

**ANNUITY COEPTIS: IS THERE A WAY TO AVOID  
AMERICAN EQUITY INVESTMENT LIFE INSURANCE CO. v.  
SEC BECOMING A HERALD FOR THE SEC GAINING  
REGULATORY CONTROL OVER ALL SECURITIES-  
RELATED INSURANCE PRODUCTS?**

*Russell Hasan*

*This note is a critique of the July 2009 D.C. Circuit case American Equity Investment Life Insurance Co. v. SEC, in which the court rejected a challenge to the Securities Exchange Commission's Rule 151A, which had subjected fixed index annuities to SEC regulation. The court held that the 1933 Securities Act's section 3(a)(8) exemption for insurance did not exempt fixed index annuities from SEC regulation. This note begins by exploring in considerable detail the case law on the insurance exemption contained in the 1933 Securities Act. The note then looks at the history of the rise of fixed index annuities, and examines the economic theory that underlies index investing, which is the investment strategy that gave birth to a demand for fixed index annuities. The note proceeds to look at contemporary case law applying the insurance exemption to decide whether fixed index annuities are exempt from SEC regulation under section 3(a)(8). The note then offers substantive analysis of why fixed index annuities should be exempt as insurance. The note argues that fixed index annuities transfer the risk of stock-picking from insured to insurer and that the beta risk vs. non-beta risk distinction from index investing theory is a suitable basis for regulating index annuities differently than variable annuities. The note argues that fixed index annuities pose challenges of solvency and contractual interpretation, which are the regulatory challenges of insurance, but do not pose disclosure challenges, which are the regulatory challenges that the SEC addresses. The note then argues that the D.C. Circuit completely misunderstood the economics of how fixed index annuities function. The note concludes by offering policy arguments on why it is best for the states and not the SEC to regulate fixed index annuities.*

**I. INTRODUCTION**

In the July 2009 D.C. Circuit case *American Equity Investment Life Insurance Co. v. SEC*, the District of Columbia Court of Appeals addressed

the question of whether fixed index annuities are insurance.<sup>1</sup> This question matters because annuity products which qualify as insurance are exempt from the requirements of the Securities Act of 1933 because of the insurance exemption in § 3(a)(8) of the Act, and are therefore not subject to regulation by the Securities Exchange Commission.<sup>2</sup> The SEC had earlier in 2009 released its new Rule 151A, which stated that fixed index annuities (for the most part) are not insurance under § 3(a)(8) and are therefore subject to SEC regulation.<sup>3</sup> The petitioners, who included American Equity Investment Life Insurance Company, the National Association of Insurance Commissioners, and as amici curiae Phillip Roy Financial Services LLC and Allianz Life Insurance Company of North America, brought suit and argued that the SEC's classification of fixed index annuities as securities and not as insurance was unreasonable.<sup>4</sup> The court in *American Equity* held for a variety of reasons that the SEC had been reasonable in determining that fixed index annuities were not insurance.<sup>5</sup> The court relied heavily upon precedent in the two most relevant United States Supreme Court cases addressing the insurance exemption, *SEC v. Variable Annuity Life Insurance Co. of America (VALIC)* and *SEC v. United Benefit Life Insurance Co. (United Benefit)*.<sup>6</sup>

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<sup>1</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 925 (D.C. Cir. 2009), amended by 2010 U.S. App. LEXIS 14249 (D.C. Cir. July 12, 2010).

<sup>2</sup> Securities Act of 1933 § 3(a)(8), 15 U.S.C. § 77c(a)(8) (2006). The insurance exemption in the Securities Act of 1933 provides that the Act does not apply to “[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.” *Id.*

<sup>3</sup> Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138 (Jan. 16, 2009) (to be codified at 17 C.F.R. Pts. 230 and 240). The SEC was responding to allegations that buyers of fixed index annuities had been victimized by various frauds necessitating heightened regulation, including the possibility that fixed index annuities might be marketed as investments and sold to buyers for whom the fixed index annuities are not suited. *See, e.g.*, Jonathan S. Coleman, *Equity Indexed Annuities: "Securities," or Exempt Insurance Products Under the Federal Securities Laws?*, 34 SEC. REG. L.J. 80 (2006).

<sup>4</sup> *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 924-25.

<sup>5</sup> *Id.* at 934.

<sup>6</sup> *Id.* at 926.

Because I believe that the D.C. Circuit both misinterpreted the relevant precedent and severely misunderstood the nature of the financial product in question, I argue in this note that the court reached the wrong result in *American Equity* in holding that the insurance exemption did not apply to fixed index annuities. In the process of this analysis I present a new conceptual framework for understanding insurance, risk, and securities, which courts will be able to use when examining other quasi-security annuity products in the future. I conclude by examining the policy implications of whether the SEC should have a broad regulatory net for catching every new and innovative financial product or whether the SEC's mandate should be more narrow and allow more control to the states; I argue that the latter choice is preferable.

I begin by explaining the precedent that is important to understanding the issues relating to fixed index annuities in Part II. I then explore the theory of index investing, the rise of fixed index annuities, and the SEC's efforts to regulate fixed index annuities in Part III.A. Then I present the contemporary cases that reached the question of whether fixed index annuities qualify for the insurance exemption in Part III.B. In Part IV.A, I present my conceptual framework for understanding insurance risk and show why a fixed index annuity is actually a form of insurance and is not a security. I conclude with policy arguments in Part IV.B.

## II. PRECEDENT DEFINING THE SCOPE OF THE INSURANCE EXEMPTION

### A. EARLY CASES DEFINING SECURITIES AND INSURANCE

One of the first Supreme Court cases to discuss the question of what is insurance is *Helvering v. Le Gierse*, a case that involved a decedent who had purchased a life insurance policy and an annuity simultaneously from the same insurer for similar amounts, such that each policy hedged or counterbalanced the other.<sup>7</sup> The decedent died and the beneficiary tried to claim the life insurance proceeds as tax-exempt under a tax exemption for life insurance.<sup>8</sup> The Court held that the life insurance policy did not qualify as insurance for purposes of the insurance exemption in the 1933 Act because the two contracts considered as a whole did not constitute "risk-

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<sup>7</sup> *Helvering v. Le Gierse*, 312 U.S. 531, 536 (1941). The Court was interpreting section 302 of the Revenue Act of 1926. *Id.* at 537.

<sup>8</sup> *Id.* at 537.

shifting and risk-distributing,” which is the essence of insurance.<sup>9</sup> The Court found that usually life insurance involves shifting the risk of death from those dependent upon the insured to a group of people (implicitly, everyone else who buys life insurance).<sup>10</sup>

*Helvering* is significant because the *United Benefit* Court cites *Helvering* for two propositions: (1) that a contract which is insured is not a contract of insurance and, (2) assuming investment risk does not create insurance. The case does stand for those propositions, but the Court in *Helvering* also looked at whether a financial product shifts and distributes economic risk to determine whether or not it is insurance, whereas the Court in *United Benefit* failed to do this kind of *Helvering* analysis; later I will argue that an analysis of fixed index annuities satisfies this risk-shifting test used in *Helvering*.

In *SEC v. C.M. Joiner Leasing Corp.*, the Supreme Court held that a contract to sell and develop land was a security even though it did not precisely match the enumerated list of products defined as securities in the 1933 Act because it matched one of the more general descriptions of securities in the Act.<sup>11</sup> This case is relevant because it held that “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect” are all relevant in determining whether a product is a security.<sup>12</sup>

The Supreme Court in the landmark case *SEC v. W.J. Howey Co.* held that deals termed land sales combined with management contracts were actually products that sold shared profits in citrus farms in exchange for contributions of money and were therefore securities.<sup>13</sup> The Court held that whether the financial product was speculative, and whether the product was backed by an asset with intrinsic value, was irrelevant to whether it was a security. Rather, “[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely

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<sup>9</sup> *Id.* at 539-40.

