



## An Overview of Equity-Indexed Annuities

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Equity-indexed annuities are complex investments sold by insurance companies that pay investors part of the capital appreciation in a stock index and guarantee a minimum return if the contract is held to maturity. Sales of equity-indexed annuities have soared in recent years despite the impenetrable formulas used to calculate their likely returns. Equity-indexed annuities to date have been regulated by state insurance commissions, rather than by the Securities and Exchange Commission and the NASD. In this note, we provide an overview of equity-indexed annuities. We also sketch how they can be valued. We estimate that between 15% and 20% of the premium paid by investors in equity-indexed annuities is a transfer of wealth from unsophisticated investors to insurance companies and their sales forces.

### **I. Introduction**

Since their introduction in the U.S. in 1995, sales of equity-indexed annuities have grown dramatically. Approximately \$25 billion in equity-indexed annuities were sold last year. Equity-indexed annuities are quite similar to equity-participation securities, which are traded on the American Stock Exchange under various brand names. Equity-participation securities guarantee that investors will receive the initial face value of the security plus the increase in the value of a stock or stock index reduced by an annual spread. The correspondence between equity-indexed annuities and equity-participation securities is closely analogous to the correspondence between variable annuities and mutual funds.

Insurance companies add trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to mutual funds and sell them as variable annuities. Insurance companies have added similarly trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to equity-participation securities and sell them as equity-indexed annuities. The primary difference in the correspondence is that repackaging mutual funds as variable annuities doesn't remove

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investor safeguards whereas repackaging equity-participation securities as equity-indexed annuities has heretofore exempted them from effective securities regulation.

A direct consequence of the difference in regulatory treatment is that investors in unregistered equity-indexed annuities cannot trace back through returns in the markets to the returns their investments will earn. Also, as a result of the lack of SEC and NASD oversight, investors in equity-indexed annuities cannot determine the costs they are incurring. Moreover, equity-indexed annuities' complexity makes it virtually impossible even for brokers and agents to properly evaluate the annuities. Salesmen can readily determine though that commissions paid for selling equity-indexed annuities – as high as 10% or 12% – are much larger than commissions paid on mutual funds and variable annuities.

A balanced portrayal of the costs and benefits of any equity-indexed annuity requires a comparison of its likely returns to the likely returns on alternative investments – including the investments the customer currently holds – under reasonable assumptions. Such a comparison need not be overly complicated to be informative as we will show below.

## **II. Regulation**

In 1997, the Securities and Exchange Commission issued a Concept Release requesting comment on the (then) recent advent of equity-indexed annuities. More recently, the Commission warned investors considering buying equity-indexed annuities that “You should fully understand how an equity-indexed annuity computes its index-linked interest rate before you buy.”<sup>2</sup>

In August 2005, the NASD issued a Notice to Members on the supervision of the sale of unregistered equity-indexed annuities by registered representatives.<sup>3</sup> The Notice describes some of the potentially misleading marketing claims used to sell equity-indexed annuities and encourages broker-dealers to adopt enhanced supervisory procedures for the sale of equity-indexed annuities by their registered representatives. The Notice tells broker-dealers that

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<sup>2</sup> See [www.sec.gov/rules/concept/337438.txt](http://www.sec.gov/rules/concept/337438.txt) and [www.sec.gov/investor/pubs/equityidxannuity.htm](http://www.sec.gov/investor/pubs/equityidxannuity.htm).

<sup>3</sup> See *Equity-Indexed Annuities* NASD Notice to Members 05-50, August 2005.



any recommendation to liquidate securities to purchase an equity-indexed annuity requires a determination that the equity-indexed annuity was suitable for the investor, even if the annuity is not a registered security. For a broker to determine that an equity-indexed annuity is suitable, he or she must understand the hidden costs generated within equity-indexed annuities' complex structures.

If the NASD applies the principles in Notice 05-50, broker-dealers will no longer be allowed to sell current equity-index annuities. As we explain below, existing equity-index annuities are too complicated for the majority of brokers and retail investors to understand. The complicated structures allow insurance companies to sell investments which are much more costly and much less liquid than available alternative investments. If brokers are required to understand equity-indexed annuities in the same way brokers must understand stocks, bonds or options, equity-indexed annuities must become simpler and more transparent.

The NASD updated a previous Investor Alert last summer warning potential investors that equity-indexed annuities are complex.<sup>4</sup> Combined with the Notice to Members 05-50, the Investor Alert makes clear that the NASD has determined that registered representatives who recommend that retail investors sell securities including variable annuities in order to buy equity-indexed annuities must do a thorough job explaining the features of the equity-linked annuity. It is also apparent that the NASD believes that broker dealers must supervise registered representatives, who send out sales material on equity-indexed annuities to ensure that the materials are not misleading and that any subsequent sale of an equity-indexed annuity is suitable.

The industry's trade groups are fighting back. In an effort to head off regulation of equity-indexed annuities, the National Association of Insurance and Financial Advisors sent out an Action Alert on November 29, 2005 urging its members to write the NASD and the Securities and Exchange Commission demanding the withdrawal of Notice to Members 05-50. The National Association for Fixed Annuities' December 5, 2005 *The Cry Over Indexed Annuities*:

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<sup>4</sup> See *Equity-Indexed Annuities – A Complex Choice*, NASD Investor Alert, June 30, 2005.



*Fact or Fiction, NAFA Sets the Record Straight* claims that equity-indexed annuities are not securities, that some equity-indexed annuities are suitable for seniors and that not all equity-indexed annuities have high surrender charges and pay exorbitant commissions.

### **III. Contract Features**

#### **A. Maturity**

Equity-indexed annuity contracts pay out at maturity just like zero-coupon bonds but unlike bonds the amount to be received is unknown until maturity. The payout is a function of the general level of price appreciation in the stock market at or shortly before maturity. Other things equal, equity-indexed annuities with longer maturities provide less value to investors than annuities with shorter maturities.

