# LIFE INSURANCE (C3) SUBCOMMITTEE

Reference:
1973 Proc. Vol. I p. 277
1973 Proc. Vol. II p. 532

Hon. Dick L. Rottman, Chairman – Nevada
Hon. Stanley DuRose, Vice-Chairman – Wisconsin

## AGENDA

1. Report of Task Force on Proposal for In-Depth Study of Life Insurance Industry.

2. Report of Task Force on Life Insurance Cost Comparison and Discussion of Model Regulation.

3. Report of the Split-Life Task Force.

4. Report on California Investigation into Deposit-Term Life Insurance.

5. Discussion on Guaranteed Issue Life Insurance.

6. Any other matters brought before the Subcommittee.

The Life Insurance (C3) Subcommittee convened on Tuesday, December 4, 1973, at 9:15 a.m. in the Las Vegas Hilton. A quorum was present.

The first item on the agenda was a report by Commissioner Huff, Iowa, Chairman of the interim task force to determine the feasibility of an in-depth study of the life insurance industry. Commissioner Huff outlined four specific areas the task force felt should receive the immediate attention of the (C3) subcommittee. Included were:

1. A study of the causes, effects and cures for life insurance policy lapses.

2. A study of agents compensation systems to determine the impact which compensation structures have on the sale of various classes of life products.

3. A study of reinsurance activities aimed at developing guide lines for eliminating various undesirable problem areas.

4. A study of the standard nonforfeiture and standard reserve valuation laws.

Mr. Manual Gorman, ALIA, endorsed the proposal and offered the full cooperation of his organization. The report was received in open session and adopted by the Subcommittee in executive session.

It was agreed by Subcommittee members that the Chairman of the Subcommittee will appoint four permanent task forces to make reports on the study in the four areas listed.

The chairmen of the task forces will be comprised of state insurance commissioners and it was urged that the commissioners themselves participate as much as possible. Commissioner

Payne, California, volunteered and was accepted as one of the task force chairman. The interim report is attached.

Commissioner DuRose gave a report on each of the matters discussed and the actions taken by the Task Force on Life Insurance Cost Comparisons. The Subcommittee voted that the report be adopted (attached).

A report was given in open session by Richard W. Plumber on a new interest adjusted consumer cost index he had prepared. The Subcommittee members during executive session received the report and referred it to the Task Force on Cost Comparison for consideration.

The report of the Split Life Task Force was presented by Harold Jacobsen, its Chairman. The report was received by the Subcommittee and is attached. The Subcommittee members will study the recommendations of the Task Force and communicate their thoughts to the Subcommittee Chairman or the Task Force members. The Task Force will report back to the (C3) Subcommittee at the June, 1974, Annual Meeting (San Francisco).

The California Department asked that the report of their investigation into deposit term life insurance be postponed until the June, 1974, Meeting. A brief discussion ensued and it was decided to broaden the study and appoint a task force. The Chairman of the Subcommittee appointed a task force with Commissioner Payne as chairman to conduct the study in this area.

The fifth item on the agenda was the discussion on guaranteed issue life insurance. There was very little interest generated on this subject either in the open or executive sessions. For this reason it was decided it would not be given further consideration at this time.

Having no further business, the meeting adjourned.

Dick L. Rottman, Chairman, Nevada; Stanley C. DuRose, Vice-Chairman, Wisconsin; John J. O'Shea, Alaska; J. Richard Barnes, Colorado; William H. Huff III, Iowa; Frank M. Hogerty, Jr., Maine; Evelyn Gandy, Mississippi; Kenneth E. DeShetler, Ohio; Carlos R. Rios, Puerto Rico; Joe Christie, Texas; Samuel H. Weese, West Virginia.

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Task Force on the Proposed In-Depth Study of the Life Insurance Industry

Springfield, Illinois

October 2, 1973

The Task Force met on October 2, 1973, at the time of the Zone IV meeting in Springfield, Illinois. The meeting was in executive session. As a result of the discussion at that meeting, this Task Force has concluded that although many areas of the life insurance industry are in need of an in-depth study by the NAIC, a single comprehensive study is not an appropriate approach for meeting this need. Since many areas of regulatory concern involving the life insurance industry are currently under study by NAIC committees, an all encompassing comprehensive study would lead to unnecessary duplication of effort.

We also believe, however, that those specific areas of concern which are not currently under study by the NAIC should be handled through the normal operation of the Life Insurance (C3) Subcommittee. We therefore recommend that this Task Force be discharged and that the Life Insurance (C3) Subcommittee continue its practice of appointing task forces for the study of specific problems.

Although the Task Force recognizes that many problem areas could be identified which are not currently under study by the NAIC and which could properly be included in a list of subjects for study, we have isolated four areas of concern which we believe should receive the immediate attention of the Life Insurance (C3) Subcommittee. The studies which we propose are as follows:

1. A study of causes, effects and cures for life insurance policy lapses. Consideration should be given to the role of the type of policy, marketing system, agent's compensation, amount of coverage, amount of premium and replacements play in high lapse rates.

2. A study of agents' compensation systems in an effort to determine the impact which compensation structures have on the sale of various classes of life insurance products. Consideration should be given to the feasibility of adopting expense limitation statutes. The goal of such a study should be to develop a compensation system which would encourage agents to sell according to the need of the buyer.

3. A study of reinsurance activities aimed at developing guidelines for eliminating fronting, reverse competition, distortion of accounting, hidden financial support or any other undesirable phenomena.

4. A study of the standard nonforfeiture and standard valuation laws. The present statutes in most states are based on the so-called Guertin Legislation which was based on a report of a special NAIC committee published as a supplement to the proceedings of the NAIC in September, 1942. The basic data underlying this model legislation was derived in a substantially different era than what exists today. The Society of Actuaries presently has a special committee reviewing the existing model legislation for the purpose of formulating suggested changes. The NAIC should study the underlying basis of existing legislation and determine the form and substance of such legislation as may be necessary and desirable in the contaxt of today's market and regulatory needs.

Hon. William H. Huff, III, Chairman, Iowa; Hon. Samuel H. Weese, West Virginia; Hon. Stanley C. DuRose, Wisconsin.

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Life Insurance Cost Comparisons (C3) Task Force

Las Vegas, Nevada

December 3, 1973

The Life Insurance Cost Comparisons (C3) Task Force met at 1:30 p.m. Monday, December 3, at the Las Vegas Hilton Hotel. A quorum was present.

The Chairman reviewed the subjects contained in the June, 1973, report of the Task Force. That report described twelve research projects and identified particular persons or organizations which were to be requested to undertake the specified research projects. The research projects were assigned as indicated in the June report. The Chairman summarized the status of each of the twelve research projects. In general, a substantial amount of work has been done on each project but progress has been slower than initially anticipated and none have been completed to date. Several of the research projects are dependent upon the use of or the extraction of information from the data bank that is being generated as a joint effort with the Subcommittee on Anti-Trust and Monopoly of the U. S. Senate Judiciary Committee. The original sample of insurers has been enlarged so that comprehensive policy data from more than 250 insurance companies is now contained in the data bank. It was reported that a complete printout of the data bank would consist of some 120,000 pages. The data base for several of the research projects will be drawn from the total data bank. The difficulties associated with the generating of this large body of data and with the development of methods of access to the data and form in which the data would be made available to those persons responsible for the associated research projects has resulted in the delay in completion of the research projects. These matters are being resolved and the actual study and review of the data will commence within the next 30 days. The Chairman reported on the specific status of each of the twelve research projects.

The Chairman reported that he had received various communications concerning the model regulations attached to the June, 1973, Task Force report. Commissioner Rottman, Nevada suggested certain changes in Section 4 of the Deceptive Practices in Life Insurance Model Regulation. The changes suggested were editorial in nature to accommodate the text of the rule to direct response merchandising. The Task Force voted to modify Section 4 of the model regulation on Deceptive Practices in Life Insurance to read as shown in the attached redraft of that section following this report.

In addition, at request of Commissioner Rottman, the Task Force voted to modify the model regulation on Deceptive Practices in Life Insurance by adding an explanatory note following Section 5 as follows:

> EXPLANATORY NOTE: In direct response merchandising, it is intended that an appropriate interrogatory at the time of the application for insurance, as to the applicant's opinion of the suitability of the product after a review of his insurance needs and means, be deemed to meet the requirements of Section 5(g).

Mr. Robert Seiler, General Counsel, Allstate Life Insurance Company, made a statement (attached) before the Task Force concerning the Life Insurance Interest Adjusted Cost Comparison Index Model Regulation. Several comments were made by industry representatives in attendance, both in support of and opposition to the statement of Allstate Life.

The Chairman noted that several commissioners had directed his attention to a misunderstanding of the action of the (C3) Subcommittee at the June meeting concerning <u>alternate</u> model regulation language contained in the Subcommittee report which amended the Life Insurance Interest Adjusted Cost Comparison Model Regulation. The result of the action of the (C3) Subcommittee as to the disclosure requirements of Section 5 was that a state regulation that would provide either:

1. that "the agent or insurer shall furnish" [the index] <u>"upon request of a sales prospect"</u> (emphasis added), OR

2. that "the agent or insurer shall furnish the sales prospect" <u>in all cases,</u>

would be consistent with the Model Regulation. [Note: the text of Sec. 5 as published in the 1973 <u>Proc. Vol.</u> II p. 540 incorrectly fails to provide two alternate versions of the second sentence in that section.]

Having no further business, the Task Force adjourned.

Stanley C. DuRose, Chairman, Wisconsin; William H. Huff, III, Iowa; Dick L. Rottman, Nevada; Clay Cotten, Texas; Samuel H. Weese, West Virginia.

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Deceptive Practices in Life Insurance Model Regulation;
Section 4 as Revised, December 3, 1973

(Additions are Underlined; Deletions are in Brackets)

Section 4. BASIC REQUIREMENTS. In connection with the selling of life insurance:

A. <u>An agent shall</u> inform the prospective purchaser that he is acting as an insurance agent <u>and give the purchaser</u> the full name of the insurance company for which he is a licensed agent <u>or an insurer shall inform the purchaser of its full name.</u>

B. <u>The agent or insurer shall</u> provide to the prospective purchaser prior to or with the delivery of a contract, a written proposal describing the elements of the contract including but not limited to:

   1. the name and signature of the insurance agent or the name of the employee of the insurer if no agent is involved, who assumes responsibility for the proposal;

   2. the full name of the company in which the life insurance is to be written;

3. the name of the policy or contract and any supplemental riders;

4. disclose any provision in the policy which will reduce the death benefit while the policy is being maintained in force on a premium paying basis, other than a reduction as the result of a suicide provision or a reduction for a policy loan;

5. except for such combinations as are authorized by statute or regulation the premiums for the life insurance shown separately from the premiums for each additional supplemental benefit provided in the contract;

6. the face amount of the life insurance shown separately from the amounts of coverage shown for any additional or supplemental benefit provided in the contract;

7. all matters pertaining to life insurance set forth separately from any matter not pertaining to life insurance.

