MEMORANDUM

Re: AEL Index Annuities
Status under the Securities Act of 1933

Date: August 23, 2005

From: Wendy L. Carlson
General Counsel

Conclusion

This memorandum addresses the issue of whether AEL index annuity products are subject to registration as "securities" under the federal Securities Act of 1933 (the "33 Act") or whether they fall within the statutory exclusion for insurance products. Based upon (i) the terms of 33 Act itself, (ii) the U.S. Supreme Court and other federal court decisions on this issue; and (iii) Rule 151 adopted by the SEC, it is our conclusion that no registration is required. Specifically, this conclusion rests upon the following facts:

1. *No Separate Accounts or Pass Through of Investment Risk.* The premiums from all our products, including fixed-rate and index as well as life insurance sales, are invested in our general account. None of the premiums from index annuity sales are invested in a separate account in which the investment experience is passed on to the policyholders. The types of investments permitted in AEL's general account are regulated by state insurance law and consist primarily of fixed income securities of which 99% are investment grade and 75% are U.S. agency bonds. AEL bears 100% of the risk of loss in any sale of such assets, whether such loss arises from credit quality, duration mismatch or interest rate movement. None of this risk is passed on to policyholders in any form. None of AEL's index annuities have "market value adjustments" of any kind.

   Interest credits on index annuities are funded by AEL through its purchase of one-year call options on the applicable indexes. AEL bears the risk that this hedging strategy is effective. Index policyholders are entitled to receive their index-based interest credits whether or not receipts from options are sufficient to cover this expense.

   AEL is required by state insurance laws to maintain prescribed levels of capital to support the risks of its business, including credit risk, interest rate risk and other insurance risks. In addition, the level of reserves AEL is required to maintain for its annuity liabilities, including index annuity liabilities, is also governed by state insurance laws.

2. *Guaranteed Premium and Minimum Interest.* Index annuity policyholders receive a guarantee of premium and minimum interest the levels of which are regulated under state insurance laws. Under the revised NAIC Standard Nonforfeiture Law for Individual Deferred Annuities ("SNF"), now adopted in some form by 47 states, the minimum

guaranteed cash surrender value of an index annuity must be at least 87.5% initially, and must increase annually by the addition of minimum guaranteed interest. The minimum interest rate under the newer SNF is a rate linked to the 5-Year Constant Maturity Rate reported by the Federal Reserve. All AEL index products comply with the minimum cash surrender value requirements of each state where the products are sold.

The current SNF replaced an earlier version which required a minimum cash surrender value for "flexible annuities" of (i) 65% on first year premiums and (ii) 87.5% on subsequent premiums. "Flexible annuities" permit the policyholder to make multiple premium deposits if he/she so chooses. For single premium deferred annuities the prior version of the SNF required a minimum cash surrender value of 90%. The current requirement of 87.5% applies to both flexible and single premium deferred annuities.

The current SNF also reduced the minimum guaranteed interest rate from 3% to a rate linked to the 5-Year Constant Maturity Rate. The changes in both minimum guaranteed premiums and interest were a response to the very low interest rate environment of the last several years applicable to fixed income securities and savings deposits.

The levels of guaranteed minimum cash surrender values in AEL's index annuities are comparable to the guarantees in its traditional fixed-rate products.

3. *Surrender Charges Cover Only Expenses*. The minimum cash surrender value of an index product reflects the deduction of surrender charges if the policy is surrendered before the surrender charge period expires. The surrender charge is a form of "contingent deferred sales charge" which is deducted upon redemption and is contingent on the number of years the contract has been in effect. Surrender charges do not apply to annual withdrawals of up to 10% of the account value, annuitizations based upon life expectancy and withdrawals under nursing home or terminal illness riders.

Unlike many variable annuities, no front-end sales commissions or annual administrative fees are deducted from index account values. Surrender charges cover primarily the unamortized portion of the upfront commissions paid to the selling agents, premium bonuses and policy issuance costs of $170 per policy. For financial reporting purposes under GAAP, premium bonuses are treated as "deferred sales inducements" which are initially capitalized and amortized on a basis similar to other acquisition costs such as agent commissions. None of the surrender charges are intended to cover investment risks or the cost of investment management.

