RECORD, Volume 28, No. 1*

Colorado Springs Spring Meeting
May 30–31, 2002

Session 34PD
Insurance for the Wealthy: Update on the Private Placement Market

Track: Product Development/Nontraditional Marketing

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Summary: Panelists discuss the latest product, distribution and regulatory aspects of this growing market. They also explain the unique design and administrative challenges that should be considered in order to succeed in the private placement arena. Attendees receive up-to-date information about the private placement market, both onshore and offshore, what companies are successful, what product designs are emerging, and how companies are handling the complex regulatory issues.

MR. DAVID A. CHRISTOPHER: I'm an account executive with McCamish Systems, which specializes in the administration of insurance with private placement. Our first speaker is Dan Theodore from Milliman USA. He's worked on a variety of life projects, including Section 7702 compliance and private placement variable universal life (VUL). He has worked on the SOA's Examination Committee and the Program Committee of the Actuarial Society of Greater New York.

MR. DANIEL THEODORE: I'm going to start off with a basic introduction to the offshore VUL market. First, who are the customers of this product? They're wealthy U.S. taxpayers with sizable offshore assets and domestic corporations in place offshore. We're talking about foreign nationals, Americans abroad. What do they want? They have large amounts of money that they're trying to put into tax-

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deferred vehicles. They are looking for large amounts of insurance, tax-deferred accumulation, and estate planning. They've got large amounts of money. They want to negotiate.

They want to keep offshore assets offshore. This money is offshore now and, usually, in domiciles that are not subject to creditors. They want to keep it that way. They want the separate account production. Most of them want it in denominations that are not U.S. dollars. Certainly, they want denominations of secure currencies, so they're looking for private placement policies. It was, substantially, offshore, but private placement policies are onshore a lot now, too. I think it was probably onshore at the same time, but my experience has been mostly offshore until recently. There is some variable annuity activity, however, I'm going to concentrate on VUL. They're selling VULs in large, single-premium amounts or spread out to keep them as nonmodified endowment contracts (non-MECs).

The reason they're going for private placement is so they can have unique investment opportunities. Some of them are using hedge funds and other forms of investment types that are not going to be available with daily liquidity and daily valuation. They avoid SEC registration but require something like a prospectus for the people to read.

The offshore companies are offshore because they're free of state regulation, so they can create more creative products and not be subject to the various difficulties of U.S. state laws. They don't pay state premium taxes. There's no federal income tax, no federal deferred acquisition cost (DAC) tax, and there is protection from U.S. creditors. Actuaries are involved in designing the universal life (UL) product and pricing it. The actuaries are also knowledgeable about compliance issues. I always think this is very important for the reinsurance negotiation and evaluation, and their guidance in the administration. Actuaries are necessary for helping these companies actually put up these products. Particularly, offshore companies don't have much familiarity with U.S.-type products.

What drives this product? The biggest issue is: Will this qualify as life insurance under the Internal Revenue Code? Is it life insurance? Is it compliant with Section 7702? Is it an MEC or a non-MEC? People are going to buy it for the highest rate of return, the internal rate of return on surrender. Therefore, purchasers are looking for the lowest assets charges, the lowest cost of insurance (COI) rates, the lowest face amounts and the least net amount at risk. They're looking for separate account protection from the insurer's creditors. That's why it needs to be separate account.

It is very important in any product to keep it simple, though I don't always follow this rule. I don't always keep it simple. One of the difficulties in product design is that the underlying funds often have limited liquidity. They're not valued daily. They may not be valued even monthly. There may be notification periods before money can come out of them — 15 days, 25 days, 60 days or 85 days. I've seen cases

where, if you want to take a withdrawal from one of the separate account funds, you need to tell them ahead of time as much as 85 days, for anything, including COIs and withdrawals. You have to set up the processing period. Are you going to value this monthly and take your COIs monthly and quarterly, and your other charges at different times? How are you going to do that? You're determining net amount at risk and deductions. You're determining the net amount at the beginning of month, the end of month, and quarterly. Because we're talking about jumbo amounts with millions and millions of face amount involved in many of these cases, many of these insurers don't have the ability to retain more than a small amount, if any, of the risk at all on mortality. They're looking for reinsurance and so that will be an issue that's very important. Finally, the product design has to be Section 7702-compliant.

This is not a product where you're selling ten thousand $100,000 policies. It's more like you're selling ten $10-million policies. These are very large face amount policies and they're going to be negotiated down to the smallest loads that they can get. People are not going to pay 5 percent premium loads. They're not going to pay 10 percent premium loads. They're not going to pay large charges. They're going to try to get things down to cost. The only source for our profit will be asset charges and mortality and expense charges. (Because these funds are not liquid, you wouldn't charge them on a daily basis the way they're commonly done on domestic VULs, but actually as a percent of asset on the day you value it, which might be beginning of quarter or end of quarter.)

One of the key issues will be the Section 7702 compliance. What makes a Section 7702-compliant policy? It has to be life insurance under local statutes. That means, if you are issuing a policy in Bermuda, it better be issued by a company that's really a life insurance company in Bermuda. That company must meet the Bermuda statutes. It should, hopefully, qualify if challenged in Bermuda law as life insurance. There are investment requirements as well, but I'll leave those to Hugh McCormick to speak of later.

You also need to meet one of two tests. This is the actuarial component. You need to meet the guideline premium cash value corridor test, which consists of the guideline premium of maximum premiums, and a minimum death benefit per cash value components, or the cash value accumulation test. Again, these are things that actually will be involved in calculating these issues or at least an administrative system will be set up to do this on the fly.

