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Functional Regulation in the 21st Century:

What's Reasonable for Investor Protection and for Agents Selling Variable Annuities?

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If complaints about an agent's sale of "ABC" mutual fund are handled by the state securities commissioner… Why should complaints about the same agent's sale of a variable annuity invested in "ABC" mutual fund be exclusively handled by the state insurance commissioner?

Are state laws enacted 35 years ago still relevant today when most agents who sell variable annuities are also licensed to sell mutual funds?

These questions and others are being discussed within the context of functional regulation and its application to agents who sell variable annuities and variable life insurance. The National Conference of Commissioners on Uniform State Laws (NCCUSL) has drafted the new Uniform Securities Act (2002) which allows the option to define variable products as securities under state law, while exempting such products from state securities registration.

One of the goals of NCCUSL is to make state laws consistent with federal law and to allow the states the option to provide for state functional regulation of agents selling variable products… since variable annuities and variable life insurance are hybrid products that are marketed as investments.

The purpose of this paper is to provide background information about the NCCUSL proposal and to address a number of concerns raised by the insurance industry. The North American Securities Administrators Association (NASAA) has been working with the National Association of Insurance Commissioners (NAIC) to share information and to discuss these issues.

The Evolution of "Functional Regulation"

The collapse of the stock market in 1929 and the ensuing economic hard times of the Great Depression generated a distrust of large, opaque financial institutions exercising unfettered financial discretion in the markets. In addition to stimulating the creation of the Securities and Exchange Commission (SEC) and the passage of the Securities Act of 1933 and the Exchange Act of 1934, these events also resulted in passage of the Banking Act of 1933 (Glass-Steagall). The primary intended effect of Glass-Steagall was to separate commercial banking from investment banking and to prevent misjudgments by the latter again causing the collapse of the former.

So with the creation of the SEC, the enactment of Glass Steagall and the 1945 McCarran-Ferguson Act awarding custody of the insurance industry to the state insurance commissions, our financial institutions had distinct roles to play and each their own band of regulators with expertise and skills to oversee their activities. The U.S. had developed a structure which carved out authorized activities that each industry--banking, insurance and securities--could pursue without the worry of competition from the others, and a friendly regulatory environment wherein at least modest profit seemed almost guaranteed.

After a few decades and another World War, there developed a certain envy among our financial institutions for participation in products and activities from which they were primarily excluded. Banks wanted to offer retail securities accounts to their customers and even harbored secret desires to do underwritings. Broker/dealers wanted to take deposits and create "sweep accounts and money market funds" to cover all investment needs of their customers. And insurance companies wanted into the mutual fund market and set about getting there through the creation of "variable annuities," a hybrid product with predominantly investment-like features.

Competitive pressures also were beginning to squeeze profitability of certain financial players. In the de-regulatory 1970's, sweeping changes were taking place. Banks and savings and loans could suddenly compete on interest rates, and safeness and soundness rules were changed to allow banking institutions greater flexibility as to where they could invest their assets. Culminating on May Day 1975, a nearly decade-long assault by the SEC on fixed brokerage commissions achieved success. Insurance providers were beginning to experience real inroads from the booming mutual fund industry. Amidst all this deregulatory ferment, policy-makers were becoming more enarmoured of the European and Japanese models where there existed much more overlap in function of financial service providers.

In order to secure the perceived competitive benefits of allowing institutions to sell products outside the brightline boxes into which they were placed after the Depression, the concept of "functional regulation," implicit in the early variable annuity cases, came fully into its own.

As the financial services industry cross-diversified, the operative theory was that each player would be able to provide insurance, banking and securities services, but safety would be provided by requiring each specialized function to be regulated by the subject matter expert over that function. The result has been a somewhat chaotic application of the "Be careful what you wish for" admonition.

As could have been predicted, functional regulation was welcomed with more enthusiasm as a theoretical key to gain entry to new product lines and businesses than as an implemented regulatory reality. If functional regulation is a good thing, it should be embraced generally. Industries should not be permitted to choose if and from whom they will tolerate regulation. The issue of whether state securities regulators should be permitted to assert jurisdiction over agents selling variable annuities is a classic example of the resistance of an industry to functional regulation.

Variable annuities are securities. In the typical variable annuity, ninety-eight percent or more of the premium available after expenses and commissions goes toward the purchase of investment products, with .75-1.25% going to pay for a death benefit. Because variable annuities are federally covered securities, they are exempt from state registration. There is agreement that the state securities regulator should not have any jurisdiction over an insurance company.

The emerging issue is the narrow policy question of whether the same person who is licensed federally to sell both mutual funds and variable annuities is subject to state investor protection authority when selling the former but not when selling the latter.

Description of Variable Insurance Products

There are three basic instruments that are called variable insurance products. They are variable annuities, which have drawn the most attention; variable life insurance, in which the cash surrender value and even the death benefit fluctuates with the performance of the underlying investments; and variable universal life which guarantees a death benefit while allowing the cash value of the policy to fluctuate. Variable universal life, as opposed to variable life, clearly separates the investment and insurance elements of the arrangement. Within these three basic structures there are a multitude of variations and nuances distinguishing one product from another. All three varieties of variable contracts have been held to be securities under federal law and should be recognized as such under the Uniform Securities Act. This paper will focus on variable annuities, except where special attention to variable life products is required, but the considerations, which recommend sales practice scrutiny of annuity products by state securities regulators are equally applicable to variable life products.

The variable annuity is a hybrid product, which incorporates an insurance guarantee into an investment package. The product was devised in the early 1950s as a response to rising inflation and the growth in popularity of mutual funds. Variable annuities can be purchased for a "lump sum" or by making periodic payments over a period of months or years. The investment portion of the premium is typically invested in mutual funds containing equities, bonds or money market instruments. The rate of return for the annuity "varies" with the performance of the funds selected.

Variable annuities differ from mutual funds in three ways. First, they are tax deferred. No taxes are owed until money is withdrawn. Withdrawals are taxed at the ordinary income rate rather than the sometimes lower capital gain rate. Second, with a variable annuity one can choose to "annuitize" the payout to assure payments for the rest of your or another person's life. Finally, there is a death benefit which assures that the value upon death will never be less than the contributions. (Some variations provide for a "stepped-up" benefit to lock in investment results at periodic stages and such annuities charge higher fees for this feature.) There are various accessories which can further dress up the otherwise "plain vanilla" variable annuities. These include attaching other forms of insurance, such as long term care or guaranteed minimum income benefits.

By their nature, variable annuities always provide a lower rate of return than the mutual funds in which they are invested. This is because in addition to the advisory fees and expenses charged by the mutual fund, the purchaser of a variable annuity also bears the "load" or commission paid to the selling agent, administrative fees charged by the insurance company, and a premium for the mortality risk undertaken in providing the death benefit. There are also "surrender" charges if money is withdrawn from a variable annuity within a specified number of years (usually six to ten). This back-end load, which is typically a percentage equal to the duration in years, declines as the surrender period advances.

