

## MEMORANDUM

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

Date: August 23, 2005

From: Wendy L. Carlson  
General Counsel

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### 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 and 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.

<b>General requirements applicable to all annuity sales</b>			
• 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.			

<b>Specific requirements for index annuities</b>
• The Index is referred to primarily as a factor that, <i>in part</i> , 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

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**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”

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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.

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.

