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EQUITY-ORIENTED PRODUCTS

I. *Organization of an Equity-Product Operation*
   A. What problems are encountered in the establishment of a variable annuity operation in the following areas:
      1. Compliance with state insurance laws and regulations?
      2. Formation of a broker-dealership?
      3. Licensing and training of field and home office personnel?
      4. Administration?
   B. What investment of funds and what special personnel are required to enter the variable annuity field? What extent of surplus commitment is required to support an assumed expanding volume of business?
   C. What problems are encountered in items A and B above with respect to a mutual fund operation?

New York Regional Meeting

MR. JOHN J. BYRNE: Mr. Wilde and I represent companies involved in both the mutual funds and the variable annuity business, and with respect to questions I, A, and I, B, our experience has been that it is very difficult to decide what was done because of the variable annuity operations and what was done because of mutual fund operations. In many respects, they are integrated. I will keep my comments aimed at the variable annuity side.

On compliance with state insurance laws and regulations there are three basic problems: (1) to get the company licensed, (2) to get the people licensed, and (3) to get the product approved. Getting the company approved today is not the problem that it was a year and a half ago.

In the roughly forty-five states permitting variable annuities today, for a company of any real substance there is no problem in getting the company licensed, except in Texas and one or two other states.

Getting the people licensed continues to be a problem, although once again it is materially better than it was thirteen months ago when we started. The early problem was that the staffs of the insurance departments had not really adopted their regulations yet. This has improved, but regulation is still not completely homogeneous and that causes extra expense and extra problems.

We have broken the people-licensing problem into two functional areas. One group of people is concerned with educational aspects of the license; another group is concerned with the administration aspects (of the license). Our experience, and that of many other companies, has been that we have underassessed the administration aspects of getting persons licensed. Now we are getting three licenses—the NASD registered representative license at the federal level, the state securities license, and the state variable annuity license. The administrative elements—the biographies, the letters of reference, the photographs, the signatures, and the fees—use substantial resources in the home office. The state securities license application raises more administrative problems than the state variable annuity license does.

In terms of product approval, once again the level of knowledge at the insurance department staff level is significantly better today than it was just a short year ago.

There are still irritants and a few things of real substance that, for the most part, you try to work around. One problem is with the assumed interest rate on variable annuities in some states; another is the whole problem of separate account accounting and annual statement presentation; a third is the matter of reserve bases against some of the revenues that flow from the loads.

The Industry Advisory Committee of the NAIC has done a fine job of drafting a model bill and model regulations; if it reaches law, life will be much easier for us in the variable annuity business.

MR. PETER R. WILDE: If you go both the mutual fund and the variable annuity product route, you are probably going to set up a subsidiary dealer, and that raises questions about minimum capital requirements and such matters.

One thing we did turn up at the state level was the noxious question about branch offices. Everyone concerns himself at the federal level with this question as it applies to the definition in the NASD rules, but it is probably a more difficult problem at the state level because of questions about a foreign corporation "doing business" there and the requirement that you must therefore file income tax returns and the like for both the company and the personnel in that state. Those of you who want to list your company's name in the Yellow Pages and on the bulletin board might consider the potential implication of "doing business."

MR. BYRNE: The Travelers formed a separate corporation as a broker-dealer. We joined the National Association of Securities Dealers.

Looking back on those decisions, I think that, if we had been in variable annuities only, the case might not have been quite as clear-cut as it is in the mutual fund business.

The arguments given in favor of separate corporations were the following: to encapsulate the total securities accounting problems, to give us better cost accounting, and to encapsulate the broker-dealer–reporting requirements. When the insurance company itself is the broker-dealer, it can cause some problems which can be avoided with a separate corporation. As to this grand world of securities liability, whatever that is going to mean to us in the years ahead, it seems to us that you can more easily isolate this with a separate corporation than by exposing the whole insurance corporation to those liabilities.

MR. WILDE: The NASD has a modest capitalization requirement necessary for forming a broker-dealer. When you check state laws, you will find that you will need fidelity bonds in many states if you have less than $25,000 capital and that, at least in the state of Michigan, you must have $100,000.

Another thing which may come as a shock is that, if you form a subsidiary dealer, it is far from clear today how you can treat the sales-charge moneys that are being paid over to the life company for acquisition of business. At least in Connecticut General we suspect that you will have to demonstrate that you are in effect performing an expense-reimbursement function and not arbitrarily paying a per cent of first commissions without justifying the moneys you have paid. The reason is that you cannot pay sales dollars to an unlicensed entity, be it a person or a company. So, if you are going to set up a subsidiary dealership, you have some exciting expense-allocating and -accounting jobs in front of you.

MR. BYRNE: On question I, B, our experience has been that it takes substantially more resources to start a variable annuity marketing operation than it does a mutual fund marketing operation in terms of people, money, and time. On the variable annuity side you would be surprised at how many good lawyers you can soak up.

The one area that often gets underassessed is the terrific amount of marketing skill required. In particular, in our company, we put some of our advanced underwriting people (whom we did not have enough of anyway) full time on the variable annuity marketing operation.

In terms of investment of capital, I will mention a number but only after qualification. If we are talking about a variable annuity operation with a relatively large staff, licensing three thousand registered representatives, with new first-year premium goals somewhere in the area of $3–$5 million after maturity, and with a complete data-processing system running, my personal estimate is somewhere between $600,000 and $1,000,000. Any complete job for less than that is fine work.

Two important qualifications are systems design, which is a big chunk, and the people-licensing job. It is very expensive, the people-licensing job. The figure usually quoted is $100 per person, but that is low! If you can start from scratch, teach yourself all the pertinent parts, go to all the regulatory authorities, learn it all, and get two thousand people licensed for less than $100 per person, you have done a very fine job.

In terms of surplus strain on a mature running operation with increasing business, there are all kinds of different merchandise, and, of course, each piece of merchandise will carry a different surplus drain with it. But, as an example, for a level load annual premium deferred annuity, I feel that somewhere between 10 and 20 per cent of first-year premium is acceptable as a realistic surplus drain.

CHAIRMAN HARRY WALKER: That depends on the loading scale and the level of commissions you are paying. There is much more surplus strain when you have a relatively high commission.

MR. BYRNE: Yes, but there are recent movements in the field that are applying pressure against paying commissions above the load, and my own opinion is that within twelve months we will not be permitted to pay commissions higher than the load.

What you say is absolutely true for the current status; if you have a 7 per cent load product and you are in fact paying a 15 per cent commission, that causes more surplus drain than my numbers. When I made my statement, I was thinking of a commission of no more than 120 per cent of the first-year load.

If some of the new products coming out have a high first-year administration fee, then, of course, that will lessen the surplus drain considerably.

MR. WILDE: Connecticut General is paying the licensing fees for our people. We spent $500,000, and we will approach $1 million before the financial drain turns downward.

If you have an unlicensed man out there talking to clients, he is almost invariably going to discuss variable annuities and the distribution devices, so I think that you had better set up early licensing of people for equity products. As long as you are going to go through with it for variable annuities, you might as well get the job done for mutual funds at the same time (if you have both products) and get it out of the way. That is going to run your costs up fairly well because of the turnover problem in the early years.

The question of whom to license rests a great deal on whether it is an inside or a subsidiary organization. The licensing costs for principals, although substantial in terms of dollars, are more significant in terms of time commitment to get these people (1) to accept the fact that they have to take the test and (2) to find the time to do it.

When you will "break even" has a great deal to do with company philosophy. Do you want to make any money on the sales charge? There is a school of thought that says that it is not popular to do this in the mutual fund industry, but that is because they want to plow money back into the business rather than because they have to. Costs and when you break even are influenced by so many parameters that it is almost impossible to pick some number. When you hear Jack Byrne and me estimate half a million dollars to start and a million dollars in toto, bear in mind that this may have no relation to your operation.

MR. BYRNE: The difference between the principal's examination of the NASD and the registered representative examination is quite significant.

Legally, we could make a case for perhaps four or five of our officers' becoming principals; instead, as a management device, we put about twenty-five through. Variable annuities and mutual funds are very much an integral part of our life department in The Travelers, and we think that it has been worthwhile to have twenty-five officers in the company understand the regulatory structure that we are working with.

MR. GEORGE T. MITCHELL: To get an individual, qualified, variable annuity product on the market cost the Equitable (N.Y.) about $600,000 in development costs. This includes the first round of agents' licensing costs, but it did not include the full development of an EDP system to administer our product. The marginal cost to get additional products or separate accounts going is much smaller than the start-up costs for the first product.

CHAIRMAN WALKER: When Equitable originally filed with the SEC, we intended to include in one separate account our annual premium deferred variable annuity for the qualified market, as well as a no-load equity-funded auxiliary fund agreement for qualified pension trusts. The SEC would not approve a loaded variable annuity and a no-load side fund in the same separate account.

We have currently filed, however, for a new 1940 Act separate account that would, hopefully, enable us to do a no-load side fund business in combination with the ordinary life type of policy.

Proposed Rule 6(e)-1, if and when it becomes effective, will probably permit the setting-up of a separate account for such a side fund without a 1940 Act registration.

MR. WILLIAM C. BROWN: Are your companies paying for NASD license fees for your men, as well as state and municipal license fees?

MR. BYRNE: We split the fees with our agents. The way we split them varies, because the fee structures vary so much from state to state. In general, the agent is paying the examination fee and any fees associated with his course of study, and we are paying the NASD registration fee.

In California, for example, the state securities fee is very substantial, so that we take a look state by state. Roughly it works out that, if there is typically $85 in fees, we pay a little more than half of that.

The educational system, the lecturers going around the country, hotel rooms, and so forth—everything except the cost of the man's time and, say, $55 typically, we are paying.