The written proposal may consist of (1) a separate written presentation, (2) the policy specifications page or (3) it may be included in the solicitation material advertising the policy. All information required to be disclosed shall be set out prominently therein in uninterrupted sequence in one location in the separate written proposal, the specifications page or in the advertising material. No additional material, other than that required, shall be interspersed between each of the items required to be disclosed.

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Statement re: the Life Insurance Interest Adjusted Cost Comparison Model Regulation

*Allstate Life Insurance Company*

December 3, 1973

As you know, in June of this year the NAIC adopted an interim model regulation regarding the use of a life insurance interest adjusted cost comparison index. That regulation was modeled in large measure on the regulation promulgated by Commissioner DuRose of Wisconsin some months earlier. Commissioner DuRose is to be commended for his leadership in this area. He promulgated a regulation at a time when the industry was totally divided on the central issue of whether or not the interest adjusted method of calculating cost indexes was appropriate. While there are some persons who still object to this development, the interest adjusted method is no longer an "industry" issue. Allstate, for one, supports the basic objectives of the interim regulation.

Six months have elapsed since the interim model regulation was adopted by the NAIC. During that period only three states, Arkansas, Kansas and California have held hearings leading to the proposed adoption of the NAIC interim model. To date, only Arkansas has issued a regulation on the subject – and that with an effective date of February 1, 1974 and differing considerably from the NAIC model. Kansas and California have deferred any action. At those hearings the comments ranged from outright opposition to the entire regulation to support provided modifications were made. Very few persons supported the regulations as proposed.

It appears to me that we must raise the level of discussion of this subject. A re-examination of the content of the regulation is in order. It may be possible to convert some of the opposition to support with a few well reasoned modifications to the interim model regulation. The type of modifications I have in mind do not have to wait for the completion of the research projects you've undertaken. We have all the facts in hand today. All that is required is the application of logic to those facts, coupled with the determination to have a model regulation that will come up to the basic purposes intended to be served.

Objectives of the NAIC Model Regulation.

It is clear from a reading of the proceedings of this Task Force and the interim model regulation itself that tne basic objectives of the regulation are:

1. to adopt a new method of calculating life insurance costs to replace the traditional net cost method, which you determined to be misleading;

2. to furnish the consumer with additional information which will enable him to make a more enlightened decision to buy; and

3. to enhance competition.

While the interim model has started down the road toward those goals, in our view, it falls far short of its objectives because it contains four very basic deficiencies.

Four Basic Deficiencies.

These deficiencies are:

1. some of the language used is inaccurate and capable of deception;

2. the interim model omits certain material information which not only makes the disclosure deceptive but actually prevents a consumer from comparing the relative costs of similar policies;

3. the regulation is inconsistent with the NAIC Model Regulation on Replacements, which seeks to achieve comparable objectives, and also with the Model Regulation on Deceptive Sales and Advertising Practices in Life Insurance; and

4. as presently drafted there is serious question of its constitutionality under the 14th Amendment to the U.S. Constitution.

These deficiencies are interwoven throughout the regulation. Let us look at these deficiencies in the order mentioned.

Inaccurate and Deceptive Language.

First, throughout the regulation the phrase "interest adjusted cost comparison index" is used to describe the "cost" information to be displayed. This is an improper label. In point of fact, the regulation now requires only that a surrender cost index be set forth. Yet the language purports to tell the consumer that this is a cost index for all purposes; that, by implication at least, it is the only cost index that is important (this is equivalent to saying that the index represents the true cost of insurance, an inaccuracy which has been perpetuated in Commission Denenberg's latest Shopper's Guide). That is an error and is deceptive. There is another cost index that is not only meaningful but necessary information, the death cost index (or annual net payments index). Unless a death cost index is included, the regulation should clearly call the index). Unless a death cost is included, the regulation should clearly call the index a "surrender" cost index.

Second, but obviously just a drafting error, the language of Section 4(a)(1) of the regulation does not require the first ten and first twenty year periods to be used in calculating the surrender cost index. Meaningful comparisons of policies will not be possible if companies can select any ten or twenty year period, as the regulation now allows.

Third, the last sentence of Section 5 of the regulation states that a lower cost index represents a better buy than a higher one. This can be very deceptive when comparing two or more participating policies. When cost indexes are recalculated using actual dividends paid, the results may often be quite different. In addition, the language tends to be deceptive in that it ignores other factors which must be taken into consideration in determining the best buy – the value of the agent's services, the financial strength of the company and, of course, the death benefit cost index.

Fourth, the language of Section 6 of the regulation implies that the dividends actually paid will differ from the illustrated dividends used to calculate the cost index only if the company's investment earnings, mortality experience and expense experience differ from that currently being experienced by the company. Recognized authorities in the life insurance industry as well as numerous court decisions and the NAIC Model Replacement regulation itself clearly state that the amount of dividends actually paid is in the sole discretion of management.

Material Information Omitted.

It has long been recognized by the regulators, and the courts, that the omission of material information can be as deceptive as affirmative statements which are deceptive. The regulation presently omits two material items of information, the absence of which makes the disclosure misleading and totally prevents a valid comparison of similar plans of insurance:

1. Death Cost Index: As we indicated earlier, a death cost index is vital to the proper disclosure of cost information. Death cost figures differ from company to company just as surrender cost figures do. To ignore death cost indexes in any comparison of policy costs is to ignore the motivating reason underlying the bulk of life insurance purchases. Relatively few life policies are sold solely for investment purposes.

   In this era of inflation we do an extreme disservice to the public if we do not give it the information which will permit it to maximize the value of its purchase. The young family man is particularly in need of protection and should be given the opportunity to learn that for the same gross amount of premium he can buy more protection, with cash values, from Company A than from Company B, even though Company B's surrender cost index for a given face amount may be lower than Company A's. The public must be given both indexes – death and surrender cost – if it is to make an enlightened decision on which of several policies to buy.

   Not only is it misleading to omit this information, but it defeats the very purpose of the regulation. No valid comparison of policies can be made and price competition will not be enhanced. I must confess that no one – regulator or otherwise – has given me a single, logical reason for ignoring the death cost index – something which is so obviously in the best interests of the public.

2. Participating policies need not show the guaranteed values cost index: Section 4 of the regulation permits a company issuing a participating policy to take full credit for illustrated dividends in calculating the surrender cost index. It need not show the cost index for the guaranteed surrender values separately from that which is, by law, not guaranteed. This is:

   a. deceptive because it implies that the dividends included in the calculation will in fact be paid. That sanctifies the dividend illustration and confers upon it a status clearly not permitted by law. Certainly dividends will be paid by most companies – but that fact has never justified any statement or implication that the illustrated dividends will be paid. The traditional dividend caveat is insufficient when there is no way for the public to ascertain what portion of the cost index is attributable to non-guaranteed illustrated dividends;

   b. deceptive because the regulation does not even require the illustrated dividends to be displayed. Certainly that is material information;

   c. inconsistent with the stated purpose of permitting the comparison of similar plans of insurance. The Task Force rejected the idea that participating and non-participating policies ought not be compared – and rightly so. However, having failed to give it the means to make such a valid comparison, the cost disclosure is of no real value to the public.

A simple adjustment will rectify these problems. Cost indexes which are net after deducting dividends should not be permitted unless the comparable index (gross before deducting dividends) is also shown separately and with equal prominence. Appropriate titles can be developed to describe these indexes in a way which will not act to the detriment of any segment of the industry but which still imparts accurate information.

Granted there is an element of competition in this suggestion. However, we should not overlook the fact that, as presently drafted, the regulation would equally prevent two participating policies from being compared. If cost comparison ultimately produces a quantum increase in the competitive environment, it may also generate an epidemic of optimism about illustrated dividends. Guaranteed values will then become even more important to the buyer.

The Task Force has a study of dividends in process. We need not wait for that study. History already clearly indicates there is a difference in company rankings comparing illustrated and actual dividends. Using information from such a comparison in Best's Review September, 1972 edition and computing the 10th year interest adjusted surrender cost indexes we see that the rankings of companies changed on policies issued in 1962, when surrender cost indexes based on illustrated dividends are compared to surrender cost indexes based on dividends actually paid. Note the following rankings for the top ten companies:

| Company | Illustrated | Paid |
|---|---|---|
| California Western | 1 | 5 |
| Occidental | 2 | 6 |
| Integon Life | 3 | 7 |
| Nationwide | 4 | 8 |
| U.S. Life | 5 | 9 |
| MONY | 6 | 2 |
| Security Benefit | 7 | 10 |
| Southern Farm Bureau | 8 | 4 |
| Life and Casualty (Tenn.) | 9 | 3 |
| Columbus Mutual | 10 | 1 |

The person who bought on the basis of the No. 1 ranking in 1962 found, ten years later, he actually bought No. 5. And so on – proof that dividends as variables are important to a cost comparison of participating policies and should be disclosed separately. Proof also that dividends are equally important to a comparison of a participating and non-participating policy.

Both industry and the NAIC may have lost their perspective on the switch from traditional net cost to interest adjusted cost. A study of the same source material discloses that there is a greater variance in company rankings evidenced by a comparison of illustrated dividends with actual dividends than that produced by comparing traditional net cost rankings with interest adjusted cost rankings. Comparing illustrated dividends with actual dividends paid: seventeen companies changed more than five positions in the rankings (eight changed ten or more positions and nine companies changed six to nine positions). Comparing net cost positions with interest adjusted cost positions: only eight companies changed more than five positions in the rankings.

We should also point out that the interim model regulation is inconsistent with the NAIC Model Regulation on Replacements, which seeks to serve a comparable purpose – to permit a comparison of two policies. The replacement regulation requires that illustrated dividends be set forth separately from tabular cash values. Obviously, if such a requirement is necessary to produce a proper comparison of policies, similar treatment must be given to cost indexes (both surrender and death benefit).

Inconsistency With Other Regulations.

The model regulation clearly sets forth as a deceptive practice the use of any cost comparison which does not recognize the time value of money. This is in direct conflict with the NAIC Model Replacement Regulation which requires a comparison of premiums, dividends and increasing cash values, with no allowance for interest. The Model Replacement Regulation also requires that dividends must be displayed separately from guaranteed values. As already noted, the interim regulation does not even require dividends to be displayed – an obvious deficiency. In addition, we have already noted the inconsistency between the two regulations in the description of dividends. Finally, because of the inaccuracies and omissions described above, the practices required by the interim regulation would seem to be prohibited by the Model Regulation on Deceptive Sales and Advertising Practices in Life Insurance adopted by the NAIC in June, 1973.

Constitutionality

It appears to us that a very good argument can be made that the interim regulation is unconstitutional because it does not confer equal protection of the laws upon those subject to the Regulation. As drafted it requires some companies to display a cost index on a guaranteed value basis but does not require other companies to do so. Differentiating between companies in this fashion is an improper classification for the purpose of the rule and is therefore unconstitutional. It acts to the detriment of one group of companies compared to the other by conferring a competitive advantage upon one group not available to the other.