#### **B. Surrender Charge Schedules**

Equity-indexed annuities have surrender charges frequently of 10% or 12% and as high as 25% if premium credits are included.<sup>5</sup> The surrender charges usually decline over a period of years. On some contracts, surrender charges last throughout the contract's life, making the contract's cash surrender value less than the premiums paid for many years.

#### **C. Guaranteed Minimum Rates of Return**

Equity-indexed annuities do not guarantee that investors won't lose money. They do guarantee a minimum rate of return – typically 3% – but the guaranteed rate is typically much less than the risk free rate of return offered on US Treasury securities with the same maturity as the annuity. Also, the guaranteed rate of return is usually only applied to a fraction of the amount invested and sometimes without compounding. On some contracts, no interest is credited unless the annuity is held to maturity. Holding constant the guaranteed rate of return, the higher the risk-free interest rate, the less valuable equity-indexed annuities are to investors.

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<sup>5</sup> Premium or bonus credits are a gimmick used to sell both variable annuities and equity-indexed annuities. These credits increase the face value of the policy but are completely offset by higher surrender charges and longer surrender periods. These credits fool investors into believing they are getting something for nothing.

#### **D. The Stock Index**

Equity-indexed annuities credit the investor a return under certain circumstances based on the change in the level of a stock price index. Most equity-indexed annuities are linked to the level of the S&P 500 Index. A few equity-indexed annuities are linked to other indices.

The indexes used are price appreciation indexes and so changes in the level of the indexes do not include the dividends investors would receive if they owned the underlying stocks or stock mutual funds. Exclusion of dividends causes the changes in the S&P 500 Index level used in equity-linked annuities to significantly understate the returns earned by investors in the S&P 500, as dividends have historically accounted for 20% of the returns investors in the S&P 500 stocks have earned.

The higher the dividend yield on the index stocks, the less valuable equity-indexed annuities are to investors. The more volatile the stock index, the more valuable equity-indexed annuities are to investors.

#### **E. The Fraction of the Index Change Credited**

The participation rate is the fraction of the change in a stock index credited to the investor. Participation rates vary significantly and can be applied to different measures of index level changes. Participation rates are easy to compare but are misleading; a higher participation rate may not mean higher payouts to investors since with equity-indexed annuities all else is seldom held constant. However other things being equal, the higher the participation rate an equity-indexed annuity pays, the more valuable it is.

#### **F. The Method for Measuring Changes in the Stock Index**

There are three common formulas, called indexing methods, used to translate changes in the index level into gross returns on the contract.

The point-to-point method measures the increase in the index level from the beginning to the end of the contract's term. If the index level was 1,000 when the contract was purchased and was 1,500 when the contract matured, the point-to-point method records a 50% increase. The



point-to-point method is the traditional way to measure, quote and interpret the change in the level of an index.

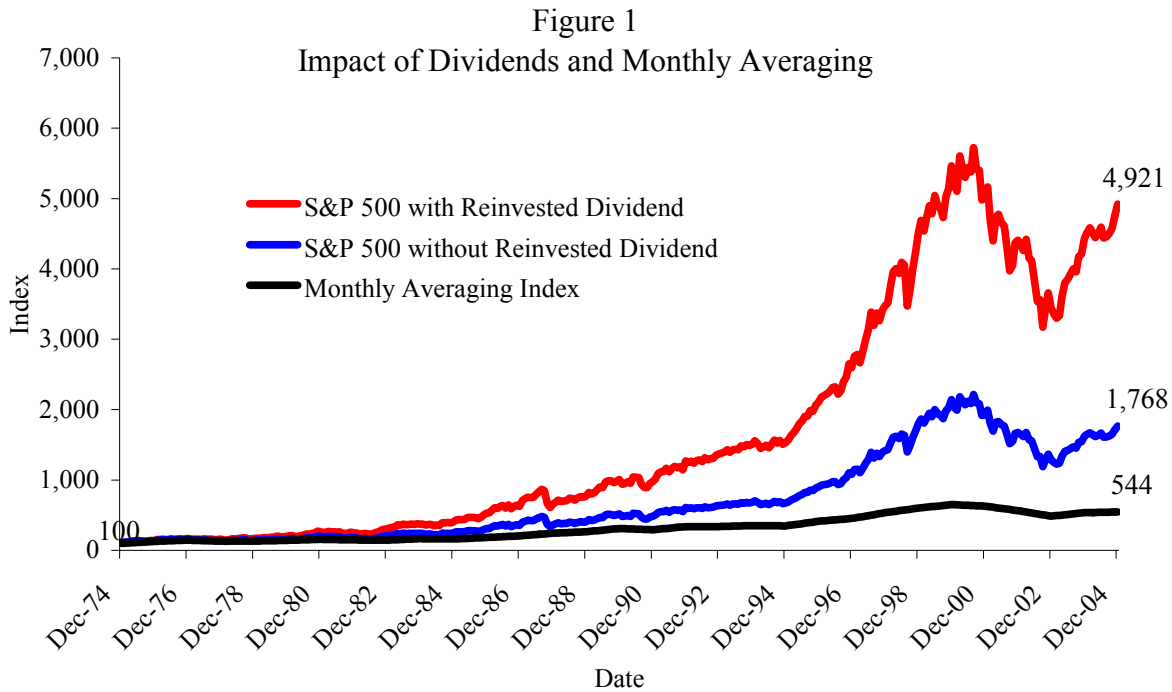
In some contracts, a point-to-point return is calculated at regular intervals, usually the contract's anniversary date, and the index value is reset or ratcheted up to reflect the credited return. If the index level is lower at the end of the contract than it was on some earlier reset date, the reset feature will record an increase that is greater than the simple point-to-point method. For instance, if in our previous example the index had been as high as 1,700 on a reset date the point-to-point with reset method will record a 70%, rather than a 50%, increase.

