

**DEVELOPMENTS IN THE MUTUAL FUND INDUSTRY –
ENTRY OF INSURANCE COMPANIES
TUESDAY MARCH 22, 2005**

RICHARD PHILLIPS: Good afternoon. I'm Richard Phillips, of Kirkpatrick, Lockhart, Nicholson and Graham, LLP and it's my pleasure this afternoon to join with Gary Cohen of Foley & Lardner LLP in Washington, DC to participate in one of the four online programs on developments in the mutual fund industry presented by the Securities and Exchange Commission Historical Society. The SEC Historical Society is a non-profit organization separate from and independent of the SEC itself. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org, and today's program will be preserved in the virtual museum so you can listen to the discussion or read the transcript later.

Today's program looks at the entry of insurance companies into the mutual fund business. Gary Cohen and I participated in some of the developments that make up the history and we look forward to sharing our thoughts with you this afternoon. The thoughts we express and the remarks we make however are solely ours and are not representative of the Society or indeed of our law firms. I'm told that this is nothing personal, but as a matter of policy, the Society, as well as our law firms, reserve the right to brand anything we say here this afternoon as pure heresy. And of course, anything we say here today is not legal advice. We're not here to give legal advice or investment advice.

Gary, why don't you start the program with outlining the discussion that we planned for today and the background that led to the entry of the insurance industry into the world of SEC regulation?

GARY COHEN: Well, if you die earlier than expected, you run the risk of not having accumulated enough assets to take care of your dependents, and you of course can protect against this risk by buying life insurance, really insurance against death or death insurance, that will pay your dependents the assets you died too early to accumulate. And if you die later than expected, you run the risk of outliving your assets, and you can protect against this risk by buying an annuity that guarantees payments to you for as long as you live to make up for not having enough assets.

Now these products have been regulated by the states for more than 150 years, and the industry did not take kindly to the prospect of federal regulation by the SEC in the 1960's. The background was that the Supreme Court in 1849 in *Paul v. Virginia* had held that the business of insurance was not subject to federal regulation under the commerce power. The Supreme Court, of course, overruled that decision in 1944 in *U.S. v. Southeastern Underwriters Association*, but Congress snapped back the following year and adopted the McCarran Act to assure that state power to regulate insurance would continue, and when the Securities Act was adopted in '33, Congress excluded these life insurance and annuity contracts from the act. The House report said that paragraph [3(a)]8 makes clear what is already implied in the act, namely that insurance policies are not to be regarded as securities subject to the provisions of that act.

So, Dick, this was the mindset of the industry when variable annuities were invented in the '50's. Variable annuities of course offer benefits that could vary with the investment performance of asset pools made up of the purchase payments, and without all of the traditional insurance guarantees. The SEC in the late '50's and early '60's brought lawsuits against three life insurance companies that we'll talk about. Two of the suits were decided by the Supreme Court. Dick and I were on the SEC staff during the latter stages. The SEC won all three lawsuits, establishing that the SEC had jurisdiction to regulate the investment aspects of variable annuities as securities and the pools of assets supporting the annuities as investment companies, and thereafter a large number of life companies registered these products. When the insurance industry invented variable life insurance, or VLI, in the '60's, there was no

company brave enough, or stupid enough to take on the SEC by inviting a lawsuit, and instead the industry hired my senior partner, Milton Kroll, to work things out with the SEC. We filed a rulemaking petition. The mutual fund industry, represented by Dick, opposed our petition. The proceedings dragged on for six years. We finally got some limited exemptive rules and life companies began selling that product.

Federal regulation of variable insurance products has not been easy for either the industry or the SEC. One SEC chairman called it “a nightmare.” There have been two big problems that have persisted for over 40 years – first, fitting the products and asset pools under statutes that were not designed for them. The SEC described this as fitting a square peg in a round hole. Second, determining what products are and are not securities. The Supreme Court unfortunately did not lay down a clear test, and the SEC and some courts have disagreed on the standard ever since.

