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SECURITIES AND EXCHANGE COMMISSION (SEC)/ MUTUAL FUND SIDE OF VARIABLE PRODUCTS

Moderator: MARY ANN BROWN
Panelists: DAVID J. PEARLMAN*
STEPHEN E. ROTH†
BARBARA J. WALTER‡
Recorder: MARY ANN BROWN

This session will discuss SEC/mutual fund issues associated with variable life and annuities, such as fund structure, legal requirements, National Association of Securities Dealers (NASD) illustration expense loads and surrender charges, filing requirements and developments regarding "hub and spoke" fund structure.

MS. MARY ANN BROWN: We have Steve Roth here from Sutherland, Asbill & Brennan, David Pearlman from Fidelity Investments and Barbara Walter from Newberger & Berman. Before I introduce them, I thought I'd give all of you a recent summary of some of the characteristics and performance from our value survey.

We did some analysis on our variable survey, to determine differences between life and annuity funds, and between internal and outside managed funds. We were surprised that there were the same average number of funds per product for both life insurance and annuities. Also, there were more than 300 different funds, not counting the ones that get repeated in many different products, at companies like Fidelity, and more than 50 different outside fund managers. The percentages of the funds for outside managers were 61% on the annuity side, and 51% on the life side. That's probably what you'd expect. You'd probably think the annuities would have more outside funds.

This year we've had tremendous fund performance in the stock and bond markets. We were trying to see if there was a distinct difference between the life and annuities in any way, but the one-year performance, as of June 30, is around 23% for both the life and annuity, the bond was around 10–12%, and the money market was 4–5% (Chart 1). Then, for the managed funds, it's around 13%, and the international, 4–7% (Chart 2). But the international side has a small number of funds, so it's not really a statistically valid conclusion to say that the life has better performance than the annuity.

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*Mr. Pearlman, not a member of the sponsoring organizations, is Associate General Counsel of Fidelity Investments in Boston, MA.

†Mr. Roth, not a member of the sponsoring organizations, is a Partner of Sutherland, Asbill and Brennan in Washington, DC.

‡Ms. Walter, not a member of the sponsoring organizations, is a Director of Newberger and Berman in New York, NY.

CHART 1
ONE-YEAR FUND PERFORMANCE AS OF 6/30/95

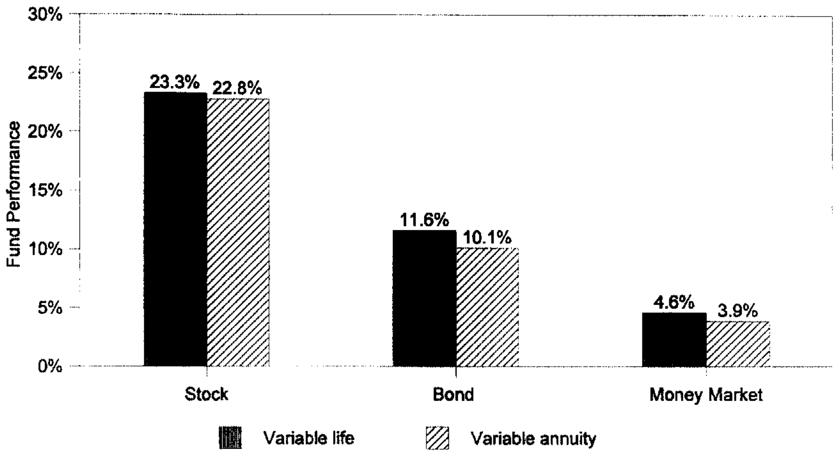
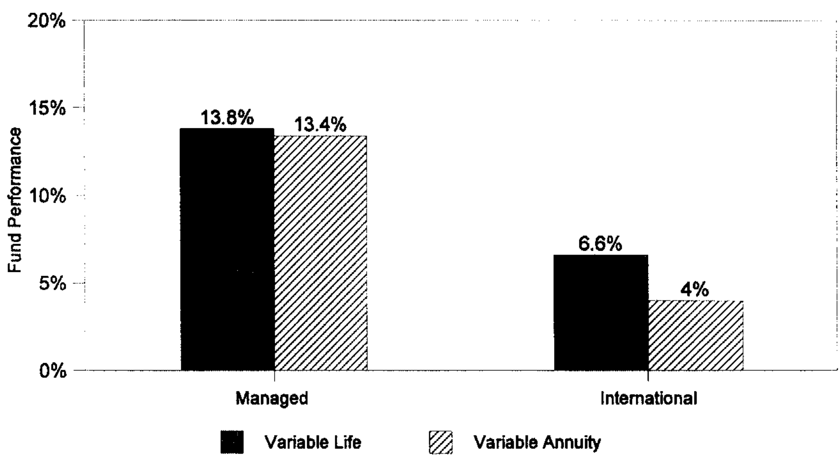


CHART 2
ONE-YEAR FUND PERFORMANCE AS OF 6/30/95



For five-year fund performance, the long term (what the products are sold for), we have done quite well. On the stock side, it's around 11–12%, the bond is at 9–10%, and the money market is around 3–4%. Then, on the managed side, Chart 4 shows that the life side is doing better than the annuity, but probably the main reason for that is because, five years ago, there was probably much more volume in the life side. The annuities have caught up very rapidly, but at that time, the life funds had been in existence for much longer.

CHART 3
FIVE-YEAR FUND PERFORMANCE AS OF 6/30/95

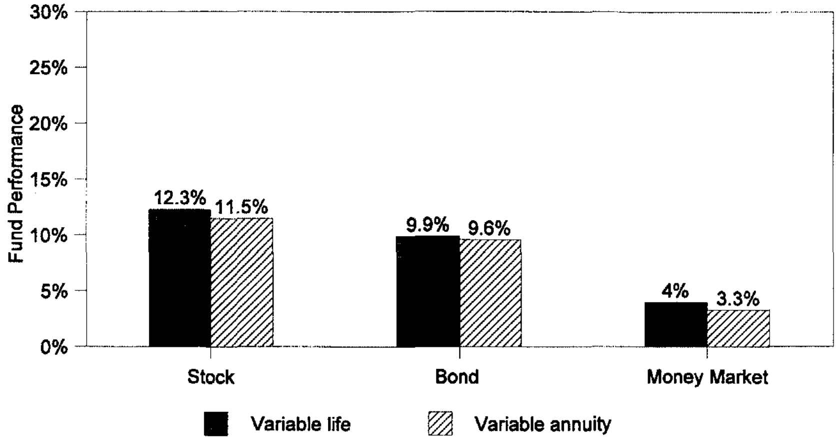
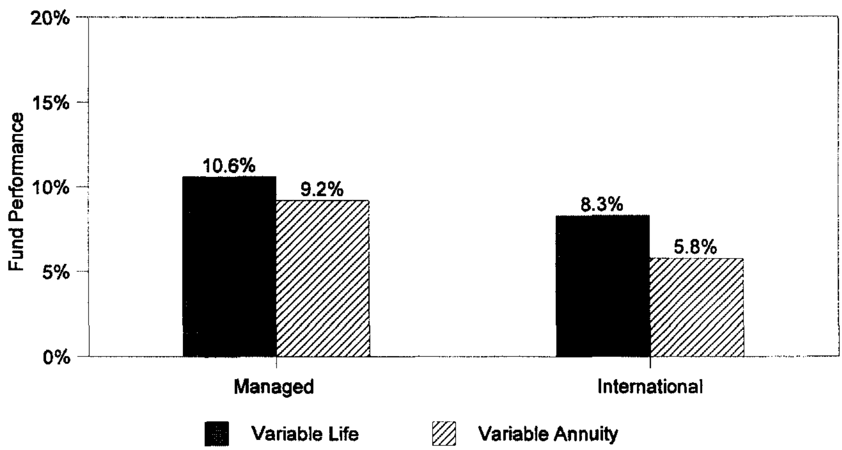


CHART 4
FIVE-YEAR FUND PERFORMANCE AS OF 6/30/95



Charts 5 and 6 show the internal versus outside funds, or what we call, in value, affiliates versus nonaffiliates. This is just for annuities. The only distinct difference that can be seen is, on the stock funds, the outside fund manager has earned about 3% more. And this is also true for the life product. For all the other different types of funds, they're really not much different at all. And in fact, on the managed side, we see the reverse of what we see on the annuity side. They're about 3% better on variable annuities, but 3% better on the life side for the outside fund managers.