MR. WILDE: We pay all the fees for a man in one state, and, if he lives in a city like Kansas City, Missouri, we license him in both Kansas and Missouri. On the other hand, if we have an agent in Connecticut who has a widowed aunt in Alabama, he pays the Alabama charges.

If he flunks the examination, he puts up the fee the next time, so that he has some incentive to get through the first time.

CHAIRMAN WALKER: CG has an array of variable annuity products in registration that will utilize the unit investment approach with an underlying mutual fund. Peter, will you comment on the pros and cons of that approach?

MR. WILDE: Among the advantages of the unit trust is the fact that you only have to worry about one set of voting rights, one shareholders' meeting, one board of directors, and one portfolio manager. Future equity products (such things as variable insurance) can make use of the existing pool with the existing track record. The agents only need to learn about the one fund that you are managing. Further, there is a built-in relationship of investment performance among the various variable products, especially if you only have one investment pool. Finally, there is the potential availability to other entities of using their own unit investment trust with our underlying fund.

The disadvantages are four in number: (1) You have to have two filings for the product, one for the initial fund and a separate filing for the trust itself. (2) The SEC appears to exercise more jurisdiction over the administrative and other charges if a unit trust is involved than if a separate account is used. (3) There are some dual expenses for transfer agent's fees and shareholder accounting, but bear in mind that there may be very few shareholders of the mutual fund (i.e., the unit investment trusts themselves). (4) There are special problems in some states, but so far we have not found any overwhelming problem.

MR. BYRNE: Is the product filed with state securities departments?

MR. WILDE: No.

CHAIRMAN WALKER: In a separate account, investment income is not taxed, whether or not you are dealing with a qualified area, but capital gains are taxed in the nonqualified area and are not taxed in the qualified area. Could you not have an investment philosophy with emphasis on investment income in the nonqualified market and greater emphasis on capital growth in the qualified market?

MR. WILDE: That is a possibility. We certainly have not precluded having another mutual fund with different investment objectives with another unit trust.

Atlanta Regional Meeting

CHAIRMAN JOHN MACARCHUK: Equity-oriented products represent one of the most fundamental and far-reaching developments that have taken place in the life insurance business. We live in a time when there is a growing recognition of the close relationship existing between the life insurance industry, the mutual fund industry, the banking industry, and the securities industry. There are growing signs that these several industries are moving closer together in the products and services which they offer. There are also growing signs that the corporate structures which furnish these products and services are being reshaped to accommodate a broader spectrum of products and services.

MR. HAROLD G. INGRAHAM, JR.: There are three basic ways in which a life insurance company may establish itself in the mutual fund business—by buying, by building, or by bowing to reality. A brief review of each of these alternate paths is pertinent to this discussion.

The acquisition of an existing fund is expensive, and the larger the fund and the better its performance, the higher the price. However, if money is not a problem and if the fund is nationally known, this is a quick way to get into the business with an instant earning asset on which to build. Furthermore, the insurer has also acquired a valuable human asset in terms of investment management talent. Retention of this talent, however, may be another matter, since salaries and fringe benefits in the fund industry at nearly every level of responsibility are measurably higher.

Forming one's own fund or funds is an adventure which should be embarked on by only the largest companies. It involves the full gamut of federal and state registration and regulation and requires a significant commitment of insurance company staff. While relatively inexpensive as opposed to purchasing an existing fund, it has the disadvantage of lacking an immediate record of investment performance. Eventually, this route offers the long-term profit potential of fund management, but only when the fund reaches a sufficient size to make the management fees attractive.

Bowing to reality—meaning affiliation with an existing fund or funds—best complements the capabilities and capacities of smaller and medium-sized insurance companies. One practical approach is for a group of insurers to create a broker-dealership and to register this sales company with the SEC, the NASD, the the various states in which the insurers do or wish to do business. The broker-dealer will probably be given a number of established mutual funds to sell, by means of selling agreements executed with the fund sponsors. This approach is relatively inexpensive, and it provides better control over the sales force than if an insurance company's agents were simply encouraged to become registered representatives of an existing NASD member for the purpose of selling one or more mutual funds.

It should be kept in mind that a mutual fund is registered under the 1940 Act, while its shares are registered under the 1933 Act and under various state "blue sky" laws. Registration of a broker-dealership under the 1934 Act and under various state laws is also required in order for it to function as the fund underwriter and distributor.

A decision must be made on whether the distributor entity will become a member of the NASD or submit to direct SEC regulation under Rule 15(b)8-1 of the 1934 Act. The pronounced trend today is toward the NASD. In this regard the control of one's sales force may be an important issue. No registered representative of a broker-dealer may sell the shares of any fund with whom that broker-dealer does not have a sales agreement. Therefore, an NASD member may prevent, if it wishes, the sale of other funds by its registered representatives by simply not negotiating other sales agreements. Also, while it is true that the NASD bylaws permit a representative to be registered with more than one broker-dealer, such dual registration can only be effected with the dual consent of both members.

The minimum capital required by the SEC in order to operate as a broker-dealer appears to be $5,000, with activities limited to the sale of mutual fund shares. However, several states require substantially larger sums as minimum capital, and some states require fidelity bonds. An increasing number of states impose a prior-experience requirement on the officers of a broker-dealer before licensing and registration are permitted.

The broker-dealership should make its registered representatives aware of NASD and SECO "suitability" rules. The most common violation of the "suitability" rule is found in "switching" a customer from one fund to another or continually taking a customer in and out of funds. An individual switch from one fund to another may not be improper, given all the facts, but the registered representative must tell his customer that an additional sales charge will be involved. Trading a customer in and out of funds, on the other hand, would undoubtedly be found unsuitable, regardless of who or how wealthy the customer is, simply because there is no logical investment purpose to be served by such an action and the cost to the customer in additional commissions is substantial.

All sales literature must be precleared by the NASD or SEC before use, and such literature can only be used if accompanied or preceded by an appropriate prospectus. The relatively casual attitudes typical in the insurance industry relative to sales aids may result in adverse consequences in the securities business.

In some states completion of SEC registration requirements will be all that is needed. In others a state filing as detailed and complete as that prepared for the SEC is required. Some states—notably California and Illinois—prohibit contractual plans. Some states impose over-all expense limitations, for all purposes other than brokerage fees, of 1 per cent of the fund net asset value. Some states require that all officers of the broker-dealer disclose all their personal assets as part of the broker-dealership filing. Also, it is necessary for at least one officer of the broker-dealer to become a semiprofessional exam-taker, since about thirteen states require that their particular state securities exams be passed.

The difficulties presented by the variations within the state acts in regard to fees and the expiration of registrations and the clerical problems which are involved in the mechanical acts of filing and record-keeping pose a substantial burden on any broker-dealer intending to sell mutual funds on a national scale.

Another problem relates to inventory controls. Since the application forms for the registration of securities in most states require that specific amounts of securities be registered, a forward estimation of sales in each state must be made. Reasonable accuracy is required to avoid the necessity of amendment in cases where the amount estimated proves to be too low.

In all states, reporting requirements must be met, and some of these can be quite extensive. Wisconsin, for example, requires monthly sales reports for registered securities. It is apparent that the problem with the blue sky laws is not the substantive nature of the acts themselves but the sheer burden of compliance.

There are now a number of states which currently have statutory provisions dealing with the "correlated sales" of life insurance and mutual funds or other securities by dually licensed agents. For example, the South Carolina statute simply permits the concurrent sale of mutual funds, if the salesman provides the prospect with a prospectus. In Oregon and Florida a written proposal is required, prepared in duplicate, with one copy going to the prospect and the other to the agent or insurer, who must retain it on file for at least three years. In at least seven other states there are "proposal regulations" which require, in the case of "correlated sales," that the dually licensed agent disclose to a prospect that he may buy insurance and/or equity products. New Mexico and Ohio require that an authorized officer of the insurer file with the annual statement a statement certifying compliance with the state rules pertaining to the dissemination of sales literature. Tennessee requires that the proposal disclose the commissions paid on mutual fund sales, both in dollars and percentages. Louisiana also requires that a company's advertising and sales-promotion material in this regard be on file and subject to inspection by the Louisiana department for a three-year period.

Recent new replacement regulations promulgated in Florida, Oklahoma, and Nebraska affect agents dually licensed to sell life insurance and mutual funds. For example, in Nebraska if such an agent proposes to sell securities resulting in a replacement of existing insurance as defined in their regulation, written notice to the policyholder and the Nebraska department must be provided prior to consummating the proposal. Replacements in Nebraska include, among other things, the "substantial borrowing" of loan values on existing policies, whether as a single loan or under a schedule of borrowing over a period of time. "Substantial borrowing" includes all transactions wherein an amount in excess of 50 per cent of the cash value is borrowed on one or more of the existing policies.

MR. JOHN M. SUTHERLAND, JR.: You can be certain that compliance with perhaps fifty-odd state regulatory bodies will not be entirely smooth. You can put a certain amount of emphasis on the word "odd." However, in fairness, perhaps I should say that our circumstances may have been fairly unusual. Under the then existing Massachusetts law, under which my company commenced operations, a regular life insurance company was not permitted to write variable annuities. However, within the life insurance section of the law there was a provision for a specialty company which would have the necessary powers. We considered that this made us a special form of life company, but there were a number of jurisdictions which delayed our entry on the grounds that we were not a life company. On the other hand, there was one jurisdiction which admitted us promptly enough but which prohibited a life company's writing any separate account business. In simple effect, no variable. Our company was not heavily capitalized, and, as a result, we have not entered a number of states, particularly those with recently up-dated minimum capital legislation. This problem is, of course, one that can be planned for, except in those jurisdictions which raise their requirements while you are in the course of entering. In one state we were told when we followed up that we were fifty-seventh on the list!

MR. INGRAHAM: Licensing costs per agent can run as high as $100 per man, when state fees are taken into account in addition to NASD or SECO exam fees. Our approach at New England Life was to pay the NASD principals and registered representatives exam fees but to require that the agent (or his general agent) cover the state licensing costs.