RICHARD PHILLIPS: Well, Gary, this is not simply an intellectual exercise, nor a question of bureaucratic extension of power. This is really at the heart, a question of competition between the insurance industry and the securities industry, particularly the mutual fund industry. I know you, at various times, have represented largely the insurance industry on these issues, and I have represented the mutual fund industry on these issues. And the mutual fund industry looked to the SEC to establish a level playing field. It was aware that the insurance industry was a very strong and powerful industry, having grown at the rate of about 7% per year since 1900. In the 1950’s, however, things began to change. As the American population became more and more inflation-conscious, they found appealing the competitive cry of the securities industry to buy term and invest the rest. And term insurance is not what the insurance industry wanted to sell, because it had no investment element. Interestingly, the insurance industry viewed itself as a provider of security, not as a provider of stock market access, and it was a small upstart company by the name of VALIC, Variable Annuity Life Insurance Company of America, that was the first company to commercially offer the so-called variable annuity. And yet, against the opposition of many elements in the insurance industry as well as in the world of state regulators, fought a long battle throughout the ‘50’s to try to get acceptance by state insurance regulators of the concept that at least during the pay-in period of a variable annuity, one ought to be allowed to invest, under the rubric of insurance, a large portion of the premium into equity securities.

Slowly, and not uniformly, the state insurance regulators bought the concept and prepared to regulate variable annuities as though they were insurance. The SEC, however, had other ideas. It thought that since a significant appeal of the variable annuity was gained through investment, investment and equity securities, it ought to be regulated by the Securities & Exchange Commission concurrently with state insurance regulation. The SEC sued to enjoin VALIC and over the ‘50’s, the battle raged in the court until it hit the Supreme Court. And in a very close 5 to 4 decision, the Supreme Court ruled in favor of the SEC. Justice Douglas, speaking for himself and two other justices, wrote the opinion of the Court, saying that the question as to whether the McCarran Act applies depends on whether you classify variable annuity contracts as insurance or securities. It looked at this contract and said there are some similarities, there are some elements of insurance. For example, the insurance companies bear a mortality risk, both in terms of the annuitant living too long, and also by virtue of the term life insurance that accompanied the variable annuity policy that was being sold by VALIC. The Court found, however, that this risk accounted for only a small portion of the premium, and that most of the premium was invested in an investment fund, and that this fund was invested in equity securities. Justice Douglas held that in order to constitute insurance and not a security, an insurance company had to bear a significant investment risk, as well as a mortality risk, and he found that in the case of the variable annuity presented to the Court in VALIC, the investment risk borne by the insurance company was not meaningful or significant. On this basis, it found that the variable annuity in VALIC was a security and not insurance under federal law for purposes of the McCarran Act, even though the states may want to, and have the right to

regulate it as insurance, and the federal government would have the right to regulate it as a security.

The concurring opinion, written by Justice Brennan, took a somewhat different tack. It applied the securities laws functionally, and asked the question, what are the risks here to the buyer of a variable annuity? Are they the risks that state insurance regulation is designed to deal with, or are they the risks that securities law is designed to deal with? Is it a risk that can be dealt with most effectively by disclosure, or is it a risk that can be dealt with by solvency requirements and minimum reserve requirements? And Justice Brennan found that as you looked at and analyzed the contract, insurance regulation became less and less relevant, and securities regulation more and more relevant. On this basis, he agreed with Justice Douglas and the majority of the Court. This was a very significant decision, but it was not the end of the fight because the insurance industry had other ways to deal with the VALIC opinion.

Gary, what happened in the significant history of the insurance company entry into the business of securities that loomed next on the horizon?

GARY COHEN: Well, a second company came along, United Benefit Life, and it offered an annuity that was a spin on the VALIC product. United Benefit tried to make its product have more insurance features and fewer investment features. For example, the payout period of the annuity was fixed, and not variable like VALIC's. Secondly, United Benefit put a floor under the accumulation during the pay-in period that increased from 50% of the premiums to 100% over a period of years. The SEC sued United Benefit, and the Supreme Court held that United Benefit's product, or at least its investment aspects, were a registerable security.

The interesting thing about United Benefit is that the opinion was written by Justice Harlan who had written a very sharp and vigorous dissent in VALIC. In addition, the United Benefit decision was unanimous, and as much as I've read the opinions, I cannot see the clear reason for those developments.