CHART 5
INSIDE VS. OUTSIDE FUND MANAGER PERFORMANCE
FOR THE ONE-YEAR PERIOD ENDING 6/30/95
VARIABLE ANNUITIES

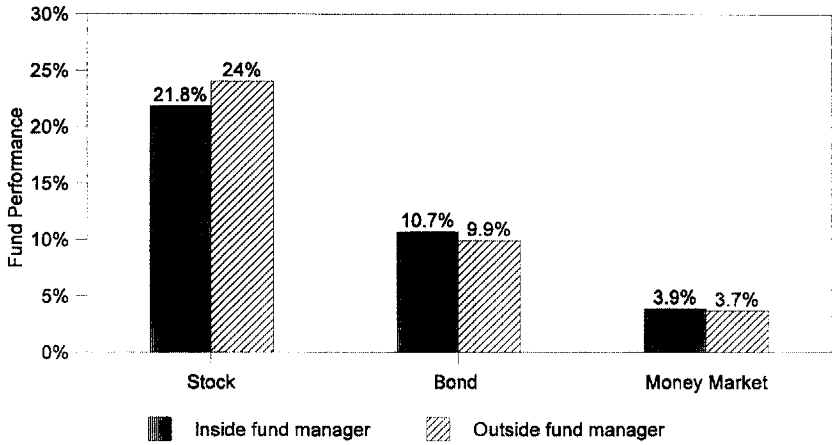
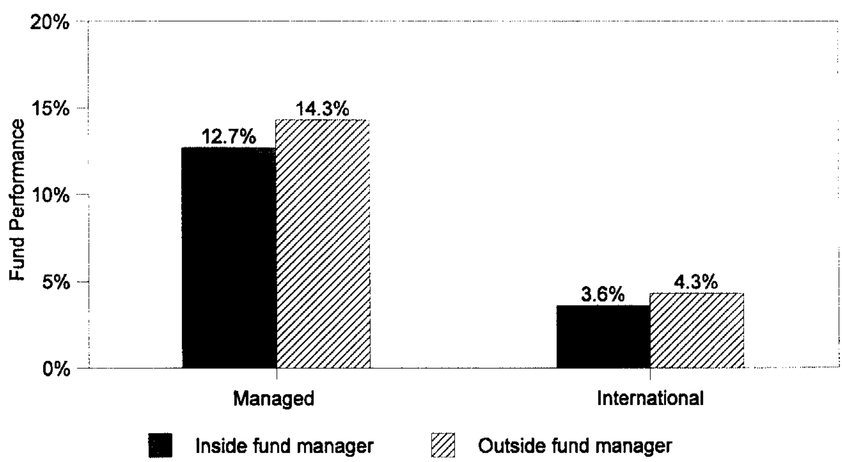


CHART 6
INSIDE VS. OUTSIDE FUND MANAGER PERFORMANCE
FOR THE ONE-YEAR PERIOD ENDING 6/30/95
VARIABLE ANNUITIES



If you average one-quarter or one-fifth of each fund in different types of investments, you see that the overall return has been about 9% over the five-year period for variable life and annuities. And we've noticed that, for some funds, like the stock funds, it is probably better to go outside. In the up market, we're seeing an increase that indicates that the outside fund manager is better. One thing to consider is that, if this was a bear market and the fund performance wasn't good, would the differential be reversed? Maybe the beta is higher on the outside funds because many are more aggressive than those that insurance companies have internally. We haven't seen that impact the market yet, but that might be one reason, when the market is increasing and doing very well, that the outside fund managers perform even better.

Overall, I you could say that with a balanced, long-term holding strategy, variable products are very strong. An 8–9% compound return is quite a good investment for policyholders over the long term. It's also advantageous that not many of these products have a great deal of transfer activity. This seems to be about less than one per year, but not coincidentally, because no commission is paid on transfers. We've just written an Emphasis article, and did some tracking to try to see what has happened with the variable sales over the last ten years. We transposed that over the Dow Jones performance and short-term interest rates. When making that comparison, we were quite surprised to see that the agents and brokers may be more motivated to sell a product immediately after the performance has been good.

We see this phenomenon of buying high, in most of the variable products, (at least the initial deposits or the initial sale tends to occur after a bull market). That's not so bad, as long as the transfers don't go out of these funds when they're relatively depressed. Then you have the worst of both worlds: buying high and selling low.

I think because we have very little transfer activity, it's still a good long-term investment for the consumer, even if they do buy high initially. And then, for the annual premium annuities and life products, we sort of build in dollar-cost averaging because of the fact that they'll pay a similar premium every time in the future. That's a good investment practice as well.

Our first panelist is David Pearlman. David is the associate general counsel of Fidelity Investments in Boston, and he's responsible for all the legal aspects of the relationships that Fidelity's mutual funds have with more than the 40 issuers of variable life and annuity products. I was surprised to see that he has been the legal counsel for Fidelity's own life insurance company since 1991. He seems to have a tremendous responsibility. In the past, he has worked with variable products and mutual funds at Prudential, Golden American, and VALIC. David's going to discuss suitability and some other issues related to the sale of annuities and mutual funds.

MR. DAVID J. PEARLMAN: I'll get to suitability later. I have a number of topics to talk about. I'm going to start with a very brief discussion of the comparison between the expenses you'll find in a retail mutual fund and one that's dedicated for sale to insurance companies to fund their variable life and annuity products. Then we'll get into the really hot issue, which are revenue-shifting arrangements between funds and the insurance companies that hold their shares. Then, I'll discuss suitability.

A couple of things are going on; one is a contrast between the general concepts of suitability that you have any time you sell an insurance product, whether it be fixed or variable. Those are state law concepts. Contrast those with the somewhat additional requirements you'll find if your firm gets into selling variable products or if your broker-dealer affiliate is going to be selling mutual funds or other things that are regulated as securities under the federal laws.

Finally, I'm going to discuss a couple of things that have helped customers do some of their own suitability work for themselves. The first one is a tool that Fidelity came out with about a year ago called Annuity Match. And the second one is something that came out only very recently from one of Steve's clients, T. Rowe Price. It's a variable annuity analyzer, which is essentially a do-it-yourself illustration kit.

Let me go back to the concept of fund expenses. What expenses are there in a retail fund, and in an insurance dedicated fund, and what's the difference? Well, obviously, both kinds of funds are registered as funds under the 1940 Investment Advisors and Investment Company Acts, and as such, they're going to have the same operational requirements to go out and buy portfolios of securities. They trade them, they manage them, and they must do reporting on them. All of these things generate the same kinds of expenses.

