

April 4, 2005

VIA ELECTRONIC MAIL

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

**Re: File No. S7-06-04; Release No. 34-51274
Reopening of Comment Period for
Point of Sale Disclosure and Confirmation Requirements**

Dear Mr. Katz:

We are submitting this letter on behalf of our client, the Committee of Annuity Insurers (the "Committee").¹ The letter responds to a supplemental request for comments by the Securities and Exchange Commission (the "Commission," or the "SEC") on Rules 15c2-2 and 15c2-3, the "point of sale" and "confirm" rules the Commission proposed just over one year ago (the "Proposed Rules").² The Proposed Rules would require broker-dealers to provide their customers with information regarding the costs and conflicts of interest that may arise from the distribution of mutual fund shares, 529 college savings plan interests, and variable insurance contracts ("covered securities").³

¹ The Committee of Annuity Insurers is a coalition of 30 life insurance companies that issue fixed and variable annuities. The Committee was formed in 1981 to participate in the development of federal securities law regulation and federal tax policy affecting annuities. The member companies of the Committee represent over half of the annuity business in the United States. A list of the Committee's member companies is attached as Appendix A. This comment letter addresses variable annuities only, since fixed annuities are not subject to the Proposed Rules.

² *Confirmation Requirements and Point-of-Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, and Other Confirmation Requirement Amendments, and Amendments to the Registration Form for Mutual Funds; Proposed Rule*, Securities Exchange Act Release No. 49148 (Jan. 29, 2004), 69 Fed. Reg. 6438 (Feb. 10, 2004) (the "Proposing Release").

³ While the Proposed Rules would govern both variable annuity contracts and variable life insurance policies, the Committee's comments in this letter address only variable annuity contracts.

The Commission recently asked for supplemental comments on the Proposed Rules in a wide-ranging release that posed over one hundred questions on a number of important issues, many of which were not addressed in the Proposing Release.⁴ The Committee appreciates the opportunity to respond to the Commission's supplemental request for comments. We hope this comment letter is useful, as it appears the Committee's earlier two detailed comment letters were.⁵ The Committee's earlier comment letters, together with other letters submitted by individual companies and industry trade groups, clearly helped to shape the Commission's understanding of how the Proposed Rules would impact variable annuity insurers. In this regard, the Committee commends the Commission for developing the new point of sale and transaction confirmation forms designed specifically for variable annuities that were included in the Reproposing Release.

Under the Reproposing Release, the Commission has taken a completely different tack with respect to two general disclosure themes: (1) revenue sharing and other non-commission forms of broker-dealer compensation, and (2) the overall "costs" of covered securities to the purchaser. Rather than disclosing revenue sharing and other non-commission compensation, and related conflicts of interest, in standard forms to be provided to broker-dealer customers at the point of sale or on confirmations, the Commission now proposes to require broker-dealers to disclose compensation and associated conflicts of interest on their websites, paper copies of which would be required to be made available to customers upon request. The scope of such an undertaking obviously would be significant.

With respect to the proposed requirement to disclose overall costs of a variable annuity contract to the purchaser of the contract, variable annuity point of sale disclosure forms would be required to disclose the potential range of costs for specified hypothetical

⁴ *Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds*, Securities Exchange Act Release No. 51274 (Feb. 28, 2005), 70 Fed. Reg. 10521 (Mar. 4, 2005). We note that the Commission appears not to have formally repropose the Proposed Rules in this release. However, the Commission included new point of sale and transaction confirmation forms on which the Commission "now propose[s] to require broker-dealers to disclose . . . comprehensive information." See *id.*, 70 Fed. Reg. at 10524. Because the proposed forms reflect some disclosure requirements that differ fundamentally from what would have been required by the Proposed Rules, the Commission's supplemental request for comments appears to amount to a reproposal of the rules; for ease of reference we refer to the new disclosure requirements as the "Reproposed Rules" and the Commission's release requesting supplemental comment on the Reproposed Rules as the "Reproposing Release."

⁵ See Letters from The Committee of Annuity Insurers to the SEC dated April 12, 2004 (the "April Letter") and July 30, 2004 (the "July Letter").

contract values, while confirmation forms would be required to disclose estimated first year costs based on the purchaser's actual investment amount. It appears that the change in focus to disclose overall costs to the purchaser, rather than disclosing just distribution-related costs, was driven primarily by consultant reports from focus group testing conducted by the SEC.

SUMMARY OF THE COMMITTEE'S COMMENTS

The Committee submits comments on three general topics: (1) increased cost disclosure in the point of sale and confirmation forms; (2) website disclosure of broker-dealer compensation; and (3) miscellaneous other issues.⁶ Some are general conceptual and/or policy issues, and others are more specific technical issues affecting variable annuities that may be particularly significant to Committee members.

1. Increased "Cost" Disclosure in Point of Sale and Confirmation Forms

In the Proposing Release, the Commission proposed to require broker-dealers to disclose only distribution-related costs. Investors participating in "focus groups" indicated that they wanted point of sale and confirmation disclosure forms to provide comprehensive information about all the costs of owning covered securities, not just distribution-related costs.⁷ In response, the Commission now proposes to require broker-dealers to disclose on the proposed new forms comprehensive information about all the costs of owning variable annuities. Disclosure of these costs would be required in both dollar terms and as a percentage of investment value.

