SOCIETY OF ACTUARIES

Article from:

The Actuary

March 1968 – volume 2 - Issue 3

A Review of Variable Annuities — Their Regulations, Marketing, Sales Compensation

The past few years have seen more and more interest in variable annuities. Little has been done, however, to bring together some of the basic information of value to anyone with an interest in the field. This article — based on a discussion at the Tri-State Actuarial Club, Nov. 16, 1967 — summarizes up-to-date information on some of the practical aspects of variable annuities.

by *Ian Rolland*

Federal Regulation

The courts have decided with finality that variable annuities are subject to the provisions of the federal securities laws which are administered by the Securities and Exchange Commission. An actuary dealing with variable annuities soon becomes quite familiar with the three relevant federal laws:

- the Securities Act of 1933
- the Securities Exchange Act of 1934
- the Investment Company Act of 1940.

Depending on type a variable annuity may be subject to all three, only one, or none of these laws.

The SEC has not applied these laws to variable annuities sold on a group basis if all three of the following criteria are met:

1. The group contains 25 or more lives.
2. Only employer money is allocated to the variable annuity.
3. The group qualifies for benefits under Section 401 of the Internal Revenue Code, but is not a group seeking benefits under H.R.10.

Variable annuities not satisfying all of these criteria are subject to varying degrees of regulation by the SEC. In the past the SEC has uniformly excluded from regulation under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 group contracts used for H.R.10 plans. Individual contracts and group contracts not previously mentioned (primarily contracts qualifying under Section 403-b of the Code) are subject to regulation under all three federal securities laws.

Prospectus

The Securities Act of 1933 requires a full disclosure of the terms of the variable annuity contracts. This involves the preparation of a prospectus, to be delivered to all prospective purchasers, which describes the provisions of the variable annuity contract and the charges or fees assessed against contract holders. Also to be included are audited financial statements of both the insurance company and the separate account in which assets supporting the variable annuity contracts are held.

One company submitted an argument to the SEC contending that audited financial statements of the insurance company should not be required as part of the variable annuity registration. This argument was rejected on the basis that both the insurance company and the separate account are the issuers of the variable annuity contracts and, therefore, prospective purchasers should be entitled to full financial information from both organizations.

The prospectus must be delivered before any attempt is made to sell a variable annuity contract registered under the Securities Act of 1933. It must also be included with most direct mail letters which describe, no matter how briefly, the provisions or purposes of the variable annuity. Unfortunately, the prospectus is complex, and therefore difficult for the general public to understand. The SEC recognizes this problem and is constantly seeking methods to simplify the prospectus. At the same time the Commission keeps requesting additional information, the inclusion of which make the prospectus even less intelligible. Simplicity is never easy to achieve, and the goal has not yet been reached.

Board of Managers

Variable annuities are offered by means of separate accounts established by insurance companies. The Investment Company Act of 1940 has been deemed to require that the separate account be registered as an investment company. Registration of a separate account as an investment company requires the establishment of a Board of Managers for the separate account and the granting of certain voting rights to variable annuity contract holders.

In complying with the various provisions of the Investment Company Act of 1940, insurance companies must also be aware of problems which might arise under state insurance laws. The 1940 Act requires that a great deal of freedom be given to the Board of Managers to control the affairs of the separate account. At the same time, most state laws require that all the assets of the insurance company be under the control of the company's Board of Directors.

Several states have recognized the problem and have given companies specific authorization to establish separate accounts that comply with the terms of the 1940 Act. Most state laws, however, are silent on this problem and companies have dealt with it by establishing an operation which gives recognition to both federal and state laws by means of a sharing of responsibilities.

Other Problems

Other interesting problems arise when a separate account is registered under the Investment Company Act of 1940. Investment company practice might not be comparable with insurance practice and, as a result, companies must request exemptions from certain provisions of the Act.

For example, securities of open-end investment companies must be redeemable within seven days after a shareholder gives notice of his intent to redeem. Obviously, an exemption is needed to prohibit annuitants from surrendering their contracts in the annuity payout period. The results would hardly fit the annuity assumptions if redemptions were allowed after the payout had commenced.

The 1940 Act prohibits inconsistent sales charges, and it is consequently necessary to obtain an exemption to permit experience refunds under group contracts. An exemption is also needed if a company wishes to issue contracts where the first contribution is less than $20. The foregoing examples give some idea of the problems which registration under the Investment Company Act of 1940 presents.