There is a plentiful supply of training material available to prepare agents for the NASD registered representatives exam. We developed our own primarily through the efforts of a former NASD lawyer now on our payroll. Our pass ratio was 87.3 per cent.

Of course, companies planning to market variable annuities but no mutual funds can do so in most states by having their agents pass the NAIC variable annuity exam plus a twenty-five-question exam on the NASD Rules of Fair Practice.

In addition to broker-dealer supervisory personnel, there are others in an insurance company home office that must take the NASD exams. These include all persons potentially involved with members of the public in discussing equity products—agency superintendents, those in group or pension departments, and those in variable annuity operations.

The licensing of agents involves biographies, letters of reference, and signatures, in addition to fees. As a minimum in licensing someone to sell shares of your mutual fund, there should be a detailed investigation of his character, business reputation, and qualifications in terms of education and background experience. One alternative is to limit the licensing of a company's existing agents to those who have demonstrated for a reasonable period of time that they are competent and trustworthy. There is a heavy burden of supervision transcending that applicable to the insurance business.

Agents who become licensed to sell fund shares should never forget the SEC Statement of Policy. Specifically, they must never imply that the fund shares have been approved by the SEC. They cannot urge someone to purchase fund shares because the fund is about to pay a dividend. It is illegal to project an anticipated rate of return on the mutual fund. Also, if applicable, the sales representative must explain to his customer that the sales load of a given fund drops at certain purchase levels. Finally, it is unlawful under Regulation T and the 1934 Act for a registered representative to participate in an arrangement or arrange directly or indirectly for a customer to borrow money to buy mutual funds. Thus policy-stripping activities in this regard could result in the suspension or expulsion of the registered representative and his broker-dealer from NASD or SECO membership.

A decision must be made on whether existing broker-dealers and registered representatives among a company's sales force will be "grandfathered" or compelled to join its newly created broker-dealership. A company must also decide whether it wishes to negotiate outside selling agreements with a limited number of other funds—until its own fund develops a track record.

Some general agents (called "sales co-ordinators") may wish to be designated as branch offices of the broker-dealership. This permits local advertising in telephone directories, local papers, or magazines and the placing of a business sign somewhere on the agency door so that the public can be made aware of the fact that they can purchase mutual funds there. The fees involved vary from state to state, and there is an annual charge per office of $30 assessed by the NASD. Another issue involved is whether the sales co-ordinator will have to become a registered principal. Also, some agencies may have restrictive covenants in their leases prohibiting them from actively selling securities from that office.

It is extremely important that the broker-dealership be adequately staffed to handle the myriad supervisory, compliance, accounting, and shareholder relations problems attendant to the distribution of mutual fund shares. Procedures must be established relative to the solicitation, execution, and follow-up of purchase orders. For example, you will probably want to acknowledge the receipt of each order in all cases in which payment is sent in with the application, with copies to the customer and the sales co-ordinator. This establishes the actual price per share of the order. For cases in which payment is not sent in with the order, the customer must receive a confirmation indicating the settlement date. The settlement date is the day by which the broker-dealer must receive full cash payment of the purchase order or the order must be canceled (within seven business days of the order date), in accordance with Regulation T of the Federal Reserve Board. In our case, NELESCO will permit telephone orders of $5,000 or more for those who wish to pin down the current day's closing price.

A broker-dealer operation must familiarize itself with the substantial record-keeping requirements imposed by Rules 17(a)-3–5 under the 1934 Act. These relate to itemized blotter transaction records, ledgers, copies of confirmations, and the like. They are subject to periodic audit by the SEC and frequently serve as the "jumping-off" place when customer complaints are involved.

It is no secret that many fund underwriters and custodian banks have bogged down under a mountain of paper work. Many of you are probably aware that sales of the Value Line Special Situations Fund have been temporarily suspended because of a backlog in paper work by that fund's transfer agent. The custodian operation is foreign to conventional insurance operation.

Let me give a few examples of situations in which problems are likely to arise.

1. Although your broker-dealer will initially confirm or acknowledge each order for outside funds, some fund underwriters will not get a confirmation out to the customer for as long as three or four months. Your registered representatives may be understandably annoyed at receiving delayed commissions on such funds.

2. On pension trust cases, we have imposed a rule that orders will only be accepted on a cash basis, since it appears almost impossible to fulfill the seven-day requirement on nonprepaid cases.

3. In the case of one-check payment plans involving the combined purchase of life insurance and mutual funds, what do you do when the insurance is subsequently "not taken" and, as a consequence, the applicant asks for his entire deposit back? If you have already purchased fund shares, you may redeem at net asset value (probably at a loss to the customer because of the sales load), but you may experience customer-relations problems if you do. Alternatively, you may refund his money in full, charge back commissions to the representative, and allow the broker-dealership to absorb any losses. A third approach would be to have the customer indicate on the mutual fund application whether the purchase order should be executed prior to the insurance underwriting date.

MR. SUTHERLAND: I would say that the licensing and training of field and home office personnel represent a fairly time-consuming process. It can also be a substantial expense item. In addition to certain out-of-pocket expenditures, it seems to me that we face a significant loss of production and that, in any assessment of the true costs, this should be counted. A word of caution may be in order. I think you may be surprised at how well you have done the job of training your field force and also your home office personnel in the advantages of guaranteed dollar coverages. I would also guess that you will be surprised at how much your agents, if they sell a participating product, rely on dividend illustrations projected into the future. In our case, with the gradual extension of our company territory, we did not try to train all our agents in one concerted effort. Instead, we tried to give the licensing training to an agency or a state or two at a time. This has meant an extended period for this work, since, after more than two years, we are still actively engaged in it. Obviously we will always face the problem for new agents. Our technique is to conduct usually two study sessions on a fairly formal basis with home office assistance and supplement by informal sessions in the agency. We try to cap this by an all-day cram session immediately prior to the exam. Our success rate has satisfied us; it runs about 80 per cent. There are now a number of study kits and tracks available which are very effective.

It is probably worth mentioning that our people feel that the licensing training is just the beginning; subsequently, a considerable amount of sales training is necessary for our agents. Our agents—and home office personnel—probably have had more trouble with the control over sales-aid material, both its preparation and its use. The controls *are* stringent in comparison with what we have been used to, and the penalties can be severe.

With respect to administration, some interesting challenges present themselves. We have been on a weekly valuation and purchase cycle, and this has meant that purchases must be made every week without fail. Furthermore, the timetable is determined not by completion of underwriting or other procedural steps but by receipt of the purchase payment in our home office in Worcester. On the other hand, we generally obtain enough information on the reverse of the application to do the financial suitability underwriting, and we have no delay problems comparable to those which arise in physical history and physical condition underwriting. I would suggest that we have to watch the potential problems in an associated sale, that is, a sale in which both an equity product and a traditional insurance product are sold in association with each other. We have found that the people in other areas, although generally interested in good time service, do not always grasp the absolute necessity for speed in processing anything tagged variable annuity. We also have to admit to some difficulty in maintaining the standards of immediate accuracy which we desire in dealing with the multidecimal numbers of the variable annuity. Our clerks seem to encounter some difficulty in applying a six-decimal unit value to a two-decimal net purchase payment to arrive at a three-decimal unit value count, which will be added to another count to obtain a new three-decimal unit count.

MR. INGRAHAM: The total start-up cost for a company establishing its own mutual fund operation, when all factors such as licensing, legal fees, auditing, and systems design are considered, can run as high as $500,000 or more. Of course, this cost will be substantially reduced in the case of companies forming a broker-dealership to market existing funds.

New mutual funds launched by insurance companies are usually "seeded" by an initial investment. In ours, $1,000,000 was put into each fund and up to $5,000,000 was authorized. It was done by the parent company's buying stock in NELESCO, which, in turn, purchased mutual fund shares. Although only an "armchair" guess at best, we estimate that the break-even point for NELESCO will occur when the combined assets of the fund reach the $20,000,000 mark. After four and a half months of experience, our total fund sales have topped $5,000,000.

Entry into the mutual fund business by a life insurance company can result in the full-time commitment of several of its lawyers. A dearth of individuals at all familiar with the securities business will be quickly noted. In this regard, our affiliation with Loomis-Sayles and our hiring of a former NASD lawyer materially smoothed the way.

However, the proper indoctrination and training of agents are continuing matters that cannot be too heavily stressed. Field backup is required with respect to such matters as agency meetings, joint sales interviews, co-ordinating the activities of outside fund wholesalers, H.R. 10 and pension case assistance involving mutual funds, and the implementation of broker-dealer sales and compliance policies.

MR. SUTHERLAND: I think that it is clear that most companies which have embarked on this excursion have started by assigning a team of people to lay out their plans. After management has decided to go on the picnic, these people would include (1) a salesman who would determine the features of your destination—that is, a lake for swimming, a mountain for hiking, or whatever can be used as an analogy for the market characteristics of TSA business, H.R. 10, nonqualified, and so on; (2) a lawyer who would read the road signs to get you there; (3) an actuary to see to it that you have the wherewithal to get where you want to go and to enjoy yourselves when you get there; (4) an administrative systems and methods man responsible for the maintenance of your vehicle; and (5) an investment man familiar with the features of the locality, to be certain that you make the most of your opportunities while there (you do not want a hunting guide to take you water-skiing and you do not want a bond or mortgage man to lead an excursion into common stocks). I might add that your picnic prospects would be improved if you could find an infallible weather forecaster.

Surplus commitment represents a tricky question. I guess the key is how to allocate overhead. If you charge reasonably full overhead shares and if you decide on a fairly broad operation to attempt to penetrate a wide variety of markets with an intermediate-sized sales force, it seems to me that you are talking about at least a $1,000,000 investment and that a more likely figure would be $2,000,000.

