that, he
11 faces or she faces what's the precise ex-ante (phonetic sp.)
12 uncertainty that Judge Easterbrook referred to in Home Life.

13 JUDGE GINSBURG: Suppose that, by your concept of
14 risk --

15 MR. CONLEY: Yes.

16 JUDGE GINSBURG: -- which is the risk that you will
17 not get the excess at all, that they'll be a zero for the
18 coming year --

19 MR. CONLEY: Well, the risk that you're going to get
20 less of what the expected return is.

21 JUDGE GINSBURG: Well there is no expected return.

22 MR. CONLEY: But, well there is an expected return
23 because you can calculate an expected return, like you can for
24 any product that has an uncertain future return. And
25 investors don't buy these products, of course, with an

1 anticipation of, of simply getting the guaranteed minimum.

2 The reason they choose these products --

3 JUDGE GINSBURG: Well I don't know that we have a
4 record on that question.

5 MR. CONLEY: I'm sorry?

6 JUDGE GINSBURG: I'm not sure there's a record on
7 that, what people do when, how they buy these things.

8 MR. CONLEY: There actually is a record. And the
9 commission refers to information that was provided by some of
10 the sellers of these contracts, which say that a substantial
11 percentage of them are buying these products not just for the
12 guarantee, but for the possibility of earning more than the
13 guarantee. Otherwise, they would be buying, I mean, just
14 logically, otherwise, they'd be buying traditional fixed
15 annuities which pay a higher guaranteed rate.

16 The reason that you're willing to accept a lower
17 rate here --

18 JUDGE GINSBURG: Okay. Let me go back. With this
19 concept of risk, which is the risk that you'll get less than
20 the expected, that you've -- the return that you've
21 calculated --

22 MR. CONLEY: The uncertainty of that.

23 JUDGE GINSBURG: -- on a possible, on a probability
24 basis.

25 MR. CONLEY: Yes.

1 JUDGE GINSBURG: On that concept, if the policy were
2 not to have this excess charge but rather just say, every
3 year, we will give you some lottery tickets. It may not pay
4 off. That would also be an impermissible risk?

5 MR. CONLEY: Well obviously, the particular
6 contracts that we're talking about here are limited to three
7 circumstances. There has to be this retrospectively
8 crediting. There has to be a link to security or securities
9 index. And it has to be more likely than not that the
10 return's coming there.

11 JUDGE GINSBURG: Oh, I'm not suggesting the
12 commission would assert jurisdiction over, I'm not suggesting
13 the commission would assert jurisdiction over policies --

14 MR. CONLEY: Right.

15 JUDGE GINSBURG: -- that are accompanied by a flow
16 of gratuitous lottery tickets --

17 MR. CONLEY: Yes.

18 JUDGE GINSBURG: -- on the ground that they're
19 securities. Although, I wouldn't be surprised.

20 MR. CONLEY: But --

21 JUDGE GINSBURG: But I am saying that the concept of
22 risk that you're using here would apply equally there,
23 forgetting whether that would make it in to a security.

24 MR. CONLEY: The risk of uncertain future return is
25 a well established notion of risk, yes.

1 JUDGE GINSBURG: And would apply in my hypothetical.

2 MR. CONLEY: I assume that some version of that,
3 there's a similar risk that you could say exists there.

4 Except that, I mean, it really is critical to note that the
5 risk here is a risk that's linked to uncertain market
6 performance. And you really are talking about something --

7 JUDGE GINSBURG: Yes. So a lottery ticket is linked
8 to an uncertainty, as well.

9 MR. CONLEY: I'm sorry?

10 JUDGE GINSBURG: A lottery ticket has a substantial
11 uncertainty.

12 MR. CONLEY: Yes. But the uncertainty that's here
13 is an uncertainty that's common to securities, generally. And
14 it's part of what makes investing in securities something that
15 the securities laws relate to, the protection of the
16 securities laws relate to. And once again, I'll bring back --

17 JUDGE SENTELLE: You have a sort of uncertainty with
18 respect to any annuity in that if it's surrenderable at all,
19 you make the decision every year on whether the investment you
20 have in that annuity could render a greater return than some
21 other form. I realize not all of them are surrenderable, but
22 if they can be surrendered, then you have to make that same
23 decision. All that's changed here is, that part of that
24 market is already tacked onto the side of it. But you would
25 always have an investor, if it's a surrenderable annuity --

1 MR. CONLEY: You're exactly right.

2 JUDGE SENTELLE: -- you could surrender and
3 potentially put the money in something else. Does that make
4 all of them investments?