4. *Index-Based Interest Calculations are Guaranteed for One Year or Longer.* The calculation of index-based interest credits is subject to contract terms including "participation rates", "caps" and "asset fees". A "participation rate" is the percentage of the annual gain in the applicable index. For example, if the participation rate is 70%, and if the applicable index increases 10% during the contract year, then 7% would be credited to the policyholder for that year. A "cap" is the upper limit on how much will be credited in any contract year. For example, if the cap is 6% and the applicable index increases 10% during the contract year, then 6% would be credited to the policyholder for that year. An "asset fee" is subtracted from the index increase and may operate as a floor below which no interest will be credited. For example, if the asset fee is 2.5% and the applicable index increases 10% during the contract year, then 7.5% would be credited to the policyholder. If the index gain were 2%, no index-based interest would be credited to the account value that year, but guaranteed minimum interest would be added to the guaranteed minimum cash surrender value in any event. Some index contracts specify that the index gain will be averaged based upon monthly index levels; others measure the gain from the first day of the contract year to the last ("one year point to point") or by month within the contract year ("monthly point to point").

   The specific levels of participation rates, caps or asset fees are guaranteed for at least one year. AEL may change these levels once annually on the respective contract anniversary dates. The ability to change these rates is an element of managing the cost of options used to fund the index credits. The ability to reset such levels once annually is comparable to the ability to reset a declared rate once annually on traditional fixed-rate annuities. In both cases, the ability to reset is limited by the contractually guaranteed minimum interest rate (for fixed-rate annuities), and minimum levels of participation rates and caps, and maximum asset fees (for index annuities).

5. *Marketing.* In sales materials AEL emphasizes the safety and stability of the products as well as the fact that such products are not investments nor alternatives to the stock market. All AEL's marketing materials for its index products <u>and</u> any materials prepared or used by its agents must adhere to written advertising guidelines which are set forth in its NMO Manual and also distributed twice annually to AEL's entire field force. Any advertising material used by an agent must be approved in advance by AEL's compliance department. General guidelines apply to all advertisements and a set of specific guidelines also apply to advertising of index annuities. "Advertising" is defined within the written guidelines to include "anything designed or used by American Equity or our agents with the intent to create an interest in purchasing our products." The following charts set forth a sample of both the general and specific guidelines.

General requirements applicable to all annuity sales
• No aspect of the piece could be considered untrue, deceptive or misleading based on the information included or omitted.
• The product being advertised has been approved in the state(s) in which the ad will run or there is a clear indication the product may not be approved in all states.
• The piece, when examined as a whole, cannot lead a person of average intelligence to any false conclusions. This conclusion is based on the literal meaning of the words, impressions from nonverbal portions of the piece, and from materials and descriptions omitted from the advertising piece.
• If the word "safety" is used with reference to AEL products, then an explanation must be provided, giving supporting information (e.g., minimum guaranteed interest rate, A.M. Best or Standard & Poor's ratings).
• The following words or similar terms are not used in connection with a policy in a context with the capacity to lead a purchaser to believe something other than an insurance product is being sold. Investment Profit Sharing Deposit Savings Profit Interest Check Account The word "plan" with any word on this list
• No references to an agent's or broker's status as a "financial planner", "financial consultant" or "investment advisor" or the words "financial planning", "estate planning" or "pension planning" appear in any advertising that uses our corporate logo, corporate name or any reference to our Company in such a way as to imply he/she is engaged in an advisory business in which compensation is unrelated to sales. If a professional designation is used it is current.
• There is no indication the insured shares in or receives a portion of the Company's general assets.

Specific requirements for index annuities
• The Index is referred to primarily as a factor that, ***in part***, determines the "excess" interest to be credited and NOT as a vehicle for participation in the stock market gains or returns. (Emphasis in original)
• If the product does not have a contractual participation rate, no reference is made to "full or 100% participation", or if reference is made, the statement is hedged with "full or 100% participation in the calculation of the index credit"; or the statement is supplemented appropriately with "Asset Fee Rates and/or Caps apply".
• It is clear that the index does not contain dividends.