Legal Theory

There can be no serious argument that, but for an express exclusion from the definition, a variable annuity is a security. This has been the universal holding under federal law, which is identical in its definition of "security" to almost all state laws. The leading case for this proposition is *SEC v. Variable Annuity Life Insurance Company of America*, 359 U.S. 65 (1959) *("VALIC").*

In *VALIC*, the SEC sought to enjoin the sale of unregistered variable annuities, and sought compliance with the Investment Company Act of 1940. Justice Douglas, writing for a plurality of the Supreme Court, held that variable annuities are not "insurance" and are therefore subject to regulation as a security. He states…

> The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity

> interests reflects - which may be a lot, a little, or nothing. We realize that life insurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of "insurance" or "annuity" into the mold they fitted when these Federal Acts were passed. But we conclude that the concept of "insurance" involves some investment risk-taking on the part of the company. **The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial**. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense. (Emphasis added)

While the Douglas opinion is not specific as to which exemplar of a security an annuity contract represents, he does, in a footnote, reference the definition of investment contract contained in the *Howey* case. Justice Brennan, in a concurring opinion, likened the contract to an investment trust.

The Supreme Court had a subsequent opportunity to analyze variable annuity contracts in *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967). Here the company had carefully drafted the annuity to include an increased level of risk to the company in order to address the holding in *VALIC*. The SEC again brought suit to enjoin the unregistered offering of the company's "Flexible Fund Annuity" and to require the insurance company to register the flexible fund itself as an investment company pursuant to the Investment Company Act of 1940.

The flexible fund annuity offered by United Benefit combined a fixed-payment annuity with a variable annuity in a single contract. The SEC urged that the variable portion of the contract constituted a security and should be treated as such, separately from the insurance portion of the contract. "The District Court held that the guarantee of a fixed-payment annuity of a substantial amount gave the entire contract the character of insurance." 387 U.S. at 206.

The Court of Appeals, in affirming, rejected the SEC's "fragmentation" theory and read *VALIC* to require only "…that a company must bear a substantial part of the investment risk associated with the contract in order to qualify its products as insurance." *SEC v. United Benefit Life Ins. Co.*, 359 F. 2d 619, 622 (D.C. Cir. 1966).

The Supreme Court, per Justice Harlan, stated "[w]e do not agree with the Court of Appeals that the 'Flexible Fund' contract must be characterized in its entirety. Two entirely distinct promises are included in the contract and their operation is separated at a fixed point in time." 387 U.S. at 207. The Court unanimously agreed with the SEC and reversed, declaring that the Circuit Court viewed *VALIC* too narrowly. Under *VALIC*, the Court held that for purposes of the Securities Act, these contracts are to be considered nonexempt securities and cannot be offered to the public absent registration.

A final Supreme Court case deserving attention is *Nations Bank of North Carolina, N.A. v. Variable Annuity Life Ins.Co.*, 513 U.S. 251 (1995). In this case, known as "*VALIC II*", the Court upheld the ruling of the Comptroller of the Currency, that for purposes of interpreting certain banking preclusions in the National Bank Act prohibiting banks selling insurance, annuities are reasonably classified as investments rather than insurance. The Court, per Justice Ginsburg, also noted in dicta that "[t]reatment of annuities under state law, however is contextual." She went on to observe "[b]ut in diverse settings, states have resisted lump classification of annuities as insurance." See, e.g., *In re New York State Ass'n of Life Underwriters, Inc. v. New York State Banking Dept.*, 83 N.Y.2d 353, 363, 610 N.Y.S.2d 470, 475, 632 N.E.2d 876, 881 (1994) (rejecting "assertion that annuities are insurance which [state-chartered] banks are not authorized to sell," even though state insurance law "includes 'annuities' in its description of 'kinds of insurance authorized' "); *In re Estate of Rhode*,197 Misc. 232, 237, 94 N.Y.S.2d 406, 411 (Surr. Ct. 1949) (annuity contracts do not qualify for New York estate tax exemption applicable to insurance); *Commonwealth v. Metropolitan Life Ins. Co.*,254 Pa. 510, 513-516, 98 A. 1072 (1916) (annuities are not insurance for purposes of tax that insurance companies pay on insurance premiums received within the State); *State ex rel. Equitable Life Assurance Soc. of United States v. Ham*, 54 Wyo. 148, 159, 88 P.2d 484, 488 (1939) (same).

Appeals Court Cases

In an important ruling, foreshadowing the rhetoric of functional regulation, the Third Circuit held in *Prudential Insurance Company of America v. SEC*, 326 F.2d 383 (1964), that the fund created by the sale of variable annuity contracts, and not Prudential, was the issuer of the securities for the purposes of the Investment Company Act of 1940 and that registration would be required under the Act, just as it would be for a mutual fund.

Grainger v. State Sec. Life Ins. Co., 547 F.2d 303 (1977), is important because it steps forward from *VALIC* and *United Benefit* and their substantial risk standard, and applies a *Joiner Leasing*, 320 U.S. 744 (1943), analysis to look at all the circumstances of the sale, including sales materials and advertising, in determining whether an annuity contract is a security.

A final, recent case is worthy of note, since, by its holding, states are preempted from registering an annuity as a security, even if they are inclined to do so. In *Lander v. Hartford Life Annuity Ins.*, 251 F.3d 101 (2nd Cir. 2001), it was held that variable annuities are "covered securities" as defined by the Securities Litigation Uniform Standards Act of 1998 (SLUSA). This definition, which is identical to Section 18b of the Securities Act of 1933 as amended by the National Securities Markets Improvement Act of 1996 (NSMIA), defines "covered securities" to include mutual funds and variable products. The operative effect of this holding is that industry's fear that states might wish to assert registration jurisdiction over these products is unfounded.

Uniform Act Treatment of Variable Annuities

The Uniform Securities Act, as Professor Louis Loss drafted it in 1956, did not exclude variable annuities from the definition of "security." The exclusionary language as originally adopted by NCCUSL read as follows:

> "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed number of dollars either in a lump sum or periodically for life or some other specified period.

In his comment, Professor Loss states:

> Last sentence: A comparable provision is found in either the definitional or the exemptive provisions of approximately fifteen statutes. Section 3(a)(8) of the Securities Act of 1933 exempts from registration any "insurance or endowment policy or annuity contract or optional annuity contract" issued by a properly supervised corporation, but the SEC has considered this to be a supererogatory on the ground that insurance policies and annuity contracts are not securities anyway. Consequently, the SEC has not attempted to apply the fraud provisions by negative implication from the fact that the federal draftsmen placed the exclusion among the exempted transactions rather than in the definition of "security." A number of courts have similarly held that traditional annuity policies are not securities under the blue sky laws even when they are not specifically excluded. *Haberman v. Equitable Life Assurance Society*, 224 F. 2d 401 (5th Cir. 1955), corrected on rehearing, 225 F. 2d 837 (1955), cert. denied, 350 U.S. 948 (1956) (Texas blue sky law); see also *Hamilton v. Pennsylvania Mutual Life Insurance Co.*, 196 Miss. 345, 17 So.2d 278 (1944); *Rinn v. New York Life Insurance Co.*, 89 F. 2d 924 (7th Cir. 1937); *Bates v. Equitable Life Assurance Society*, 206 Minn. 482, 288 N. W. 834 (1939). The last sentence of Section 401(1) has been explicitly phrased so as not to exclude from the definition the so-called "variable annuities" which have recently been developed. This is consistent with the view expressed in a recent report of the Variable Annuities Committee of the NASAA. See also the comment under Section 402(a)(5).

