Approved: March 10, 2004
Date

MINUTES OF THE HOUSE FINANCIAL INSTITUTIONS COMMITTEE

The meeting was called to order by Chairman Ray Cox at 3:30 p.m. on February 18, 2004 in Room 527-S of the Capitol.

All members were present except:
Representative Vaughn Flora- excused

Committee staff present:
Bruce Kinzie, Revisor's Office
Bill Wolff Legislative Research Department
Maggie Breen, Secretary

Conferees appearing before the committee: Chris Biggs, Securities Commissioner
Rick Fleming, Security Commissioner's Office
Amy Lee, Security Benefit Group
Scott Colby, Ks. Assn.of Insurance and Financial Advisors
Larry MacGill, Kansas Association of Insurance Agents
James Hall, The American Council of Life Insurers

Others attending:
See Attached List.

Chairman Cox opened the hearing on **HB 2613** - A security includes a variable annuity.

Proponents:

Chris Biggs, Securities Commissioner, said the issue is whether or not we're going to treat variable annuities as a security; they are a hybrid product which has both an insurance and an investment component. They are sold as investments and many times they are not appropriate for the clients they are sold to. As with any security, they have to be suitable for the customer. Even though they don't have jurisdiction over them and despite all the different kinds of securities they regulate, about a third of the complaints he receives in his office involve allegations of abuse in variable annuity sales. All they can do now is refer them to the Insurance Commissioner's office. And unlike the Insurance Department, his office doesn't rely on the support of the industry they regulate. He emphasized that they want to regulate the sales and not the product. He requested the committee move **HB 2613** forward. **(Attachment 1)**

Rick Fleming, Security Commissioner's Office. In the simplest of terms a variable annuity is basically a mutual fund in an insurance wrapper. It's subject to market risk and is considered to be a security at the federal level. Even though the bill would define a variable annuity as a security, the product would be considered a "federal covered security" that is not required to be registered at the state level. The bill doesn't give the Securities Commissioner the authority to review the terms of the variable annuity contracts or interfere with an insurance company's ability to develop new products. It merely gives the Security Commissioner the authority to take action against the seller when the product is sold in an unethical manner. The bill is an effort to strike an appropriate balance and to keep securities regulation in the Securities Department and to subject the people who sell variable annuities to the same type of ethical rules that they have to live by if they sell a mutual fund. **(Attachment 2)**

Kathy Diehl, Assistant Director of Compliance, Security Commissioner's Office - Written Only **(Attachment 3)**

Opponents:

Amy Lee, Vice President and Associate General Counsel of Security Benefit Life Insurance Company, said that what she thinks is really needed is communication between the Insurance and Securities Departments. There is broad authority for the Insurance Commissioner to investigate unfair or deceptive acts on the part of insurance companies and their agents. She also said that she thought it would be relative simple to make the series 63 a requirement for the variable insurance license. She said she thought it would be an easy regulatory fix. She said that this bill would be an add on regulator. Do we really want two

state regulators, or one? In light of the Insurance Commissioner's regulatory authority, they do not see compelling reasons for an additional regulator of variable insurance products and believe that shared regulations of the sale of such products would present problems. **(Attachment 4)**

Scott Colby, Kansas Association of Insurance and Financial Advisors, said he was a sales person who is going to be regulated by these laws and licenses and who is going to have to pay these fees. He now has to have a license in every state where he sells variable annuities and is currently paying $1,000 annually for these licenses. This bill adds on an additional $50. His organization believes that additional regulation of these products by state securities commissioners is unnecessary. Variable Life Insurance and Variable Contracts are already among the most regulated products in the financial marketplace with numerous layers of both state and federal regulation. **(Attachment 5)**

Larry MacGill, Kansas Association of Insurance Agents, said his association is opposed to this bill and has been opposed to its predecessors. **(No Written Testimony)**

James Hall, The American Council of Life Insurers (ACLI), handed out copies of testimony, a chart of states statutory rules affecting this area of the law, a resolution from the American Legislative Exchange Council, a resolution from the National Conference of Insurance Legislators, and chart that shows the current suitability regulations. ACLI strongly opposes **HB 2613** because it redefines security and takes Kansas from the majority to the minority of states and also because it would remove the Insurance Commissioner's jurisdiction over insurance agents selling variable annuities. That's a new twist to a long standing debate and he feels the final paragraph on page 6 is quite out of bounds. **(Attachments 6 thru 10)**

Kevin Davis, American Family Insurance - Written Only **(Attachment 11)**

Kathy Damron, Prudential Insurance - Written Only **(Attachment 12)**

Chairman Cox closed the hearing on **HB 2613** and said the committee would work the bill.

Representative Campbell made a motion to move **HB 2613** with no recommendation. Representative Lane seconded the motion. The motion carried.

Meeting adjourned at 4:55 p.m.

Date of the next meeting is undetermined at this time.

HOUSE FINANCIAL INSTITUTIONS COMMITTEE GUEST LIST

DATE: February 18, 2004

NAME	REPRESENTING
Kathleen Diehl	Office of the Kansas Securities Commissioner
Gail Bright	Office of the Kansas Securities Commissioner
Lynn Hammes	Office of the Kansas Securities Commissioner
Rick Fleming	" " " "
Chris Biggs	Securities Commissioner
Frank Cavella	" "
Scott Schultz	"
Sarah Novascone	Federico Consulting
Melissa Kasprzyk	American Express
Jeff Bottenberg	American Investors Life
John Campbell	KID
Cindy Hermes	KID
Jim Hall	American Council of Life Ins.
Larry Magill	Ks. Assn of Ins Agents
Sandy Braden	KAIFA
John Peterson	Security Benefit Grp
Steve Wassom	KSC
Kevin Davis	Am. Family
Ray Wilk	KDOR / DofV

Matthew Moser DOV / KDOR.

OFFICE OF THE SECURITIES COMMISSIONER

KATHLEEN SEBELIUS, GOVERNOR
CHRIS BIGGS, COMMISSIONER

TESTIMONY IN SUPPORT OF HOUSE BILL No. 2613
House Financial Institutions Committee

Chris Biggs, Securities Commissioner
February 18, 2004

I would like to thank the Chairman and the Committee for the opportunity to speak briefly in support of HB 2613.

The Office of the Kansas Securities Commissioner (the Office) has a long and admired history. On March 15, 1911, Kansas became the first state to enact "blue sky" laws to protect citizens from investment scams. This pre-dated federal legislation in 1933 by over two decades, and Kansas remains a model of enforcement. The Office registers securities and also supervises broker-dealers, agents, and investment advisers. The mission of the Office is to "protect and inform Kansas investors, to promote integrity and full disclosure in financial services, and to foster capital formation."

Variable Annuities As Securities

Variable Annuities have an investment component and are subject to market risk and abusive sales practices. They meet the legal test for a security. They are a security at the federal level --but not presently in Kansas. As a result, Kansas citizens are denied the protections provided in the sale of other securities. Variable annuities quack like a duck. They are a duck.

Securities versus Insurance Regulation

In testimony last year the Insurance Commissioner acknowledged that there were abusive practices in the sales of variable annuities. It was proposed that the Insurance Department would come up with regulations. It is worth noting that the previous position of the Insurance Commissioner was to be neutral on this proposal.

The Securities Industry is regulated nationally by the Securities and Exchange Commission, by self-regulatory bodies, to include the NASD, and most importantly by state regulators who are the "cops on the beat." Anyone who follows Wall Street news events knows of the actions taken by state regulators which have uncovered systemic

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abuses in investment circles and resulted in far-reaching changes to protect investors. The irony is that Kansas could not take regulatory action for abusive industry practices for broker-dealers in our own backyard concerning variable annuities when federal regulators and even some other states could. (see attached article) It is expected that the next industry scandals will concern variable annuity practices.

By contrast the insurance industry is not regulated at the national level. There has been no Insurance crash, like the stock market crash of 1929 ---yet. State insurance regulators have no experience enforcing NASD rules or regulating Broker-Dealers. Over 90% of those selling variable annuities in Kansas are already registered with our Office to sell other securities. The duplication of regulation is not in having variable annuities as a security, but in having the Insurance Department attempt to gear-up to do the kind of regulation we already do. If variable annuities are not treated as a security, disciplinary actions for unethical sales or industry practices will unnecessarily take two tracks. Unlike the Insurance Department, our Office does not rely on the support of the industry we regulate to retain our authority.

It is my hope that the Committee will determine the best way to protect Kansas consumers and assure there are no gaps in oversight.

This is not a partisan issue. Former Commissioner David Brant, was a nationally recognized advocate on the regulation of variable annuities, has supported the concept of this bill.

I urge the Committee to pass this to the floor for considered debate. It should not be strangled by political pressure in Committee. Public policy concerns should be paramount.

I thank the Committee for the opportunity to speak, wish you well in your endeavor, and hope that HB 2613 will move forward.

Sincerely,

Chris Biggs
Commissioner

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Waddell & Reed faces charges in variable annuity switches

NASD wants firm to repay $47M in commissions, fees

By Christine Dugas
USA TODAY

Regulators charged brokerage firm Waddell & Reed on Wednesday with failing to consider the best interests of its customers when it urged them to switch variable annuities.

In the biggest variable annuity enforcement action it has filed, the National Association of Securities Dealers accused the Overland Park, Kan., firm of recommending more than 6,700 variable annuity switches without determining the suitability of the transactions. The NASD complaint also named the firm's former president, Robert Hechler, and its national sales manager, Robert Williams.

Variable annuities are insurance products that provide a death benefit and tax-deferred investment options, often for a high fee. Investors who cash in an annuity early pay a surrender charge.

The exchanges generated $37 million in commissions and cost Waddell's customers nearly $10 million in surrender fees, the complaint says. The agency is seeking an order requiring the brokerage firm to disgorge commissions and compensate customers, in addition to other unspecified sanctions.

Waddell & Reed denied the charges. In a statement, it said that it would vigorously defend its practices. "We believe our actions were consistent with NASD rules and guidance," said Keith Tucker, chairman of Waddell & Reed Financial. "This complaint attempts to attack the credibility and character of our organization with factual misrepresentation, factual omissions and half truths."

The firm has 25 days to submit an answer and request a hearing.

The NASD alleges that from January 2001 to August 2002, Waddell engaged in an aggressive campaign to switch variable annuity contracts of its customers from those issued by United Investors Life Insurance to similar annuities from Nationwide Insurance.

Waddell stopped selling United annuities after a dispute over its fee income, the complaint says. It switched more than 700 customers to one Nationwide annuity even though another was less expensive and would have provided more benefits, the NASD claims.

"Today's action should make crystal clear that brokers may not recommend that clients replace their variable annuity contracts when the broker has no reasonable basis for believing the replacement is in the client's, not the broker's, best interest," said Mary Schapiro, NASD vice chairman.

USA Today
1/15/04

Wall St Journal

THURSDAY, JANUARY 15, 2004 C1

NASD Charges Waddell & Reed Over Annuities

By Theo Francis

IN WHAT COULD herald a new front in regulatory inquiries into improper investment-product sales practices, the National Association of Securities Dealers accused a unit of **Waddell & Reed Financial** Inc. of improperly switching thousands of customers from older variable-annuity contracts into versions that were more profitable for the company and often costlier for investors.