The Arkansas Insurance Department has sought to cure this constitutional objection by requiring companies writing participating policies to set forth the interested adjusted cost index for the illustrated dividends separately from the surrender cost index net after deducting illustrated dividends. Perhaps a court would find that requirement solves the constitutional problem, who knows. One thing I know for sure, it does not solve the problem from the standpoint of the consumer. He is not told that he must add those two indexes together in order to get the equivalent guaranteed surrender cost or death cost index so as to compare similar participating and non-participating policies. That approach attributes a level of sophistication to the average buyer of insurance that is unwarranted. It is too easy a response to assert that the competing agent will tell him he must add those figures together. That may or may not happen depending upon which agent he sees first – the one selling par or non-par insurance. What happens if there is no agent involved?

Conclusion.

In conclusion, we repeat our belief that the interim regulation permits deceptive sales practices. We recognize this a harsh judgment, but one we believe is entirely justified. Fortunately the deficiencies are easily cured. Some require what may be described as editorial changes. Others merely require inserting a second cost index – the death benefit cost index – and separating the cost indexes for guaranteed values from those which by law cannot be guaranteed. We have attached for your convenience – as Exhibit A – a redraft of the model regulation incorporating these suggested changes.

We see some early signs that other companies are recognizing the validity of some of these basic points. Northwestern Mutual, for example, recently testified in Arkansas in favor of having the proposed regulation on "costs" apply to term insurance. We agree with the suggestion. That action would seem to be an agreement with our assertion regarding the need for a death benefit cost index on all plans. Northwestern Mutual and a number of other companies are already giving their agents the interested adjusted cost index for the illustrated dividends, as a supplement to the surrender cost index net after taking credit for the illustrated dividends. A step in the right direction, but not far enough!

May I respectfully urge the Task Force to redraft the interim model regulation at this meeting. Experience to date indicates the present regulation may not be adopted by the states if you defer action on this matter. What will the consumer advocates and the critics of our industry and state regulation have to say about our inability to fill this void with meaningful and practical regulation? We stand ready to be of assistance to you in any way we can. Thank you.

Respectfully submitted,

Robert S. Seiler
General Counsel

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EXHIBIT A

ALLSTATE LIFE INSURANCE COMPANY
Suggested Revision to the NAIC Life Insurance Interest Adjusted Cost Comparison Index
Model Regulation

*(Additions are underlined; deletions are in brackets)*

LIFE INSURANCE INTEREST ADJUSTED COST COMPARISON [INDEX] INDEXES

Section 1. AUTHORITY. This rule is adopted and promulgated by (title of supervisory authority) pursuant to sections _____ of the Insurance Code.

Section 2. PURPOSE. It is in the interests of prospective purchasers of life insurance that there should be available to such persons [a] cost comparison [index] indexes prepared on a uniform basis for comparison of the relative cost of similar plans of insurance. It is in the public interest to make such [an index] indexes available so that price competition in the life insurance market is encouraged and stimulated.

Section 3. SCOPE.

a. Except as provided in paragraph b. this rule shall apply to any solicitation, negotiation, or procurement of life insurance occurring within this state.

b. This rule shall not apply to:

1. Annuities,

2. Credit life insurance,

3. Franchise life insurance,

4. Group life insurance,

[5. Term life insurance,]

5. [6.] Plans of life insurance with benefits which vary by policy duration including but not limited to such plans as retirement income and variable life insurance,

6. [ 7.] Benefits which are supplemental to basic life insurance benefits such as accidental death and dismemberment, waiver of premium, or guaranteed insurability benefits (if the cost of any of these benefits are included in the price of the basic life insurance without separate identifiable charge, then in calculating [the] any life insurance interest adjusted cost comparison [index] indexes a reasonable adjustment in the annual premium payable on a per $1,000 basis may be made),

7. [ 8.] Benefits purchased by a special option applicable to dividends,

8. [ 9.] Life insurance policies wherein the face amount of insurance is $5,000 or less,

9. [10.] Life insurance on substandard risks,

10. [11.] Life insurance policies issued in connection with [split funded] pension trust plans.

Section 4. INTEREST ADJUSTED COST COMPARISON [INDEX] INDEXES DEFINED.

a. Surrender Cost Index. The interest adjusted surrender cost comparison index for level premium plans of insurance shall be calculated by applying the following steps.

[1. Select the 10 year or 20 year period over which the analysis is to be made.]

1. [2.] Determine the cash value (and terminal dividend, if any) available [at the end of] for the periods [selected.] ending with the 10th and 20th policy years.

2. [3.] For participating policies, accumulate the annual dividends at 4% interest compounded annually to the end of the period selected (10th or 20th year) and add this accumulation to the result of Step [2.] 1.

3. [4.] Divide the result of Step [3] 2 (Step [2] 1 for non-participating policies) by an interest factor that converts it into a level annual amount accruing over the respective periods [selected] stipulated in Step 1. If the period is 10 years, this factor is 12.486 and if the period is 20 years, the factor is 30.969.

4. [5.] Subtract the result of Step [4] 3 from the annual premium payable.

5. [6.] Divide the result of Step [5] 4 by the number of thousands of the amount of insurance to arrive at the Life Insurance Interest Adjusted Surrender Cost Comparison Index.

[b.] The life insurance interest adjusted surrender cost comparison index for plans of insurance with premiums which are not level shall be calculated as follows:

[1. Select the 10 year or 20 year period over which the analysis is to be made.]

1. [2.] Determine the cash value (and terminal dividend, if any) available [at the end of] for the periods [selected] ending with the 10th and 20th policy years.

2. [3.] For participating policies, accumulate the annual dividends at 4% interest compounded annually to the end of the period selected (10th or 20th year) and add this accumulation to the result of Step [2.] 1.

3. [4.] Divide the result of Step [3] 2 (step [2] 1 for non-participating policies) by an interest factor that converts it into a level annual amount accruing over the periods [selected] stipulated in Step 1. If the period is 10 years, this factor is 12.486 and if the period is 20 years, the factor is 30.969.

4. [5.] Subtract the result of Step [4.] 3 from the equivalent level premium determined by accumulating the annual premium payable at 4% interest compounded annually to the end of the periods stipulated in Step 1 and dividing the result by the respective factors stated in Step [4.] 3.

5. [6.] Divide the result of Step [5.] 4 by the number of thousands of the amount of insurance to arrive at the Life Insurance Interest Adjusted Surrender Cost Comparison Index.

b. Death Cost (annual net payments) Indexes. The interest adjusted death cost comparison indexes shall be calculated in the same manner as the comparable interest adjusted surrender cost comparison indexes except that the cash values and terminal dividends used in step 1 for level and non-level premium plans would be set at zero.

c. Interest adjusted guaranteed surrender cost comparison indexes and interest adjusted guaranteed death cost comparison indexes are calculated by assuming that all illustrated dividends are zero.

Section 5. DISCLOSURE REQUIREMENTS. In connection with the selling of life insurance to which this rule applies the agent or insurer shall furnish, upon request of a sales prospect at or prior to delivery of the policy, the Life Insurance Interest Adjusted Surrender Cost and Death Cost Comparison Indexes calculated for both [a] the 10th [year] and [a] 20th [year period] policy years. For participating policies, the indexes shall be set forth on a guaranteed cost and net after deducting illustrated dividends basis. All indexes shall be set forth with equal prominence. The indexes need not be provided for a period which extends beyond the end of the premium payment period for the plan. The indexes must be accompanied by an explanation substantially to the effect that the life insurance interest adjusted cost comparison indexes [is] are a measure of the relative cost of protection of similar plans of insurance and other services rendered by the insurer and that, for each specific index, a low index number represents a better value than a higher one.

Section 6. LIMITATIONS. The life insurance interest adjusted cost comparison indexes must be used with caution and should not be emphasized to the point that actual premiums and policy benefits are overshadowed[.] nor so as to minimize the value of the services of an agent, if any, or the financial strength of the insurer. [Only] These indexes are most useful in comparing similar plans of insurance. [should be compared.] Any illustrated dividends used in calculating the Life Insurance Interest Adjusted Cost Comparison Indexes must be displayed and shall be based on the current dividend scale in actual use by the insurer. In respect to participating policies, care must be taken to accurately describe the policy dividend as a refund or return of part of the premium paid, which is not guaranteed and which [is dependent on] tends to reflect the investment earnings, mortality experience, and expense experience of the insurer[.] and the actual dividends paid may be more or less than the illustrated dividends used to calculate the cost indexes.

Care must also be taken that the interest adjusted cost comparison indexes be furnished to the sales prospect in a manner which does not minimize the indexes or otherwise render them obscure.

Section 7. EFFECTIVE DATE. This rule shall become effective ____________

Section 8. PENALTY. Violations of this rule shall subject the insurer or agent to the penalties provided in ____________

EXPLANATORY NOTE: The life insurance interest adjusted cost comparison indexes can be viewed as a measure of the relative cost of protection and other services rendered by the insurer and [is] are most useful for comparison of similar policies. [More technically the interest adjusted cost comparison index is the average annual premium minus any average annual dividend and average yearly cash value increase for the period, all adjusted for interest. In respect to the annual dividend the effect of the interest adjustment is that the illustrated annual dividends are converted into equivalent level annual dividends so calculated that when accumulated with interest for the specified period they have the same accumulated value at the end of the period as the actual non-level dividends. If premiums are not level a similar calculation process is used to determine the average yearly premium adjusted for interest. An average yearly cash value increase is calculated as the annual amount which accumulated with interest for the specified period will have the same accumulated value at the end of the period as the cash surrender value at that time.] More technically the interest adjusted guaranteed surrender cost comparison index is the average annual premium minus the average yearly cash value increase for the period adjusted for interest. The interest adjusted guaranteed death cost comparison index is the average annual premium for the period adjusted for interest. For non-guaranteed cost indexes, the interest adjustment converts the illustrated annual dividends to equivalent level annual dividends so calculated that when accumulated with interest for the specified period they have the same accumulated value at the end of the period as the illustrated non-level dividends. If premiums are not level, a calculation process – similar to that used to calculate the equivalent level annual dividend -- is used to determine the average yearly premium adjusted for interest. An average yearly cash value increase is calculated as the annual amount which accumulated with interest for the specified period will have the same accumulated value at the end of the period as the cash surrender value at that time.

[Since the life insurance interest adjusted cost comparison index is a measure of the amount paid for the protection and other services rendered by the insurer, a low figure represents a better value that a higher one.] Since interest adjusted cost comparison indexes are a measure of the amount paid for the protection and other services rendered by the insurer, a low figure for any one index represents a better value than a higher one for the same index.

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## SPLIT LIFE INSURANCE (C3) TASK FORCE
Reno, Nevada

October 29, 1973

The Split Life (C3) Task Force met Monday morning, October 29, 1973, at the Continental Lodge in Reno. Task Force members attending were: Harold J. Jacobsen, C.L.U.; Commissioner Rawls, Oregon Department; Harold Baird, C.L.U., Northwestern Mutual; Don Sondergeld, F.S.A., Hartford Life; Thomas Sullivan, Counsel, Aetna Life and Casualty.