A more complicated indexing method - the monthly average return method - calculates the increase in the index level from the start of each year to the average month-end level during the year. The base is then reset at the beginning of the next year and the process is repeated until the contract matures. Other things equal, equity-indexed annuities with resets are more valuable than annuities without resets and point-to-point annuities are more valuable than monthly-averaging annuities.

Advocates for equity-indexed annuities claim that the monthly average return method makes the resulting calculated index level changes less volatile and that this reduced volatility makes the return guarantee less costly so the industry can offer investors a higher participation rate on annuities which use monthly averaging. Such statements are misleading since the volatility primarily relevant to the cost of the guaranteed minimum return is the volatility of the underlying stock index.

Insurance companies can offer higher participation rates on annuities with monthly averaging rather than point-to-point indexing because monthly averaging systematically understates the increase in the level of the index. The expected index change with monthly averaging will be roughly half the expected change calculated by the traditional point-to-point method. Thus, under the monthly averaging method insurance companies can claim to pay 100% participation of the calculated index level change while only paying 50% of the actual change in the index level.

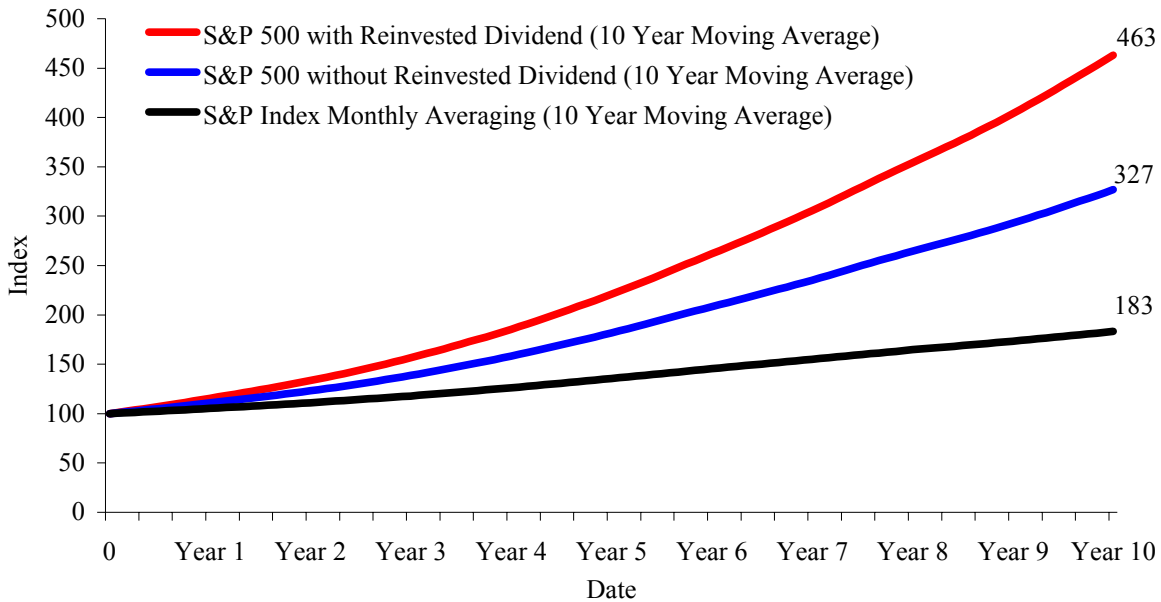
Figure 1 illustrates the impact of monthly averaging on the calculation of index changes from 1975 to 2004. On December 31, 1974 the S&P 500 closed at 68.56. The top line shows the value of the S&P 500 over time with reinvested dividends. The second line from the top shows the level of the S&P 500 index excluding dividends. As you can see, excluding dividends reduces the return over the 30 year period by 64%. The lowest line shows the value of the index calculated by applying the monthly averaging with annual reset method. Monthly averaging further reduced the change in the price level of the index by 70% over 30 years.



The impact of monthly averaging is not a phenomenon of the time period covered. We constructed 241 10-year periods by rolling 10 years of data forward one month at a time from 1975 to 2004. The first months' returns, second months' returns and so on were then averaged across the 241 periods. The impact of dividends and monthly averaging on these average returns is illustrated in Figure 2. Excluding dividends reduces the average return over 10-year periods by 29%. Monthly averaging reduces the change in the level of the index by a further 44%.

Unsophisticated investors might believe that they will get 100% of the increase from 100 to 463 when in fact they receive only 23% of this increase.

Figure 2  
Impact of Dividends and Monthly Averaging (10 Year Moving Average)



### G. Additional Deductions: Spreads, Caps and Fees

The gross credit calculated by multiplying the index change by the participation rate is then sometimes further reduced by an amount called a spread that can be as great as 3%. Thus, two contracts linked to the same index, with the same indexing method and the same participation rate can have significantly different net returns.

Caps are also used to reduce the credited index level changes on some annuities. For example, the increase in a contract's index value under the point-to-point method with annual resets might be capped at 14% meaning that the contract's index value will increase by only 14% in years when the index level increases by more than 14%. The effect of annual caps is dramatic because the average long run return to stocks is heavily influenced by years with unusually high returns. For example, the annualized price appreciation in the S&P 500 from 1975 to 2004 was



10.0%. If we cap the yearly increase at 14%, the resulting series has an annualized appreciation of only 5.5%.

#### **IV. A Simple Comparison**

Equity-indexed annuities are touted as excellent investments for investors wanting to participate in market returns without bearing market risk. We can evaluate the industry's claims by directly comparing the value of the point-to-point structure to a simple combination of stocks and Treasury Securities.