The Overland Park, Kan., financial-services firm reaped $37 million in commissions and $700,000 in fees—and cost investors $9.8 million in "surrender" charges for closing out as many as 6,700 investment contracts in favor of "very similar" new ones, many of which were likely to generate more money for Waddell & Reed at the expense of investors, the NASD said in a 22-page complaint lodged yesterday.

Variable annuities—a clunky name for what amounts to mutual funds wrapped in an insurance policy—became one of the hottest investment products of the late 1990s, thanks to favorable tax treatment and a booming stock market.

In a statement, Waddell & Reed said NASD's complaint was marred by "misrepresentations, factual omissions and half-truths," and questioned the organization's methodology in quantifying whether and how investors were harmed. It also maintained that it adequately considered whether the replacements were suitable for each investor and gave its sales force tools for evaluating the exchange.

The complaint against Waddell & Reed comes a day after the Securities and Exchange Commission said it had found questionable sales practices widespread in the mutual-fund industry, and amid months-long inquiries by state and federal regulators into the conduct of mutual-fund companies, many of which also sell variable annuities. In addition, New York state's attorney general, Eliot Spitzer, who has led widely publicized investiga-

Please Turn to Page C5, Column 1

Waddell & Reed Unit Faces NASD Charges On Annuity Switches

Continued From Page C1

tions into stock-analyst conflicts of interest and mutual-fund trading improprieties, intends to look into annuity sales practices, but isn't yet actively investigating, a spokesman said.

Although annuity sales overall slumped after the stock bubble burst, they have rebounded heartily with the improving stock market. Their complexity and high cost long have led consumer advocates to caution that securities brokers were peddling them to people who didn't fully understand the intricacies or costs. Among the costs: the surrender charges, which are steep fees for cashing out an annuity within the first few years after purchase, and which typically vanish after five to eight years.

The NASD also charged Robert Hechler, president and chief executive of Waddell & Reed Inc. from 1993 to 2001, with encouraging the firm's sales force to embark on the torrent of annuity exchanges. And it charged Robert Williams, the unit's national sales director since 1996, with failing to supervise adequately the sales force to ensure that contracts were switched only when the move was suitable for a given investor.

An attorney for Mr. Williams said he "has had a long and distinguished career in the financial-services industry, and he looks forward to being vindicated." An attorney for Mr. Hechler couldn't be reached to comment. Waddell & Reed and the two executives have 25 days to respond to the complaint, and ultimately a hearing may be held before a three-person panel under NASD rules. Either side could appeal the resulting decision within the organization, and ultimately bring the case to court.

More than 1,400 of the Waddell exchanges probably led to investors losing money, the NASD complaint said. More than 700 investors had their existing annuities switched into new ones that were "more costly, had higher fees, less benefits—but a greater payout for the [sales] rep and the firm," said Barry R. Goldsmith, NASD's executive vice president for enforcement.

In 18 other cases cited in the complaint, investors swapping existing annuities for nearly identical ones paid a penalty of least 5% of the account value for surrendering their initial annuities soon after buying them.

In its statement, Waddell & Reed said the NASD arrived at its figures showing harm to investors "based on the retroactive application of a hypothetical academic predictive model" that failed to reflect all the benefits of the new annuities, which it called "far superior to the policies being replaced." Waddell & Reed, which in June had disclosed the NASD's inquiry, also said it believed the NASD had initiated its inquiry "without a single investor complaint" and at the behest of United Investors.

"We believe our actions were consistent with NASD rules and guidance," Waddell & Reed Chairman Keith A. Tucker said in the company's statement, which also said Messrs. Hechler and Williams acted responsibly. "Waddell & Reed strenuously denies the NASD's allegations and plans to vigorously defend its sales practices and compliance procedures."

—*Tom Lauricella contributed to this article.*

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OFFICE OF THE SECURITIES COMMISSIONER

KATHLEEN SEBELIUS, GOVERNOR
CHRIS BIGGS, COMMISSIONER

TESTIMONY IN SUPPORT OF HOUSE BILL No. 2613
House Financial Institutions Committee

Rick A. Fleming, General Counsel
February 18, 2004

Mr. Chairman and members of the committee,

The purpose of House Bill 2613 is to include variable annuities and other variable insurance products within the definition of a security. The bill is a spin-off from HB 2347, the Kansas version of the new Uniform Securities Act. In the Uniform Securities Act, the drafters left a bracket within the definition of a security so that each state legislature could decide whether to exclude variable annuities from the definition. Because that decision was the only controversial portion of HB 2347, the House Judiciary Committee opted to leave variable annuities out of HB 2347 and introduce HB 2613 to separately address the issue.

I recognize that your committee is familiar with this issue, but I would like to remind you of some of the basic facts. In simple terms, a variable annuity is a mutual fund in an insurance wrapper. Like a mutual fund, a variable annuity is subject to market risk and is purchased as an investment product, so it is considered a security at the federal level and in several other states. Because it is a security at the federal level, the person selling a variable annuity must have a securities license through the National Association of Securities Dealers (NASD), and the product must be sold through a brokerage firm.

Even though the bill would define a variable annuity as a security, the product would be considered a "federal covered security" that is not required to be registered at the state level. Therefore, the bill does not give the Securities Commissioner the authority to review the terms of the variable annuity contracts or interfere with an insurance company's ability to develop new products. It merely gives the Securities Commissioner the ability to take action against the seller when the product is sold in an unethical manner. Of course, in order to subject the sellers to the traditional sales practice rules for securities, the Securities Commissioner would have to require them to obtain a license to sell securities in Kansas. However, the sellers have already taken the required tests to get the same type of license from the NASD, and the vast majority are already licensed by the Kansas Securities Commissioner because they sell mutual funds along with variable annuities.

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Undoubtedly, the opponents of this bill will use the same arguments that your committee has heard before. For example:

- The insurance lobbyists will tell you that the bill creates an additional layer of regulation, even though the bill would give the Securities Commissioner no authority over the actual variable annuity contracts, or the insurance companies who issue them, unless the insurance companies engage in outright fraud.

- The opponents will tell you that the bill is "a solution in search of a problem," even though the Securities and Exchange Commission, the NASD, and the North American Securities Administrators Association have all seen significant increases in complaints related to variable annuities in the past few years. As noted in the written testimony provided by Kathleen Diehl, the Assistant Director of Compliance for the Office of the Securities Commissioner, issues involving variable annuities are among the most common complaints we receive.

- You will be told that the Kansas Securities Commissioner doesn't need to get involved in regulating the sale of variable annuities because any Kansas citizen can complain to the federal government or the NASD, even though it is clear that state regulators are often more responsive to your constituents' complaints than the federal government. In fact, the NASD supports the inclusion of variable annuities within the definition of a security at the state level because they recognize that the states are vital partners in securities enforcement.

- Finally, you will be told by the insurance lobby, along with the Kansas Insurance Department, that the Securities Commissioner does not need jurisdiction over variable annuity sales practices because the Insurance Department is gearing up to handle the problem. This is the argument I would like to focus on this afternoon.

I applaud the efforts of the Insurance Department, but I question the rationale for giving insurance regulators exclusive jurisdiction over a product that is marketed as an investment. The typical complaints concerning variable annuities do not involve the terms of the contracts or the insurance features of the product, but rather the *investment* aspects of it. As explained in the attached investor alert issued by the NASD, the typical variable annuity complaints involve questions of whether the product was suitable for the particular investor in light of the investor's financial status, age, risk tolerance, etc. The complaints also involve switching, churning, and the salesperson's failure to adequately explain the features of the product to the customer. These are classic securities issues that the Securities Commissioner addresses every day.

I ask you to consider a simple scenario. Assume that an examiner from the Office of the Securities Commissioner is conducting a routine examination of a branch office of a large brokerage firm and comes across evidence that a stock broker has been taking advantage of clients. The broker has elderly clients who need safety of principal and enough liquidity to meet their living expenses, but the broker puts his clients in high risk, illiquid securities because they pay higher commissions. As a result, the clients lose 75% of their life savings, so the examiner

refers a case to me with the recommendation that we revoke the broker's license because the broker cannot be trusted to manage the nest eggs of senior citizens.

This scenario illustrates two problems. First, if the broker was selling a *mutual fund* or other type of security, our office would be able to revoke the broker's license to sell securities in Kansas, but the broker could simply call up all his clients and begin selling them variable annuities. But even worse, if the stock broker was selling a *variable annuity* instead of a mutual fund, the Securities Commissioner would have to rely upon the insurance regulators to take appropriate action against the stock broker for abusive sales practices involving an investment product. Of course, the insurance lobby would have this committee believe that HB 2613 is merely an attempt by the Securities Commissioner to grab turf and usurp authority over insurance issues from the Insurance Commissioner, but in reality the bill is an effort to strike an appropriate balance and keep securities regulation in the securities department.

The Insurance Department has proposed regulations to adopt suitability standards for the sale of variable annuities. However, the proposals are flawed in at least two respects. First, the regulations focus solely on unsuitability and ignore other common unethical practices such as the improper switching of similar products to generate commissions, failure to execute a trade on a timely basis, etc. In contrast, the inclusion of variable annuities within the definition of a security would subject their sales to the full range of ethical rules.

The other flaw in the proposed insurance regulations is that they apply to the insurance companies who issue the variable annuities, but not the brokerage firms who sell them. Because federal law requires variable annuities to be sold through brokerage firms, the Insurance Department cannot effectively police sales practices unless they are prepared to regulate brokerage firms, and the proposed regulations make no attempt to assert direct authority over the brokerage firms. Instead, the proposed method for asserting authority is to require the insurance companies to monitor compliance by the brokerage firms. *In essence, the Insurance Department proposes that insurance companies should do compliance audits of brokerage firms rather than the Office of the Securities Commissioner.*

Under the regulatory scheme advocated by the Insurance Commissioner, neither she nor the Securities Commissioner would have the authority to investigate the alleged sales practice abuses at Waddell & Reed which are described in an article attached to the testimony of Commissioner Biggs. In that case, the NASD has alleged that Waddell & Reed recommended 6,700 variable annuity exchanges to its customers without determining the suitability of the transactions. The transactions generated $37 million in commissions for Waddell & Reed and cost the customers nearly $10 million in surrender fees. Many of those dollars came from Kansas citizens, and the case involves a Kansas-based brokerage firm, but no agency of the State of Kansas has the authority to take enforcement action against Waddell & Reed because the company happened to be selling variable annuities. Under the Insurance Commissioner's proposal, that would not change. Worse yet, smaller cases that do not attract the interest of the SEC or NASD would continue to fall through the wide cracks that exist in variable annuity regulation.

Mr. Chairman and members of the committee, I thank you for the opportunity to speak in favor of HB 2613, and I ask you to recommend it favorably for passage.

NASD Investor Alert

Variable Annuities: Beyond the Hard Sell

May 27, 2003

The marketing efforts used by some variable annuity sellers deserve scrutiny - especially when seniors are the targeted investors. Sales pitches for these products might attempt to scare or confuse investors. One scare tactic used with seniors is to claim that a variable annuity will protect them from lawsuits or seizures of their assets. Many such claims are not based on facts, but nevertheless help land a sale.

While variable annuities can be appropriate as an investment under the right circumstances, as an investor, you should be aware of their restrictive features, understand that substantial taxes and charges may apply if you withdraw your money early, and guard against fear-inducing sales tactics.