The Task Force members deliberated at great length and they submit the following recommendations to the (C3) Subcommittee.

1. Disclosure at Sale and Disclosure in the contract

   The fact that the continuation of the term coverage is contingent upon the renewal of the annuity contract caused the Task Force to feel the insured should not be exposed to loss of his protection if the annuity were terminated. The Task Force recommends each term contract include a provision giving the insured the right to convert without evidence of insurability to any ordinary life or endowment policy being issued by the company at the time of conversion, or a level term contract, convertible and renewable, within thirty days after he receives notice of termination of his life coverage from the company.

   The Task Force concurs with the opinion of the Vermont Department that enforcement of adequate disclosure and consumer protection can best be provided by reviewing in one submission the following material:

   a. Policy forms and applications.

   b. Premium rates and the reserving method used.

   c. A statement from the company's legal counsel that, in his opinion, the material submitted is in compliance with state insurance code and regulations governing split life sales.

   d. Copies of all sales material used for marketing the product.

   e. A position statement, including forms, describing the company's procedures in replacement situations.

2. Entire Contract

   The Task Force determined that split life policies will not violate the "Entire Contract" provision of states' insurance laws provided that in each case all terms and conditions of the term-insurance policy or policies which affect the contractual rights and obligations set forth in the annuity contract are incorporated in the annuity contract and conversely, all the terms and conditions of the annuity contract which affect the contractual rights and obligations set forth in the term insurance policies are incorporated in the term policy. Generally this means the conditional aspect of the renewability of the split life term policy must be stated in the term policy and in the annuity contract – not just in the annuity contract.

3. Unfair Discrimination

The Task Force does not feel that split life concept would be construed as unfair discrimination under the state insurance laws, as long as the split life policy forms are offered to the public in a uniform way, not unfairly discriminating between individuals of the same class and equal expectation of life that apply for such policy forms.

The Task Force is in accordance with the feelings of the Vermont Department in that, "It is important to remember that discrimination by itself, namely, treating one person differently from another is not forbidden. What is forbidden is unfair discrimination or treating differently persons of the same class under the same circumstances. The division of risks into different classes must not be arbitrary but must be for some reasonable purpose. A reasonable purpose supports the proposed classes of premium rates, graded by the amount of insurance."

4. The Task Force is cognizant of the fact that there has been a considerable amount of discussion concerning the imposition of a maximum age limit on renewable term Insurance. The Task Force recommends that the NAIC adopt no uniform maximum age limit, but rather leave the resolution of this question with the individual states.

5. Deficiency Reserves

The Task Force endorses the recommendation of the California Split Life Actuarial Committee regarding the establishment of deficiency reserves. That Committee's October 19, 1973, report is attached. The principal recommendations are as follows:

"a. For the purpose of valuation of renewable term insurance contained in split life, such term coverage shall be considered continuous for the period for which premiums are guaranteed including any automatic conversion to whole life insurance.

b. Resulting deficiency reserves may be calculated using either a method which permits offset of "negative deficiencies" or through the use of the "uniform" percentage gross method.

c. At the advanced ages, the amount of each gross premium used in the calculation of deficiency reserves should be limited to certain specified amounts recommended by the California Split Life Actuarial Committee as specified in the attached report."

6. Advertising the Sales Concepts

The Task Force advocated strong regulation of misleading advertising and the use of unfair comparisons. Split life coverage, the advertising, sales materials and brochures should all be subject to the Unfair Trade Practice Act and to any Deceptive Practice Regulations which may be in effect in the various states.

7. Replacements

The Actuarial Committee recommends that the standards of full disclosure in any replacement involving split life be followed consistent with the objectives of the NAIC Model Replacement Regulation, with such modifications as are necessary to afford full disclosure of the policies involved.

For information purposes, a draft of this same report incorporating the reasoning behind the Task Force conclusions and recommendations (prepared by Thomas Sullivan, Counsel, Aetna Life and Casualty) is attached.

To: Commissioner Gleeson Payne, California

From: California Split Life Actuarial Advisory Committee

Re: Report – October 19, 1973

The report of the above committee is respectfully submitted herewith. It is the unanimous opinion of the committee that the proposals contained in the report should provide a sound actuarial basis for regulations aimed at solving certain problems which have arisen in connection with split life. Furthermore we believe that certain of the principles discussed in the report (particularly the principle of continuous coverage) might ultimately be applied to the valuation of all forms of renewable term insurance.

Since the report was agreed to by the Committee, one member has suggested a modification of the way in which the "recognized" loadings might be applied in the calculation of deficiency reserves for split life plans other than the conventional one year renewable terms split life product. I believe the suggestion has merit and, with your permission, would like to explore the implications of such a modification and if necessary have the Committee submit a supplementary report. I did not want to delay the main report just to tidy up this loose end.

Such a supplementary report, if made, would in no way affect the basic conclusions of the Committee and would only be concerned with types of split life which are not now being sold but which may be sold in the future.

All the members of the Committee wish to express their appreciation for the opportunity to be of assistance to you. We would also like to acknowledge the cooperation and help of the staff of the California Department.

Respectfully submitted,

Alan Richards
President, Life Insurance Company of California
Chairman, California Split Life Actuarial Advisory Committee

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Report of California Split Life Actuarial Advisory Committee

This Committee was appointed by Commissioner Payne in February 1973 to review the actuarial aspects of so-called "Split Life" Insurance. The Committee was asked to make appropriate recommendations for regulatory action if the study uncovered any features of the coverage not adequately covered by existing regulations.

Background

Split Life insurance generally involves the issuance of an annual premium deferred annuity with a companion one year renewable term life policy. The renewable term plan is issued at very low premium rates or, if participating, with a very low net outlay (premiums less dividends).

A key feature of the plan is that the life insurance may be renewed from year to year only if the companion annual premium deferred annuity is maintained in force. Typically little or no commission is paid on the life insurance. Agents' compensation comes almost entirely from the annuity. Subject to the requirement that the annuity remain in force the life insurance may be renewed to an advanced age – at least to the 70's and usually up into the 90's. Usually the term insurance may be renewed after premiums on the annual premium deferred annuity have been discontinued provided the contract is in an income paying status. Some companies may permit renewal of the life insurance indefinitely after termination of the annual premium deferred annuity provided at least a minimum number of premium payments have been made on the annuity. Essentially, therefore, Split Life provides a form of "no load" life insurance with agents being compensated by commissions on the annual premium deferred annuity.

Deficiency Reserves

Three meetings were held. Early in the first meeting the conclusion was reached that the most important actuarial question to be resolved related to deficiency reserves. In view of the very low one year term rates associated with Split Life the determination of whether deficiency reserves are required and, if so, how they should be calculated, is one of major concern to regulators.

Information furnished to the Committee indicated that when this plan was first marketed at least one company had taken the position that one year renewable term life insurance is, by terms of the Standard Valuation Law, not subject to deficiency reserve requirements. The argument was advanced that plans such as five and ten year renewable term insurance are widely sold and each renewal of such plan is, by convention, treated as a separate policy for valuation purposes. In the event that the net premium for any renewal period is greater than the gross premium, deficiency reserves are calculated only for such renewal period and any other period is ignored.

To carry this argument to its logical conclusion, one year renewable term policies would be treated as successive unrelated single premium one year term policies. Thus, deficiency reserves could never arise, regardless of the amount by which the gross premium fell short of the net premium.

The Committee recognized that such an approach had been accepted by regulatory authorities and by actuaries as satisfactory in the past. The advent of Split Life, however, with its long term renewal privilege and its potential for much larger differences between net and gross premium had exposed a fundamental weakness in this system. The Committee concluded that the theoretical cornerstone of any recommended action should be a clarification of the status of renewable term insurance for valuation purposes and, in particular, for the determination of deficiency reserves. The committee felt that such policies should be considered as providing continuous coverage at varying premiums for the period for which such premiums are guaranteed since the company should anticipate the increasing mortality rates which it has contracted to cover. The continuous coverage concept should be adhered to irrespective of whether the wording of the policy form treats each renewal period as a discreet entity. Such continuous coverage would logically include automatic conversions of term insurance to whole life insurance at guaranteed rates.

Possible Calculation Methods

Having accepted the principle of continuous coverage under renewable term insurance the Committee then considered various methods by which deficiency reserves might be calculated.

1. At least one state had proposed (in the case of Split Life) that deficiency reserves would be required with respect to an arbitrary number, e.g., 5, of premiums following the valuation date. The Committee concluded that there was no justification for this method other than as an emergency expedient for preserving solvency in a given situation. It implied that deficiency reserves might be calculated using a crude "average policy life" based on expected withdrawal rates but this has no support in law or regulation.

2. Valuation net premiums can be calculated for each renewal period. Deficiency reserves would be determined as the present value of all future excesses of net premiums over gross premiums for the entire period for which premium rates are guaranteed. This method can be applied in three ways:

    a. Only years for which the net premium exceeds the gross premium would be in the calculation.

    b. The present value of the excess of gross premiums over net in all years where this occurs may be used as offsets to the deficiencies calculated in a.

    c. The offsets described in b. may only be used as a credit against subsequent deficiencies.

3. Valuation net premiums are translated into a uniform percentage of gross premiums for the entire period for which the policy can be renewed or converted at guaranteed rates and deficiency reserves would be calculated using these adjusted net premiums. This approach would appear to be a reasonable corollary to the assumption that the policy provides coverage at a guaranteed but varying premium rate and is consistent with the approach suggested by Menge (Record of the American Institute of Actuaries, Vol. 35, page 238).

The Committee concluded that the conventional approach embodied in method (2)(b) was generally satisfactory and should be permitted for California and other states where the statutes did not specifically require the use of method (2)(a). It was also felt that method (3) had much to commend it and probably came closest to satisfying the spirit of the valuation statutes. This method should be permitted as an alternative to any of the methods under (2).

Considerable concern was expressed that under methods (2)(b) and (3) the use of very high gross premiums at advanced ages could result in elimination or substantial reduction of deficiency reserves that would be required by a more realistic scale of renewal premium rates. The Committee also recognized that such artificial premiums might be set at so high a level that their only purpose is avoidance of deficiency reserves at earlier durations.

After considerable discussion it was agreed that a practical solution to this problem would be to limit the gross premium loading at the higher ages which may be used in calculating deficiency reserves. Loading in this context is defined as being the excess of the gross premium in any renewal period over the net valuation premium calculated by the conventional method, i.e., by treating each renewal as a discreet entity. Before making any deficiency reserve calculations a new series of gross premiums would be developed in which such maximum "recognized" loadings (as defined below) would be substituted for the actual loadings for any attained age at which the actual loadings are larger. Deficiency reserves would then be calculated using these adjusted gross premiums and either method (2)(b) or (3) above. It should be emphasized that no restriction would be put on the actual gross premium which might be charged.