We were talking before about how these people are looking for best return on cash value. They are looking for the lowest cost. One of the ways to lower the cost is reduce the COI charges. If you can't reduce the rate for a thousand lower than your own cost, then you'd better reduce the amount of insurance you're selling them. There's some degree of competition as to how low the face can go for a given amount of premium. It's very important to get these things right. You can be very, very conservative and leave out charges you might, otherwise, take into account.

You can generate excessive guideline premiums that are conservative and leave lots of room. It's worth trying to be precise, because someone else will come in with a higher guideline or a lower face amount for a given premium.

You should take into account first-year guarantees on charges. As with all of the Internal Revenue Code, particularly in this, for lack of regulation, there is a range of interpretation on what the code means and what people do. The cash value corridor test is a multiple of the cash value. The death benefit is always defined as a minimum percentage of the cash value. The question is, what is cash value on death if the policy is illiquid on that day? That's one of the questions you have to ask and determine.

There's an increasing net amount at risk occurring once you're in a corridor. That's important to recognize because of reinsurance limits. You have to be watching out for that. Your reinsurer may not take on unlimited risk as the cash value rises to unlimited amounts. Cash value accumulation test policies should always be contractually in compliance. Procedures must actually comply. Values that are used are in compliance. You should make sure you're using the right values. What is "death benefit"? What is "cash value"? Again, the question of limited liquidity comes up for the same thing.

There's also a question of, if a value is determined on date of death and there's some time frame between date of death and notification to the company, who's on the hook for the investment risk to that period, that gap? In U.S. companies, for a $100,000 policy, generally they absorb that risk. They just pay based on date of death. In the case of a $20-million premium, the cash value could rise or fall a million dollars or more between date of death and date of notification. Who's on the hook for that?

Some people are going for non-MECs. In this market, people are looking for internal rate of return on death. They're trying to maximize the premium and minimize the face. But single-premium policies are automatically MECs, so the best thing to do to avoid an MEC is to minimize the early year of premiums, determine the amount and pay. Some companies may reduce the face amount after the first seven years, assuming no future premiums are anticipated, because it doesn't matter after that point.

Reinsurance issues are very important. We're talking about $20 million of premium on a 35-year-old that might generate a face amount of $60 million. Is there $60 million of coverage out there? Can your reinsurer provide that? If the net amount at risk starts to rise in the corridor, how much will your reinsurer absorb before you either have to absorb it yourself or start pushing money out of the policy? It's very important that, if you're going to design your policy with specific death benefits, you should make sure your coverage is consistent with the coverage in your policy. You don't want to use terminology for what the amount is going to be paid on death

that's different from what's in your policy. Reinsurers may be able to help provide offshore underwriting services since offshore policies have to stay offshore.

As far as administration, you have to keep your records offshore so as not to be drawn into the U.S. market. That's going to be very important for these offshore reinsurers, as they are not paying U.S. taxes. They're not under state regulation. They're not doing that because they're offshore. They're marketing offshore. They're record-keeping offshore. They're taking applications offshore. This is all occurring out of the jurisdictions of the states or the federal government. So the records have to be kept offshore.

You have to have people offshore who are capable of doing it. Some companies may use offshore TPAs. Those TPAs may be associated with onshore companies and have the experience to know how to handle these types of products. They may design a home-grown system. They may buy an off-the-shelf administrative system and adjust it for their needs. If we're talking about selling 20 policies to some companies per year, maybe they're doing it in a loose-leaf notebook. We hope not.

Why do the marketing people want to sell this? The product is marginally priced, but it has a definite source of income from a guaranteed investment spread. You know you're getting cost, plus a margin. It is a generous source of profit. Finally, there's one other reason that most of the marketing people are interested in this and that's high net worth.

MR. CHRISTOPHER: Gabe Schiminovich joined M Financial Group in Portland, Ore., in 1990 and is currently director of product research and product development. His strengths are in high-end life insurance product development for estate planning, corporate-owned life insurance, competitive analysis, and actuarial functions. His key responsibilities at M Financial Group are product development, product research, competitive analysis and actuarial support. Gabe is an ASA and holds a BA in Mathematics from New York University.

MR. GABRIEL R. SCHIMINOVICH: M Financial could be thought of as a producer group. It's an entity that's owned by a network of life insurance producers that sell, primarily, to the high-net-worth, bulk-transfer, and corporate-life marketplaces. M Financial, in our marketplace, has been actively distributing private placement products for some time in the corporate marketplace. More recently, we've introduced an initiative to try to penetrate the high-net-worth marketplace for the wealth transfer marketplace. We introduced that initiative in 2001, and we have about $150-million worth of new domestic, onshore life insurance premiums. It's a growing marketplace, and we think that we are gaining some familiarity with it.

The focus of my talk is going to be to give a brief overview of the domestic private placement marketplace as seen from a distribution system. I'm going to focus, primarily, on private placement life, although, we do see some desire for private placement annuities. I'm going to give an overview of what I think are some of the

drivers for this marketplace, why people are attracted to private placement products. I will talk about some of the product and regulatory issues and close with some observations on the success factors that may be critical in this marketplace.

Private placement products have been around domestically for some time. In the late 1980s, primarily in the corporate-owned life insurance (COLI) marketplace, we saw a few companies selling very large policies to large corporations. Why the application of private placement was good for COLI and maybe not for wealth transfer had a lot to do with the 3(c)-1 limitation of a credited investor. It limited the number of beneficial owners of a particular product to 100. While it could be a 100 corporations, you can get a lot more premiums and a lot more sales from 100 individual owners.

In 1997, there was the National Securities Markets Improvement Act that, basically, created a new definition of the qualified purchaser, a 3(c)-7 definition that expanded the number of beneficial owners that could purchase a private placement product. Depending on how people interpret it, I've heard anywhere from a 400 beneficial owner limitation to maybe being unlimited. It certainly increased the scope of how many owners you can have in a private placement product.