Now, as a more substantive matter, the United Benefit opinion says that the Court granted it because of the "need for clarifying the implications of the VALIC decision," which indicates that the Court was less than clear in its VALIC opinion. The Court in United Benefit said that, in considering the VALIC opinion to have turned solely on the absence of any substantial investment risk-taking on the part of the insured there, we think that the court of appeals in the present case viewed that decision too narrowly.

Now you can read that statement two ways. When it says the absence of any substantial risk-taking, you can read that to mean that what was lacking was mortality risk assumption, as you suggested, or it can mean that the degree of investment risk-taking was too low.

RICHARD PHILLIPS: I think that you can find, you can look at Justice Douglas' opinion and say, well, was there a meaningful investment risk during the pay-in period, when the vast bulk of the premium went into the investment account, and I think the court found there wasn't a significant sharing of investment risk. I also think something else happened between VALIC and United Benefit, and that is the Court took a look at how the variable annuities were sold, and it was quite evident from the selling literature that the variable annuities were pitched to appeal to the interest of the public in gains through equity investment, and it was, I think, that additional element that may have led to the strong, I think it was unanimous was it not, United Benefit opinion after the VALIC opinion, but that's speculation of course.

GARY COHEN: But what I would take issue with is your statement a minute ago that the VALIC holding was that mortality risk-taking was required. The SEC has not read VALIC to require mortality risk assumption and it's debatable, as I said a second ago, whether United Benefit does. What happened was that Harlan, in his dissent in VALIC, said that analysis by fragmentation, by taking the product apart, was hazardous at best. But then when Harlan wrote the majority opinion in United Benefit, that's precisely what he did. He divided the product into the pay-in period, and the payout period, and had the Court analyze the pay-in period

separately, and found the pay-in period to be a security. He said that the guarantee was insufficient to integrate the two promises whose operation was separated in time.

RICHARD PHILLIPS: That's exactly right. They did separate the investment and insurance elements by looking separately at the pay-in/payout periods, and when you get to the variable life insurance product, it became clear that that's precisely what the SEC was doing even though there were no separate pay-in and payout periods in variable life as there is in a variable annuity.

But before we go to variable life, let me just mention the Prudential opinion. The insurance industry, I think, got tired of battling through the courts and then turned to the Commission for relief, and the Prudential Insurance Company was the leader in this effort, and prosecuted an exemptive application through the SEC in an attempt to get hopefully a complete exemption, or if not a complete exemption, a very broad exemption through various provisions of the Investment Company Act. And this effort also failed, as the SEC took the position in the Prudential case that even though the payout represented fixed, guaranteed premiums, they separated the payout period from the pay-in period, they looked at the pay-in period and said, gee, the bulk of the premium goes into the investment account, that's the way it's going to be sold, notwithstanding the guaranteed fixed payments in the payout period and notwithstanding a guaranteed payback of premium in the event of death during the pay-in period, the investment element was a separate element that could be regulated as a security.

The interesting part of the Prudential opinion that I found was Chairman Cary's belief that there was no reason why variable contracts could not be effectively and efficiently regulated under both a concurrent system of state insurance and federal securities regulation. And his opinion expressed confidence that the system of concurrent regulation would operate effectively to the benefit of both the insurance industry and investors. Clearly, whether in the years since the Prudential opinion in 1963, over 40 years, that sense of comfort and optimism in the implementation of the dual system of regulation was justified. I think we're going to talk a little bit more about that as we go on, but the real battle, the really important battle for regulation of variable contracts occurred not in the realm of variable annuities, but in the realm of variable life insurance that to the insurance industry was the important product. Annuities were always a secondary product to the insurance companies. Their business was largely life insurance, death protection, and it was in the area of life insurance that the industry was feeling the heat from the competition offered by the securities industry, particularly the mutual fund industry in an inflation-conscious era, post-World War II era. "Buy term and invest the rest" became a more and more popular slogan, which more and more people followed, and in order to deal with that threat, in order to feed the public's awareness of the danger of inflation and to provide them with an insurance-based solution, the industry developed the so-called variable life insurance policy. And this was not done by the marginal players in the industry; it was done by the leading insurance companies – Equitable, Aetna and Prudential, the John Hancock Company rather than Prudential. And these three companies joined together to prosecute an exemptive application with the Commission, and Gary, you represented the insurance applicants. Tell us why the insurance industry felt it was possible to get a complete exemption from securities regulation through the SEC, and what were their arguments and strategy.