5 MR. CONLEY: The critical point though, Your Honor,
6 is whether you have all the information that's necessary to be
7 able to make that decision.

8 JUDGE SENTELLE: You can never have all the
9 information necessary to make that decision.

10 MR. CONLEY: You have enough information, you have
11 enough information to be able to make what we would call an
12 informed investment decision, which is what the securities
13 laws relate to.

14 JUDGE SENTELLE: Why don't you have the same
15 information here? If your decision otherwise is whether to
16 take the money, if it can be surrendered, or if it has to be
17 renewed and you're deciding whether to renew, if you can take
18 that money and put it somewhere else and make a greater
19 return, you're making a market prediction when you make that
20 decision. Just as you would do with a CD as to whether it
21 would at the close. Here, you're making the same decision,
22 only you have a little more information. You know that you're
23 going to have some key to --

24 MR. CONLEY: Actually, I don't think that's correct,
25 Your Honor. The information that you don't have here is what

1 the return will be for that component of the contract.

2 JUDGE SENTELLE: That's the information that you
3 don't have when you're making the surrender decision or
4 renewal decision.

5 MR. CONLEY: No, you would have that. And
6 contract --

7 JUDGE SENTELLE: You don't know what's going to be
8 happening in the future market.

9 MR. CONLEY: No. But you'll know what you'll be
10 earning under this, this particular product for that period.
11 What is removed is the uncertainty of the future return. And
12 when you have, that, that's exactly what the courts have
13 found --

14 JUDGE SENTELLE: Somehow, we're missing each other
15 on my hypothetical comparison.

16 JUDGE GINSBURG: I think I have your point. It's
17 that in one instance, you're saying well, under the policy,
18 I'm going to earn 5 percent for the coming year. Do I want to
19 take, surrender the policy and go in to the market --

20 MR. CONLEY: Correct.

21 JUDGE GINSBURG: -- versus under the policy, I'm not
22 sure what I'm going to get. I'm just sure of the minimum, 3,
23 and I have to decide whether to go in to the market instead.

24 MR. CONLEY: That's exactly right.

25 JUDGE SENTELLE: That's a fairly narrow difference

1 in risk, then, counsel. You're not risking anything that you
2 have. You're risking how much you can make on what you have.

3 MR. CONLEY: But that's, that's an essential element
4 of, of risk in the sense of uncertain future return, which is
5 described as investment risk, generally.

6 JUDGE GINSBURG: Well why did the Academy of
7 Actuaries describe the risk profile of this product as being
8 essentially similar to that of a conventional annuity?

9 MR. CONLEY: The discussion that was made there was
10 talking about what insurance companies do in order to respond
11 to the risk that's presented. And they said because there is
12 a guaranteed minimum in this contract, to the extent that the
13 contract functions in that way, and they have to, they have to
14 cover that guaranteed minimum, they're making very similar
15 investments to what they would do in a fixed annuity. But
16 that really doesn't address the risk that we're talking about
17 here, which is the risk of uncertainty with respect to the
18 purchaser's risk of uncertainty with respect to the return
19 that's going to be made. It just doesn't --

20 JUDGE GINSBURG: But I mean, so on the insurance, on
21 the insurance company's side.

22 MR. CONLEY: On the insurance company's side.

23 JUDGE GINSBURG: There are different but similar
24 strategies for hedging that risk.

25 MR. CONLEY: That's correct.

1 JUDGE GINSBURG: Buying an index, for instance.

2 MR. CONLEY: That's correct. That's the difference
3 here between fixed annuities and that, and the insurance
4 company responds to that exactly as you said, by purchasing
5 hedging contracts and so on in order to, to address it.