You have the brokerage commissions built into the price of the securities. You're going to have legal and accounting expenses, reports to shareholders, and so on. All of the types of expenses are the same, but there's one kind of expense where the number is really going to be different in an insurance-dedicated fund, and that's your transfer agency expense. A retail fund has a myriad of shareholders. Fidelity Magellan is up to some ridiculous number in the millions. There are nine or ten million shareholders, at last count. Some of our variable insurance product funds, which include ten portfolios now, are fairly small because they're new. They have about $15 billion in them, but the transfer agent expenses for those funds are very minimal because all ten portfolios have only 40 shareholders.

To get a feel for this, I went back and looked at a paper that the chairperson of our life insurance company, Rod Rohda, had written. He had done some studies on various funds, (insurance-dedicated versus retail counterparts), and came up with a ballpark figure that said there was probably a 25-basis-point difference in the expense ratios of a retail fund compared with an insurance fund. I thought we could probably get a very good comparison by looking at some of our Fidelity VIP funds (the ones that we sell to insurers). We will compare those with the very similar retail counterparts that we base them on.

We have a total of ten funds. I removed some of them because they were new and were very small and had larger expense ratios because they hadn't yet hit economies of scale. I removed a couple of others because the fee structures were somewhat different; they had all-in fees or different sorts of fee structures. I was left with some portfolios that I thought were really very comparable.

Then I looked in the Fidelity mutual fund guide to see what their expense ratios were for the first six months of 1995. I took out the management fees from the overall fees and overall expense ratios, and I was left with the category of other expenses. And those other expenses typically are not that large. They are typically 20–40 basis points for a retail fund, or even less for the insurance-dedicated fund. And I thought that, just by comparing those two categories, I'd come up with something that reflected the difference in transfer agent expenses. What I got was a number that was pretty close to what you'd expect. The difference was an arithmetic average, a simple average, of 20 basis points. Although the variation was a little larger than I thought, the lowest difference was 14 and the highest was 29. Most of them, however, came pretty close to 20 basis points.

I'd like to cover the revenue shifting issue in more detail. Can funds that are sold only to insurance companies pay the insurance companies in some fashion? I spoke on that subject earlier this year. It's a very hot issue. We have seen, over the last couple of years, a diminution in the number of new insurance companies getting into the variable products field. Consequently, as more fund companies have entered into competition for those insurers, we've seen a real buildup in competition to attract the dollars from the insurers.

Every insurance company that comes into Fidelity these days, or even thinks about it, comes to us with one question first: how much can you pay us? They don't want to know the legal reasons. They just want to know how much. Unfortunately, the answer is, we can't pay a large amount because we're not yet sure what's legal and what's not, and we want to be very careful.

There are a number of dangers, from the insurance company's standpoint, in accepting payments, and from the funds standpoint, in making them. The biggest dangers are to the insurance company. An insurance company that takes payments from the fund group may subject itself to action by the SEC in one of a number of ways. First, the SEC has expressed the idea in the past that taking these payments may be a violation of 17(e)(1) of the 1940 act for a registered investment company, in this case, the insurance company's separate account, the unit investment trust (UIT) that buys fund shares, to take money, or for its broker-dealer to take money, in return for buying shares of the underlying fund.

The other thing, and this is a little more complicated, is to look at the insurer's mortality and expense-risk exemptive relief. The SEC has always insisted that the condition for giving you the ability to charge the mortality and expense (M&E), is that you make a number of representations in your exemptive application. One of the representations they require you to make is that you not make a profit on your administrative charges, such as the $30 a year you might charge your contract owner or the 25 basis points or however you express it. If you do, you've violated one of the conditions for getting your M&E relief, and you'll have to give back all your M&E.

It's difficult to know what the payments from the fund to the insurer might be. It might be for something akin to a subtransfer agency arrangement. Many companies have gone on this theory. The idea behind a subtransfer agency is that the mutual fund, because it has few shareholders, is really delegating to the insurance company the duty to keep track of the money of ten million people that eventually ends up in the underlying funds.

There may be a million variable product owners at company one and a million at two, and a million at three through ten. But the fund obviously doesn't have to go through that trouble, and that's why the expense ratios are lower at the fund level. On the other hand, the insurance company has to do all that work. The people at the insurance company say to the mutual fund company, "We're doing the work that you'd normally be doing. Why don't you pay us for that?" The possible counter argument to the insurance company is, "You're already charging for administration services. Part of the administration that you're doing is keeping all these customer records. You're charging for it; you're getting paid for it; and you're not supposed to make a profit on it. If you're charging for it again by getting money from the mutual fund company, maybe you're making a profit on it. Show us your books and your records; show us how much you're getting; show us what it costs. If it's too much, you're in trouble." We have been very much afraid of that and have told our insurance company partners that we're very leery of that approach.

I think there's one very safe harbor in this area, and that's to look at things that the mutual fund company or its transfer agent or its advisor would be doing in the normal course of its business, but the insurer is really, in fact, taking it off its hands in no uncertain terms. At Fidelity, our transfer agent for the mutual fund is responsible for determining things like, the fund's portfolio holdings, the turnover ratio, its investment objectives, what it is doing lately, who the portfolio manager is, and what else is currently going on with the fund.

Since we delegate to the insurance companies enough information and enough responsibility to pass that on to their variable contract owners, we think that justifies the payment of some amount of money to the insurer. I don't think it justifies a tremendously large amount, and I'd be very uncomfortable with anything over a small number of basis points. On the other hand, we see a number of fund companies that are out there paying for a rather nebulous concept of services, anywhere from 5 to 10 to 20 or even as high as 25 basis points. And if I were a company either paying or receiving something in the 20–25-basis point range, I'd feel a little uncomfortable without some backup that would ensure that I wasn't going to expose myself to possible commission action later.

Because this is such a hot topic, I spoke on it earlier this year at the Mutual Funds Industry conference. I was on a panel with Brenda Sneed, the head of the SEC insurance products office. I tried to make a public pitch there for the SEC to give us some additional guidance in this area, and I was promised that they would take a look at this. Well, after a number of months, we still hadn't received any guidance from the staff. We went to someone a level higher than Brenda—Barry Barbash, the head of the division of investment management, which oversees the insurance products office. I said, "Won't you please give us some guidance?" Mr. Barbash has agreed to take a look at this. He has one of his staff people looking at one of the papers I wrote earlier this year on the subject, and we are expecting that by the end of 1995, we will have some sort of informal guidance on the subject. Possibly then, we'll be able to go back in with some more formal request, perhaps in the form of a no-action letter, and obtain some clearer set of rules.

One possibility is that we may end up with a reversal of the existing commission disfavorment of 12b-1 fees for insurance-dedicated funds. People tried to implement some true 12b-1 plans back in the 1980s on these funds, and were told, it's not appropriate. After all, it's the insurance company that's selling a product; all that the fund is doing is selling shares to the insurance company. Well, it ignores the fact that when the insurance company goes out and distributes its product, beneficial interests in the fund shares are also being distributed. The legal title in those shares is in the insurance company, but if you ask one of your variable product's contract owners, "What do you hold?", they're not going to tell you, "I hold units in a subaccount in XYZ insurance company." They're going to tell you, "My money is in Fidelity Magellan," if that's the underlying fund. That makes a great deal of sense, so we're hoping that might be the outcome.

We're going to go on to the topic that Mary Ann started, which is the concept of suitability. How does that work in the variable products world, how does that work for an insurance company that gets into the mutual fund distribution world, and how may that be different from what insurers have done in the traditional fixed-products world?

The first thing to understand is that all of the state insurance suitability requirements that go for fixed products also go for variable, and there's no diminution of responsibility there. If you have an agent that's going out discussing needs and benefits with an individual, and saying, "I really think that, based upon the information I've gotten from you, that this product is the thing that you really should consider, or should be investing in or buying to meet your life insurance or annuity needs", then you have somebody who's in a position of being held to a standard because he or she made a recommendation. He or she better have some information somewhere. It can be a discussion, a written record or whatever, but something in the files had better reflect that he or she had some basis for making that recommendation. Otherwise the state regulators will get involved.