GARY COHEN: As I said a minute ago, there was no individual company that wanted to begin offering variable life and take the risk of the SEC suing it. The three companies were Equitable, Aetna and New York Life, Dick. New York Life, the actuaries in New York Life had "invented" variable life if I can use that term as a lawyer rather than an actuary. The actuaries had created the breakthrough, I think, with the help of the new technology of computers, and had come up with a feasible way of making the mortality prognostications that would protect the company as well as the owners.

The industry came, as I said, to my senior partner, Milton Kroll, to our law firm, to see how this new product might be presented to the SEC. In 1970 we approached the SEC with the

idea of a rulemaking proceeding, which would be hopefully peaceful and rational and allow all interested persons to have a voice. We filed a rulemaking petition in November of '71.

The SEC set the matter down for formal administrative hearings in April '72. The SEC reached a determination in January of '73 which was very favorable to the insurance industry. There was a complete exemption from the '40 Act, and although not from the '33 Act, the SEC did indicate it would cooperate with the industry in developing disclosure. The mutual fund industry, led by Dick, sued for court review. The SEC announced reconsideration in September '73. The SEC set a second round of hearings in '74 to determine whether state regulation was an efficient substitute for federal regulation, reached a second determination in February '75 of "no," and announced that it was going to withdraw the complete exemption under the Investment Company Act. Finally in 1976, October '76, almost exactly six years after our first submission to the SEC, the SEC adopted a limited exemptive rule.

Now what had happened in between was that Equitable, one of the three companies that participated in the hearing, got impatient, saw the handwriting on the wall and asked our firm to get its product registered as a security and its separate account registered as an investment company. In order to do that, we had to fashion an application for exemptions under the '40 Act that was innovative and relied on the record being made.

RICHARD PHILLIPS: As I recall, it was innovative in the sense that it was aggressive and sought a complete exemption from each and every provision of the securities laws including the '33 Act and the Investment Company Act.

GARY COHEN: That was the rulemaking petition, not the exemptive application. Now going back to that, the rulemaking petition was aggressive and Dick asked for our thinking, and I think part of our thinking was this. United Benefit is curious because it came after Prudential but didn't say anything about Prudential, and it went on to say that the question, I'm quoting now, paraphrasing: the question whether the separate account may be separated from United Benefit's other activities and considered an investment company is a difficult one. An investigation into the relationship between the separate account and United Benefit's insurance business, as well as an investigation of the possible conflicts between state and federal regulation, is required for a proper resolution. How can the courts say that after Prudential?

RICHARD PHILLIPS: Assuming that's so, Gary, why in the world did the insurance industry think that they would get the most sympathetic hearing on that issue from the SEC, rather than the courts?

GARY COHEN: Well, we were smart lawyers. We saw that coming and we did win the first round.

RICHARD PHILLIPS: You did win the first round but that was pure accident. Let me go back. The mutual fund industry strongly opposed the rule making petition for exemption from the Investment Company Act as well as the Securities Act by the insurance industry for variable life insurance.

The issue was very simple. Life insurance carried sales charges in the first year that generally exceeded, whole life that is, that generally exceeded the first year's premium. The insurance salesman himself generally received a commission of 55% of the first year's premium, and the rest of it went to support a very strong marketing effort. The Investment Company Act, however, limited sales loads to 9% of the offering price, except in the case of contractual plans, where the limit was 50% of the first year premiums and 9% over the life of the contract. The mutual fund industry felt that if the insurance industry obtained an exemption from these provisions of the Investment Company Act in particular, they would have an overwhelming and uneven competitive advantage, and it was that competitive advantage that they sought to combat with the slogan that the insurance industry, by this application, was seeking to charge more than the Investment Company Act permitted and to disclose less than required by the Securities Act. Disclose less, charge more, and that was the fighting cry of the mutual fund industry, that we tried to develop a record through the SEC hearings. Interestingly, after the