I think that the mutual fund business would prove to be noticeably less expensive to enter. The patterns are more standardized. There are administrative agents available to save you systems development costs. Agent compensation probably has a different pattern, since there is nothing similar to the emphasis on TSA business and it is basically a single-character product in contrast to the dual-character VA. My guess is that $500,000 or $600,000 is a minimum and that $1,000,000 would not be on the high side.

II. *Product Design*

What considerations are involved in determining the following:

A. For a variable annuity: (1) mortality assumptions; (2) assumed investment rate; (3) investment management fees; (4) mortality and expense risk charges; (5) sales and administrative expense deductions; (6) agents' compensation; (7) frequency of unit value determination and formula for determining annuity payments; (8) charges for taxes on realized capital gains, and reserves, if any, for taxes on unrealized capital gains; (9) minimum death and disability benefits, if any; (10) packaging of fixed and variable features; and (11) balancing requirements.

B. For mutual funds: What considerations are involved in question A, 3, 5, and 6, with respect to a mutual fund operation?

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MR. GEORGE T. MITCHELL: I do not see any reason for the mortality assumptions on a variable annuity to be different, as a practical matter, from those on a fixed-dollar annuity. The big difference is that, for a fixed-dollar annuity, you are setting an annuity rate which combines an interest margin with any mortality or expense margins which might be present. On the variable annuity the interest margin is no longer available (all investment earnings are credited to the contractholder), but what is available is a risk charge for mortality and other contingencies, which typically is about 1 per cent of the assets in the fund per year. This charge would be available to cover mortality losses. Here you have a new type of balance to strike among the various contingencies.

In the setting of the assumed interest rate (AIR), there are multiple considerations.

1. One factor is the long-term prospects for the investment performance of common stocks. In this regard, much consideration is given to avoiding declining annuity payments or to producing rising annuity payments. There are philosophical differences here. One theory is that we want to avoid the disappointment of declining annuity payments. Another theory is that the AIR should be set so that annuity payments rise with the general trend of inflation. It is quite obvious that, no matter how low the AIR is, there are going to be times when the level of annuity payments will go down.

2. There are some state limitations on the AIR. At present about eight states limit the amount of first annuity payment, typically limited to the first payment produced by the Standard Annuity Table, 1937, at $3\frac{1}{2}$ or 4 per cent. NAIC model regulations are being adopted by a growing number of states. These impose no limit on the AIR for use in group products

but do impose a limit of 5 per cent on individual products, except with the approval of the Commissioner.

3. For group variable annuities, you also get into the picture the desires and investment philosophy of the employer.

4. Another factor is comparison with fixed-dollar annuity interest rates. If the starting income for either the fixed or variable annuity is quite different from that available on the other form, then the prospective annuitant has quite a choice to make. Let us say, for instance, that the fixed-dollar annuity provided a higher starting income. He would have to choose whether he wanted a higher current level income or whether he wanted lower current income with the hope of future growth of the income through the variable annuity. In our company we try to set the starting rate so that you have roughly a comparable starting income, whether it is a fixed or a variable annuity that is elected.

5. What remains to be seen is the extent to which the AIR will be a competitive factor. The variable annuity should not be sold on the basis of its having either a low or a high assumed interest rate, but it is easy to see how the agent or client could misinterpret the impact of the AIR.

As to the amount of risk charge or provision for mortality and expense contingencies, we have no precise formula whatsoever on how this ought to be determined. These charges are levied as a percentage of the assets in the fund for a year (generally about 1 per cent). All I can say here is to run down some of the risks covered by such a charge.

1. The biggest risk, of course, would be the risk of mortality improvement. It can occur both before and after retirement of the annuitants.

2. There is a persistency risk involved in expense financing. Products are usually designed so that the loading over the lifetime of the contract will level out to expected expenses. If the contractholder should surrender or cease to make premium payments very early in terms of the contract, there will probably be a loss on expenses versus loading.

3. Another risk is misestimation of what the expense levels will be. This could occur through general inflation, or it could also occur because of stringent administrative requirements imposed by the regulatory authorities.

4. Another risk for many companies is the provision of a return of premium minimum death benefit. Generally, this provision will provide that for an individual variable annuity, prior to retirement, the death benefit will be the greater of the cash value or the sum of gross premiums paid in. There are a few modifications offered, but this is the standard one. Some companies make a specific charge for this benefit—a percentage of the premiums (often three-quarters of 1 per cent)—while others, such

as my company, make no specific charge for this. In either case, whether there is a specific loading for it or no charge whatsoever, the mortality risk charge could be called upon to absorb losses on this benefit.

This minimum death benefit is different from other things insurance companies have offered—it is a limited guarantee of stock market results. We studied the cost of this benefit by using historical common stock indices. We found that, on the average, the cost would have been very small, but the fluctuation in the claims from year to year was extremely high. In all cases our mortality and risk charge—for mortality and expense risks—covered all the claims that we would have expected to incur through the minimum death benefit over the last seventy years if we had offered our product through a separate account invested in a stock index.

In New Jersey, this benefit does not seem to be permitted, and a company could adjust the product in New Jersey in either of two ways. If there is a specific charge for the minimum death benefit, it could be omitted. The other approach is to give the contractholders a small, fixed-dollar term benefit in lieu of the minimum death benefit.

CHAIRMAN HARRY WALKER: There is at least one company that offers not only a minimum death benefit but a minimum maturity benefit at retirement equal to the sum of premiums paid. That is a much more costly benefit than the minimum death benefit.

I would emphasize that there can be a serious problem for a company using an assumed investment return of 5 per cent, which may, with a much more conservative mortality assumption and higher loading, show a first annuity payment that is materially greater than that shown by a company which is really offering a more liberal product. With no right to make investment projections, I do not see how the public will be able to choose between the two products. I would venture to guess that this may force companies into one mold.

Another item in the actuarial structure in a variable annuity contract which would make it very difficult for the buyer to compare products is this charge against the fund for the mortality and expense risks. To the uninformed, unsophisticated buyer, it is very insignificant to look at the difference between 1 and $1\frac{1}{2}$ per cent. It does not look like much on paper, but it really is a decidedly different charge.

MR. JOHN J. BYRNE: We have carefully considered the charge for mortality and expense contingencies as a risk premium and part of the insurance business. The Commission staff has generally kept hands off, but last week they insisted that we split it out—so much for expense and so much for mortality. This is dangerous ground.

MR. PETER R. WILDE: These may be security products first and insurance products second. The SEC is not interested in the fact that the insurance industry for one hundred and twenty-five years has set down its own terminology. You must use their language, and, even though it does not fit with the insurance language, that is the way the game is going go be played.

MR. HAROLD G. INGRAHAM, JR.: This question is addressed to any and all the panelists. Have any of your companies requested an exemption of section 22(d) of the 1940 Act with respect to policy cash values?

I am thinking specifically of combination pension trust plans which now permit, in many instances, the commingling of cash values and auxiliary funds for retiring participants to provide a fixed-dollar annuity payout using current nonparticipating settlement option rates.

The argument which one might use with the SEC in requesting a 22(d) exemption in order to provide a "no-load" variable dollar payout in such situations is that the participant has already paid a load with respect to his insurance policy. However, it is a little less clear if one tries to make the same argument with respect to auxiliary funds, where no load may have been imposed.

MR. WILDE: CG has not yet requested any exemptions. It is a long, depressing process.

MR. BYRNE: We did ask for an exemption similar to the one you mentioned for policy cash-value proceeds, and we did get it. However, we have not requested an exemption for such things as auxiliary fund money where no sales charge has been paid.

MR. MURRAY L. BECKER: In view of the fact that life insurance companies with variable annuities will be competing against mutual funds as well as against banks and other organizations for investment in equities, the fact that only variable annuities have risk charges for mortality and expense guarantees, and the fact that insurance companies are competing against those who do not, I am interested in the panelists' views on whether the buying public will think that guarantees are worth the price that has to be charged?

MR. WILDE: There seems to be a greater interest on the part of many employers to get into the separate account and to get as modest a guarantee under that as they have to, by whatever device they want to employ. I think that there will be an element of the *individual* buying public that will purchase annuities with guaranteed features, however.

CHAIRMAN WALKER: One company that has been in the business a year or so has been delightfully surprised with its production. It is greater than had been expected. We, in the Equitable, felt that our production to date in the Keogh H.R. 10 variable annuity area has lived up to expectations. I think there is a great market for the single-premium variable annuity.

MR. JOHN T. LONGMOORE: One thing about the AIR has always bothered me. Under an individual contract, a contractholder can now take advantage of current purchase rates based on interest rates of at least 5 per cent. If you force him to take a $3\frac{1}{2}$ per cent AIR on a variable annuity, he has the choice of having a high amount of fixed income or a low amount of variable income which will probably increase yearly.

CHAIRMAN WALKER: You can give him the right to substitute the single-premium variable annuity with a higher AIR and without a sales load, which I would propose to do.

MR. LONGMOORE: Wouldn't you need an exemption under 22(d) to do this?

CHAIRMAN WALKER: I suppose that you would.

MR. ROBERT N. POWELL: Has the SEC indicated its position on the need for experience rating these?

MR. BYRNE: It has a continuing interest in the whole experience-rating mechanism.

MR. POWELL: Is it really going to insist that contracts be experience-rated, recognizing that the experience rating will be a one-way street?

MR. BYRNE: No, but I think that we have seen enough evidence to indicate that the SEC will insist that, if you say there is experience rating, there will be a regular mechanism for experience rating. It has not gotten into what the form of this should be or what the mechanism should be.

MR. WILDE: If you do not plan to experience rate on an individual product, would you have to anyway?

MR. BYRNE: No. If you do not say in the prospectus that there is an experience-rating element, I have seen no evidence that the SEC will force you to experience rate the charges.