In addition, if you have a variable product and you're making recommendations, you have National Association of Securities Dealers (NASD) rules to worry about. The NASD requirements are triggered, again, by the concept of a recommendation. If you're a direct marketer, a direct-response issuer of a variable product, or a direct seller of a mutual fund, you may not be making recommendations. And if so, then you don't have the requirement to make the suitability determination that this, indeed, is in the best interest of your customer. If you look at all the federal requirements, however, you see that you have a number of rulemaking bodies. You have the municipal securities rulemaking board, the NASD, the New York Stock Exchange (NYSE), and if your broker-dealer firm is a member of the NYSE, it's subject to the know-your- customer rule that the exchange has.

There are other regulatory bodies with similar requirements. However, in the securities arena, unlike the insurance arena, all of the requirements are triggered only if you have the recommendation concept. What's a recommendation? Well, you're not going to worry about that if you're in the full-service brokerage business. You're going to take the position that your broker is out there doing what's best for its clients; the people that are contacting those clients are making recommendations. You're going to get pieces of paper, and you're going to put them in a customer file, and you're going to satisfy your suitability determination that way.

The concept gets a little bit dicier if you're a discount broker in a direct-response business, because there, you're going to want to relieve yourself of the burden that comes along with keeping all those books and records. You must steer away from that. You're going to try to structure your business so that you're not in the business of making recommendations. That's not such an easy thing to do. Occasionally, I listen in on the phone lines at Fidelity. I try to make sure that the people selling our products aren't crossing that line, but it's an easy thing to do.

Let's suppose, for example, a customer calls into a discount mutual fund or a discount brokerage operation and says, "I've read the ads, I've read the guides, I've read some stuff. I want to talk to you some more, give me some information about your 27 mutual funds in the growth arena." We'll say, "The equity income fund has this sort of strategy, Magellan has another, and other funds have yet other sorts of strategies and turnover ratios." The customer says, "That's all very nice. I narrowed it down to these three funds. Tell me, which one would you invest in if you were me?" It's a very human and natural and sympathetic reaction to say, "I think I'd put my money in XYZ fund."

Even though it may be an "I think," and I'm not recommending and I'm not suggesting, customers are going to assume Fidelity said this is the fund they should be in. And if you go to an NASD arbitration, the customer is going to sit there, in good faith, and say, "He told me to put my money in Magellan. I didn't know Magellan was going to go down 20 points the next day. I want my money back." Generally, you'll win those cases if you're the brokerage firm, but it costs money and time to defend them, and it's not good for your customer reputation.

It gets even worse if you have similar funds that are retail funds and that are wrapped inside a variable annuity or a variable life product. Somebody might call in and say, "I love equity income funds. I see that you have an equity income one and an equity income two. What's the difference?" A registered representative at Fidelity might tell them the difference. The registered representative might then talk to the customer a little more, and find out that the customer is a high-bracket customer with a large amount of liquid assets and long-term investible assets. The representative might ask, "Have you ever thought about something with tax deferral attached to it?" The customer might like the tax deferral idea, but has money in a 401(k), or has maxed out an individual retirement account (IRA). Or maybe the person has a Keogh or a simplified employee pension (SEP) plan IRA or something and can't put any more money into those accounts.

The representative might say, "Do you know that we also offer a variable annuity product, which is a tax-deferred product? It has a fund in it that's very much like the equity income fund." Is that a recommendation that the client go buy an annuity and put his money in the equity income fund? Probably not, but it's dangerous again. At Fidelity, we take the position that in the vast majority, if not all cases, we're not making a recommendation, but you're always out there with a possible exposure from a customer who hears what they want to hear, and not what you're trying to tell them.

Let me turn to the two tools that have come along in the last couple of years as do-it-yourself suitability tools for your customer. The first one was the Fidelity Annuity Match. Annuity Match is sort of a simplistic black box, if you want to think of it that way, for the customer who may or may not have seen a variable annuity product before, but may already be a mutual fund investor. John O'Sullivan, who is in the audience, can take credit for this product as it was John's brainchild. Public response has been very good, and even Steve Roth, the SEC and the NASD seem to be very happy with it, which makes me feel very good.

Annuity Match is a cousin of Fidelity's fund match, and the fund match was conceived of as a way to help Fidelity customers decide which of the myriad of Fidelity funds might best match their investment objectives, their risk tolerance, and more. However, Annuity Match was designed for a very different purpose. Instead of narrowing the field from a broad number of mutual fund products down to a category containing a relatively small number of funds from which the investors could pick for themselves, Annuity Match is more of a self-screening tool for people who are trying to decide whether they want to buy another mutual fund, or if they have enough assets, or if they should consider a variable annuity.

Annuity Match is a worksheet with a series of questions. The first three questions are screening questions. They're designed to weed out people for whom an annuity is not a good idea. The first question asks if the prospective purchaser is making maximum use of other tax-deferred vehicles, such as a 401(k), 403, IRA, or Keogh. All of these other vehicles provide tax deferral, and all are available at a lower cost than a variable annuity. The second question asks if the reader has a cash emergency fund of three to six months' living expenses. The thought behind this question is that tying up all of one's liquid assets in an annuity is going to be very, very expensive in terms of surrender charges and possibly penalty taxes if some unforeseen event results in a need to surrender the annuity soon after it's bought. The third question gets at a similar concept, and asks if the reader is comfortable that he or she can meet all of their planned expenses with nonannuity dollars. Annuity match then tells you that if you've answered no to any of these three preliminary questions, you probably don't want to look at an annuity.

However, if you survive the first three with yes answers, then you move on to a worksheet with five more questions. One, what portion of your investible assets might go into the annuity? Two, how long do you plan on letting the dollars accumulate before any withdrawals or annuitization can be made? Three, do you expect to withdraw more than a third of the money before age 59½ (the magic age for the penalty tax)? Four, what's your federal income tax bracket? Five, how do you plan to liquidate the annuity, that is, is it going to be in a lump sum, a large partial withdrawal followed by systematic withdrawals, or some sort of systematic withdrawal program which might be annuitization.

You get a numerical score for each of these five questions, and you add up the individual scores to get a total score. The total scores are then used to place the customer on a "tax-deferral-continuum," in one of five bands, which are really allocation splits between dollars that might be suited to tax-deferred investments, and dollars that might be better left in other products. The more the reader's answer indicates that a deferred annuity might be appropriate, the higher the percentage of their investible assets they might want to consider putting into a deferred annuity.

That's a good black box, but what's the methodology behind it? I was told by our business people that it's fine to talk about the methodology, but not the actual numbers that underlie the factors that we're going to talk about in a moment. Let me go through what the basic assumption parameters were here. There are ten basic categories of assumptions. Number one is the length of the accumulation period before any annuitization or withdrawals. Number two is the utilization strategy, once you get to the accumulation period's end, whether it's annuitization, systematic withdrawals, surrender, or whatever. Three is some assumptions about the tax rates, both current and future. Four will be the investment returns. There we got a little fancy, we had different assumed investment returns for the variable portion of the annuity contract or the fixed account portion. Five, when you look at the mutual fund, on the retail side, what's the mix of long-term capital gains and ordinary income? Six, also with the retail fund, what's the percentage of mutual fund capital gains that are deferred?

Obviously, if you have portfolio turnover or other things, you're distributing capital gains every year. You also have shares that are held by the fund on which it doesn't realize capital gains and doesn't have to make a distribution every year. Different funds have different characteristics, and you can get very fancy in trying to build a number of assumptions about different sorts of funds.