Consider a point-to-point annuity purchased on December 31, 2005 which pays out 50% of the change in the S&P 500 Index over a 10-year term. It guarantees a 3% return, compounded annually, on 90% of the premium paid and the return of the principle if the investment is held until maturity. The annuity has a 10% surrender charge which declines 1% per year. The S&P 500 Index closed on December 30, 2005 at 1,248.29. On December 30, 2015 the annuity will return to the investor \$100 plus the greater of \$30.95 (i.e. 3% interest on \$90 for 10 years) or 50% of the difference between the S&P 500 on December 30, 2015 and 1,248.29.

The comparison portfolio consists of \$60,000 invested 10-year Treasury strips maturing on December 30, 2015 and \$40,000 invested in a low cost S&P 500 Index fund.<sup>6</sup> \$60,000 would have purchased \$92,628 face value on December 31, 2005 and so the \$60,000 Treasuries investment would be worth \$92,628 on December 31, 2015 regardless of the level of the S&P500.<sup>7</sup> The \$40,000 invested in the S&P 500 Index fund will be worth more or less than \$40,000 depending on the total return on the fund. Consistent with historical dividend yields on the S&P 500 companies, we assume that the stocks in the index have an average dividend yield of 2.5%. The value of the equity-indexed annuity and of the stock/cash portfolio as a function of the level of the S&P 500 on December 31, 2015 is plotted in Figure 3. The probability distribution of the S&P 500 Index level in 2015 is also plotted in Figure 3.<sup>8</sup> Except in extremely

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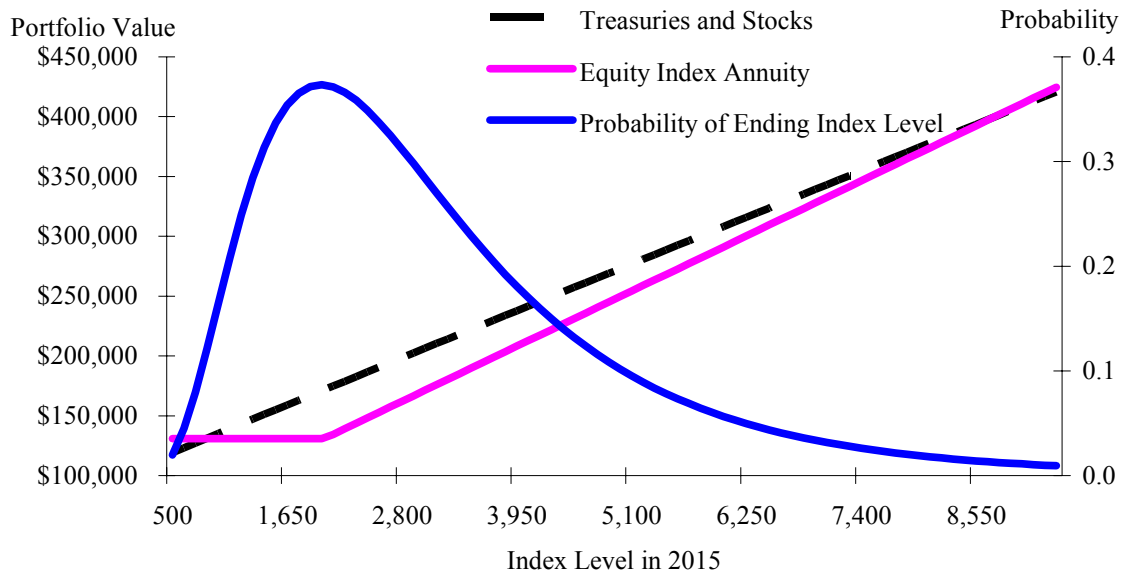
<sup>6</sup> We assume the fund has an expense ratio of 0.25%.

<sup>7</sup> The yield to maturity on 10-year strips on December 31, 2005 was 4.39%.

<sup>8</sup> The annual changes in the S&P 500 Index level are assumed to be log-normally distributed with a mean of 10% and a standard deviation of 20%.

rare cases, the equity-indexed annuity returns much less to investors than a portfolio of risk-free Treasury securities and large-cap stocks.

Figure 3  
Equity Index Annuity and 60% Treasuries / 40% Stock Portfolio  
After 10 Years



We performed a Monte Carlo simulation on the two investments pictured in Figure 3 based on realistic assumptions and determined that 96.9% of the time the investor is better off with the Treasury securities and stocks than with the equity-indexed annuity. That is, investors sold this example annuity would be worse off 96.9% of the time, even if they held the annuity to maturity and it performed exactly as designed.

After 10 years, the expected value of the Treasuries and stocks is \$219,696 and the expected value of the equity-indexed annuity is \$186,265. The \$33,431 equity-index annuity shortfall can be broken down into a \$219 expected benefit for when the annuity is better and a \$33,650 expected cost for when the Treasuries and stock would have been better. The expected

cost/benefit ratio is thus a staggering 153 to 1. That is, investors pay \$153 in costs for every \$1 in benefits relative to the Treasuries and stock portfolio.

Even this comparison is overly generous to the annuity because we have assumed that the contracts were held to maturity and so no surrender charge was applied. In addition, equity-indexed annuities are worse than our illustrations imply because of their disadvantageous tax treatment. The returns earned on equity-indexed annuities are taxed at the investor's marginal income tax rates when the returns are withdrawn. Currently this rate could be as high as 35%. Long term capital gains and dividends for most investors are currently taxed at 15%. Thus investors keep 80 or 85% of the returns earned in the stock index fund but only 65% of the returns paid out of the annuities. If, as seems likely, the before-tax return on the equity-indexed annuity equals about 40% of the before-tax return on index fund, the after-tax return on the equity-indexed annuity will equal only about 30% of the after-tax return on index fund.<sup>9</sup>

## V. Equity-Indexed Annuity Valuations

In the previous section, we illustrated the payoffs to a typical equity-indexed annuity and an ultra low-risk portfolio of Treasury securities and stocks. These illustrations suggest that typical equity-indexed annuities are a poor investments but don't tell us just how bad they are. We have extended models found in the actuarial science literature using complex mathematical formulas, numerical approximations and Monte Carlo simulations to value real world equity-indexed annuities.<sup>10</sup> Our software allows us to evaluate various equity-indexed annuities and to calculate the likelihood different investors would benefit from an equity-indexed annuity. This ongoing research is the subject of a related technical working paper.