So who buys private placement life insurance? Basically, it's high-net-worth individuals for wealth transfer applications or large corporations. In each case, the buying decision is influenced by a large number of advisers. There are lawyers, accountants and actuaries. The people who are buying the product come to the table with a lot of opinions on life insurance and its cost and structure. A lot of these points may be debatable, but I think these are some of the opinions that the adviser community has about life insurance. They like to focus on the insurance product cost. It's something that's very tangible. They can compare products based on cost. There's a lot of pressure on margins and costs and everyone's, basically, looking to squeeze cost down fairly low.

There's a perception that the high-net-worth marketplace should, just by its nature, be entitled to a cheaper product. People who are wealthier should automatically get a better deal. There's a perception that private placement variable life means a low-load or no-load concept. As far as the investment alternatives or options that are added, there's a perception that almost any investment can be wrapped or added to the product. Offshore is thought to have even lower cost by avoiding state premium and federal DAC taxes. There's a feeling that it's really not an insurance sale, but more of an investment sale. We're looking to take investments and find a tax deferred or tax advantage vehicle for them. Again, that's the perception of the marketplace. A lot of times you'll hear the buyers say, "Well, I'm not buying insurance, I want to buy something else." Our experience has been that it really does boil down to an insurance sale.

In the 1990s, we saw a tremendous shift to separate account products. In 1990, less than 15 percent of the ordinary life sales were in separate account products. By

the year 2000, over 70 percent of the sales were in separate account products. A lot of this was attributable to the bull market or the equity returns that we saw in the 1990s. Basically, the marketplace got more comfortable taking on the market risk or mark-to-market risk of the investment or asset component of the insurance product. People started to look for, in this marketplace, other investment choices. Also, the target market has grown substantially. It is projected to grow at around a 17 percent annual growth rate. There are just more high-net-worth individuals to access in this. They have more, so there's more wealth and more potential sales.

What does the marketplace want? One of the most important things the buyers in this marketplace want is alternative noncorrelated investment options. They, typically, don't like to buy what they would perceive as retail mutual funds for their investment choices. Most of these clients are used to having their own select boutique money managers, or they're very used to having private institutional investment options. They want that in their insurance portfolio as well. They expect customized product solutions. They are used to having investment products or other services customized for their needs, and they expect that in the insurance product environment. They want to see what they would call "pricing characteristics" for the high-net-worth marketplace, which, typically, translates to a lower cost. There seems to be a preference for life insurance over annuities. I think that some of the planning options that life insurance gives in this marketplace are very attractive. There's a small annuity market mix, but life insurance seems to be the much broader application.

Just to make a case for what is an alternative investment, typically, we would call those maybe hedge funds. But alternative investments are, typically, investments that are not correlated to the equity market returns. There are two things that people are looking for in the alternative investment marketplace. One is to reduce volatility for the same level of return. Or, they want higher returns for the same level of volatility. Through the 1990s, the Hedge Fund Equity Index has, basically, returned a substantial premium over the S&P 500. So, for the same level of volatility, we're seeing more returns. There's less correlation, let's say, to the equity market returns, but there's a stable return that can be generated. To take another view, from an efficient frontier perspective, the hedge funds are where you'd want to be. You get a very good tradeoff. For increased risk, you're getting a much higher return.

There are some product issues to consider in designing your products for this marketplace. The product is really required to offer all the flexibility that you've ever seen in a registered VUL product and, potentially, more. People want everything that they can get in a registered environment and they expect to be able to add features also. The product has to be able to handle funds that have restricted liquidity. So we're talking about funds that are not valued daily. They may be valued monthly or quarterly. How do we handle that in the product design and the mechanics? There's an expectation of a high level of service, so we need to make sure we build an administrative infrastructure that can support that. Again,

we're talking about a marketplace that's used to having a high level of service provided to it in other products that it buys including investment products or other services. How do we do this in a low-load or no-load cost structure?

As far as some pricing assumptions that we see in the marketplace, there's an expectation that we're going to reflect the experience of a large face marketplace. I think, generally, the preferred mortality rates that we see for the large face marketplace are primarily driven by better access to health care and better quality of life that the high-net-worth marketplace enjoys. However, this may be offset by having a much fewer number of policies over which to spread the risk. I'm not so sure that we'll see those same cost savings, because they're very large policies and fewer of them.

The marketplace is affected by the capacity in the reinsurance marketplace. The reinsurance will become a very important part of the sale process, and you must be able to access the reinsurance market efficiently. Also, you need to give some consideration to what's going to happen to excessive returns in the hedge funds if they perform the way they, historically, have. They may actually force them at risk to increase by hitting the tax quarter. One has to be prepared for how you're going to handle that. Do you have to force cash out of the contract, or what kind of mechanism do you utilize to handle that approach?

Regarding persistency, the market expects a high, early cash value. You'll always see positive growth on your premiums, so cash values usually exceed premiums. I think the point here is that it's important to create good relationships with distribution and the client to help improve persistency. The hedge funds present an unknown risk. We've never had a hedge fund in an insurance product have a run on the bank, so we're not sure how that's going to affect the policyholder and the client.

Typically, the funds that we're looking to add to these products are not your riskier hedge funds. Hedge funds have lots of applications in the marketplace. We tend to be looking more for stable return, low volatility hedge funds, as opposed to some of the funds that were out there and we've heard about, like long-term capital; I think that would be considered much riskier and have a lot of volatility.

Regarding distribution costs, the marketplace has a fairly high need for sophisticated planning techniques. While clients want to buy the private placement product at low cost, they also want to make sure it fits into their overall financial portfolio. There's a need to provide for a sophisticated needs analysis and sophisticated planning. On an ongoing basis, there's an expectation that there's going to be a high level of service provided. A lot of information is important. Sometimes people want information monthly, quarterly or whenever they want it. There are a lot of requirements for information.