<sup>10</sup> *Id.* at 540.

<sup>11</sup> *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). The Court was interpreting section 2(a)(1) of the Securities Act of 1933. *Id.* at 350.

<sup>12</sup> *Id.* at 352-53.

<sup>13</sup> *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The Court was interpreting section 2(a)(1) of the Securities Act of 1933. *Id.* at 297.

from the efforts of others.”<sup>14</sup> Fixed index annuities would clearly fit within this definition of securities unless the insurance exemption applied.<sup>15</sup>

B. *VALIC*

1. The Majority Opinion

The United States Supreme Court first had the chance to directly address the question of whether security-related annuities qualify for the insurance exemption to the 1933 Securities Act in *SEC v. Variable Annuity Life Insurance Co. of America (VALIC)*.<sup>16</sup> In *VALIC*, the court was faced with a variable annuity product in which the insured paid premiums into an account which were invested in common stocks and other equities by the insurer and then received payments from the insurer based upon the return of the investments.<sup>17</sup> The variable annuity insurer claimed that the variable annuity was insurance exempt from SEC regulation.<sup>18</sup> The *VALIC* majority held that the variable annuity was a security and not insurance.<sup>19</sup> Its reasoning is summed up in a key quote from the case:

We realize that life insurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of ‘insurance’ or ‘annuity’ into the mold they fitted when these Federal Acts were passed. But we conclude that the concept of ‘insurance’ involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense. It is no answer to say that the risk of declining returns in times of

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<sup>14</sup> *Id.* at 301.

<sup>15</sup> *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).

<sup>16</sup> *SEC v. Variable Annuity Life Ins. Co. of Am. (VALIC)*, 359 U.S. 65 (1959).

<sup>17</sup> *Id.* at 69.

<sup>18</sup> *Id.* at 66-68.

<sup>19</sup> *Id.* at 71.

depression is the reciprocal of the fixed-dollar annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low. We deal with a more conventional concept of risk-bearing when we speak of 'insurance.' For in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts. The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities an interest that has a ceiling but no floor. There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.<sup>20</sup>

Thus, the Court found variable annuities were securities, not insurance, because the insurer did not assume risk and did not pay out a fixed amount.<sup>21</sup> I will return to this quote later, but for now I point out two things. First, the Court claims that fixed payments are required in order to constitute insurance.<sup>22</sup> The Court can be read to say that fixed payments are necessary to be insurance as a per se rule, or it can be read to say that the insurer assuming risk and providing a reduction in risk for the insured are necessary to constitute insurance, since the reasoning the court offers is that fixed payments are necessary precisely because they offer the reduction of risk for the insured and an assumption of risk in the insurance sense for the insurer. I discuss what it means to assume risk in the sense of insurance below. Second, the Court says it does not freeze a definition of insurance. To summarize the overall theory of the case, the *VALIC* majority expresses a theoretical paradigm for understanding insurance according to which "insurance" is defined as a product in which the insurer—not the consumer—bears the investment risk.

## 2. Justice Brennan's Concurrence

Justice Brennan wrote a long and influential concurrence in *VALIC* in which he agreed that the variable annuity was not insurance, but on

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<sup>20</sup> *Id.* at 71-73 (citations omitted).

<sup>21</sup> *Id.*

<sup>22</sup> *VALIC*, 359 U.S. at 70-71.

slightly different grounds than the majority.<sup>23</sup> His analysis was based upon looking at the purpose of the insurance exemption. In his view, the purpose of the insurance exemption was not that Congress wanted to prevent dual state-Federal regulation, nor that Congress believed that state insurance regulators who regulated insurance at the time the Act was drafted were perfect.<sup>24</sup> Rather, Justice Brennan argued that the insurance exemption existed because there were insurance financial products that state insurance regulators were better designed to deal with than the SEC. In his view, the test for whether a financial product is a security to be regulated by the SEC or an insurance product to be regulated by the states should depend upon whether the product poses the kind of challenges that were being dealt with either by the 1933 Securities Act or by the state insurance regulations that existed at the time the Securities Act was passed.<sup>25</sup>

When he fleshed out this test, Justice Brennan asserted that the purpose of the 1933 Act was primarily to ensure disclosure to investors.<sup>26</sup> He said that “the philosophy of the Act is that full disclosure of the details of the enterprise in which the investor is to put his money should be made so that he can intelligently appraise the risks involved.”<sup>27</sup> According to Justice Brennan, state insurance regulation of annuities is different in that the focus of annuities regulation is, first, to interpret contractual terms, and second, to ensure that the insurance companies are solvent and have adequate financial reserves capable of paying out the benefits that they are obligated to pay under the policies.<sup>28</sup> According to the nature of fixed annuities at the time the 1933 Act was created, there was no need for disclosure relating to fixed annuities, whereas there was a strong need for solvency and reserves regulation of fixed annuities.<sup>29</sup> Therefore, because the annuities at the time the Act was passed did not require disclosure regulation, and the purpose of the 1933 Securities Act was primarily to enforce disclosure, the insurance exemption made perfect sense.<sup>30</sup>

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<sup>23</sup> SEC v. Variable Annuity Life Ins. Co. of Am. (VALIC), 359 U.S. 65, 73 (1959) (Brennan, J., concurring).

<sup>24</sup> *Id.* at 75.

<sup>25</sup> *Id.* at 75-76.

<sup>26</sup> *Id.* at 77.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> VALIC, 359 U.S. at 77.

<sup>30</sup> *See id.*

Applying his analysis to variable annuities, Justice Brennan held that because variable annuity insureds are exposed to the investment management of the insurers, the disclosure regulations of the 1933 Securities Act were highly relevant, and the contractual, solvency and reserves regulations of state insurance regulation were not.<sup>31</sup> Justice Brennan, while arguing that the variable annuities also fall under the scope of the Investment Company Act of 1940, said “[t]hese are the basic protections that Congress intended investors to have when they put their money into the hands of an investment trust; there is no adequate substitute for them in the traditional regulatory controls administered by state insurance departments. . . .”<sup>32</sup> In footnote 26, Justice Brennan notes that the “least-subtle” example of an area that state regulators are not equipped to cope with is “investment policy,” in that the states do not regulate how the variable annuity insurers invest the premiums, which stocks they may invest in, and when they are allowed to change their investing strategy.<sup>33</sup>

Justice Brennan astutely opined that “[m]uch bewilderment could be engendered by this case if the issue were whether the contracts in question were ‘really’ insurance or ‘really’ securities—one or the other. It is rather meaningless to view the problem as one of pigeonholing these contracts in one category or the other,” because what matters is the relevance of state insurance or Federal securities regulation, and not the intrinsic essence of the product itself.<sup>34</sup> Despite his rejection of any effort to classify the essence of the product, Justice Brennan took the time to explore the features of the product at issue in great detail and based his analysis of the relevance of Federal or state regulation on what he found the product’s risks to consist of.<sup>35</sup> Summarizing the theory of the concurrence, Justice Brennan’s paradigm of what constitutes insurance is quite different from the majority: it turns not on the risk-shifting nature of the product, but rather on the presence of risks that state insurance regulation seeks to address (i.e., solvency and contract interpretation).

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<sup>31</sup> *Id.* at 78-80.

<sup>32</sup> *Id.* at 85.

<sup>33</sup> *Id.* at 86 n.26.

<sup>34</sup> *Id.* at 80.

<sup>35</sup> *See VALIC*, 359 U.S. at 81-85.

