RECORD, Volume 27, No. 2*

Toronto Spring Meeting
June 20–22, 2001

Session 104PD
Insurance For The Wealthy: Private Placement

Track: Product Development

Moderator: NANCY M. KENNEALLY
Panelists: JOSEPHINE CICCHETTI†
MARK S. REILLY

Summary: There is a lot of talk about private placement life insurance, sold both offshore and onshore. This session examines the private placement of high-net-worth market and discusses:

- *What it is*
- *Who the market is*
- *Product design issues*
- *Marketing issues*
- *Regulatory issues*

MS. NANCY KENNEALLY: Welcome to our session on Insurance For The Wealthy: Private Placement. I'm a consultant with Tillinghast-Towers Perrin in our New York office. Over the last six years in my consulting career I've helped insurance companies price, design, develop and implement new products—especially in the variable life and variable annuity markets. We have two great speakers with us today—Josephine Cicchetti and Mark Reilly, whom I'll introduce in a moment.

Over the last several years, variable life insurance in the U.S. has enjoyed tremendous success due in part to the success of the equity market. Sales last year in the retail registered market reached nearly $7 billion—that is first-year target premium dump-ins and 10 percent of single premiums. Variable life continues to gain market share in the individual life market at the expense of other products such as universal life and traditional life. But recently, many of the larger variable life manufacturers and distributors have turned their attention to what has been called the "high-net-worth insurance market" and how variable life can play in that

---

*Copyright © 2002, Society of Actuaries

†Josephine Cicchetti, not a member of the sponsoring organizations, is a partner with Jorden Burt LLP in Washington, D.C.

market.

What exactly is this "high-net-worth market?" The definition varies depending on whom you talk to, and it's somewhat blurry. Certainly, I think the high-net-worth market includes the domestic onshore private placement market in which people are using non-registered variable products. To some, it also includes the offshore market selling variable products to U.S. citizens living abroad. In some cases it even includes corporate owned life insurance (COLI). But our session today will focus on the private placement market and we'll also touch upon the offshore markets.

In addition to the blurry definitions of this market, there are a number of other uncertainties. People are always asking who the players are in this market, what the size of the market is, what the sales results are, and what the sales potential is. I think the answer to all these questions is a big unknown. A lot of the larger variable life players are either currently working in this high-net-worth market or have certainly have expressed an interest in it. By the size of the crowd here today, we can definitely see that there is a lot of interest in the market. There is no real source for tracking sales results or the size of this market, so it's really difficult to gauge actual numbers. I think companies have had varying levels of success. This market is a complex market; it's difficult to crack. There are complex marketing issues and there is a whole new set of regulatory issues that comes along with it, as well as product design and pricing considerations that are really unique to this market.

Now I'll introduce our two panelists. Mark Reilly is the vice president of Institutional Life Products for Travelers Insurance. He is responsible for the product manufacturing of both offshore and domestic high-net-worth products, as well as manufacturing and distribution of COLI products. Mark has nine years of experience designing products for institutional markets, concentrating on both registered and private placement variable products. He also brings the unique perspective of field experience, having worked for two years with a brokerage firm. Mark is going to talk about the pricing and design considerations in this market.

After Mark, we'll hear from Josephine Cicchetti. Jo is a partner with Jorden Burt LLP, a Washington, D.C. law firm. Jorden Burt is a boutique national law firm specializing in the representation of the financial services and related industries. The firm represents many of the largest financial institutions in the U.S., Latin America and Europe in the development and implementation of financial products for their clients. They are also involved in outside transactions, class action defense and trial practice in government relations. Jo's practice focuses on securities regulation, insurance regulation and legal issues associated with insurance product development in marketing. She has had extensive experience in the private placement market for insurance and other investment products representing many of the leading insurers in this market. Now I will turn it over to Mark.

MR. MARK REILLY: One of the things I will discuss is the uniqueness of this market and the high-net-worth marketplace with regard to both private placement and offshore markets. In the uncertainties surrounding it, there are a many issues that I will touch upon that you will need to deal with as we try to analyze this market. A couple of months ago an internal article was being written and someone asked me for a quote, which was to be included in this article. They asked me, "So what's your title anyway? You're the vice-president of all the weird stuff." That's how it's looked at, not only in terms of the marketplace, but also inside companies. These are new markets and new opportunities that people are looking at, and it really takes a unique perspective in regard to a lot of resources and outsources to be able to figure out the best way to attack these markets.

First I am going to discuss what the marketplace characteristics are. What are we talking about when we say, high-net-worth market, private placement and offshore? What are some of the product design issues that we need to look at and work through? What are some of the private pricing issues?