Table 1 presents an example valuation of a 10-year point-to-point equity-indexed annuity guaranteeing a 3 percent return compounded annually on 90% of the initial premium. We

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<sup>9</sup> Withdrawals from equity-indexed annuities' made before the investor is 59 ½ may be subject to early withdrawal penalties further exacerbating the annuities' underperformance relative to Treasury securities and stock mutual funds.

<sup>10</sup> See Serena Tiong, "Valuing equity-indexed annuities," *North American Actuarial Journal*, 4, pp. 49–170, 2000 and Sebastian Jaimungal, *Pricing and Hedging Equity-indexed Annuities with Variance Gamma Deviates*, working paper, November 2004.



assume the risk-free interest rate is 4.5%, the dividend yield on the S&P 500 is 2% and the volatility is 25%. We solve for the “breakeven” participation rate,  $\alpha$ , which makes the annuity worth \$1 for each \$1 the investor pays and find it to be 92% in this example. The forgone dividends plus 8% of the total price appreciation foregone is the “fair” price for the downside protection provided by the equity-indexed annuity’s return guarantee.

**Table 1**  
**Typical Point-to-Point EIAs Have Large Hidden Costs**

Base Assumptions:		
Guaranteed Return Base (Percentage of Initial Premium)	90%	
Minimum Guaranteed Return	3%	
Years to Maturity	10	
Risk-Free Interest Rate	4.5%	
Dividend Yield	2%	
Standard Deviation	25%	
Fair Participation Rate	<b>92%</b>	
Typical Participation Rate		50%
Investment Value Per Dollar Invested	\$1.00	<b>\$0.84</b>

The last column of Table 1 re-calculates the value of the annuity under the same set of assumptions except we assume a 50% participation rate.<sup>11</sup> A 50% participation rate reduces the value of the annuity by 16%. This 16% is a good estimate of how much wealth is transferred from the investor to the insurance company and broker when the equity-indexed annuity is sold.<sup>12</sup>

There is an interesting fee and expense twist in equity-indexed annuities. Equity-indexed annuities do not have explicit annual fees or expense ratios. Instead, the insurance company makes money by giving investors less than a fair share of the increase in the value of the S&P 500 index. In the example above, fair compensation for the downside guarantee is the dividends

<sup>11</sup> 10-year point-to-point annuities typically have participation rates of around 50%.

<sup>12</sup> This example does not include many features – most of which further reduce the value of the annuity.

paid on the underlying stocks plus 8% of the capital appreciation in the S&P 500 index. The insurance company in our example takes the dividends plus 50% of the capital appreciation.

This 42% spread is more valuable to the insurer – and more costly to the investor – the longer the maturity of the equity-indexed annuity. If we change the maturity in our example to 5 years, a contractual 50% participation rate in the capital appreciation compared to the “fair” participation rate of 81% implies a cost to the investor of 8% of their investment. With a maturity of 15 years, a contractual 50% participation rate compared to the “fair” participation rate of 100% implies a cost to the investor of 23%. *See* Table 2.

**Table 2**  
**Equity-Indexed Annuities With Longer Maturity**  
**Have Higher Imbedded Costs**

Years to Maturity	5	10	15
Fair Participation in Capital Appreciation	81%	92%	100%
Investment Costs at 50% Participation	\$0.08	\$0.16	\$0.23

## **VI. Conclusion**

Equity-indexed annuities are complicated investments sold to unsophisticated investors without the regulatory safeguards afforded to purchasers of similar investments. If brokers and agents told investors of the effect equity-indexed annuities’ shaving of index returns and extraordinary costs the market for these products would dry up.

Ironically, both the SEC and the NASD caution investors to review and understand the impact on likely returns of the myriad equity-indexed annuity features. No registered rep, insurance broker, or retail investor, and precious few finance PhDs, could understand these products. The net result of equity-indexed annuities’ complex formulas and hidden costs is that they survive as the most confiscatory investments sold to retail investors.

**NASD Notices to Members**

**Equity-Indexed Annuities**

# Notice to Members

AUGUST 2005

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Registered Representatives  
Senior Management  
Executive Representatives  
Insurance  
Variable Contracts

## KEY TOPICS

Equity-Indexed Annuities  
Rule 3030 (Outside Business Activities  
of an Associated Person)  
Rule 3040 (Private Securities Transactions  
of an Associated Person)  
Supervision

## GUIDANCE

### Equity-Indexed Annuities

#### Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities

#### Executive Summary

This *Notice to Members* addresses the responsibility of firms to supervise the sale by their associated persons of equity-indexed annuities (EIAs) that are not registered under the federal securities laws.<sup>1</sup>

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, (240) 386-4500.

#### Background and Discussion

Equity-indexed annuities are 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. Some EIAs are not registered under the Securities Act of 1933 (the Securities Act) based on a determination that they are insurance products that fall within that statute's Section 3(a)(8) exemption and therefore are not considered to be securities.<sup>2</sup>

According to one recently published estimate, in 2004 sales of equity-indexed annuities increased over 50 percent, from \$14 billion in 2003 to an estimated \$22 billion.<sup>3</sup>

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## 1. Investor Protection Issues Presented by Equity-Indexed Annuities

EIAs are complex investments. Many EIAs permit investors to participate in only a stated percentage of an increase in an index. Many of these investments also impose a “cap rate” that represents the maximum annual account value percentage increase allowed to investors. Unregistered EIAs typically do not provide for investor participation in the dividends accumulated on the securities represented by the index.<sup>4</sup> EIAs have other features that contribute to their complexity such as minimum guarantees and fees and expenses, including surrender charges, premium bonuses, and multiple premium payment arrangements. In addition, investors may assume mistakenly that EIAs provide the same returns as an index mutual fund.