The Committee agrees that it is critical for investors to understand the costs of owning any variable annuity contract. The Committee also agrees with the general notion that investors should have access to comprehensive cost information at the point of sale and thereafter. However, the Committee believes that the format in the proposed forms for disclosing the often-complex cost structure of variable annuity contracts would result in confusing, and in some cases misleading, cost information that would be inconsistent with the existing format for disclosing variable annuity costs in prospectus fee tables.

⁶ The Committee respectfully notes that it would have been impossible for it to comment on many, if not most, of the myriad questions the Commission asked in the Reproposing Release. The lack of Committee comment on any specific question or topic should not be viewed as concurrence or lack of concurrence with the Reproposed Rules.

⁷ While the Committee has not thoroughly reviewed the sampling technique nor retained statisticians to review the sampling methodology, the Committee was puzzled by the limited scope of the sampling pool used in the focus groups (*e.g.*, a total of 26 applicants interviewed in 4 geographic locations).

For the reasons discussed herein, the Committee strongly urges the Commission to continue to require that investors be provided with the consistent cost information provided through the existing prospectus format. To ensure that investors have access to this information at the point of sale, the Committee recommends that point of sale forms be required to disclose prominently that comprehensive cost disclosure is provided in the variable annuity prospectus and that the purchaser should ask for a copy of the prospectus at the point of sale if the investor wants to review such information at that point. If the Commission concludes that it is necessary and appropriate to include cost information in the new point of sale form, the Committee strongly recommends that this cost disclosure be in the form of the fee table reprinted from the applicable variable annuity contract prospectus.

2. Internet Disclosure of Broker-Dealer Compensation

The Committee believes that, in general, detailed broker-dealer compensation and conflict of interest information is much better suited for Internet disclosure than for either the point of sale or the confirmation form, or both. As described in detail below, however, there are a number of specific issues the Committee provides comments on with respect to the details of the proposed Internet disclosure form (“Internet Disclosure Form”), including proposed changes to the compensation, revenue sharing and promotional payments, and differential compensation sections of the Internet Disclosure Form.

3. Other Comments

The Committee also provides comments on a number of specific issues, some of which were addressed in the Committee’s prior letters to the Commission. In particular, the Committee recommends that: (a) revenue sharing payments from underlying fund investment advisers to the investment companies generally not be required to be disclosed on variable annuity point of sale forms; (b) the Commission clarify that Internet disclosure of compensation should only be required for selling firms, and not for wholesaling broker-dealers or principal underwriters of variable annuities who do not engage in retail selling activities; (c) the Commission should not expand the required disclosure on the point of sale form to include a general description of the features and risks of a variable annuity; (d) the Commission simplify its proposal for addressing point of sale disclosure for telephone sales; and (e) the Commission clarify the definition of “point of sale” so that a timely delivery of the point of sale form can be provided in all different types of selling situations.

DISCUSSION

The remainder of this comment letter provides a detailed discussion of the three topics identified above in the Summary of the Committee's Comments.

SECTION I. INCREASED COST DISCLOSURE IN POINT OF SALE AND CONFIRMATION FORMS

Background. The Commission's original intention was for the Proposed Rules to require broker-dealers to provide their customers with targeted information, at the point of sale and in transaction confirmations, regarding the costs and conflicts of interest that arise from the distribution of covered securities. The SEC received over one thousand separate comments on the Proposed Rules, as well as over four thousand comments from individuals and entities using a variety of standard letter types. Because the Proposed Rules were intended to provide clear and useful disclosure to investors, the Commission actively encouraged comments from individual investors and investor groups. The Commission also met with numerous investor groups and engaged a consultant to assist in investor testing of possible forms for confirmation and point of sale disclosures.

The comments and other feedback the Commission received suggested a number of areas where the proposed point of sale and confirmation disclosure requirements could be improved both with respect to more effective communication to investors, and reduced costs of compliance. In addition, some feedback suggested that the Commission should take a different approach to disclosure by requiring broker-dealers to use the Internet to supplement point of sale and confirmation disclosure.

When the Commission first published the Proposed Rules, it proposed a single set of disclosure requirements that would have applied to variable annuity contracts as well as all other covered securities. Industry commenters, including the Committee, observed that the proposed point of sale forms were not well suited to illustrating the costs associated with variable annuity contracts, the compensation flows payable to broker-dealers selling variable annuities, and did not reflect the product's particular terminology, features, and pricing structure.

According to the Reproposing Release, the Commission has concluded that point of sale disclosures for purchases of variable annuity contracts should take into account the unique characteristics of the products and has proposed point of sale and confirm forms that are tailored to address the costs and conflicts particularly associated with variable annuity contracts. Accordingly, it included a separate point of sale and confirmation form specifically for variable annuities in the Reproposed Rules.