Basically, when you're designing products for high-net-worth U.S. citizens, it is important, especially when we get to the offshore part of the presentation, that the target market is U.S. citizens and not foreign, nonresident aliens. We're expecting that this money is going to originate in the U.S., and eventually through death benefits, going to want to come back into the U.S., even if an offshore trust is established as a beneficiary and owner.

MARKETPLACE CHARACTERISTICS

The first thing that I think this market needs is expert distribution. I will go into more detail later, but this is a market that we don't know much about. It's new, it's unique and a lot of times, the people who know the most are the people who have talked to the clients and who have looked at this thing. They will tell you that you really need strong distribution and good distribution relationships to gather information and competitive intelligence in order to inter-work through the issues.

The next issue is investment flexibility. Another sub-statement of the private placement is that a lot of people who think of institutional priced think of competitive products, low comp and levelized comp when you say "private placement life insurance," but there's another aspect to it. You have another segment that thinks you wrap in different types of funds. Dealing with investment flexibility and figuring out how flexibly you're going to put the investments in your product is an important design issue.

Next is institutional pricing. With product design flexibility, a lot of these things are individually negotiated case-by-case, and case-by-case pricing is associated with them. It's a market where there's going to be few cases and policies sold with large premiums and large death benefits. It's not $1,000 or $10,000 premium policies, we're talking $10, $20, $25 to $50 million single premium-type policies. Because of this, you're also going to have a long selling issue and issue process. The client is usually going to want to keep his investment account intact and the legal advisers involved will say that you have to sell and show that you thought all of the issues through. It takes time for that analysis and each case is unique in terms of working through the issues with each client.

PRODUCT DESIGN ISSUES

As I said before, in this part we'll discuss U.S. money eventually coming back to the United States, if it even goes offshore. Therefore, you need to meet the definition of life insurance. The cash-value accumulation test is much more prevalent in this marketplace as opposed to the guideline premium test. The other issue, and this gets to your investment flexibility, is that investment control and diversification requirements need to be met in order for the cash value to grow tax deferred and to not be deemed as an asset of the purchaser. The same rules would rather use offshore U.S. carrier purchases, offshore purchases or domestic trust purchases. Again, if the money is coming back, you want it to be deemed life insurance by U.S. tax even in the offshore trust. The uniqueness, and from a domestic point of view, what makes this one of the results of private placement, is that the polices aren't registered with the Securities and Exchange Commission (SEC).

In order to do that, companies generally limit sales to accredited investors and limit 100 beneficial owners per separate account. You could probably do more and get more exotic with that, but I'll leave that for Jo to talk about in more detail. In general, companies say, "We're only going to sell it to the accredited investors in with 100 beneficial owners."

Sometimes, and this gets into investment flexibility, SEC-registered mutual funds or mutual funds that you have in a lot of your retail products can be underlying the private placement. We ask why a purchaser is purchasing and what he or she is looking for in the private placement. Is the purchaser looking for institutionally priced products? Investment flexibility? More of an exotic fund offering? Sometimes you have hedge funds, and limited partnerships in some contracts will do even more exotic things and have a single investment separate account, which has its issues in and of itself.

There's a private placement memorandum, which is usually very similar to the prospectus. It has no general solicitation to market in and it needs to be sold through registered reps. The National Association of Securities Dealers (NASD) rules apply to this also. Offshore policies are not designed to be securities subject to SEC rules. This might change a couple of times. I originally had offshore policies that didn't seem to work right. This is important. If you do it right, your offshore policies are offshore policies and the SEC does not come into play. But in doing it right, you need to consider where the solicitation is really taking place. Where does the application take place? Where is the underwriting being done? Where are the issuant activities being done? It really needs to be an offshore transaction. You walk into what I call a gray area. It's going to vary by company depending on what the company is comfortable doing. Hopefully, it will not vary by case. I think that it's subject to interpretation.

U.S. rules are usually monitored as guidelines. It is a comfort that some of the rules that will fall in the U.S. are good disclosure and good business practices. Instead of a private placement memorandum prospectus, an offering circular is usually provided. This provides really different names, and although it is somewhat different than a private placement memorandum, it is also similar. There's no general solicitation and the focus is on the high-net-worth market. There are two reasons for that, (1) the market you're going after is the high-net-worth and the high premiums that deal through all these issues, and (2), if something happens on the first bullet that may cause some issues with whether it was a U.S.-offered security, some companies get comfort by thinking they still didn't have the right insured because we did not offer it to the general public. Again, you've had them technically follow and comply with all of the rules, but it is some sort of comfort as to whom you are dealing with in some companies. Then the underlying funds are generally private funds and not SEC-registered.