hearings were over, we all filed our memorandums, our post-hearing memorandums, our reply memorandums, the insurance industry arguing that, gee, unlike variable annuities, there's no separate pay-in/payout period. The pay-in/payout periods are all inextricably intertwined and you couldn't separate the investment element from the life insurance element, and the fund industry arguing, sure you could. You just regulate the separate account, that's the investment element, okay? And most of the premium goes into the separate account anyhow. In any event, we write our briefs and lo and behold, the staff comes out with an unpublished report to the Commission, 150 pages and adopts all of the arguments that the fund industry had presented in the hearing - a 100% victory for the fund industry. Lo and behold, some months later, the Commission that was then chaired by Bill Casey, the fund industry started calling him Wild Bill Casey because in a burst of reckless candor and the emphasis is on recklessness, he issued a 9-page opinion upholding and granting the exemption sought by the insurance industry for complete freedom from the '40 Act regulation, at the same time, the 150-page staff report arguing the other way. It was the strangest phenomena that I had seen in my years as a Washington lawyer, then and even today. The regulatory agency issuing a 9-page broad brush opinion, granting an exemption and releasing a 150-page staff report arguing in great detail just the opposite.

Well, although the mutual fund industry was tired of this expensive litigation, and so were we, I might add, the opportunity to appeal on the basis of the staff report was too tempting, and so we appealed to the DC Circuit Court and we filed our brief. And in the interim while the appeal was pending, Chairman Casey moved from the SEC to become Director of the CIA. A new chairman came in, Chairman Garrett, a well-known, celebrated securities lawyer from Chicago. And I recall at the time, that when the SEC's reply brief to our brief in the Court of Appeals for the fund industry, when defending their decision, when that brief was due, I was going on vacation soon after and I wanted to get working on the reply to that brief as soon as I could, and I remember calling the Assistant General Counsel. And I have a tough time, even today, forgiving him because I said to him, hey, would you let me know the minute the brief is available, the minute it's filed, because I want to send a messenger down, and he said okay. And by gosh, the next day, the very next day, the Commission issued an opinion revoking their earlier decision and saying that variable life insurance should be regulated under both the Securities Act and the Investment Company Act, subject to various exemptions. It was truly one of the more amazing administrative law reversals I had ever seen and I think will see for a long time. The Commission never filed that brief, and I went on my vacation a very happy guy, but a little miffed that the Assistant General Counsel didn't tell me to relax and say maybe the deadlines will be extended.

GARY COHEN: But the predicate that we laid during the hearing paid off 20 years later, because the SEC threw in the towel on regulating individual fees and charges under variable products. The staff that Dick relied on turned over and produced a report in 1992 that recommended repeal of Sections 26 and 27, so far as regulation of variable products. Dick's right, the SEC had characterized VA's and VLI as periodic payment plan certificates, and subject to Sections 26 and 27 that regulated sales loads and certain payments out of the separate accounts.

During the VLI proceeding, we had argued that that was forcing a round peg into a square hole, but we did not prevail. But in this '92 report, the staff said that the SEC had jurisdiction to regulate the charges on the investment side, but not the insurance side. This was because the Congress had adopted the McCarran Act, which tied the SEC's hands in terms of regulating insurance, and the problem was, as the SEC staff said, this is a quote, its "efforts to regulate some charges but not others, may be ineffectual because issuers may compensate for restrictions on regulated charges by increasing unregulated charges and using the proceeds for regulated purposes." So the staff recommended that the Commission propose regulation to exempt variable products from specific charge limitations. Now the SEC, the Commission itself,

didn't act on that recommendation, but a few years later, Congressman Fields picked up the recommendations, and the SEC did not object when Congress amended the '40 Act in '96 to relax that regulatory approach and subject charges and fees under variable products to a reasonable standard in the aggregate, which happened to be the standard that mutual fund fees were subject to, so it put the insurance products on a level playing field with mutual fund products.

RICHARD PHILLIPS: Are you saying that Chairman Cary was right in the Prudential opinion, that gee, concurrent state insurance regulation and federal regulation of the securities element of the insurance element can exist happily, peacefully, consistently side-by-side, and that there was no reason for the insurance companies' concern over securities regulation? Or am I overstating things a little bit?

GARY COHEN: I think the SEC, of which I'm an alumnus, has done a good job of tailoring its regulation to the variable products, but it has been very arduous and very expensive, and, I'll quote Commissioner Loomis in a minute, who queried whether it was worth it. There hasn't been that many head-to-head conflicts between state and federal law. There've been some conceptual conflicts, but by and large, most of the problems were trying to fit the variable products under statutes that just weren't designed for them.