NASD is issuing this Investor Alert to help seniors and other prospective variable annuity buyers to make informed decisions about how to invest for their retirement. This Alert focuses solely on *deferred variable* annuities and the unique issues they raise for investors.

What Are Variable Annuities?

Although **variable annuities** offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds:

1. Tax-deferred treatment of earnings;
2. A death benefit; and
3. Annuity payout options that can provide guaranteed income for life.

Generally, variable annuities have two phases:

1. The "accumulation" phase when investor contributions - **premiums** - are allocated among investment portfolios - **subaccounts** - and earnings accumulate; and
2. The "distribution" phase when you withdraw money, typically as a lump sum or through various annuity payment options.

If the payments are delayed to the future, you have a **deferred annuity**. If the payments start immediately, you have an **immediate annuity**.

As its name implies, a variable annuity's rate of return is not stable, but varies with the stock, bond, and money market subaccounts that you choose as investment options. There is no guarantee that you will earn any return on your investment and there is a risk that you will lose money. Because of this risk, variable annuities are securities registered with the Securities and Exchange Commission (SEC). The SEC and NASD also regulate sales of variable insurance products.

Evaluating Variable Annuities

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The variety of features offered by variable annuity products can be confusing. For this reason, it can be difficult for investors to understand what's being recommended for them to buy - especially when facing a hard-charging salesperson.

Before you consider purchasing a variable annuity, make sure you fully understand all of its terms. Carefully read the prospectus. Here are seven factors you should bear in mind before investing:

1. Liquidity and Early Withdrawals

Deferred variable annuities are long-term investments. Getting out early can mean taking a loss. Many variable annuities assess surrender charges for withdrawals within a specified period, which can be as long as 6 to 8 years.

Also, any withdrawals before an investor reaches the age of 59 ½ are generally subject to a 10% tax penalty in addition to any gain being taxed as ordinary income.

2. Sales and Surrender Charges

Most variable annuities have a sales charge. Like Class B shares of mutual funds, many variable annuities shares typically do not charge a front-end sales charge, but they do impose asset-based sales charges or surrender charges. These charges normally decline and eventually are eliminated the longer you hold your shares. For example, a surrender charge could start at 7% in the first year and decline by 1% per year until it reaches zero.

3. Fees and Expenses

In addition to sales and surrender charges, variable annuities may impose a variety of fees and expenses when you invest in them, such as:

- **Mortality and expense risk charges**, which the insurance company charges for the insurance to cover:
    - Guaranteed death benefits;
    - Annuity payout options that can provide guaranteed income for life; or
    - Guaranteed caps on administrative charges.
- **Administrative fees**, for record-keeping and other administrative expenses;
- **Underlying fund expenses**, relating to the investment subaccounts; and
- **Charges for special features**, such as a:
    - Stepped-up death benefits;
    - Guaranteed minimum income benefits;
    - Long-term health insurance; or
    - Principal protection.

These annual fees on variable annuities can reach 2% or more of the annuity's value. Remember, you will pay for each variable annuity benefit. If you don't need or want these features, you should consider whether this is an appropriate investment for you.

4. Taxes

While earnings in a variable annuity accrue on a tax-deferred basis - typically a big selling point - they do not provide all the tax advantages of 401(k)s and other before-tax retirement plans. 401(k)s and other before-tax retirement plans not only allow you to defer taxes on income and investment gains, but allow your contributions to reduce your current taxable income. That's why most investors should consider annuity products only after they make their maximum contributions to their 401(k)s and other before-tax retirement plans. To learn more about 401(k)s,

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please read *Smart 401(k) Investing*.

Once you start withdrawing money from your variable annuity, earnings (but not principal) will be taxed at the ordinary income rate, rather than at the lower capital gains rates applied to investments in stocks, bonds, mutual funds or other non-tax-deferred vehicles in which funds are held for more than one year.

Furthermore, proceeds of most variable annuities do not receive a "step-up" in cost basis when the owner dies. Other types of investments, such as stocks, bonds, and mutual funds, do provide a step up in tax basis upon the owner's death.

5. Bonus Credits

In an attempt to attract investors, many variable annuities now offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1% to 5% for each premium payment you make. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods.

Exchanging or Replacing Your Current Annuity

Variable annuity sales have dropped along with the decline in the equity marketplace. An exchange of an existing annuity for a new annuity may be the only way a salesperson can generate additional business. However, the new variable annuity may have a lower contract value and a smaller death benefit. You should exchange your annuity only when it is better for you and not just better for the person trying to sell you a new annuity. To learn more about exchanges, please read our Investor Alert, Should You Exchange Your Variable Annuity?

6. Guarantees

Insurance companies issuing variable annuities provide a number of specific guarantees. For example, they may guarantee a death benefit or an annuity payout option that can provide income for life. These guarantees are only as good as the insurance company that gives them. While it is an uncommon occurrence that the insurance companies that back these guarantees are unable to meet their obligations, it happens. There are several credit rating agencies that a company's financial strength. Information about these firms can be found on the New Jersey Department of Banking & Insurance's Web site.

7. Variable Annuities within IRAs

Investing in a variable annuity within a tax-deferred account, such as an individual retirement account (IRA) may not be a good idea. Since IRAs are already tax-advantaged, a variable annuity will provide no additional tax savings. It will, however, increase the expense of the IRA, while generating fees and commissions for the broker or salesperson.

Also, if the annuity is within a traditional (rather than a Roth) IRA, the government requires that you start withdrawing income no later than the April 1 that follows your 70½ birthday, regardless of any surrender charges the annuity might impose.

Individual Retirement Annuities.

Some variable annuity providers sell what is termed an Individual Retirement Annuity (IRA). You should be aware that this "IRA" is not an Individual Retirement Account (IRA). The Internal Revenue Service sets specific restrictions regarding

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Individual Retirement Annuities, which are not met by all annuity products. To learn more, please read IRS Publication 590.

How to Protect Yourself

Brokers recommending variable annuities must explain to you important facts, including:

- **liquidity issues**, such as potential surrender charges and 10% tax penalties;
- **fees**, including mortality and expense charges, administrative charges, and investment advisory fees; and
- **market risk**.

Brokers also must collect important information from you about your age, marital status, occupation, financial and tax status, investment objectives, and risk tolerance to assess whether a variable annuity is suitable for you.

Before purchasing a variable annuity, you should specifically -

Ask the person recommending that you purchase a variable annuity:

- How long will my money be tied up? Are there surrender charges or other penalties if I withdraw funds from the investment earlier than I anticipated?
- Will you be paid a commission or receive any type of a compensation for selling the variable annuity? How much?
- What are the risks that my investment could decrease in value?
- What are all the fees and expenses?

Thoroughly Check Out Your Broker.

Check the NASD Public Disclosure Web page to learn whether your broker is licensed and has a history of complaints.

And remember to ask yourself:

- Am I already contributing the maximum amount to my 401(k) plan and other tax-deferred retirement plans?
- Do I have a long-term investment objective? Am I going to need the money before the surrender period ends (usually at least 7 to 10 years)? Will I need the money before I'm 59½?
- Do I understand how the variable annuity works, the benefits it provides, and charges I have to pay?
- Have I read and understood the prospectus?
- Are there special features provided such as added long-term care insurance that I don't need?
- If I've decided to purchase a variable annuity, have I shopped around and

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compared the features of various variable annuities, such as sales loads other fees and expenses?

- Do I understand the effect annuity payments could have on my tax status?

- If I'm considering purchasing a variable annuity within an IRA, do I understand that IRAs already provide for tax-deferred savings?

- Am I being pressured into making a quick purchase?

Have You Already Purchased a Variable Annuity?

If you have purchased a variable annuity and now have second thoughts, the policy may have a "free look" period that allows you to cancel within a specific period.

If you believe a variable annuity sale has violated NASD rules, you can file a complaint online at NASD's Investor Complaint Center.

Additional Resources

- Understanding Professional Designations
- NASD Investor Alert, Should You Exchange Your Variable Annuity?
- NASD Investor Alert, Should You Exchange Your Variable Life Insurance Policy?
- NASD, Equity Indexed Annuities -- A Complex Choice.
- SEC, Variable Annuities: What You Should Know.

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OFFICE OF THE SECURITIES COMMISSIONER

KATHLEEN SEBELIUS, GOVERNOR
CHRIS BIGGS, COMMISSIONER

TESTIMONY IN SUPPORT OF HOUSE BILL No. 2613
House Financial Institutions Committee

Kathleen Diehl, Assistant Director of Compliance
February 18, 2004

Mr. Chairman and members of the committee, thank you for this opportunity to testify in support of HB 2613.

I would like to inform you of my background. I have been with Division of Compliance with the Office of the Securities Commissioner for 2 years as Examiner and Assistant Director of Compliance. For six years I worked for the NASD as Examiner and Supervisor.

In my positions with both the NASD and the Office of the Kansas Securities Commissioner, I have been on the front line dealing with complainants on the phone and, frequently, face to face. I have seen the damage first hand that unsuitable variable annuity sales can do to the life savings of investors. I have had investors in my office reduced to tears as they relate their stories. I then have to tell them that our office cannot help them other than to refer the complaints to the Kansas Insurance Department and the NASD. The irony is that our office could help them if variable annuities were defined as securities under Kansas law.

Let me describe two of our complainants. Both men were 62 years old, both had approximately $100,000 in liquid net worth which was their life savings, both invested in a variable annuity because they were told the return was a guaranteed 6%. One man was told that this was a "sleep at night" investment. Both men had planned to retire within three years and were adamant about limiting risk. These men did not know each other and had separate investment advisors.

What they were not told is that their life savings would be invested in sub-accounts which were subject to market risk, the guaranteed 6% was available only if they annuitize and they had to pay an additional fee for that guarantee and the money was unavailable to them for 8 years unless they paid a substantial penalty. One man lost $20,000 in the first three months of his investment and the other saw his principal decrease by $60,000 in one year.

Kansas Securities Laws require that agents obtain customer suitability information prior to any sale of a security. This information includes age, net worth and investment objectives including risk tolerance and time frame for investing. If the agents had gathered such information from each of these complainants, would they have believed that these investments were suitable? Or were these agents more interested in the compensation they received?

Customers, particularly **senior citizens**, are being sold variable annuities without adequate explanation of the complex features and fees involved. In most cases they are given disclosure documents but that disclosure consists of a complex prospectus that is difficult for a novice investor to comprehend. Most clients rely on their agent to explain the product but are unaware that sellers of variable annuities are highly compensated in comparison to the sales of other investment products. We have found that the majority of complaints received relate to the suitability of the product for the customer and the possible misrepresentation of the product by the agent. Was the product suitable for a client when factors such as age, net worth and risk tolerance are considered and was the product adequately explained? The following is a list of facts that are frequently omitted when the agent is selling a variable annuity:

Liquidity Issues:	Up to 100% of a customer's liquid net worth invested in a product with limited access and penalties for withdrawal.
Guaranteed Income:	Up to 6% income guaranteed without an explanation that the receipt of that income requires annuitization.
Time Frame:	Guaranteed income benefits may require at least a ten year time frame.
Market Risk:	Customers are not aware that their investment is subject to market risk.

Why sell variable annuities?

I. Commissions:
   a. Extremely high compensation rates – variable annuities pay roughly 6% - 8% compared to mutual funds which average 2% - 6%.

   b. Commissions are heaped (they are paid in the first year, rather than spread out over several years).

   c. Unlike mutual funds, there are no breakpoints – commissions aren't reduced when selling larger amounts.