You still need to file domestic private placements with state insurance departments and get approval in every state that you deal with. One of the issues that you need to be comfortable with and think about is pricing flexibility. How does that work with state discrimination laws? Do you need to re-file the contract every time you tweak a policy? You need to establish strict discrimination and underwriting guidelines for the aged. It's going to impact your cost and time to market. It really is a company decision as far as how they deal with these issues, and I've seen companies come up with different interpretations on each of these. Are there filing requirements for fund additions? What needs to be done if you need to modify a plan of operation? That varies state-by-state and probably company-by-company. We talked about how much activity is being done in the U.S. for being deemed a U.S. offering if you're using an offshore company. It's a similar issue on the state. How much activity sales solicitation, management of the company is necessary if you're using an offshore company, if an offshore contract is being done in any given state? You're going to have that issue, too. One other filing issue on the domestic side is that when you sell a private placement, you need to file a Form D with the SEC.

One thing that is important is the fund offering. As I said, you can get exotic fund offerings in these policies. You may have a policyholder or potential policyholder who has a preferred fund manager and may just want to do a single investor separate account. Actually, you just need to have rules to prevent investor control issues.

The private letter rulings allow single separate accounts on some very restrictive terms. Again, investor control is one of those issues that is a gray area as far as what people can do and what people are comfortable doing. The IRS is watching private placements and watching the separate account activity in single investment separate account activity. Some questions from an economic point of view are, what is your minimum size? What makes it economically viable for the money manager to run the money? Does the insurance company need to subsidize the money manager until you go to critical mass? That's another rule that needs to be established, which is going to vary by fund and by fund manager.

If you want to add hedge funds and/or limited partnerships in general, those are not liquid assets. They're extremely illiquid. The question then becomes, how does liquidity of the fund compare to your contract provision? This was easier to do offshore until two or three years ago. This is a state contract filing issue, but right now you can get language in your contract approved in some states. Most states will deal with limited partnerships and with limited flexibility and liquidity in the contracts.

What is the cash value of a fund on a day it can't be valued? What is the death benefit associated with that? Going back to the cash-value accumulation test in the corridor factor, this is an issue that people need to get comfortable with. If you went into the next valuation day, what is the cash value of a fund on a day it cannot be valued and what is the death benefit for purposes of meeting the definition of life insurance? In some instances, the hedge funds are registered with the SEC and there are some companies that are out there trying to do that. I know a couple of funds that are able to do daily evaluation and are actually in registered products.

One of the typical product charges featured in product design is that you have a limited-to-no front end or percentage of premium loads. You have deferred acquisition cost (DAC) tax passed-through charges. For offshore contracts, the contract owner may have a one percent excise tax, or they will have that if they're written by a foreign insurer not engaged in U.S. trade or business. Also, depending upon the residency of the insured, the contract owner may have the equivalent of premium tax. Is there a state usage tax? Some states impose a state usage tax even on offshore insurance contracts. There are typically no surrender charges with these products. You have low loan spread on these products. That's more of a product sizzle type of feature. It's funny, because in some of the cases that we've done, you get beat up on the loan spread and then the person ends up having to be a single pay. I don't know that they're necessarily contemplating taking distributions from the policy in that type of situation. You have tiered asset charges where you basically get one set of pricing for 10 million when it goes up to 50 million. You may reduce your mortality and expense (M&E) and money management may reduce their funds with that. You have to potentially hire administration loads in terms of going through a small number of contracts.

How are you going to cover your expenses? I will give more detail on that later. The cost of insurance (COI) is actually monitored closely in terms of if they know the sophisticated broker and the sophisticated client. They typically know that when we talk about contract features and charges in the private placement memorandum, we usually only talk about the guaranteed COIs. A lot of times they're going to ask for a table of your current COIs. You see it in single- premium and limited-pay situations and in both modified endowment contracts and policies that are designed not to be modified endowment contracts.

The distribution is important. It is your source to the market and agents also need to be willing to trade high front-end commissions for asset-based compensation. It's hard to have a low-load, low-sales product with no surrender charge and then continue to pay your agent 100 percent commission. When it's all said and done, you're looking for agents who look at this as a long-term relationship and are willing to take the asset-based compensation and think it will stick around. As I said before, our required broker needs to know solicitation rules for both domestic and offshore policies. One of the things that keeps the offshore product offshore is what you do onshore.

Another exception to having to file with the SEC is how you solicit the product. Those are two important distinctions and you need to have a distributor in each who knows and follows the rules, or all of a sudden, you're going to have issues that you weren't planning on. I think you really need a distributor that you are able to develop a relationship with and that you trust to give you the information that you need. You also need a distributor and a broker who are going to be able to go in front of the account expert, investment expert or tax person and be able to answer their questions and show the appropriate knowledge.

