



CRS Report for Congress

Annuities and the Securities and Exchange Commission Proposed Rule 151A

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Summary

The Securities and Exchange Commission (SEC) recently released a proposed rule that would effectively reclassify equity indexed annuities as a security product in addition to being an insurance product. Since insurance products are solely regulated by the states, rather than by the SEC, this proposed rule would expand SEC authority over these annuities. The SEC cited numerous problems with improper marketing and sales of these annuity products as a primary reason for increased SEC oversight. This proposal has been controversial, with more than 1,000 public comments made to the SEC before the initial comment period closed on September 10, 2008. On October 17, 2008, the SEC published notice in the *Federal Register* that they reopened the comment period until November 17, 2008.

This report presents the different types of annuities, explains the taxation of annuities, and disentangles the federal and state roles in the regulation of annuities. It outlines the proposed SEC rule and its current status. It will be updated as legislative or regulatory events warrant.

Background on Annuities

Types of Annuities¹

In its most simple form, an annuity can be thought of as the opposite of life insurance. In a basic life insurance contract, a person pays an insurer a small sum for many years, and then upon the insured's death, a large payment is made to a beneficiary. In the simplest form of annuity, a large sum is paid to the insurer and then a smaller sum is paid out to the insured over his or her lifetime. More formally, an annuity can be

¹ This section is based on CRS Report RS22439, *The Market for Retirement Annuities*, by Neela K. Ranade.

defined as “a contract that provides an income for a specified period of time, such as a number of years, or for life.”² As with life insurance, annuities can be more complex, with insurers offering a wide variety of both insurance and investment features in the annuity contracts that they sell.

Annuities can be classified as follows:

- *Immediate versus Deferred* — Under an immediate annuity, an individual pays an insurance company a sum of money and the insurance company begins making regular monthly payments to the individual immediately. Under a deferred annuity, an individual pays the insurance company a sum of money and the insurance company begins making regular monthly payments some time after purchase. For example, an individual at age 45 might buy a 20-year deferred annuity that would start making monthly payments when the individual reaches age 65. Deferred annuities may also be funded over time, with a person making periodic payments into the annuity, as they might with a 401(k) account or other savings vehicle. After this “accumulation phase” is finished, the annuity would then make period payments based on the value of the final contributed amount.
- *Fixed versus Variable* — A fixed annuity pays a flat monthly amount for the life of the annuitant whereas a variable annuity pays a monthly payment amount tied to the performance of an investment portfolio containing assets such as corporate stocks or bonds. Under a variable annuity, the annuitant bears the risk that the monthly annuity payment could go down.
- *Level Payment versus Graded Payment* — In a level payment annuity, the monthly payments remain the same whereas in a graded annuity the monthly payments increase each year. The payments may increase at a specified rate such as 2% per year or may increase at the rate of inflation.
- *Single-Life versus Joint-and-Survivor* — A single-life annuity makes regular monthly payments for the life of one person. A joint-and-survivor annuity makes regular monthly payments for the lives of two people, the primary annuitant and a secondary annuitant, typically the spouse of the primary annuitant.

As noted above, annuities can be complex products, and insurers have introduced many different annuity variations. A significant and relatively new hybrid type of annuity is called an *indexed annuity*, which combines some of the characteristics of fixed and variable annuities. In an *equity indexed annuity*, the annuity payment is based on the rate of return of a stock index. In addition, the insurer offers a minimum return provision, such as 3%, that limits the downside risk to the purchaser.

² Vaughn, Emmett J. and Therese Vaughn, *Fundamentals of Risk and Insurance*, 9th Ed. (Hoboken, NJ: John Wiley & Sons, 2003), p. 639.

Tax Treatment of Annuities

One of the primary advantages of annuities compared to other financial products, such as mutual funds or certificates of deposit, is the deferral of tax on the investment earnings of the annuity contract. These earnings are taxed only when the annuitant actually receives the annuity payments, according to formulas specified in the law and IRS regulations. Internal Revenue Code section 72 provides that the taxable income from an annuity contract in a given year is the total amount received under the contract that year less that year's prorated share of the cost of (or investment in) the contract. This allows the investment income to compound tax-free for potentially several years before any tax is due. The tax due on annuity investment income, however, is calculated at ordinary income rates, as with interest from savings accounts and certificates of deposits, rather than at the reduced rates that currently apply to capital gains and dividends. Ordinary income tax rates are as high as 35%, while most long-term capital gains and dividends end up being taxed at 15%, although capital gains rates can be as low as 0%.³ This potentially higher tax rate for annuity investment income can have a significant impact on the economic rationale for a consumer purchasing an annuity, and thus makes the annuity market, and the insurers offering annuities, very sensitive to tax proposals that might change rates on investment income.

Regulation of Annuities

State Insurance Regulation.⁴ As insurance products, all annuities are regulated by the individual states following the 1945 McCarran-Ferguson Act, which identifies the states as the primary regulators of insurance. This state oversight generally includes regulation of insurer solvency, regulation of the content of insurance products, and regulation of the market conduct of insurers and those selling insurance products. Annuities, particularly variable annuities, have attracted attention for allegedly abusive sales tactics. The National Association of Insurance Commissioners (NAIC) has responded to the abuses with a "Buyer's Guide" for prospective purchasers of annuities and model laws on annuity suitability and annuity disclosure. NAIC model laws, however, must be enacted by the individual states before having any effect. According to the NAIC, 33 states have enacted the NAIC model law on annuity suitability and 22 have enacted the model law on annuity disclosure.