To continue with the 10 basic categories of assumptions, seven, on the retail side, is how often will a person exchange their mutual fund holdings? Fidelity research shows that a retail fund customer will hold their funds for a given number of years. (I'll discuss that when we get to the T. Rowe Price product.) And then they're going to trade out that money and buy a different fund. Eight is, even if people aren't making complete transfers of assets from one retail fund to another, many people will rebalance. They want 60% of their money in equity, and 40% in bonds. If the equity portfolio does very well for a couple of years, they'll sell off some shares, pay tax on the gains, take the proceeds, and put them back in the bond fund to get back to the 60/40 match.

Nine is that you have additional expenses associated with the annuity. Generally, it's going to be fund expenses plus annuity expenses, minus about 25 basis points for insurance fund expenses that are lower than retail fund expenses, to come up with a number for that. And ten, is that there is a 10% penalty tax, generally on distributions from the annuity before age 59½.

Once you're done number crunching, and there are a large number of assumptions that go into all these things, the result is a number that translates into a perceived advantage, either for the annuity or the mutual fund side. If you end up with an advantage in favor of the annuity, the degree of that advantage determines which of those five tax-deferral continuum bands you'll find on the annuity match worksheet. Obviously, if anything has such a large number of assumptions, all the answers have to be taken with a grain of salt.

If you change any of the assumptions, or if they're off, you're going to have a problem. Annuity match is very clear in telling the readers that this is not something you follow blindly, it's just a starting point. It's intended to give you a ballpark estimate to help you determine if you look at this thing, and if so, in what quantity? The legal aspects of annuity match are pretty uncontroversial. We filed it with the NASD as sales literature, since Fidelity offers a deferred annuity product. And in fact, we filed it under Rule 482, which is the rule that lets you give out a piece of literature associated with a product without having to give out the accompanying prospectus. Annuity Match, while fairly simple and easy to use from a customer perspective, doesn't give the customer a chance to modify the assumptions and try to fine-tune it. In a sense, that's what the T. Rowe Price variable annuity analyzer does. Let's turn to that one for a moment.

The variable annuity analyzer just came out recently, and there was a piece in the *Wall Street Journal* a few weeks ago listing T. Rowe's 800 number from which you can get the disk. Unlike the Fidelity piece, the T. Rowe was filed as sales literature under Rule 156, on the theory that this is supplemental sales literature, an illustration program, essentially, in conjunction with the annuity that Security Benefit Life issues, which has T. Rowe funds underneath it. Therefore, it needs to go out with a prospectus. So if you called them up and asked for the disk, they're going to send you a prospectus and the disk for your PC. Steve Roth worked on getting exemptive relief from the SEC for this piece.

There are a couple of issues. One was, under 17(a) of the 1933 Securities Act, could the piece be considered misleading in that it involves a number of things in which the SEC has expressed interest in the past? Two, under Rule 156, the sales literature rule, is there anything about it that might be considered incomplete or misleading? And, Steve made a number of representations on behalf of T. Rowe and Security Benefit. The staff took a look at it, said "No, we don't believe this is misleading." I think perhaps one of the compelling factors in there was limiting the assumed investment returns to a gross rate of 0–12%, which is in line with the other NASD pronouncements and SEC pronouncements that state that you shouldn't go above a 12% gross return in illustrating things on variable products.

The software is fun to play with. It's a do-it-yourself illustration program. There are a large number of graphs that come out of it, and the permutations that you can play with are virtually endless. As with Annuity Match, there are many assumptions involved. There are 23 of them listed in the program itself, and obviously, underneath those are more assumptions.

I think the most striking difference between the two products is that, obviously, the annuity match is a simple one. T. Rowe Price lets you change your own numbers, to see how much a small change in assumptions will affect the value of the two products. But among those assumptions, there's one very interesting difference. I mentioned before that Fidelity assumes that once every four years, a customer will turn over their mutual fund holdings. That's more advantageous, obviously, from the annuity standpoint versus the mutual fund standpoint. T. Rowe took a more conservative approach to that, and assumes that there is a single mutual fund investment which is held for the entire time period. We're going to turn to Steve now for his presentation.

MS. BROWN: Steve Roth is a partner with the firm of Sutherland Asbill and Brennan in Washington D.C., and has been a partner there for over 12 years. He regularly advises clients on the regulatory issues associated with the mutual funds and variable product regulation. He's going to discuss several recent developments that have occurred both with the SEC and NASD.

MR. STEPHEN E. ROTH: I thought I would start out by commenting briefly on three of the things that David commented on, because I think they're very important issues. First, a comment on the revenue-sharing arrangements that David talked about. The issues he pointed out are all valid. What I would note is that, in an effort to shift from arrangements that are deemed to be payments to the insurer for administrative services to 12b-1 arrangements, which are distribution fee payment arrangements, other more complicated issues can arise. If the insurance company receives a 12b-1 fee—or if the investor is paying a 12b-1 fee, does that 12b-1 fee need to be counted along with the explicit sales load in the insurance contract for purposes of determining whether the overall investment complies with the SEC sales load limitations? To the extent that more expansive rule 12b-1 plans are pursued, that issue could come up. Both the SEC and the NASD may be interested in such arrangements. The NASD, with respect to retail mutual funds, does have a system in place for limiting explicit sales loads on retail mutual funds. It is going to be interesting to see how that evolves.

My second comment relates to suitability. What I would point out here is that two leading mutual fund organizations, Fidelity and T. Rowe Price, have produced what I believe are fairly sophisticated programs to enable the investor to determine whether the annuity investment is suitable. The insurance industry's traditional distribution forces and regional and wirehouse broker-dealers, are employing such sophisticated techniques to determine whether these investments are suitable for their clients. What collateral effect can the actions that organizations like Fidelity and T. Rowe have on the direction in which suitability determinations generally need to be made? In other words, to what extent will regulators look at the Fidelity and the T. Rowe models, which admittedly are in a direct-response context, and hold them up as the standard for determining suitability in other markets?

The final comment I'd make about the T. Rowe software is that it's very significant, but the story is not finished. In the past, the SEC and the NASD had allowed hypothetical illustrations to be used during the payout phase to show how a payout works. And, variable life products have always used hypothetical rates of return to illustrate variable life cash values and death benefits. But, the T. Rowe letter is really the first time, in approximately 16 years, that both the SEC and the NASD have said it is OK, in this context, to use a hypothetical rate of return to show how the accumulation phase works in conjunction with the payout phase.

I have heard that there has been discussion with the NASD by some of the mutual fund groups who are asking, what's going on? Since mutual funds can't ordinarily use hypothetical rates of return to sell their shares, they may question allowing this variable annuity product to be sold with mutual funds. The NASD and the SEC examined this very carefully. They have, I believe, very good reasons for drawing the line where they did. Nonetheless there will likely be some further evolution in this area. David, would you like to add anything?

MR. PEARLMAN: There are a couple of topics there. First, on the no-action letter that you got on behalf of T. Rowe, there's a sentence at the end that's very explicit that says not to take anything about what's in here in the mutual fund context, which I presume means, as Steve says, they've left this open for further developments.

Second, I want to go back to the 12b-1 issue for a moment. If you're going to bring up the whole can of worms, it might start crawling around. If there is 12b-1 permitted for an insurance-dedicated fund, you get some very interesting ones. I think the toughest one is to consider a product, as most products are, with funds from a number of companies. Some of those may implement 12b-1 plans, and some may not. The ones that do may have different levels of payments to the insurer. If you have a variety of funds in a product and some are paying the insurer while some are not and you start to see a flow of customer money from the fund groups that are not paying to the ones that are paying, that raises you, I think, to a level of concern where you have to look at your sales and marketing practices and ask, "are our people out there steering people into these particular funds so that the insurer will make more money?"