II. The product is deceptively simple to describe:
   a. The benefits are often touted while disadvantages are ignored.

b. Many insurance agents don't fully understand the products or their complicated tax results.

c. The products are evolving very quickly, making it difficult for agents to keep current.

In August, 2001, the American Council of Life Insurers presented to the National Conference of Commissioners on Uniform State Laws a memorandum of opposition to the inclusion of variable annuities within the definition of security. The North American Securities Administrators Association, Inc. responded to that memo and the text of that response is attached to my written testimony.

Because of the apparent abuses of this product which focus on the most financially vulnerable members of our society, it is vital that a state agency have the capability to enforce the securities regulations that govern the sales practices of the agents that sell the product. If variable annuities are defined as securities, that agency would be the Office of the Kansas Securities Commissioner.

In closing, it is vitally important that we understand that the proposal that state law conform to federal law in the treatment of variable annuities as securities will not affect insurance companies or the regulation of the products, but will enable state functional regulation of the agents who sell variable annuities.

Thank you for your consideration.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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Functional Regulation in the 21st Century:

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

Updated January 10, 2003

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

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> 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:

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> "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
Kansas Securities Commissioner

Royce Griffin
NASAA General Counsel

Attachments

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

House Committee on Financial Institutions

Testimony of Amy Lee, Vice President and Associate General Counsel of Security Benefit Life Insurance Company

House Bill No. 2613

February 17, 2004

Security Benefit Life Insurance Company ("Security Benefit") is a Kansas life insurance company located in Topeka, Kansas. Security Benefit offers fixed and variable annuities, retirement plans and, through its subsidiary broker/dealer, Security Distributors, Inc., a family of mutual funds. We offer fixed and variable annuities to fund both qualified and non-qualified retirement plans.

Because the variable annuity is our primary product, we would like to comment on House Bill No. 2613 and, in particular, on the proposal to include variable insurance products in the definition of security. House Bill No. 2613 is based upon the Uniform Securities Act, which provides that the term "[s]ecurity . . . 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."[1] The prefatory note to the Uniform Securities Act explains that for those states that wish to continue or adopt an exclusion for variable insurance products from

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Attachment 4

the definition of security, the brackets should be removed from the phrase "or variable." We believe that the historical exclusion of variable insurance products from the definition of security under Kansas law should be continued by including the term "or variable" in the definition of security. Missouri and Oklahoma recently adopted the Uniform Securities Act with the exclusion of variable insurance products from the definition of security.

House Bill No. 2613 would eliminate the exclusion of variable insurance products from the definition of security under Kansas law. We believe that this change is inconsistent with the Kansas insurance code, which provides as follows:

> The [insurance] commissioner shall have the sole and exclusive jurisdiction and authority to regulate the issuance and sale of such contracts and to promulgate reasonable rules and regulations as may be necessary to carry out the purposes and provisions of this act, and such contracts, the companies which issue them, and the agents or other persons who sell them, shall not be subject to the provisions of Article 12 of Chapter 17 of the Kansas Statutes Annotated [the securities act] nor to the jurisdiction of the securities commissioner of the state.[2]

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[1] The Uniform Securities Act (Last Revised or Amended in 2002) as approved and recommended for enactment by the National Conference of Commissioners on Uniform State Laws ("NCCUSL").

[2] K.S.A. 40-436(l)

The proposed change in the definition of security would provide for the securities commissioner to have jurisdiction with regard to the sale of variable insurance products and would be inconsistent with the sole and exclusive jurisdiction of the insurance commissioner with regard to insurance products. We believe that this change potentially adds unnecessary layers of regulation to an already highly regulated industry and creates possible regulatory conflicts and confusion on the part of insurers, sales agents and the public. We also believe that the insurance features of variable life and variable annuity products can be complex and are better understood and regulated by the insurance commissioner.

The long-standing regulatory structure for variable insurance products, which dates to the creation of variable annuity products in the 1960s, is regulation of the products as insurance at the state level[3] and as securities at the federal level. For example, an individual who wishes to sell variable insurance products in Kansas, must be licensed as an insurance agent by the state insurance commissioner and must be registered as a representative of a broker/dealer with the National Association of Securities Dealers, Inc. ("NASD"), a federal self-regulatory organization. With the proposed change in the

[3] The states are the exclusive regulators of insurance in accordance with the McCarren-Ferguson Act, which generally prohibits federal statutes from preempting state insurance law.

definition, an individual would further need to be registered under the Kansas Securities Act and pay any applicable fees.

Security Benefit is concerned about sales practices with regard to variable insurance products, and we know, that as with any industry, there are some sales agents that are engaging in unethical sales practices. We believe, however, that the current regulatory structure can adequately address any such practices. Under current law, the insurance commissioner may revoke an agent's license under the following circumstances[4]:

- License was obtained by fraud or misrepresentation
- Agent misrepresented the provisions of an insurance or annuity contract
- Agent engaged in rebating or any inducement not contained in the insurance contract
- Agent intentionally omitted a material fact
- Agent made misleading representations or incomplete comparisons for the purpose of inducing a surrender of in-force insurance
- Agent has been convicted of a misdemeanor or felony involving fraud, deceit, dishonesty, intent to defraud or intent to deprive
- Agent's license does not serve the interests of the insurer or the insurable interests of the public

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[4] K.S.A. 40-242.

The Insurance Commissioner also has the power to investigate any potential unfair or deceptive act or practice pursuant to K.S.A. 40-2405 and to order payment of a money penalty, suspend or revoke an insurance license, or order redress of injury to a consumer pursuant to K.S.A. 40-2407. Further, the Insurance Commission has recently proposed a regulation, K.A.R. 40-2-14b, that would require the insurer and insurance agent to ensure that any recommendations with regard to transactions involving variable life insurance or variable annuity products meet the minimum suitability requirements established by the regulation. As a result, insurance producers in Kansas would be subject to suitability requirements under Kansas Insurance Department regulations and the NASD Conduct Rules.[5]

With regard to any fraud in the sale of variable annuities, the Kansas Insurance Department has a fraud unit that has the power to prosecute cases of potential insurance fraud. The Insurance Commissioner Sandy Praeger was quoted in a recent article in The Topeka Capital-Journal as stating that "[i]f fraud is occurring, we want to discover it, investigate it and prosecute it when appropriate." The article also reported that the fraud unit was investigating allegations of insurance crimes in seven counties.[6] As a result, in addition to traditional regulatory powers, the Insurance Commissioner, with the creation of

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[5] Any sales agent selling variable insurance products in Kansas is subject to the jurisdiction of the NASD and the NASD Conduct Rules.

[6] "Fraud Unit to Target Insurance Schemes," The Topeka Capital-Journal, October 30, 2003.

the fraud unit, has prosecutorial powers with regard to crimes involving insurance, including variable annuity and variable life insurance products.

In light of the Insurance Commissioner's regulatory authority, we do not see compelling reasons for an additional regulator of variable insurance products, and we believe that shared regulation of the sale of such products by the insurance and securities commissioners presents potential problems, as follows:

- Potential for conflicting positions taken by the two regulators
- Difficulties in regulating the agents, without also regulating the principals, i.e., the insurance companies
- A regulatory framework that is inconsistent with the vast majority of other states
- Regulation of insurance products by a secondary regulator without insurance expertise
- Unnecessary additional regulation and the costs thereof

In conclusion, we ask that you consider whether a change in a long-standing regulatory structure is justified, taking into account the following:

- Variable insurance products industry is currently regulated by the state insurance departments, SEC and NASD

- The Insurance Commissioner is the long-standing functional regulator of insurance products
- Current regulatory structure has sufficient tools to address bad conduct on the part of industry participants
- Additional regulation imposes a burden on business with very little, if any, incremental protection of the public

I appreciate the opportunity to share our views on this bill with you. We would be happy to address any questions that you may have.

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Testimony of Scott Colby, CLU, ChFC

On behalf of the Kansas Association of Insurance and Financial Advisors (KAIFA)

Regarding House Bill 2613

Submitted to the House Financial Institutions Committee Wednesday, February 18, 2004

Testimony of Scott Colby, CLU, ChFC
Kansas Association Insurance and Financial Advisors
(KAIFA)
In Opposition to HB2613
February 18, 2004

Mr. Chairman and Committee Members:

Thank you for the opportunity to address the House Financial Institutions Committee today on behalf of the members of Kansas Association of Insurance and Financial Advisors (KAIFA) in opposition of HB2613. Our membership consists of 1,100 Kansans who are actively engaged as insurance agents and brokers.

HB2613 would grant the state securities commissioner jurisdiction over variable products, and persons who sell these products would be required to register and be licensed under the state securities code. The Kansas Association of Insurance and Financial Advisors (KAIFA) believe that additional regulation of these products by state securities regulators is unnecessary.

Variable life insurance and annuity contracts are already among the most regulated products in the financial market place. Between state insurance departments and federal securities regulators governing these products, variable products are simultaneously subject to numerous layers of both state and federal regulation.

Variable products must be registered under the Investment Company Act of 1940 and the Securities Act of 1933, which are both under the jurisdiction of the U.S. Securities and Exchange Commission. The registered representatives of broker/dealers who are members of the National Association of Securities Deals (NASD) may only sell these products. NASD rules impose tight restrictions on all aspects of the conduct and activities of these persons, ranging from strict suitability standards to the manner in which they promote their products. Advertisements pertaining to variable contracts are subject to extensive regulation under the federal securities laws, and advertisements used by sales persons licensed by the NASD are also subject to NASD approval.

And regulation is working. In the United States, 50% of the registered broker dealers are insurance company affiliated broker dealers. Of that 50%, only 8% of all disciplinary actions are affiliated with sales conduct by representatives registered with the insurance company broker dealers,

On the state level, a wide range of state laws and regulations apply to variable products, and state insurance commissioners, specifically, have broad jurisdiction over all insurance products and the persons who market these products. KAIFA supports the continued efforts by the Kansas Insurance Commissioner to aggressively enforce laws to insure that fraudulent acts in regard to sells and promotion of variable insurance products are prosecuted.

KAFIA is also supportive of the continued efforts of the Kansas Insurance Commissioner to develop rules and regulations to assist in preventing unsuitable products that may be sold to the consumer. Insurance Commissioner Praeger also has joined with the NAIC (National Association of Insurance Commissioners) in their model standards prohibiting unsuitable annuity

product sales to senior citizens, another indication of how seriously the Insurance Commissioners office is regarding the oversight of annuity products.

Variable products are already subject to a comprehensive federal/state regulatory regime. Subjecting a product, which already falls under the jurisdiction of state insurance departments, the NASD and the SEC to state securities regulation will provide little in the way of meaningful or necessary additional regulation.

Persons who sell variable products are already subject to several levels of regulation as well as to registration and filing fees. KAIFA is greatly concerned that granting state securities regulators jurisdiction over variable products will add additional costs. These additional costs inherent in duplicative regulation and the disincentives for insurers to market these products in states in which the state securities commissioner has jurisdiction over the marketing and sale of variable life insurance and annuity contracts would ultimately result in insurance products being more costly to consumers. This could lead to fewer sales of variable products to consumers who might otherwise use these products as part of a comprehensive, well thought-out financial plan.