6 JUDGE GINSBURG: All of which, whatever they do is
7 essentially irrelevant. To you concerns, it's a solvency
8 issue.

9 MR. CONLEY: That, the insolvency issue in the fixed
10 annuity context, right, is what state law relates to.

11 I would like, if I can, have just a brief moment to
12 respond to this point on state law, because I think it's, I
13 think it's a significant one that. The Supreme Court has
14 actually considered this and rejected the precise argument
15 that's being made by petitioners here. I would urge Your
16 Honors to look at the VALIC decision. The paragraph that they
17 refer to, the portion of Justice Douglas' opinion at the
18 beginning which says that we're reluctant to, to enter in to
19 the area of insurance which is traditionally the purview of
20 states.

21 There's a paragraph that follows that which says,
22 but, we have to do so because in this case, the issue before
23 us was what the meaning is under federal law. And of course
24 then, the concurring opinion says specifically that this
25 notion that because these, because state insurance regulation

1 exists of these products, and of course, the other, the other
2 thing that's correct here is that these products were subject
3 to state insurance regulation at that time, the products in
4 VALIC, that that's enough. We don't have to worry basically
5 about these. We'll let the state insurance regulators deal
6 with whatever problems might arise with respect to new
7 contracts. That was squarely rejected.

8 And in fact, the author of the dissenting opinion in
9 VALIC was Justice Harlan. And Justice Harlan, who wrote for
10 the unanimous court --

11 JUDGE SENTELLE: You are over your time. So --

12 JUDGE GINSBURG: I do have one --

13 JUDGE SENTELLE: -- let's make this, if you're going
14 to say something else about that, say something brief about
15 it.

16 MR. CONLEY: Okay, I will. Justice Harlan --

17 JUDGE SENTELLE: We don't want to hear about
18 Harlan's further history or what his granddaddy wrote or
19 anything like that.

20 MR. CONLEY: Okay. I promise. Justice Harlan
21 acknowledged in United Benefit that this argument was squarely
22 rejected by the court.

23 JUDGE ROGERS: But I, but as I understand the
24 argument in part, it's that at the time he wrote, that was an
25 accurate description. But since then, states have done a lot

1 more. So the argument that state law does not address
2 investment techniques and that type of thing is no longer
3 valid. And the commission, as I read its explanation, simply
4 says, we don't care what the states are doing because it could
5 be less than a uniform requirement, and the disclosure that
6 federal law provides and the protections under federal law
7 should exist irrespective. So the argument is made
8 hypothetically, if all the states were doing everything that,
9 so that the federal law would require under the applications
10 of this rule, would the commission be venturing in to an area
11 where it has no authority to venture unless Congress gives it.

12 MR. CONLEY: Two points if I can to respond to that.
13 First, the notion that state law is comprehensive and uniform
14 here is simply not borne out by the record, as we've said.
15 The second point, though, is that the Supreme Court actually
16 did address this very point and say that what is relevant for
17 these purposes is whether securities laws are relevant to the
18 risk that's presented. And if states move in to this area,
19 that Congress fully contemplated concurrent regulation by
20 states and the federal government. So that's in the Supreme
21 Court opinion. That's the authority.

22 JUDGE GINSBURG: Mr. Conley?

23 MR. CONLEY: Yes.

24 JUDGE GINSBURG: I have one other concern with the,
25 and that's with the commission's analysis of the effect of the

1 rule on competition and --

2 MR. CONLEY: Yes.

3 JUDGE GINSBURG: -- capital formation and so on,
4 which is relevant only if we agree with you to this point, on
5 everything that's been said to this point.

6 MR. CONLEY: Right.

7 JUDGE GINSBURG: That analysis has, as one of the
8 factors on which the commission depended, the resolution of
9 the uncertainty now prevailing over the legal status of these
10 products.

11 MR. CONLEY: That's correct.

12 JUDGE GINSBURG: I don't see how that can possibly
13 be relevant to the analysis that's required under statute
14 2(b), I guess it is. In other words, you can't say, well,
15 competition will be unproved because we've messed it up by
16 dawdling over this issue or by saying we might regulate it,
17 and now we're resolving the uncertainty and that will improve
18 competition. For one thing, it would be true no matter how
19 you resolve the uncertainty.