The Committee commends the Commission for proposing tailored variable annuity forms. However, the proposed forms depart dramatically from the initial forms by requiring extensive cost disclosure. This addition was in response to the comments the Commission received to the Proposed Rules and related forms after it sought feedback from investors and hired consultants to test the proposed forms. Through that testing, the Commission discovered that many investors want point of sale and confirmation disclosure to provide comprehensive information about *all the costs* of owning covered securities, not just *distribution*-related costs.

The Committee's Recommendations Regarding Variable Annuity Point of Sale Forms. The Committee agrees that investors should have access to comprehensive variable annuity contract cost disclosure at the point of sale. The Committee does not believe, however, that variable annuity point of sale forms need to include this information, since detailed cost information already is included in variable annuity prospectuses.

Based on the summary information the Commission provided in the Reproposing Release, the Committee was not able to ascertain whether investors in the Commission's focus groups found prospectus information, if provided at the point of sale, to be inadequate. This is because the Commission did not explain whether focus group participants were provided with alternative point of sale forms that contained only distribution-related costs and the investors stated they wanted comprehensive cost disclosure in addition to the distribution-related costs, or whether the investors were also provided with prospectuses. Unless the latter was the case, the Committee does not believe the Commission has a substantiated basis for requiring cost disclosure to be included in the point of sale document when it is already provided in the prospectus, which could be made available at the point of sale.

The Committee recognizes that while some point of sale settings require the delivery of a prospectus, others do not. The Committee therefore recommends that variable annuity point of sale forms be required to disclose prominently that comprehensive cost disclosure is provided in the variable annuity prospectus (as well as in underlying fund prospectuses) and that the investor should ask for a copy of the prospectus at the point of sale if the investor wants to review such information at that point in the sales process.

If the Commission provided focus group participants with variable annuity prospectuses, and investors concluded nonetheless that they want summary information in a point of sale document, the Committee strongly urges the Commission not to adopt the "Fees" section in the point of sale document in the form proposed, for the following reasons. The proposed variable annuity point of sale form in the "Fees" section organizes sales and ongoing cost disclosure in three main sections: "You pay when you buy," "You pay when you sell," and "You also pay each year." This format is inconsistent with the

format of the variable annuity fee table already required to be in all variable annuity prospectuses by the Commission's variable annuity registration statement, Form N-4.

Specifically, the variable annuity prospectus fee table format has three sections. The first section is essentially a "transaction" cost section where all sales or surrender fees, as well as any other transaction fees, must be disclosed. This first fee table section is roughly equivalent to the first *two* sections of the proposed variable annuity point of sale form, which would lead to investor confusion. The second section of the Form N-4 fee table is roughly the equivalent of the "Insurance Charges" line of the proposed point of sale form. Importantly, however, Form N-4 recognizes the complexity and importance of individual insurance charges by requiring specific categories of insurance charges to be shown and by requiring such information to be calculated and disclosed in accordance with an extensive set of form instructions. The third section of the fee table is roughly equivalent to the point of sale form's "Investment Option" line in the "You also pay each year" section. However, the variable annuity fee table and the accompanying form instructions provide a much more structured and considered approach to disclosing portfolio fees.

Yet another problem is posed by the fact that the Commission's proposed variable annuity point of sale form would require sales and ongoing costs to be shown using standardized \$1,000, \$50,000 and \$100,000 payment or investment amounts and, if a customer requests at the point of sale, broker-dealers would be required to use "fill in the blank" boxes to disclose cost information reflecting the customer's anticipated payment amount. The Commission's variable annuity prospectus fee table currently requires an "Example" in variable annuity prospectuses illustrating total costs based on an assumed \$10,000 purchase payment. Form N-4 contains comprehensive instructions on how to calculate annual costs, and Commission staff reviewers have from time to time provided extensive and detailed comment on the complex issues unique to variable annuity contracts in this regard, such as what optional guarantee rider charges to include in the Example. The Committee believes strongly that any attempt to "boil down" the existing prospectus Example to the format proposed in the point of sale form would be confusing and potentially misleading, while the requirement to illustrate the costs associated with a \$1,000 and \$100,000 purchase payment in addition to the \$10,000 amount currently illustrated in variable annuity prospectuses, would likely be confusing and provide investors with "information overload."⁸

⁸ The nature of certain specific questions asked by the Commission indicates the complex nature of the interpretive questions that would arise if the Commission adopts a second cost disclosure format for variable annuities:

- How could disclosure of comprehensive information about the costs of owning variable insurance products, such as mortality and expense risk fees, insurance costs, and fees associated with underlying funds, be accomplished? Should each fee category be listed separately, or would disclosure of

Perhaps more fundamentally, the point of sale form proposed by the Commission would not provide for adequate disclosure of certain variable annuity insurance charges, such as guaranteed minimum income benefits or guaranteed withdrawal benefits where the charge varies from contract owner to contract owner based on a calculated amount often referred to as the “benefit base” rather than on the level of the separate account assets. Because these charges vary from owner to owner and are assessed against individual account values rather than separate account assets, they cannot be combined together with separate account asset-based charges and shown simply as “Insurance Charges” as a percentage of separate account assets, and any attempt by the Commission to tailor the point of sale form to address these significant complexities in a format different than that of the current variable annuity prospectus fee table format would in the Committee’s view not be in investors’ best interests.

