

Equity-Indexed Annuities: Are They Worth the Risk? **By Steven Malina and Michael Berenson**

The recent increase in sales of equity-indexed annuities has attracted the attention of the NASD and state regulators. Broker-dealers whose registered representatives are selling or want to sell equity-indexed annuities need to understand the issues raised by these sales activities and make an informed decision about whether to allow them. If they do, they should also consider whether to impose any restrictions on these activities.

What Is an Equity-Indexed Annuity?

An equity-indexed annuity (“EIA”) is a fixed annuity that earns interest or provides a return linked to an equity index. EIAs are complex financial instruments in which the issuer, usually an insurance company, guarantees a stated interest rate and some protection from loss of principal, and provides an opportunity to earn additional interest based on the performance of a securities market index.¹ EIAs allow for accumulation of payments and interest followed by payment of the accumulated value to the owner in a lump sum or in a series of payments. During the accumulation period, the owner receives a return based on changes in an equity index, such as the S&P 500. In addition, the issuer guarantees a minimum rate of return. Although EIAs are of relatively recent origin, sales have increased dramatically in the past few years, growing from \$14 billion in 2003 to \$22 billion in 2004.² EIA sales exceeded \$27 billion in 2005.³ As explained in further detail below, most EIAs are currently being treated as nonsecurities, and the registered representatives that offer them do so in their capacity as appointed agents of the issuing insurance company.

Is an Equity-Indexed Annuity a Security?

As the NASD has noted, “the question of whether a particular EIA is an insurance product or a security is complicated and depends upon the particular facts and circumstances concerning the instrument offered or sold.”⁴ The NASD has not taken a position in the debate over whether EIAs are securities. It has, however, cautioned firms to exercise caution even if they are treating EIAs sold by their registered representatives as nonsecurities.

The starting point for the analysis of whether an EIA is a security is Section 3(a)(8) of the Securities Act of 1933 (“Securities Act”) and the safe harbor provision contained in Securities Act Rule 151. Section 3(a)(8) provides an exemption from the definition of a “security” for any 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.

In 1986, the Securities and Exchange Commission (“SEC”) adopted Rule 151 under the Securities Act, which created a nonexclusive “safe harbor” for certain annuity contracts,⁵

- 1) under which the insurance company bore the investment risk,⁶ and
- 2) which were not marketed primarily as an investment.

In the release adopting Rule 151, the SEC expressly noted that the principles underlying the various elements of Rule 151 should be used in analyzing an annuity which could not directly rely on Rule 151.

With respect to the marketing test in Rule 151, the SEC stated its belief that insurers and others marketing a contract with primary emphasis on discretionary excess interest and other investment-oriented features, while relegating mention of the traditional retirement planning features of an annuity contract to the “fine print,” must be viewed as offering a security and not insurance.⁷

In response to criticism in comments on the rule proposal, the SEC noted that it continues to believe, as the relevant case law supports, that the manner in which a contract is primarily marketed is a significant factor which must be considered in determining a contract’s status under the federal securities laws.⁸

While the SEC declined to establish a checklist of acceptable marketing practices, it did state that a marketing approach that fairly and accurately describes both the insurance and investment features of a particular contract, and that emphasizes the product’s usefulness as a long-term insurance device for retirement or income security purposes, would undoubtedly “pass” the rule’s marketing test.⁹

On the other hand, it noted that if a contract is promoted with primary emphasis on current discretionary excess interest, and the possibility of future interest, or other investment-oriented features of the contract, that contract would likely fail the marketing test.¹⁰

In August 1997, the SEC issued a concept release requesting comments on certain issues related to equity-indexed insurance products.¹¹ The release posed a lengthy series of questions concerning the structure of these products, how they are marketed and other issues related to their status under the federal securities laws. Although the release expressly stated that the “Commission believes that both purchasers and insurers may benefit from greater clarity in this area,”¹² the SEC has not taken any further action to provide guidelines on the status of equity-indexed insurance products under the federal securities laws.¹³

State Regulatory Activity

State regulatory authorities are also scrutinizing how firms market and sell EIAs. For example, in an Interpretative Release issued on December 5, 2005, concerning compliance with the safe harbor, the Kentucky Office of Financial Institutions Division of Securities warned:

Use of certain phrases in connection with the promotion or sale of EIAs will be deemed by the Division to be attempts to market the products as investments, thereby violating the “safe harbor” requirements and bringing the products within the purview of securities regulation. Phrases such as “take advantage of market gains while avoiding market losses;” “grow with the stock market without risk;” “obtain competitive yield with minimal risk;” or substantially similar assertions are examples of language that the Division deems to subject the products to securities regulation. Additionally, any promotion referencing rates of return or comparing products to recognized financial instruments (CDs, mutual fund shares, etc.) would be viewed as promoting the products as an investment vehicle and therefore subject to securities regulation.

