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Index Annuities May Be The Perfect Product

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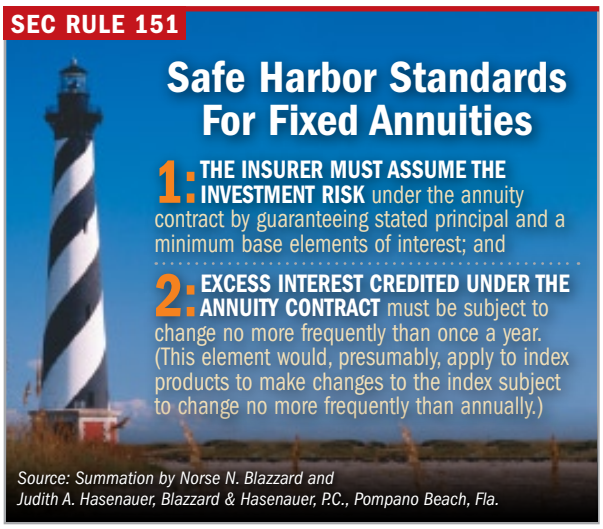
EVEN THOUGH THE TWO OF US HAVE FOCUSED mostly on variable annuities during our collective 75+ years in the annuity business, if we were to start over today knowing all we have learned, we believe we would probably design index annuities (IAs) rather than VAs.

We say this despite all the controversy over index products, despite the bad reputation that some index products have with regulators and despite the bad press many have had with the financial media.

In fact, we believe an index product can accomplish most of the goals of a VA and of a traditional fixed annuity (FA) and yet be free of many problems inherent with both.

The VA was originally created to provide retirement funds that could not be outlived while affording protection against the ravages of inflation of a portfolio of professionally managed and widely diversified equity investments. But shortly after their creation, federal securities regulators determined that VAs were little more than mutual funds with slight trappings of insurance and thus were not exempt from federal securities registration and regulation.



The US Supreme Court, in *SEC v. VALIC, 359 U.S. 65 (1959),* agreed, and so the VA entered an era of multiple levels of regulation—not only by the SEC, but also by state insurance regulators and the National Association of Securities Dealers.

In recent years, even state securities regulators have begun to try to exercise degrees of jurisdiction over VAs and their sales process.

The regulation is such that it seems the only thing more thoroughly regulated than VAs is nuclear waste.

The critical element in the Supreme Court decision to subject VAs to federal securities regulation was the fact that the entire investment risk in a VA is, unlike with traditional FAs, shifted from the insurer to the policy owner. Thus, the court determined that a VA was not the type of annuity Congress intended to be exempt from the federal securities laws. The result is the abundance of regulation that the product is subjected to today.

By comparison, IAs have the ability to provide consumers with the VA's 2 main advantages: income for life and a hedge against inflation. Yet, the IA insurer guarantees stated principal and a minimum investment return. These factors operate to retain the most meaningful elements of the investment risk in the insurer, rather than shifting it to the policy owner.

It is this guarantee of investment results that enables the IA to avoid the federal securities laws and to remain subject only to the regulatory constraints applicable to life insurance products.

Recent pronouncements by the NASD have caused concern regarding whether IAs would continue to be treated as "insurance" rather than "securities."

The position of the NASD seems to be that registered representatives of broker-dealers that are members of the NASD should be "supervised" by their B-Ds when selling IAs, even though it is not clear that the products themselves are "securities" and therefore subject to NASD jurisdiction.

The NASD has not yet taken the formal position that IAs are, *per se*, securities. Prob-

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ably this is because that type of determination is within the purview of the SEC and the courts, not the NASD.

However, it certainly appears that the NASD would like to see IAs classified as "securities," therefore subjecting the sales process to NASD jurisdiction.

Obviously, if IAs can, through the back door, be determined to come under NASD jurisdiction, it will not be difficult to achieve the same result for all life insurance products sold by registered representatives of B-Ds that are members of the NASD.

It is of interest that, although the SEC has been studying IAs for quite some time, the SEC staff has not yet made any determination regarding their status as "insurance" or "securities."

This is not the first time that controversy has stirred over the status of fixed annuities (one type of which is the IA).

In the late 1980s, a major seller of very competitive annuity contracts became insolvent. In the ensuing scandal, a considerable amount of political pressure was exerted on the SEC to force it to exert jurisdiction over all forms of annuities. As a result, the SEC published Rule 151 [SEC Release No. 33-6645 (May 29, 1986)], a rule intended to clarify which type of annuities were "securities" and which were not.

Rule 151, for the first time, created a safe harbor that afforded protection for FAs that meet the safe harbor definition. To qualify for such a safe harbor, the FA must meet certain standards (shown in the box).

Despite the safe harbor, the courts and the SEC have long held that any product, if it is sold like an investment security, will be treated as one, regardless of what it, in fact, is. This legal precedent alone should put everyone in the IA business on notice. They should monitor carefully their sales processes to ensure the product is sold more as a retirement product than as an investment.

The "equal dignity" rule applies to all insurance products—i.e., firms and their representatives must give equal dignity to all elements of the product they selling.

So, do not emphasize the index feature more than the insurance guarantees built into the product. Using the equal dignity rule will strengthen the index industry's ability to continue to offer the public this versatile product, free from much of the regulatory problems that apply to VAs. NU

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