In conclusion, for the reasons discussed above, the Committee recommends strongly that if the Commission concludes that ongoing cost information needs to be included in variable annuity point of sale forms, that the “Fees” section of the point of sale form be required to incorporate the fee table currently required in variable annuity prospectuses.

The Committee’s Recommendations Regarding Variable Annuity Confirmations. The Committee also agrees that investors should have access to information about the total costs that will be associated with a specific variable annuity contract after they have purchased the contract. However, similar to the Commission’s

aggregate fees associated with a particular type of expense, such as insurance or fund costs, be preferable? Would disclosure of aggregate underlying fund fees, rather than discrete disclosure of each element of the fees’ composition, be sufficient? Should the forms explain that insurance and underlying fund costs may be deducted daily from contract value, while other charges may be imposed quarterly or annually?

- Would point of sale disclosure of the maximum surrender charge percentage, and the general basis for its calculation, be sufficient to alert investors to these costs, particularly in light of the potential complexity of the surrender charge calculation? Should broker-dealers be required in the point of sale disclosure to disclose the potential recapture of bonus credits?
- Should terms used in the point of sale disclosure be consistent with language commonly used in variable insurance product disclosure documents, including prospectuses, and sales materials?
- Should broker-dealers be required in point of sale disclosure to enumerate any non-recurring costs of owning variable insurance products, such as fees associated with excessive underlying fund transfers, or loan processing fees?

proposed point of sale cost disclosure format, the proposed confirmation cost disclosure format would in certain respects be inconsistent with the current variable prospectus fee table cost disclosure format and would not adequately provide for disclosure of charges that are not based on separate account assets. Moreover, generating ongoing cost information for every one of an insurer's variable annuity contracts and for every possible combination of standard and optional charges and investment options would raise significant cost and implementation issues that we believe outweigh whatever limited additional benefit investors would receive from including cost information in confirmations, since variable annuity prospectuses contain extensive cost information already and must be provided to investors no later than at the time a confirmation is delivered.

SECTION II. WEBSITE DISCLOSURE OF BROKER-DEALER COMPENSATION

In the Reproposing Release, the Commission proposed that a significant amount of broker-dealer compensation information be included in Internet-based disclosure on the broker-dealer's website, which could be used to "supplement" the point of sale and confirmation disclosure provided to customers. The Committee agrees generally with this approach for a number of reasons, the primary of which is that it allows for streamlined and focused disclosure of general broker-dealer compensation practices at the point of sale and in confirmations, while providing for more comprehensive and quantitative information to be provided on the broker-dealer's website. Due to concerns about information overload, the Committee agrees that with respect to the information related to broker-dealer compensation for selling variable annuities, Internet website disclosure is a far more appropriate vehicle for delivery of that information than through a lengthy point of sale or confirmation form.⁹ In addition, the Committee views the ability to provide this information through a web-based, rather than paper, delivery mechanism as creating cost savings.

While the Committee agrees generally with the Commission's approach with respect to the method of disclosing broker-dealer compensation on the broker-dealer's website, it does have several comments on the details of the proposed Internet Disclosure Form under the Reproposed Rules. Most of the Committee's comments on the details to be included on the Internet Disclosure Form result from the complexity of the compensation structures both for payments made by the insurance company issuing the variable annuity to the selling firms, as well as the payments made by the selling firms to their registered representatives. The Committee's general view is that the level of specificity requested for certain of the items on the Internet Disclosure Form could lead to disclosure that would take significant effort to construct on a contract-by-contract and representative-by-representative basis, or worse, could provide the customer with

⁹ The Committee also understands the SEC's longstanding position with respect to the availability of information from sources other than the Internet, and agrees that alternatives should be available for customers without Internet access.

inaccurate information, without a concomitant increase in the customer's understanding of the compensation and conflicts of interest faced by the broker-dealer and its registered representatives.

Providing Consolidated Information on “Up-front Compensation” and “Additional Annual Compensation.” While we understand that the Internet Disclosure Form is drafted presuming the sale of a mutual fund, it appears to indicate that broker-dealer compensation information, at least with respect to standard payments of “up-front compensation” and “additional annual compensation” (referred to collectively as “selling compensation”) would be provided on a fund-by-fund basis. The Committee recommends to the SEC that such information with respect to variable annuity contracts should be provided not on a “contract-by-contract” basis but rather on the basis of the portfolio of annuity contracts offered by the particular insurance carrier through the broker-dealer.