On the investment expense side, these funds typically have a very high expense structure. These hedge fund managers generally get compensated very well, and there may not be an opportunity to create margins that can help support the pricing of the product there that we would see in the registered environment. A big question is, will we get sufficient assets within these funds to help cover the fixed expenses of the funds, the noninvestment-related expenses?

From an administrative and underwriting perspective, we are talking about large face amounts that will have a high level of medical and financial underwriting services. Again, we have to make sure we build that administrative infrastructure to handle the complexities of the product as well as provide information to policy owners.

For federal and state taxes, there's a high sensitivity in this marketplace because the offshore alternative presents a perception that you can avoid state, premium, and federal DAC tax. Clients look to minimize that cost. There are, also, a number of states that offer premium tax reductions if you have a large premium in that state.

From a modeling perspective, we're seeing a large variation in types of premium scenarios that people are presenting in the marketplace. It might be that in the offshore marketplace you will see, primarily, the single-premium or non-MEC funding level. In the domestic marketplace, we're seeing people have many different types of premium requests. There are funding patterns that have a lot of different needs that they're bringing to the table. This makes it more difficult for model risk, to develop an initial model. It's difficult to predict what kinds of cases we're going to see, so we're very sensitive to model risk and how we manage that.

Customizable means, does the product have an ability to meet a variety of different compensation patterns? The distribution is looking to get compensated in many different ways. The traditional base-term mix of producers used to adjust their compensation may not be sufficient for this marketplace. They're, also, looking for flexible charge structures. The distribution needs to be able to support itself, but the client may want to have some options on how those charges get reflected in the policy.

Finally, I keep on getting back to this low-load or no-load. No-load seems to have two interpretations in the marketplace. It could mean no percent of premium charges, so the buyer doesn't see any percent of premium loads, but there are, typically, commissions still paid out of the product. Or, it means that there are no commissions paid by the product and the client expects to pay the distribution a fee or some sort of a service charge directly. In both cases, the product always still has charges that cover company expenses such as cost of insurance, mortality, expense risk and other monthly charges. So no-load doesn't really mean no cost. It typically means no percent of premium charges. In this marketplace, people hate to pay a percent of premium charges.

Regulatory issues need to be considered. Again, the products have to be Section 7702-compliant. We typically see that the products have to offer all flavors of cash value simulation tests, guideline premium tests and all the different options that you would see. There are some state issues around fund liquidity as far as distribution and valuation. How do you value death benefits? That needs to be managed. Also, how do you file a product chassis that's quite flexible?

There are the investor control questions that need to be considered. Typically, it's how aggressive is a company willing to go? We see a wide spectrum in the marketplace of some companies being so conservative that you have to clone the fund, in essence, to have an insurance-only fund or insurance-assets-only fund. Other companies seem to be a little more willing to be lenient and do what's called individually managed separate accounts. These companies are, in essence, customizing investment options for buyers.

There are a number of issues that have to be considered in distributing the product as far as how people qualify under the 3(c)-1 or 3(c)-7 exemptions. For those of you who aren't familiar with those exemptions, they are the rules that determine what kind of buyer can buy a private placement product. Another part of Regulation D is that you're actually prohibited from marketing a private placement product, so it has to be with a preexisting client relationship. I think there are some compliance issues that come up in making sure that the product is distributed properly. While there are no registration costs because it's private placement, our experience has been that there are plenty of other legal costs to offset any savings that the lack of registration may offer. We have to make sure that you comply with all the insurance and investment product sales practices, so there's a fairly high regulatory or compliance component of the product.

In closing, I have some observations on this marketplace. It's very competitive. There's a high focus on cost and the adviser community is geared up to negotiate. They want to negotiate on price and they're coming to the table. One key element in that is, how are you going to get access to this marketplace? Having good distribution that can access that marketplace may be key to being able to get a broad base of sales. Many times we see that people have one or two connections, but there's not a lot of depth to the number of relationships that they can create. I think it's going to be important to build a platform that can deliver high-quality service and timely and accurate information. It's not a very forgiving marketplace. Clients expect accurate numbers and they will hold you to it.

Scale is very important. With limited retention capacity, how are you going to get enough assets or enough volume into the product line to help support your administrative infrastructure? How are you going to manage your retention? How are you going to get access to the reinsurance marketplace? Again, that all comes from developing good relationships and having a base from which to build.

It's important to have good pricing controls in place to monitor the products closely. Again, there's a lot of analysis going on, so if there's a pricing hole in a product, the marketplace finds it very quickly. You have to assume that they're going to compare all of the products in the marketplace and choose the one that has the pricing hole in it.

With risk management, you need to be sensitive to how persistency is going to be affected and how to manage the process. The key question is, can we build a product that has long-term viability? We have to sustain this product over a long period of time to help recover the costs.

Coming from a distribution system, we feel that developing key partnerships with distribution is going to be important for persistency. We look to create long-term relationships with the clients, with the advisers, and with the insurance companies that we are, in essence, partnering with to deliver this product.

MR. CHRISTOPHER: Hugh McCormick is a partner in the New York office of LeBoeuf, Lamb, Greene & McRae. He advises U.S. and foreign insurance and reinsurance companies on tax, regulatory and corporate matters arising in connection with mergers and acquisitions, demutualizations, reinsurance transactions, and insurance products. He represents a variety of life insurers and reinsurers located in offshore jurisdictions. From 1977 to 1981, he was an attorney adviser in the Office of General Chief Counsel of the U.S. Internal Revenue Service, specializing in insurance tax matters.

MR. HUGH T. MCCORMICK: I'm going to do an overview of some of the issues that we've talked about from a lawyer's perspective. I'm going to try to avoid touching on anything that's already been discussed. Life insurance products, onshore and offshore, must comply with U.S. tax rules and Section 72(s) for annuity contracts. We've talked about Section 7702 for life insurance contracts. I'm going to touch on the diversification rules, which are a very important consideration for these kinds of products.