PRODUCT PRICING ISSUES

This is not a market where you're going to say, "Yes, I've nailed these pricing assumptions." Even the mortality aspect of it is a different type of a market to look at. We do not know what the size of the market is, so a lot of times you don't know the critical mass that you develop into. Competitive information is unbelievably difficult to come by. This is for a couple of reasons. One reason is that I think people who are trying to figure out the market tend to hold it a little more closely. The second reason is the question of, should we be sharing the information on this? I don't know, because it's not public information. It's not as if you can get a prospectus. This is a private type of market.

You have to take a guess at the persistency of the new business because lab studies aren't available. This business is not old enough. As a sophisticated investor you can argue this two ways. One, they've gone through a big analysis in order to purchase and choose this policy. Do they want to revisit that every year? Probably not. Two, the sophisticated investor has people knocking on the door and calling with different ideas all the time. This thing probably is not just going to be put away and forgotten.

Again, let's talk about the fund costs and revenue. One of the key assumptions in developing the variable products is fund revenue and fee sharing, if there is any. You don't know what your funds are going to be in this product. People may be bringing new funds to you and moving new funds. How do you deal with the uncertainty of your money manager relationship and participation agreement? What is that going to look like? Is there going to be any revenue coming back from the money manager? In other words, you need to look at your access to reinsurance. If someone is giving you $50 million of premium, I don't know that there are any automatic pools out there that can accommodate that. I would bet that there are not.

And again, your ROI and ROE targets are probably less applicable. You can get a 15 percent ROI, ROE or whatever the target may be in this marketplace very easily because there's very limited investment in the contract. But I think companies move to their return of assets being more appropriate to deem the long term and absolute profitability of this type of business.

Other things that you need to carefully analyze are the necessary expenses to cover costs, how you are going to allocate expenses in the reinsurance issue. There are some large-size policies and large increases in the net amount of risk that have done $100 million single premium contracts. Earlier this week, a producer called me and said, "Okay, I have this large single premium I'm about to pay. Do you underwrite on the net amount at risk?"

Instead of the face amount, the investor was thinking that it would be a good thing if someone gives $50 million and it's a $100 million death benefit. He thought you were just writing a $50 million. My answer to him was, "Yes, we generally do underwrite the net amount of risk. But we underwrite the net amount of risk 15 to 20 years down the road because of the cash value corridor could be grow to $200 million." So, reinsurers are looking at that. It's facultative in most of the cases. You need to secure reinsurance claims capacity through a form of facultative pools. You want to try to have that part bound up, but still, cases come in where you still have to send it to the facultative pool and they have to look at it, but at least it's a consistent relationship with the insurers. Hopefully it is consistent in pricing as well.

Reinsurance is even more important than the offshore market. A lot of times the companies are low, small companies with low capital requirements and are generally going to have low retention levels. The buyer is going to be interested in who your reinsurer is and ask about it. Again, every aspect of this field is being analyzed.

The expense assumption is another thing that is not going to fit easily into your typical unit expense analysis because of high premium, high face amount and low number of sales. As I mentioned, it's a specialized market and you need specialized expertise. How are you going to get sales and distribution management? Who's going to do your new business in underwriting? Where is your legal expertise going to come from in the actuary support in the systems development? As the sales support, you need to have a focused plan and you probably need to dedicate a higher level of home office people to support it. Is it worth developing an illustration system? How are you going to quote on these cases? Is there overhead associated with it? Is your illustration system flexible enough right now to handle it? What's the cost of that, and where is it going to be covered? Do you need a dedicated market and support? Again, as I mentioned before, distribution can get you in trouble with these markets. As far as the underwriting, they're sensitive to the doctors that they go to for these exams. So in general, you're going to send them to your top-level medical exams and you're going to pay some increased underwriting costs.

You need very intensive legal support. You're going to have to balance flexibilities with the risks that are associated with it. As I mentioned, there is uncertainty in getting new funds. If it's a new market, you probably need to enter into participation agreements. You have plan of operations work and you definitely want to look at investment control with that. You're going to need to be involved on a case-by-case basis most of the time. In systems development, I think you'll need the different system and, in some instances, a different platform. You're going to need a flexible system. It's great to go out and price a case with some flexibility, but you have the system behind it that can handle it. How quickly can your system handle new managers, get new funds on the system and include the hedge funds?

I have a couple more comments on what is unique to offshore. You also are going to be somewhat limited as to how much you can leverage your domestic capabilities. It's a facts-and-circumstances type of issue that looks at where the risk is insured and where the systems reside. Every single aspect of the company of the sale can be looked at. Where did that happen? Where did this happen? Do you just use your domestic system or do you have to develop a new system in Bermuda or wherever your offshore companies are located?