MR. WILDE: The SEC is asking, in the latest prospectuses now being filed, that, if you are not going to provide lifetime guarantees for all the elements, you so state in great big capital letters that this guarantee is only of a temporary nature, on every page where it might be applicable.

MR. ROBERT H. JORDAN: If the SEC makes a change such as the one you are describing, in the description of expense and mortality guarantee charges, what effect does that have on contracts you have already issued or on those you plan to issue?

MR. WILDE: It is not so much the contract provisions as it is the disclosure in the prospectus which is causing the problem. Every time your prospectus comes up for renewal, you do not know what you may go through.

MR. JORDAN: What effect is there on the policies of changing the language in the prospectus?

CHAIRMAN WALKER: If you said in your contract that you are charging 0.75 per cent for combined mortality and expense risk and in your prospectus you say that you are charging 0.25 per cent for the expense risk and 0.50 per cent for the mortality risk, then the prospectus and contract are still in accord.

MR. BYRNE: We expect the investment management fee to be a source of profit, so it should be adequate to provide a reasonable profit.

The sales and administrative expense deductions, the load coming out of the premium, in my view, should be adequate so that the present value of those deductions covers the present value of sales and administrative expenses. At the current levels, we do not look for a profit margin here. They should be competitive, and here the competitive aspects are very important. The difference between a 7 per cent load and a 9 per cent load in a tax-sheltered annuity case is a very important difference.

The extent to which these fees and loads are guaranteed (this has been varied in the different contracts in the market place today) should be reflected back to the risk fees that Tom spoke about.

Unlike the investment management fee, these fees are very directly regulated. In fact, there have been some recent changes which have been reported to me. It used to be that just the sales piece of our charge had to fit within the 9 per cent limit; now I understand that both the sales and administration fees must fit. Is that correct?

MR. MITCHELL: Our thinking was that, if you went beyond the 9 per cent limit on the total charge, you had to carefully justify the split, which might not be so easy to do.

MR. BYRNE: As far as agents' compensation is concerned, this is a very involved question. Unlike the insurance business, where we feel that commissions and compensation are pretty much our own business, it is not likely to be so in the securities business.

In the individual nontax-benefited variable annuity, we simply must leave enough compensation in there to create a sale. This is very much a face-to-face creative sale, and if we do not leave enough money in there, the product can be the greatest in the world yet it is simply not going to be shown and the public is not going to get any good from it.

The whole track that we are running on, as far as agency compensation is concerned, is one of relating the compensation to a pound of creative sales effort.

MR. WILDE: I will stick to the mutual fund aspect. The typical investment management fee is one-half of 1 per cent. There is a great deal of interest currently in providing incentive rewards in the management fee; if you outperform one of the industry's indices, such as Standard & Poor's or Dow-Jones, you get a bonus. This area is going to come under increasing surveillance, because the regulators will begin to recognize that competing with the industrial averages is not a true measure of success or failure.

California has a limit of 1 per cent for management and administrative costs, and any of you who plan to sell in California will find that, if you have costs which exceed 1 per cent, any excess has to be paid by the management company out of the management fee, particularly in the first year or two.

Bear in mind on mutual funds that, unlike the gross premium approach of life insurance, where the premium charge covers everything, including your administrative costs, in the mutual fund field it is essentially an add-on charge. Furthermore, most companies are using outside banks to handle the administration work, and many companies, I suspect, will find that they cannot compete with the fees of these outside professionals and the administrators who handle it for them.

There is increasing interest in the policy-fee concept on mutual funds. A number of companies in the business are now adopting an annual account charge, whereby semiannually or annually this account charge is deducted from the dividend payment.

Finally, the agent's compensation is somewhere around 3–5 per cent. With stock exchange firms, the commission probably falls within 3 to $3\frac{1}{2}$ per cent. If the dealer is offering only mutual fund shares, you might find commission rates of 5, 6, and even slightly higher sometimes, plus compensation for good production.

CHAIRMAN WALKER: Looking at the experience of the Equitable in a period of four months, the average-sized variable annuity sale in the tax-sheltered variable annuity market is one and a half times what it was in the year 1968 in the corresponding markets where we used the fixed-dollar contract. While we reduced our first-year commission with the introduction of our variable annuity product in this area, the commissions per contract sold are about the same as they were before.

MR. WILDE: At CG our average mutual fund sale for a year was in excess of $2,000. When you apply a 3–4 per cent commission rate to that number, it does not compare too badly to what you might get as a first-year commission on a life plan. There are different dollars being attracted into mutual funds in comparison with life insurance. One of your tasks as actuaries and as assistants to marketing experts is to convince them that this is indeed true.

MR. BYRNE: We tell our agent, "You are not a mutual fund salesman. You are a financial planner."

MR. DONALD S. GRUBBS, JR.: Some of the smaller companies are selling package products in which they redistribute expense and commission costs between the two halves of the product; for instance, a no load mutual fund with an insurance policy which has higher than usual loading for commissions and other expenses. Are many major companies doing this?

MR. BYRNE: In certain market places, the pension trust area, it has more appeal than in general, I would say. Of course, there are wide differences of opinion on this.

We are concerned about the long-range implications of having a distribution system paid for by just one of our products. It is a valid consideration, so we are trying to have each product line share reasonably in its own marginal distribution costs.

MR. WILDE: I think that one of the grave concerns is to be careful not to tie the insurance and equity products so closely together that the whole thing can be viewed by the authorities as one security, so that they would require a prospectus describing your whole contract.

MR. LESLIE A. CANNON: Some of the individual contracts that I have seen for H.R. 10 are a combination of fixed dollar and variable annuity, and I think they have the same loading! Would this mean that they would pay the same commission on both sides?

CHAIRMAN WALKER: We have such a contract at the Equitable, and we pay the same commission on both parts of the contract. Our philosophy is that the agent ought not to be motivated to sell either equity contracts, on the one hand, or fixed dollar, on the other hand, by virtue of how well his pocket will be lined by that sale.

MR. WILDE: For example, in the tax-sheltered variable annuity market, where you want to give the teacher a choice of fixed or variable or both, if you want to allow them to move money between the two products after a time without any further charge, I think that it is fair to say that the SEC would view it rather dimly if there were sharply different sales charges on the two sides. In fact, you probably would not get that cleared.

In so doing, you may have to bring the fixed-dollar rate down to the variable level. Of course, that is not something you would view with much enthusiasm, but, if you want to put the two together in one package, that may be the only way to accomplish it.

MR. BYRNE: From what I know of competitors and of our own company, if there is a product with a 6 per cent total load, of which 4 per cent is sales charge, it seems to me that most of the companies in the industry are paying as much as 80 per cent of the sales charge as commission, or maybe even more.

We are looking for the present value of the commissions to equal roughly 80 per cent of that charge. There is a heaping option available in some of our contracts.

CHAIRMAN WALKER: For a variable annuity, what considerations are involved in resolving the frequency of unit value determination, the formula for fixing annuity payments, and the balancing requirements?

MR. BYRNE: We will be going to daily pricing by July. Our systems and administration people do not really think that it will add materially to the expense of renewal maintenance.

On balancing requirements, there are regulatory aspects and there is marketing strategy. There are some state insurance departments that have insisted on so much life insurance before one can sell a variable annuity. This is very difficult to administer. I do not think that the requirement will be with us for too long.

On the federal aspects, basically you have an obligation as broker-dealer to insure the suitability of the investment, and you can work into that suitability some balance with the client's insurance needs, if you care to. It is not neccessarily a part of the regulation.

I like to think that the question really is not one of regulation as much as it is one of marketing strategy. As I said earlier, we are selling and emphasizing balanced dollars; selling death, disability, fixed savings, and equity savings in one check and one package. By serving the customer in this way, the agent will serve himself and his company best.

We do get a suitability application on each and every new account, whether it be a variable annuity or a mutual fund. There is an optional question, which simply says, "I, the customer, understand that the registered representative had to ask me these questions, but I have exercised my option not to answer them." Over 85 per cent of our forms have that option checked. This is a shame, because we are trying to demonstrate to our agents what a marvelous opportunity this is to gather more facts on a regular basis.

CHAIRMAN WALKER: I will comment briefly on item (8) of II, A. We are dealing here with taxes on capital gains in the nonqualified area. The capital gains credited to reserves in qualified plans are nontaxable.

It is my personal view that we ought not only to charge for taxes on realized gains in determining unit values but also to set aside 25 or 27½ per cent of unrealized gains as a reserve for taxes.

It may be argued that you should allow for the fact that, if the gain is realized, the tax may not be due for many years. I think that we in effect discount, if we credit in the unit values the investment income and capital gain on the tax reserve itself. I suspect that the SEC will require that you hold a reserve for taxes on unrealized gains.

A question was raised at the federal tax panel this morning: How can you market a deferred variable annuity to the man on the street in the nonqualified market and hold back 25 per cent of the unrealized gains as a reserve for taxes assuming complete disclosure?

One response to this question is that, while this might inhibit the sale when you are starting off in this business, after you have been in the business ten years or so and have built up unrealized gains that you have not reserved for, who will then buy your product? They will be buying into a potential tax liability unless you can draw on a reserve to pay for the taxes on realized gains. If you do not, there will be a sudden precipitous drop in the unit value when gains are realized.

MR. WILDE: If you did not disclose this, you would have the potential for a shareholder suit on your hands.

MR. BYRNE: One of the companies that are currently in a tax-loss situation is integrating the tax gains in its separate account into its total tax return and not charging the shareholder.

That is one thing, but at least one company seems to be going further and guaranteeing that, for the life of that contract, there will never be a tax charge. It is hard for me to see why they would not have a very material problem a few years from now.

CHAIRMAN WALKER: It is my personal view that, while you are taxed on capital gains for the company as a whole, the unit value ought to be determined with reference to the tax on realized gains and potential tax on unrealized gains in the separate account, without reference to gain or losses in another separate account or the general account.