Briefly, regarding tax benefits, why are we here? What are we talking about? One of the speakers mentioned that annuities are a lot less popular in this market than life insurance products. Why is that? Annuities only offer tax deferral. Sooner or later somebody pays the tax on an annuity, either through annuity payments stretched out over time, or on surrender, or on commutation on a lump-sum basis. In addition, if the person who received the annuity payments has not attained age 59½ or met certain other requirements, not only will the payments be considered ordinary income, but he or she loses any kind of capital gains treatment. There is, potentially, a 10% penalty tax that applies to distributions from annuity contracts.

When you look at the economic impact or the economic benefits of life insurance versus an annuity, a life insurance contract offers the possibility of tax-free death benefits. The death benefits are both income tax-free and estate tax-free, if you

plan properly. Like an annuity, there's tax deferral on the inside buildup. Unlike an annuity, there can be tax-free loans from a life insurance contract. There are advantageous withdrawal rules for non-MEC life insurance contracts. MECs are treated much like annuities. They have all the detriments of the annuities on lifetime distributions, but still get tax-free death benefits when the insurer dies. So you see the possibility of absolute forgiveness of the income tax payments with respect to life insurance contracts and that, frequently — not always, but frequently — drives the purchase.

We've heard already that contracts must comply with Section 7702. They must be life insurance under applicable law. Dan Theodore mentioned that. One of the issues that you run into is insurable interest. This is a legal concept that underlies whether or not the contract will qualify as life insurance for tax purposes. If a person buys a policy of life insurance in which there is not what's known as an insurable interest—a family relationship or some kind of economic relationship — the contract may not be life insurance for federal income tax purposes, in which case, you lose all your tax benefits.

Insurable interest issues in the offshore market are a bit more forgiving than they are in the onshore market. Under the Bermuda insurance law, consent of the insured is enough to pass on an insurable interest. That is not true in the United States, generally. We've also looked at Cayman law and have come to the conclusion with local counsel there that there are no insurable interest requirements in Cayman.

We've talked a little bit about the Section 7702 issues. The late notice of death issue was touched upon. In the offshore market, companies have come up with a technique to avoid taking on the risk of late notice. If the company doesn't receive notice of the death of the insured for a long after the time of death and if the value of the assets in the separate account have deteriorated or have declined, who bears that risk? Well, one of the things you see in the offshore market, where you have a lesser regulatory burden, is the distribution. If notice of death comes in within a certain period of time, and it's reasonably lengthy, typically, the insurance company takes on the risk of late notice of death. But if the notice is too delayed, what some of the companies will do is pay out the cash that they received from their reinsurers, and mostly the net amount at risk will, typically, be fully reinsured in the offshore market. They then will distribute an investment contract that represents the interest in the separate account assets. The investment contract will, in theory, have the date of death value, but, in fact, have a current value when you actually go to cash in the contract.

That can be done in the offshore market. I doubt that it could be done in the onshore market for regulatory reasons. Whether or not it's compliant with Section 7702, we believe that it is. There's no guidance on this. Other reputable New York counsel have opined that it is, but it is an issue that merits a little further thought.

We've talked about Section 7702 and all the various requirements for life insurance contracts. To qualify as annuities for tax purposes, there are fewer requirements; they have fewer benefits, and they have fewer requirements. The big issue is, Section 72(s) distributions. For a qualified annuity contract to qualify for U.S. tax purposes it must have certain distribution of death requirements, and they have to be tied to the owner of the contract not the annuitant, unless the annuity's owned by a trust. In that case, you would look to the life of the annuitant. This is a mistake that is made by insurance companies all the time. Those of you who work for insurance companies ought to go back and look at your annuities. Some of you will find that your annuities trigger these distributions of death rules off the death of the annuitant, which is, generally, incorrect.

I will go over the diversification rules. This is something that has not been touched on thus far. The diversification rules apply to life insurance and annuity contracts that are variable in nature. They apply equally to the offshore contracts and to the onshore contracts. The diversification rules apply to determine whether or not a contract is life insurance or an annuity for federal income tax purposes. If you fail the diversification rules, the contract will not be treated as a life insurance or annuity contract for federal income tax purposes.

The diversification rules are applied to segregated asset accounts. Segregated accounts are not the same as separate accounts. A separate account can be a segregated asset account. If it's a state law or foreign law separate account in which there are subaccounts, as there typically are in variable insurance products, each one of the subaccounts will be the segregated asset account. You have to test diversification at the subaccount. If you take a typical onshore, retail, variable life product that has 10 different investment options, and different policyholders can choose among those 10 different investment options, each one of those 10 different investment options will be independently a segregated asset account.

In essence, the diversification rules require no fewer than five different investments in the segregated asset accounts. There have to be at least five different identifiable investments. An investment is, for example, all issuances of a single issuer, G.M. stock, G.M. bonds or G.M. anything else. A G.M. guaranteed debt instrument would be a single investment, so you have to be thoughtful.

There are detailed regulations issued by the IRS in Section 817(h) that tell you how all these rules work, but you have to be careful as to what constitutes a single investment. A public mutual fund or a public partnership is, generally, a single investment. Fidelity's Magellan fund is a single investment, even though it owns a thousand investments. There are, however, what are known as clone funds. If a mutual fund or a partnership is dedicated to insurance companies' separate account products, you get look-through treatment. Most of the retail mutual fund companies have funds that are dedicated to insurance products and you get the look-through. You get to test diversification by the underlying investments. The same thing is true

for partnerships, unit investment trusts, grantor trusts and other kinds of entities that can be used as investment vehicles.