In most cases, broker-dealers marketing variable annuities will do so for a number of issuing insurance companies. Moreover, in most cases, the broker-dealer will be marketing a number of different annuity contracts from the same issuing insurance company. The selling compensation paid to the broker-dealer may vary between such contracts issued by the same insurance company.¹⁰ Finally, many insurance companies issuing variable contracts do so through more than one, and often several, affiliated insurance carriers.¹¹ Working through the math and assuming a somewhat limited menu of issuing insurance companies and variable annuity contract forms, it becomes apparent that the number of separate, product specific disclosure pages that might be required of a broker-dealer that is only relatively active in the variable annuity market could be substantial. For example, assuming that a broker-dealer markets the products of only 6 issuers, each of which are comprised of 2 separate legal entities, and each of which have 4 different variable annuity contracts that can be offered, a broker-dealer would be required to maintain at least 48 product-specific web page layouts for those contracts. The Committee believes that, without risk to the consumer of providing diluted or inaccurate information, it would be at least as helpful to provide customers with information providing the range of up-front compensation and additional annual compensation of all the variable annuity contracts of an issuing insurance.

Compensation Received by Broker-Dealers. The Committee suggests that, with respect to the Section of the Internet Disclosure Form entitled “Our compensation for selling AAA Equity Fund,” several changes be made for a similarly structured page

¹⁰ Selling agreements that grant broker-dealers the authority to sell variable annuities typically include schedules that identify both the particular variable annuities that can be sold, as well as the compensation for those specific contracts.

¹¹ Many insurance companies that issue variable annuities on a nationwide basis do so through at least two separate legal entities, one that issues such products in New York, and another carrier that issues products in non-New York jurisdictions.

for a variable annuity contract. First, the statement “Compensation that all broker-dealers receive for selling this fund” should be revised so as not to imply that all broker-dealers receive the same “up-front compensation” and “additional compensation.” Because the selling compensation provided for variable annuities from issuing insurance companies to selling firms may not be uniform, the Committee proposes that the language clarify that such a statement speaks only to the compensation of the particular broker-dealer firm. For variable annuity sales, the Committee recommends that only when there are breakpoints on “up-front compensation” or “additional annual compensation” should information be provided on separate charges at different asset or purchase levels. The Committee believes that most investors would get little or nothing out of a table that shows a purchaser the arithmetic involved in, for example, multiplying 1 percent by a variety of dollar amounts.

Special Revenue – Expected Payments.¹² The current Internet Disclosure Form includes information in both the “Other Payments” and the “Additional Payments” section about the payments the broker-dealer expects to receive in the current fiscal year. Given the number of variables and the complexity of the structuring of these types of payments, the Committee believes that projecting an expected payment for the current fiscal year is not terribly accurate or valuable information to a client in many circumstances. Therefore, the Committee recommends that any information about expected payments be voluntary and not required under the form. To the extent that the Commission viewed the “expected payments” information to provide “fresher” information, the Committee would submit that the actual information from the most recent fiscal quarter is more valuable and addresses the issue of whether the prospective customer is receiving timely information.

Differential Compensation. The proposed Internet Disclosure Form includes a separate section on differential compensation practices, entitled “Special incentives we pay to our personnel for selling this fund or particular share classes.” As described in the Reproposing Release, the section is designed to get at two forms of differential compensation: payments to representatives by the broker-dealer firm at a higher payout rate for one issuer’s products than other issuers; and payment of “above average” compensation to the broker-dealer itself by the issuer of the covered securities.

With respect to the former type of differential compensation, the Committee believes that such information is valuable to a consumer and is appropriate to include on the Internet Disclosure Form. The Committee has concerns, however, about the proposed level of quantitative detail that is currently indicated on the form. For example, the Internet Disclosure Form includes information essentially detailing what a registered representative’s payout grid might look like (*e.g.*, stating that – 42 percent of the firm’s

¹² With respect to the disclosure of revenue sharing payments made to the issuing insurance companies by the advisers (or their affiliates) of the underlying investment options of a variable annuity, please see the discussion in Section III of this letter.

concession is customary but for a particular product the registered representative receives 45 percent). As noted in numerous places in the Reproposing Release, consumers are most interested in how much the product is costing them, and not as interested in the precise details of what their individual broker might be getting paid. Moreover, the complexity of the payout grid for a broker-dealer's representatives cannot be understated, and many broker-dealers have registered representatives on a variety of different grids, each of whom may get a variety of different levels of increased payout rates from selling particular products. Therefore, to provide quantitative information with the precision identified in the Internet Disclosure Form, without significant qualifying language, seems an inaccurate manner of communicating the information. The Committee recommends that information on any increase in a registered representative's payout rate, if provided in quantitative terms, be provided through a potential range of increased payout rates, rather than one particular rate.

The second type of differential compensation disclosed on the Internet Disclosure Form is "above average compensation." As described in the Reproposing Release, the Commission did not require such above average compensation to be disclosed under Proposed Rules because, among other things, it would be too "unwieldy."¹³ The Commission requested comment on whether the information on "above average compensation" or "relatively higher dealer concession" would be feasible to implement, and whether it would be useful to investors. The Committee believes that there are a number of difficulties with requiring the broker-dealer to provide special disclosure when above average compensation is paid.