Thank you for your consideration, and I will be available to respond to any questions.

Statement

of

The American Council of Life Insurers

On Kansas House Bill 2613

This testimony is offered on behalf of the American Council of Life Insurers ("ACLI"), a national trade association of 383 life insurance companies whose assets approximate 70% of the life insurance business written in the United States. Three hundred two ACLI members are licensed to do business in Kansas, accounting for 73 percent of the ordinary life insurance and 82% of the annuities written in the state. Thank you for the opportunity to offer comments on HB 2613.

We strongly oppose HB 2613's proposed amendment to the definition of term "security" and we strongly oppose HB 2613's attempt to strip the insurance commissioner of her long-standing exclusive jurisdiction over variable life insurance and variable annuities.

Kansas law currently follows that in the majority of states, where the definition of "security" excludes variable life insurance and variable annuities. This is in keeping with the decisions of the United States Supreme Court in *SEC v. Variable Life and Annuity Insurance Company, 359 U.S. 65 (1959)* and *SEC v. United Benefit Life Insurance*

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Company, 387 U.S. 202 (1967). In those cases, the Supreme Court found that variable insurance products were hybrid products containing elements of both securities and insurance. The Court ruled that the securities features of the products would be regulated by federal securities law and the insurance features of the products would be regulated by state insurance law. This is currently the law in Kansas and in the majority of states.

HB 2613's amendment to the term "security" would alter the existing regulatory framework and place Kansas in the minority of states by conferring jurisdiction over variable life insurance and variable annuities to the Office of the Securities Commissioner. The American Council Of Life Insurers opposes HB 2613's proposed expansion of jurisdiction over variable life insurance and variable annuities and we strongly support the Kansas Insurance Department retaining its long-standing exclusive jurisdiction over these insurance products.

The Kansas Insurance Department already has ample regulatory authority and expertise to regulate the sale of variable insurance products. The Kansas Unfair Trade Practices Act (K.S.A. 40-2404) already prohibits fraud and misrepresentation in the sale of insurance. Insurance regulations already require that sales of insurance products be suitable for the buyer (K.A.R. 40-2-14, 40-15A-1). In addition, in order to provide added consumer protections, the Insurance Department is currently in the process of promulgating a new regulation containing even more detailed suitability standards.

In 2003, both the American Legislative Exchange Council (ALEC) and the National Conference of Insurance Legislators (NCOIL) adopted Resolutions that oppose the type of amendments that are proposed by HB 2613. The Resolutions state that ALEC and NCOIL support "...state insurance commissioners having exclusive authority at the state level over the regulation of the issuance, marketing and sale of variable life insurance and variable annuities, and opposes any state legislation or regulation that would grant state securities regulators jurisdiction over the issuance and sale of such products or that would define variable life insurance or variable annuities as "securities" under state law."

The sale of variable insurance products is already subject to considerable regulation at both the federal and state level. Variable contract separate accounts must be registered under the Investment Company Act of 1940, which is administered by the U.S. Securities and Exchange Commission. The disclosure appearing in variable contract prospectuses is reviewed by the SEC. Advertisements must satisfy several detailed regulations under the federal securities laws, and must be filed with the SEC.

The activities of securities salespersons are also subject to SEC jurisdiction under the Securities Exchange Act of 1934. In addition to these specific standards, the federal securities laws impose broad antifraud proscriptions and give the SEC significant enforcement authority. Unlike other regulatory structures, the federal securities laws uniquely provide for private rights of actions by individual investors on certain core protections.

Variable contracts subject to the federal securities laws can only be sold by registered representatives of a broker-dealer that is a member of the National Association of Securities Dealers. The NASD's rules of conduct strictly govern the activity of securities salespersons, and impose detailed standards concerning advertising, supervision and the suitability of individual securities transactions. All advertisements used by NASD licensed salespersons must be filed with, and approved by, the NASD Advertising Department.

Salespersons distributing variable contracts must obtain an NASD license in order to sell these products, and must maintain rigorous continuing education standards. Supervising broker-dealers enforce the NASD's rigorous rules of conduct, and fulfill significant supervision and suitability standards. Individuals committing felonies and dishonesty crimes are statutorily disqualified from being NASD licensed. Broker-dealers immediately must report salespersons terminated for cause on Form U-5, which is available on the NASD's publicly available computerized database, the CRD.

State insurance departments have comprehensive authority over life insurers and the products they issue. In addition to the variable contract statutes and regulations in most jurisdictions, variable life and variable annuities must also satisfy a broad array of requirements protecting the interests of consumers, such as unfair trade practices acts, illustration regulations, and advertising regulations. State insurance departments wield substantial authority over variable contracts in the issuance of variable contract

certificates of authority, and in policy form filing and approval. State insurance departments also continually evaluate insurers and their product distribution through detailed market conduct examinations.

In sum, variable life and variable annuities pass meticulous scrutiny from design through approval.

The amendments proposed by HB 2613 would add an additional and unnecessary fourth layer of regulation over the sale of variable insurance products. In addition, the proposed amendments would cause duplicate regulation of the same product under the Kansas Insurance and Securities Codes.

Complaints regarding the sale of variable insurance products should be referred to the Kansas Insurance Department, the SEC and the NASD. These regulatory organizations already have the authority and the expertise to deal with any alleged illegal activity associated with the manufacture or sale of variable insurance products. In cases where illegal activity is confirmed, the perpetrators should be punished accordingly.

Summary of Position

- By defining variable life insurance and variable annuities as "securities," HB 2613 would subject these products to the Kansas Securities Code for the first time and would move Kansas from the majority to the minority of states.

- HB 2347 would disrupt a coordinated system of state and federal regulation established by the U.S. Supreme Court.

- HB 2613 would strip the Kansas Insurance Commissioner of her long-standing sole and exclusive authority to regulate the issuance and sale of variable life insurance and variable annuities. The Insurance Department has both the statutory and regulatory authority as well as the experience and expertise to protect consumers in the sale of variable insurance products. No dilution of their jurisdiction is warranted.

- Two national legislative organizations, ALEC and NCOIL, have both adopted Resolutions opposing the type of amendments proposed by HB 2613.

- Variable life insurance and variable annuities are one of the most heavily regulated financial products in today's broad marketplace. The bill would impose a fourth layer of regulation on variable life insurance and variable annuities on top of comprehensive SEC, NASD, and state insurance regulation.

- The bill would cause duplicate regulation of the same product under the Kansas Insurance and Securities Codes.

- The need for amendments to the Kansas Securities Code and the Kansas Insurance Code has not been justified.

For the reasons stated above, the committee should reject HB 2613's proposed amendments to Kansas law. The committee should decline to pass the bill.

Thank you for the opportunity to offer comments on Kansas HB 2613.

THE STATUS OF VARIABLE CONTRACTS UNDER STATE SECURITIES AND INSURANCE LAWS			
State	**Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts**	**Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"**	**Other Parallel Exclusions from State Securities Code**
Alabama	§27-38-4	[4]	§ 8-6-2(10)
Alaska	§21.42.370(k)	§45.55.990 (32)	
Arizona	§20-651 (l)	[5]	
Arkansas	§23-81-405	§23-42-102(15)(B)	
California	§10506(h)	§25019	
Colorado	§10-7-404 (l)	§11-51-201 (17)	
Connecticut	§ 38a-433(c)	§36b-3(17)	
Delaware	§2932(d)	§7302(13)	
D.C.	§31-4442(f)	[6]	
Florida	§ 627.805	[7]	

[4] Definition of "security" in Alabama includes "annuity contract **unless** issued by an insurance company."[*See,* §8-6-2(10)]. Variable annuities issued by a life insurance company, therefore, are excluded from the definition of security in Alabama.

[5] No categories of any kind are excluded from the definition of security in Arizona. [*See*, § 44-1801(26)].

[6] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in the District of Columbia. [*See*, §31.5601.01(31)(A)].

[7] No categories of any kind are excluded from the definition of security in Florida. [*See*, §517.021(19)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
Georgia	§33-11-65(h)	[8]	
Guam	§12204	§46401(l)	
Hawaii	§431:10D-118(d)	[9]	
Idaho	§41-1939(1)	§30-1402(12)	Bulletin 88-9
Illinois	5/245.24	[10]	
Indiana		§23-2-1-1(k)(1)	
Iowa	§508A.4	§502.102(19)	
Kansas	§40-436(l)	§17-1252(j)	
Kentucky	§304.15-390(7)	[11]	
Louisiana	§1500(J)	[12]	

[8] Georgia statute refers only to variable *annuities* in the exclusion from the definition of security. Therefore, variable life insurance contracts are technically not within the exclusion, although exclusion of both variable annuities and variable life insurance contracts was probably intended by legislature. [*See*, §10-5-2(26)].

[9] Definition of "security" in Hawaii does not include any insurance or endowment policy or fixed *annuity* contract. Variable *life* insurance, therefore, is excluded from definition. [*See*, §485-1(13)].

[10] No exclusion from the definition of security for any type of insurance, endowment, or annuity contracts in Illinois. [*See*, §2.1].

[11] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Kentucky [*See*, §292.310(18)].

[12] Fixed insurance endowment and annuity contracts are excluded from the definition of security in Louisiana. The Louisiana statute also refers to variable annuity contracts in the exclusion from the definition of security. [*See*, §51:702(15)(6)(i)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
Maine	§2537(12)	§10501(18)	
Maryland	§16-601(b)	§11-101(r)(2)	
Massachusetts	§132G	§401(k)	
Michigan	§ 500.925, § 500.4000	§451.801(z)	
Minnesota	§§61A.18, 61A.20	§80A.14(18)(a)(l)	
Mississippi	§83-7-45	§75-71-105(n)	
Missouri	§376.309(6)	§409.401(o)	
Montana	§33-20-602	[13]	
Nebraska	§44-2220	§8-1101(15)	
Nevada	§ 688A.390(4)	[14]	
New Hampshire	§408:52	§421-B:2(XX)(a)	
New Jersey	§ 17B:28-14	§ 49:3-49(m)	

[13] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Montana. [*See*, §30-10-103(22)(b)].

[14] Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Nevada. [*See*, §90.295(1)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
New Mexico	§59A-20-30(E)	[15]	Opinion No. 69-97 Reaffirms Exclusive Authority of Insurance Commissioner and precludes Securities Commissioner jurisdiction
New York	§4240(7)	[16]	
North Carolina	§58-7-95(r)	§78A-2(11)	
North Dakota		[17]	
Ohio	§3911.011(C)	[18]	

[15] No exclusion from the definition of security for any type of insurance, endowment, or annuity contracts in New Mexico. [See, §58-13B-2(X)].

[16] The New York statutes do not specifically define "securities" in a manner similar to other states. Section 352, which grants investigate power to the attorney general, defines security as "...any stocks, bonds, notes, evidences of interest or indebtedness or other securities, including oil and mineral deeds or leases and any interest therein ... or negotiable documents of title, or foreign currency orders, calls or options therefore hereinafter called security or securities...." *See* N.Y. Gen. Bus. Law §352(1).

[17] No categories of any kind excluded from definition of security in North Dakota. [*See*, §10-04-02(15)].