### 3. Justice Harlan's Dissent

In *VALIC*, Justice Harlan authored a spirited dissent in which he began by observing that the insurance exemption codified a longstanding tradition that insurance regulation belonged to the states and not to the Federal government.<sup>36</sup> Although the dissent failed to adequately address the arguments raised in the majority opinion and the concurrence, it did make an interesting argument, typified by two quotes, the first of which is: “[Congress’ intent that the states regulate insurance] in my view demands that bona fide experiments in the insurance field, even though a particular development may also have securities aspects, be classed within the federal exemption of insurance, and not within the federal regulation of securities.”<sup>37</sup> The second quote, which evinces a strong state’s rights view, is:

It is asserted that state regulation, as it existed when the Securities and Investment Company Acts were passed, was inadequate to protect annuitants against the risks inherent in the variable annuity and that therefore such contracts should be considered within the orbit of SEC regulation. The Court is agreed that we should not ‘freeze’ the concept of insurance as it then existed. By the same token we should not proceed on the assumption that the thrust of state regulation is frozen. As the insurance business develops new concepts the States adjust and develop their controls. This is in the tradition of state regulation and federal abstention. If the innovation of federal control is nevertheless to be desired, it is for the Congress, not this Court, to effect.<sup>38</sup>

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<sup>36</sup> *SEC v. Variable Annuity Life Ins. Co. of Am. (VALIC)*, 359 U.S. 65, 97 (1959) (Harlan, J., dissenting). The dissent quoted portions of the legislative history showing that Congress had been concerned because at the time the Act was passed it was debatable whether the Federal Government could regulate insurance under the Commerce Clause power. *See* 77 CONG. REC. 2935-39, 2945-46, 3109 (1933).

<sup>37</sup> *VALIC*, 359 U.S. at 100.

<sup>38</sup> *Id.* at 100-01.

Thus, although the dissent did not delve into the ways in which contemporary state insurance regulation might be adequate to regulate the investment aspect of variable annuities, Justice Harlan argued that experiments could be classified as insurance, and should be so classified given the strong history of state regulation of insurance. He also argued that there is every possibility that state insurance, if capable of evolution and not frozen in the form it consisted of in 1933, might actually become competent to regulate quasi-security products.<sup>39</sup> Justice Harlan's theory of insurance seems to be that any time an insurance company launches a bona fide experiment, the resulting product is insurance. In other words, the defining feature of insurance is the involvement of an insurance company, not the risk-shifting nature of the product (as in the *VALIC* majority's theory) or the risks being regulated (as in Justice Brennan's theory).

### C. *UNITED BENEFIT*

In *United Benefit*, the United States Supreme Court was tasked with evaluating a new quasi-security product called a Flexible Funds annuity and deciding whether it qualified for the insurance exemption.<sup>40</sup> The annuity in question greatly resembled a variable annuity in that the premiums, less a deduction for expenses (namely the net premiums,,), were held in a separate account and were invested primarily in common stocks for the purpose of both interest returns and capital gains.<sup>41</sup> The annuity differed from prior variable annuities in that a percentage of net premiums, which increased over the life of the contract from 50% in year one to 100% in year ten, was guaranteed to be paid back to the insured, although the product did not guarantee a rate of interest.<sup>42</sup> The Court held that Flexible Funds annuities do not qualify for the insurance exemption even though part of the payments were fixed, for several reasons.

First, the Court argued that because the aspect of the payments that were fixed could have been offered separately from the investment aspect of the product, the fixed aspect was conceptually separable from the variable investment-related payments and the two aspects could be

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<sup>39</sup> *Id.*

<sup>40</sup> *SEC v. United Benefit Life Ins. Co. (United Benefit)*, 387 U.S. 202, 204 (1967).

<sup>41</sup> *Id.* at 205.

<sup>42</sup> *Id.* at 205-06.

considered and analyzed separately.<sup>43</sup> Secondly, the Court found that the products were marketed for growth and were “considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of ‘growth’ through sound investment management.”<sup>44</sup> Third, the Court held that the product was not insurance because it was an insured, i.e., hedged),) contract rather than a contract of insurance, and the mere assumption of investment risk did not create insurance.<sup>45</sup> The Court cited *Helvering* in support of this proposition and used that citation to argue that the Flexible Fund was not insurance even though the insurer’s guarantee of a return of principal reduced somewhat the insured’s risk. *Helvering* formed the basis of this distinction, meaning that risk-shifting and risk-distributing seem to be a factor in distinguishing an insured (hedged) contract from an insurance contract.<sup>46</sup>

The *United Benefit* Court cited with approval Justice Brennan’s *VALIC* concurrence, and claimed that under Brennan’s analysis the purchasers of Flexible Funds were seeking “growth through professionally managed investment,” and were comparable to purchasers of mutual funds and, therefore, entitled to SEC regulations governing disclosure.<sup>47</sup> The Court in *United Benefit* appeared to espouse the theory of insurance embodied in Justice Brennan’s *VALIC* concurrence in that disclosure was the relevant regulatory challenge for the growth and investment management aspects of the Flexible Funds and its regulatory risk determined whether the product was insurance.<sup>48</sup>

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<sup>43</sup> *Id.* at 209.

<sup>44</sup> *Id.* at 211.

<sup>45</sup> *Id.* The contract was hedged in the sense that some portion of the investment was guaranteed.

<sup>46</sup> *United Benefit*, 387 U.S. at 211; *see supra* notes 9-10 and accompanying text.

<sup>47</sup> *United Benefit*, 387 U.S. at 210-11.

<sup>48</sup> The *United Benefit* Court also cited *C.M. Joiner* for the proposition that a relevant test of a security is “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect,” and found that this test showed that the product was a security because it was marketed for growth rather than stability and security. *Id.* at 211.

### III. THE RISE OF FIXED INDEX ANNUITIES AND SEC'S RESPONSE

Fixed index annuities are a type of financial product that first took off in the 1990s. The SEC has attempted to regulate fixed index annuities, taking differing approaches to regulation at different times. This section will explain what fixed index annuities are and trace the SEC's regulatory response.

#### A. THE THEORY BEHIND INDEX INVESTING

In order to understand the nature of fixed index annuities it is important to understand the investment theory behind index investing. Index investing employs the strategy of passively investing in a securities index (which is a very large group of stocks taken to represent the market as a whole, for example the S&P 500, which consists of 500 stocks, or the Russell 2000, which contains 2000 stocks) instead of picking individual stocks. The theoretical basis for index investing is based upon two schools of financial thought: Modern Portfolio Theory (also known as MPT) and Capital Asset Pricing Model (also known as CAPM).<sup>49</sup> Modern Portfolio Theory, first developed by Harry Markowitz,<sup>50</sup> essentially boils down to the proposition that the best way to reduce the risk inherent in a portfolio of stocks is to diversify (in other words, to purchase a multitude of stocks each of which will perform differently under different conditions so that at any given time the odds are that some of the stocks in the portfolio will be doing well and, therefore, the odds of the portfolio as a whole doing well will increase,,),, and to the corollary proposition for investing strategy that a diversified portfolio is superior to a non-diversified portfolio from the point of view of managing uncorrelated risk.<sup>51</sup>

Modern Portfolio Theory later evolved into a new financial theory called Capital Asset Pricing Model, developed by William Sharpe among

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<sup>49</sup> See BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 183-210 (4th ed. 1985).

<sup>50</sup> See generally Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952) (presenting what is widely viewed as the original presentation of Modern Portfolio Theory).