20 MR. CONLEY: Your Honor, I think, if I understand
21 the point --

22 JUDGE GINSBURG: It's pretty simple.

23 MR. CONLEY: Right. That the resolution of the
24 uncertainty about how these products have been regulated will
25 have the effect of making it clear to --

1 JUDGE SENTELLE: That would be true no matter what
2 you decided. That simply supports the making of a decision.
3 What Judge Ginsburg I think is suggesting is, it doesn't
4 support the making of the decision one way or the other. It
5 can't be part of the reasoning as to why we decided this in
6 any particular way. It simply says, we should decide this,
7 get it over with.

8 MR. CONLEY: That's correct. And that has --

9 JUDGE SENTELLE: Would you --

10 MR. CONLEY: -- that has an effect. That has an
11 effect, and I think that's the point.

12 JUDGE GINSBURG: But that can't be relevant to the
13 analysis of the effect of the rule. Of the rule, not of
14 resolution. That's the effect of just getting this done one
15 way or the other.

16 MR. CONLEY: I see.

17 JUDGE SENTELLE: If we decided exactly the opposite,
18 it would be equally true.

19 MR. CONLEY: I see your point.

20 JUDGE GINSBURG: So it doesn't say that the rule is
21 good for competition or, or, well that's what it claims. And
22 that's one of the factors on which the commission based its
23 analysis, which takes us to Chenery (phonetic sp.) and my
24 further question, which I assume if I'm right, that's one of
25 the factors, we would have to recommit this to the agency to

1 reconsider this.

2 MR. CONLEY: Well, I don't believe that's the case
3 for two reasons, Your Honor. First, I think that we've made
4 the argument, and it's before the Court obviously, that the
5 section 2(b) requirement to undertake this analysis didn't
6 apply in this, in this --

7 JUDGE GINSBURG: That's your argument in the brief.
8 But your rule making document says, here's the required 2(b)
9 analysis.

10 MR. CONLEY: That's, that's correct.

11 JUDGE GINSBURG: All right. So it's a little late
12 to be switching your interpretation of whether 2(b) applies.
13 You applied it.

14 MR. CONLEY: And in the essence of the commission's
15 explanation for why that's the analysis that had to be
16 undertaken with respect to comparisons of state law, which is
17 really the only objection that was raised here by petitioners.
18 The only objection they make is that the commission didn't do
19 this comprehensive analysis of state law and say what extra
20 was being added here and whether that was necessary. And the
21 commission said that to do so, to allow them to use this
22 general provision this way, would contravene what the Supreme
23 Court said in United Benefit and VALIC about the relationship
24 between state law and whether a security is entitled to an
25 exemption under, under section 3(a)(8).

1 JUDGE GINSBURG: Well that's, that's another point I
2 was going to get to about the competitive analysis and the
3 competition, capital formation and so on analysis. And that
4 is that one can't say whether something is beneficial to
5 competition, let's say, without saying, compared to what. So
6 if compared to not promulgating the rule, that means leaving
7 the state regime in place. So without knowing what the, what
8 the marginal effect is, in other words, of promulgating the
9 rule, you haven't analyzed the required, you haven't addressed
10 the requirement of 2(b).

11 MR. CONLEY: But again, I would come back to the
12 point that I just made I think is the response to that, which
13 is that it cannot be the case that the commission is required
14 to undertake this particular kind of analysis as part of a
15 general provision that would contravene what the Supreme Court
16 has said is the correct relationship between state law --

17 JUDGE GINSBURG: Well, no, no, no. You may, you may
18 conclude it will have an adverse effect on capital formation
19 and competition, but we have to do it.

20 MR. CONLEY: Well --

21 JUDGE GINSBURG: But you didn't do the analysis.

22 MR. CONLEY: I believe the commission actually said
23 there that the state laws that are out there and the
24 improvements that have recently been made by states in this
25 area are commendable, but they can't ultimately substitute for

1 the comprehensive, complete protections that are required for
2 securities. And if securities require these protections, then
3 without regard to what the states are doing, those
4 requirements are still in place. And they can't be superceded
5 by, and it doesn't mean that these things are not securities,
6 and that purchasers of these products are not entitled to the
7 same protections.

8 JUDGE GINSBURG: I understand. You're making the
9 legal response to the statute that puts you in the unusual
10 position of, of making an economic response. And it's been,
11 it hasn't set well with the commission ever since it's been
12 passed. It was ignored for 10 years and then finally in the
13 investment company cases, the court twice remanded it so you
14 would actually do it.