Even in the context of service payments, we've seen dramatic shifts within a particular product. For example, there's one large company that Fidelity used to represent. There were 6 of 22 investment options and those six options accounted for 55% of the money in the product. The company added five other investment options about a year ago, and the share of assets in our funds has now dropped from 55 to 40. They pay money, we don't pay very much, or none. Perhaps that has had some influence on where the money has gone; we don't know. But it's something that bears consideration from a compliance standpoint and certainly from a marketing standpoint.

MR. ROTH: Let me address, as Mary Ann said, some current developments which relate as much to the product side as they do to the fund side of the equation. It has been a particularly active period at both the SEC and the NASD. There have been a number of developments related to product design and also some developments related to marketing. Let me start with product design.

There are six developments that I'd like to list for you. First, three-and-a-half years ago, the SEC staff recommended that legislation be enacted that would overhaul the manner in which the SEC regulates the charges assessed under variable annuity and variable life products. That recommendation was greeted favorably by the industry. It went nowhere largely because there was a change in administration in 1993, and a wholesale departure of the SEC staff in 1993–94. That recommendation has not been pushed by the current commission or staff.

Instead, in the spring of 1995, the Republican Congress introduced a bill with many of the recommendations that were issued back in the spring of 1993. Absent from the bill as introduced was the recommendation to replace the charge-by-charge regulation we now live with under the 1940 act with the overall reasonableness standard that was being recommended back in 1993. That absence was not a result of any considered judgment on the part of the House committee staff. Rather, they wanted to introduce a bill and allow the various industries regulated by the 1940 act the opportunity to provide suggestions for additional provisions to modernize the 1940 act. It is highly unlikely that this bill will go anywhere this year.

The insurance industry trade associations are now in the process of approaching the committee staff with a view towards the next session of Congress and specifically with an intent to work with the committee staff to place a provision in the 1940 act. It would replace what we now have with an overall reasonableness standard for variable products. There is still a question as to whether this legislation will ever pass, but the point is, it's not dead.

The second development relates to M&E charges. As you know, under a variable annuity product, one of the things that must be filed with the SEC is an individual application for exemptive relief for the M&E charge. The good news in the past couple of years has been that the SEC has removed the cap where enhanced death benefit features are involved. The bad news is that companies still have to go through the exercise of preparing and filing this application. From the staff's perspective, they have to go through the exercise of reviewing the application. Both sides are tired. The SEC staff this past summer and early this fall have been working on an M&E rule that would cover variable annuity products so that variable annuity issues would not need individual start-up relief for an M&E charge.

The staff has indicated informally that they expect to publish their rule proposal in early December. They have not revealed the contents of that proposal, but early indications are that the standard for the M&E charge in this rule may be somewhat looser than in prior proposals. In other words, the representations that they have been requiring of insurers will be relaxed. So that's something to look for in December.

The third development relates to limitations on partial withdrawals. A number of insurers have received comments within the last several months regarding features in their contracts that limit partial withdrawals. The staff's view is that any limitation on the frequency with which partial withdrawals can be taken under a variable annuity contract, or any limitation on when you can begin taking them, is contrary to the redeemability requirements of the 1940 act. Many companies took the position and assumed that the staff agreed that the redeemability provision of the 1940 act only requires that the contract be surrendered in full. The staff is disagreeing with that.

The fourth development relates to a scrutiny of asset-based administrative charges. As you know, these administrative charges must be cost-based without any anticipated element of profit. This is not a dead letter because the staff is, as part of their inspections of insurers, requesting materials and written procedures that the insurance company has in place to monitor the cost-based nature of their administrative charges. If the staff finds that there are no such procedures in place to monitor the cost-based aspects of the administrative charges, or if those procedures are not being rigorously applied, they are citing companies for deficiencies. I'm not aware of any situation where the SEC has required that any administrative charges be refunded, but you should be aware that it is an area of interest.

There are several other things worth mentioning. We're seeing a great deal of activity in the variation of loads going beyond what we used to see. Traditionally, we saw disclosure in prospectuses for varying loads in connection with group or sponsored arrangements. We're now seeing much broader applicability of that and questions are arising due to the fact that the disclosure in the prospectus is frequently not broad enough to cover all the situations in which companies want to vary their loads. I would recommend reviewing your prospectuses to see whether the disclosure is broad enough.

The last product design issue relates to market-value adjusted (MVA) annuity products. A couple of years ago the SEC took the position that if an insulated separate account was used to support a modified guaranteed annuity product, the insulated account should be treated as an investment company. This meant that the separate account would need to comply with the operational and product design restrictions imposed by the investment company act. The new staff that has been in place for a year has been studying this issue. These staff members are not happy with the way the staff came out two years ago and all indications are that they are on the verge of issuing a no-action letter that will reverse the staff's prior position. The effect will be, at least from an SEC standpoint, that the SEC will not stand in the way or pose any additional requirements on insurers that want to insulate separate account assets that support their modified guaranteed annuity products.

There also have been several SEC or NASD developments affecting the marketing of variable products. First, the emphasis of regulators today has shifted away from regulation of product design to marketing, disclosure, sales practices, suitability and so forth. This is evidenced by the initiatives now underway for simplified variable annuity prospectuses and for a variable annuity profile similar to the one that mutual funds are now able to use. We're likely to see some action on both the variable annuity profile and a variable annuity simplified prospectus within the next year. We also hope to see some action on a new prospectus format for variable life contracts that will take a lot of the information that's now in the prospectus and move it to the statement of additional information.

The other point I will mention relates to what the NASD is doing in the compensation area. In the past, whenever a company inquired about the SEC/NASD regulatory scheme, I would explain limitations on charges that are imposed by the SEC, but would note that neither the SEC nor the NASD regulated the amount of compensation paid. This is all about to change, however, you may be familiar with the NASD's proposed rule that regulates cash and noncash compensation. The focus of that rule proposal is on incentive programs, noncash awards and bonuses for meeting specified sales targets. The rule is not yet final, but I predict that it will become final in the next few months.

When the rule becomes effective, it will change the way in which incentive programs can be administered by broker-dealers selling a number of different variable products. What's most important is that sales contests limited to a particular company's product will no longer be permitted. The award will need to be based on total sales of all variable products distributed by that broker-dealer. That's going to mean that any awards will be required to be based on sales of all variable annuity products that the broker-dealer is offering or all variable life products that are being offered. Individual companies are not going to be able to go to these broker-dealers selling a multitude of products and have a targeted program just for their own product.

The NASD also is studying in a general way the cash compensation arrangements for selling variable products and they are going to mandate disclosure for compensation arrangements. Currently, the variable products industry enjoys a competitive advantage, if you will, over mutual funds in that the NASD rules don't mandate disclosure of compensation for variable products. That is going to happen and it'll happen in the near future. The question that I'll leave you with is whether this study that they're undertaking might lead to more of a "hands-on" regulation in the manner in which base compensation is paid. It is possible that it might since there have been studies about compensation practices in the industry—such as the so-called Tully Commission Report that was issued last spring—that highlight the conflicts between compensation practices and customers' interests. To the extent the NASD follows the recommendations in that report, they may propose some rule changes that could do more than simply mandate disclosure of the general compensation arrangements.