Another thing is contract expense. There are premium tax and DAC tax considerations. A lot of times people say that one of the advantages of an offshore contract is that there is no premium tax or DAC tax. DAC tax is usually paid if the offshore company has a U.S. connection. A lot of times companies that are selling to U.S citizens have basically made an election that taxes themselves effectively as U.S. corporations. This would include DAC tax. Premium tax may also be due, if again, a state comes in and says, "You guys are doing a lot and did a lot in this state with the resident of my state." But that's probably less of an issue than the DAC tax.

SUMMARY

It's really the uncertainty around the assumptions, the price and the flexibility that you need that make this unique. I think that there needs to be a global understanding of the business plan before you price in with different prices and targets that may be necessary. Again, that poses the question, how are you going to handle all your expenses? How are you going to know you're covering your expenses with this business? A lot of times you have dedicated units to handle this type of business and staffing, and you need to have a clear plan as to how you're going to support that. Again, a relationship with the distributor is very important. There's no clear-cut answer as to whether you do offshore or domestic contracts. If I pick up the phone and someone wants to do an offshore private placement I'd say, maybe 30 percent of the time, that no, a domestic private placement would fit too. It depends on whether the person needs to buy an offshore or domestic contract. As I discussed, reinsurance is key. I also discussed the highly skilled and dedicated support that you need.

Legal and tax interpretations will drive the product, the marketing efforts and your administrative procedures. This is something that poses a lot of questions and has a lot of gray area. A lot of different companies, as I mentioned before, are going to answer the questions differently and that will drive their product designs. We have walked away from some things in the past that other companies are doing, and there are probably some things that we are doing that other companies may not do. You need to balance the flexibility and expenses in your appetite for risk in order to bring it all in and look at it all at once.

MS. JOSEPHINE CICCHETTI: This part of the session could be called "Unregistered, Doesn't Mean Unregulated," or "How To Keep the Private in Private Placement." Before I start though, how many people remember the old *Saturday*

Night Live skit that Father Guido Sarducci used to do? The one with the five-minute university where no one remembers what he or she learned in college 20 years later. For $500 he would give you the five-minute university. I think he'd say, all you need to remember for economics is supply and demand. Philosophy—who is God? Spanish—Como estas usted? After I go through some very dry material, I'll give you the five-minute private placement law school.

PRIVATE PLACEMENT

For those of us who have not worked in the private placement market before, the 1933 Securities Act basically says that, "unless an exemption is available, you have to file a registration statement with the SEC and deliver a prospectus to each prospective client." We all know this is time and money. The way to avoid this is to conduct what's called the private placement.

Private placement generally refers to a securities transaction that is exempt from registration pursuant to Section 42 of the Securities Act of '33. Section 42 exempts transactions by an issuer not involving a public offering and, of course, this ends up becoming a facts-and-circumstances test that generally turns on whether investors are purchasing for investment, and not for distribution; whether the offering is unrelated to a public offering; whether the person solicited has a substantive and preexisting relationship with the issuer; and whether there's been a general solicitation. If you look at those facts and circumstances, I would presume that most people wouldn't know what a private placement is, and a lot of people didn't. So they came up with Regulation D, which is a rule under Section 42, and Reg D has Rule 506 that provides a nonexclusive safe harbor from registration for up to 35 nonaccredited investors, which is irrelevant to this market, and an unlimited number of accredited investors, what ends up happening is that the issuer has to have a reasonable belief that the investor is accredited, and that means you'll have to fill out all kinds of questionnaires and paperwork in order for them to certify that they are accredited.

There's no dollar limit on the amount of the offering that you can conduct under Rule 506. It's the most-used rule under Reg D for private placement variable life. It does require that you file a Form D with the SEC within 15 days of the first sale. You still need to prepare a private placement memorandum because you still have to provide full and fair disclosure of the material terms of the transaction. That's under another section of the Securities Loss Act of '34.

Of relevance to the high-net-worth market would be trust. Trust with assets in excess of five million, if not formed for the specific purpose of purchasing the investment, would be considered an accredited investor in its own right. If you have an entity that's owned solely by creditor investors, that too, is an accredited investor. It's easy to meet the accredited investor test in this market, but Reg D also regulates the manner of sale, and one of the big restrictions is no general solicitation. Rule 502C prohibits advertisements and other kinds of public promotion of the security. It also prohibits seminars where the attendees are invited by general solicitation, as well as solicitation through a publicly available Web site. We'll discuss Web sites and password-protected Web sites later.