In 1958, the National Conference had a change of heart, no doubt prompted by intense lobbying of the life insurance industry, and changed Loss' original language to:

> "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or some other specified period.

The Official Comment to this proposed change of language was: "if it is desired to exclude variable annuities on the ground that the former are sufficiently regulated by the insurance authorities in the particular state, the bracketed language should be deleted."

NCCUSL returned to Loss' original formulation in 1985 with the drafting of the Revised Uniform Securities Act. The language in that Act states:

> (i) an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically for life or some other specified period.

The Uniform Securities Act (2002) was approved by the NCCUSL Commissioners at their Annual Conference held July 26 – August 2, 2002, and a copy of the entire act can be found at www.nccusl.org. The definition of "security" is found in section 102(28) and the exclusion for insurance products is written as follows:

> "Security"
>
> (B) does not include an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed [or variable] sum of money either in a lump sum or periodically for life or other specified period;

The definition provides that variable insurance products are securities and that fixed products are excluded from the definition. This is accomplished by removing the brackets and the words "or variable", thereby making the definition consistent with federal law. The definition allows the option to exclude variable products, in addition to fixed products, if the brackets are removed and the words "or variable" are included in the text.

According to a survey compiled by NASAA (attached as Exhibit A), there are currently 17 jurisdictions that do not exclude variable annuities from the definition of "security". The state of Washington became the eighth jurisdiction on March 22, 2002 to adopt the "fixed sum of" exclusion which results in variable products being included in the definition of "security". In addition, it appears that eight other states have no exclusion in their definitions and that Hawaii regards variable annuities as securities but does exclude variable life insurance. Thus, NASAA concludes that the states are currently non-uniform with regard to the regulation of agents selling variable products under both state securities and insurance laws.

Support of the Proposal and NASD Actions

The National Association of Securities Dealers (NASD) is supportive of state functional regulation. In a November 2002 letter to a Michigan legislative committee (attached as Exhibit B), NASD President of Regulatory Policy and Oversight Mary Schapiro wrote:

> Based on our experience, we have found that variable products' sales-related problems parallel those of mutual funds and other securities. These problems include, among other things, unsuitable recommendations, switching and churning of customer accounts to increase sales commissions, and broker/dealers' failure to disclose fees and other important characteristics of these products. Because of the substantial similarities between variable contracts and other securities products, we believe it is incongruous for agents and sales practices involved in variable annuities not to be covered by state securities laws.

In 2001, the NASD announced eight enforcement actions with fines and restitution totaling $254,500 involving marketing, unsuitable sales, and supervision in the sale of variable products. On December 4, 2002, the NASD announced that it censured and fined American Express Financial Advisors, Inc. $350,000 for violations in the sale of variable annuities and variable life insurance products. These cases are the result of a series of special examinations focusing on the sale of variable contracts conducted by NASD Regulation during 1999 and 2000.

Sales of variable products, particularly tax-free exchanges, have increased dramatically over the last several years. To help investors evaluate the factors involving replacement sales, the NASD issued an Investor Alert (available at www.nasd.com) in providing investors with key points to review before replacing a variable product. The NASD has previously offered guidance to its members on the proper sale of variable products through the issuance of Notices to Members 99-35 and 00-44 and an article in the Summer 2000 issue of the *Regulatory and Compliance Alert*.

SEC Complaints and Enforcement Actions

The Securities and Exchange Commission has noted a 45% increase in the number of complaints received regarding variable annuities for the twelve month period ending August 31, 2002. In a letter (attached as Exhibit C), Susan Wyderko, the SEC's Director of Investor Education and Assistance describes the subject of a number of complaints:

> Many investors appear to not have understood the product they purchased. A number of investors who write, for example, are shocked to learn that the "guarantee" feature of a variable annuity requires them to die. We have received many complaints from older Americans, who did not understand that a variable annuity was a long-term investment, and who need their money returned to them to cover adverse life events.

On January 18, 2002, the SEC announced a settlement in the administrative case of *In re Raymond A. Parkins, Jr.* (SEC Release No. 33-8055). The SEC had alleged that Parkins, an investment adviser and agent registered in Florida, induced his clients to switch variable annuities by providing them with unfounded, false, and misleading justifications for the switches and by misrepresenting or omitting to inform them of the sales charges associated with the switches. As a result of Parkins' fraudulent conduct, his clients incurred unnecessary sales charges of more than $168,000, and in some cases, lost a portion of their investment principal. Parkins received commissions of more than $210,000.

On June 27, 2002, the SEC's San Francisco office announced the filing of civil fraud charges against *Gregory P. Waldon* (SEC Release No. LR17591). The SEC alleges that Waldon, an agent registered in California, recommended 57 switches between 1998 and 2001 in which his customers, most of whom were at least 70 years old and retired, received no economic benefit or lost money and incurred $200,000 in needless transaction costs while Waldon received approximately $275,000 in commissions. The SEC's case is pending.

The SEC has prepared an educational brochure entitled "Variable Annuities: *What You Should Know…*" (available at www.sec.gov) which outlines the factors that investors should consider before purchasing a variable annuity.

Responses to ACLI's Concerns

In August 2001, the American Council of Life Insurers (ACLI) presented to NCCUSL a memorandum of opposition to the inclusion of variable annuities within the definition of security. In their apocalyptic rendering of the damage soon to be visited upon the insurance industry, it is easy to lose sight of what is really at stake here.

At the outset, it should be emphasized again that defining variable annuities as securities will not permit state securities regulators to attempt review or registration of the annuity contract itself. Under NSMIA and the recent *Lander* case interpreting SLUSA, it is clear that the regulation of disclosure and the registration process is exclusively within federal securities jurisdiction.

What the USA (2002) optional language would permit is state securities oversight of agents selling variable products. This is a needed and salutary thing. State securities regulators have been described as the "local cop on the beat." This is because it is to their offices investors can go and tell their stories. The states are best suited to assist "Main Street" investors and they can and do bring smaller cases than the SEC or NASD.

ACLI's concerns are greatly overblown. Let's consider them one by one.

ACLI: The proposed modification to Section 101(w) *conflicts with 47 state insurance codes* that give insurance commissioners *exclusive jurisdiction* to regulate the issuance and sale of variable life insurance and variable annuities.