MS. BROWN: Barbara Walter is a director of Newberger and Berman, and she's responsible for business development in the area of executive benefit programs and insurance wrap investment products. She has 12 years of investment and insurance experience, which includes an extensive background in product line development management, especially registered and private placement variable life products. Prior to Newberger, she was vice president in the corporate-owned life insurance (COLI) division at Cigna, where she headed up the variable product line. And before Cigna, she was product manager of variable products at Transamerica. She'll discuss Newberger's "hub and spoke" or "master/feeder" fund structure, including the pros and cons of its development.

MS. BARBARA J. WALTER: I want to just give a few introductory remarks about how arrangements are structured, between investment companies and insurance companies in the industry today. These can be set into three primary categories. The first arrangement would be what we would view as the oldest and most basic arrangement, where the insurance company does it all. The insurance company produces or manufactures the insurance product. They use their own internal resources for investment management, and they look for profit sources to both the investment piece as well as the insurance piece. The downside to doing it this way is that you really have single-channel dependency. You're dependent on your own internal agents and brokers. As widespread as that may be, we're finding, in the industry, among your peers, that people are saying that they're looking for other external channels to distribute their products, and the internal mutual fund complexes are not as attractive today as they may have been in the past.

This takes us to our second scenario, which would be the use of outside funds, but in what we call a subadvisory arrangement. In this arrangement, the insurance company acts as the advisor to the separate account, and hires independent investment complexes to manage the assets on their behalf. And the term that we use for a manager who manages assets on the behalf of another advisor is a subadvisor. In this arrangement, again, from the insurance company's perspective, there are good profit opportunities both for the investment piece of the product, as well as the normal profit opportunities that you would look for in the insurance piece of the products.

Let me step back for a minute and mention that, across the board, insurance carriers are delivering proprietary products using their own internal fund groups. Many other people on my side of the fence are hearing that, on average, you all are looking for somewhere in the range of 15–25 basis points in profit opportunity derived from the investment piece of these proprietary funds. Now, when you go to a subadvisory arrangement, we're hearing, from your peers, that profit piece moves down into the range of 10–15 basis points.

That varies from insurance company to insurance company, but on average, I think that those are, for the average insurance company, very credible numbers to be thinking about. Now, the reason why there's a drop is because the subadvisor, of course, needs to have some profit participation also. So you give up a little bit on your profit participation when you go to a subadvisory fund. However, you do gain some marketing opportunities, and you also gain the opportunity to perhaps bring in styles that you, internally, are not currently delivering.

Because of the new trend that we're seeing in the industry toward the use of asset allocation models with these products, with variable annuities and also with variable life, we are noticing that there is an increasing demand for what we could call core styles in these products. Your core styles will be equity, fixed income, money market, and some sort of a balanced portfolio, which is a combination of equity and fixed income. Some of the other style choices that are included in these asset allocation models are mineral funds, hard asset funds, commodity opportunities, and the new styles are not styles that you would find typically within your own insurance company, and within your own internal investment complex. So, this strategy does give you an opportunity to bring in some more esoteric styles that you may not already have available to you internally.

The third strategy would be to forego the opportunity to be the advisor to the separate account, and go directly to hiring outside fund complexes and fund managers as advisors to your separate account. Now, again, you will get the variety in the fund selection. You will have some opportunities to participate in the fees and charges that the outside fund manager offers, and that range we're hearing is anywhere from five basis points up to 25 basis points. So, in the past, let's say pre-1991, when you went to outside funds, it was not typical for an outside fund manager, who was performing advisory duties, to offer to the insurance company some opportunity for fee sharing, whether it was in the form of reimbursement for marketing, sponsorships for conferences, or sales meeting sponsorships. Those types of fee-sharing arrangements were not available pre-1990 or 1991. Today, it's fairly common for an insurance carrier who's approaching an outside fund to have a discussion with them about how they can at least get some sort of a marketing reimbursement in return for promoting the entire product, which would include the outside fund manager.

I'm bringing this up because I found that when we were running pricing models in my former job, there was a large variance and a long strategic discussion about whether or not it really made sense to use outside funds. If you want to go the advisor/subadvisor route, there is a cost to entry because you are essentially performing the oversight, the due diligence, the manager selection, and many of the reporting functions for your subadvisors, for your products. So, in a sense, you're bringing up a form of a fund company. You already have to do some reporting functions for your separate account. Going to the advisor/subadvisor role lays in another several levels of expense into your pricing models. When you go to the outside funds, many of those expenses go away because your outside fund manager performs all of the oversight, performs all of the 8–17 checking and diversification checking, and prepares all of the reports. Everything is transmitted to you electronically on feeds. They produce the prospectuses for you. The only piece that's left that's similar in the two scenarios would be your due diligence, which you have to do anyway, when you take these funds to your boards. You also need some form of annual review, which you would be doing anyway.

The fourth arrangement, or the new arrangement, called hub and spoke, has been very interesting and very attractive to us in the investment industry, particularly those into variable insurance products, because it allows us, for the first time, to deliver to an insurance company any of the scenarios that I have just described. A proprietary product, which would be a form of the first scenario I described, is a product that has your insurance company name on it. In the second scenario, a subadvisory arrangement can be arranged through the master/feeder. Hub and spoke is a trademark name that we're not supposed to use. And also, in the third arrangement that I described, just through the use of outside funds, you can also get that through master/feeder.

You may wonder why we are going to all this trouble. The reason why we find this structure so attractive is because, in master/feeder, the money flows into what we call the master. With all of the money from all of the sources—from our arrangement on behalf of an insurance company in a proprietary sense, our arrangement on behalf of an insurance company as a subadvisor, and our arrangement with an insurance company as a pure advisor, outside fund—we are able, with one portfolio, to affect those three arrangements and have all of the money from those three arrangements, with all of their numerous distribution channels, flow into the master. Now, what that means is there is available to you, through the money flow into the master, the historical performance of the portfolio. When you hire a subadvisor, the subadvisor must bring up a fund that's independent of anything else that they're doing. They generally can't commingle the money.

There are some variations on this, but in general, that's what happens. When you hire an outside fund, you are commingling. When you're bringing up a proprietary fund, you're only bringing that up for yourself. In this scenario, we can give you the feeling that you have a proprietary fund; you have a subadvisory arrangement, or you have an outside fund, and you get the benefits of commingling, which allows you to hit investment advisory breakpoints quicker. You get the benefits of any historical performance that fund may have had. Many of these funds have been out for ten or more years, and any of you who have to deal with your field force and your sales forces know that is a very important piece of information to them. In many cases, you may be able to avoid the seed money requirements for starting up the fund. So, in an all-around perspective for us, in the investment industry, this became a very compelling argument, because with one fund, we were able to meet the needs of every insurance company that was coming to us; we could give them something extra that they couldn't have received in two of the three scenarios.

Let's look at Chart 7 to see the way a mutual fund company really works. The left hand bubble is a typical mutual fund. A mutual fund portfolio is really a two-companies-in-one portfolio. You have the portfolio management function, which is the securities selection, the securities trading, and the actual management of the buys and sells within the portfolio. Then you have, as a secondary company, the marketing and distribution function. Now, marketing and distribution would provide prospectus, proxies, shareholder servicing, and all of the other functions that go along with services and benefits not only for the people who sell your products, but the people who buy them.

We've separated the two functions of the master/feeder into two separate entities (Chart 8). The master is where the portfolio management, the securities trading, and all of the advisory functions occur. In the feeder, all of the marketing and distribution functions occur—providing proxies, prospectus, shareholder servicing, and special pricing deals that relate to specific distribution channels, all of the special things that we can do for each of the different insurance companies that occur in the feeder. The fees are set in the master. They are what they are. They are the investment advisory fees. Those are not negotiable. They're set in stone, and they do have a breakpoint schedule to them, as I mentioned earlier.