But before I get into that, I do want to articulate one irony that I see. Although the mutual fund industry opposed the rulemaking petition and eventually won out after six years, at least that stage of it, a great deal of the money today coming into variable products is managed by the industry that opposed the rulemaking petition. What happened, I think this is interesting historically, was that life insurance companies under state insurance law invested most of the assets underlying regular traditional insurance in fixed income securities and were not expert, and were not known to be expert, in managing equities. So when variable life came out in December '75, Equitable faced a market that was down for a period of time and so it didn't really sell that well. When Hancock came out in 1980, that didn't sell so well either and to make a long story short, the insurance industry, in order to make its products more attractive, offered as investment options funds like Fidelity and Scudder that were not sponsored by the life companies.

RICHARD PHILLIPS: That's right.

GARY COHEN: And the problem with that was the life companies forwent all of the management fee, so the life industry changed that model too, so that the life companies were the investment advisers and these managers like Fidelity were the sub-advisers.

RICHARD PHILLIPS: And they were basically managing another institutional account. Basically they treated the underlying fund for the variable contract to be another institutional account, and like the institutional account business, it's a good business, and mutual fund management organizations, as well as non-fund organizations, have competed seriously for that kind of business.

GARY COHEN: Now to get back to Dick's question about could federal regulation live with state regulation, I collected, since this is an historical society, some quotes. Chairman Ray Garrett, Jr. said, this was in '74, the Commission persuaded the Supreme Court that variable annuity contracts offered by insurance companies are securities and that the variable annuity portfolio or fund thus created is an investment company subject to regulation under the '40 Act, salesmen are regulated under the '34 Act, but the '40 Act registration has been something of a nightmare. Philip A. Loomis, our beloved Commissioner, whom we both work with said I tend to share some of the views of the industry spokesman. The staff knew very little about insurance and about variable annuities. There was a long period of experimentation and learning and looking and trying to find the right answers to problems, and in retrospect it is quite clear that this effort was not always successful. Arthur Levitt, Chairman, testified before Congress in '96. "The application of the '40 Act provisions governing periodic payment plans in those products has been difficult, resulting in the regulatory equivalent of fitting a square peg in a round hole."

In 1992, the SEC published a release that said the public is asked to consider whether insurance, variable insurance contracts should continue to be regulated as securities under the Securities Act. So you see, the experience was not a completely happy one, and the SEC asked whether it should continue to regulate?

RICHARD PHILLIPS: Well, happiness is a relative thing, Gary. If I recall back in the Prudential case, in the variable life insurance litigation before the Commission, the insurance industry said it could not offer this product, this variable product which was so important to the needs of so many people in an inflation-prone era, it could not possibly offer this product if it were regulated under the securities laws, particularly the Investment Company Act. Now, won't you concede, agree with me today, can't we find some common ground that that perhaps was an overstatement?

GARY COHEN: Well, I'm not really here to recreate history. I'm here to record history, and what the SEC said in 1992 and again I'll paraphrase, but there are differences between variable life insurance and variable annuities that may "warrant differing treatment" of these two types of contracts under that act. I mean it sounds as if the SEC went back to the submissions we made during the hearing, and maybe is sorry that it reversed the original determination that was in our favor.

RICHARD PHILLIPS: They were very good submissions, Gary. They were just arguing for the wrong thing.

GARY COHEN: Well, you hear echoes of them now across the decades. Now listen to this. This again is the 1992 SEC report. These are the questions that the SEC raised with the public – "what should be deemed to be the security? Who should be deemed to be the issuer? When should a sale be deemed to occur?" Now, Dick, those are pretty basic questions for an agency administering the federal securities laws. This is just 14, 15 years ago. The SEC still hasn't got it straight.

RICHARD PHILLIPS: At the same time, while the SEC may not have gotten the answers to its theoretical questions, it has regulated variable life and variable annuities. It has produced much more extensive disclosure under that regulation, and it has moderated relative to conventional life insurance and annuities the sales charges and other charges for this product, and the product has done well. I don't know what the latest figures are, but variable life insurance and variable annuities have become a mainstay of the insurance agents' package of products. It's not a sideline. It is a significant product, and it has saved, in my view, the insurance industry from being relegated to the sale of term insurance. But for the development of variable products, the insurance industry would have a very difficult time competing in this equity-conscious, inflation-prone world of today.