• The focus is on the product, not the link to the Index.
• Long-term retirement security is emphasized.
• Guarantees are emphasized including guaranteed minimum interest rates and values.
• The insurance benefits of the product, such as death benefit and annuitization options, are emphasized.
• The indexing feature is clearly explained.
• Any potential changes to the participation rate or any other components of the indexing formula are clearly disclosed.
• The downside protection is stressed.
• It is clear that it is a fixed annuity insurance product.
• No language creating a perception that this could be a security is used.
• No standard equity market terminology or references to "Wall Street", or investment terms like "stock market", "investing in the contract", "performance", or "investment returns" are used.
• The index annuity is not compared to or suggested as an alternative to a registered product, unless to contrast.
• The indexing feature is not described as a means of "participation" in the "stock markets", the "equity markets", or the Index". Consumers must not be led to believe in any way they are participating in the stock market or purchasing securities.

In addition, AEL is a member of the Insurance Marketing Standards Association (IMSA) which prescribes a variety of standards for marketing of insurance products. A periodic independent audit of compliance with such standards is required for continued membership.

6. *Mortality*. AEL's index annuities all contain two primary components with mortality considerations. First, at the death of the policyholder, full contract value is paid to the named beneficiaries without deduction of surrender charges. AEL manages this mortality risk by reducing sales commissions and surrender charges on sales at older ages. For certain blocks of business, AEL has also purchased reinsurance for this risk. Second, policyholders may exercise a privilege to annuitize their full contract value, without deduction of surrender charges, at any time after the first contract year for a period based on life expectancy. All such annuitization payments include a rate of interest equivalent to then current base crediting rates on fixed-rate annuity products – at present, 3.25%.

7. *State Regulation*. Index annuities are subject to extensive regulation under state insurance laws, many of which are based upon NAIC model laws. The following is a partial list of laws pertaining to the regulation and management of AEL's annuity business:

• Standard Nonforfeiture Law for Individual Deferred Annuities
• Model Law on Examinations (AEL has just completed its regular triennial examinations by the state of Iowa and the state of New York In addition AEL has undergone separate market conduct examinations by Florida and Nevada, and examinations by California and Arizona are upcoming).
• Model Regulation Requiring Annual Audited Financial Reports
• Risk Based Capital Model Act
• Standard Valuation Law
• Investments of Insurers Model Act
• Life and Health Insurance Guaranty Association Model Act
• Actuarial Guidelines XXXV and XXXIII (which address reserve and hedging issues pertaining to equity index annuities)
• Senior Protection in Annuity Transactions Model Regulation
• Life Insurance and Annuities Replacement Model Regulation
• Annuity Disclosure Model Regulation
• Model Annuity Illustrations Regulation
• Advertisements of Life Insurance and Annuities Model Regulation
• Producer Licensing Model Act (including continuing education requirements)
• Unfair Trade Practices Act

Section 3(a)(8) of the Securities Act of 1933 and related Supreme Court Decisions

The analysis of whether an "annuity" is a "security" subject to registration under the Securities Act of 1933 (the "33 Act") begins with the language of the statute itself, which expressly excludes "any insurance or endowment policy or *annuity contract* or optional contract issued by a corporation subject to supervision of the appropriate insurance regulatory of any state." 15. U.S. C. §77c(a)8) (Emphasis added). The statutory definition of a security *includes*:

> [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, or , in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. 15. U.S. C. §77 (b)(1).

The express exclusion of insurance products, including annuities, is consistent with the requirements of the McCarran-Ferguson Act, 15 U.S. C § which leaves the regulation of the business of insurance to the states. However, as products have evolved, the boundaries between which are "insurance" and which are "securities" have become less distinct.

The Supreme Court first addressed the question of whether a variable annuity is within the exclusion for annuities in *SEC v. Variable Annuity Life Insurance Co. Of America* 259 U.S. 65 (1959). The Court noted that a variable annuity has some of the characteristics of a fixed or conventional annuity, in that both permit annuitization of fund values over the life of the holder. However, this assumption of some mortality risk was outweighed by the fact that *none* of the investment risk was borne by the insurer. Specifically, the court described this essential element as follows:

> [A]bsent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interests reflects – which may be a lot, a little, or nothing. We realize that life insurance is an evolving institution....But we conclude that the concept of "insurance" involves some investment risk-taking on the part of the company.... For in common understanding "insurance"

> involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts.... 359 U.S. at 71.