NASAA: It should be noted that the "exclusive jurisdiction" language in state insurance laws is a related, but separate, issue.

We are not unaware that the ACLI exercises considerable lobbying influence before state legislatures. The statutes referenced by ACLI were enacted almost 35 years ago and ACLI continues to vigorously oppose attempts toward functional regulation. The attached NASAA survey (updated as of 9/3/02) shows that six states and the District of Columbia do not currently have the "exclusive jurisdiction" language in their insurance laws. In addition, the states of South Dakota and Washington specifically recognize the jurisdiction of the state securities administrator to functionally regulate agents selling variable products.

Major economic and regulatory decisions of the past two decades leave the exclusive jurisdiction language with no persuasive underpinning. As we have noted above, the courts have permitted banks and stockbrokers to sell variable annuities. The courts have also made it clear that the McCarran-Ferguson Act does <u>not</u> restrict the ability of the SEC and the NASD to apply their full regulatory authority over variable annuities as they would over any other form of security. And the drumbeat of Gramm-Leach-Bliley reminds us that financial services companies may compete across the board as long as the playing field is made level through functional regulation supplied by the regulator appropriate to each regulated activity.

The National Association of Insurance Commissioners (NAIC) has recently taken very promising steps to advance the increasing cooperation that is occurring between securities and insurance regulators at the state level. In the last three years, insurance and securities regulators have worked together in many states to coordinate the regulation of viatical settlement contracts.

On November 12, 2001, the NAIC Antifraud Task Force announced the creation of a new subgroup, the NAIC/NASAA Enforcement Coordination Subgroup. The press release announcing the formation quoted Mike Pickens, NAIC President and Arkansas Insurance Commissioner, who chairs the subgroup: "The subgroup's mission, in general, is to increase communication and cooperation between state insurance and securities regulators in an effort to fight fraud and misconduct that can overlap the two regulatory areas. In particular, this new subgroup was created to address improper sales of investment-type products by insurance agents." The NAIC has also expressed interest in sharing enforcement data contained on their new computerized registration system in return for access to the CRD system.

In 2002, the NAIC Life Insurance and Annuities Committee created the Variable Annuities Functional Regulation Working Group to undertake the following charge: "To coordinate with all interested parties to develop a recommendation on functional regulation of agents selling variable products." The NAIC working group is chaired by Lawrence Mirel, the District of Columbia's Commissioner of Insurance and Securities. NASAA has proposed language to amend the NAIC Model Variable Contracts Act that would harmonize and clarify the jurisdiction between insurance and securities regulators over agents selling variable products, which would give effect to the optional language in the Uniform Securities Act (2002) .

Finally, there is an emerging trend observable in state governments to coordinate financial services regulation. The attached NASAA survey shows insurance and securities regulators are part of the same entity or report to the same appointing authority in 13 states and the District of Columbia. The inevitable outcome of this trend is to foster functional regulation. State Insurance Commissioners know that variable annuities are investments. That's why many of them are already working cooperatively with their securities counterparts.

ACLI: The NCCUSL option *contradicts 37 state securities codes* that exclude *all* insurance, endowment and annuity contracts from the definition of "security." The NCCUSL change would create non-uniformity and is currently followed by *only* 8 states.

NASAA: There already is non-uniformity in states securities laws as shown in the attached survey. NASAA agrees that eight jurisdictions have adopted the "fixed sum of" wording in the definition of "security". In addition, it appears that nine other states also have no exclusion in their definitions (see Exhibit A).

It is interesting to note that when faced with this same argument in 1985, NCCUSL decided to go back to Professor Loss' formulation because it was better public policy. If cooperative measures with the NAIC bear fruit, greater uniformity through functional regulation will be achieved in more states.

ACLI: The proposed modification to Sections 101(w) and 201(d) would disrupt a coordinated system of state and federal regulation considered by the U.S. Supreme Court when it addressed the regulatory status of variable life insurance and variable annuities.

NASAA: This is a somewhat mystifying interpretation of *VALIC*. The Supreme Court did not have before it a "coordinated system of state and federal regulation" to consider. The industry, in *VALIC*, was fighting the imposition of just such a system.

It was the interpretations in *VALIC* itself which created the new, prevailing dual system of regulation. Justice Brennan, in his concurrence, goes to considerable lengths to explain away the insurance exclusions in the securities laws. Speaking of the milieu in which those acts were passed, the Justice said, "[a]t this time, of course, the sort of 'Variable Annuity' with which we are concerned did not exist. When Congress made the exclusions provided for in the Acts, it did not make them with the variable annuity contract before it." *VALIC*, 359 U.S. at 75, 76.

The *VALIC* Court was also acutely aware of, and apparently approving of, the dual system of state/federal regulation which then existed over investments. Justice Brennan, again:

> Conversely, of course, however adequately State Securities Commissioners might regulate an investment, it was not for that reason to be freed from federal regulation. Concurrent regulation, then, was contemplated by the Acts as a quite generally prevailing matter. Nor is it rational to assume that Congress thought that *any* business whatsoever regulated by a specific class of officials, the State Insurance Commissioners, would be for that reason so perfectly conducted

> and regulated that all the protections of the Federal Acts would be unnecessary. *VALIC*, 359 U.S. at 75.

It is clear, therefore, that *VALIC* contemplated functional regulation of the sort NASAA endorses for inclusion in the Uniform Act.

One further note, it is interesting that when the insurance industry appears before state legislatures it portrays variable annuities as "insurance". However, when the industry is defending against a class action lawsuit such as the *Lander* case in which the plaintiffs alleged that the marketing of certain variable annuities included "materially false and deceptive" representations, the industry strongly defends variable annuities as "covered securities" so as to be entitled to SLUSA's preemption. The *Lander* decision also concludes that SLUSA is not preempted by the McCarran-Ferguson Act as the "covered securities" designation does not encroach on a state's insurance regulatory regime.

ACLI: The initiative would impose a fourth layer of regulation on variable life insurance and variable annuities on top of comprehensive SEC, NASD, and state insurance regulation. Life insurers marketing group variable contracts also must comply with the ERISA statute administered by the U.S. Department of Labor.

NASAA: This assertion ignores the reality of the effected change. Regulation of insurance companies remains exclusively with state insurance regulators. Registration and regulation of variable products will remain with the SEC and state insurance regulators. The contracts would not be regulated in any fashion by state securities regulators, since NSMIA prohibits it (see the *Lander* decision as discussed above).

ACLI: The proposed modifications to Section 101(w) would cause duplicate regulation of the same product under state insurance *and* securities codes, and would contradict financial services modernization of the Gramm-Leach-Bliley Act.