<sup>51</sup> See MALKIEL, *supra* note 49, at 193-99.

others.<sup>52</sup> Capital Asset Pricing Model introduced the idea of “beta,” a mathematical statistical quantification of market risk, also called the systematic risk.<sup>53</sup> The Capital Asset Pricing Model posits that the risk that is specific to an individual stock—the non-beta risk—can be diversified away by building a diversified portfolio based on sound statistical and mathematical models with other stocks that counterbalance the risk of the first stock. At the same time, CAPM asserts that each stock also contains a risk inherent in the individual stock which cannot be diversified away, which is risk that comes from the relation of the stock to the market as a whole; that risk is called beta.<sup>54</sup> An example of non-beta risk is the risk that a specific public company will have incompetent or dishonest management. Beta quantifies the risk that a stock will go up or down because the market as a whole goes up or down.<sup>55</sup> The Capital Asset Pricing Model modifies the general investing principal that more risk earns greater reward to assert that more beta should earn greater reward, but more non-beta risk should not earn more reward because any competent investor can diversify all non-beta risk away and be left only with beta risk.<sup>56</sup>

The Modern Portfolio Theory and Capital Asset Pricing Model became fashionable in the 1970s.<sup>57</sup> The MPT/CAPM theory, with its strong emphasis on diversification, is the theoretical structure that gave rise to index investing.<sup>58</sup> Index investing seeks to accomplish as much diversification as possible and to diversify to the point of having only systematic beta risk and eliminating non-beta risk by buying the stocks of an index, such as the S&P 500, which is a collection of 500 reputable stocks that is generally used as a measure of the performance of the stock market as a whole.

The theory of index investing is that by buying an index one assumes beta, the risk that the market as a whole will go up or down, but avoids the individualized risks inherent in each stock that comprises the market. The reasoning is that one can avoid non-beta risk without any loss

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<sup>52</sup> See generally William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425 (1964) (presenting what is usually viewed as a substantial contribution to the creation of Capital Asset Pricing Model).

<sup>53</sup> See MALKIEL, *supra* note 49, at 199-209.

<sup>54</sup> See *id.*

<sup>55</sup> See *id.*

<sup>56</sup> See *id.*

<sup>57</sup> *Id.* at 208-09.

<sup>58</sup> *Id.* at 322.

in returns, and therefore sensibly risk-averse investors will do so; however, one cannot avoid the risk that the market as a whole will go up or down because every stock's beta inextricably ties it to the market, and therefore beta is the only risk that a sensible investor will assume.

The index investing philosophy believes that it is impossible to beat the market average, i.e., the index, by picking stocks. This is because the movements of individual stocks are random, the stock market is efficient and therefore stocks are usually priced correctly and rarely present opportunities to buy undervalued stocks or sell overvalued stocks, and the costs of picking stocks exceed the costs of passive investment.<sup>59</sup> It is important to understand that index investing, unlike most investing strategies, is not a strategy for choosing the right stocks, and does not purposefully assume any of the risks inherent in choosing stocks. It is a strategy that foregoes choosing individual stocks and chooses to invest only in the market as a whole as a way to eliminate the risks inherent in choosing individual stocks and to grow one's money as the economy grows. The fundamental idea behind index investing is diversification as a means of reducing financial risk. This matters because an investment strategy devoid of stock-picking does not pose the same regulatory challenges as traditional investing.

#### B. THE RISE OF INDEX INVESTING PRODUCTS

Given that MPT/CAPM and the associated postulates of index investing hold that one can and should diversify all non-beta risk away, that it is impossible to beat the indexes by picking stocks, and that the market can only go up over the long term, it follows from this investing philosophy that a smart investor, instead of choosing individual stocks, should simply buy the market. Doing so reduces or eliminates the risks associated with picking stocks and hopefully allows one's money to keep pace with the growth of the market over the long term. In the 1970s, Wall Street saw the demand for financial products designed to satisfy believers in MPT/CAPM, and Wall Street gave birth to the index mutual funds, including mutual funds that allowed small individual investors to invest according to an

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<sup>59</sup> See MALKIEL, *supra* note 49, at 129-33, 174-76. See also CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 201-05 (5th ed. 2006).

index such as the S&P 500.<sup>60</sup> By 2007, the fixed index annuity market had grown such that there were 322 fixed index annuities offered by 58 different insurance companies, and at that time the collective sales volume of fixed index annuities was \$24.8 billion, and fixed index annuity assets had reached \$123 billion.<sup>61</sup> Since their inception, index mutual funds have become very popular, with at least \$255 billion invested in S&P 500 index mutual funds as of June 2005.<sup>62</sup>

Life insurance companies began to offer fixed index annuities in 1995.<sup>63</sup> There are many kinds of fixed index annuities with different features, but generally a fixed index annuity is an annuity in which the insured makes payments to the insurer, and the insurer guarantees a return of some percentage of the principal plus a minimum percentage interest rate of return, similar to a fixed annuity. In addition, a fixed index annuity offers the possibility for a higher percentage rate of return in excess of the guaranteed rate of return, calculated by reference to the annual growth of an equity index, although the formula used to calculate the excess rate can be complicated.<sup>64</sup> A fixed index annuity is similar to an index mutual fund in that both offer returns based on the performance of indexes, but there are also differences between the two. The purchaser of a mutual fund suffers the risk that if the index goes down he will lose money, whereas the owner of a fixed index annuity does not risk loss below the guaranteed levels.<sup>65</sup> In addition, an index mutual fund actually invests the purchaser's money in the stocks comprising the index, whereas a fixed index annuity insurer is free to invest the insured's payments however it wishes so long as it ends up with enough money to pay the insured the amounts that he is owed under the policy.<sup>66</sup>

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<sup>60</sup> See MALKIEL, *supra* note 49, at 322-23; see Gary O. Cohen, *Indexed Insurance Products Versus Index Mutual Funds: Status Under the Federal Securities Laws 2007*, 1596 PRACTICING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 507, 515-16 (2007).

<sup>61</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 928 (D.C. Cir. 2009), *amended by* 2010 U.S. App. LEXIS 14249 (D.C. Cir. July 12, 2010).

<sup>62</sup> See Cohen, *supra* note 60, at 517.

<sup>63</sup> *Id.* at 518.

<sup>64</sup> See *id.* at 526-43.

<sup>65</sup> *Id.* at 511-12.

<sup>66</sup> *Id.*

C. THE SEC'S EFFORTS TO REGULATE FIXED INDEX ANNUITIES

The SEC's approach to regulating fixed index annuities has changed and evolved considerably over the last twenty years. Beginning in 1986 fixed index annuities were covered by Rule 151, which is a "safe harbor" SEC regulation under which insurance products meeting certain conditions are considered to be insurance not subject to the 1933 Securities Act.<sup>67</sup> Rule 151 provides that:

(a) Any annuity contract or optional annuity contract (*a contract*) shall be deemed to be within the provisions of section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)), *Provided, That*

(1) The annuity or optional annuity contract is issued by a corporation (the insurer) subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

(2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this section; and

(3) The contract is not marketed primarily as an investment.

(b) The insurer shall be deemed to assume the investment risk under the contract if:

(1) The value of the contract does not vary according to the investment experience of a separate account;

(2) The insurer for the life of the contract

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<sup>67</sup> Gary O. Cohen, *SEC Regulation of Index Annuities Versus Index Mutual Funds*, 1732 PRACTICING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 699, 727 (2009).