In a concurring opinion, Justice Brennan, joined by Stewart, discussed in detail the reasons insurance and annuities were excluded from the 33Act, as follows:

> At the core of the 1933 Act are the requirements of a registration statement and prospectus to be used in connection with the issuance of 'securities" – that term being very broadly defined. Detailed schedules, set forth in the Act, list the material that the registration statement and the prospectus are to contain. The emphasis is on disclosure; 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.
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> The regulation of life insurance and annuities by the States proceeded, and still proceeds, on entirely different principles. It seems as paternalistic as the Securities Act of 1933 was keyed to free, informed choice. Prescribed contract clauses are ordained legislatively or administratively. Solvency and the adequacy of reserves to meet the company's obligations are supervised by the establishment of permissible categories of investments and through official examination. The system does not depend on disclosure to the public, and, once given this form of regulation and the nature of the "product," it might be difficult in the case of traditional life insurance or annuity contract to see what the purpose of it would be... 359 U.S. at 77-78.

The U.S. Supreme Court again reviewed the question of whether a then new type of annuity was "insurance" or a "security" in *SEC v. United Benefit life Insurance Co.*, 387 U.S. 202 (1967). The product at issue in the case was a "Flexible Fund Annuity" which involved the investment of premiums in a separate account and accumulation of contract value through the performance of the account. United Benefit's advertising for the product emphasized the possibility of investment return and the experience of the company's management in professional investing. Cash surrender values were guaranteed initially at 50% of net premiums which grew to 100% after 10 years. United Benefit had established the level of the guarantee "by analyzing the performance of common stocks during the first half of the 20th century and adjusting the guarantee so that it would not have become operable under any circumstances." 387 U.S. at 209 fn.12.

The lower courts concluded that the presence of the guarantee was sufficient to make the product "insurance", and the fact the purchaser's return varied with the performance of the separate account during the accumulation phase could not considered separately and treated as a "security". The high Court disagreed, noting that "the basic difference between a contract which to some degree is insured and a contract of insurance must be recognized." 387 U.S. at 211. The court contrasted the features of a tradition fixed annuity which permits accumulation to a fixed amount at a stated rate of interest from the United Benefit product which allowed the policy holder to share in its investment experience based upon its investment management expertise, with only a guaranteed minimum at maturity which was substantially less than that guaranteed under a conventional deferred annuity contract.

Under *VALIC* and *United Benefit*, AEL's index annuity products are clearly "insurance" and not "securities" because: (1) the policyholder's return is not tied to a separate account of investments; (2) net index annuity premiums are invested in AEL's general account along with net premiums from AEL's traditional fixed annuities and life insurance; (3) the types of investments within AEL's general account are regulated by state insurance laws, as are required levels of index annuity reserves and capital; (4) the guaranteed minimum cash surrender values in AEL's index annuities are substantial, and are comparable to the level of guarantees provided in its traditional fixed-rate products.

SEC Rule 151
Safe Harbor Definition of
Certain "Annuity Contracts or Optional Annuity Contracts"
within the meaning of Section 3(a)(8)

As a part of developing its very first index annuity product, AEL conducted extensive due diligence regarding all applicable state and federal laws and regulations. Rule 151 was and is the principal basis for the design of the products, and AEL's intent is to remain squarely within the parameters of the safe harbor. Rule 151 provides that:

> (a) Any annuity contract or optional annuity contract (a contract) shall be deemed to be within the provision os section 3 (a) (8) of the Securities Act of 1933, Provided, That
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> (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

(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 that once per year.

(C) The term *specified rate of interest,* as used in paragraph (b)(2)(ii) of this section, means a rate of interest under the contract that is at least equal to the minimum rate required to be credited by the relevant nonforfeiture law in the jurisdiction in which the contract is issued. If that jurisdiction does not have any applicable nonforfeiture law at the time the contract is issued (or if the minimum rate applicable to an existing contract is no longer mandated in that jurisdiction), the specified rate under the contract must at least be equal to the minimum rate then required for individual annuity contracts by the NAIC Standard Nonforfeiture Law.