First, as noted in the Reproposing Release, there is the difficulty in determining how to classify the particular covered security and determining the class of securities with which it should be compared. The examples provided in the Reproposing Release focus on relying on the investment objectives of mutual funds as criteria. With variable annuities, a comprehensive review and evaluation of each variable annuity contract would be required to rationally determine whether the features and structure of one contract make it "comparable" to another variable annuity product. In addition, because variable annuity contracts are sold in many cases with special "riders" that modify the general features of the product, there is even more complexity in trying to define a class of variable annuity contracts that are comparable. Second, a broker-dealer would need to determine when the concession becomes "relatively higher." Given the relatively aggressive pricing structures in the variable annuity marketplace, it may be that the overall range of concessions paid to a selling firm by its issuing insurance carriers does not vary by enough to be of interest to the customer.

The Committee agrees with the Reproposing Release in that it suggested that the broker-dealer might be put into the position of being conservative and thus routinely disclosing that it is offering a product that is "above average" in price. The Committee

¹³ Reproposing Release at 10539.

recommends that the Reproposed Rules eliminate the requirement for the broker-dealer to get involved in a complex determination of both whether certain variable annuity contracts are “comparable” and whether the gross dealer concession paid is “relatively higher.” Given the difficulties in administering this disclosure and ensuring that it provides meaningful information to customers, the Committee recommends either that it be eliminated, or that a generic statement be provided identifying to the customer that some product manufacturers may pay higher concessions than others.

SECTION III. OTHER ISSUES

The Committee also comments on several miscellaneous items. While some of these comments are restatements of those that the Committee provided in the April Letter and the July Letter, they also respond to specific questions raised in the Reproposing Release.

Disclosure of Revenue Sharing Payments by Underlying Funds to Insurance Companies

Background. Under the Reproposed Rules, broker-dealers would be required to disclose as a conflict of interest, on point of sale disclosure forms and transaction confirmation forms, the *existence*, but not the *amounts*, of “revenue sharing” payments they receive for promoting covered securities. Specifically, broker-dealers would be required to provide a “Yes” or “No” answer to the question: “Does the fund or its affiliates pay us extra to promote this fund over other funds?” A required legend next to this question on the forms would encourage customers to “[a]sk us for a summary of the special incentives we receive to sell this fund.” Consistent with the newly-proposed Internet disclosure requirements discussed above in Section II of this letter, broker-dealers also would be required to disclose an Internet web site and a toll-free telephone number customers can use to find more detailed information about disclosures of those payments, including the amounts of, and sources of, the payments.

This disclosure construct differs significantly from the Proposed Rules, which would have required broker-dealers to disclose the existence of revenue sharing payments on both the point of sale disclosure form and the confirmation form, as well as the specific amounts of revenue sharing payments associated with a transaction on the confirmation form. The Commission explained the new approach as reflecting the fact that some investors, including those in the Commission’s focus groups, expressed more interest in information about the existence of the conflict of interest created by revenue sharing payments than the amounts actually paid. As a result, the Commission concluded that while descriptive information about the conflicts posed by revenue sharing arrangements is necessary to inform customers about the conflicts of interest facing their broker-dealers, Internet-based disclosure may be a preferable means for giving investors detailed and more thorough information about revenue sharing payments their broker-dealer receives and the conflicts of interest those payments create.

With respect to variable annuity contracts, the Reproposing Release poses the following specific questions related to revenue sharing payments received by insurance companies from underlying fund investment advisers:

- “How should investors be informed of payments received by the insurance company issuing a variable annuity from the investment advisers of underlying funds?”
- “What types of conflicts do these payments raise?”¹⁴

The Committee’s Recommendations. Most registered variable annuity contracts offered today are funded by a “two-tier” investment company structure. In this two-tier structure, there are two separate and distinct investment companies and two separate and distinct investment company securities. The “top tier” investment company is the “separate account” of the insurance company; the separate account is a segregated investment account established by the insurer under state insurance law. The insurer issues variable annuity contracts funded by the separate account.

Because variable annuity contracts are securities, absent an applicable exemption from registration under the Securities Act of 1933 Act (the “1933 Act”), the contracts or interests therein are registered with the Commission under the 1933 Act. Additionally, the separate account is treated as an investment company under the Investment Company Act of 1940 (the “1940 Act”) and is therefore (unless exempted from the definition of “investment company” under the 1940 Act) required to be registered with the Commission as a unit investment trust under the 1940 Act.¹⁵ Separate accounts ordinarily are divided into subdivisions called “subaccounts,” each investing in the shares of an underlying mutual fund or portfolio of a mutual fund. These mutual funds are the “lower tiers” of the two-tiered investment company structure.¹⁶

¹⁴ Reproposing Release at 10538.

¹⁵ The contracts are registered under the 1933 Act and the separate account is registered under the 1940 Act on one integrated registration form, Form N-4.