If there is a gain in the separate account and an offsetting loss in the general account, I think you ought to credit the unit values in the separate account with 72½ per cent of the gain. I think you ought to credit the general account with the tax savings that the company has enjoyed by virtue of their offsetting the loss in the separate account.

MR. ARDIAN C. GILL: I can confirm your suspicion that the SEC does now require that you set up these reserves, and I would like to ask you about the converse to your situation. Suppose that the tax laws change and that you are then required to distribute this reserve. The individual who buys in just before this gets a precipitous windfall.

MR. BYRNE: I do not think that you can do any better than to set up the liabilities on the best generally accepted accounting practices on liabilities that you see in the law in its current state. It is a very nasty problem.

CHAIRMAN WALKER: Don't you think the change in the law is academic?

MR. GILL: Not at all. It is double taxation and may well end.

MR. MITCHELL: I would like to talk briefly about the combination of a fixed and a variable deferred annuity. Our company offers such a product. Our loading and commission scales are the same on both the fixed and the variable side. We allow policyholders to put each premium in the contract into either the fixed or variable side or any mixture between the two.

They are allowed to change this allocation from time to time. For instance, they could put $100 in the first month on the fixed side; the next month they could put in $50 on the fixed side and $50 on the variable side. We felt that the combination of fixed and variable accumulations offered more flexibility than offering separate accumulations.

For instance, we allow the premiums in renewal years to be up to 150 per cent of the level in the first contract year. If a man put $100 each into the fixed side and the variable side the first year, if we had separate contracts, then in succeeding years with that rule he could put in between zero and $150 on the fixed side and zero and $150 on the variable side. Under the combination contract, he puts the $200 in the one contract and it is split 50/50 the first year. Then in succeeding years he could put in anywhere from zero to $300, and this could be $300 fixed or $300 variable, or any mixture. This is a more flexible result.

MR. WILDE: We talked earlier about tying the two products together, the fixed dollar and the variable. You will have to be very careful with some of your young insurance company agents who might be carried away with the degree to which they are going to guarantee these variable elements when they first make the sale. They must be viewed as a security right from the beginning.

MR. BYRNE: In our variable annuities we have at every level contracts on both the fixed and variable side, and we carry the same economics all the way through, including the agents' compensation.

In the mutual fund, we have started to promote a one-check plan with its own name and separate product designation. We know one major company that did not want to encourage life insurance premiums on a monthly basis and did not go into the one-check program for this reason. If you want to offer a combined life/fund plan and do not wish to register the combination itself as a security, you must proceed with special caution.

MR. WALTER N. MILLER: With respect to the deferred variable annuity that offers both fixed and variable accumulation, as elected, are people at the outset primarily electing more variable?

CHAIRMAN WALKER: Seventy-two per cent are electing variable in the Equitable.

MR. WILDE: Our product is so dynamic that we expect to do more than 90 per cent in the variable.

MR. BYRNE: On our tax-sheltered annuities, it is 90 per cent variable. Where the package is like H.R. 10 with ordinary life and variable annuity, or ordinary life and mutual fund, we have a 50/50 split.

All the literature makes it very clear to the customer that, if the customer says, "I like your sales presentation, but I only want to buy the mutual fund," we welcome him with open arms.

MR. INGRAHAM: Here is a question for Mr. Byrne on the one-check payment plan. Let us suppose that an applicant is rated or declined for insurance when underwriting procedures are completed. What do you do if he does not want to participate in the mutual fund aspect of the program? If you have already invested his money, would you then redeem his shares at net asset value? Since that applicant has already incurred a sales load, his redeemed shares will undoubtedly be worth less than the amount paid in. I would think that this might create a public relations problem.

MR. BYRNE: Yes, there is a public relations problem. Another company that I know of is doing it a different way. They are not investing the money right away. They are waiting for the business to be issued. But you get into other regulatory problems with this practice. We are disclosing fully to the applicant that the money is being invested and that he gets back the net asset value. Full disclosure in the application should go a long way to mitigating the problem. We also believe that our agent will be able to convince the applicant to leave the rest of the money in the mutual fund.

Atlanta Regional Meeting

MR. JOHN M. SUTHERLAND, JR.: The mortality assumption is the one which causes me to lose sleep in this business. We have the ancient dilemma of balancing the demands of competitive attraction in the market place against the necessity to achieve financially sound results over an extended period. It seems safe to say that the traditional factors considered in choosing a mortality table come into play here and do not need elaboration. There is, however, one point which I do think deserves emphasis, and that is that you do not have excess interest as we have known it in the past as a source of margin. You do have whatever you charge for risk assumption, but I think that in most cases this is less than we have in fact built into our premiums in the past. I think that step-rate guarantees are entirely logical here and permit a company to offer the fairest possible guarantees to its contractowners. We did not start this way and have not yet changed over. You see, I can say with some assurance that that grass is greener, because I am standing on the other side of the fence and can see the greenness of the whole field.

With regard to the assumed investment rate, most companies, I think, are using $3\frac{1}{2}$ per cent. This assumption minimizes any difficulties with the regulatory authorities, since there are some states that object to the use of actuarial assumptions which produce initial annuity benefits higher than those that would result from the use of their minimum valuation standards. However, this puts you at quite a competitive disadvantage facing your own fixed-dollar products where current guaranteed interest assumptions are generally much higher. If your various charges and expenses run $1\frac{1}{2}$ per cent or so, a $3\frac{1}{2}$ per cent assumed investment return requires about a 5 per cent actual investment return. Generally this would not have been difficult to achieve over any reasonable period in the past, and your annuity payments would have increased.

MR. HAROLD G. INGRAHAM, JR.: Mutual fund management fees are usually computed as a percentage of the average daily net assets of the fund, payable to the investment management company daily or quarterly. Typically, the annual fee is about one-half of 1 per cent of the average daily net assets.

Other contracts provide a scaling-down of the fee with respect to assets in excess of some amount, such as $100 or $500 million. A more recent innovation is the performance fee concept—the fee may be more or less than one-half of 1 per cent depending on the fund's performance relative to some index, such as Standard & Poor's.

The SEC basically regards this traditional level of management compensation as excessive. The Mutual Fund Reform Bill, reintroduced this past January in the Senate by Senator Sparkman, would require that the fees that mutual funds pay to separate management companies be "reasonable" and would empower courts to determine whether a particular fee met that standard.

It should be noted that management of fund assets is only a part of the whole job of the management company. Under its contract, the management company is also charged with rendering a broad range of administrative services, such as prospectus printing, shareholder relations, record-keeping, and reporting. The mutual fund industry's argument for retaining a management fee structure proportionate to fund assets is that the economic responsibility of fund management—not direct management costs—increases in proportion to fund size.

The Wharton report, submitted to Congress in 1962, noted, however, that "a financial analysis of 34 advisers who also serve as principal underwriter for their controlled mutual funds revealed that underwriting is not more expensive than advising per dollar of gross income received, but that in a substantial number of cases the underwriting expenses (mainly selling outlays) were subsidized out of advisory incomes." In other words, the Wharton report is saying that funds are willing to incur substantial expenses in the distribution of shares in order to reap later profits through management fees.

MR. SUTHERLAND: Most of us in variable annuities have tied the risk charges for mortality and expense guarantees together. Approximately 1 per cent is probably the most common level, but there are some companies which charge less. Obviously, nobody knows exactly what these risk guarantees are going to prove to be worth. With the spectacular advances in medicine today and with the continuing upward thrust of the expenses of doing business, these guarantees have real value. We have been asked by the SEC to identify the value of each component part here. Our answer was based on actuarial judgment rather than on calculations.

An investment management fee of $\frac{1}{2}$ per cent annually appears to be about maximum. This is the basic rate charged by most mutual funds, although there is some grading when the fund passes certain large amounts. Frankly, I do not see a good reason to reduce this figure on a small accumulation fund. In a mutual fund, while most expenses of an administrative nature are charged directly to the fund, there are a number of functions for which costs are paid by the investment management entity. One example might be the costs of reinvestment of income and capital gains distributions. Furthermore, the compensation commanded by successful portfolio managers is not low. I think that the fee income is there, available to us, and that we need it.

MR. INGRAHAM: Any discussion of sales and administrative expense deductions should start with consideration of section 27(a) of the 1940 Act. In substance this section prohibits the sale of any periodic payment plan certificate if (1) the sales load exceeds 9 per cent of the total payments to be made on such certificate, (2) the sales-load deductions for each of the first twelve months' payments exceed 50 per cent or are not proportionately equal, and (3) the sales-load deductions after the first twelve months are not proportionately equal. The proposed Sparkman bill would reduce to 20 per cent the maximum sales and administrative expense deductions from any contractual plan, and it would limit to 64 per cent the total charge that could be deducted in the first four years.

The SEC favors amendment of section 27(a) to prohibit future sales of contractual plans on a front-end load basis. It also favors reducing the maximum aggregate permissible sales load on level load mutual funds from the present 9 per cent level to 5 per cent.

The prevailing level of sales and administrative loads applicable to level load mutual funds seems to be about $7\frac{1}{2}$–$8\frac{1}{2}$ per cent of the offering price. These scale down to lower percentages at break points, such as $10,000, $20,000, $50,000, and so on. For example, under one fund, the sales charge applicable to a single purchase of $100,000 would be 3 per cent. Many funds contain an "accumulation discount" feature which cumulatively reflects the total of all purchases made by the investor in determining the sales charge applicable to an additional purchase.

One feature suppressing the downward pressures that normal market forces might otherwise exert on sales-load levels is section 22(d) of the 1940 Act, which bars retail price competition by prohibiting dealers from selling a redeemable investment company security except at a current offering price described in the prospectus.