Mentioned earlier were the investor control issues. The investor control issues go back to a series of revenue rulings issued by the IRS with respect to what were known as wraparound annuities in the late 1970s and early 1980s. I would look to Revenue Rule 81-225 as probably the best place to start on the investor control revenue rulings.

Under the revenue ruling, the classic investment example, if a policy had the right to select specific investments, is a variable annuity which is wrapped around a CD and gives you tax deferral on the CD and the protection before there were state guarantee funds to give the policyholder FDIC protection so that principal loss wouldn't be risked. The IRA ruled that the owner of the insurance contract in the wraparound annuity rulings was actually the tax owner of the underlying asset. So according to the IRS, if you have too much control over the investments held inside the insurance company's separate account, you, the policyholder, will be treated as the tax owner and you'll pick up gain, loss, income, whatever, and report it on your individual return.

This is a very hot issue these days with the IRS and with the hedge fund with the variable product industries. The high-net-worth market, where you have a lot of interest in these high-net-worth individuals in having their policies wrapped around hedge funds or other aggressive investments, is interested in this issue. At what point does the insurance company's willingness to work with the policyholder create an investor control situation? That is very much an open issue at this point. People debate it endlessly. It has become a huge issue. You go to any hedge fund conference at which people talk about high-net-worth insurance products and the subject that people talk about is investor control. No one knows what the answer really is.

When I was at the IRS, almost 30 years ago, these rulings were first being worked on, and people talked about what they had in mind. They issued the rulings. Then everything went silent for almost 20 years. The IRS has not been very forthcoming about what it thinks the investor control rulings cover. You've had 20 years of development in the life insurance industry of these products now. For example, Nationwide's Best of America is a retail product that you can go out to your local Nationwide agent and buy that has a separate account offering 60 different investment options that you can choose among. Now, is that an investor control issue when you can choose among 60 different investment options through a single variable contract? In the high-net-worth market, the real question is: When the insurance company wraps around a hedge fund is that an investor control issue?

One of the interesting debates is, if my life insurance product or my annuity complies with the diversification rules, do I have to worry about the investor control rulings anymore. I mean, I've got a law and a statute enacted and regulations

promulgated after these rulings were done; do they replace the investor control rulings? Do they just occupy the field, if you will? I argue yes. The IRS argues no. It's never been decided.

One of the biggest issues that you run into in the high-net-worth market, where you have hedge-fund wrap products, is whether a hedge fund is a single investment for diversification or investor-control purposes. If you want to wrap a life insurance product around a hedge fund offered by a well-known hedge fund manager and that hedge fund is available to investors, other than investors who come in through the insurance product, does that mean that you have an investor control problem? Magellan, for example, is a publicly available hedge fund, just like Magellan is a publicly available investment. Therefore, the IRS, we think, would be inclined to argue that it's a single investment and, therefore, you would not get look-through treatment. You would have to have other investments to meet the diversification rules. Also you would probably have too much ability to work with the insurance company to say, "I want you to offer a product that's wrapped around the XYZ hedge fund."

Now, interestingly enough, under the diversification regulations, if an investment is offered through a partnership that is not registered under a federal or state law regulating your offering or sale of securities, you automatically get look-through treatment. Hedge funds are virtually always organized as unregistered partnerships or organizations that are allowed to elect partnership status for federal income purposes. The argument is that virtually any hedge fund that's available today is, technically, under the regulations, eligible for look-through treatment. So when the IRS says, "I lose that battle," then the issue becomes, "But I still think you have an investor control issue. You have these hedge fund investors in the fund today. They're going to bail out of the fund. They're going to buy into a life insurance product that's wrapped around the same fund. Wouldn't that be an investor control issue?" The answer to that is unknown. There are no cases. There are no rulings other than the old investor control rulings.

We suspect strongly that the IRS would come out and say that you have some kind of an investor control issue. We think they'd lose under the diversification rules, but they're going to come back and say that you have an investor control issue. I'm a little troubled by an IRS argument that says that you win under the diversification rules by treating this nonregistered partnership as a pass-through — as a nonexistent entity almost — yet treats it as a single entity for purposes of the investor control rules. It doesn't seem to be logically supportable that you would be arguing these, basically, inconsistent legal concepts, but we think that the IRS would be prepared to do it. The IRS is prepared to do a lot of things.

Now, let's talk about the offshore market. People earlier talked about some of the advantages and disadvantages of offshore. What is offshore? Offshore these days for the United States is, typically, Bermuda or the Cayman Islands and, to a lesser degree, the Bahamas. There are some companies in those jurisdictions that sell

U.S. compliant products, but, generally speaking, we're talking about Bermuda, the Caymans and the Bahamas.

Typically, the people who go offshore are the high-net-worth individuals. How does one go offshore? That's a very, very tricky issue from a regulatory point of view. Do you get on a plane and fly to Bermuda? Do you hire an attorney in Bermuda? Do you secretly do everything in the United States and pretend you went to Bermuda? I fear for the last one.

There are many advantages in the offshore market. There are lower capital requirements for insurers. That allows the insurers to operate in a more economically efficient manner with reduced regulatory burden. In the offshore market in Cayman and Bermuda, there are regulators. They are concerned about the solvency of their companies. There is a focus on maintaining an honest insurance industry, but they don't really care terribly much what goes into the separate accounts. That's not their issue. Unlike the New York Insurance Department or the other regulators who care desperately what shows up in the separate accounts of domestic insurance companies, the offshore regulators don't terribly much care. That allows for investment flexibility.

We've talked about minimization of state and local taxes. I don't really know if the costs are much lower. I've heard about lower cost, I've heard about high cost. That's something that may be company-specific, or it may be different times. It may just be that, as the domestic market becomes more competitive and more willing to do low-cost products, that what used to be a cost advantage in the offshore market may, in fact, be disappearing.