NASAA: This argument turns GLBA on its head. As early as *VALIC*, the Supreme Court recognized that state insurance regulation is functionally different from the securities regime. Justice Brennan states:

> The regulation of life insurance and annuities by the States proceeded, and still proceeds, on entirely different principles. It seems as

> paternalistic as the Securities Act of 1933 was keyed to free, informed choice. Prescribed contract clauses are ordained legislatively or administratively. Solvency and the adequacy of reserves to meet the company's obligations are supervised by the establishment of permissible categories of investments and through official examination. The system does not depend on disclosure to the public, and, once given this form of regulation and the nature of the "product," it might be difficult in the case of the traditional life insurance or annuity contract to see what the purpose of it would be.

Even today, state insurance regulation emphasizes "safeness and soundness" concepts, with less emphasis on inspections or audits designed to uncover improper conduct by agents. Securities regulators have been enforcing "suitability" standards on their industry since at least the 1960s. While the NAIC has a working group looking into the need for this concept on the insurance side, to date, no such model rule exists.

The fact is that insurance regulators on a day-to-day basis regulate insurance. Sales of variable annuities are not best regulated under insurance principles. That's because, for the most part, variable annuities are not insurance; they are securities. Excluding them from the definition of security under the Uniform Act does not change their basic character nor the kind of functional regulation needed. It merely serves to deprive the public of protections which state securities regulators provide.

Two former state insurance regulators have written a March 11, 2002 letter in support of functional regulation on behalf of the Consumer Federation of America (see Exhibit D). Mr. James H. Hunt, a former Vermont Commissioner of Banking and Insurance, Observed: "If insurance commissioners have ever enforced suitability laws, word has not reached this observer."

ACLI: Variable life insurance and variable annuities are already one of the most heavily regulated financial products in today's broad marketplace. Drawing these products into state securities codes provides no added regulatory value.

NASAA: The product will not be impacted at all. No state can or will attempt to regulate the product because it is a federal covered security and state regulation is pre-empted by NSMIA. To say that states add no regulatory value arrogantly ignores the quality work the states have done in the enforcement of securities laws for the past 90 years. The NASD's President of Regulatory Policy and Oversight apparently believes the states add value as she has endorsed the USA (2002) approach (see Exhibit B).

State securities and insurance regulators have been working together in recent years to address the problems with viatical settlement contracts and problems with insurance agents selling promissory notes, pay telephones and other unregistered securities. In many cases, insurance regulators have deferred to the state securities regulators to take disciplinary actions against the agents since the problem transactions involved "investment" products.

In recent years, discretion on licensing decisions has typically been more limited on the part of insurance commissioners. For example, NASAA believes that agents who have been revoked or barred from selling securities, including mutual funds, should NOT be allowed to sell variable products with mutual fund subaccounts. In several cases, agents have been allowed to continue selling variable products after losing their securities license because state insurance regulators have been limited in taking licensing actions unless an agent has a felony conviction.

Hopefully, these "licensing gaps" will be reduced in the future since many states have adopted NAIC's new Uniform Insurance Producers Licensing Act giving insurance regulators more discretion to deny, suspend, and revoke insurance licenses when an agent has "used any fraudulent, coercive, or dishonest practice, or demonstrated any incompetence, untrustworthiness or financial irresponsibility in the conduct of business." However, there is still a concern that lengthy administrative delays can occur before an insurance commissioner can react to an administrative order by a securities regulator. Thus, the most straightforward way to avoid such gaps is through functional regulation.

Clearly, state securities regulators, at a minimum, provide needed resources and expertise to perform more thorough licensing scrutiny and can better respond to customer complaints about suitability and sales practices. The added value is enhanced investor protection.

ACLI: The proposed modifications to Sections 101(w) and 201(d) would create expensive, unnecessary burdens for life insurers and salespersons, and would lead the life insurance industry to oppose the NCCUSL amendments whenever introduced in state legislatures.

NASAA: As described above, the regulation of insurance companies and variable products will not change.

If variable products are included in the definition of "security" under section 102(28), it should be understood that all insurance company securities are "exempt securities" under section 201(4) of the Uniform Securities Act (2002). Exempt securities, including variable products, are exempt from registration, notice filing and fee requirements of section 302, and the filing of sales literature under section 504 of the Act. Thus, states that adopt the 2002 Act will not require notice filings or fees for variable products.

The only impacted class is the agents. Agents selling variable products are required to be registered with the NASD and with a broker-dealer firm. Because most of the broker-dealers and agents who sell variable annuities also sell mutual funds, they are already required to have state securities licenses.

For example, a December 2001 review by the Kansas Securities Commissioner concludes that 93% of Kansas agents (4,778 of 5,143 with variable insurance licenses) also have a state securities license.

In 2002, the state of Arizona approved a new law, Senate Bill 1107, which clarifies that agents need a state securities license in order to sell variable products.

The vast majority of broker-dealers and agents will experience no additional regulation or fees. In fact, the vast majority of agents selling variable products will never realize that the laws have changed… unless an agent is the subject of a complaint or a regulatory action.

ACLI: The need for the proposed amendments has not been justified or properly explained. A pattern of market conduct has not been identified to warrant these Uniform Securities Act changes.

NASAA: The sales of variable annuities have exploded in the last six years. *The VARDS Report* for the industry shows $138 billion in variable annuity sales and total net assets of almost $1 trillion for the year 2000. Variable annuities are among the highest commissioned products. Great incentive exists to "churn" customers in and out of contracts. The tax aspects of the investment make it unsuitable for certain kinds of accounts. The USA (2002) option closes a gap in regulation. There may not be a crisis yet, but the storm clouds are gathering. Witness the NASD and the SEC heightened state of alarm over Section 1035 exchanges and "bonus" annuities and the increased level of enforcement over the sales of these products.

ACLI: The amendment principally appears to facilitate expanded state securities revenue and jurisdiction, rather than uniformity and tangible consumer protection.

NASAA: This proposal for functional regulation is not an issue of "regulatory turf" or an attempt to obtain any significant additional fees, as discussed above. State securities agencies are funded by appropriation not expropriation. The suggested statutory changes will have negligible impact, if any, on the variable products industry. The benefits of creating uniformity in the state/federal treatment of variable annuities and in enhancing consumer protection are self-evident.

ACLI: [State legislatures should ignore the optional] changes proposed in Section 101(w) and 201(d), and should retain instead the language currently appearing in Section 401(L) of the Uniform Securities Act (1956). With these suggested corrections, the ACLI and the life insurance industry could support the other Uniform Securities Act amendments implementing commendable uniformity.

NASAA: At what price, honor.

Conclusion

The functional regulation option for the Uniform Securities Act (2002) is a reasonable one, one that was proposed by Professor Loss in 1956 and adopted again in 1985. It does not promote bigger government or unnecessary regulation. The proposal should be supported for the following reasons as discussed above:

- Variable products are "securities" and should be defined the same under both state and federal law;

- The regulation of insurance companies and variable products will not change and the proposal will not be a burden on the industry;

- The vast majority of agents are already dually licensed to sell insurance and securities and will not be affected; and

- Investor Protection will be enhanced with functional regulation.