This ends up being a bit of a problem. How do you get clients when the SEC is saying you need a substantive relationship between the issuer or its agents and the offerees prior to the offering? The relationship has to be sufficient to give the issuer an awareness of the financial circumstances and sophistication of the prospective purchaser. This is usually a relationship that the company has had and maybe they or the broker have been a prior customer. The broker doesn't necessarily have to have sold something to the individual, but the broker does need to have had prior sufficient contact with the individual in order to enable the broker as agent of the issuer to have an awareness of the financial circumstances and sophistication of the purchaser. Sometimes what I've seen done in the venture fund area—and I think it would probably be applicable here because the same legal analysis would apply—is brokers that were selling private placements in venture capital funds during the heyday of the initial public offering (IPO) would contact prospects and indicate to them that venture capital investment funds would be made available from time to time on a private placement basis. They would ask if you would be interested, and if you answered yes, they would ask if you would fill out a questionnaire. It would not be with reference to any particular company or fund, and they would develop a database. They would wait 30 to 60 days, then make another contact basically letting you know that they have this fund and then would ask you if you would you like to look at it. That's one way of developing a prior relationship.

So we've avoided the '33 Act, which is really the easy part, except for the general solicitation concept. Now we have to avoid the Investment Company Act of 1940. Why do you want to avoid the '40 Act? Well, those of you who have worked in the registered product area know why you want to avoid the '40 Act, but with respect to these types of investments, leverage is limited by the '40 Act and transactions with affiliates are restricted. There are all kinds of corporate governance rules and you have all kinds of periodic filing requirements. They cost money, and we don't want to spend our money that way. So the '40 Act has provided for two exclusions that the high-net-worth market can use. One is the 3C1 exclusion. It's for the 100 beneficial owners. It excludes from the definition of investment company any issuer, the outstanding securities of which are beneficially owned by not more than 100 persons, and which is not making and does not propose to make a public offering. That's the 100 beneficial owner separate account.

Each policyholder is usually a beneficial owner. Married couples purchasing jointly are treated as one beneficial owner. One issue that you need to be aware of in connection with the use of the 3C1 exemption is called "the integration issue," and integration of similar funds can result in the merger of securities for purposes of a public and a private fund, or two private funds. The result is that the 100 beneficial owner limit can be exceeded inadvertently and you lose your exemption. If you lose your exemption, what ends up happening is that you are operating an unregistered investment company. The purchaser has decision rights and the SEC can come after the issuer. This means the insurance company, and that's not something we want to get into.

The test is whether a reasonable purchaser would view one separate account offering as materially different from the other. We advise our clients to quickly mix the contracts and investment options, if possible in order to avoid this integration concern. Again, it's one of those facts-and-circumstances determinations, and you would have to convince the SEC that they are materially different in the minds of a reasonable purchaser. There's another newer exclusion about four years old and it's being used in the high-net-worth market, but it's intended for a different level of customer. It's a Section 3C7 exemption, and that exempts an investment company from registration that's not making a public offering and only has qualified purchasers as investors.

Qualified purchasers are natural persons that own at least $5 million in investments and, in this market, an institutional investor's definition really doesn't apply. Again, the issuer has to have a reasonable belief that the investor is a qualified purchaser, and that reasonable belief must be evidenced by obtaining detailed purchaser questionnaires.

When does the 3C7 purchaser have to qualify? He or she has to qualify when they first invest in the fund when the initial premium is paid. But since these are flexible products and flexible contracts, they have to be qualified every time they make a new investment. Unless, of course, there was some prior commitment that was legally binding to make additional premium payments. But that's usually not the case in these contracts.

What are investments? This often comes up. Obviously the list of assets, which include securities, real estate, commodities, financial contracts and cash equivalents, are investments. When they're held for investment purposes, they have to be unleveraged. So associated indebtedness has to be deducted and real estate that is used for residential purposes, or to enable an investor to conduct the business, is not included. Of course, artwork, antiques and other similar properties are excluded because these items don't necessarily indicate that the person is supposedly sophisticated in investment matters. I would disagree with that, but that's what the SEC says.

One good thing about using 3C7 is that the integration concern is not really a concern. When you use 3C7, integration doesn't apply. You could actually have two 3C7 separate accounts that are identical, and the SEC doesn't care about that. So now we've avoided the '33 Act, the '40 Act and we have another act to avoid—the '34 Act. The '34 Act basically says if an issuer has a class of securities held by 500 or more persons, they may have to register under the '34 Act. That would mean you have to file 10Ks and 10Qs and all kinds of other regulatory burdens imposed by the '34 Securities Act. So when you hear about these private funds and the limit of 500, this is where the limit comes from.