When you go offshore, we talked about tax minimization. You do tend to get rid of the DAC tax, unless you're dealing with a company that's made what's known as the 953(d) election to be taxed as a domestic company. I'll tell you why companies do that in a minute. So you get rid of the DAC tax. You think you get rid of the state premium tax. The tradeoff is you pickup a 1 percent federal excise tax on the premiums. So we're down 2 percent, plus the cost of the DAC tax. We're down 3 percent, but we're up 1 percent. So we're down net 2 percent so far. Then you have to look at state direct placement taxes. California would impose a tax of 3 percent on the policyholder who buys this offshore policy. Most states, based on the surveys that we've done thus far, could tax an offshore life policy bought by a resident. About half of the states could do that and half could not.

The Bank Secrecy Act is something I throw out at every one of these meetings I go to just so that people are aware of it. Particularly after September 11, there will be a tremendous focus on what goes on in the offshore market. People are going to be doing everything they can to develop information about offshore accounts. Now, at the present time, under the Bank Secrecy Act, U.S. citizens have to report interest in foreign trusts, foreign bank accounts and foreign financial accounts. The thinking thus far has been that offshore life insurance policies are not subject to the Bank

Secrecy Act reporting requirements, but I have seen a Treasury Department letter that says that they are. It was a letter issued to a single person many years ago. It's never been published. It's never been made available publicly. I do know that privately, people at the Treasury Department do think that foreign, offshore life insurance policies are reportable foreign financial accounts. I think we'll see a lot more guidance on this over the next few months as the Patriot Act and as the various responses to September 11 work their way through the system.

One of the interesting issues in the offshore market is that annuities issued by a foreign insurance company to a U.S. citizen, in theory, will not be subject to the beneficial tax treatment for annuities, but rather to the less beneficial treatment afforded debt instruments under what are known as the Original Issue Discount (OID) Rules. The OID rules are a form of accrual basis tax reporting for cash basis taxpayers. In other words, you report income even when you haven't received cash. It's called the Blackfoot Bank problem, because it goes back sever or eight years ago when a Native American who owned a bank in Montana was going to issue annuity contracts as bank manufactured. Not bank-sold, but bank-manufactured annuity contracts. There was a whole big flap over that, and the insurance industry was successful in getting the IRS to issue regulations saying, in essence, that annuities had to be issued by certain entities, one of which was insurance companies subject to tax under Subchapter L. That kicked out the bank. We thought at the time that it also may have kicked out annuities issued by foreign insurance companies that did not actually pay tax to the United States.

There has since been some legislation and some regulations clarifying that, so it is now certain that an annuity contract, particularly a fixed, deferred annuity contract, an intrasensitive annuity contract issued by a foreign insurance company will be taxed as a debt instrument. For a variable annuity, the kind of annuities that we're talking about in this market, we don't know. The answer there is uncertain. Whether or not a variable annuity is a debt instrument is an open issue. It may fall out of these new rules and regulations, but that's an unsettled issue.

One of the ways to solve the issue if you're a foreign company is to make the 953(d) election to be taxed as a U.S. taxpayer, even though you are a Bermuda or Cayman company. In that case, you can issue annuities, and you can have some of the benefits of the lesser regulatory burdens on offshore insurance companies. You can still stay away from the state premium taxes. There's no more federal excise tax, but the company would be subject to the DAC tax and other federal tax liabilities.

One use of annuity contracts or life insurance contracts for the high-net-worth market is when you have people coming to the United States for only a period of time. They're non-U.S. taxpayers when they life offshore. They're going to be U.S. taxpayers while they live in the States. When they go back to their home country, they're not going to be taxpayers anymore. If these people buy a qualifying life insurance or annuity contract from a U.S. carrier, when they cash it in they're going

to be subject to a 30 percent withholding tax. It can be lesser if they live in a country with a tax treaty. But, generally speaking, there's a 30 percent withholding tax when they cash in their contract.

In this case, these people want to buy a U.S.-qualifying product from an offshore company. It has to be U.S. qualifying so that they get the benefits of the tax deferral. But when they cash it in, in this case, it cannot be a 953(d) company, because that's treated as a domestic company. So there's a substantial market of high-net-worth Europeans coming to the States. Before they come over, they buy a qualifying product. They hold it in a Bermuda company or a Cayman company. They hold it during the period of time they're a resident in the United States. When they go back and they're no longer a U.S. taxpayer, they cash it in and that avoids the imposition of the 30 percent withholding tax on U.S. source income that's paid to foreign persons.

Some of the other issues in the offshore market are "cell" companies. Bermuda and Cayman law allow for the creation of individuals cells—individual separate accounts for each policyholder. The questions that come up include: Are they protected in bankruptcy? They've not been tested in any of the offshore jurisdiction. In contrast to the United States, where the separate accounts of insurance companies have been upheld as being insulated in bankruptcy, no one knows what the treatment in Bermuda or Cayman is. The law is the law. The law says that they're insulated, but there have not been any court cases testing any of these issues. It is something that's very common. You can do it Cayman. You can set up cell accounts as a matter of right. In Bermuda, you have to go to the legislature and get a special act for your company, which is routinely done. Bermuda has been working on cell company legislation as a matter of right. It has not been enacted as yet. They almost enacted it in 2001 and then pulled it back. You can get a special act of the legislature.

The variable products are securities under the 1993 Act. Retail products in the United States have to be sold through registration through a prospectus. Private placement variable life, both in the onshore and offshore market, is sold pursuant to special rules, particularly Regulation D, that allows for private placements. You can sell to accredited investors and up to 35 sophisticated investors without running into the registration requirements. Registration requirements involve filing a registration statement with the SEC. These cannot be public offerings. You have to be careful how the offerings are done, as stated earlier. Private placement means private sales. I mention Regulation S. There are rules for doing purely offshore offerings, but you cannot have any contact with the United States at all.