In the adopting Release for this Rule, the SEC provided commentary regarding the intent and scope of rule. As a "safe harbor", the SEC first noted that "while compliance with the rule would assure 'non-security status'", a product which failed to satisfy all of the rule's conditions may still be exempt under section 3(a)(8). 17 C.F.R. Part 230 (Release No. 33-6645).

In connection with the provision regarding the crediting of "excess interest", the SEC specifically addressed the issue of excess interest computed in accordance with an external formula or index, stating:

> [T]he Commission has determined that it would be appropriate to extend the rule to permit insurers to make limited use of index features in determining the excess interest rate, so long as the excess rate is not modified more frequently than once per year. The insurer, therefore, would be permitted to specify an index to which it will refer, no more often than annually, to determine the excess rate that it will guarantee under the contract for the next 12-month or longer period. Once determined, the rate of excess interest credited to a particular purchase payment or to the value accumulated under the contract must remain in effect for at least the one-year time period established by the rule. Thus, while the rate of interest calculated under a particular index or formula may fluctuate upward or downward on a daily basis, the excess interest rate actually credited may not fluctuate more than once per year. The Commission is concerned that index feature contracts that adjust the rate of return actually credited on a more frequent basis operate less like a traditional annuity and more like a security and that they shift to the contractowner all of the investment risk regarding fluctuations in that rate.

With respect to the marketing criteria, the SEC noted that this element of the rule is the most subjective. Even so, the SEC remarked upon the strong emphasis placed on this element by the Supreme Court in *United Benefit,* where the defendant insurer had touted the possibility of investment returns through its own investment management expertise. The SEC declined to articulate explicit guidelines, it stated 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."

AEL's index annuities comply in every respect with the provisions of Rule 151. Specifically:

(i) AEL is regulated by the state insurance departments of 49 states and the District of Columbia.

(ii) None of AEL's index annuities base the determination of contract value on the investment experience of a separate account.

(iii) Net premiums are guaranteed less deductions only for surrender charges which cover sales commissions, premium bonuses and nominal administrative expenses.

(iv) Net premiums accumulate interest at a specified rate which equals or exceeds the rates required under each state's standard nonforfeiture law.

(v) The index-based excess interest credits are based upon contractual rates which cannot be modified more than once annually.

(vi) AEL's marketing materials adhere to strict guidelines which require emphasis on the safety and stability of the products and which prohibit statements regarding market-based returns.

Malone v. Addison Insurance Marketing

In 2001 the New York-based firm of Milberg, Weiss, Bershad, Hynes & Lerach filed a lawsuit in the federal district court for the western district of Kentucky against AEL and several of its agents. The plaintiff, Beverly Malone, was (and is) an AEL index annuity holder residing in Kentucky. The suit alleged several claims, including one based upon Rule 10b-5 of the Securities Exchange Act. Mrs. Malone had purchased an AEL Index-5 annuity, which was a single strategy index annuity (predating AEL's introduction of its current "multi-strategy" products). The Index-5 guaranteed that 3% interest would be credited annually on 100% of the premium deposits. Index-based interest was also credited utilizing a "participation rate", or percentage, of average annual gain in the S&P 500 Index. The participation rate was guaranteed to be no lower than 50%, and minimum interest was credited at 3% even if the average annual gain in the S&P 500 Index was less than 3%.[1]

The securities laws claim was eliminated by the court in a ruling on AEL's motion to dismiss, and its decision is reported at *Malone v Addison Insurance Marketing*, 225 F. Supp. 2d 743 (W.D.Ky. 2002). The court's opinion was based on *VALIC* and *United Benefit*, as well as on Rule

[1] Mrs. Malone initially deposited approximately $280,000 in her annuity at the time of purchase in 1999. As of the date of this Memorandum, she has taken penalty-free withdrawals aggregating approximately $100,000, leaving net premium deposits (principal less withdrawals) of approximately $190,000. Her current contract value, including all interest credits on her net deposits, is approximately $220,000, and her cash surrender value is approximately $201,000. Had Mrs. Malone surrendered her policy, surrender charges would been deducted from the contract value returned to her. Her cash surrender value at the end of the 1st, 2nd, 5th and 10th contract years would have equaled the following percentages of her net premium deposits: 1st year – 92.7%; 2nd year – 96.5%; 5th year – 105.3%; and 10th year – 122.0%.