(i) Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and

(ii) Credits a specified rate of interest as defined in paragraph (c) of this section to net purchase payments and interest credited thereto; and

(3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b)(2)(ii) of this section will not be modified more frequently than once per year.<sup>68</sup>

The application of Rule 151 to fixed index annuities was relatively uncertain from 1986 until 2008. In 1997 the SEC, having learned of the growth of fixed index annuities since 1995, issued a concept release seeking comments as to how it should regulate the new financial products.<sup>69</sup> But the SEC did not follow the comment process by immediately promulgating a rule, and in the wake of SEC's silence the industry assumed that fixed index annuities could qualify for the insurance exemption on a case-by-case basis, an approach that was tacitly approved by the SEC in a statement on the SEC website.<sup>70</sup>

The SEC proposed Rule 151A, a new rule which defined fixed index annuities as securities unless they met a specific set of requirements, in June of 2008.<sup>71</sup> After two separate comment periods in 2008, during which the issue of fixed index annuity regulation led to divisive debate in the insurance community, the SEC adopted Rule 151A by a vote of four to one in December of 2008.<sup>72</sup> The rule takes effect in January 2011.<sup>73</sup>

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<sup>68</sup> 17 C.F.R. § 230.151 (2009).

<sup>69</sup> See Cohen, *supra* note 60, at 518.

<sup>70</sup> *Id.* at 518-19.

<sup>71</sup> Cohen, *supra* note 67, at 711.

<sup>72</sup> *Id.* at 711-13.

<sup>73</sup> *Id.* at 715.

The text of Rule 151A provides that:

(a) *General.* Except as provided in paragraph (c) of this section, a contract that is issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia, 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.<sup>74</sup>

A summary of Rule 151A is that to be insurance a fixed index annuity must calculate its excess rate of return at or after the conclusion of the time period during which the index’s performance is measured, and it must be probable that the majority of money paid to the fixed index annuity owner will be guaranteed (i.e., will not come from the index-linked excess rate of return).<sup>75</sup> The SEC’s adopting release on the Federal Register seems

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<sup>74</sup> 17 C.F.R. § 230.151A(a) (2009). The exception in paragraph (c) of Rule 151A states that “[t]his section does not apply to any contract whose value varies according to the investment experience of a separate account.” § 230.151A(c).

<sup>75</sup> § 230.151A.

to suggest that the centerpiece of the rule is the “more likely than not” test, which was designed to express SEC’s belief, based on its interpretation of *VALIC*, that if the majority of payout is guaranteed then the insurer bears the majority of the risk and the financial product is therefore insurance, whereas if the majority of the payout is not guaranteed then the insured bears the majority of the risk and the product is therefore a security.<sup>76</sup>

#### IV. CONTEMPORARY CASES APPLYING INSURANCE EXEMPTION JURISPRUDENCE TO FIXED INDEX ANNUITIES

There is scant case law to date on whether fixed index annuities are insurance and thus exempt from regulation under the 1933 Act. The status of fixed index annuities has been addressed in two recent cases. The first was *Malone v. Addison Insurance Marketing Inc.*, a 2002 case in federal district court in Kentucky in which the court held that fixed index annuities qualified for the § 3(a)(8) insurance exemption and also met the criteria to qualify under the Rule 151 safe harbor.<sup>77</sup> The second case is *American Equity Investment Life Insurance Co. v. SEC*, a case in which a coalition of life insurance companies challenged the SEC’s Rule 151A in the D.C. Circuit in 2009.

##### A. *MALONE*

*Malone* was a case in which a plaintiff claimed securities fraud in her purchase of fixed index annuities, requiring the U.S. District Court for the Western District of Kentucky to decide whether her fixed index annuities were securities or were exempt under the insurance exemption.<sup>78</sup> The court focused on *VALIC* and *United Benefit* as the two controlling cases, and phrased its task as one of determining whether the contract at issue operates more like a variable or fixed annuity.<sup>79</sup> The court quoted the United States Supreme Court as saying that “in searching for content in the term ‘security,’ ‘form should be disregarded for substance and the

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<sup>76</sup> See Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138, 3141-44 (Jan. 16, 2009) (to be codified at 17 C.F.R. Pts. 230 and 240).

<sup>77</sup> *Malone v. Addison Ins. Mktg. Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

<sup>78</sup> *Id.* at 745-48.

<sup>79</sup> *Id.* at 748-49.

emphasis should be on economic reality.”<sup>80</sup> The court discussed *VALIC* and *United Benefit* and focused on whether the insured was exposed to investment risk, and whether the insurer guaranteed a fixed dollar amount for the insured, as factors in determining risk in the insurance sense.<sup>81</sup> The court then had this to say:

Plaintiff's effort, therefore, to classify her American Equity contracts as the sale of a variable annuity fails for several reasons. First, Plaintiff's two contracts with American Equity *guaranteed* her a minimum 3 percent return, irrespective of the performance of the S & P 500 Index. As the Benefit Summary and Disclosure form states, the annuity contracts were “designed to accumulate value based on the average change in the S & P 500 Equity Index during each contract year, without risking loss of premium due to the S & P volatility.” In other words, in the event the S & P 500 performed poorly, Plaintiff still received a 3 percent interest payment on top of her principal annually. Consequently, American Equity assumed the investment risk and not Plaintiff who received payment regardless of how poorly the market performed.

Second, Plaintiff's benefit payments from American Equity were not directly dependent on the performance of investments made with her money. That is to say, as a structural matter, Plaintiff's contract did not operate like a variable annuity: her payments were not a function of a personalized portfolio and her principal was not held in an independent account. Had Plaintiff participated in a variable annuity, she would have retained control over the investment of her account. In this case, Plaintiff paid American Equity lump sum premiums in the amount of \$216,289.53 and \$64,214.32 and signed a contract that guaranteed her a 3 percent return or more if the S & P 500 Index fared well. Moreover, at no point does Plaintiff's complaint allege that her premiums were maintained in separate accounts or that, for some reason, they should

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<sup>80</sup> *Id.* at 748 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

<sup>81</sup> *Id.* at 749-50.

have been-the keystone characteristic of all variable annuity contracts.<sup>82</sup>

Thus, the *Malone* court held that because both principal and interest were guaranteed, the insurer had assumed a risk sufficient to constitute insurance and the insured was not exposed to the risk of the index performing poorly, and because there was no separate account that invested the insured's money, the insured was not exposed to investment risk.<sup>83</sup> The *Malone* court then went on to address and refute an argument which the *American Equity* court later found to be dispositive in reaching an opposite result, the argument being that because the potential for increased returns was tied to the performance of the S&P 500 that the insured was exposed to a securities-like investment risk. The *Malone* court said:

Finally, Plaintiff focuses on the fact that her return over and above the guarantee depended on the performance of the S & P 500 Index. In that way, her annuity contract did involve an element of risk and uncertainty. However, this argument is not conclusive for Plaintiff in these circumstances. Defendants actually bore as much or more of the risk than Plaintiff. American Equity guaranteed Plaintiff at least three percent of the return on the S & P 500 Index based on whichever was greater. If American Equity was unable to surpass this indexed rate in its own investment of the Plaintiff's premium, then it was the loser. More importantly, Plaintiff's risk was not that she would lose the value of her initial investment, but rather the risk that had she chosen a different contract her money might have been worth more than 134 percent at the end of the ten-year contract period. That type of risk-that she could have gotten a better deal but for the pressure she encountered to enter into this particular contract-is not the type of risk central to determining whether a security exists. See VALIC, 359 U.S. at 71, 79 S.Ct. 618 (noting that "it is no answer to say that the risk of declining returns in times of depression is the reciprocal of the fixed-dollar

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<sup>82</sup> *Id.* at 750.

<sup>83</sup> *Malone*, 225 F. Supp. 2d at 750.

annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low"). Because the Defendants assumed a much greater risk, Plaintiff's Investment seems a lot more like insurance and less like an investment for the Plaintiff.<sup>84</sup>

The court seems to be saying that because the principal and interest were guaranteed, the risk of loss from the index not performing well was smaller than the reduction in risk that came from the guaranteed portions of the contract. The court also implies that the risk that the index will not perform well enough to increase the payout is not the risk that the insured will lose her money, it is the risk that if she had invested in a different financial product she might have made more money. Here we see a hint of the question of whether the risk of not receiving a benefit is the same as the risk of suffering a loss. The *Malone* court seems to think that it is not; I will argue later that the question is debatable but that the *Malone* approach is preferable.