There was another regulatory issue that was discussed, the Investment Company Act of 1940. Insurance companies are typically not required to register as investment companies. However, the separate accounts are, which is why those of you who deal with variable products have probably noticed two prospectuses, one for the product and one for the separate account. This applies to offshore

companies as well. Offshore companies cannot be trapped in selling a product that is based on an investment company that is not registered. It's virtually impossible to register under the Investment Company Act of 1940, so you have to figure out a way to avoid the requirements of registration.

You've heard about the 100 Investor Rule. The old way to do it was keep the number of policyholders below 100. Then you had to worry about who were really the policyholders. Could you integrate different offerings? What happened if you went over the 100 limit accidentally? There were all kinds of concerns.

The Qualified Purchaser Limitation, which was enacted just a few years ago, makes it simpler to deal with, because it's more of a bright line test. An accredited investor is someone who has income of $1 million a year over a period of time for investable assets. A qualified purchaser is, basically, a person who has investable assets of $5 million or more or an institution that has investable assets of $25 million or more. It's a bright line test. It's easy to administer. It limits you to very high-net-worth individuals, but as long as you deal with strictly the qualified purchaser market, you have no 100-person limit. You can deal with an unlimited number of qualified purchasers as long as — and this is important to keep in mind — everyone is a qualified purchaser. You can't have any nonqualified purchaser. If you have even one nonqualified purchaser, then you're subject to the 100-person limit. You get thrown back to the other limit. It's something that people have to be careful about and keep track of.

One of the big issues that will affect actuaries, both those who work for companies and those who have consulting practices, is how you market these offshore products. In essence, you're not supposed to do anything in the States. There are tax rules, but, even more importantly, there are state insurance laws and securities rules as to what can actually be done in the United States. In essence, there is almost nothing. The state insurance laws prohibit solicitation, negotiation and policy delivery in the United States. You're not supposed to do anything in the United States. Most states have aiding and abetting statutes, and New York's is the broadest. New York's aiding and abetting statute says that anything you do to facilitate the placement of a life insurance policy or an insurance policy with an unlicensed company can be a violation of the law, and this applies to anyone. This is not just companies or agents. It's any person. It's, technically, a misdemeanor. So a consulting actuary who gets involved with consulting with people and, perhaps, sending them to offshore insurance companies could, technically, be in violation of the aiding and abetting statute. It's something that people need to be aware of and to be careful about.

The New York Insurance Department has issued a series of letters in which they ask the question, "What can you do with respect to an offshore life insurance policy?" The answer, in a word, is "nothing." They cover a situation where a bank had nonresident, alien clients and the nonresident alien clients wanted to work with the bank in New York to be referred to a Bermuda insurance company. Now, keep in mind, you're talking about foreign clients of the bank going to a foreign insurance

company. The referral by the bank in New York was held to violate the aiding and abetting statute. Most of the laws in the other states aren't quite as bad as New York's. They focus more on residents of the state. New York and a handful of other states would prohibit anything to do with referring people to an offshore insurance company. This is something where lawyers could get picked up, accountants can get picked up, and actuaries can get picked up. It's something you need to know about if you're working in this market at all.

We've talked about the life insurance products. One of the interesting developments of the last few months really has been high-net-worth people asking, "How about if we invest in the hedge fund through a capital investment in an insurance company?" Some of you may be familiar with Max Re, a Bermuda company that has a very aggressive investment portfolio as part of its capital structure. It is a real live reinsurance company. The next thought was, "How about we set up a reinsurance company in Bermuda? We have different classes of stock. Different investors will buy a class of stock. That class of stock will be invested in this hedge fund. Class A will go into this hedge fund. Class B will go into that hedge fund. Classes C and D will go into that hedge fund and on and so forth." In theory, all of these classes of stock will be exposed to the insurance risk of this reinsurance company. But the investment return, the underwriting profits and the profits on the shares of stock will then pass through this class of stock back up to those specific investors who wanted to get into this.

We, at LeBoeuf, have had a number of inquiries and a number of discussions with people talking about precisely this model. After September 11 everyone was focused on the possibilities for the reinsurance market in Bermuda. What could you do and was it suitable? There are a number of interesting issues that float up. But the most interesting issue is every one of the conversations we've had on something like this is that people come in and they say they want to reinvest in a reinsurance company. They want the capital structure of the reinsurance company to invest in hedge funds. They want to make a great return, because what they're doing now is deferring income and turning ordinary income into capital gains.

Hedge funds, incidentally, are very tax inefficient. There is lots of ordinary income and lots of short-term capital gains. Just to defer and turn things into capital gains, is maybe not a home run from a hedge-fund perspective, but it's at least a triple. The people come in and say that they invest their money in the hedge funds and make a great return. It's capital gain. Our answer is always that you have to understand one thing and that is, it has to be an insurance company. You're going into the insurance business. The answer, invariably, is, "No, we're not in the insurance business. We don't know anything about the insurance business. We just want tax-advantaged investments."

If you're a passive foreign investment company, you have fairly horrible tax results. To avoid being a passive foreign investment company, which these companies would be, you actually have to be predominantly engaged in an insurance business.

In other words, you really have to take on insurance risk in this company. That usually cools people off. At that point, you start losing their interest. Some people stick with it for a while and try to figure out exactly how much is enough. How much insurance is enough? That's a fun question, the how much is enough? You just kind of look at them blankly and say that your guess is as good as mine.

Earlier, I mentioned Max Re, which, is a single class of stock. It has an aggressive investment portfolio, but it does not have the different classes of stock. So, in many respects, Max Re is a fairly conventional reinsurance company with a very interesting investment portfolio.