Amount of Maximum "Recognized" Loadings

The Committee decided to propose that the maximum "recognized" loadings should be equal to the one year term cost multiplied by the factor shown in column 1 of the attached Table A. Table A also illustrates the resulting "recognized" loadings using the 1958 CSO Table at 3-1/2% based on age nearest birthday.

Application of Recommended Principles

The Committee concluded that the application of the above valuation basis to all forms of renewable term insurance was not appropriate at this time and, in any event, lay outside the charge to the Committee. It was agreed that the Committee's recommendations should apply only to Split Life and only to policies issued after the operative date of any regulations which might be promulgated as a result of this report. However, the Committee decided to recommend to the Society of Actuaries Committee to Study Valuation and Nonforfeiture Laws, Regulations, and Practices that the principle of basing valuation of renewable term insurance on the concept of continuous coverage be considered for adoption for all kinds of renewable term insurance. In addition, the Society Committee would be urged to define net premiums using the "uniform percentage of gross" method referred to above for the guaranteed premium period under renewable term insurance. The adoption of this latter principle by the states would lead to uniformity in calculating deficiency reserves for all renewable term policies.

Other Actuarial Matters

The Committee reviewed certain other questions of an actuarial nature which had been raised concerning Split LIfe. These included the following:

a. Possible "evasion" of Standard Nonforfeiture Law

To the extent that Split Life might be regarded as being a substitute for a whole life insurance policy, it could be criticized for not providing reduced paid up or extended term insurance benefits, although if the term portion and the annuity portion are combined, the annuity cash values are generally higher than required by application of the nonforfeiture laws. The Committee did not regard this as a serious problem although there was a feeling that the Society of Actuaries Committee on Nonforfeiture Laws might be asked to review this question.

b. Premium Taxes

Since most states either have a lower premium tax rate on annuities as compared with life insurance, or do not tax annuities at all, the widespread sale of Split Life as a substitute for whole life could result in some loss in revenue to the states. This was not felt to be serious at the present time but should be watched.

TABLE A

Maximum "Recognized" Loadings to be Used for
Calculation of Deficiency Reserves
(1958 CSO @ 3-1/2% Age Nearest Birthday)

| Attained Age | (1)% Maximum | (2) $1000\,vq_x$ | (3) Maximum "Recognized" Loading Col. (1) x Col. (2) |
|---|---|---|---|
| 70 | 0 | 48.11 | 0.00 |
| 71 | 5 | 52.32 | 2.62 |
| 72 | 10 | 56.67 | 5.67 |
| 73 | 15 | 61.12 | 9.17 |
| 74 | 20 | 65.82 | 13.16 |
| 75 | 25 | 70.89 | 17.72 |
| 76 | 30 | 76.50 | 22.95 |
| 77 | 35 | 82.80 | 28.98 |
| 78 | 40 | 89.91 | 35.96 |
| 79 | 45 | 97.77 | 44.00 |
| 80 | 50 | 106.26 | 53.13 |
| 81 | 55 | 115.31 | 63.42 |
| 82 | 60 | 124.80 | 74.88 |
| 83 | 65 | 134.67 | 87.54 |
| 84 | 70 | 144.94 | 101.46 |
| 85 | 75 | 155.69 | 116.77 |
| 86 | 80 | 166.98 | 133.58 |
| 87 | 85 | 178.87 | 152.04 |
| 88 | 90 | 191.55 | 172.40 |
| 89 | 95 | 205.28 | 195.02 |
| 90 | 100 | 220.42 | 220.42 |
| 91 | 100 | 237.46 | 237.46 |
| 92 | 100 | 256.94 | 258.94 |
| 93 | 100 | 279.52 | 279.52 |
| 94 | 100 | 305.95 | 305.95 |
| 95 | 100 | 339.36 | 339.36 |
| 96 | 100 | 387.01 | 387.01 |
| 97 | 100 | 471.91 | 471.91 |
| 98 | *** | 545.56 | 320.62 |
| 99 | *** | 966.18 | 0.00 |

c Company Solvency

Rates under the term portion of Split Life are exceeding low. This is largely accounted for by the substantial reduction in or elimination of commissions. This adoption of the Committee's recommendations concerning deficiency reserves should discourage (but not necessarily eliminate) the sale of new business at rates which are actually inadequate.

d. Servicing Multiple Life Contracts

It was recognized that the "sprinkling" of life insurance coverage among several lives would increase the costs of writing Split Life. The Committee determined that this occurred in only a small minority of policies issued and should be of minimal concern.

e. Other approaches to Split Life

These include:

1. Participating Split Life contracts wherein the gross premium is usually the net valuation premium and dividends are used to reduce the costs of term insurance.

11. Nonparticipating contracts wherein the rates are guaranteed to be no greater than the net valuation premium. The company actually charges a lower premium comparable with prevailing nonparticipating rate.

Neither of the above approaches were felt to carry with them any special actuarial problems. However, the use of a current rate which is not guaranteed (except as to a possible maximum) should receive some attention to determine if full disclosure is made to the prospective policyholder.

Summary of Principal Recommendations

The Committee recommends the following:

1. For purposes of valuation of renewable term insurance contained in Split Life such term coverage shall be considered continuous for the period for which premiums are guaranteed including any automatic conversion to whole life insurance.

2. Resulting deficiency reserves may be calculated using either a method which permits offset of "negative deficiencies", or through the use of the "uniform" percentage of gross method.

3. At advanced ages, the amount of each gross premium used in the calculation of deficiency reserves should be limited to certain specified amounts recommended by the Committee.

Respectfully submitted,

Alan Richards, Chairman; David R. Carpenter; Harold Crandall; Louis Garfin; John Gilchrist; Myles Gray; Howard Kayton; Harold Deutscher; Richard V. Minck; Ian Rolland

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Proposed "Extended" Draft of the Split Life
(C3) Task Force Report of October 29, 1973

The C3 Split Life Task Force met on October 29 at the Continental Lodge in Reno, Nevada. Task Force members attending were Harold Jacobsen, CLU, Chairman; Commissioner Lester Rawls of the Oregon Insurance Department; Harold W. Baird, CLU, Northwestern Mutual Life; Donald R. Sondergeld, F.S.A., Hartford Life; and, Thomas M. Sullivan, Counsel, Aetna Life & Casualty for Willard P. Yeats, Counsel, Aetna Life & Casualty.

Following an organizational meeting on November 13, 1972, members of the Task Force reviewed pertinent regulatory materials including all current guidelines, etc. Also, a considerable amount of research was done in an effort to resolve the major legal questions presented by the split life concept, i.e. compliance with entire contract requirements, compliance with unfair discrimination statutes, etc.

Following are the Task Force recommendations to the C3 Subcommittee.

1. ENTIRE CONTRACT REQUIREMENTS

Most states have adopted what is generally termed an "entire contract" requirement which typically provides that every policy of life insurance shall contain the entire contract between the parties and prohibits incorporation by reference to any other writings unless a copy thereof is provided to the insured.

This requirement, obviously intended for the benefit of the insured and beneficiaries, i.e. so that the insured may fully apprise himself of all of the insurer's undertakings, has been advanced by critics of the split life concept and many regulators as an insurmountable obstacle to the survival of the principal split life theory (and advantage): the "splitting" of the ownership of the annuity and the term insurance contracts. Split life defenders have argued that informing the owner of one contract of the provisions of the other contract which affect the first is sufficient and fully satisfies the entire contract requirement.

We submit that the highest possible purpose that can be assigned to the entire contract requirement is to enable the insured to understand each and every term of his contract with the insurer and to "ban every device by which terms of the contract could be altered or defeated by statements of insured or agreements made orally or in another writing which insured might have made without fully understanding their purport or effect". Abbott v. Prudential Ins. Co. of America, 281 N.Y. 375, 24 N.E.2d 87 (1939). Even if another, more restrictive purpose could be assigned (e.g. to forbid the formation of any such contract, which arguably would be interference with the right to contract), the typical statute provides its own curative: the endorsement or attachment of a copy of the other writing referred to.

It does not seem necessary either to argue that the split life "package" actually constitutes only one contract (which is simply not true) or that the entire contract requirement without more necessitates the use of an annuity policy plus term rider. The most realistic approach would seem to be that adopted by most state insurance departments which have considered this question. We commend to the attention of the Subcommittee the Memo of the Vermont Insurance Department dated August 25, 1972.

Thus, the Task Force has determined that split life policies will not violate the "entire contract" provision of the state insurance laws provided that in each case all terms and conditions of the term insurance policy or policies which affect the contractual rights and obligations set forth in the annuity contract are incorporated in the annuity contract and, conversely, all the terms and conditions of the annuity contract which affect the contractual rights and obligations set forth in the term insurance policies are incorporated in the term policy. Generally, this means that the conditional aspect of the renewability of the split life term policy must be stated in the term policy and in the annuity contract – not just in the annuity contract.

2. UNFAIR DISCRIMINATION

There exists sufficient authority for the proposition that what is generally prohibited is not simple discrimination between persons but unfair discrimination between members of a class to make unnecessary a lengthly treatise on this distinction. The question of discrimination is engendered in the split life context by the fact that the term policy issued in conjunction with the annuity is a special, extremely low cost contract which is not available to anyone who does not purchase it under the split life "plan". Those who assert that the low rates developed by this policy violate the prohibition against discrimination do so on the basis that the policy is *not* available to all prospective purchasers of the same sex, age, condition of health, etc. (i.e. of the same class of risk and expectation of life), but rather only to those members of the class who purchase the policy in conjunction with the companion annuity. The obvious purpose of this requirement is to prevent disparate treatment of applicants who share like characteristics pertinent to the underwriting decision.

Obviously, the low rate on the term policy in the split life arrangement is based on the existence of the annuity and presumably, the income lost in the former is made up for in the latter. Taking all these factors into account, it is evident that the purchaser of the term contract in the split life arrangement does not get something for nothing because while he pays a lower premium for the coverage than his brother in the same class would pay for a like policy, he assumes an obligation or, more accurately, risks the loss of the advantage provided by the existence of the annuity, which would not be present in the second purchase. This distinction has been recognized by the California Insurance Department (in Bulletin No. 72-5, p. 3):

> The split life insurance arrangements which have been reviewed by this Department do not on their face violate Insurance Code Section 790.03 (f) which prohibits unfair discrimination, including when the yearly renewable term life component of such plan is being offered at lower rates than the same insurer would issue a conventional yearly renewable term life policy. We are not aware of any insurer that offers two identical term life policies to persons of the same underwriting risks, at different premium rates.
>
> (Emphasis supplied.) See also, the memorandum by Deputy Insurance Commissioner Lemke of Vermont, pages 2-3.