15 But let me ask you this. Mr. Scalia said, if I
16 understood correctly, that it's the commission's position, and
17 I'm not sure this is correct, that if we find the rule is
18 invalid, that it should be vacated rather than remanded.

19 MR. CONLEY: That's not the commission's position.

20 JUDGE GINSBURG: Okay. Then it follows, I trust,
21 that if we find the competition analysis, the 2(b) analysis
22 insufficient, again, you would think it should not be vacated
23 but rather left in place while remanded.

24 MR. CONLEY: That's correct, Your Honor.

25 JUDGE GINSBURG: Thank you.

1 JUDGE SENTELLE: And I hate to do this, but we'll do
2 it anyway. I'm going to bring up another aspect. Mr. Scalia
3 says that the commission did not respond to an important area
4 of comment, the actuaries comments. Now it is normally the
5 rule that we do require rule makings to respond to important
6 comments. So what do you say to his argument in that regard?

7 MR. CONLEY: I think that the rule did, the, I'm
8 sorry, the commission in the release did respond to this
9 position that these products are more like fixed annuities
10 than they are variable annuities by explaining that. Although
11 a part of the rule, a part of these products looks like that,
12 there is an important part that doesn't. And the commission
13 responded even more importantly in structuring the way that
14 the rule works. When in fact these products are functioning
15 more like fixed annuities, traditional fixed annuities, then
16 the rule does not make the exemption unavailable.

17 In other words, when it's more likely than not that
18 the return is going to be the guaranteed minimum, then the
19 exemption is not unavailable. And so that directly responds
20 to the point about how these contracts are structured and when
21 they resemble traditional fixed annuities.

22 JUDGE GINSBURG: So you're saying at most, you may
23 not have mentioned them in that connection, but you
24 responded --

25 MR. CONLEY: That's correct.

1 JUDGE GINSBURG: -- in substance.

2 MR. CONLEY: That's correct. Thank you.

3 JUDGE SENTELLE: Thank you, counsel. You had used
4 all your time. We'll give you back three minutes for
5 rebuttal, Mr. Scalia.

6 ORAL ARGUMENT OF EUGENE SCALIA, ESQ.

7 ON BEHALF OF THE PETITIONERS,

8 AMERICAN EQUITY INVESTMENT LIFE INSURANCE COMPANY, ET AL

9 MR. SCALIA: Thank you, Your Honor. With --

10 JUDGE SENTELLE: We'll give intervenor one in a
11 minute. Go ahead with your three.

12 MR. SCALIA: Pardon me?

13 JUDGE SENTELLE: Go ahead with your three. I'm
14 going to give him one. Go ahead.

15 MR. SCALIA: With respect first of all to the
16 actuaries report, the commission never responded to the
17 actuaries' point that from an actuarial risk bearing
18 perspective, these products put all the same risks, in fact
19 slightly more, on a company as compared to a traditional
20 annuity. They never --

21 JUDGE GINSBURG: That's on the company side.

22 MR. SCALIA: Pardon me?

23 JUDGE GINSBURG: That's on the company side.

24 MR. SCALIA: That's correct.

25 JUDGE GINSBURG: But if I understood Mr. Conley,

1 your objection here is on the insured's side, the risk. You
2 object to their saying that the, that the insured is bearing
3 the risk.

4 MR. SCALIA: Well it's both, Your Honor. The
5 question, they said the hinge of our rule is the allocation of
6 risk. They said there's been an improper transfer of risk to
7 the purchaser. Part of that analysis is well, does the seller
8 bear the same amount of risk that he bears otherwise.

9 One case they've completely ignored is the Altman
10 (phonetic sp.) case.

11 JUDGE GINSBURG: Well now, wait a minute. The
12 seller could bear the same amount of risk as otherwise, and
13 yet, the insured bears a risk, a new risk not otherwise borne
14 because this is a riskier product. There's more risk to go
15 around.

16 MR. SCALIA: Well, and it's the commission's just to
17 explain why if that's risk, if it's risk - and I'd like to
18 address that briefly - why it's so serious to trump the
19 products otherwise annuity character. They never explain
20 that. They just said, oh, we found some risk.

