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"VARIABLE ANNUITIES" • • • • A Problem for the Securities Business and the Investor?

What It's All About

An apparent dream-type of investment has been thought up by one of the large insurance companies, and the prospect that it may soon be offered to the public has stirred-up the securities business in a way nothing has since the securities acts were proposed more than twenty years ago.

Cause of all this is something called a variable annuity contract.

The Board of Governors of the National Association of Securities Dealers, Inc. has taken the official position that such contracts are in fact securities and should be sold only if surrounded by the same Federal and state regulations that govern—for protection of the public—the sale of other securities. To this end, the NASD has asked the Securities and Exchange Commission to determine whether the Commission has jurisdiction in this area. If SEC declares it has not, NASD will seek legislation in the Congress declaring variable annuity contracts to be securities within the jurisdiction of the Federal securities statutes.

A "variable annuity" contract would be bought by the payment of one lump sum or the making of periodic payments. Payments would be invested in *common stocks* or other equity-type investments (conventional annuities are contracts calling for the payment of a fixed sum at fixed periods). A "variable annuity" guarantees an equal and fixed number of annuity units of *variable value* (conventional annuities guarantee an equal and fixed number of DOLLARS). Income to the owner could start immediately or at some future time and be payable annually, semi-annually, quarterly or monthly.

Even the most objective discussion of the subject of a "variable annuity" usually begins with a statement of what it is NOT . . . rather than what it IS. The above attempt at a definition is an example of this. Experts even question the correctness of the word "annuity" as applied to the thing proposed.

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What is more binding: There is grave question about the propriety of a mutual fund type of investment masquerading as a type of insurance.

The difficulty the securities business has with the insurance company idea has one prime motivation: Every other type of "security" offered to the public has to comply with securities laws of the states and/or the Federal government, so why shouldn't something that is a participation in an ownership of common stocks *also* be required to meet these standards? More than this, the securities business looks at the tax "shelter" insurance companies have enjoyed and wonders if it is in the public interest for "variable annuities" to be accorded the same protective covering.

A sponsor of the variable annuity idea is the Prudential Insurance Company of America. Legislative clearance was sought for the idea in several States during the past year with no success. Meanwhile, a company has been licensed in the District of Columbia to sell variable annuity contracts.

While it is still not clear how a variable annuity would operate, the following description is adequate for the moment:

A company issuing variable annuities would set up the assets behind them in a segregated account. Against this segregated account, two types of units would be issued; namely, accumulation units and annuity units.

The assets behind such units would consist of common stocks. As the annuitant made his payments, accumulation units would be credited to him in the same manner as shares of a mutual fund; that is, his payments would go to purchase units at the then value of such units, just as a person purchases investment company shares. When the "annuitant" was ready to retire, his accumulation units would be valued at the then asset value and converted into annuity units.

The amount of annuity units then available would depend on three factors: (1) the asset value of all his accumulation units; (2) his life expectancy; and (3) a projected yield of the annuity fund. Once the number of annuity units, based upon the above factors was determined, they would remain fixed for the remainder of his life or such other periods as he specified. What he got each year would depend upon the asset value of the annuity units.

Because the annuity fund would be invested primarily in common stocks, this value would increase and decrease with the fluctuations of the market.

In view of the above, one thing seems clear; variable annuities may properly be called "variable." But are they "annuities"? The assistant general counsel of the Metropolitan Life Insurance Company and two of that company's own attorneys are authors of an article which cites court decisions and other authorities in support of their conclusion that:

> "Any legislation which would authorize the 'variable annuity' in such form as to permit the issuing company to use the word 'annuity' in its title or to characterize its contracts, would represent a complete about-face from the general pattern of insurance legislation over the years, which has been to protect the beneficiaries of insurance policies and annuity contracts from the adverse consequences of fluctuation and speculative schemes in the handling of funds entrusted to the companies."

Among the arguments these authorities offer in support of their position is the traditional role of the insurance company. And on that score they say:

> "A true annuity involves insurance—the assumption of risk on the part of

(Turn Page)

the issuing company . . . However, in the case of the 'variable annuity,' there would be no assumption . . . of . . . risks on the part of the issuing corporation. Instead of a guarantee of . . . variable elements, there would be complete exposure of the participants in the 'variable annuity' to such loss as might be occasioned by inadequate yield from the investments and from unfavorable mortality that might be experienced within the group.