That the rate charged is not based on the class of risk or expectation of life but rather on the "tie-in" between the annuity and the term policy is of more relevance to the question of the sufficiency of the rate (whether viewed along or in conjunction with the rate charged for the annuity) that it is to the question of discrimination. It is an over-simplification to state that the mere fact that the term policy under the split life arrangement is available on a uniform basis to all members of a particular class obviates the discrimination problem. But once one acknowledges that the purchaser of the term policy in the split life arrangement does assume an "extra" risk or obligation, the problem becomes one of semantics.

On the basis of the foregoing, the Task Force does not feel that the split life concept should be construed as unfair discrimination under the state insurance laws, as long as split life policies are offered to the public in a uniform way, not unfairly discriminating between individuals of the same class in expectation of life that apply for such policies.

3. DISCLOSURE AND CONVERSION.

The fact that the continuation of the term coverage is contingent upon the renewal of the annuity contract causes the Task Force to feel that the insured should not be exposed to loss of his protection if the annuity is terminated. Thus, the Task Force recommends that each term contract include a provision giving the insured the right to convert without evidence of insurability to any ordinary life or endowment policy being issued by the company at the time of conversion or a level-term contract, convertible and renewable, within 30 days after he receives notice of termination of his life coverage from the company.

In addition, the Task Force believes that further consideration should be given to requiring some form of disclosure statement concerning, for instance, the tax treatment of policy proceeds, etc. if the Subcommittee feels that such a requirement is necessary because of the novelty of the product.

4. DEFICIENCY RESERVES

After a thorough review of the report of the California Split Life Actuarial Advisory Committee, the Task Force generally endorses the Committee's Recommendations. However, the members of the Task Force feel that it would be inappropriate for us to comment on the specific requirements recommended by the Committee. Rather, we suggest that the report be reviewed by the appropriate Committee of the NAIC in order to establish specific reserve requirements.

5. ADVERTISING AND SALES CONCEPTS

The Task Force advocates strong regulation of misleading advertising and the use of unfair comparisons. Split life coverage, advertising, sales material and brochures should all be subject to the Unfair Trade Practices Acts of the several states and to any Deceptive Practices Regulations which may be in effect.

The Task Force suggests that it may be necessary to modify Unfair Trade Practices Acts and Deceptive Practices Regulations in order to make them more suitable for application to this unique product, if only to take account of the fact that the split life policy typically encompasses two separate contracts.

6. REPLACEMENTS

The Task Force recommends that the standards of full disclosure in any replacement involving split life be followed consistent with the objectives of the NAIC Model Replacement Regulations, with such modifications as are necessary to afford full disclosure of the policies involved.

7. INSURABLE INTEREST

In the typical split life arrangement, the owner of the annuity is given the right to purchase term insurance in designated amounts on a life (or lives) other than his own in the same rationale which would require the prospective owner of any term policy to have an insurable interest in the person to be insured would likewise have application in this situation and require that the owner of the annuity have an insurable interest in any person insured under the term policies issued pursuant to the annuity holder's option and owned by the annuity holder.

8. MAXIMUM AGE FOR RENEWABLE TERM

The Task Force is cognizant of the fact that there has been a considerable amount of discussion concerning the imposition of a maximum age limit for renewable term insurance. The Task Force recommends that the NAIC adopt no uniform maximum age limit, but rather leave the resolution of this question with the individual states.

CONCLUSION

The members of the Task Force are of the opinion that most of the major difficulties associated with the marketing of split life insurance can be resolved through the employment of the regulatory tools discussed herein. There remains the question, however, of whether the final regulatory requirements should be embodied in a set of guidelines or in a regulation and it is suggested that existing guidelines be re-examined to determine their appropriateness for adoption as a uniform requirement.

Finally, acknowledging that there can be no regulation in a vacuum and that a split life concept is indeed novel, the Task Force suggests that it may be appropriate to set up a procedure whereby split life marketing and regulatory experience can be monitored with a view toward tailoring regulation to the best interests of both the insurance-buying public and insurers marketing split life.

Respectfully submitted,

Thomas M. Sullivan, Counsel
Aetna Life and Casualty

## Variable Life Insurance and Variable Annuities (C4) Subcommittee

Reference:
1973 Proc. Vol. I p. 300
1973 Proc. Vol. II p. 550

Hon. James M. Jackson, Chairman – Nebraska
Hon. Gleeson L. Payne, Vice-Chairman – California

AGENDA

1. Report of various subcommittee meetings held since Washington, D. C. meeting in June.

2. Report on the current status of the SEC in the regulatory field for variable life insurance.

3. Consider adoption of a model variable life regulation.

4. Any other matters brought before the Subcommittee.

The NAIC Variable Life Insurance and Variable Annuities (C4) Subcommittee met at 2:00 p.m., December 4, 1973 at the Las Vegas Hilton in public session.

Chairman Jackson requested Mr. O'Regan, California Department, to review and comment on the changes made by the Subcommittee reflected in its December 2, 1973 exposure draft of the proposed model variable life insurance regulation.

Chairman Jackson then made a report on the status of developments with the Securities and Exchange Commission.

Commissioner Payne, California, made a statement that a number of comments were made at the public hearing on the possibility that the regulatory requirements established by the proposed variable life insurance regulation might be applicable to fixed benefit life insurance products. Mr. Payne said that any such inference drawn from the adoption of this regulation would be an erroneous assumption, and requested that the minutes of this Subcommittee clarify the point. It was the sense of the Subcommittee that the minutes should so indicate.

The Subcommittee heard comments from the following persons with reference to the proposed draft: Mr. Gilbertson, Aetna Variable; Mr. Mason, representing ALIA; Mr. Walker, Equitable Life Society; Mr. Hanson, League Life Insurance; Mr. Marchese and Mr. Rolland, representing Lincoln National; Mr. McCallion, representing New York Life; Mr. Hallett, representing Travelers Insurance; Mr. Harman, representing ALIA; Mr. Nelms of Provident Life; Mr. Anderson of Connecticut General; Mr. Walter Runkle of Federal; Mr. Bodenhamer, representing First Variable Life; Mr. Younger of the Prudential; Mr. Lawrence Evans, representing Maccabees Mutual; Mr. Blakeslee of Aetna Life & Casualty; Mr. Stocker of Equitable Life Society; and Mr. Wooddy of NARe.

Mr. Blakeslee, Aetna, spoke in response to a question concerning the development of an NASD type of self-regulatory organization for variable contracts.

There being no further comments, the Subcommittee went into executive session at approximately 5:00 p.m.

A motion was made and seconded to amend Article VI, Sec. 7 a (5) to allow a charge of .75% rather than .50% against the separate account for mortality and expense guarantees. The motion failed by a vote of four to six.

A motion to combine Article VI, Sec. 7 a (4) and Sec. 7 a (5) to reflect a decreasing scale of charges against the separate account totaling a maximum of 1.25% to 1.05% failed for lack of a second.

A motion was made and seconded that Article VI, Sec. 7 a (4) be amended to include an additional bracket for investment management expenses to include .75% of that portion of separate account assets valued at or under $75 million. The remainder of the section would also be amended accordingly. The motion was adopted by a vote of eight for, one against and one abstention.

The following amendments were adopted:

The definition of "affiliate", Article II, Sec. 1, was amended to insert the word "specific" in front of "fee".

Article IV, Sec. 3 e (1) was amended to add the following language, "except to the extent permitted by Sec. 5 c (6) of this Article." e."

Note 9 on page 23 was deleted with the understanding that standards to be applied in determining what is a material change would be developed in drafting notes and comments to be prepared by this subcommittee.

Article III, Sec. 4 a was amended by inserting the words "variable life insurance" following the work "All".

The first line of Article IX, Sec. 1 was amended to allow more than one statement.

It was agreed that footnote 9a, concerning modifications for state laws relating to previous convictions, should be added to the bottom of page 18.

Article IV, Sec. 2 b, line 7 was amended by deleting the words "while the insurer is in the process of determining the insurability and suitability of the applicant and prior to issuing such variable life insurance policy." The amendment was adopted by a vote of eight for and two against.

Article VII was amended to allow the use of a prospectus "to the extent" that the information required by this Article is combined in a prospectus, and the language of the amendment was revised to refer more specifically to the actual S.E.C. procedure in relation to the use of a prospectus and registration statements.

A motion was made and seconded that the proposed regulation, as amended today, be adopted. The motion was unanimously adopted.

The following resolution was proposed and seconded: Resolved that this Subcommittee develop a comprehensive summary of historical comments, notes, and other explanatory material relating to the deliberations and decisions which were made in formulating the Variable Life Insurance Model Regulation, and that the NAIC Central Office Staff should commence, at the earliest possible date, a draft of such a comprehensive supplemental report. The resolution was unanimously adopted.

The following resolution was proposed and seconded: Resolved that questions relating to appropriate illustrations of hypothetical variable life insurance benefits should be referred to the Insurance Advertising Regulations and Guidelines (B6) Subcommittee. The motion was adopted.

The Subcommittee adopted the minutes of all the previous meetings of the drafting task force and this Subcommittee.

Chairman Jackson expressed appreciation to all of the members of the Subcommittee for their time and efforts in developing the model regulation.

Chairman Jackson also expressed his appreciation for the work of Mike Kessler of the NAIC Central Office in connection with the development of the model regulation.

There being no further business to come before the Subcommittee, the meeting was adjourned.

James M. Jackson, Chairman – Nebraska; Gleeson L. Payne, Vice-Chairman – California; Thomas White, Connecticut; Maximilian Wallach, D.C.; Fred A. Mauck, Illinois; Frank M. Hogerty, Jr., Maine; Daniel J. Demlow, Michigan; Berton W. Heaton, Minnesota; Edward G. Farmer, Jr., Missouri; Benjamin R. Schenck, New York; Halbert L. Carter, Jr., Tennessee.

## NAIC MODEL VARIABLE LIFE INSURANCE REGULATION

### ARTICLE I. AUTHORITY

The following regulations applicable to variable life insurance policies are promulgated under the authority of Section ___, of the Insurance Laws of ___, and are effective ___. [1]

### ARTICLE II. DEFINITIONS[2]

As used in this regulation:

1. "Affiliate" of an insurer means any person, directly or indirectly, controlling, controlled by, or under common control with such insurer; any person who regularly furnishes investment advice to such insurer with respect to its variable life insurance separate accounts for which a specific fee or commission is charged; or any director, officer, partner, or employee of any such insurer, controlling or controlled person, or person providing investment advice or any member of the immediate family of such person.

2. "Agent" means any person, corporation, partnership, or other legal entity which is licensed by this state as a life insurance agent.[3]

3. "Assumed investment rate" means the rate of investment return which would be required to be credited to a variable life insurance policy, after deduction of charges for taxes, investment expenses and mortality and expense guarantees to maintain the variable death benefit equal at all times to the amount of death benefit, other than incidental insurance benefits, which would be payable under the plan of insurance if the death benefit did not vary according to the investment experience of the separate account.

4. "Benefit base" means the amount, not less than the amount specified under Sec. 2b of Article VI, specified by the terms of the variable life insurance policy to which the difference between the net investment return and the assumed investment rate is applied in determining the variable benefits of the policy.