¹⁶ When contract owners make premium payments, they specify the subaccounts to which they want the insurer to allocate their payment and the relative percentages for each such subaccount allocation. On an ongoing basis, contract owners typically may instruct the insurance company to transfer existing contract value from one subaccount to another by redeeming contract value, measured by “accumulation units” similar to “shares” of mutual funds, from one subaccount and using the proceeds to purchase units in the new subaccount. Insurers typically aggregate buy and sell orders for each subaccount daily and, in accordance with contractual terms specified in “participation agreements” with the underlying funds, transmit the net or “omnibus” orders to the corresponding underlying funds after the close of trading each business day. Some contracts offer as many as 40 to 50 subaccount choices to contract owners with the same

Importantly, under this two-tier structure “inbound” revenue sharing payments from underlying fund advisers (or their affiliates) are generally paid to the insurance company, and not to selling firms. That is, these payments go to the insurer’s general account and are commingled with other types of revenue the insurer accumulates, whether related to its variable contracts or any other business. The insurance company may use revenue sharing payments for any lawful purpose it chooses, including paying sales commissions or other compensation for sales of its variable contracts.

In these general situations, it is the compensation ultimately paid to selling firms, and not the revenue sharing payments made to the insurer, that is intended to provide the incentive to the selling firms to sell the contracts. This compensation would be disclosed under the Reproposed Rules as such. The Committee does not believe that revenue sharing payments received by insurance companies from underlying fund investment advisers generally should be required to be disclosed on variable annuity point of sale or confirmation forms, or on selling firms’ websites, as the case may be, because unlike retail mutual fund “revenue sharing payments,” they are not paid directly to selling firms and therefore do not create conflicts of interest at the point of sale.

Whether these payments should be disclosed as conflicts of interest for any particular *insurance company* (as opposed to its selling firms) is necessarily a factual determination based on the insurer’s specific arrangements with underlying funds, including an assessment of what services are provided for the revenue sharing payments under the arrangement. In this regard, variable annuity contract prospectuses typically describe underlying fund revenue sharing payments as payments for administrative or other services provided by the insurance company to the underlying fund. The payments may compensate the insurance company for providing its contract owners with the types of shareholder services, primarily personal services and the maintenance of shareholder accounts, that the fund otherwise would have been required to provide itself if the fund had been sold directly to the contract owners.

If revenue sharing payments do create a conflict of interest for a particular insurance company, the Committee believes the conflict may appropriately be disclosable. The Committee believes, however, that where and how to disclose such conflicts is a more difficult question. One option would be for the Commission to require revenue sharing payments to be disclosed in all variable annuity contract prospectuses and/or Statements of Additional Information. In this regard, however, the Committee notes that while Form N-8B-2 (the original 1940 Act registration statement for unit investment trusts required to be used by variable annuity separate accounts organized as

number of corresponding underlying funds. Because investor transactions in subaccounts are processed under aggregation and netting rules, an investor’s investment in or redemption from a given subaccount is not “mirrored” by a corresponding individual purchase or redemption transaction in shares of the underlying fund.

unit investment trusts) mandated disclosure of revenue sharing payments from underlying funds¹⁷ the Commission did not include such a requirement when it adopted the current variable annuity registration form, Form N-4.

Given the extreme brevity of the comment period for the Reproposed Rules and the complexity of the disclosure issues involved, the Committee has not formulated a specific recommendation as to where such conflicts, if any, should be disclosed or the nature and extent of such disclosure. The Committee recommends that the Commission continue to study these issues, and would strongly urge the Commission to request additional public comment before adopting disclosure requirements in this regard.¹⁸

Disclosure of Compensation of the Principal Underwriter of a Variable Annuity

The Committee's April and July Letters to the Commission addressed the issue of including compensation information of a broker-dealer other than the retail selling firm.¹⁹ The Commission requests comment on a matter similar to the topic addressed in the prior Committee letters:

How should [compensation] disclosure requirements be applied to broker-dealer underwriters for mutual funds and other covered securities? Would investors benefit from disclosure of underwriter compensation in the same way as they would benefit from disclosure of the compensation received by selling broker-dealers?²⁰

As a general matter, the Committee believes that information related to the compensation, if any, of a broker-dealer firm serving as the principal underwriter of a variable annuity contract, or wholesaler of such contract, need not be disclosed in the proposed Internet-based disclosure to the purchaser of a variable annuity. The compensation that is received by an entity other than the firm that has the direct contact with the customer should not be relevant to the customer's analysis and review of the selling firm's incentives to recommend a particular variable annuity contract. However,

¹⁷ See Item 26(b) of Form N-8B-2.

¹⁸ We note the Commission currently is fundamentally re-examining how all registrants should disclose information to investors, including whether a more "layered" approach would be appropriate. See, e.g., *The Regulation of Securities Offerings*, Securities Act Release No. 7606A (Nov. 13, 1998), 63 Fed. Reg. 67174 (Dec. 4, 1998) ("Aircraft Carrier Release"); *SEC Task Force Looks at Disclosure Overhaul*, Ignites (Apr. 27, 2004) (Reporting that Paul Roye, Director of Investment Management, announced at a Practicing Law Institute conference that an SEC task force on disclosure was focused on disclosure of fund fees, expenses, and costs, "which will occur...within a more sweeping overhaul of the full disclosure regime.")