GARY COHEN: But what you left out was the cost of achieving this result. As Commissioner Loomis said in '77, "Ultimately what emerged was really not so bad, and these investor interests are being protected, although certainly at a cost." And then Loomis said "whether the protection of investors is worth what it costs is a matter that can be debated."

RICHARD PHILLIPS: Absolutely, but no one is seriously debating that somehow the regulation of variable life insurance and variable annuities ought to be left to state insurance regulation, that the primary focus of the regulation should be the preservation of financial solidarity, and the maintenance of adequate, high-quality reserves which were then, and are today, a main focus of state insurance regulation.

GARY COHEN: But what happened was that the SEC took on the responsibility of regulating these variable products, but did not devote the person power or the resources to get it done. For example, it took the SEC 29 years to develop a registration form for variable life. You say that the states couldn't have enforced the disclosure, but we in the industry had to create the mode of disclosure in the absence of guidance from the SEC. In 1973, Chairman Casey, you called him Wild Bill Casey?

RICHARD PHILLIPS: Wild Bill Casey.

GARY COHEN: He wrote to the industry and said: "With regard to the form of the disclosure document to be required under the Securities Act, you and your members are in a good position to propose solutions to the problems related to this endeavor. The Commission strongly urges that you consider further discussions with our staff with a view to an orderly development of guidelines." I wrote the guidelines the next two months and sent them in, and it was 29 years, 29 years, before they were reflected in the Form N-6 Registration Statements.

RICHARD PHILLIPS: He did get things done. Gary, you've made two valid points. No one has ever suggested that regulation is cheap, and no one has ever suggested that regulation is quick, although 29 years is, I think a startling fact. But it is symptomatic that throughout that 29-year period, the SEC has been chronically underfunded, not just in the insurance regulatory area, but throughout most of its activities, and it wasn't until the Enron/WorldCom debacles that the SEC was able to get significantly greater appropriations.

GARY COHEN: Well, I think that's true and I think that the turnover on the staff, as you and I experienced, has been the problem. When we talk about disclosure, let me just mention illustrations, because that was a key disclosure technique. When I was writing the first prospectus for Equitable, I had a choice of disclosing the theory of electricity or what happens when you flip the light switch, and we chose to follow the second approach. We went to Alan Levenson, who was Director of Corp Fin, who had the jurisdiction over disclosure at that time, and his assistant, Mary Beach, called Mickey Beach, and we said to them look, we could come in here and explain how these products work by putting in some numerical illustrations of the premiums, the death benefits, and the cash values under certain assumed rates of return.

RICHARD PHILLIPS: Which is the traditional way that insurance products were sold.

GARY COHEN: But not variable annuities. Manny Cohen, for whom you and I worked, Chairman Manuel Cohen, had said that illustrations are inherently fraudulent. I can hear him in my mind saying this, because he would say, Gary, Dick, a company will never earn the same rate of return year after year and your columns of illustrations are set up that way.

RICHARD PHILLIPS: Well, those were the days, Gary, where the Commission was deaf on projections and any kind of forward-looking statement. People like Manny may well turn over in their graves if they saw the MD&A and all the forward-looking statements that are not only made, but are required. I mean, the world of disclosure has changed. Maybe not fast enough as regulation is never fast, but it has changed, and what you saw was a Commission steeped in a depression psychology that felt that any kind of optimistic forecast, any kind of projection was inherently suspect and perhaps even fraudulent.

GARY COHEN: Right, and so because of that...

RICHARD PHILLIPS: That permeated the whole disclosure philosophy of the Commission, not limited to insurance products.

GARY COHEN: But to their credit, Alan and Mickey saw the value of the illustration in promoting a shorter and more direct disclosure and did permit it.

RICHARD PHILLIPS: Well at that time, they were the young Turks.