5. "Commissioner" (Director, Superintendent) means the Insurance Commissioner (Director, Superintendent) of this state.[4]

6. "Control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing more than ten (10) percent of the voting securities of any other person. This presumption may be rebutted by a showing made to the satisfaction of the Commissioner that control does not exist in fact. The Commissioner may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support such determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

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1. DRAFTING NOTE: The blank portions of this article should be completed with appropriate references to the section of the Variable Contract Law authorizing promulgation of regulations and to appropriate additional citations such as the general rule-making authority of the Commissioner.

2. DRAFTING NOTE: Each definition should be reviewed to assure that the definition corresponds to the actual language used by the statutes of the particular state. Additional definitions may be necessary.

3. DRAFTING NOTE: Those states which have life insurance brokers and/or solicitors should modify the definition of agent to include them.

4. DRAFTING NOTE: Each state should modify the term "Commissioner" so that it corresponds to the correct title of the insurance regulatory official in the state where this regulation is adopted.

7. "General account" means all assets of the insurer other than assets in separate accounts established pursuant to Section ___ of the Insurance Laws of this state, whether or not for variable life insurance.

8. "Incidental insurance benefit" means all insurance benefits in a variable life insurance policy, other than the variable death benefit and the minimum death benefit, including but not limited to accidental death and dismemberment benefits, disability income benefits, guaranteed insurability options, family income, or fixed benefit term riders.

9. "May" is permissive.

10. "Minimum death benefit" means the amount of the guaranteed death benefit, other than incidental insurance benefits, payable under a variable life insurance policy regardless of the investment performance of the separate account.

11. "Net investment return" means the rate of investment return actually credited to a variable life insurance policy, after deduction of charges for taxes, investment expenses and mortality and expense guarantees in accordance with the terms of the policy.

12. "Person" means an individual, corporation, partnership, association, trust, or fund.

13. "Separate account" means a separate account established under Section ___ of the Insurance Laws of this state for variable life insurance.

14. "Shall" is mandatory.

15. "Variable death benefit" means the amount of the death benefit, other than incidental insurance benefits, payable under a variable life insurance policy dependent on the investment performance of the separate account, which the insurer would have to pay in the absence of the minimum death benefit.

16. "Variable life insurance policy" means any individual policy which provides for life insurance which varies according to the investment experience of any separate account or accounts established and maintained by the insurer as to such policy, as provided for in Section ___ of the Insurance Laws of this state.

ARTICLE III: QUALIFICATION OF INSURER TO ISSUE VARIABLE LIFE INSURANCE

The following requirements are applicable to all insurers either seeking authority to issue variable life insurance in this state or which have authority to issue variable life insurance in this state.

1. Licensing and Approval to Do Business in This State: An insurer shall not deliver or issue for delivery in this state any variable life insurance policy unless:

   a. the insurer is licensed or organized to do a life insurance business in this state;

   b. the state of domicile of such insurer requires that permissible investments be substantially the same as provided in Section 3 of Article VI and that changes in the investment policy of the variable life insurance separate account be regulated in a manner substantially similar to that required under Article VI for such separate accounts operated by insurers domiciled in this state; and

   c. the insurer has obtained the written approval of the Commissioner for the issuance of variable life insurance policies in this state. The Commissioner shall grant such written approval only after he has found that:

      1. the plan of operation for the issuance of variable life insurance policies is not unsound;

      2. the general character, reputation, and experience of the management and those persons or firms proposed to supply consulting, investment, administrative, or custodial services to the insurer are such as to reasonably assure competent operation of the variable life insurance business of the insurer in this state; and

3. the present and foreseeable future financial condition of the insurer and its method of operation in connection with the issuance of such policies is not likely to render its operation hazardous to the public or its policyholders in this state. The Commissioner shall consider, among other things:

   A. the history of operation and financial condition of the insurer;

   B. the qualifications, fitness, character, responsibility, reputation, and experience of the officers and directors and other management of the insurer and those persons or firms proposed to supply consulting, investment, administrative, or custodial services to the insurer;

   C. the applicable law and regulations under which the insurer is authorized in its state of domicile to issue variable life insurance policies. The state of entry of an alien insurer shall be deemed its state of domicile for this purpose; and

   D. if the insurer is a subsidiary of, or is affiliated by common management or ownership with another company, its relationship to such other company and the degree to which the requesting insurer, as well as the other company, meet these standards.

2. Filing for Approval to Do Business in This State: Before any insurer shall deliver or issue for delivery any variable life insurance policy in this state, it must file with this Department the following information for the consideration of the Commissioner in making the determination required by Section 1, subsection c of this Article:

   a. copies of and a general description of the variable life insurance policies it intends to issue;

   b. a general description of the methods of operation of the variable life insurance business of the insurer, including the names of those persons or firms proposed to supply consulting, investment, administrative, or custodial services to the insurer;

   c. with respect to any separate account maintained by an insurer for any variable life insurance policy, a statement of the investment policy the company intends to follow for the investment of the assets held in such separate account. The statement shall include a description of the investment objective and orientation intended for the separate account;

   d. a description of any investment advisory services contemplated as required by Section 10 of Article VI;

   e. if requested by the Commissioner, a copy of the statutes and regulations of the state of domicile of the insurer under which it is authorized to issue variable life insurance policies; and

   f. if requested by the Commissioner, biographical data with respect to officers and directors of the insurer on the National Association of Insurance Commissioners Uniform Biographical Data Form.

3. Standards of Suitability. Every insurer seeking approval to enter into the variable life insurance business in this state shall adopt by formal action of its Board of Directors and file with the Commissioner a written statement specifying the Standards of Suitability to be used by the insurer and applicable to its officers, directors, employees, affiliates, and agents with respect to the suitability of variable life insurance for the applicant. Such Standards of Suitability shall be binding on the insurer, and those to whom it refers, and shall specify:

   a. that no recommendation shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of reasonable grounds to believe that the purchase of such policy is not unsuitable for such applicant on the basis of information furnished after reasonable inquiry of such applicant concerning the applicant's insurance and investment objectives, financial situation and needs, and any other information known to the insurer or to the agent making the recommendation.

   b. Lapse rates for variable life insurance within the first two policy years which are significantly higher than both those encountered by the insurer or an affiliate thereof for corresponding fixed benefit life insurance policies and lapse rates of other insurers issuing variable life insurance policies shall be considered in determining whether the guidelines adopted by the insurer are reasonable and also whether the insurer and its agents are engaging, as a general business practice, in the sale of variable life insurance to persons for whom it is unsuitable. For purposes of this subsection, conversions from variable life insurance to fixed benefit life insurance policies pursuant to this regulation shall not be considered lapses.

4. Use of Sales Materials: An insurer authorized to transact variable life insurance business in this state shall not use any sales material, advertising material, or descriptive literature or other materials of any kind in connection with its variable life insurance business in this state which is false, misleading, deceptive, or inaccurate.[5]

   a. All variable life insurance sales material, advertising material, and descriptive literature shall be filed (___ business days prior to use)[6] (within ___business days after use)[7] with the Commissioner who shall require an insurer to cease the use of any such materials upon finding that any such materials are false, misleading, deceptive, or inaccurate. Revised versions of such materials containing changes of substantial import from versions on file with the Commissioner shall be filed with the Commissioner.

   b. For purposes of this regulation, variable life insurance sales material, advertising material, or descriptive literature shall include but is not limited to:

      1. printed and published material, audio-visual material, and descriptive literature of an insurer used in direct mail, newspapers, magazines, radio scripts, TV and film scripts, billboards, and similar displays for variable life insurance;

      2. descriptive literature and sales aids of all kinds used to sell variable life insurance by or on behalf of an insurer or any person authorized to sell variable life insurance for presentation to members of the insurance-buying public, including but not limited to circulars, leaflets, booklets, depictions, illustrations, and form letters; and

      3. prepared sales talks, presentations, and material for use in the sale of variable life insurance by any person authorized to sell variable life insurance.

5. Requirements Applicable to Contractual Services

   a. Any contract between an insurer and suppliers of consulting, investment, administrative, sales, marketing, custodial, or other services which are material with respect to variable life insurance operations shall be in writing and provide that the supplier of such services shall furnish the Commissioner with any information or reports in connection with such services which the Commissioner may request in order to ascertain whether the variable life insurance operations of the insurer are being conducted in a manner consistent with these regulations and any other applicable law or regulations.

   b. Such contract shall be fair and equitable to all parties and not endanger any policyholders of the insurer in this state.

   c. Such contract shall not relieve the insurer from any responsibilities or obligations imposed upon the operations of its variable life insurance business by this regulation or any other law or regulation.

6. Reports to the Commissioner: Any insurer authorized to transact the business of variable life insurance in this state shall submit to the Commissioner, in addition to any other materials which may be required by this regulation or any other applicable laws or regulations:

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5. DRAFTING NOTE: Those states which do not wish to have sales material filed may make appropriate amendments to this Section.

6. DRAFTING NOTE: Those states which desire filing prior to use should include this provision and insert the desired number of days.

7. DRAFTING NOTE: Those states which desire use and file should use this provision and insert a maximum time period after use for filing.

a. an Annual Statement of the business of its variable life insurance separate account or accounts in such form as may be prescribed by the National Association of Insurance Commissioners; and

b. prior to the use in this state any Information Furnished to Applicants as provided for in Article VII; and

c. prior to the use in this state the form of any of the Reports to Policyholders as provided for in Article IX; and

d. such additional information concerning its variable life insurance operations or its variable life insurance separate accounts as the Commissioner shall deem necessary.

e. Any material submitted to the Commissioner under this Section shall be disapproved if it is found to be false, misleading, deceptive, or inaccurate in any material respect and, if previously distributed, the Commissioner shall require the distribution of an amended report.

7. Authority of Commissioner to Disapprove: Any material required to be filed with the Commissioner, or approved by him, shall be subject to disapproval if at any time it is found by him not to comply with the standards established by this regulation.

ARTICLE IV: INSURANCE POLICY REQUIREMENTS

Policy Qualification: The Commissioner shall not approve any variable life insurance form filed pursuant to this regulation unless it conforms to the requirements of this Article.

1. Filing of Variable Life Insurance Policies: All variable life insurance policies, riders, endorsements, applications, and other related documents which are to be attached to and made a part of the policy shall be filed with the Commissioner and approved by him in writing prior to delivery or issuance for delivery in this state.

   a. The procedures and requirements for such filing and approval shall be, to the extent appropriate and not inconsistent with this regulation, the same as those otherwise applicable to other life insurance policies.

   b. The Commissioner may approve variable life insurance policies and related forms with provisions the Commissioner deems to be not less favorable to the policyholder and the beneficiary than those required by this regulation.

   c. The requirements of Sections 2a, 2d, and 3q of this Article shall not apply to variable life insurance policies and related forms issued in connection with corporate pension and profit-sharing plans and retirement income H.R. 10 pension plans which are exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940 and where applicable other provisions of the Federal securities laws because of their tax qualified status.