As so often happens in state legislatures, this may come down to a struggle between what's reasonable and raw political power. Investors in variable products and in mutual funds both deserve the same quality of state protection in the regulation of agents selling these virtually identical forms of investments --- not a disjointed structure devised 35 years ago through the exercise of insurance industry influence. Times and markets have changed… and financial modernization dictates that state regulatory laws, should be modified to cope with the 21st Century.

David Brant	Royce Griffin
Kansas Securities Commissioner	NASAA General Counsel

<u>Attachments</u>

Exhibit A: NASAA State Survey updated as of September 3, 2002

Exhibit B: Letter from NASD Vice-Chairman Mary Schapiro

Exhibit C: Letter from the SEC Director of Investor Education and Assistance

Exhibit D: Letter from the Consumer Federation of America

UPDATED 9/3/02 **Exhibit A**

NON-UNIFORMITY IN THE FUNCTIONAL REGULATION OF AGENTS SELLING VARIABLE ANNUITIES

Compiled by the NASAA Variable Annuities Project Group

JURISDICTION	DEFINITION OF SECURITY [1] Exclusion or No Exclusion of Variable Annuities	AGENTS [2] Need State Securities License	INSURANCE CODE [3] Jurisdiction Citation	REGULATORY STRUCTURE Securities and Insurance Divisions (Same entity or appointing authority)
Alabama	EXCLUSION [ALA. CODE §8-6-2(10)]	**YES**	§27-38-4	
Alaska	EXCLUSION [ALASKA STAT. §45.55.990 (32)]	NO	§21.42.370(k)	Community & Economic Development
Arizona	**NO EXCLUSION** [ARIZ. REV. STAT. §44-1801(22)]	**YES** [2]	§20-651 (I)	
Arkansas	EXCLUSION [ARK. CODE ANN. §23-42-102 (15)(B)]	NO	§23-81-405	
California	EXCLUSION [CAL. CORP. CODE §25019 (3)]	NO	§10506(h)	
Colorado	EXCLUSION [COLO. REV. STAT. §11-51-201(17)]	NO	§10-7-405 (1)	
Connecticut	EXCLUSION [CONN. GEN. STAT. §36B-3(17)]	NO	§38a-433(c)	
Delaware	EXCLUSION [6 DEL. CODE §7302 (a)(13)]	NO	18 Del. C. §2932(d)	
District of Columbia	**NO EXCLUSION** [D.C. CODE ANN. §31-5601.01(31)(A)]	**YES** [2]	**NONE**	Insurance & Securities Commissioner
Florida	**NO EXCLUSION** [FLA. STAT. §517.021]	**YES**	§627.805	
Georgia	EXCLUSION [GA. CODE ANN. §10-5-2(a)(26)]	NO	§33-11-65(h)	
Hawaii	**NO EXCLUSION** [HAW. REV. STAT. §485-1(13)]	NO	§431:10D-118(d)	Commerce & Consumer Affairs
Idaho	EXCLUSION [IDAHO CODE §30-1402(12) & §30-1434(1)(e)]	NO	§41-1939(1)	
Illinois	**NO EXCLUSION** [ILL. COMP. STAT. §2.1]	NO	215 ILCS §5/245.24	
Indiana	EXCLUSION [IND. CODE §23-2-1-1]	NO	**NONE**	
Iowa	EXCLUSION [IOWA CODE §502.102(19)]	NO	§508A.4	Insurance Commissioner
Kansas	EXCLUSION [KAN. STAT. ANN. §17-1252(j)]	NO	§40-436(1)	
Kentucky	**NO EXCLUSION** [KY. REV. STAT. ANN. §292.310(18)]	NO	§304.15-390(7)	
Louisiana	EXCLUSION [LA. REV. STAT. ANN. § 51:702 (15)(b)(i)]	NO	§1500(J)	
Maine	EXCLUSION [ME. REV. STAT. ANN. §10501(18)]	NO	§2537(11)	Professional & Financial Regulation
Maryland	EXCLUSION [MD. CODE ANN. §11-101(r)(2)	NO	§16-601(b)	
Massachusetts	EXCLUSION [MASS. GEN. LAWS c. 110A §401(k)]	NO	c.175 § 3	
Michigan	EXCLUSION [MICH. COMP. LAWS §451.801(1)]	NO	§500.925, §500.4000	Financial & Insurance Services
Minnesota	EXCLUSION [MINN. STAT. §80A.14(18)(a)(1)]	**YES**	§61A.20	Commerce
Mississippi	EXCLUSION [MISS. CODE ANN. §75-71-105(n)]	NO	§83-7-45	
Missouri	EXCLUSION [MO. REV. STAT. §409.401(o)]	NO	§83-7-45(6)	
Montana	**NO EXCLUSION** [MONT. CODE ANN. §30-10-103(22)(b)]	**YES**	§33-20-602	State Auditor
Nebraska	EXCLUSION [NEB. REV. STAT. §8-1101(15)]	NO	§44-2220	
Nevada	**NO EXCLUSION** [NEV. REV. STAT. §90.295(1)]	**YES**	§688A.390(4)	
New Hampshire	EXCLUSION [NH REV. STAT. ANN. §421-B:2(XX)(a)]	NO	§408:52	
New Jersey	EXCLUSION [N.J. STAT. ANN. §49:3-49(m)]	NO	§17B:28-14	
New Mexico	**NO EXCLUSION** [N.M. STAT. ANN. §58-13B-2x]	NO	§59A-20-30	
New York	**NO EXCLUSION** [N.Y. GEN. BUS. LAW §352(1)]	NO	INSUR. LAW §4240(d)(7)	