Federal Securities Regulation.⁵ While insurance products are primarily regulated at the state level, securities products are generally regulated at the federal level, primarily by the Securities and Exchange Commission (SEC). SEC securities regulation is typically less extensive than state insurance regulation. Companies that sell securities to the public are required to register with the SEC, as are brokers and others selling

³ For more information on capital gains and dividend taxes see CRS Report 96-769, *Capital Gains Taxes: An Overview*, and CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, both by Jane G. Gravelle.

⁴ See CRS Report RL32789, *Insurance Regulation: Issues, Background, and Current Legislation*, by Baird Webel.

⁵ See CRS Report RL33235, *Banking and Securities Regulation and Agency Enforcement Authorities*, by Mark Jickling, Gary Shorter, M. Maureen Murphy, and Michael V. Seitzinger.

securities. In addition to SEC registration, securities brokers are required to be members of the Financial Industry Regulatory Authority (FINRA), a non-governmental self-regulatory organization for the securities industry. Much of the direct oversight of securities dealers occurs through FINRA rather than through the SEC, though the SEC retains authority over FINRA and may require it to adopt, or not adopt, certain policies or rules. There is little SEC oversight equivalent to state solvency requirements for insurers.

Federal securities regulations only apply to those financial products that are considered securities under the federal securities laws. For a number of years after the introduction of the variable annuity, some controversy existed as to whether or not these products are securities. The Supreme Court decided that variable annuities should be considered securities under federal law.⁶ Following this decision, variable annuities are generally subject to SEC and FINRA requirements, while other types of annuities are not.

SEC Proposed Rule On Indexed Annuities (generally known as Rule 151A)

On June 26, 2008, the SEC announced a proposed rule regarding equity indexed annuities.⁷ These annuities, as mentioned above, are a relatively new type of product combining features of variable annuities and fixed annuities. Typically, an equity indexed annuity will base the returns from the annuity on the returns from a basket of publicly traded stocks, combined with a guarantee of minimum returns. Up to this point, these annuities have generally been treated purely as insurance products, and thus have not been subject to SEC regulation.

The proposed rule would change the definition of an annuity contract such that many, if not most, of the sales practices of those selling equity indexed annuities would be regulated by the SEC, as well as by state insurance commissioners. Specifically, the proposed rule 151A would remove an annuity contract from the insurance exemption in the Securities Act of 1933 if “the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract.”⁸ The same proposal would also add rule 12h-7, which would exempt state-regulated insurance companies from the requirements under the Securities Exchange Act of 1934 to file reports on such annuity contracts. The original comment period for this rule ended on September 10, 2008. On October 10, 2008, the SEC released a proposed rule reopening the comment period for an additional 30 days. The effective date of the rule would be 12 months after the rule is finalized.

⁶ *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959).

⁷ See the SEC press release “SEC Moves to Protect Seniors from Fraudulent and Abusive Practices in Sale of Equity Indexed Annuities,” available at [<http://www.sec.gov/news/press/2008/2008-123.htm>]. The proposal would add rule number 151A under the Securities Act of 1933 (15 U.S.C. 77a *et seq*) and rule number 12h-7 under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq*).

⁸ U.S. Securities and Exchange Commission, “Indexed Annuities and Certain Other Insurance Contracts,” 73 *Federal Register* 37752, July 1, 2008.

In proposing the rule, the SEC cited the need to protect investors, particularly older investors, from fraudulent and abusive practices related to the sale of equity indexed annuities. Annuity sales practices have drawn complaints from consumers and various regulatory actions from state regulators and the SEC/FINRA over many years. Annuity products, especially variable annuities and equity indexed annuities, are frequently very complicated. Such complexity can make it possible for unscrupulous sellers to take advantage of less-sophisticated buyers, while high commissions on some annuities may give sellers a substantial financial incentive to sell these products. The alleged sales abuses seem to particularly concern older consumers. For example, a joint “Investor Alert” by the SEC, FINRA, and the North American Securities Administrators Association (NASAA) cites variable annuities as one of a number of products that are commonly used to defraud senior citizens.⁹

Reaction to the Proposed Rule. The SEC has received more than 1,000 public comments on the proposed rule, with the large majority of them being either opposed to its adoption or requesting an extension of the time limit for filing comments.¹⁰ Two complaints frequently made by those opposed to rule are (1) equity indexed annuities fundamentally are not securities, and thus should not be regulated as such; and (2) state regulation of insurance products is superior to SEC regulation of securities products, so the proposal would add a layer of complexity and duplicative regulation for little benefit.

Eighteen Members of Congress, led by Representative Gregory Meeks, sent a letter to the SEC calling for an extension of the comment period for an additional 90 days. The authors of this letter¹¹ observed that the proposed rule would have a significant impact, imposing a layer of federal regulation on top of state regulation, and expressed concern that stakeholders, including state insurance regulators and the insurance industry, were not consulted in the development of the rule. Such concerns, and the request for delay, were echoed in letters from various state insurance regulators and state legislators, as well as by individual comments made to the SEC.

Extension of Comment Period. In response to “numerous letters” requesting that the comment period be extended, the SEC announced on October 10, 2008, that it was reopening the comment period for an additional 30 days. The official extension announcement was published in the Federal Register on October 17, 2008 and, thus, the comment period closes on November 17, 2008.¹²

⁹ “Investment Products and Sales Practices Commonly Used to Defraud Seniors: Stories from the Front Line,” available on SEC’s website at [<http://www.sec.gov/spotlight/seniors/elderfraud.pdf>].

¹⁰ The full comments can be reviewed on the SEC website at [<http://www.sec.gov/comments/s7-14-08/s71408.shtml>].

¹¹ Letter available on the SEC website at [<http://www.sec.gov/comments/s7-14-08/s71408-1008.pdf>].

¹² See [<http://sec.gov/rules/proposed/2008/33-8976fr.pdf>].