NASD is concerned about the manner in which associated persons are marketing and selling unregistered EIAs, and the absence of adequate supervision of these sales practices. We have seen sales material for unregistered EIAs that do not fully describe the features and risks of the product. For example, we have seen the following claims:

- ◆ “What if the market goes down and you would lose nothing? The market goes up-you gain!”
- ◆ “A Win/Win Investment Vehicle!”
- ◆ “How Your Retirement Funds Can Have: Security of Principal, Higher Than CD Rates of Interest, Opportunity for Growth (No Losses)”
- ◆ “Pick up where Social Security leaves off with NEW tax-deferred annuities...featuring... 2 indexed accounts linked to a popular stock market index.”
- ◆ If you’re looking for upside potential and no market downside look no further than [name of EIA]. This fixed annuity... enables you to make the most of S&P 500 Index gains...”
- ◆ “Growth Potential *without* Market Risk.”

We understand that some associated persons who also act as insurance agents might be using this type of sales material in their insurance sales capacity. NASD is concerned that the unsupervised use of such sales material could confuse or mislead investors. If sales pieces containing these statements were deemed to be broker-dealer communications with the public, then they would be subject to the NASD advertising rules, and would have to provide a balanced description of the features and risks of the product.

Moreover, because of the product’s complexity, some associated persons might have difficulty understanding all of the features of the product and determining the extent to which those features meet the needs of the customer. While unregistered EIAs may be appropriate for some retail investors, they are not suitable for all investors. For example, possible surrender charges and the combination of caps and participation rates associated with a particular product are factors that must be considered in any suitability determination.



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## 2. The Uncertain Status of Unregistered Equity-Indexed Annuities

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. NASD does not seek to resolve that issue in this *Notice*; nor is this *Notice* intended to describe those circumstances in which an EIA might be deemed to be a security. However, a brief summary of the applicable provisions of the federal securities laws may be useful.

Section 2(a)(1) of the Securities Act broadly defines “security” to include such financial instruments as evidence of indebtedness, participation in profit-sharing agreements, and investment contracts. Section 3(a)(8) generally exempts from the Securities Act any security that is an “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 Commission adopted Rule 151, a “safe harbor” under the Securities Act, which clarifies when certain annuity contracts are exempted securities under Section 3(a)(8). The fundamental construct of Rule 151 is derived from prior judicial interpretations of Section 3(a)(8). Consequently, the Commission has stated that the rationale underlying the conditions set forth in the rule are, along with applicable judicial interpretations, relevant to any Section 3(a)(8) analysis.<sup>5</sup>

In order for the Rule 151 safe harbor to apply:

- ◆ the product must be issued by an insurer that is subject to state insurance regulation;
- ◆ the insurer must assume investment risk, as provided in paragraph (b) of the rule; and
- ◆ the product may not be marketed primarily as an investment.

As noted above, the status of any particular EIA under the safe harbor (or under Section 3(a)(8)) will depend on the facts and circumstances. In 1997 the Commission issued a concept release requesting comment regarding EIAs.<sup>6</sup>

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### 3. Supervision under Rule 3030 and Rule 3040

Many firms assume that EIAs that are not registered under the Securities Act are insurance products and not securities. These firms treat the sale of unregistered EIAs by associated persons in their capacity as insurance agents as an outside business activity under Rule 3030, beyond the mandated purview of the firm's supervision. Rule 3030 does not require that the firm supervise or even approve an outside business activity, although a firm may choose to deny or limit the ability of associated persons to engage in the activity. Rule 3030 simply requires that an associated person promptly notify the firm in writing that he is engaging in a business activity outside the scope of his relationship with the firm.

However, if a particular EIA were a security, and an associated person sold the EIA outside the regular scope of his employment with the firm, Rule 3040 requires that the firm treat the sale as a private securities transaction and supervise the sale in accordance with the provisions of that rule. The associated person must notify the firm in writing before participating in a private securities transaction. If the associated person will receive compensation for the transaction, the firm must provide written approval of his participation in the transaction. If the firm does approve the participation, it must record the transaction on its books and records and supervise the associated person's participation in the transaction as if the transaction were executed on behalf of the firm.

A broker-dealer runs certain risks in applying Rule 3030 to the sale of an unregistered EIA on the assumption that the product is not a security. It is often unclear whether a particular EIA qualifies for the exemption under Section 3(a)(8), since the analysis is made on a case-by-case basis and may turn on the particular features and marketing materials associated with the product. As a result, if a particular EIA did not qualify for the exemption, a firm might incorrectly treat the EIA transaction as an outside business activity under Rule 3030 rather than a private securities transaction under Rule 3040 and thereby fail to supervise sales of the product as required by NASD rules.

Perhaps for these reasons, some firms require that associated persons obtain firm approval to sell exempt insurance products. Other firms require that their associated persons obtain more specific approval to sell unregistered EIAs. Still other firms maintain a list of approved EIAs and prohibit the sale of all others.

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#### 4. Supervisory Measures

Due to the uncertainty as to whether a particular unregistered EIA may be a security, as well as the potential regulatory violations and investor protection issues that would arise by the marketing and sale of unregistered EIAs that are deemed to be securities, firms must adopt special procedures under Rule 3030 with respect to these products. In particular, firms must require that their associated persons promptly notify the firm in writing when they intend to sell unregistered EIAs. Moreover, all recommendations to liquidate or surrender a registered security such as a mutual fund, variable annuity, or variable life contract must be suitable, including where such liquidations or surrender are for the purpose of funding the purchase of an unregistered EIA.