UPDATED **Exhibit A**
9/3/02

JURISDICTION	**DEFINITION OF SECURITY** [1] **Exclusion or No Exclusion of Variable Annuities**	**AGENTS** [2] **Need State Securities License**	**INSURANCE CODE** [3] **Jurisdiction Citation**	**REGULATORY STRUCTURE Securities and Insurance Divisions (Same entity or appointing authority)**
North Carolina	EXCLUSION [N.C. GEN. STAT. §78A-2(11)]	NO	§58-7-95(r)	
North Dakota	**NO EXCLUSION** [N.D. CENT. CODE §10-04-02(15)]	**YES**	**NONE**	
Ohio	**NO EXCLUSION** [OHIO REV. CODE ANN. §1707.01(B)]	NO	§3911.011(A) and (D)	
Oklahoma	EXCLUSION [71 OKLA. STAT. § 2(w)]	NO	36 0.S. §6061.D	
Oregon	EXCLUSION [OR. REV. STAT. §§59.015 (19)(b)(A)]	NO	ORS 731.046	Consumer & Business Services
Pennsylvania	EXCLUSION [70 P.S. §1-102(t)(iii)]	NO	40 P.S. §506.2(d)	
Puerto Rico	**NO EXCLUSION** [10 L.P.R.A. §881(1)]	**YES**	§1334	
Rhode Island	**NO EXCLUSION** [R.I. GEN. LAWS §7-11-101(20)(i)]	**YES**	§27-32-7	Business Regulation
South Carolina	EXCLUSION [S.C. CODE ANN. §35-1-20 (15)]	NO	§38-67-40	
South Dakota	**NO EXCLUSION** [S.D. CODIFIED LAWS §47-31A-401(m)]	**YES**	**NO see §58-28-31** [3]	Commerce
Tennessee	EXCLUSION [TENN. CODE ANN. 48-2-102(12)(E)]	NO	T.C.A. §56-3-508	Commerce & Insurance
Texas	EXCLUSION [TEX. REV. STAT. ANN. Art. 581-4(A)]	NO	Art. 3.75(8)	
Utah	EXCLUSION [UTAH CODE ANN. §61-1-13(24)(b)(i)]	NO	§31A-5-217.5(6)	
Vermont	**NO EXCLUSION** [VT. STAT. ANN. §4202(a)(16)]	**YES**	§3858	Banking, Insurance & Securities
Virginia	EXCLUSION [VA. CODE ANN. §13.1-501A]	NO	**NONE**	Corporation Commission
Washington	**NO EXCLUSION** [WASH. REV. CODE ANN. §21.20.005(12) **as amended**] [1]	**YES**	**NO see R.C.W. 48.18A.070** [3]	
West Virginia	EXCLUSION [W. VA. CODE ANN. §32-4-401(n)]	NO	§33-13A-4	
Wisconsin	EXCLUSION [WIS. STAT. ANN. §551.02 (13)(b)]	NO	**NONE**	
Wyoming	EXCLUSION [WYO. STAT. ANN. §17-4-113 (a) (xi)]	**YES**	§26-16-502(d)	
TOTAL	**17 of 52 HAVE NO EXCLUSION**	**14 of 52 REQUIRE**	**7 of 52 NOT EXCLUSIVE**	**14 OF 52 RELATED**

[1] A total of 17 jurisdictions do **not** exclude variable annuities from the definition of a "security": 8 jurisdictions (DC, KY, MT, NV, PR, RI, SD, and WA) only exclude contracts which pay "a fixed sum of" which is the bracketed option under the Uniform Securities Act of 1956; 1 state (HI) includes variable annuities but excludes variable life insurance and fixed annuity contracts; 2 states (IL and NM) have no exclusion for any type of insurance, endowment, or annuity contracts; and 6 states (AZ, FL, NY, ND, OH, and VT) have no exclusion of any kind. **In the state of Washington, the definition of security was amended to include variable products by Senate Bill 6483 which was signed into law by the Governor on March 22, 2002.**

[2] All agents selling variable products are required to: 1) be affiliated with a securities broker-dealer firm; 2) be registered with the National Association of Securities Dealers (NASD); 3) have passed the NASD's Series 6 or Series 7 exam; and 4) be licensed with the state insurance department to sell variable insurance products. At least 14 jurisdictions (AL, AZ, DC, FL, MN, MT, NV, ND, PR, RI, SD, VT, WA, and WY) require agents to have a state securities license in order to sell variable products. **In Arizona, a new law, Senate Bill 1107 (was signed by the Governor on May 6, 2002), clarifies that agents need a state securities license in order to sell variable products. In the District of Columbia, the Securities Bureau is preparing a release to be issued in the near future that will provide guidance to issuers of variable products and their sales agents regarding compliance with the requirements.**

Most agents also have a state securities license in order to sell mutual funds or other securities. For example, a review completed by the Kansas Securities Commissioner in December 2001 concludes that 93% of Kansas agents (4,778 of 5,143 with variable insurance licenses) also have a Kansas securities license.

[3] In the late 1960s, many states adopted the NAIC Model Variable Contracts Statute granting "exclusive jurisdiction" over variable products to the Insurance Commissioner. It appears that seven jurisdictions (DC, IN, ND, SD, VA, WA, and WI) do not have the "exclusive jurisdiction" language. The states of South Dakota and Washington specifically recognize the jurisdiction of the securities administrator to regulate agents.

Mary L. Schapiro
Vice Chairman, NASD
President, Regulatory Policy and Oversight

Via Federal Express

November 11, 2002

Commissioner Frank M. Fitzgerald
Office of Financial & Insurance Services
State of Michigan
611 West Ottawa Street, 2nd Floor
Lansing, MI 48933

Dear Commissioner Fitzgerald:

I am writing in regard to House Bill No. 6338, which we understand would adopt the Uniform Securities Act in Michigan and include variable annuities and variable life insurance contracts within its coverage.

NASD was established under authority granted by the Securities Exchange Act of 1934, and is the largest self-regulatory organization for the securities industry in the world. Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of the NASD. The NASD's membership comprises almost 5,500 securities firms that employ more than 675,000 registered securities professionals.

As you know, variable contracts are hybrid products that combine securities and insurance components. Our experience in regulating our members' sales of variable contracts leads us to strongly support the bill because it provides functional regulation over the sales practices and licensing of agents involved in the sale of variable contracts.

Sales of variable contracts have grown enormously over the past ten years. NASD has found through its examination of member broker/dealers that frequently these contracts are promoted on many of the same grounds as other securities products. Broker/dealers recommend variable annuities and variable life insurance policies as vehicles to save for retirement, just as mutual funds and other non-insurance securities are recommended as retirement vehicles. In many cases broker/dealers recommend variable contracts over other securities because of their perceived advantages, particularly the potential for tax-deferred growth of a customer's investment. Like other securities, variable contracts present investment risks because of the fluctuation of underlying sub-accounts in which customers' funds are invested. Given the increasing prominence of variable contracts, NASD has stepped up its efforts in this area through focused examinations, guidance to our members, enforcement actions, and Investor Alerts.

Examples of our active engagement in this very important area can be found generally on www.nasdr.com, and include:

- *Notices to Members* 96-86 http://www.nasdr.com/pdf-text/9686ntm.pdf, 99-35 http://www.nasdr.com/pdf-text/9935ntm.pdf and 00-44 http://www.nasdr.com/pdf-text/0044ntm.pdf

- *Regulatory and Compliance Alerts*, Summer 2000 http://www.nasdr.com/rca_summer00.htm and Spring 2002 http://www.nasdr.com/rca_summer02.asp

- NASD cases reported in our press releases of July 8, 1999 (Pruco Securities fined $20 million http://www.nasdr.com/news/pr1999/ne_section99_170.html), February 15, 2001 (NASD files six actions involving marketing and sales of variable annuities, includes fines and restitution of $112 thousand) http://www.nasdr.com/news/pr2001/ne_section01_022.html), December 5, 2001 (NASD files two actions involving variable annuity and life insurance sales, levies fines of $142 thousand) and January 18, 2002 (Tower Square Securities fined $200 thousand, ordered to make restitution of $4.3 million http://www.nasdr.com/news/pr2002/release_02_004.html).