Broker-Dealer Registration

The Securities Exchange Act of 1934 regulates the selling activities and establishes licensing procedures for salesmen and it is assumed that the Act requires an entity be registered as a securities broker-dealer. A variety of methods has developed for dealing with the broker-dealer problem. One company has registered itself as a broker-dealer under the 1934 Act. The agents and general agents of the company are deemed to be "associated persons" and, therefore, are not required to register. The procedures for becoming registered as an "associated person" are simpler than registering as a broker-dealer and this method allows individual agents to be authorized to sell variable annuities with a minimum of administrative burden.

Other companies have established subsidiary corporations to act as the securities broker-dealer. This approach might have the advantage of lessening the implications of registration under the 1934 Act for the insurance company itself. But it carries the disadvantages that the new subsidiary corporation would have to be admitted to the various states and the insurance company's agents would have to be licensed with the new company.

A third approach adopted to deal with the broker-dealer problem has been to license the company's General Agents as broker-dealers. This approach is currently used by another company specializing in variable annuities, but has not been followed by any companies of recent entry into the variable annuity field.

State Regulations

There is no uniform pattern in state regulation of variable annuities. Almost all states permit the issuance of some type of contract under which assets are placed in a separate account. Some of the more important variations in the regulations are:

- Many states will permit group contracts but not individual.
- Some states require that the contract be qualified under some provision of the Internal Revenue Code.
- Some states will not permit a variable pay-out. Several of these will not permit the use of the term "variable annuity."
- Some states only permit employer money to be used to purchase the variable annuity.

Many states have recently passed new variable annuity laws or have amended old laws. Several are now drafting regulations covering variable annuities. The company with which I am associated now has its Group Variable Annuity approved in 42 states and the Individual Variable Annuity in 32.

State licensing requirements for variable annuity salesmen also vary. Thirty states have adopted the examination jointly prepared by the SEC and the NAIC for variable annuity salesmen. Most of these states also have additional special licensing requirements for variable annuity salesmen.

Examination requirements are imposed by the SEC in connection with variable annuities sold by a broker-dealer registered under the Securities Exchange Act of 1934. This covers all individual contracts and primarily group contracts qualifying under Section 403(b) of the Internal Revenue Code. Generally, the states follow the lead of the SEC in determining to whom examination and licensing requirements apply.

An additional aspect of the regulatory problems is the possible applicability of the state "blue sky" (or securities) laws. In many states the variable annuity is specifically exempted from registration under these laws. A few states require a "blue sky" registration in connection with certain variable annuity contracts. In other states the situation is unclear.

Agency Compensation

The method of agency compensation depends greatly upon the pattern of charge for sales expenses assessed against the contract holder. In the case of contracts offered in connection with separate accounts registered under the Investment Company Act of 1940, sales expenses are limited to 9% of the contributions applied to the contracts. Sales expenses include commissions and other acquisition expenses.

Group variable annuities have a loading charge for both sales and administrative expenses of 6% to 7%. Commission patterns associated with these group contracts vary greatly from company to company. Several companies pay *only* a first-year commission, thereby reducing renewal administration. Companies paying renewals are holding them at very modest levels. First-year commissions will usually exceed the amounts deducted from the first-year contributions, producing some surplus drain for the company.

Some individual variable annuities are now being offered with level deductions from stipulated payments for sales expenses. Others have higher sales expense deductions in the first year than in renewal years; these are generally referred to as "front end load" plans.

The SEC is known to dislike the "front end load" plans and has indicated informally they might not permit such a contract for qualified pension plans. Commissions under the "front end load" variable annuities are of the same pattern paid on conventional fixed-dollar annuity contracts. Under level load contracts, however, the company is forced to spread the commissions, the first-year rate being reduced and the renewal rate being increased.

Marketing

A company can develop several approaches to marketing. It may wish to offer the variable annuity through its agency force as simply another product line, or it may develop a group of variable annuity specialists trained in sales techniques for variable annuities.

Most variable annuity sales efforts are now being directed primarily at individuals or groups qualifying for tax benefits under the Internal Revenue Code. Most sales to date have been tax sheltered annuities or H.R.10 plans; generally, these are group variable annuities.

While current activity involves mainly group plans, possibly the most important market ultimately might be in individual sales. In addition to the market for individual contracts in certain tax favored areas, there is a vast market for an individual policy sold to "the man

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on the street" who qualifies for no particular tax advantage. In this latter market the real competition between variable annuities and mutual funds will emerge.