21 And let me emphasize the United Benefit decision,
22 which did not turn on a conclusion that there was too much
23 risk on the purchaser. Instead, the court said it would be an
24 error to think that VALIC turned only on that. And Judge
25 Ginsburg, as you pointed out, it focused on two other things.

1 It looked first to state law and said, these products are
2 exempt from state risk requirements. That was important to
3 the analysis. And the second thing it looked at was whether
4 there was an investment management relationship, which Judge
5 Ginsburg you had noted. And all of the other cases that have
6 been cited involve the circumstance where the purchaser was
7 committing funds from management for profit by the seller.

8 So in the Home Life Easterbrook decision, for
9 example, the returns that the purchaser got were, quote,
10 derived from, quote, the returns of the, of the seller. And
11 the court characterized the product as a variable annuity.

12 The Altman case has been completely ignored by the
13 SEC. That's a case just like this, where there was a formula
14 set in advance. The purchaser didn't know what the rate of
15 return would be, nor did the seller. But the seller
16 committed --

17 JUDGE GINSBURG: Which case? I'm sorry.

18 MR. SCALIA: It's the Altman, 10th Circuit case.
19 And what the SEC is inviting is a conflict between this Court,
20 the 10th, and the 7th on one side and the 10th on the other
21 that's unnecessary. Because Altman said, because a company
22 pre-commits, it's taking risk and that's sufficient. And
23 again, certainly Judge Easterbrook said, it's like a series of
24 fixed annuities. But there's no legal requirement that there
25 be a series of fixed annuities. That's like saying all

1 annuities must be traditional, which isn't the rule.

2 Again, that case was --

3 JUDGE SENTELLE: But it mostly said there's no, we
4 have not yet said how much risk is too much risk, and I'm not
5 sure that I knew when we got through what he still thought was
6 too much risk.

7 MR. SCALIA: Well, and what VALIC and United Benefit
8 both make clear is that it's, the rule is not that there can
9 be no risk borne by the seller or borne by the purchaser, but
10 that's at the end of the day what this rule depends on. VALIC
11 at page 71 says very clearly, we're interested in a particular
12 kind of risk, the risk of no fixed returns. The SEC has
13 interpreted its mandate to find any kind of risk. Your
14 lottery example, Your Honor. Remember, the way this rule
15 functions is it's only if you're more likely than not to get
16 more than the guarantee, the rule applies. If I sell you a
17 product with a 20 percent chance of a 10 percent guarantee,
18 and a 40 percent chance of 2 percent, the SEC doesn't care.
19 It's only if I give you a 95 percent chance of a 2 percent
20 return that the rule kicks in. That's absurd.

21 Finally, on the subject of vacating the rule. I'd
22 like to be clear. The SEC has never said that it agrees, and
23 I did not mean to say that. I don't believe I did. It has
24 never until this moment said that the rule shouldn't be
25 vacated. It's waived its opposition to vacating the rule.

1 But in any event, the APA itself, as Chief Judge Sentelle you
2 know, says that if the rule is invalid, shall be vacated.

3 JUDGE SENTELLE: You know that I have said they
4 should vacate the rule in so many other context.

5 MR. SCALIA: That's correct. I'm not addressing
6 every member, member of the panel at this moment.

7 JUDGE SENTELLE: You assume I will this time.

8 MR. SCALIA: But additionally, there has been
9 extensive evidence put before the commission and the court
10 about how this rule will radically alter this industry, impose
11 enormous costs that must begun to be incurred now. The
12 rules --

13 JUDGE SENTELLE: We have let you go well beyond the
14 three minutes that I ceded to you. So unless my colleagues
15 have further questions, we'll give the intervenor a minute if
16 they want it.

17 MR. SCALIA: Thank you, Your Honor.

18 JUDGE SENTELLE: They're not asking for it.
19 Therefore, we will take a brief recess.

20 (Recess.)

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DIGITALLY SIGNED CERTIFICATE

I certify that the foregoing is a correct transcription of the electronic sound recording of the proceedings in the above-entitled matter.

Stephanie N Collins

Stephanie N. Collins

May 25, 2009

DEPOSITION SERVICES, INC.