151, and included a separate analysis of each prong of Rule 151. Regarding the "investment risk" component of the Rule, the court stated:

> The second prong of the Safe Harbor test requires that the "insurer assumes the investment risk under the contract" and then sets out three criteria, all of which the American Equity annuities meet in this case. Under the first criteria, American Equity assumes the investment risk if "the value of the contract does not vary according the investment experience of a separate account." Nothing in Plaintiff's complaint suggests that the value of her annuity varies with the result of a separate account maintained by American Equity. To the contrary, as noted in the American Equity brochure attached to the Complaint, American Equity did not invest Plaintiff's money [in equity securities], but rather attempted to ensure the safety of it by maintaining a portfolio comprised of investment grade bonds, cash and cash equivalents. *Id.* at 752 (Citations omitted)

The court went on to discuss the guarantee of the principal amount of purchase payments and interest in Mrs. Malone's annuity, noting also that deductions for sales, administrative and other expenses would apply. In addition, the "participation rate" was guaranteed for the first year and could change only once annually, satisfying the requirement that "excess interest" must not be modified more frequently than once per year. Finally, the court discussed the "marketing" prong of Rule 151, stating:

> Plaintiff is correct in noting that the American Equity brochure and contract made reference to the success of the American Equity portfolio and that it advertised the S&P 500 indexing feature. However, making reference to investments in the context of assuring the security of an annuitant's premium, and an aggressive marketing strategy related to the potential for growing that premium have distinct legal significance...
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> American Equity's brochure, though it mentions the company's "sound financial management," does so in the context of explaining that the company promises "stability and flexibility." In addition, the contract itself states plainly just before Plaintiff's signature, "[I] understand that past S&P 500 Index activity is not intended to predict future activity and that the S&P 500 Index does not include dividends." Moreover, the one-page summary Plaintiff signed, which focused on how her Contract Value was calculated at any one point to assure her that initial principal plus interest, did not emphasize the

> potential increase in her assets, but focused on explaining to her that she was guaranteed her principal plus three percent interest... *Id.* at 753-754.

AEL's current generation of index products are substantially similar in all material respects to the Index-5 reviewed by the court in *Malone*. AEL has no separate accounts, and its general account assets consist of fixed income investments of which over 99% are investment grade and 75% consist of U.S. agency bonds. Premium deposits are guaranteed, subject to deduction for surrender charges, and accumulate interest at the minimum rates required under state insurance laws. The current levels of such guarantees reflect changes in the rates specified in such laws, and are still very similar to the levels of guarantees provided by the Index-5. While AEL now includes "caps" and/or "asset fees", as well as "participation rates", in the calculation of index-based interest credits for some products, no cap, asset fee or participation rate may be changed more frequently than once per year. Marketing materials continue to have exactly the same focus as those reviewed by the *Malone* court. AEL believes that the court's decision in *Malone* is strong support for its conclusion that its index products are insurance products and not securities.

<u>Other Relevant Case Law</u>

Several other cases have explored the issue of whether a particular product sold by a life insurance company was exempt as "insurance" under Section 3(a)(8) and Rule 151. Each is summarized below.

In *Otto v. Variable Annuity life Insurance Company*, 814 F.2d 1127 (7th Cir. 1986) the court examined a fixed annuity product which guaranteed a rate of 4% per year for the first ten years and 3½% thereafter, with the rate of excess interest over the guaranteed rate determined at the discretion of VALIC. Funds were invested in VALIC's unsegregated general account and invested primarily in long-term debt securities. The plaintiff argued that the use of a "banding method" of determining excess interest credits, involving the crediting of different rates for deposits made at different times, constituted a violation of various laws including the Securities Exchange Act of 1934. The court rejected the securities laws claims based upon its conclusion that the fixed annuity at issue was "insurance" under the Supreme Court rulings in *VALIC* and *United Benefit*. The decision focused on the guarantees in the product as well as VALIC's marketing approached which emphasized long-term accumulation of funds for retirement through compound interest. Premiums were invested as a part of the company's general account and held primarily in debt securities. The court also discussed Rule 151, which was newly adopted at the time. After noting that all elements of the Rule were satisfied by the fixed product at issue in *Otto*, the court focused on the "banding" method of interest crediting and noted that such a method had been specifically addressed and approved by the SEC in Release No. 6645. Once VALIC declared a rate, it was effective for the life of the premium deposit to which it applied. The fact that different rates were declared for subsequent premium deposits did not negate compliance with the one-year requirement for excess rates.