As discussed above, NASD is not taking a position on whether a particular EIA is a security, nor are we attempting to describe the circumstances in which an EIA would be deemed a security. However, the uncertainty of this matter has led some firms to treat an associated person's sale of an unregistered EIA outside the regular course or scope of his employment with the firm, as a private securities transaction. These firms supervise the sale according to Rule 3040 procedures. Firms are well advised to consider whether they should take a similar approach. Firms should consider maintaining a list of acceptable unregistered EIAs and prohibiting their associated persons from selling any other unregistered EIA, unless the associated person notifies the firm in writing that he intends to recommend an unregistered EIA that is not on the firm's list, and receives the firm's written confirmation that the sale of the unregistered EIA is acceptable.

Firms are encouraged to consider whether other supervisory procedures also might help protect the firm's customers. For example, a firm could require that all sales of unregistered EIAs occur through the firm. If an associated person is selling the unregistered EIA through the firm, the firm must supervise the marketing material, suitability analysis, and other sales practices associated with the recommendation of unregistered EIAs in the same manner that it supervises the sale of securities.

Firms also must provide any associated person selling any unregistered EIA through the firm with the proper training to understand the EIA's features and the extent to which the EIA meets the needs of a particular customer. The fact that an associated person holds a license as an insurance agent may not adequately qualify him to understand the features of an EIA or the extent to which an EIA meets the needs of a particular customer.

Of course, in this as in all other areas, NASD expects every associated person to comply with the procedures adopted by his firm.

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## Endnotes

- 1 The sale of an EIA registered under the federal securities laws is subject to the full panoply of regulation applicable to the sale of any security.  
  
The principles articulated in this *Notice* apply to EIAs that are sold by associated persons of a broker-dealer, whether the EIA has been manufactured by an insurance company that is affiliated with the broker-dealer or by an unaffiliated insurance company.
- 2 The Securities and Exchange Commission (the Commission) has previously stated that Congress intended any insurance contract falling within Section 3(a)(8) to be excluded from all provisions of the Securities Act notwithstanding the language of the Act indicating that Section 3(a)(8) is an exemption from registration but not the antifraud provisions. See Definition of "Annuity Contract or Optional Annuity Contract," Securities Act Release No. 6558 (Nov. 21, 1984), 49 Fed. Reg. 46750, 46753 (Nov. 28, 1984).
- 3 "A Do-It-Yourself Kit for Investors: Build Your Own Equity-Indexed Annuity," *The Wall Street Journal* (January 26, 2005).
- 4 The index return may be calculated in a variety of ways, such as the "annual reset" method, under which the index starting point is reset each contract year; the "point-to-point" method, under which the change in the index from the start of a term is compared to the index at the end of the term; and the "annual high-water mark with look-back" method, which is a variation on the point-to-point method except that it compares the index starting point to the highest anniversary value during the term.
- 5 Securities Act Release No. 6645, 35 SEC Docket 952 (May 29, 1986) (adopting Rule 151) ("Adopting Release").
- 6 Request for Comment on Equity-Indexed Products, Securities Act Release No. 7438; File No. 57-22-97 (August 20, 1997). At least one court has ruled on the question of whether an EIA is a security. The court granted a motion to dismiss based upon the finding that the EIA, which was the subject of litigation, in that case was exempt from the federal securities laws. See *Malone v. Addison Insurance Marketing*, 225 F. Supp. 2d 743 (W.D. Ky. 2002).

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Last Updated: 6/30/05

## NASD Investor Alert



### Equity-Indexed Annuities-A Complex Choice

Updated: June 30, 2005

#### Why an Alert on Equity-Indexed Annuities?

Sales of **equity-indexed annuities (EIAs)** have grown considerably in recent years. Although one insurance company includes the word "simple" in the name of their product, EIAs are anything but easy to understand. One of the most confusing features of an EIA is the method used to calculate the gain in the index to which the annuity is linked. To make matters worse, there is not one, but several different indexing methods. Because of the variety and complexity of the methods used to credit interest, investors will find it difficult to compare one EIA to another.

Before you buy an EIA, you should understand the various features of this investment and be prepared to ask your insurance agent, broker, financial planner, or other financial professional lots of questions about whether an EIA is right for you.

#### What is an Annuity?

An annuity is a contract between you and an insurance company in which the company promises to make periodic payments to you, starting immediately or at some future time. If the payments are delayed to the future, you have a **deferred annuity**. If the payments start immediately, you have an **immediate annuity**. You buy the annuity either with a single payment or a series of payments called premiums.

Annuities come in two types: fixed and variable. With a **fixed annuity**, the insurance company guarantees both the rate of return and the payout. As its name implies, a **variable annuity's** rate of return is not stable, but varies with the stock, bond, and money market funds that you choose as investment options. There is no guarantee that you will earn any return on your investment and there is a risk that you will lose money. Unlike fixed contracts, variable annuities are securities registered with the Securities and Exchange Commission (SEC). To learn more about variable annuities, read our Investor Alert, [Should You Exchange Your Variable Annuity?](#)

#### What is an Equity-Indexed Annuity?

EIAs have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. So EIAs give you more risk (but more potential return) than a fixed annuity but less risk (and less potential return) than a variable annuity.

EIAs offer a minimum guaranteed interest rate combined with an interest rate linked to a market index. Because of the guaranteed interest rate, EIAs have less market risk than variable annuities. EIAs also have the potential to earn returns better than traditional fixed annuities when the stock market is rising.