Promotion, Advertising

Finally, for companies involved with registration under federal securities laws, marketing problems are further complicated by the need to file all sales promotion and advertising material with the SEC. Although these filings are not required by the Investment Company Act of 1940 until 10 days after the material has been put into use, it is wise to obtain advance approval.

Advertising material is particularly hard to draft because the SEC considers it as a prospectus. Consequently, it must conform to very rigid requirements. Most advertising managers of insurance companies will find the advertising limitations confining. Sales promotional material may be difficult to draft because of changing attitudes on the part of SEC. To illustrate, four months ago the SEC approved promotional material using the term "tax sheltered annuity." Their current position is that "tax sheltered annuity" must be replaced by "tax deferred annuity."

The material presented in this article is only a summary of some current information. In this fast developing field, regulations and practices are constantly changing and what has been said here may have to be updated before long. □

Man for All Seasons

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ing without such relevance as to have proved memorable.

The view of those who favoured wider fields was stressed by one speaker who referred to the actuary as a person trained to look into the future, not as a star-gazer, but by making use of his techniques and what knowledge he can derive from past experience in order to evaluate future events. As another contributor eloquently remarked, "An actuarial career is something better than just counting dead men's heads."

There appeared to be some support for the interest of actuaries in Operations Research and perhaps for more recognition of this subject in the examinations. While one speaker pointed out that actuaries had really established this science two hundred years earlier by producing a model in the form of a life table with which to examine the experience of the life insurance industry of that day, the actuary was not keeping his place in modern developments.

For example, in 1903 a race was held for the then new horseless carriage. Since the only previous experience related to horse drawn vehicles, on which the driver needed a high vantage point to see over the horse, this design was retained, with the result that the high centre of gravity caused the horseless vehicles to over-turn at the first sharp corner. Had any actuary of that day been able to postulate a model which resulted in the seating of the driver low down between the wheels as in modern racing cars, Detroit might today be associated in the public mind with the actuarial profession!

Reasons for Interest

This interest in management techniques expressed by several speakers arose because, while actuaries in the past have frequently risen to senior managerial positions, there was a fear that unless they were suitably equipped they would be unable to progress to such positions in the future. In that event, the result might well be that actuaries will have a progressively smaller say in the management of life insurance companies.

One speaker went on to say that, while the actuary learned techniques such as the derivation of probabilities for the happening of future events, so much emphasis was placed on the application of those techniques to mortality and sickness problems that broader applications were rarely considered. Such may be the maintenance costs of fleets of buses, or aircraft, or stock distribution costs involving the rates of deterioration of bottled drink, and managerial problems generally. Actuaries had long used discounted cash flow techniques, but in recent years those have been "discovered" and popularized by others, without actuaries having any influence on the modern developments.

It was suggested that the examinations represent the formal portion of the actuary's education, while he serves his apprenticeship in employment to gain the experience he needs. One eulogist even related at length the applications he had found, after qualifying, for the various matters which he had learned during his studies for the examinations. The impact of this prescience on the part of the examination committee was somewhat modified when it was discovered that he had discontinued after achieving his associateship in order to avoid spoiling the record!

Add to Formal Training

While the part played in education by office training during and after qualification appeared to be appreciated, there were those who wished to see Management Techniques, Operations Research or Computer Systems included—in the formal training by amendment of the examination syllabus. There was, however, no consensus on the elimination of any matter, other perhaps than the present requirement of a detailed knowledge of government report forms.

Clearly, however, many felt that the present examination syllabus was fully adequate for the formal education of actuaries, with other tools being assimilated in company employment or through "post-graduate" study. The possibility of total formal education being undertaken full-time at university was also mooted.

To this time all discussion had remained on a most intellectual plane, but suddenly the crux was reached. It was suggested that the actuary must be able to communicate effectively in writing and that one could progress too far in the present examinations without this attribute! As the Chairman struggled to avoid more than two or three members speaking simultaneously and as the words "message" and "medium" were bandied back and forth the consensus appeared to be that lucid writing should (or perhaps "should not"?) be a prerequisite to becoming an actuary. Fortunately, at this stage refreshments appeared and the meeting terminated. □

To the Actuarial Clubs

The Actuary is pleased to list future meetings of the Actuarial Clubs. To ensure publication, notify us at least two months prior to the meeting date. We are also anxious to consider publishing papers submitted and discussions at the meetings.