The *Malone* court went on to also hold that the fixed index annuity in question satisfied the Rule 151 safe harbor.<sup>85</sup> This part of the opinion is interesting mainly because the court, after examining the product's insurance contract and sales brochure, found that the fixed index annuity had been marketed primarily for stability and security and not primarily for growth.<sup>86</sup> The court, although it did not address the issue explicitly, noticed no difference between setting the index rate before the annual period or after the annual period for the purpose of meeting the safe harbor requirement that the index rate be set annually.<sup>87</sup>

#### B. *AMERICAN EQUITY*

*Malone* did not decide the validity of Rule 151A, having been decided six years before. In 2009, after the promulgation of Rule 151A, a coalition of insurers, joined by the National Association of Insurance Commissioners, sued to overturn the SEC's Rule 151A, culminating in the D.C. Circuit's opinion in *American Equity Investment Life Insurance Co. v.*

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<sup>84</sup> *Id.* at 751.

<sup>85</sup> *Id.* at 751-54.

<sup>86</sup> *Id.* at 753-54.

<sup>87</sup> *Id.* at 753.

*SEC*.<sup>88</sup> The petitioners argued that the SEC's Rule 151A conflicted with the plain language of the insurance exemption in the 1933 Act, that it was not supported by *VALIC* and *United Benefit*, and that it contradicted the prior Rule 151, and the petitioners additionally made an administrative procedural argument about the promulgation of Rule 151A.<sup>89</sup> The court applied the *Chevron* two-step test that would affirm the rule if, as the first step, the statute in question was ambiguous, and, as the second step, the SEC as the agency interpreting the statute offered a reasonable interpretation.<sup>90</sup> The court held that both steps were satisfied and affirmed the SEC's Rule 151A, based on the Supreme Court's decisions in *VALIC* and *United Benefit*.<sup>91</sup> In particular, the *American Equity* court placed a great deal of emphasis on *VALIC*'s holding that a variable annuity is not insurance because the concept of insurance involves investment risk-taking on the part of the insurer, that all the investment risk was on the insured and none was on the insurer, and that the variable annuity insurer assumes no true risk in the insurance sense.<sup>92</sup> The court took *United Benefit* to stand for the proposition that a financial product marketed for growth rather than stability and security is not insurance.<sup>93</sup>

The *American Equity* court wholeheartedly accepted SEC's characterization of the facts in the case, specifically SEC's analysis of the nature, function and appeal of fixed index annuities.<sup>94</sup> According to the SEC, the buyer of a fixed index annuity is "exposed to a significant investment risk-*i.e.*, the volatility of the underlying securities index," the insured "assumes the risk of an uncertain and fluctuating financial instrument, in exchange for participation in future securities-linked returns," and "an FIA's return was neither known nor guaranteed."<sup>95</sup> The SEC asserted that the fixed index annuity's guarantees as to principal and interest rate were "superficial and unsubstantial" and they did not shift the

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<sup>88</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 925 (D.C. Cir. 2009), amended by 2010 U.S. App. LEXIS 14249 (D.C. Cir. July 12, 2010).

<sup>89</sup> *Id.* at 929-30.

<sup>90</sup> *Id.* at 930-31.

<sup>91</sup> *Id.* at 926-27, 930-31, 934.

<sup>92</sup> *Id.* at 926.

<sup>93</sup> *Id.* at 927.

<sup>94</sup> *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 928-29.

<sup>95</sup> *Id.* (quotation marks omitted) (quoting Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138 (Jan. 16, 2009) (to be codified as 17 C.F.R. Pts. 230 and 240)).

investment risk to the insurer.<sup>96</sup> While the court mentioned that fixed index annuities do not entail any investment management, it said that this was not the only relevant factor in the analysis.<sup>97</sup>

The court agreed with the SEC's argument that the fixed index annuity's guarantee did not eliminate risk because the apt comparison was between a traditional fixed annuity guaranteeing a five percent interest rate and a fixed index annuity guaranteeing a one percent interest rate with a potential for an index-based ten percent interest rate, such that the fixed index annuity which fluctuates from one to ten percent was obviously far more risky than the traditional fixed annuity which remains stable at five percent, even though some rate of interest was guaranteed by the fixed index annuity.<sup>98</sup> The court accepted this argument in response to petitioner's challenge that the SEC used an unreasonable definition of risk.

The insurers in *American Equity* and their amici argued that SEC's definition of risk is irrational because risk is loss of principal and it is arbitrary that an annuity with a guaranteed minimum return is less risky than the same annuity with that minimum plus a chance at a higher return tied to an index. The flaw is their argument, and the reason the court did not buy it, is that it does not analyze risk in terms of the function of an insurance contract. It is also problematic because the court believed that the insured would have to pay higher premiums to gain access to index-based rewards than those in a comparable non-indexed annuity.

Obviously for the analogy between a five percent rate of return and a rate of return between one and ten percent to be persuasive the court must have believed that the risk of not receiving a benefit is the same risk as the risk of suffering a loss. The court held that how a product is marketed is not a necessary component of insurance exemption analysis, even though it was central to *United Benefit*.<sup>99</sup> The court nonetheless found that the fixed index annuities were being marketed as securities, although this finding was based not on empirical data but on the *a priori* analysis that because the product entailed investment risk it was therefore surely being marketed as a security.<sup>100</sup>

The court accepted the SEC's analysis along the lines of Justice Brennan's *VALIC* concurrence that fixed index annuities were better suited

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<sup>96</sup> *Id.* at 929.

<sup>97</sup> *Id.* at 930-31.

<sup>98</sup> *Id.* at 931.

<sup>99</sup> *Id.* at 933.

<sup>100</sup> *Am. Equity Inv. Life Ins. Co.*, 572 F.3d at 933.

to be regulated by federal securities regulators than by state insurance regulators. But the court did not look at the risks necessitating disclosure as opposed to the risks necessitating solvency and reserves requirements as Justice Brennan had done. Instead it looked only at whether the product was a risky product or a no-risk product.<sup>101</sup> The court, in response to the petitioner's argument that Rule 151A contradicted Rule 151, held that fixed index annuities do not fall under the Rule 151 safe harbor requirements, because according to the court's interpretation of Rule 151 the interest rate for the annual period had to be set prospectively at the beginning of the annual period.<sup>102</sup>

After affirming the SEC's decision that fixed index annuities are not insurance, the *American Equity* court proceeded to address a second issue, whether Rule 151A's rulemaking was arbitrary and capricious under the Administrative Procedure Act. The court found that it was arbitrary because SEC had failed to properly conduct an analysis of Rule 151A's effects upon efficiency, competition, and capital formation, and also because the purpose that SEC claimed for its Rule 151A, namely that it would provide clarity and certainty, would have been provided by any rule.<sup>103</sup> The court initially remanded the case for SEC to complete the proper economic analysis.<sup>104</sup> However, in July 2010 the D.C. Circuit amended the decision in an unreported opinion, changing only the final paragraph of the prior opinion and ordering that Rule 151A be vacated.<sup>105</sup> The court observed that the SEC had argued that it was likely to reissue Rule 151A, but noted that SEC's analysis of the rule's effects upon state law had not yet been completed.<sup>106</sup> The SEC has refused to say whether it will reissue Rule 151A and has refused to comment on the legal status of fixed index annuities in the wake of Rule 151A's being vacated, so one can presume that the current legal status of fixed index annuities is uncertain.<sup>107</sup>

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<sup>101</sup> *Id.* at 928. The court also interpreted Justice Brennan's concurrence to mean that the presence or absence of adequate state regulation is irrelevant to insurance exemption analysis. *Id.* at 931.