MR. SUTHERLAND: The sales and administrative expense deductions and the agents' compensation in the variable annuity are naturally tied together. Your answer may be largely determined by your answer to this question, "Do you see your primary competition coming from mutual funds or from insurance companies?" If your answer is mutual funds, it seems to me that you might expect to have a basic product with the mutual fund loan and sales compensation pattern, although you might also have the competitive equivalent of a contractual plan. If your answer is insurance companies, you may, in fact, be opting for a relatively low volume with relatively high unit cost operations. Actually, I believe that this question deserves a great deal of emphasis, because it involves one of the fundamental decisions that establish the basic character of your VA operations.

MR. INGRAHAM: The range of registered representatives' commissions payable on funds being distributed by broker-dealerships established by life insurance companies is 2–4 per cent. In the 4 per cent example, commissions might be 50 per cent of the fund sales and administrative expense charge at all levels of deposit, thus being reduced at various break points. From the balance of the fund charge not paid to registered representatives, a portion would be paid to general agents (sales co-ordinators) and the balance retained by the broker-dealer. In the case of outside funds sold by means of selling agreements negotiated with the broker-dealer, the level of agents' commissions may be the same or lower, depending on the extent of the dealer's concession granted by the particular fund sold. Some life insurance company–sponsored broker-dealers pay production-incentive bonuses ranging up to 20 per cent of total commissions paid to a registered representative during a given calendar year, with respect to sales of their own newly established mutual funds.

You may find—as we did—that a number of your agents and general agents are already broker-dealers. These individuals will stubbornly resist being forced to become registered representatives for a newly established broker-dealership created by the insurance company, since it may represent a considerable cut in compensation, if their fund business is at all substantial. For example, consider the following fund margins granted to broker-dealers:

	Per Cent
Value line	8.00
Side fund	8.00
Dreyfus	7.875
Putnam	6.25
Keystone	6.00

On the other hand, these individuals are subject to all the headaches of broker-dealer compliance, high operational expenses, and a substantial tie-up of their idle cash because of minimum net capital requirements under the 1934 Act.

MR. SUTHERLAND: Daily pricing, tax reserves, death and disability packaging, and balancing requirements are special problems associated with variable annuities.

July 14, 1969, Bastille Day, will mark the advent of the SEC requirement for daily pricing, that is, daily accumulation unit value determination. There is an interesting little question hidden away here which has not been answered, to my knowledge. Given daily pricing and given its application to redemptions and possibly certain other types of transactions, does it, in fact, require daily purchasing? Suppose that you decided to retain weekly or even monthly purchasing and that you described this fully and properly in your prospectus. Would this be permitted? We understand that there is at least one mutual fund on this basis.

We do hold reserves in the fund for taxes at the rate of $27\frac{1}{2}$ per cent on unrealized long-term capital gains. Here again, another interesting question presents itself. Our accountants assured us that it represented proper accounting procedure to assess these long-term capital gains taxes against the accumulation fund, just as though it were a separate entity independently subject to taxation, since for these purposes it had a status similar to that of an affiliate. However, we understand that the question has now been opened as to whether these taxes should be assessed if on the consolidated return they are offset by operating losses of the "general account"—in other words, the VA company. We would be interested in any current developments.

A number of companies include a death benefit to assure the purchasers that, in the event of the annuitant's death, there will be no loss under the contract. I do not know what it is worth. I have heard that one state, Texas, I believe, wanted a specific loading charge of $1\frac{1}{2}$ per cent identified for this. Some companies do not identify its value; others identify $\frac{1}{2}$, $\frac{3}{4}$, or 1 per cent. Naturally, if your sales and administrative loadings are on the low side, this benefit is worth less than if the loadings are on the high side. There are some questions of semantics here, and I would urge that any contract language be drawn with careful consistency. We consider that death is simply one kind of cause for redemption and that the death benefit, if any, should be only that amount which, when added to the redemption value, protects against loss. I am not familiar with any disability benefits offered within a VA contract, although our field force is encouraging us to create a sales package.

In our case, Massachusetts law originally prohibited packaging fixed and variable accumulations in a single contract; in fact, we could not offer fixed coverages at all in our VA company. We have had reason to regret this acutely.

There are many administrative advantages to simple contract (one payment notice, one collection, one record, and so on) packaging. In addition, it is advantageous to pay similar commissions to your field force in order to eliminate any possibility of bias in their sales efforts. This leads directly into the next item—balancing requirements.

It is a fundamental requirement that the purchase of a VA contract, as in a mutual fund investment, be financially suitable. We have not laid down rigid rules for our financial suitability underwriting in my company, but we do perform the underwriting in a careful and formal manner. The reverse of the application asks for appropriate information concerning the applicant and annuitant and the circumstances of the sale. We do look for some ready cash reserve and for a reasonable amount of life insurance. Generally social security goes a long way in providing fixed retirement income. We ask appropriate income and asset questions. While most applicants are accepted, not all are. This is one area in which our agents really do help us, because they are naturally eager to sell life insurance.

III. *Variable Life Insurance*

A. What is the current status of variable insurance benefits in Canada and the United States? What policies or benefits are being offered? What are the advantages and disadvantages of these benefits over other products?

New York Regional Meeting

MR. W. JAMES D. LEWIS: In the United States my own view in talking to people is that, while there is a great deal of interest in variable insurance and a great deal of thought being given to it, any development that has taken place so far is, at least at this point, done in an atmosphere of complete secrecy, lest what any company is planning gets exposed to the market place too soon.

Therefore, most of my comments this afternoon are going to deal with the situation as it exists in Canada, where the direction of development of equity-based contracts has been quite different from that in the United States.

I will start with a brief review of the development of these contracts in the United Kingdom. The reason for this is that British companies operate in Canada and a number of the larger Canadian companies have United Kingdom operations. For these reasons the United Kingdom practices have had a major influence on the development of variable life insurance in Canada.

In the United Kingdom there is little if any supervisory regulation of life insurance, so that the development of variable insurance contracts and links with mutual funds, or unit trusts, as they are called there, have been permitted in an atmosphere of relative freedom in following market demands. The tax allowance granted on life insurance premiums encourages the purchase of investment-type life insurance contracts. Concern over inflation and currency stability has also encouraged equity investment. These two factors inevitably led to the direct linking of life insurance and equity investment into variable life insurance contracts.

In any case, the situation has developed rapidly. A recent survey called STELLA (Survey of Trusts and Equity Linked Life Assurance) describes, in some detail, the characteristics of no fewer than eighty-nine different variable contracts being issued in the United Kingdom in September of 1968. These break down by plan as follows:

No.

44 Equity-based annual premium endowments. By this is meant that the amount of each premium available for investment is invested in a segregated fund, which may be a unit trust. Of these, twenty provide guaranteed maturity benefits.

No.	
5	Unit trust-linked annual premium endowments. This is a combination of a conventional endowment with a unit trust plan. The premium is the sum of that for the two schemes.
7	Equity-based annual premium whole life contracts.
7	Unit trust-linked annual premium whole life contracts.
10	Single-premium equity-based whole life contracts.
6	Single-premium equity-based endowment contracts—one with a guaranteed maturity benefit.
6	Deferred annuities, equity-based.
4	Immediate variable annuities.

Possibly this brief enumeration will serve to hint at the broad range of variable contracts offered and also to indicate that the development of variable contracts has been along quite different lines from their development in the United States. In any case, such contracts began to appear in the early 1960's in the United Kingdom, where they came to the attention of the Canadian companies doing business there. Also, about four years ago a combination life insurance–separate equity investment contract was introduced into Canada by a British company.

The Canadian federal legislation was altered in 1961 to permit the issuing of contracts, under which the liabilities would depend on the market value of a specified and segregated group of assets. For some years this power granted by this legislation was utilized only for group pensions. However, in the last four years the development of individual variable contracts and benefits in Canada has been very rapid. The direction of this development has been different from that in the United Kingdom and quite different from that in the United States, which my fellow panel members have covered so well. There are a number of reasons for this.

1. *Supervisory.*—As already mentioned, the basic legislation in Canada has been in existence since 1961. This legislation empowers companies in Canada to offer variable contracts based on segregated funds and brings their supervision clearly under the insurance authorities. The Canadian companies are not, at least yet, starting from the premise that variable contracts are securities. The situation in Canada appears to be that we are starting from the premise that the contracts are life insurance contracts. This has clearly encouraged the experimentation in and development of variable insurance contracts and benefits without bringing them under the jurisdiction of the security commissions. On the other hand, there is no corresponding enabling legislation permitting Canadian companies to establish investment companies or mutual funds. Such a step is legal in Canada by using the holding company concept in a stock company, but no corresponding ability is available to a mutual company.

Accordingly, in Canada the main thrust of the development has been along the lines of variable contracts rather than of linking insurance and mutual funds. Surprisingly enough, individual variable annuities are not commonly offered.

With an increasing number of variable insurance contracts being offered, the supervisory authorities have promulgated guidelines. Those issued by the federal authorities in December, 1968, are concerned with variable contracts which provide for guarantees on death or maturity, requiring that they be financially self-supporting and that appropriate provisions be made for funding the guarantees. Certain restrictions are also imposed on the nature and extent of the guarantees.

In September of 1968, following a conference of the provincial superintendents of insurance, uniform rules covering variable contracts were issued by the provinces of Canada. These rules require the full disclosure, to the prospective purchaser of a variable contract, of all its provisions, charges, method of determining a policyowner's equity, and the details of the operation of any segregated fund. These rules also provide for the filing and approval of contract forms and literature and for the annual reporting to each owner of a variable contract of his investment during the preceding year, the total value of his investment, and a statement of the assets and securities in the segregated fund supporting his contract.

It is interesting to note that, through an agreement between the provincial superintendents and the insurance industry in Canada, the initial screening in relation to these rules of proposed new variable contracts and their supporting literature is done by a committee of insurance company officers set up by the Canadian Life Insurance Association.