In *Peoria Union Stockyards Co. v. Penn Mutual Life Insurance Co.*, 698 F.2d 320 (7th Cir. 1991) the court reversed the dismissal of a securities claim arising out of a group annuity sold to the trustees of a pension fund. The annuity guaranteed interest for the first three years of the contract. After the third year, interest was to be credited at rates determined by the insurer, and, in addition, the contract was to "participate in divisible surplus" with dividends apportioned to the contract as determined by Penn Mutual's board. In determining that a viable securities claim had been alleged, the court noted that under *VALIC*, the insurer could not pass all the investment risk to the contract holder and remain exempt from registration, and under *United Benefit* the level of risk retained by the insurer must be more than minimal. Because no interest was guaranteed after the third year and because Penn Mutual sold the product on the basis of its investment expertise, the court allowed the securities based claim to go forward.

In *Associates in Adolescent Psychiatry v. Home Life Insurance Co*, 941 F.2d 561 (7th Cir. 1991), the court affirmed summary judgement for the insurer in a case involving a fixed annuity contract provided for accumulation of earnings at an annual guaranteed rate plus a variable excess rate. The excess rate was to be declared annually by the board of Home Life. The court determined that because the excess rate was declared in advance of each contract year, that adequate risk was retained by the insurer. While nothing prohibited the board of Home Life from changing the rate more than once annually, the board had varied the rate during any year. The court also remarked that the existence of a withdrawal penalty covering sales and administrative expense did not transfer investment risk to the investor.

In *Berent v. Kemper Corporation*, 780 F. Supp. 431(E.D. Mich. 1991) *affirmed* 973 F.2d 1291 (7th Cir. 1992), the plaintiff purchased a whole life policy from the defendant insurer based upon the insurer's sales materials which stated that the interest rate paid on the accumulation value of the policies would be based upon the investment experience of the insurer. First-year interest rates offered by the insurer ranged from 11.5% to 12%, which exceeded the yields on the insurer's portfolio. Second year renewal rates were lowered to 7%. The plaintiff claimed that the bonus first year rates were a form of "bait and switch" scheme. The court determined that the exemption of section 3(a)(8) applied based upon its analysis of Rule 151, noting specifically that: (i) the defendant was an insurance company subject to the supervision of a state insurance regulator; (ii) the value of the policies at issue did not vary with the investment results of a separate account (despite the fact that the insurer "segmented" its general account assets); (iii) principal and minimum interest was guaranteed at rates exceeding the applicable state nonforfeiture requirements; (iv)excess interest was guaranteed for full policy years; and the products were marketed in such a way as to emphasize the long-term insurance benefits of the policies. With respect to the marketing element, the court noted that the facts that the insurer's sales brochures discuss the investment features of the policies and that the plaintiffs themselves perceived the policies as investment vehicles did not change the conclusion that the policies at issue were not marketed primarily as investments.

In *Rothwell v. Chubb Life Insurance Company of America*, 1998 U.S. Dist. Lexis 22630 (D.N.H. 1998), the court reviewed potential securities violations involving a life insurance policy. The plaintiff alleged that sales approaches were misleading in that purchasers were led to believe that the accumulation value of the policies would cover future premiums, known as a "vanishing premium" feature. Because the products at issue were sold prior to the adoption of Rule 151, the court based its decision on section 3(a)(8) itself and related cash law, but also utilized Rule 151 to facilitate the analysis. The court noted that the insurer guaranteed principal and minimum interest, and credited excess interest yearly at a rate announced prospectively. The court distinguished the facts of cases such as *VALIC* and *United Benefit* where the rate of excess interest was determined after the insurer held the policyholder funds for some time, shifting investment risk to the policyholder. Because Chubb declared the rate in advance, the court determined that Chubb retained the investment risk.

With respect to AEL's annuity products, nothing in any of the foregoing decisions would suggest any conclusion other than that such products are clearly exempt from registration under the 33 Act.