¹⁹ See April Letter at 8-9; July Letter at 9-10.

²⁰ Reproposing Release at 10539.

in those cases where the principal underwriter also acts through its registered representatives as a selling firm, the Committee believes that Internet-based compensation disclosure would be appropriate.

Substantive Risk and Tax Disclosure

The Commission requested comment on whether “the point of sale disclosure for variable insurance products [should] describe the features and risks of particular to these products, such as their insurance aspects, tax treatment and penalties for early withdrawal?”²¹ The Committee strongly opposes expanding the point of sale form to include this disclosure. Including this disclosure on the point of sale form would create a substantive duty of describing a variable annuity product that well exceeds the duties required on either of the other covered securities (*i.e.*, 529 plans and mutual funds). In addition, including this type of general, descriptive information about variable annuities would increase customer confusion with respect to the focus of the point of sale form, as it would depart dramatically from its perceived function as a document that, under the Reproposed Rules, helps an investor understand how much the variable annuity costs.

Oral Disclosure of Point of Sale Information for Telephone Sales

The Committee commends the SEC’s recognition of the difficulties of providing the point of sale disclosure in connection with telephone sales. However, the Committee believes that the options highlighted by the Commission are still not designed to meaningfully improve a telephone purchaser’s understanding of the required point of sale information.²² Given the level of mental ability that would be required to absorb and retain any information from a several minute-long recitation of the point of sale form to a telephone customer, the Committee recommends that the SEC adopt a different approach that does not impose unreasonable demands on the purchaser. The Committee recommends that, in the context of the purchase of a variable annuity through a telephone transaction, the broker-dealer firm should be required to: (1) direct the purchaser to either a website form, or a toll-free telephone number that includes the information on a recorded basis, so the purchaser can specifically retrieve the information; and (2) provide the client with a written point of sale form when the contract is delivered to the customer. The Committee believes that these requirements would allow purchasers to better understand the point of sale information, and their contractual rights to return the contract, and they could ask further question when they receive the point of sale form via mail or hand delivery.

²¹ Reproposing Release at 10533.

²² Reproposing Release at 10529.

When is the Point of Sale Form Delivered

The Committee has previously highlighted a number of timing-related issues with respect to the delivery of the point of sale form for variable annuity transactions.²³ The Commission posed numerous questions in the Reproposing Release on when the point of sale form should be delivered. In general, the Committee agrees with the Commission that the form should be delivered early enough in the sales process to provide purchasers an adequate opportunity to consider the information, but not so early that the client receives too many such documents for potential variable annuity contracts or other covered securities that they are very unlikely to purchase. Moreover, the variety of distribution channels and selling methods for variable annuities makes it extremely difficult to craft a rule that fits all such situations. The Committee recommends that the SEC require that the point of sale form be delivered to the customer: (1) prior to the acceptance of the order for variable annuity purchases funded through a brokerage account; and (2) no later than the time at which the application has been completed and provided to the broker-dealer's registered representative or delivered to the product manufacturer for variable annuity transactions conducted on a "check and app" basis.

As described in our April and July Letters, the Committee reiterates its comments that the point of sale form should only be required to be delivered to the purchaser upon their initial purchase of a variable annuity contract, and not upon making any subsequent purchase payments.

CONCLUSION

The Committee appreciates the time and resources that the Commission and its staff have devoted to this important initiative and that the staff has been open to the Committee's recommendations. We are pleased to have this opportunity to provide

²³ See April Letter at 9-10; July Letter at 12-14.

Mr. Jonathan G. Katz
April 4, 2005
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further comments to the Commission. We appreciate the Commission's careful consideration of the Committee's specific recommendations and what we are confident will be the agency's continued commitment to create a workable disclosure format for the variable annuity industry that will provide meaningful information to investors.

Respectfully Submitted,

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FOR THE COMMITTEE OF ANNUITY
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Cc: The Honorable William H. Donaldson
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The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Catherine McGuire, Division of Market Regulation
Susan Nash, Division of Investment Management

APPENDIX A

THE COMMITTEE OF ANNUITY INSURERS

Allmerica Financial
Allstate Financial
American General Life Insurance Company
AmerUs Annuity Group Co.
AXA Equitable Life Insurance Company
Chase Insurance
F & G Life Insurance
Fidelity Investments Life Insurance Company
Genworth Financial
Great American Life Insurance Co.
Guardian Insurance & Annuity Co., Inc.
Hartford Life Insurance Company
ING North America Insurance Corporation
Jackson National Life Insurance Company
John Hancock Life Insurance Company
Life Insurance Company of the Southwest
Lincoln Financial Group
Merrill Lynch Life Insurance Company
Metropolitan Life Insurance Company
Nationwide Life Insurance Companies
New York Life Insurance Company
Northwestern Mutual Life Insurance Company
Ohio National Financial Services
Pacific Life Insurance Company
The Phoenix Life Insurance Company
Protective Life Insurance Company
Prudential Insurance Company of America
Sun Life of Canada
Travelers Insurance Companies
USAA Life Insurance Company