"THUS, THE 'VARIABLE ANNUITY' PLAN AMOUNTS TO NOTHING MORE THAN THE MUTUAL SHARING BY THE INDIVIDUAL PARTICIPANTS OF AN INVESTMENT AND MORTALITY RISK." (Emphasis supplied)

There are others in the insurance field and in the ranks of state insurance and securities departments who feel just as strongly as the responsible men quoted above. And they—state administrative people, particularly—go on to inquire as to the protection of the public interest in "variable annuity" distribution. One of them has said:

". . . Bills introduced . . . do not, within themselves, contain the provisions for the protection of the public which are contained in State and Federal laws with respect to the purchase of mutual fund shares and other securities." The National Association of Securities Administrators has gone on record as opposed to adoption by the states of any enabling legislation "without exhaustive study," and the body further found that legislation so far proposed has lacked legal safeguards and that their absence "could prove very detrimental to the investing public."

In view of the opinions expressed above by insurance company executives and officials entrusted with protecting the public in its investments, the position the securities business takes regarding variable annuities certainly is not extreme.

What the National Association of Securities Dealers has said can be summed up about as follows:

Maybe the variable annuity idea has merit and certainly it shouldn't be condemned simply because it has some defects of nomenclature and because it looks like a new form of competition for people in the securities business. America has a dynamic economy and experimentation should be encouraged and not discouraged out-of-hand.

However, speaking for 3,400 dealers in securities and 40,000 individuals earning a livelihood from transactions in securities, the Association argues that the public interest should be uppermost in the minds of those who would induce people to part with their savings in a venture of risk. It doesn't think this kind of precaution has been provided for, and therefore feels that the variable annuity MUST NOT BE OFFERED TO THE PUBLIC until it can be subjected to the same kind of State and Federal regulation that governs the traffic in all other types of securities.

The Association looks upon this position as one of wholesome self-interest. It points out that the securities business has lived with the Securities Acts for more than twenty years and feels that it has done its share to build up public confidence in securities investments over that time. The Association does not welcome any untried venture—regardless of sponsorship—which could produce repercussions that would do damage to the whole securities business even though that business were not instrumental in bringing the venture before the public.

To the Association, it is the simplest kind of safety-first to say to any sponsor of a new investment medium: comply with the law and provide proper investor protection.

The absence as yet of any law to require registration of variable annuity contracts in a form that would fit their characteristics; the lack of any standards of disclosure for their public sale; uncertainty as to what agencies of State and Federal governments shall be responsible for the regulation of these ventures—these are but a few of the reservations the Association has about variable annunities. It advocates, if the public is to be protected, full compliance by such issues with all State and Federal laws covering the offering and sale of securities.

Out of its experience of sixteen years as the self-regulating arm of the securities business, the Association takes understandable alarm from the prospect that 200,000 insurance salesmen could be turned loose to sell an investment contract that does not have to comply with any of the securities laws, and it wonders what might be used in the way of selling literature unless that is subject to standards of fair and equitable practice in the public interest.

The Association points out that every one of its members and every one of their registered representatives is bound to observe all Federal and State laws in the sale of securities and, more than this, must comply with the letter and the spirit of strict rules of conduct laid down by the Association, for the evasion of which they are subject to penalties including revocation of their privilege to do business as members or employees of members.

The National Association of Securities Dealers is putting its members and their thousands of employees on notice concerning what it considers to be inherent dangers in the "variable annuity" type of investment contract. By acquainting them with these dangers, the Association feels it is speaking in the interests of all of these people and the public as well.

It raises these questions specifically:

Whether insurance companies may properly offer such contracts in the guise of insurance . . .

Whether the word "annuity" is a misnomer and seriously misleading . . .

Whether, whatever form the "variable annuity" may ultimately take, it should be defined to be a "security" and therefore subject to the securities laws of the States and the Federal government . . .

Whether State and Federal tax revenue departments should examine this new proposition in the light of its status as an "investment" and not a form of "insurance" . . .

Whether those who will sell the "variable annuity" must be subject to the same obligations to the public as are registered representatives of brokers and dealers in securities.