BROKER / DEALERS

The broker/dealers have to be registered, they have to be licensed and appointed under the state insurance laws and they have to play by the National Association of Securities Dealers (NASD) conduct rules. The big rule is NASD Rule 2210. I'm not going to go into great detail, but you should be aware that the broker/dealers do have the same requirements as the ones they have for registered product.

Obviously, there's no advertisements permitted for private placements, but if sales literature is used, it has to be maintained in separate files. You have to keep the information for three years and it has to be approved by registered principals. You don't have to file the private placement memorandum with the NASD, but the policy premium methods (PPMs) are subject to the content and conduct rules of the NASD. It's all the same rules. Again the brokers have to maintain the same supervisory systems when they're selling private placement as they do for registered product. That's Supervision Rule 3010.

We discussed private placement materials earlier. They should not be placed on a Web site accessible by the general public. Web sites are considered as sales literature, so the same rules that apply to the sales literature that is handed out in hard copy form also apply to Web sites. The NASD rules would require that you have principal review, approve and follow the content rules.
Brokers have suitability requirements. These are the same concerns as for registered product. I don't want to dwell too much on the broker side of things. All you will be interested in is making sure that they're doing their job.

INVESTMENT VEHICLES

Next, I wanted to briefly discuss some issues related to the underlying investment vehicles that we are seeing in these high-net-worth products—hedge funds that are organized as limited partnerships or limited liability companies. Insurance contracts are attractive to hedge fund managers and to the investors because the insurance contract offers more tax efficiency. Hedge funds are tax-inefficient, because the majority of their gains are short term. Hedge funds can actually borrow more than registered mutual funds against their securities and they can use cash to take short or long positions during market fluctuation. There is a potential of doing better performance-wise and that's why they're attractive.

One of the aspects of these investment vehicles is a performance fee. Performance fees are based on capital gains, and you're seeing the performance fee structure of comp paid to the brokers, to the investment advisor and to insurance companies as well. The rules are that you have to have a qualified client, and the qualified client definition usually works with the 3C7 definition. But, if you're doing a 3C1, you have to be careful because you're going to have to raise your limits a little if you have performance fees. This is because, under the Investment Advisors Act, a natural person has to have at least $750,000 under management by an advisor, and the natural person or the investment advisor must have a reasonable belief that he or she has a net worth of more than $1.5 million or as a qualified purchaser into the '40 Act, has a $5 million investment. So, if you're doing a 3C1 offering, you're going to have to raise the qualifications if you have performance fees in your underlying investments.

Brokers have a comparable rule—NASD Rule 233F, and again, those are the qualifications for the brokers. You need to raise the limits so that the advisors and the brokers can get those fees.

What's interesting about the performance fee is that the compensation formula has to take into account both gains and losses over the period of at least one year. You can't have short-term formula comp. Another issue, and I bet you've heard of this one, is the Commodities Exchange Act. The Commodities Futures Trading Commission (CFTC) in the National Futures Association registered commodity pool operators and commodity trading advisors. What's a commodity? It includes anything upon which it is possible to have a futures contract including securities. A commodity pool operator is any person who solicits, accepts or receives from others funds for purposes of trading in any commodities future contract and commodity options contract in connection with an investment, trust or similar enterprise. The definition is similar for advisors. The Council of Economic Advisors (CEA) also traps any advisor who, for compensation or profit, engages in advising on these types of interests.

It is possible for insurance companies to be considered commodity pool operators if their separate account has a hedge fund in it. If the separate account invests in commodity interests such as stock index futures either directly or through the hedge funds, or other underlying investment vehicles, you have to be concerned about the Commodity Exchange Act. The trading advisors also have to be worried about being registered as a commodity-trading advisor. But, fortunately, we have ways to avoid that if you're willing to step through a few hoops. The most used exemption for the insurance company separate accounts is Rule 4.5. But that requires that you file a notice of eligibility with the CFTC and represent that the separate account will not use more than five percent of its assets to establish positions and commodity interest for purposes other than bona fide hedging purposes. That means that you can speculate with up to five percent of the assets. There's a similar exception for the advisors in which the underlying hedge funds are usually run by registered commodity trading advisors. Those guys rely on Rule 4.7 so their hedge fund doesn't have to be registered.

There are a couple of things to focus on, and Mark touched on all of these. The liquidity issues, the valuation issues and the reinsurance issues. All of these impact your contract. So when you're designing your contract, if you're starting from scratch and you're not trying to modify a registered contract and turn it into a high-net-worth private placement, you have the luxury of making sure you cover concerns in those areas. I would recommend that you do because it would make life a lot easier. The other thing you should do is check the investment laws in your state of domicile. A number of states have caught up with the times and they do permit these types of investments, as well as and investments that are called "pooled investment vehicles" without limiting you to registered companies and mutual funds. But always take a look at your state law and check with your regulator. They may have an antiquated statute.

