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Market-timing Scandal Leads to Variable Insurance Annuities

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While the latest headline news from New York Attorney General Eliot Spitzer's office concerns the insurance industry and "contingent commissions," another alleged "scandal"—market timing—may be quietly boiling beneath the surface for the insurance industry as well. Many of the most highly esteemed mutual fund families have been mired in the wake of the market timing investigations. "Market timing," previously an obscure term of art in the securities business and while never illegal *per se*, has now become a household phrase, garnering some of the largest monetary settlements regulators have reached in recent history. And now some of the most recognized names in insurance could be heading into the "market timing" morass. Why? Because variable insurance annuities are "kissing cousins" to mutual funds, and subject to the same allegations of abuse. Only recently the Securities and Exchange Commission brought its first enforcement action charging insurance companies with securities fraud for facilitating market timing of mutual funds through the sale of variable annuities and, as with the mutual fund families, the SEC's settlement for restitution and penalties numbered in the millions of dollars.

Albeit not exactly known or understood by your average investor, the actual operation of a variable annuity is relatively straightforward. Variable annuities are hybrid financial vehicles where underlying investments are wrapped inside insurance contracts. The modern variable annuity was created in 1982 with the Tax Equity and Fiscal Responsibility Act, and generally works like this: During the "accumulation phase," the investor makes purchase payments for the annuity contract, and allocates the payments among various investment alternatives. There are two types of investment alternatives–fixed account and variable sub-account. Under the fixed account option, one earns a fixed rate on the purchase payments, which is a rate guaranteed by the insurance company. Under the variable sub-account option, the investor selects from a series of variable insurance funds managed by the major mutual fund families. These funds generally mirror, in both name and investment objectives, the retail funds that are available to the public. If the investor chooses the variable sub-account option, the investment return on the payments will vary depending on the performance of the corresponding variable insurance fund. Like mutual funds, "transfers" or exchanges from one variable insurance fund to another are allowed during the accumulation phase. During the "payout phase," one will receive income payments for a pre-set period of time, or alternatively for life, based upon the amount of money earned under the annuity contract during the accumulation phase.

Variable annuities differ from a mutual fund in three distinct ways. First, a variable annuity contract will offer a guaranteed death benefit should the investor die before the payout phase, although this amount is usually limited to the amount of the purchase payments then made. Second, taxes are also deferred on investment gains until the investor withdraws his or her money. Third, it is solely the insurance company that governs the relationship between the annuity holder and his or her "transfer" or exchange privileges; although the variable insurance funds are patterned on and managed similarly to corresponding retail funds offered by a fund complex, the insurance company and a mutual fund complex are tied together only through a participation agreement.

Variable annuities have grown by leaps and bounds as an alternative investment and retirement device. According to the National Association of Variable Annuities, an industry trade group, the combined net assets of U.S. variable annuities increased 23.7% to $985.3 billion at the end of the fourth quarter of 2003, as compared to the end of the fourth quarter of 2002. Given that variable annuities are securities, insurance companies offer their variable annuity products through prospectuses, which in addition to describing investment objectives, strategies, and risks, may describe an insurance company's policies on excessive or frequent trading. As with

the allegations made regarding market timing of mutual funds, the regulators are now asking whether insurance company prospectuses comported with insurance company actions regarding excessive or frequent trading, with the belief that market timing through variable annuities can result in increased expense to, and cause dilution in, the underlying mutual fund portfolios. This question may be particularly acute for regulators because market timers may be attracted by the ability to defer taxes on their gains under a variable annuity contract.

At this stage, it appears that–one way or another–the insurance companies will, indeed, be faced with allegations of market timing. All indications from the regulators reflect their belief that market timing was prevalent in some variable annuities. On August 9, 2004, the Securities and Exchange Commission brought the first enforcement action charging insurance companies with securities fraud for facilitating market timing of mutual funds through the sale of variable annuities. The insurance companies are subsidiaries of Conseco, Inc., and the company to which Conseco sold its variable annuity business in 2002, Inviva, Inc., and its subsidiary Jefferson National Life Insurance Company. The insurance companies agreed to settlements that include a total payment of $20 million in disgorgement and penalties as well as undertakings of compliance reforms. Among other things, the SEC found that hedge funds and other market timers invested upwards of $100 million in the variable annuities at issue. The SEC's charges were premised on the language of the prospectuses, finding that the prospectuses falsely stated that these products were not "designed for professional market timing organizations," and gave the misleading impression that companies would act independently to monitor or block detrimental trades.

The Conseco settlement appears to be a natural outgrowth of the "mutual funds scandal." As early as November 2003, the SEC had requested information on trading practices from most top insurers regarding their variable insurance products, including variable annuities. Since that time, the SEC's reforms targeted at curbing market timing abuses in mutual funds have been equally applicable to variable annuities. In fact, David Brown, head of the NYAG's general investment protection bureau, told a meeting of the Securities Industry Association that he believes that the market timing of mutual funds in variable annuities is "widespread," and it is probably little coincidence that the SEC's Conseco settlement acknowledged "the assistance of the New York Attorney General."

Conseco may be just the beginning. In November 2003, the TheStreet.com asked fund-research firm Lipper to run a screen for suspiciously high trading levels in variable annuity funds. The screen compared, for example, total net assets at year-end 2002 against redemptions as a percentage of the year-end assets. In the screen of nearly 1,000 funds, the median redemption rate as a percentage of assets was 29%, i.e., the average investor held the fund for more than 3 years. Several of the funds in the screen, however, showed redemption rates as percentage of assets greater than 20 times that amount. Perhaps equally telling was that most of these were international or foreign funds–the type of funds alleged to be most vulnerable to market timing arbitrage.

In the end, even if market timing turns out to be prevalent in variable annuity funds, imposing legal liability on the insurance companies will remain a separate task, notwithstanding the recent Conseco settlement. Foremost, market timing, in and of itself, is not illegal. Both the public and private sectors have been dealing with it for many years before the regulators brought it to its recent forefront. But that aside, regulators may face additional hurdles with alleging that insurance companies were complicit in improper market timing. Many insurance companies did not include "transfer" or exchange limitations or include prohibitive "market timing" language. On top of that, state insurance laws might have imposed certain restrictions on any insurance companies that, in fact, would have sought to prohibit annuity holders from transferring their sub-accounts.

Whatever the regulators, the industry, and most importantly, the courts may eventually conclude about market timing in variable annuity funds, one thing remains plain – regulators have their eyes focused on the insurance companies, and the insurance companies should act now to prepare for their potential arrival.

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