Earlier this year, the Iowa Insurance Division¹⁴ asked the Insurance Marketplace Standards Association (“IMSA”) to work with Iowa member companies to explore standards for the marketing and sales of indexed products.¹⁵ On May 15, 2006, IMSA released its “IMSA Indexed Annuity Standards.” The Standards are applicable to any IMSA-qualified company that distributes indexed annuity products¹⁶ and require producers to gather information about a customer’s financial situation and experience, risk tolerance and liquidity needs when conducting a “needs-based” selling analysis. The Standards also require disclosure regarding, among other things, surrender charges, the index used, indexing method, cap and participation rate, how interest is calculated and annuitization options.¹⁷ Finally, the Standards require agent training on the features of the issuer’s indexed products.¹⁸ The Standards mandate that issuers have policies and procedures in place to address each of the referenced subject areas.¹⁹

NASD Notice to Members 05-50

NASD Notice to Members (“NTM”) 05-50 is the most detailed statement on EIAs issued by the NASD and is of particular interest to any NASD member. NTM 05-50 addresses the responsibility of member firms to supervise the sales of EIAs that are not registered under the federal securities laws. In the NTM, the NASD declared its concern “about the manner in which associated persons are marketing and selling unregistered EIAs, and the absence of adequate supervision of these sales practices.”²⁰ While the NASD was very careful to defer to the SEC and not take a position on which EIAs are securities, it left no doubt that it is prepared to scrutinize very closely the total facts and circumstances present if a member’s registered representative engages in abusive behavior involving EIA sales, even if the registered representative is engaged in an outside business activity acting as an agent of an unaffiliated insurance agency.

In NTM 05-50, the NASD cautioned firms about the risks of applying Rule 3030 (“Outside Business Activities of an Associated Person”) to the sale of unregistered EIAs based on the assumption that the product is not a security.²¹ Rule 3030 requires associated persons to provide prompt written notice to the member of any business activity outside the scope of their employment with the firm. The rule does not require member firms to supervise or even approve of the outside activity. The NASD cautioned that since the analysis of whether a particular EIA qualifies for the Section 3(a)(8) exemption is made on a case-by-case basis and may turn on the particular features and marketing materials associated with the product at issue, firms may incorrectly treat the subject transaction as a Rule 3030 outside business activity instead of a private securities transaction under Rule 3040 (“Private Securities Transactions of an Associated Person”). If a particular EIA is deemed a security, and the representative sold it outside the regular scope of his or her employment, Rule 3040 mandates that the representative first provide written notice describing in detail the proposed transaction and receive from the firm written approval. Rule 3040 further mandates that firms maintain the books and records and supervise an approved private securities transaction as if the transaction were executed on behalf of the firm.

To prevent such violations, the NTM 05-50 indicates, with implicit approval, that some firms have adopted one or more of the following precautionary rules:

- Representatives must obtain approval before selling nonsecurity insurance products;
- Representatives must obtain specific approval to sell nonsecurity EIAs; and
- Representatives can only sell EIAs that are on an approved list.

NTM 05-50 concludes with a discussion of supervisory responsibilities, which emphasizes the NASD's view that broker-dealers should be very conservative when EIA sales are involved. As discussed *infra*, even if a nonsecurity EIA is involved (and, therefore, Rule 3030 is applicable), broker-dealers should be aware that a recommendation to sell a security is subject to suitability standards,²² including where the sale proceeds will be used to purchase a nonsecurity EIA.

NTM 05-50 goes on to highlight practices some firms have adopted and encourages all firms whose representatives are involved in the sale of EIAs to consider:

- Applying Rule 3040 procedures even to nonsecurity EIAs. (The NASD states that firms are "well advised" to consider whether they should adopt such an approach.)
- Maintaining a list of acceptable nonsecurity EIAs and prohibiting sales of other non-security EIAs unless the representative has provided written notice and received written permission to sell the previously unapproved EIA.
- Requiring all sales of nonsecurity EIAs to occur through the firm, in which case the firm must supervise the marketing material, suitability analysis, and other sales practices in the same manner as it supervises the sales of securities.
- Ensuring that representatives selling EIAs are trained to understand the various features of EIAs and to analyze whether the instrument "meets the needs of a particular customer."²³

In summary, whether or not a particular EIA is a security depends on a comprehensive review of how the EIA is marketed as well as a close analysis of the EIA's contractual terms. The NASD has made it clear that it is very concerned about inappropriate sales of EIAs and that, even in those cases in which the registered representative is acting as an insurance agent in an outside business activity, it will closely scrutinize a member's conduct in any circumstances in which a registered representative engages in abusive behavior in connection with the sale of an EIA.