[18] No categories of any kind excluded from definition of security in Ohio. [*See,* §1707.01(B)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
Oklahoma	§6061(D)[19]	§71-1-2(w)	
Oregon		§59.015(19)(b)(A)	
Pennsylvania	§506.2(d)[20]	§1-102(t)(iii)	
Puerto Rico	§1334[21]	[22]	
Rhode Island	§27-32-7	[23]	
South Carolina	§38-67-40	§35-1-20 (15)	

[19]The statute's grant of exclusive jurisdiction to the Insurance Commissioner is unique in additionally stating that "the companies which issue them [variable contracts] and the agents or other persons who sell them shall not be subject to the Oklahoma Securities Act nor to the jurisdiction of the Oklahoma Securities Commission thereunder."

[20]The statute's grant of exclusive jurisdiction to the Insurance Commissioner has a unique added sentence which states: "Variable contracts, and agents or other persons who sell variable contracts, shall not be subject to the act of December 5, 1972 (P.L. 1280, No. 284), known as the 'Pennsylvania Securities Act of 1972,' or to regulation by the Pennsylvania Securities Commission."

[21]This section states that "[t]he Commissioner shall have authority to prescribe appropriate rules and regulations to carry out the purposes and provisions of sections 1301, 1329 and 1330 of this title." §1335 also states that "[t]he powers granted to the Securities Office of the Treasury Department under sections 851-895 of Title 10 known as Uniform Securities Act, with regard to the regulation and supervision of all the aspects of the variable annuities insofar as they are securities, shall in no wise [sic] be affected upon the taking effect of this section and sections 1329—1334 of this title. These securities, the variable annuities, shall continue under the coverage of the Securities Act and the regulations approved under said statute."

[22]Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in Puerto Rico. [*See*, §881(1)].

[23][*See*, §7-11-101(20)(i)] Only fixed insurance, endowment and annuity contracts excluded, but §7-11-101(20)(ii) excludes group *variable* contracts subject to ERISA.

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
South Dakota	§58-28-31[24]	[25]	
Tennessee	§56-3-508	§48-2-102(13)(E)	
Texas	Art. 3.75(8)	Art. 581-4(A)	
Utah	§31A-5-217.5(6)	§61-1-13(24)(b)(i)	
Vermont	§3858	[26]	
Virginia		§13.1-501(A)	

[24]The provision granting the Insurance Commissioner exclusive jurisdiction to regulate variable contracts reflects the language of the NAIC Model Variable Contract Statute, but also contains two additional unique sentences stating that "The division of securities may, upon request by the director, review the underlying investments in securities of variable contracts. The division of securities may require filing a disclosure document with the division of securities pursuant to chapter 47-31A." *But see*, South Dakota Insurance Bulletin 93-2 (Revised December 17,1993), which states that "Over the past year, the Division of Securities has reviewed the [variable] products for compliance with specific securities requirements. For the most part, the Division of Securities has found that the products meet its requirements and that nothing out of the ordinary is disclosed in the filings. In an attempt to conserve regulatory resources, the Division of Securities will no longer review variable products. The Division will continue to assert its jurisdiction over the variable agents, requiring registration as it always has, and will enforce the anti-fraud provisions of the law against violators."

[25]Only fixed insurance, endowment and annuity contracts are excluded from the definition of security in South Dakota. [*See*, §47-31A-401(m)].

[26]No categories of any kind are excluded from the definition of security in Vermont. [*See,* §4202(a)(16)].

State	Statute Granting Insurance Commissioner Exclusive Jurisdiction to Regulate Variable Contracts	Complete Exclusion from State Securities Code for *All* Insurance, Endowment and Annuity Contracts. Occurs Through Exclusion from the Definition of "Security"	Other Parallel Exclusions from State Securities Code
Washington	§13.1-501[27]		
West Virginia	§33-13A-4	§32-4-401(n)	
Wisconsin	[28]	§551.02(13)(b)	
Wyoming	§26-16-502(d)	§17-4-113(a)(xi)	

[27]Although granting the insurance commissioner sole authority to regulate the issuance and sale of variable contracts, the provision further states that the insurance commissioner shall not have jurisdiction "for the examination, issuance or renewal, suspension or revocation, of a security salesman's license issued to persons selling variable contracts. To carry out the purposes and provisions of this chapter he or she may independently, and in concert with the director of financial institutions, issue such reasonable rules and regulations as may be appropriate."

[28]§611.24 of the Wisconsin Insurance Code grants the Insurance Commissioner significant authority to regulate variable contracts, but lacks reference to the insurance commissioner's "sole" or "exclusive" jurisdiction as contained in other insurance codes or the NAIC Model Variable Contract Statute.

NUMERICAL SUMMARY OF VARIABLE CONTRACT STATUS CHART	
# of jurisdictions granting Insurance Commissioner *exclusive jurisdiction* to regulate the issuance and sale of variable annuities and variable life insurance contracts	48
# of jurisdictions excluding *all* insurance endowment and annuity contracts from the definition of "Security" in state securities code	34/37[29]
# of jurisdictions *specifically* defining variable annuity and variable life insurance contracts as a "Security" in state securities code (i.e., these states have inserted the optional bracketed language "[a fixed sum of]" from § 401(l) of the USA of 1956.	8[30]
# of jurisdictions excluding *no* categories of any kind from the definition of "Security" in state securities code	6[31]
# of jurisdictions having *no* exclusion from the definition of "Security" for *any* type of insurance, endowment or annuity contract (i.e., fixed *and* variable insurance, endowment or annuity contracts are defined to be securities).	2[32]

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[26]The total of 37 could be used for this category, but needs explanation because in four states the definitional exclusions do not include *all* variable insurance, endowment or annuity contracts.

- The definition of "security" in Alabama includes "annuity contract **unless** issued by an insurance company."[*See,* §8-6-2(10)]. Variable annuities issued by a life insurance company, therefore, are excluded from the definition of security in Alabama.

- The Georgia statute refers only to variable *annuities* in the exclusion from the definition of security. Therefore, variable life insurance contracts are technically not within the exclusion, although exclusion of both variable annuities and variable life insurance contracts was probably intended by legislature. [*See*, §10-5-2(26)].

- The definition of "security" in Hawaii does not include any insurance or endowment policy or fixed *annuity* contract. Variable *life* insurance, therefore, is excluded from definition. [*See*, §485-1(13)].

- The Louisiana statute also refers to variable annuity contracts in the exclusion from the definition of security. [See, §51:702(15)(6)(i)]

[30]These states are: DC, KY, MT, NV, PR, RI, SD and WA. There is a qualification to one state in this category. RI excludes from the definition of security *group* variable contracts subject to ERISA.

[31]These states are: AZ, FL, ND, NY, OH, and VT.

[32]These states are: IL and NM.

Resolution in Support of Insurance Commissioners' Exclusive State Regulatory Authority over Variable Life Insurance and Variable Annuities

Whereas variable life insurance and variable annuities are subject to a comprehensive federal and state regulatory structure, enforced by state insurance commissioners, the Securities and Exchange Commission and the National Association of Securities Dealers, which covers these products from design through their marketing and sale and;

Whereas an overwhelming majority of the states give their insurance commissioners exclusive state jurisdiction to regulate the issuance and sale of variable life insurance and variable annuities and;

Whereas an overwhelming majority of the state securities laws exempt variable life insurance and variable annuities from state securities regulation and;

Whereas variable life insurance and variable annuities are among the most heavily regulated products in today's financial services marketplace and;

Whereas there has been no demonstration of empirical statistical evidence of abuses in the marketing and sale of variable life insurance and variable annuities and;

Whereas there has been no evidence presented that state insurance commissioners are unable or unwilling to effectively and comprehensively regulate variable life insurance and variable annuities and;

Whereas a streamlined, efficient system of regulatory oversight is necessary for insurers and producers to be competitive in today's rapidly evolving financial services marketplace and;

Whereas the National Conference of Commissioners on Uniform State Laws (NCCUSL) has adopted the Uniform Securities Act (2002) which, among other things, allows each legislature to determine whether to include variable life insurance and variable annuities within the definition of the term "security" and;

Whereas NCCUSL rejected a proposal that would have expressly brought variable life insurance and variable annuities within the definition of the term "security," which would have subjected these products and the producers who sell them to an unnecessary, redundant and inconsistent layer of oversight by state securities commissioners and;

House Financial Institutions
2-18-04
Attachment 8

Whereas in the upcoming legislative sessions, state legislatures may be considering legislation to revise their laws to conform with the Uniform Securities Act (2002) and;

Whereas the members of these state legislatures may be looking for guidance on this issue;

Now, therefore, be it resolved that the American Legislative Exchange Council endorses and supports state insurance commissioners having exclusive authority at the state level over the regulation of the issuance, marketing and sale of variable life insurance and variable annuities, and opposes any state legislation or regulation that would grant state securities regulators jurisdiction over the issuance and sale of such products or that would define variable life insurance or variable annuities as "securities" under state law.

Adopted by the ALEC Board of Directors April 2003.

PRESIDENT: SEN. WILLIAM J. LARKIN, JR., NY
VICE PRESIDENT: REP. CHRIS LIESE, MO
SECRETARY: REP. KATHLEEN KEENAN, VT
TREASURER: SEN. STEVEN GELLER, FL

RESOLUTION IN SUPPORT OF INSURANCE COMMISSIONERS' EXCLUSIVE STATE REGULATORY AUTHORITY OVER VARIABLE LIFE INSURANCE AND VARIABLE ANNUITIES

Adopted by the NCOIL State-Federal Relations Committee and the NCOIL Executive Committee on February 21, 2003.

WHEREAS, variable life insurance and variable annuities are subject to a comprehensive federal and state regulatory structure, enforced by state insurance commissioners, the Securities and Exchange Commission and the National Association of Securities Dealers, which covers these products from design through their marketing and sale; and

WHEREAS, an overwhelming majority of the states give their insurance commissioners exclusive state jurisdiction to regulate the issuance and sale of variable life insurance and variable annuities and

WHEREAS, an overwhelming majority of the state securities laws exempt variable life insurance and variable annuities from state securities regulation; and

WHEREAS, variable life insurance and variable annuities are among the most heavily regulated products in today's financial services marketplace; and

WHEREAS, there has been no demonstration of empirical statistical evidence of abuses in the marketing and sale of variable life insurance and variable annuities; and

WHEREAS, there has been no evidence presented that state insurance commissioners are unable or unwilling to effectively and comprehensively regulate variable life insurance and variable annuities; and

WHEREAS, a streamlined, efficient system of regulatory oversight is necessary for insurers and producers to be competitive in today's rapidly evolving financial services marketplace; and

WHEREAS, the National Conference of Commissioners on Uniform State Laws (NCCUSL) has adopted the Uniform Securities Act (2002) which, among other things, allows each legislature to determine whether to include variable life insurance and variable annuities within the definition of the term "security"; and