CHART 7
TYPICAL FUND STRUCTURE VS. NEW MASTER/FEEDER

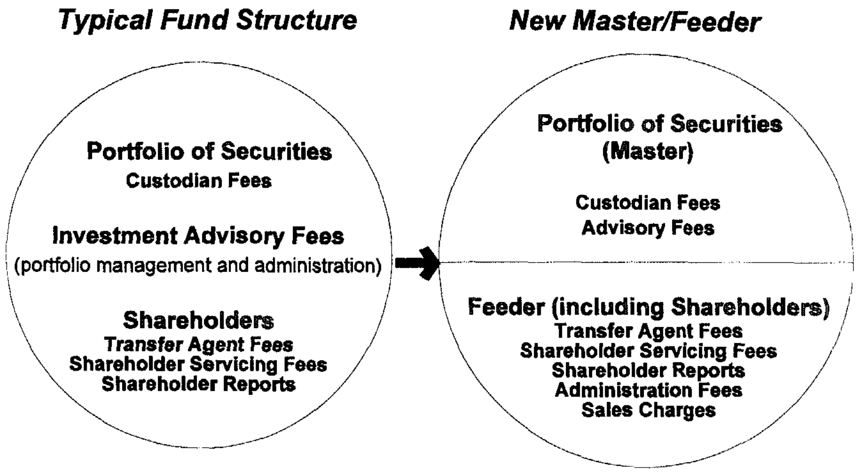


CHART 8
MASTER/FEEDER STRUCTURE

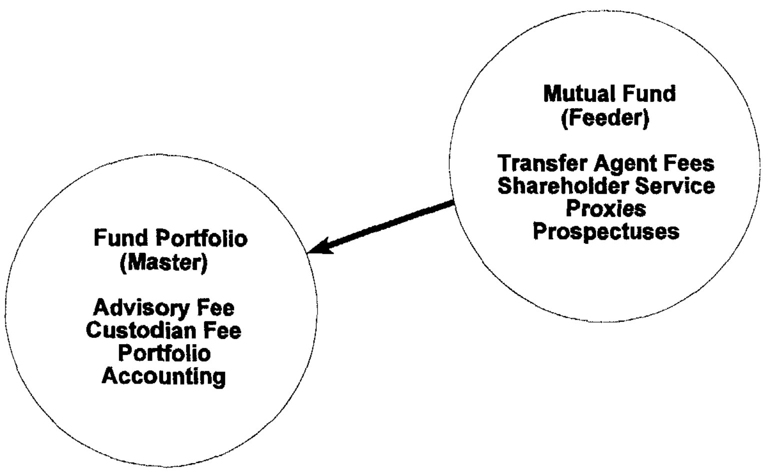
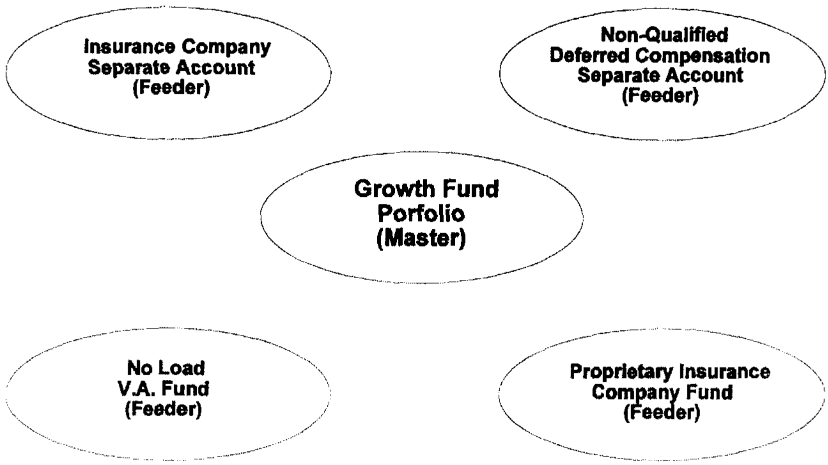


Chart 9 is another illustration of what I just described. Let me say something about this illustration. When we have this scenario, as I mentioned before, that feeder, the lower right bubble, could be a proprietary fund for an insurance company. We could have another bubble below it that could be a subadvisory arrangement for an insurance company. And then, we would always have a third that would be our standard outside advisor arrangement.

CHART 9
MASTER/FEEDER POSSIBILITIES IN INSURANCE PRODUCTS



In the standard outside advisor arrangement, as I said before, the fees in the master always stay the same. In that standard outside advisory arrangement, the fee schedule would also remain the same. Anyone who came to us and said, "You do it all, we really don't want to do anything," would get that fee structure. If someone wanted to perform a subadvisory function for us, we would be able to, not through the master, but through the feeder, set a different fee schedule for him or her. The same applies to someone who wanted to have their own proprietary fund; we would set a separate fee structure for them.

What we have, in effect, are three separate fee structures, all feeding into one master portfolio. The money from your premium deposits flow from your product into your separate account, into the feeder, and directly flow through to the master. So no matter whom we're dealing with, we're able to commingle their assets at the master level.

This is essentially what we envision, in the industry, as the way the master/feeder structure will work. In fact, there are several fund complexes out there that have contemplated and have actually implemented this, and this is actually what we are seeing. There is one issue and that is, to participate in this, you must realize that you really don't have any control over the investment objectives or the policies of the portfolio.

When going into this arrangement, you must be sure that you are satisfied with the investment objectives and the policies of that particular portfolio. If, for example, you were looking for a proprietary fund, and you were not interested in doing the master/feeder, you could go to a fund complex and negotiate not only the fees and expenses that would be inside of that portfolio, but you could also have long discussions with them about the objectives and the policies. You would have a great deal of control in terms of influencing the future objectives and policies of that portfolio. In this structure, it's a little more rigid. But a master needs to stay static, because the investment complex is serving a number of different clients. It's not a dynamic process. It can be very attractive, though, for those of you who look at the downside to bringing up a proprietary fund, such as seed capital and significant oversight requirements. You're not necessarily concerned about your ability to sell the product, but do want the portfolio itself to grow rapidly so that the expenses that are associated with the management of the investments go down quickly and become less and less of an element in your product pricing.

For those of you who are interested in performing subadvisory duties, and are interested in a particular portfolio and not interested in having a great deal of control over how the portfolio itself is managed, there's a great deal of latitude and negotiations that can be used with the investment manager, in terms of who does what, and just how involved the investment manager is in the process of delivering information to your clients. We have had some recent discussions with several insurance companies who are at the high end of the market in the COLI market. We have found that recently, while we expected this, we didn't exactly anticipate it, that there are some very significant applications and possibilities when using this structure for those of you who are working in the high-end COLI market, particularly in the private placement side of it.

The benefits that we see of utilizing this process are really pricing-based. You have much more flexibility in running through the possible scenarios by using the master/feeder than you would by using the old traditional structures. I believe you have much more leverage with the investment companies in negotiating deals with them. I believe that this will be a very good development for the investment industry as well as for the insurance industry. When you think about it, it's no different than what we used to do, or what you have done in the variable life business, in which you have one separate account and that separate account will service a variable universal life product and various variable annuity products.

When I started in the variable industry in the early 1980s, we thought we were being very clever by saying, we can get some economies of scale and mass. Unfortunately for us, we made an assumption that the products were going to catch on a lot quicker than they did. But we're at a point today where we're seeing a great deal of activity in the marketplace that's positive for a variable product, for COLI, for high net worth, and for lower-end retail. Because many of us have moved to this type of a structure, we'll be able to offer services to you that are more in line with where your industry is today.