Sell-Side Suitability

Since its release of NTM 05-50, the NASD has repeatedly expressed its concern about how and to whom EIAs are being marketed and sold. In the context of elderly investors, for example, the NASD "is particularly concerned about possible sales practice abuses in the distribution [of] equity indexed annuities."²⁴ Although the NASD acknowledges that "most sales of equity indexed annuities are treated as insurance sales and are not made by brokers subject to NASD oversight," it has urged firms to adopt and implement more complete supervisory procedures with respect to EIAs.²⁵ The NASD is scrutinizing the suitability of sell-side transactions when EIAs are purchased with rollover funds. For example, EIAs are frequently purchased with rollover funds from the sales of variable annuities. Variable annuities are securities, and recommendations to sell them are likely subject to the NASD's Suitability Rule 2310. Many representatives have marketed EIAs to investors holding variable annuities whose sub-accounts have declined in value. The NASD would likely be skeptical of a recommendation to an elderly or other investor to sell a variable annuity already held close to or beyond the surrender period to purchase an EIA with a new surrender period.

Are EIAs Worth the Risk?

Broker-dealers must ask themselves whether it is prudent to continue to allow their sales forces to sell EIAs as approved outside business activities. From a financial perspective, the impact to their bottom lines can only be negative. EIAs generate profits for the issuing insurance companies and commissions for the insurance agencies and registered representatives who hold appointments with those insurance companies—not the broker-dealers the registered representatives work for. The broker-dealers do not receive any of these commissions or any other compensation as a result of these transactions. The fact that broker-dealers are not generating commissions or fees on the sales of EIAs has not, however, shielded the firms from intense regulatory scrutiny. Broker-dealers are expending staff resources and legal fees on compliance costs and responding to regulatory inquiries from the SEC and others regarding EIAs, including presenting employees for on-the-record examinations. The potential upside to the broker-dealers that permit sales of EIAs is somewhat limited. There is the unquantifiable good will that may accrue from existing or potential members of their sales forces that want to sell EIAs. In addition, broker-dealers may retain valuable members of their sales forces who otherwise would have found a more accommodating broker-dealer. Finally, if

the issuing insurance company is affiliated with the broker-dealer, the EIA sales activities would be contributing to the profits of the overall enterprise.

Is it worth the risk? Some broker-dealers have said “no” and prohibited sales of EIAs. In light of the fact that the regulators have placed EIAs squarely in their cross-hairs, restrictions or prohibitions on EIA sales may prove to be a prudent business decision. □

1. NASD Issues Guidance Regarding Equity Indexed Annuity Sales, NASD News Release (Aug. 5, 2005).
2. *A Do-It-Yourself Kit for Investors: Build Your Own Equity-Indexed Annuity*, Wall St. J., Jan. 26, 2005.
3. *Ignites*, July 17, 2006.
4. NASD Notice to Members 05-50 (August 2005), available at www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_01421.pdf.
5. Securities Act Rel. No. 6645 (May 29, 1986). Rule 151 was proposed in Securities Act Rel. No. 6558 (Nov. 21, 1984). Previously, in Securities Act Rel. No. 6051 (April 5, 1979), the SEC issued a general statement of policy regarding the availability of Section 3(a)(8) for such contracts.
6. Rule 151(b) states that an 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
 - (i) Guarantees the principal amount of purchase payments and interest credited thereto, less 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 rule) 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) will not be modified more frequently than once per year.
7. Release 6558, at text accompanying n.23.
8. Release 6645, at text accompanying n.42.
9. *Id.* at text accompanying n.47.
10. *Id.* at n.47.
11. Securities Act Rel. No. 7438 (Aug. 20, 1997).
12. *Id.* at text following n.7.
13. At least one court has addressed the issue of whether an EIA is a security. In *Malone v. Addison Insurance Marketing, Inc.*, 225 F. Supp. 2d 743 (W.D. Ky. 2002), the court held that the EIA in question, which guaranteed principal plus a 3% annual return, met the SEC's test for how much investment risk an insurance company must bear for an EIA not to be a security. The court granted a motion to dismiss based upon its finding that the EIA at issue was exempt from the federal securities laws.
14. Four companies based in Des Moines, Iowa accounted for approximately one-third of all EIA sales in 2005. www.desmoinesregister.com (June 28, 2006).
15. IMSA News Release (Mar. 14, 2006). IMSA is a nonprofit, independent organization “created to strengthen consumer trust and confidence in the marketplace for individually sold life insurance, long-term care insurance and annuities.” IMSA website (July 18, 2006).
16. *Id.* IMSA-qualified companies agree to follow a specific set of ethical standards in their advertising, sale and service of individual life insurance, long-term care insurance, and annuity products. IMSA website (July 18, 2006).
17. *Id.*
18. *Id.*
19. *Id.*
20. NTM 05-50 at 2.
21. *Id.* at 4.
22. *Id.* at 5.
23. *Id.*
24. *Elderly Investment Fraud: Hearing Before the S. Comm. on Aging* (March 29, 2006) (Statement of Elisse B. Walter, Executive Vice President, Regulatory Policy and Oversight, NASD).
25. *Id.*