- *Investor Alert: Should You Exchange Your Variable Annuity?* http://www.nasdr.com/alert_annuityexchanges.htm

Based on our experience, we have found that variable contracts' sales-related problems parallel those of mutual funds and other securities. These problems include, among other things, misleading advertising, unsuitable recommendations, switching and churning of customer accounts to increase sales commissions, and the failure to disclose fees and other important characteristics of these contracts. Because of the substantial similarities between variable contracts and other securities products, we believe it is incongruous for agents and sales practices involved in variable contracts not to be covered by state securities laws.

If you have any questions regarding our position or NASD operations, please do not hesitate to contact me at (202) 728-8140, or Tom Selman, Senior Vice President, Investment Companies/Corporate Financing, at (240) 386-4533.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Vice Chairman, NASD
President, Regulatory Policy and Oversight

cc: Tom Selman

Exhibit C

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Office of
Investor
Education
And Assistance
Director

Phone: (202) 942-7240
Fax: (202) 942-9634
Email: help@sec.gov
www.sec.gov

November 20, 2002

Mr. David Brant
Securities Commissioner
Office of the Securities Commissioner
618 South Kansas Avenue, 2d Floor
Topeka, Kansas 66603-3804

Dear Commissioner Brant:

This letter responds to your recent inquiry as to whether we have any statistics regarding complaints about variable annuities. As you may know, our Office answers complaints and inquiries from investors who contact the SEC. Investors contact us through telephone calls, e-mails and regular letters. We keep statistics concerning the products complained of, the firms involved, and other relevant information, so that, we can better target our Enforcement and Inspections resources.

We recently calculated the number of complaints we have received relative to different products that we regulate. In the twelve months ended August 31, 2002, we received approximately 460 complaints from investors regarding variable annuities, which represents an approximately 45% increase over the Preceding 12 month period. This is in sharp contrast to the decrease in complaint volume during that same period of time that we saw concerning other products we regulate, such as equities, mutual funds, and options.

The Securities and Exchange Commission sees but a small fraction of investor complaints nationwide. We have found, however, that our complaint statistics are an accurate reflection of developing problems in the securities area. For that reason, I am concerned about the rise in complaints about variable annuities that we are seeing.

The investors who complain to us about their variable annuity purchases generally identify several problems. Many investors appear to not have understood the product they purchased. A number of investors who write, for example, are shocked to learn that the 66 guarantee" feature of a variable annuity requires them to die. We have received many complaints from older Americans, who did not understand that a variable annuity was a long-term investment, and who need their money returned to them to cover adverse life events. Investors who have subsequently come to understand the features of their variable annuity tell us that they do not believe the variable annuity product was appropriate for their personal situation.

As you may be aware, we have a very helpful brochure concerning variable annuities, which we believe appropriately outlines the factors investors should consider before purchasing a variable annuity. I have enclosed a copy of that brochure with this letter. I have heard from a number of registered representatives of securities firms that they make this brochure available to customers who are contemplating purchase of a variable annuity, in order to make sure the customer is fully aware of the characteristics of the investment. We believe that investors would be better served if more of them were given this kind of brochure at the time they are introduced to variable annuities as an investment choice.

Please let me know if you need any further information in this or any other area.

Sincerely,

Susan Ferris Wyderko
Director

Consumer Federation of America

March 11, 2002

David Brant, Chair
NASAA Variable Annuities Project Group
State of Kansas
618 S. Kansas Avenue
Topeka, Kansas 66603-3804

Subject: Regulation of Sales of Variable Products

Dear Commissioner Brant:

Thank you for inviting CFA to review the matter of whether state securities commissioners, in states where they do not now have such jurisdiction, should be given authority to aid those who are missold variable annuity contracts and variable life policies. We understand that only a few state security commissioners may hear the complaints of consumers in their states about sales tactics used in the sale of these instruments, which are of course defined as securities under federal law.

We understand that the National Conference of Commissioners on Uniform State Laws (NCCUSL) is considering a new Uniform Securities Act that could effect added protections for buyers of these insurance products that are also securities. We are pleased to support this effort.

The writer, a Fellow of the Society of Actuaries since 1963 and a Member of the American Academy of Actuaries since 1965, for more than 15 years has operated a low cost service evaluating life insurance policies, since 1995 under the auspices of CFA. (A description of the service may be found at www.consumerfed.org/backpage/evaluate_insurance_policy.htm.) In that capacity he has dealt with hundreds of variable life policies and has seen many that seemed unsuitable. These are extraordinarily complex vehicles that almost no one understands well. They are accompanied by an array of charges that are difficult to assess, including rarely disclosed cost of insurance rates that typically exceed, often substantially, market term rates. The effect of surrender charges, which in larger policies can only be described as huge, is poorly understood. While insurance companies must find sales of such policies suitable for buyers, a reviewer of existing contracts is hard pressed to discern any effect of this rule. If insurance commissioners have ever enforced suitability laws, word has not reached this observer.

The writer's variable annuity experience is less that of an expert than that of an expert observer. One cannot discuss variable life insurance without a working knowledge of the variable annuity market. It is well known that extraordinarily high fees accompany sales of variable annuities, with some contracts fetching four to five times the asset charges of the lowest cost variable annuities. There is frequent churning in the market, especially as surrender charges reach or near zero. Litigation is pending regarding the sales of variable annuities within Individual Retirement Accounts. Most recently, in his work as a volunteer tax preparer in an IRS/AARP program, Tax Counseling for the Elderly, the writer encountered a woman whose income was several thousand dollars below the level that required paying federal income taxes, yet she had been rolled out of one variable annuity into another. The transfer was completely unsuitable for her.

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

The principal objection to the proposal to expand the authority of state securities commissioners to hear consumer complaints about variable sales is that it would add another layer of regulation for insurers to deal with. As has been clearly explained in the documents we have seen, regulation of insurers and of their variable products would not be expanded. And it appears to us that relatively few agents are not now dually licensed. The writer served as Vermont's Commissioner of Banking and Insurance in the late 1960s; that title encompassed securities as well. In both banking regulation, where examinations were conducted jointly with FDIC examiners, and in securities, where duties were shared with the Securities and Exchange Commission, no complaints were heard that the dual regulation was unduly onerous or expensive.

We have read the position of the American Council of Life Insurers, with whom CFA cooperates from time to time in educational projects. We respect ACLI's concern about over-regulation, but we disagree that the effect of the NCCUSL proposal would "create expensive, unnecessary burdens for life insurers and salespersons." Understandably, the ACLI does not dwell on the potential benefits that the limited authority to hear consumer complaints would bring to disaffected buyers of variable life and variable annuities. A more likely outcome would be that a degree of competition in dealing with and publicizing the excesses of industry sales practices would provide more public confidence in purchases of these securities.

Mr. Hunt prepared this CFA position paper. It was shown to Mr. Hunter, recently Texas insurance commissioner, who agreed to add his support.

Respectfully submitted,

J Robert Hunter

J. Robert Hunter JHH
CFA Director of Insurance

James H Hunt

James H. Hunt
CFA Life Actuary