INVESTOR CONTROL

I want to spend a few minutes on the investor control issue. Part of the outline that was provided is a tax outline. The investor control issue is a very big topic for these private placement products. I am not going to go into what I would call a dissertation of Section 8-17, the diversification requirements and the other rules with respect to investor control or the interpretations that people try to divine what investor control means. But I would like to go through some do's and don'ts that we like to remind our clients of.

We'll start with the don'ts first. Investment mangers should not discuss specific investment decisions with clients concerning the portfolio assets. The investment manager should not communicate with clients or the clients' agent—when I say client, I mean policyholder—anything concerning the quality or rate of return of any specific investment or group of investments held in a separate account. There should be no plan between the investment manager and the client regarding the investments in any particular investment item or items. The client cannot direct the investment manager to select or sell any particular investment. The client does not have the right by law, and they should not have the right by contract either. When I say contract, I don't mean just in the insurance contract, I mean any written representation or other piece of paper that you could be exchanging with the policyholder. They have no right to have any of the terms of the investment guidelines under the policy aside from the right to select among the investment strategies available under the contract. Clients do have the right to select among the investment strategies available under the contract subject to the terms of the contract.

There are some permitted activities, and these are the do's. External investment managers may release their periodic asset reports to clients as long as the content and format of those reports have been reviewed for compliance with applicable rules. However, the external investment managers should provide their reports to the insurance company, who should distribute them to the clients. The client can have some direct communication with the investment managers to discuss client asset and activity reports, general performance that the portfolio is under the contracts, the actual investment performance compared to any applicable benchmark and/or general economic and market environment for the purpose of aiding the clients in selections among the investment strategies available under the contract.

When you're talking about investor control, you unfortunately always have to stay in touch with a decent tax lawyer who has experience in the field because it's a very facts-and-circumstances oriented determination. And as Mark said, the IRS is looking. We need to be very careful before we even initiate a contract. It would always be a good idea to just check with someone who is knowledgeable because you wouldn't want to be stepping over the line. The ownership of the assets will be attributed to the policy owner if you violate investor control, and there goes the tax deferral. That's a very serious issue.

I promised you the Father Guido Sarducci five-minute private placement law school. As actuaries, you have to remember three things in the legal area: rich people, no general solicitation and no investor control. If you can remember these three things, the other legal principles can be handled by your lawyers. You're the actuaries, so you know the rest.

MR. FRANK ROBERTSON: I have a question for Mark. Talking about reinsurance to the extent that people have their investment choice, say private equity, and sometimes those kinds of investments have annual returns of 500 percent, 1,000 percent and so, if you're in corridor, certainly the amount of insurance at risk is highly unpredictable. So most reinsurance agreements have some kind of upper ultimate limit. So does the common place in these products actually stipulate that you're going to force out cash if the fund grows too fast?

MR. REILLY: Right now the market concentrates on the premiums coming in. The premiums can underwrite increased premiums and with the returns they increase. I've seen it. I've not seen it in many contracts today, but insurance companies handle that.

MS. CICCHETTI: If you have the luxury of dealing with this issue while you are designing your product, you should consider adding language to your contracts. You probably already have language that says that you can return premium if you need to in order to meet the requirements of the Internal Revenue Code. What you should do is look at that language and see if you can play around with it in order to provide flexibility in that area. Now obviously, there are tax issues that will come up and you'll need to work closely with your tax advisors. But I have seen attempts to do that. It hasn't been tested yet, but there's language out there that people have used. We don't know whether it will work yet, but try it.

FROM THE FLOOR: I have a question on the requalification of 3Q7 and each premium we make. You could face the odd issue of a client paying on a seven pay basis, and they're, for example, a dot.com CEO or something and they don't qualify the second year or third year. If they don't keep paying, the policy falls apart. You have a state file form that gives them the right to pay every year. But meanwhile, you're not letting them pay. So you have an odd conflict of law issue.

MS. CICCHETTI: We'll cross that bridge when we get to it. That is possible, but we haven't seen that happen yet. But that is very possible because you have this conflict. Section 3C7 says that every time the investment decision is made they have to be a qualified purchaser. Now obviously, if they were qualified when they did their initial premium payment, that's fine. That sale is good for securities law purposes. But, as you say, there will be other collateral consequences if there's a problem with it in the future. I haven't seen that happen yet. I'm going to think about it, but I would probably put some language in the private placement memorandum warning that this could happen.