In Canada, up to the present time, the problem of licensing salesmen has not been a problem. Starting from the premise that these contracts are life insurance contracts, there was not any question of special licensing, although the provincial superintendents are, at this point, taking an increased interest in this aspect of it; in fact, it looks as if the examinations for life insurance salesmen will actually include questions covering variable contracts.

2. *Marketing.*—Quite apart from the legal and regulatory situation which tended to direct product development in Canada into variable insurance contracts and benefits rather than into the direct marketing of mutual funds, I believe that there has been a great degree of underlying company management direction serving to lead to the same result.

The insurance industry has grown to its present dimensions by providing, with considerable success, contracts containing guarantees. Why abandon, or appear to abandon, this concept which has served so well?

On the other hand, there is no doubt of the market demand for more imaginative and entrepreneurial utilization of equity investment. Cannot the insurance product be made more attractive in these modern circumstances by making use of segregated funds while continuing to provide most, if not all, of the traditional life insurance benefits? The answer would appear to be yes, and, to illustrate this point, I would like to review Confederation Life's experience. It was one of the first in the field in Canada with a dividend option applicable to any participating contract under which the regular dividends could be placed on deposit, not in the traditional way but through using the dividends to buy units in a segregated equity fund. This dividend option, first offered on January 1, 1967, has now become the most popular dividend option elected on new sales and has stimulated those sales.

Also on January 1, 1967, a series of equity-based endowments was introduced by Confederation Life in its United Kingdom operation. These endowments provide a minimum guaranteed maturity value equal to the sum of all the gross premiums. This is also the minimum guaranteed death benefit. The special feature is that the portion of each monthly premium which is available for investment, instead of being invested in the company's general funds, is used to purchase units in a segregated equity fund. If the value of the units, purchased under this contract, exceeds, at death or maturity, the guarantee, then the higher amount is paid. These contracts were immediate marketing successes and now account for roughly one-quarter of the company's individual sales in the United Kingdom.

In October of 1967 a corresponding series of endowments was introduced into Canada. It is now accounting for roughly one-seventh of the company's Canadian individual policy sales.

There are now roughly twenty major companies operating in Canada which offer one or more variable insurance products or benefits. Three offer the dividend option based on investment in a segregated fund. Most offer permanent life insurance combined with an investment of part of the premium in a segregated fund. These contracts provide guaranteed minimum death benefits, and in some cases, like our own contract, a guarantee at maturity. Two companies' contracts provide that a specified proportion of the reserve increase each year be invested in a segregated equity fund. Equity riders have appeared on the scene. Deferred annuity contracts are also issued under which the build-up prior to vesting is in an equity fund.

Apart from the regulatory advantage of such products in Canada, there are others of more general significance. The organizational implications are minimal, because they can be readily fitted into existing arrangements. Similarly, special training of field and home office personnel, while necessary, is not a major undertaking. New concepts and techniques, administratively, are required for the periodic valuing of the segregated fund and the recording of policy units, but these have not proved of major import. All and all, the special problems associated with the sale and administration of variable life insurance benefits have not proved of great magnitude.

One special problem has arisen in the area of product design; this is the determination of the cost and reserve for any guarantees provided, particularly at maturity, under variable insurance. The technique of solution has been to determine a frequency distribution of monthly changes in some equity index and to use this variate in a Monte Carlo type of simulation of the results under variable insurance contracts. By repeating the simulation, a distribution of financial results can be obtained, and this, in turn, is used to determine the cost of the guarantee to achieve any predetermined probability of financial soundness.

Another special problem on which positive comment is not possible is the impact or effect of the new Canadian tax legislation, announced last October, on variable insurance contracts.

My own view is that, due primarily to the regulatory and compliance rules in the United States, a corresponding development of variable insurance is still very much in its preliminary stages. It is, however, most encouraging to see in the general drafting of model bills that recognition is being given to the fact that there are many ways in which segregated funds and equity investments can be used imaginatively, other than for variable annuities and mutual funds, to enhance our industry's image and provide a real service to the public.

Atlanta Regional Meeting

MR. CHARLES B. BAUGHMAN: So little has been done in variable life insurance in the United States that we do not have a definition of variable life insurance. For the purpose of my remarks only, I am going to make a distinction between two kinds of variable life insurance. One kind is nonequity-oriented, and the other is equity-oriented. The first kind is usually funded with fixed-dollar assets, and the latter is usually funded with equities.

I shall briefly describe, first, some nonequity-oriented variable life policies offered in the United States, second, some equity-oriented variable life policies offered in the United States, and, third, some equity-oriented policies offered in Canada and England.

A few companies are offering policies whereby the death benefit increases by a predetermined amount or percentage each year. Usually the increases terminate after ten or twenty years, and after this period the death benefit reverts to its initial amount. This is done to avoid a very high premium. A whole life policy, increasing 3 per cent a year for life, would require an extra premium of about $35 per thousand independent of age.

One company has offered a term policy with a guaranteed premium whereby the death benefit varies with the cost-of-living index. The company can safely assume the risk, because the little extra mortality cost resulting from the increase is such a small portion of the gross premium for a term policy.

The most interesting new policy that I have seen is the one John Bragg developed for Life of Georgia. It has a guaranteed level premium payable to age 65. After age 65 the death benefit reverts to the original amount, but before age 65 the death benefit increases in proportion to the cost-of-living index, with the provision that there is a maximum of twice the original amount. The cash values are predetermined and calculated on the assumption that the future death benefit will be the maximum and that the past death benefit was the original amount. This results in cash values which will never be lower than those required by the Standard Nonforfeiture law, regardless of what the actual death benefits may be or may have been.

A few years ago a policy was offered which was a whole life policy with an increased premium. The additional premium accumulated at interest only, and this portion of the policy was charged annually with the cost of purchasing additional insurance, so as to keep pace with a cost-of-living index. The policy did not sell well.

Let me express here a personal opinion about increasing amount and cost-of-living policies. I do not believe that they offer protection against inflation. On the contrary, because of the higher premium required, there is more fixed-dollar cash value that is subject to the inroads of inflation. I believe that the only defense against inflation is some equity-oriented product.

Maybe I should mention here Life of Virginia's variable premium policy, although I do not believe that it is a variable life policy. The death benefit is fixed, but the premium is adjusted every three years by a formula which takes into consideration yields on long-term government bonds. It appears to be a new wrinkle of introducing a participating element into a nonpar policy, and in theory it should avoid some replacement problems in times of high interest rates.

Now let us consider some equity-oriented products. For many years we have had sales of mutual funds on a periodic payment plan in conjunction with life insurance, whereby the death benefit is completion of payments for the mutual fund shares or a cash payment of the amount of remaining payments. The insurance could also provide for payments in the event of disability.

Companies offering variable individual annuities usually offer decreasing term riders too. In the event of death, the death benefit consists of the life insurance and the cash value of the variable annuity, thereby giving some approximation to a variable endowment policy with variable settlement options. These companies also offer the waiver of premium benefit, and some offer variable disability income.

Let us now consider some products offered in Canada and Great Britain. One policy that has been very successful is a twenty-year endowment policy. Almost all the premium is accumulated in a fund of common stocks. The death benefit and maturity value is the greater of the face amount or the policy's interest in the common stocks. It has been estimated that the cost of providing the guarantees is only 1 per cent of the total premium.

Another policy being offered is one which is paid up at age 65. The amount of insurance to age 65 is ten times the monthly premium times the number of years up to age 65. The portion of the premiums deposited in mutual funds is 35 per cent the first year and 70 per cent in renewal years. The death benefit before 65 is the value of the mutual funds plus the amount of insurance. At age 65 the value of the mutual fund shares purchases fixed-dollar insurance on a paid-up basis. There is an option permitting the purchase of paid-up insurance every five years with the value of the mutual fund shares.

Another policy consists of the placing of dividends on a fixed-dollar participating policy in a fund which is invested in equities.

Another policy being offered in Canada consists of the company's regular participating whole life policies with half of the reserves being deposited in the company's segregated fund. The sum of the dividend and investment earnings on the equity portion is used to purchase nonpar paid-up fixed-dollar insurance. This sum can be negative, and when this occurs the paid-up insurance is reduced in such amount as will make up the deficit. In other words, negative paid-up additions are purchased. The company sends illustrations to the policyholder showing what the combined dividend, additional paid-up insurance, and total sum insured would have been if the policy had been purchased in 1927 and 1947. For a $10,000 policy purchased in 1927, the sum insured was greater than $10,000 in all years except 1932 and 1933, when the sum insured was $9,520 and $9,390, respectively. In 1946 it was $15,160.

This has been a survey of some of the variable products which have been offered to date. I feel that it would be helpful to make a few comments on what we as actuaries might want to do about the future.

The surface has not been scratched. A policy has been offered in the Netherlands which is a totally variable policy. The death benefit, reserves, cash values, and premiums are proportional to the value of a mutual fund share. Such a policy has not been offered here, but I believe that it is possible under existing law. It would be desirable to have a variable policy with a level premium and with some guaranteed minimum. I believe that this type of policy too can be offered here under existing law.

A serious question is, What would the SEC do about such policies? Nobody knows the answer. I hope that the industry can find a way of avoiding SEC regulation of variable life insurance, because we need that freedom in order to develop sound variable life products which will best serve the needs of the public. To accomplish this, we will need excellent state regulation, and I hope that the industry will help to establish this.

Another question has been raised on whether we need a change in existing state laws. I believe the answer is no. It is my hope that the industry will in the next few years experiment under existing laws. This period of experimentation may suggest some desirable changes in the laws, but, if we try to change the laws now before we know what we want, we may do more harm than good.

Most of us have doubts whether our industry should offer variable life insurance. I am not going to debate that question here. I am going to say simply that, whether we like it or not, the industry *is* going to offer it. Let us devote much careful attention to it and do it right this time.