<sup>102</sup> *Id.* at 933-34.

<sup>103</sup> *Id.* at 934-36.

<sup>104</sup> *Id.* at 936.

<sup>105</sup> *Am. Equity Inv. Life Ins. Co. v. SEC*, 2010 U.S. App. LEXIS 14249, at \*2-4 (D.C. Cir. July 12, 2010).

<sup>106</sup> *Id.* at \*3.

<sup>107</sup> Telephone Interview with John Heine, Deputy Dir., SEC Office of Pub. Affairs (Sept. 17, 2010).

V. WHY *AMERICAN EQUITY* WAS MISTAKEN IN HOLDING THAT FIXED INDEX ANNUITIES ARE NOT INSURANCE

Although petitioners won the *American Equity* case based on procedural grounds, ultimately their victory may be pyrrhic if the SEC cures the procedural defects. In this section I argue why, from a purely legal point of view applying the relevant precedent to the facts of the case, the *American Equity* opinion's decision that fixed index annuities are not insurance was wrongly decided. I will then outline the various policy justifications for leaving regulation of fixed index annuities to the states.

## A. LEGAL ARGUMENTS

## 1. The VALIC Argument

The risk that is transferred in a fixed annuity from the insured to the insurer is the risk of picking stocks when investing for retirement. This is the same risk that is transferred with a fixed index annuity. In a variable annuity, the insured bears the stock-picking risk of the insurer; with a fixed index annuity the risk of picking stocks is eliminated.

Risk-reward analysis may be useful to understand what is the reduction of risk in the insurance sense, which was key to the *VALIC* majority opinion.<sup>108</sup> The fundamental principle that ties insurance and securities together is the principle that to earn a greater reward you must assume more risk. A security is an assumption of more risk in exchange for a higher potential reward. An insurance policy is a reduction in risk bought in exchange for a reduction in reward (i.e. you get less money in return for a lower reward). Quasi-security insurance products do not fit neatly into either category but can be examined using the same analysis. A traditional fixed annuity provides a full guaranteed return that is lower due to the buyer's reduced risk. This is why it makes sense to fall under the insurance exception. In a variable annuity in contrast, the buyer assumes higher risk—in the form of investment risk—in exchange for greater reward in the future, but more risk is in exchange for greater reward. This makes it a security. On its surface, a fixed index annuity appears to involve an assumption of market risk in exchange for greater reward. As such it may be interpreted as a security. In fact, however, its purpose is to eliminate non-beta risk, so like a fixed annuity its purpose is actually the reduction of

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<sup>108</sup> See *supra* text accompanying note 20.

risk, via the transfer of risk to the insurer. From the buyer's point of view, he: (1) shifts the non-beta risk to the insurer, and (2) reduces some beta risk via the guarantee (absent the insurer's insolvency).<sup>109</sup>

If a person saving for retirement himself could not use insurance products and had to save for retirement, he would have to invest in equities to keep pace with inflation, and he would bear the risk that those investments would decrease in value. This risk, the risk of investing for retirement and of suffering losses if one incorrectly chooses stocks while investing for retirement, which can also be called the risk of investment management, is precisely the risk that is transferred to the insurer from the insured with a fixed index annuity. The insurer bears the non-beta risk of investing, not the buyer. This risk is not transferred with variable annuities that are invested in actively managed stocks, because the insured continues to bear non-beta risk.

With a fixed index annuity, the buyer transfers his non-beta risk to the insurer and keeps only the beta risk, i.e., that the economy will irrevocably collapse. The insurer then takes the risk of investing the insured's money from the insured. It is not the guarantee of being paid a certain percentage of premiums that makes it insurance, and indeed the Supreme Court's jurisprudence precludes such an argument. The fact that the insurer bore some risk was not sufficient to create insurance under the *VALIC* analysis in *United Benefit*, and I would argue that it is not the insurer's bearing risk but rather the insurer's taking the insured's risk away from the insured that creates insurance. It is the act of transferring risk from the insured to the market that makes a fixed index annuity insurance.

What risk does the insured pass to the insurer in a fixed index annuity? The risk that the insured would have kept in the absence of the contract, which is the non-beta risk. It is the transfer of this non-beta risk, that a fixed annuity insurer takes from the insured in exchange for premiums.

## 2. The Risk of Loss

In *American Equity*, the insurers argued that the insurers assume the risk of investing because if they invest badly they will have to pay the insured's payments with their own money, which is clearly true. But the

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<sup>109</sup> It must be acknowledged that the buyer does not receive full return of principal (either gross or net of fees).

court did not buy this argument because it believed that the buyer retained market risk over and above the guaranteed return.

What risk of loss does the fixed index annuity buyer bear? He bears a risk that the index will not perform well enough for him to receive a higher interest rate above the minimum.<sup>110</sup> But this is not a non-beta risk, because it does not depend upon stock picking; it is a market risk, it is beta. The insured bears the risk of not receiving a benefit, but this is not the same thing as a risk of loss. The insured bears the risk of short-term market downturns resulting in a loss of potential earnings. The *American Equity* court seemed to think that potential loss of potential earnings is a risk, but if you understand the theory behind index investing then it makes sense to suppose that the buyers themselves will not understand it as a risk, and the court should defer to their understanding.

Regarding the *American Equity* court saying that a fixed annuity with a five percent guaranteed interest rate is less risky than a fixed index annuity with a one percent guaranteed interest rate and a potential ten percent index-related interest rate, the court is comparing apples and oranges.<sup>111</sup> The comparison of apples to apples is a fixed annuity with a five percent interest rate compared to a fixed index annuity with a guaranteed five percent interest rate that could go up to ten percent based on an index.<sup>112</sup> That is the right example, but the court simply ignores it. In fact, a fixed index annuity is not riskier than a comparable fixed annuity.<sup>113</sup>

### 3. The Brennan Concurrence Argument

The Brennan concurrence in *VALIC*, as elaborated on in *United Benefit*, dictates that the insurance exemption does not apply where disclosure is the regulatory problem and does apply where contractual interpretation, solvency and reserves are the regulatory problems.<sup>114</sup> Disclosure and anti-fraud protections make a lot of sense with equity

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<sup>110</sup> He also has a certain loss of some fraction of his principal, maybe consisting of the insurer's costs, maybe more.

<sup>111</sup> See *supra* text accompanying note 98.

<sup>112</sup> All other things being equal, of course, including the guaranteed amount of principal returned.

<sup>113</sup> The court's argument regarding risk of loss is not totally invalid, but to the extent that there is a legitimate concern the states can adequately regulate fixed index annuities.

<sup>114</sup> See *supra* text accompanying notes 26-30.

investments, whose shares and financial information can be manipulated or misrepresented. Meanwhile, for the market risk aspects of fixed index annuities, the disclosure concerns are less. There are big problems with the calculation of the principal return on fixed index annuities and even with the calculation of the excess interest rate that require disclosure. But on top of that, fixed index annuities present insolvency concerns. State regulators can address both—the SEC cannot.

The gist of Brennan's *VALIC* concurrence is that the 1933 Act's purpose is to require disclosure so that investors can make an informed decision. Normally when purchasing an individual stock there is a very great deal of risk, and so it makes sense from a policy standpoint to ensure that the consumer is making an informed decision and knows what he is getting into. Otherwise there is the risk that the consumer may be taken advantage of, and even if he is not, he is still entitled to know and understand the details of where his money is going.