EXECUTIVE COMMITTEE CHAIR: REP. CRAIG EILAND, TX; EXECUTIVE COMMITTEE: REP. SHERYL ALBERS, WI; REP. GLENN ANSARDI, LA; DEL. J.D. BEANE, WV; REP. SHIRLEY BOWLER, LA; SEN. THOMAS BOZEK, CT; SEN. NEIL BRESLIN, NY; SEN. THOMAS BUFORD, KY; REP. LON BURNAM, TX; ASSEM. NANCY CALHOUN, NY; REP. JAMES COLVIN, VT; REP. ROBERT DAMRON, KY; REP. GREGORY DAVIDS, MN; SEN. BOB DEARING, MS; SEN. FRANK DEEM, WV; REP. ANTHONY DELUCA, PA; SEN. PATRICK DELUHERY, IA; SEN. DAVID DONLEY, AK; SEN. ROBERT DUNCAN, TX; SEN. JOANNE EMMONS, MI; REP. DAVID EVANS, OH: ASSEM. DONNA FERRARA, NY; SEN. LIZ FIGUEROA, CA; REP. RICH GOLICK, GA; REP. BEN HARBIN, GA; SEN. BILLY HEWES, MS SEN. JAY HOTTINGER, OH: REP. GEORGE KEISER, ND; REP. BRIAN KENNEDY, RI; SEN. DEAN KIRBY, MS; SEN. JERRY KLEIN, ND; SEN. MARY KRAMER, IA; REP. RICHARD LAIRD, AL; SEN. DAVID LANDIS, NE; SEN. CAL LARSON, MN: REP. ALLAN LAYSON, AL; SEN. JAMES LEWIS, JR., IN; REP. JIMMY LORD, GA; SEN. GLENN F. MCCONNELL, SC; REP. ANTHONY MELIO, PA; REP. JANET METCALF, IA: REP. VIRGINIA MILKEY, VT: REP. PHIL MONTGOMERY, WI; SEN. FRANK MRVAN, IN: SEN. JOHNNY NUGENT, IN; SEN. ALAN NUNNELEE, MS; SEN. EDWARD OLIVER, MN; REP. TIMOTHY OSMOND, IL; ASSEM. LOU PAPAN, CA; SEN. PAMELA REDFIELD, NE; REP. ANDREW RICHNER, MI; REP. STEVE RIGGS, KY; SEN. BEN ROBINSON, OK; SEN. EDWARD E. SALEEBY, SC; REP. ALAN SANBORN, MI; SEN. DALE SCHULTZ, WI; SEN. DAN SEUM, KY; SEN. JAMES SEWARD, NY; SEN. DAVID SIBLEY, TX; REP. MIKE SMITH, IN; REP. THOMAS T WARD, MO; REP. LESLIE WATERS, FL; SEN. KATHERINE WELLS-WHEELER, NH; REP. MARK YOUNG, VT; PAST PRESIDENTS AND MEMBERS IL; ASSEM. CLARE FARRAGHER, NJ; REP. DAVID COUNTS, TX; REP. LEO W. FRASER JR., NH; SEN. HARVEY TALLACKSON, ND; SEN. HAROL MACKIN: DEPUTY EXECUTIVE DIRECTOR: SUSAN NOLAN; NATIONAL OFFICE: 139 LANCASTER STREET, ALBANY, NY 12210-1903; TEL: 518
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WHEREAS, NCCUSL rejected a proposal that would have expressly brought variable life insurance and variable annuities within the definition of the term "security," which would have subjected these products and the producers who sell them to an unnecessary, redundant and inconsistent layer of oversight by state securities commissioners; and

WHEREAS, in the upcoming legislative sessions, state legislatures may be considering legislation to revise their laws to conform with the Uniform Securities Act (2002); and

WHEREAS, the members of these state legislatures may be looking for guidance on this issue,

NOW, THEREFORE, BE IT RESOLVED, that the National Conference of Insurance Legislators endorses and supports state insurance commissioners having exclusive authority at the state level over the regulation of the issuance, marketing and sale of variable life insurance and variable annuities, and opposes any state legislation or regulation that would grant state securities regulators jurisdiction over the issuance and sale of such products or that would define variable life insurance or variable annuities as "securities" under state law.

A·C·L·I AMERICAN COUNCIL OF LIFE INSURERS
FINANCIAL SECURITY FOR LIFE

SUITABILITY

How Current Standards Protect Consumers and Ensure Appropriate Sales

Duty To Determine Suitablity

NASD Rule 2310 establishes a suitability obligation for broker-dealers whenever the firm or its registered representative makes a "recommendation" to a customer.

- The rule requires a broker-dealer to have reasonable grounds, when making a recommendation to a customer, for believing that the recommendation is suitable for the customer upon the basis of facts, if any, disclosed by such customer as to his security holdings and as to his financial situation and needs.
- The rule requires a broker-dealer to make "reasonable efforts" to obtain information from a customer, prior to executing a transaction, concerning the customer's: financial status, tax status investment objectives, and such other information used or considered to be reasonable by the broker-dealer or registered representative in making the recommendation to the customer.
- The information must be recorded and preserved.

Requirement for Principal Sign-off

NASD Conduct Rule 3010 (a) requires every broker-dealer to establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Supervision—NASD Conduct Rule 3010(b) requires each broker-dealer to establish and maintain systems to supervise the activities of each registered representative and associated person in order to achieve compliance with the securities laws and NASD rules.

NASD Guidelines

NASD NTM 96-86 reiterates suitability requirements in the sale of variable products and identifies factors that should be considered in selling a variable annuity, including the customer's:

- Representation that their life insurance needs are already adequately met.
- Express preference for an investment other than an insurance product.
- Inability to fully appreciate how much of the purchase payment or premium is allocated to cover insurance or other costs.
- Ability to understand the complexity of variable products generally.
- Willingness to invest a set amount on a yearly basis.
- Need for liquidity and short-term investment.
- Need for retirement income.
- Investment sophistication and ability to monitor the investment experience of the separate account.

NASD NTM 99-35 provides detailed suitability guidance in variable annuity sales, and notes that when recommending a variable annuity, broker-dealers and or registered representatives should make reasonable efforts to obtain comprehensive customer information about:

- Occupation
- Marital status
- Age
- Number of dependents
- Investment objectives
- Risk tolerance
- Tax status
- Previous investment experience
- Liquid net worth
- Other investments and savings
- Annual income

The notice instructs that the variable annuity contract as a whole and the underlying sub-accounts should be suitable.

NASD NTM 01-23 established broad criteria for determining whether a customer communication is a recommendation subject to suitability requirements, and covers online communications.

NASD IM-2210-2 establishes guidelines for advertisements and sales literature about variable life insurance and variable annuities that help assure suitable sales and informed purchase decisions.

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Additional NASD Guidance

NASD NTM 99-45 provides guidance on broker-dealer supervisory procedures and systems, which must be tailored specifically to the business conducted and cover all registered representatives, and may include automated exception reports and surveillance programs monitoring unusual activity.

IMSA Guideposts.

Over 200 life insurers representing 65 percent of the industry are members of the Insurance Marketplace Standards Association, which has detailed standards involving customer needs, financial objectives, and replacements in the distribution of insurance products. Code A of IMSA Principal 1 states that insurers should implement policies and procedures designed to provide reasonable assurance that:

- The insurer believes the financial objectives of its customers are determined based upon relevant information obtained from the customer and the company enters into transactions which assist the customer in meeting his or her insurable needs or financial objectives.
- IMSA encourages fact-finding tools for determining customers' insurable needs or financial objectives, which could include:
  - Questionnaires
  - Software packages
  - Financial plans
  - Customer profiles
  - Capital needs analyses
  - Financial needs analyses
- IMSA standards also instruct to its members to monitor, on an individual or trend basis, that independent and captive distributors make determinations of customers' insurable needs or financial objectives, and take corrective action, where appropriate. Among other things, IMSA members:
  - Use fact-finding tools in the company's report and recognition system for independent and captive distributors.
  - Monitor lapse trends as an indicator of whether customers' insurable needs have been addressed, and take corrective action, appropriate.
  - Seek to identify potential undisclosed replacements through detailed replacement reports, and take corrective action, where appropriate.

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Kevin R. Davis
Government Affairs Counsel

February 18, 2004

The Honorable Ray Cox
Chair, House Financial Institutions Committee

On behalf of American Family Insurance Group we want to express our opposition to HB 2613 which would subject variable life insurance and variable annuities to the Kansas Securities Code. This imposes additional regulation on insurers and agents, who already must have an insurance license, a series 6 license, and a series 63 license, to sell these products in Kansas. We believe that establishing another layer of regulation or an additional regulator to a system that already has appropriate state and federal regulation is an unnecessary burden.

As you know currently these products are filed with both the Insurance Department and the SEC. The SEC also regulates the sales of these products through the NASD, with which our agents and broker/dealers are and must be registered. We support one state regulator, the Insurance Department, to fulfill this function. If there is a concern about the capability of the Insurance Department to fulfill their regulatory obligation, we suggest that a review of the Department is in order, rather than mandating a new or additional regulator.

Attached is a letter from the National Association for Variable Annuities to the NAIC which gives more specifics on our rationale to maintain regulation through the Insurance Department. The promulgation of the model securities law by the NCCUSL has thrust the regulation of variable annuities before the legislature. While we can support the uniform securities law, we note that the NCCUSL did not make a recommendation on the issue of variable annuity regulation which they left to the individual states. The uniform securities law is being considered in HB 2347.

We hope that you and your committee will support leaving the regulatory control of variable annuities with the Insurance Commissioner and the NASD and not allow additional burdensome regulations.

We respectfully request you vote **NO** on HB 2613.

Thank you for your consideration of our position.

KEVIN R. DAVIS
American Family Insurance Group

NATIONAL ASSOCIATION FOR VARIABLE ANNUITIES

March 3, 2003

Ms. Carolyn Johnson Speck
Senior Counsel and Model Laws Coordinator
NAIC Legal Division
National Association of Insurance Commissioners
2301 McGee, Suite 800
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The Honorable Lawrence H. Mirel
Commissioner of Insurance and Securities, District of Columbia and
Chair, Variable Annuities Functional Regulation Working Group
D.C. Department of Insurance and Securities Regulation
810 First Street, NE, Suite 701
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RE: **Statement of Position on Regulation of Variable Insurance Products**

Dear Ms. Johnson and Commissioner Mirel:

NAVA appreciates the opportunity to offer its views on the issue of the regulation of variable insurance products and their sellers by state securities departments.

NAVA is a not-for-profit organization which represents all segments of the variable annuity and variable life insurance industry. NAVA's membership includes substantially all of the major participants in the variable insurance products industry with over 350 member organizations, including insurance companies, investment management firms, banks, brokerage houses and other distributors of variable products.

Background

In August 2002, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") adopted an updated version of the Uniform Securities Act, which, among other things, leaves it up to each individual state to decide whether to include variable insurance products within the definition of the term "security." The North American Securities Administrators Association ("NASAA") has sought the support of the NAIC in its efforts to subject variable insurance products and the persons who sell them to state securities department jurisdiction.

Statement of Position

We believe that imposing another layer of overlapping and potentially conflicting regulation on top of the comprehensive and well-established existing regulatory framework, already proven effective for investor protection, would create a burden for the industry that far outweighs any potential benefit.

The sale of variable insurance products is presently subject to a well thought out regulatory system. On the state level, in order to sell variable contracts on behalf of an insurer, a person must generally obtain a variable products insurance license in each state in which he or she operates. State insurance departments exercise considerable authority over licensees and may impose fines and 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. There has been no showing that state insurance regulators have not effectively discharged their responsibilities.

In addition to being governed under this state regulatory framework, sales of variable products are also regulated as securities pursuant to a comprehensive regulatory framework under the federal securities laws. As securities under federal law, variable contracts are required to be registered as such under the Securities Act of 1933. Distributors of variable contracts must register with the Securities and Exchange Commission ("SEC") as broker-dealers pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Broker-dealers and individual producers, or registered representatives, are subject to extensive operational, financial and sales practice rules that cover, among other things, minimum net capital requirements, reporting, recordkeeping, supervision, advertising, and sales activities. The SEC has broad enforcement authority over registered representatives selling variable products, as well as their supervisors.