#### What is the Guaranteed Minimum Return?

The guaranteed minimum return for an EIA is typically 90% of the premium paid at a 3% annual interest rate. However, if you surrender your EIA early, you may have to pay a significant surrender charge and a 10% tax penalty that will reduce or eliminate any return.

#### How good is this guarantee?

Your guaranteed return is only as good as the insurance company that gives it. While it is not a common occurrence that a life insurance company is unable to meet its obligations, it happens. There are several

private companies that rate an insurance company's financial strength. Information about these firms can be found on the [New Jersey Department of Banking & Insurance's Web site](#).

**What is a market index?**

A market index tracks the performance of a specific group of stocks representing a particular segment of the market, or in some cases an entire market. For example, the S&P 500 Composite Stock Price Index is an index of 500 stocks intended to be representative of a broad segment of the market. There are indexes for almost every conceivable sector of the stock market. Most EIAs are based on the S&P 500, but other indexes also are used. Some EIAs even allow investors to select one or more indexes.

**How is an EIA's index-linked interest rate computed?**

The index-linked gain depends on the particular combination of indexing features that an EIA uses. The most common indexing features are listed below. To fully understand an EIA, make sure you not only understand each feature, but also how the features work together since these features can dramatically impact the return on your investment.

- **Participation Rates.** A participation rate determines how much of the gain in the index will be credited to the annuity. For example, the insurance company may set the participation rate at 80%, which means the annuity would only be credited with 80% of the gain experienced by the index.
- **Spread/Margin/Asset Fee.** Some EIAs use a spread, margin or asset fee in addition to, or instead of, a participation rate. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10% and the spread/margin/asset fee is 3.5%, then the gain in the annuity would be only 6.5%.
- **Interest Rate Caps.** Some EIAs may put a cap or upper limit on your return. This cap rate is generally stated as a percentage. This is the maximum rate of interest the annuity will earn. For example, if the index linked to the annuity gained 10% and the cap rate was 8%, then the gain in the annuity would be 8%.

**Caution!** Some EIAs allow the insurance company to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurance company subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, this could adversely affect your return. Read your contract carefully to see if it allows the insurance company to change these features.

**Indexing Methods.** As described in the table below, there are several methods for determining the change in the relevant index over the period of the annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index.

Indexing Method	Description
Annual Reset (Ratchet)	Compares the change in the index from the beginning to the end of each year. Any declines are ignored. <b>Advantage:</b> Your gain is "locked in" each year. <b>Disadvantage:</b> Can be combined with other features, such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.
High Water Mark	Looks at the index value at various points during the contract, usually annual anniversaries. It then takes the highest of these values and compares it to the index level at the start of the term. <b>Advantage:</b> May credit you with more interest than other indexing methods and protect against declines in the index.

Point-to-Point	<p><b>Disadvantage:</b> Because interest is not credited until the end of the term, you may not receive any index-link gain if you surrender your EIA early. It can also be combined with other features; such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.</p> <p>Compares the change in the index at two discrete points in time, such as the beginning and ending dates of the contract term.</p> <p><b>Advantage:</b> May be combined with other features, such as higher cap and participation rates, that may credit you with more interest.</p> <p><b>Disadvantage:</b> Relies on single point in time to calculate interest. Therefore, even if the index that your annuity is linked to is going up throughout the term of your investment, if it declines dramatically on the last day of the term, then part or all of the earlier gain can be lost. Because interest is not credited until the end of the term, you may not receive any index-link gain if you surrender your EIA early.</p>
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- **Index Averaging.** Some EIAs average an index's value either daily or monthly rather than use the actual value of the index on a specified date. Averaging may reduce the amount of index-linked interest you earn.
- **Interest Calculation.** The way that an insurance company calculates interest earned during the term of an EIA can make a big difference in the amount of money you will earn. Some EIAs pay simple interest during the term of the annuity. Because there is no compounding of interest, your return will be lower.
- **Exclusion of Dividends.** Most EIAs only count equity index gains from market price changes, excluding any gains from dividends. Since you're not earning dividends, you won't earn as much as if you invested directly in the market.

### Can I get my money when I need it?

EIAs are long-term investments. Getting out early may mean taking a loss. Many EIAs have surrender charges. The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA.

Also, any withdrawals from tax-deferred annuities before you reach the age of 59½ are generally subject to a 10% tax penalty in addition to any gain being taxed as ordinary income.

### Do EIAs and other tax-deferred annuities provide the same advantages as 401(k)s and other before tax retirement plans?

No, 401(k) plans and other before-tax retirement savings plans not only allow you to defer taxes on income and investment gains, but your contributions reduce your current taxable income. That's why most investors should consider an EIA and other annuity products only after they make the maximum contribution to their 401(k) and other before-tax retirement plans. To learn more about 401(k)s, please read [Smart 401\(k\) Investing](#).

### Is it possible to lose money in an EIA?

Yes. Many insurance companies only guarantee that you'll receive 90% of the premiums you paid, plus at least 3% interest. Therefore, if you don't receive any index-linked interest, you could lose money on your investment. One way that you could not receive any index-linked interest is if the index linked to your annuity declines. The other way you may not receive any index-linked interest is if you surrender your EIA before maturity. Some insurance companies will not credit you with index-linked interest when you surrender your annuity early.

## If You Have Questions

If you have questions about EIAs, you can contact your [state insurance commissioner](#). You can check out whether the person selling an EIA is registered with the NASD check [NASD BrokerCheck](#) or call our Hotline at (800) 289-9999.

## Additional Resources

NASD Investor Alert, "[Variable Annuities: Beyond the Hard Sell](#)"

NASD Investor Alert, "[Should You Exchange Your Variable Annuity?](#)"

National Association of Insurance Commissioners' [Buyer's Guide to Equity-Indexed Annuities](#).

Securities and Exchange Commission's [Variable Annuities: What You Should Know](#).

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