But this concern largely exists only for individual stocks and actively managed investment strategies, which present non-beta risk and can be amazingly complicated. Indexes are relatively simple compared to stocks, because the index is an aggregate that over the long-term reflects the strength of the market and the economy as a whole. The information necessary to disclose the risks of investing in an index are quite simple: the risk is only that the market and the economy will go up or down, and so disclosure of non-beta risk is a second order issue. In contrast, the terms of the fixed index annuity contracts, and concerns about the insurer making proper payments, having adequate reserves from which to make payments, and remaining solvent, are far more of an issue, and this falls generally under what Brennan claimed to be the scope of state insurance regulation. Therefore fixed index annuities should also be treated as insurance under Brennan's concurrence analysis.

The *American Equity* court seemed to have thought that the insurers were arguing that the insurance exception applies because state regulation is adequate and fixed index annuities contain no risk, which is a horribly oversimplified, incomplete account of what the insurers' argument was (or should have been) with respect to the Brennan concurrence.<sup>115</sup> What Brennan is saying is that the question is not whether adequate state regulation exists, but that there is a kind or genus of investment, called insurance, which presents different problems than the 1933 Act was designed to deal with, and therefore qualifying for the insurance exemption

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<sup>115</sup> See *supra* note 101 and accompanying text.

turns on whether the financial product contains the risks that insurance regulation was designed to prevent. Because the *American Equity* court mistakenly ignored the solvency risk inherent in fixed index annuities it thinks that the problem is the same as for stocks. Because the fixed index annuity is not based on picking stocks, disclosure is a lesser issue and the solvency and reserves regulation that Brennan claimed for the states is more relevant.

The needs for disclosure that the SEC claims are met by Rule 151A include disclosure of the terms of the contract, pricing, benefits, the details of the guarantees, and the ways in which the rate is calculated from the index.<sup>116</sup> None of the SEC's disclosure provisions pertain to the index itself, which is supposedly where the riskiness of the product comes from. Instead, they all have to do with the terms of the annuity contract, which are fundamentally no different than the contractual terms of a fixed annuity contract that are traditionally regulated by the states.

#### 4. The *United Benefit* Argument

The fundamental argument under the *United Benefit* rule, which can be seen as the updated version of *VALIC*, is that to be insurance the purpose of the financial product must be stability and security rather than growth through investment management.<sup>117</sup> The purpose of a fixed index annuity, like the purpose of index investing itself, is precisely this, to achieve stability and to enable money to grow at a greater rate without assuming any non-beta risk.

The MPT/CAPM theory shows that the purpose of index investing is stability and security, not growth. Can reasonable men differ on Modern Portfolio Theory? While people can differ on whether it is a good strategy for managing money, no one can dispute that its purpose is to reduce and spread risk, which is the definition of insurance. Similarly, no one can interpret index investing as investment management with the risks of stock-picking. The purpose of index investing is identical to that of a fixed annuity, to eliminate the risk of stock-picking. Its purpose is stability and security, not growth.<sup>118</sup>

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<sup>116</sup> Indexed Annuities And Certain Other Insurance Contracts, 74 Fed. Reg. 3138, 3161.

<sup>117</sup> See *supra* text accompanying notes 47-48.

<sup>118</sup> Indeed, the United States Supreme Court, when it adopted the "fraud on the market" theory for Rule 10b-5 securities fraud analysis, effectively endorsed the

The *American Equity* court repeatedly asserts that fixed index annuities appeal to consumers on the basis of growth rather than stability and security. Hence, according to the court, it necessarily follows that fixed index annuities are marketed like a security because their appeal is based on the performance of securities.<sup>119</sup> If that were true, people who buy fixed index annuities would buy variable annuities or individual stocks instead. What attracts people to fixed index annuities is not the assumption of investment risk in exchange for higher returns, it is a way to eliminate investment risk by investing in the market over the long term by means of products whose guarantees of interest and principal eliminate the risk of loss in the event that the index has a short-term loss. The *Malone* court found as much.<sup>120</sup> Therefore, if marketing is a necessary prong in the analysis the SEC was unreasonable because the product, ever so far from appealing as an investment risk, has as its main appeal, and has achieved widespread popularity, as a means of using index investing to reduce and eliminate investment risk.

## B. POLICY CONSIDERATIONS

### 1. What Should SEC Worry About?

With the recent troubles on Wall Street the SEC has enough to worry about in preventing frauds involving traditional stocks without expanding its mandate to claim regulatory control over every financial product that it can get its hands on. The SEC would perform best if it kept to a tightly focused mission and did not overextend itself by becoming too broad. Such a strategy would utilize the SEC's limited resources in the most efficient manner.

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efficient market hypothesis which underlies much of Modern Portfolio Theory and Capital Asset Pricing Model. *See* *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>119</sup> *See supra* text accompanying notes 94-96, 100

<sup>120</sup> *See supra* text accompanying note 86.

## 2. Consumer Protection

Some commentators have argued that SEC regulation is necessary to protect insureds from fraud by fixed index annuity insurers.<sup>121</sup> However, the kind of fraud of which there is a risk is not distinctly securities fraud and is such that state insurance regulators can guard against it.

## 3. Cost-Benefit Analysis

As SEC acknowledged, compliance with Rule 151A could cost the insurance companies many millions of dollars, even up to \$800 million.<sup>122</sup> There seems to be little benefit to the consumers who would eventually be forced to bear these costs. In the contemporary recession-plagued economy there is no basis for placing a major burden on the insurance industry absent a compelling justification, especially when it is the fixed index annuity consumers who will ultimately pay the SEC's bills.

## 4. The Benefits of State Regulation

There are classic yet relevant arguments that states are just as competent as the Federal government, that allowing freedom to the states increases experimentation which leads to progress and innovation in regulation, and that the Federal government is bureaucratic and inefficient.<sup>123</sup> These ideas remain forceful today.<sup>124</sup>

## VI. CONCLUSION

The variable annuities in *VALIC* and *United Benefit* were investment management products masquerading as insurance in order to

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<sup>121</sup> E.g., J.S. Coleman, *Equity Indexed Annuities: "Securities," or Exempt Insurance Products Under the Federal Securities Laws?*, 34 no. 2 SEC. REG. L.J. Art. 1 (2006).

<sup>122</sup> See *Indexed Annuities And Certain Other Insurance Contracts*, 74 Fed. Reg. at 3168.

<sup>123</sup> E.g., Douglas R. Richmond, *When It Comes to Insurance Regulation, Is Uncle Sam the New Sherriff in Town?*, 2008 EMERGING ISSUES 2696; see *supra* text accompanying notes 37-39.

<sup>124</sup> Indeed, it is worth noting that during the housing boom which led to the recent recession, insurance regulation largely worked better than federal securities regulation.

escape from the SEC, but that doesn't mean that it is impossible for a securities-related financial product to truly be insurance. Fixed index annuities are such a product. From a policy viewpoint, too much unnecessary regulation is unwise and inefficient. From a legal viewpoint, a logical argument can be made that an insightful analysis of the case law on the insurance exemption in the Securities Act of 1933 combined with an astute understanding of the facts involving fixed index annuities leads to the conclusion that fixed index annuities qualify for the insurance exemption. Even if the United States Supreme Court is unwilling to overturn *American Equity*, hopefully this note will provide a conceptual framework involving risk-reward analysis for future judges to use going forward so that the insurance exemption in the 1933 Securities Act continues to function. There is every reason to believe that imaginative, creative financial entrepreneurs will develop new kinds of insurance, some of which may be connected to securities, and even though the trend seems to be towards giving the SEC control over all new securities-related financial products, it would be unfortunate to see a day when insurance exemption analysis is abandoned and every securities-related insurance product is automatically classified as a security.