GARY COHEN: They were the young Turks. And in fact, they required the illustrations in all of the prospectuses. And then what happened? The SEC reversed itself just recently when it adopted the Form N6 Registration Statement for VLI. The SEC said look, we've got too many of these illustrations now. We wanted them in there for cost comparison purposes, but different companies have different markets. They want illustrations for different ages, different risks, etc. and we've lost our cost comparison, we lost the simplicity of disclosure, so now we're going to make them optional, no longer mandatory.

RICHARD PHILLIPS: I tend to agree with the Commission on that one. You open even a mutual fund prospectus and there are so many numbers and tables in there that apply to 16 different situations other than your own that ferreting through that is like working through a morass. You have to be a scholar and one who likes numbers in order to get anything out of

many of the fund prospectuses and that goes with even greater force for the variable contract prospectuses.

GARY COHEN: And a third disclosure problem is the “evergreen” prospectus because, as I just read, the SEC could never tell us whether the sale of the security involved the contract or the units under the contract. So did the sale take place when the contract was sold, or at each time a subsequent payments for units comes in. So many companies said, like the South when it lost to the North, said well phoo on you, we are going to deem the sale of the contract to be the sale of the security, and each year after that, we’re not going to provide updated prospectuses for the product or the underlying fund to our individual contract owners. And there are companies to this day that are saying that. The SEC has never objected, has never brought an enforcement action, never taken an insurance company to court. So is that the kind of disclosure scheme we want for the public? I don’t know. You see, the SEC never really stepped up to the plate and decided some of these fundamental questions.

RICHARD PHILLIPS: You’re absolutely right, but I don’t think you can judge the success of regulation by looking at the defects. You’ve got to look at the broader picture, and the broader picture is a variable contract business in the insurance industry that is growing, is viable, has brought important benefits to the holders, and has done so at a more moderate cost, and I think with better disclosure than I think would have been the case had it been left solely to state regulation. And despite all the complaints that the insurance industry may have about the SEC and federal regulation, what is this rumor I hear that the insurance industry now wants to abandon state insurance regulation and replace it with a federal system of regulation for the industry?

GARY COHEN: And that’s the final irony.

RICHARD PHILLIPS: And that’s the irony of this.

GARY COHEN: And that’s the final reversal that we’ll talk about today, that the industry that fought so hard against federal regulation is now actively working for federal regulation. Now I better add that this is not unanimous. Not every company agrees with this, but many companies believe that state regulation is outdated. Now part of it is because both the state insurance regulators and the state securities regulators want a piece of it.

RICHARD PHILLIPS: That’s right.

GARY COHEN: Then there’s a redundancy of federal regulation, and there’s the non-uniformity of state regulation, which means it takes too long to get a product to market.

RICHARD PHILLIPS: You bet. And in this global economy where speed is important, it is truly an antiquated system of having to go through 50 state regulators, sometimes two sets of regulators at the state level as well as the federal government.

GARY COHEN: So the American Council of Life Insurers is lobbying Congress for federal insurance regulation along the lines of federal bank or thrift regulation. Life companies would choose between traditional state or the new federal regulation. The federal regulator would be a department, preferably Treasury.

RICHARD PHILLIPS: Not the SEC?

GARY COHEN: No, but the SEC would still regulate the products.

RICHARD PHILLIPS: Oh, okay.

GARY COHEN: Still regulate the products, but Treasury would regulate and set insurance policy, and the insurance companies think that it would protect them against the, for example, repeal of the tax benefits, to have a cabinet level clout.

RICHARD PHILLIPS: To have a constituency in Washington?

GARY COHEN: A constituency in Washington. It would be federal.

RICHARD PHILLIPS: How interesting. The wheel turns. Well Gary, this has been a very interesting discussion and I want to thank you for putting up with me and sharing and debating our thoughts on the entry of insurance companies into the mutual fund industry.

I want to remind our audience that today's program is now archived in the Society's virtual museum. You can listen to this discussion again and again and again if you choose at any time, or you can read the transcript later on.

Our four-part series on developments in the mutual fund industry will resume next week on Tuesday March 29. Marty Lybecker of Wilmer Cutler Pickering Hale & Dorr will moderate a discussion on the development of money market funds with John McGonigle, vice chairman of Federated Investors, Inc., Robert Plaze from the SEC's Division of Investment Management, and David Silver, retired president of the Investment Company Institute. Please join us at 2 PM Eastern Standard Time and thank you for being here with us today.