Registered broker-dealers selling variable products must also become members of the National Association of Securities Dealers, Inc. ("NASD"). The NASD is a self-regulatory organization charged with regulating broker-dealers and is overseen by the SEC.[1] Members of the NASD must comply with an extensive series of rules, including, most notably, rules relating to fair dealing, suitability and supervision.

[1]The NASD describes itself on its web site as follows: "As the world's leading private-sector provider of financial regulatory services, NASD has helped bring integrity to the markets - and confidence to investors - for more than 60 years. Under federal law, virtually every securities firm doing business with the US public is a member of this private, not-for-profit organization. Roughly 5,300 brokerage firms, over 92,000 branch offices and more than 664,000 registered securities representatives come under our jurisdiction. NASD registers member firms, writes rules to govern their behavior, examines them for compliance and disciplines those that fail to comply". Statement from the NASD's web site, http://www.nasd.com (visited on February 25, 2003).

NASD Conduct Rule 2110 provides that a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade. This concept is further defined in interpretative guidance relating to the suitability rule to be discussed below. IM-2310-2 imposes a duty of fair dealing with customers. IM-2310-2(a) (1) states:

> Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public.

This obligation to deal fairly with customers is the foundation for the NASD's conduct rules regarding the making of suitable recommendations to customers. NASD Conduct Rule 2310 provides:

"(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer,[2] other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;
(2) the customer's tax status;
(3) the customer's investment objectives; and
(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer".

In summary, Conduct Rule 2310 requires broker-dealers to recommend a security only when the broker-dealer reasonably believes that the security is suitable for the customer, and places upon the broker-dealer an affirmative duty of inquiry.

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[2]Conduct Rule 2310(c) defines a "non-institutional customer" as a customer that does not qualify as an "institutional account" under Conduct Rule 3110(c)(4). Conduct Rule 3110(c)(4), in turn, includes as institutional accounts banks, insurance companies, registered investment companies, investment advisers registered under the Investment Advisers Act of 1940 or with a state securities commission, and investors with total assets of at least $50 million.

The NASD has issued several interpretations of its suitability rule specifically as it applies to the sale of variable annuities and variable life insurance.[3] In Notice to Members 98-86 ("NASD Regulation Reminds Members And Associated Persons That Sales Of Variable Contracts Are Subject To NASD Suitability Requirements"), the NASD provides a list of factors regarding a recommendation to purchase variable products that could be considered under suitability rules. NASD Notice to Members 99-35 ("The NASD Reminds Members Of Their Responsibilities Regarding The Sales Of Variable Annuities") identifies areas of concern that the NASD expects to be addressed in the supervisory procedures of member firms that sell variable annuities. Among the guidelines identified are:

- ***Customer Information.*** Broker-dealers and their registered representatives should make reasonable efforts to obtain comprehensive customer information. A registered representative should discuss all relevant facts with the customer, including liquidity issues, fees, applicable premium taxes, and market risk. When a variable annuity transaction is recommended, the registered representative and a registered principal should review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying subaccounts recommended to the customer are suitable.

- ***Product Information.*** The guidelines indicate that registered representatives should have a thorough knowledge of each variable annuity that is recommended. To the extent practical, a current prospectus should be given to the customer when a variable annuity is recommended. Prospectus information about important factors should be discussed with the customer. Registered representatives may use only approved sales material.

- ***Liquidity and Earnings Accrual.*** The guidelines indicate that variable annuities may be unsuitable for customers with short-term investment objectives. A registered representative should make sure that the customer understands applicable surrender charges and tax penalties. The broker-dealer should develop special procedures to screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a specific age, since depending on certain contract features some customers of advanced age may be unsuitable for a variable annuity investment.

- ***Income, Net Worth, and Contract Size Thresholds.*** The guidelines provide that broker-dealers should establish procedures to require a principal's review of variable annuity investments that exceed a stated percentage of the customer's net worth and any contract in which a customer is investing more than a stated dollar amount.

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[3] See Notice to Members 96-86 (December 1996); Notice to Members 99-35 (May 1999); Notice to Members 00-44 (July 2000).

- ***Investment in Tax Qualified Accounts.*** The guidelines also address situations in which a registered representative recommends the purchase of a variable annuity for a tax-qualified retirement account (*e.g.*, 401(k) plan, IRA). The guidelines indicate first that the representative should disclose to the customer that tax deferral is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. Then, according to the guidelines, the representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.

- ***Variable Annuity Replacements.*** The guidelines suggest that broker-dealers should develop an exchange or replacement form. The form should, among other things, include an explanation of the benefits of replacing one contract for another variable contract, and should be signed by the customer, registered representative, and registered principal. The representative and principal should determine that replacing the existing contract is suitable. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges. The guidelines indicate that the broker-dealer should consider developing compliance systems, such as computer programs, that can monitor and identify registered representatives with high rates of exchange activity.

Similar guidance was provided in regard to the sale of variable life insurance contracts in Notice to Members 00-44 ("The NASD Reminds Members Of Their Responsibility Regarding The Sale Of Variable Life Insurance").

Perhaps the cornerstone of the NASD's regulation of the sale of securities, including variable products, is its requirement that broker-dealers establish comprehensive supervision procedures. The duty to supervise covers all activities of the broker-dealer's registered representatives and is taken very seriously by member firms.

The supervision performed by registered broker-dealers begins when a registered representative is first hired. A Form U-4 containing complete background information on the registered representative must be sent to the NASD at the time of hire. Similarly, the broker-dealer must file a Form U-5 upon the termination of a registered representative, detailing any disciplinary action that has been taken. These documents are reviewed carefully by the NASD. Broker-dealers are also responsible for ensuring the proper training and continuing education of registered representatives engaged in the solicitation or sale of variable insurance products.

NASD Conduct Rule 3010 requires registered broker-dealers to establish a rigorous system of supervision built upon offices of supervisory jurisdiction (OSJs) that bring a structured framework to the management of field sales conduct. Registered principals within each OSJ carry out supervisory responsibilities such as:

- the maintenance and enforcement of written supervisory procedures and compliance manuals;
- review and approval of all customer transactions;
- periodic examination of customer accounts;
- branch office inspections;
- review and endorsement of the correspondence of registered representatives; and
- approval of all advertising and sales materials.

The NASD has recently moved to further strengthen its supervision requirements by proposing new NASD Conduct Rule 3012 which would require members to develop general and specific supervisory control procedures that independently test, verify and modify, where necessary, the members' supervisory procedures, and amendments to Rule 3010 to require that office inspections be conducted by independent persons.[4]

The supervision performed by broker-dealers also extends to outside work performed by their registered representatives. NASD Conduct Rule 3030 provides that a registered representative may not be employed by, or accept compensation from, any other person as a result of any business activity outside the scope of his relationship with his employer firm unless he has provided prompt written notice. In addition, NASD Conduct Rule 3040 prohibits a registered representative from participating in a "private securities transaction" for compensation unless he has first received approval from his employer firm to participate in the transaction. Broker-dealers carefully review any such outside activity and private securities transactions and will not permit their registered representatives to conduct outside business or participate in private securities transactions that are deemed to be inappropriate.

Legal and compliance department personnel assist firm principals in meeting their supervisory responsibilities by participating in the development of written policies and procedures, providing regulatory and legal advice, conducting regular branch office examinations, and investigating indications of irregular activity.

The NASD oversees member firms' compliance efforts and supervisory procedures through the examination process. The NASD examines broker-dealers on a periodic cycle, ranging from annually to once every four years, depending on the business of the firm. Violations can result in deficiency letters, enforcement actions, fines, suspensions and revocations of licenses. The NASD has conducted a series of special examinations over the last few years that focused on the sale of variable contracts and has issued various alerts to both firms and investors to help ensure that these products are properly sold. Enforcement actions have been initiated where indicated and include both the

[4] Securities and Exchange Commission: Self-Regulatory Organizations, National Association of Securities Dealers, Inc., Notice of Filing of Proposed Rule Change Relating to Supervisory Control Amendments, 67 Fed. Reg. 70990 (November 20, 2002).

registered representative making an allegedly unsuitable recommendation and the registered broker-dealer. Fines for violations have been substantial.[5]

In addition to NASD oversight, the SEC is authorized under Section 15(b) of the Exchange Act to sanction a broker-dealer and its associated persons for "fail[ing] reasonably to supervise" another person. This examination process and the filing of enforcement actions in appropriate cases serve as a constant reminder to broker-dealers and their registered representatives of the critical importance of comprehensive supervisory procedures to detect and prevent potential sales practice abuses. In those instances where the NASD or SEC find that a particular firm's supervisory procedures are deficient, existing authority adequately empowers the NASD and SEC to require that corrective action be taken.

Conclusion

There has been no showing that the existing comprehensive framework of state and federal regulation of the sale of variable insurance products has been inadequate to protect the public interest or that state insurance commissioners, the NASD and SEC have not effectively carried out their regulatory responsibilities. Accordingly, NAVA and its members respectfully request that the NAIC adopt a position that the current state and regulatory oversight is adequate and that additional oversight by state securities departments is unnecessary.

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Thank you for your consideration of our comments on this issue. If we can answer any questions or be of further assistance, please call me at (703) 707-8830, extension 20, or Judith Hasenauer at (954) 771-7909. Ms. Hasenauer chairs NAVA's Regulatory Affairs Committee.

Sincerely,

Michael P. DeGeorge

Michael P. DeGeorge
General Counsel

[5] On December 4, 2002, the NASD announced that it had fined a member company $350,000 for sales practice and supervision violations in connection with its sales of variable annuities and variable life insurance products. In 1999, a fine of $20,000,000 was assessed against a member company for violations relating to the offer and sale of variable life insurance policies.

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MEMO

TO: Chairman Ray Cox

FROM: Kathy Damron, Prudential

DATE: February 18, 2004

Mr. Chairman, I appreciate having the opportunity to convey the opposition of Prudential to HB 2613, defining variable annuities as a security. This has been a policy question analyzed by the company, the industry and policymakers throughout the country. In Kansas, the issue was considered and rejected during consideration of HB 2347, the Uniform Securities Act. This decision was made after a number of years of careful consideration and analysis. The compelling arguments in opposition to the change contemplated in HB 2613 include:

Variable annuities and variable life insurance are hybrid products with important insurance and securities components. The U.S. Securities and Exchange Commission regulates the securities features and State insurance commissioners in 48 jurisdictions have exclusive authority to regulate the insurance and variable annuities. These products are already subject to three layers of state and federal regulation. The addition of state securities jurisdiction would impose significant, unnecessary regulatory burdens on life insurers and their distributors.

In several 2003 actions, The American Council of Life Insurers sought to have the unique characteristics of variable products accommodated in several regulatory actions before the SEC and the NASD, including new rules or amendments concerning broker-dealer supervision, books and records standards, and the definition of "branch" office. ACLI obtained favorable treatment of variable contract financial certifications under Sarbanes-Oxley requirements, and sought clarification on the status of "split-dollar" insurance arrangements under that statue.

Thank you for your consideration of these matters.