2. Mandatory Policy Benefit and Design Requirements: Variable life insurance policies delivered or issued for delivery in this state shall comply with the following minimum requirements:

   a. Coverage shall be provided for the lifetime of the insured with the mortality and expense risk borne by the insurer.

   b. Gross premiums for death benefits shall be a level amount for the duration of the premium payment period, but this subsection shall not be construed to prohibit temporary or permanent additional premiums for incidental insurance benefits or substandard risks. This subsection shall not be deemed to prohibit the use of fixed benefit preliminary term insurance for a period not to exceed 120 days from the date of the application for a variable life insurance policy. The premium rate for such preliminary term insurance shall be stated separately in the application or receipt.

   c. A minimum death benefit is provided in an amount at least equal to the initial face amount of the policy so long as premiums are paid when due (subject to the provisions of Section 4b of this Article);

   d. The amount payable upon the death of the insured so long as premiums are paid when due (subject to the provisions of Section 4b of this Article) shall be not less than a minimum multiple of the gross premium payable in that year, exclusive of that portion allocable to any incidental insurance benefit, by a person who meets standard underwriting requirements, as shown in the following table:

| ISSUE AGES | MULTIPLES |
|---|---|
| 0 - 5 | 80 |
| 6 - 10 | 71 |
| 11 - 15 | 63 |
| 16 - 20 | 55 |
| 21 - 25 | 47 |
| 26 - 30 | 40 |
| 31 - 35 | 33 |
| 36 - 40 | 27 |
| 41 - 45 | 21 |
| 46 - 50 | 15 |
| 51 - 55 | 13 |
| 56 - 60 | 11 |
| 61 - 65 | 9 |
| 66 - 70 | 8 |
| 71 and over | 7 |

e. The policy shall provide that the variable death benefit shall reflect the investment experience of the variable life insurance separate account established and maintained by the insurer and that the excess, positive or negative, of the net investment return over the assumed investment rate, as applied to the benefit base of each variable life insurance policy, shall be used to provide either:

1. fully paid-up variable life insurance providing coverage for the same period as the basic insurance under the policy or fully paid-up fixed benefit term insurance amounts, positive or negative, as the case may be, or a combination thereof; or

2. variable life insurance amounts, positive or negative, as the case may be, so that the reserve maintains the same percentage relationship to the variable death benefit as it would have on a corresponding fixed benefit policy.

f. Each variable life insurance policy shall be credited with the full amount of the net investment return applied to the benefit base.

g. Changes in variable death benefits of each variable life insurance policy shall be determined at least annually.

h. The cash value of each variable life insurance policy shall be determined at least monthly. The method of computation of cash values and other non-forfeiture benefits, as described either in the policy or in a statement filed with the Commissioner of the state in which the policy is delivered, or issued for delivery, shall be in accordance with actuarial procedures that recognize the variable nature of the policy. The method of computation must be such that, if the net investment return credited to the policy at all times from the date of issue should be equal to the assumed investment rate with premiums and benefits determined accordingly under the terms of the policy, then the resulting cash values and other non-forfeiture benefits must be at least equal to the minimum values required by Section ___ of the Insurance Laws of this state (Standard Non-Forfeiture Law) for a fixed benefit policy with such premiums and benefits. The assumed investment rate shall not exceed the maximum interest rate permitted under the Standard Non-Forfeiture Law of this state. The method of computation may disregard incidental minimum guarantees as to the dollar amounts payable. Incidental minimum guarantees include, for example, but are not to be limited to, a guarantee that the amount payable at death or maturity shall be at least equal to the amount that otherwise would have been payable if the net investment return credited to the policy at all times from the date of issue had been equal to the assumed investment rate.

i. The computation of values required for each variable life insurance policy may be based upon such reasonable and necessary approximations as are acceptable to the Commissioner.

3. Mandatory Policy Provisions: Every variable life insurance policy filed for approval in this state shall contain at least the following:

a. the cover page or pages corresponding to the cover page of each such policy shall contain:

1. a prominent statement in either contrasting color or in boldface type at least four points larger than the type size of the largest type used in the text of any provision on that page, that the death benefit may be variable or fixed under specified conditions;

2. a prominent statement in either contrasting color or in boldface type at least four points larger than the type size of the largest type size used in the text of any provision on that page, that cash values may increase or decrease in accordance with the experience of the separate account subject to any specified minimum guarantees;

3. a statement that the minimum death benefit will be at least equal to the initial face amount at the date of issue if premiums are paid when due and if there are no outstanding policy loans, partial withdrawals, or partial surrenders;

4. the rule, or a reference to the policy provision, which describes the method for determining the variable amount of insurance payable at death;

5. a captioned provision which provides that the policyholder may return the variable life insurance policy within 45 days of the date of the execution of the application or within 10 days of receipt of the policy by the policyholder, whichever is later, and receive a refund of all premium payments for such policy; and

6. such other items as are currently required for fixed benefit life insurance policies and which are not inconsistent with this regulation.

b. a provision for a grace period of not less than thirty-one days from the premium due date which shall provide that where the premium is paid within the grace period, policy values will be the same, except for the deduction of any overdue premium, as if the premium were paid on or before the due date;

c. a provision that the policy will be reinstated at any time within two years from the date of default upon the written application of the insured and evidence of insurability, including good health, satisfactory to the insurer, unless the cash surrender value has been paid or the period of extended insurance has expired, upon the payment of any outstanding indebtedness arising subsequent to the end of the grace period following the date of default together with accrued interest thereon to the date of reinstatement and payment of an amount not exceeding the greater of:

1. all overdue premiums and any other indebtedness in effect at the end of the grace period following the date of default with interest at a rate not exceeding __ percent[8] per annum compounded annually; or

2. 110% of the increase in cash surrender value resulting from reinstatement.

d. a full description of the benefit base and of the method of calculation and application of any factors used to adjust variable benefits under the policy;

e. a provision designating the separate account to be used and stating that:

1. such separate account shall be used to fund only variable life insurance benefits, except to the extent permitted by Section 5c(6) of this Article;

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8. DRAFTING NOTE: Each state should fill this blank with its maximum permissible policy loan interest rate.

2. the assets of such separate account shall be available to cover the liabilities of the general account of the insurer only to the extent that the assets of the separate account exceed the liabilities of the separate account arising under the variable life insurance policies supported by the separate account; and

3. the assets of such separate account shall be valued at least as often as any policy benefits vary but at least monthly.

f. 1. If the gross premiums for any variable life insurance policy delivered or issued for delivery in this state produce an excess of (A) over (B) as defined in (2) below, the present value as of the date of issue of the adjusted premiums used in determining the minimum cash values required by Section 2h of Article IV shall be decreased by such excess by decreasing each adjusted premium by a uniform percentage.

2. The excess of (A) over (B) referred to in subsection (1) above shall be determined as of the date of issue on the basis of the mortality table and maximum rate of interest permitted by Section —— of Insurance Laws of this state (Standard Non-Forfeiture Law); and

A. is the present value of the gross premiums for the policy, decreased by one dollar per thousand of equivalent uniform amount for policies with an equivalent uniform amount of less than ten thousand, payable on an annual basis (exclusive of those portions of the gross premiums allocable to any incidental insurance benefits) by a person who meets standard underwriting requirements; and

B. is the product of (1) times (2) where (1) is the present value of the maximum premium rates per thousand of insurance shown below payable at the beginning of each policy year to attained age 65 of the insured for issue ages below age 51, for fifteen years for issue ages 51 to 70 and for life for issue ages above age 70 and (2) is the ratio of (i) the present value of the benefits under the policy to (ii) the present value of an insurance of one thousand for the whole of life.

TABLE OF RATES

| Age at Issue | Premium Rate | Age at Issue | Premium Rate |
|---|---|---|---|
| 0 | 11.50 | 41 | 38.65 |
| 1 | 11.60 | 42 | 40.45 |
| 2 | 11.76 | 43 | 42.51 |
| 3 | 11.97 | 44 | 44.89 |
| 4 | 12.22 | 45 | 47.62 |
| 5 | 12.50 | 46 | 50.71 |
| 6 | 12.80 | 47 | 54.17 |
| 7 | 13.11 | 48 | 58.00 |
| 8 | 13.43 | 49 | 62.18 |
| 9 | 13.75 | 50 | 66.67 |
| 10 | 14.08 | 51 | 68.58 |
| 11 | 14.42 | 52 | 70.54 |
| 12 | 14.77 | 53 | 72.57 |
| 13 | 15.13 | 54 | 74.69 |
| 14 | 15.49 | 55 | 76.92 |
| 15 | 15.87 | 56 | 79.29 |
| 16 | 16.27 | 57 | 81.84 |
| 17 | 16.70 | 58 | 84.61 |
| 18 | 17.16 | 59 | 87.63 |
| 19 | 17.65 | 60 | 90.91 |
| 20 | 18.18 | 61 | 94.45 |
| 21 | 18.74 | 62 | 98.25 |
| 22 | 19.34 | 63 | 102.31 |
| 23 | 19.97 | 64 | 106.61 |
| 24 | 20.62 | 65 | 111.11 |
| 25 | 21.28 | 66 | 115.48 |
| 26 | 21.95 | 67 | 119.39 |
| 27 | 22.64 | 68 | 122.51 |
| 28 | 23.37 | 69 | 124.50 |
| 29 | 24.15 | 70 | 125.00 |
| 30 | 25.00 | 71 | 118.86 |
| 31 | 25.92 | 72 | 123.96 |
| 32 | 26.91 | 73 | 129.66 |
| 33 | 27.97 | 74 | 135.96 |
| 34 | 29.10 | 75 | 142.86 |
| 35 | 30.30 | 76 | 150.36 |
| 36 | 31.55 | 77 | 158.46 |
| 37 | 32.84 | 78 | 167.16 |
| 38 | 34.17 | 79 | 176.46 |
| 39 | 35.56 | 80 | 186.36 |
| 40 | 37.04 | | |

3. For purposes of this Section, any portion of the premium set aside to support a guarantee that any surrender value shall not be less than a specified amount or for any other benefit that the Commissioner shall deem to be excludable, shall not be included.

g. The policy shall also contain a provision that at any time during the first eighteen months of the variable life insurance policy, the owner may exchange the policy for a policy of permanent fixed benefit insurance for the same initial amount of insurance as the variable life insurance policy, provided that the new policy:

1. shall bear the same date of issue and age at issue as the original variable life insurance policy;

2. is issued on any plan of permanent insurance offered by the insurer or an affiliate on the date of issue of the variable life insurance policy and premium rates in effect on that date for the same class of insurance;

3. include such riders and incidental insurance benefits as were included in the original policy if such riders and incidental insurance benefits are issued with the fixed benefit policy. If the conversion results in an increase or decrease in cash value, such increase or decrease will be payable to the insurer or the insured as the case may be.

4. The insurer must apply as an advance premium on the new policy any excess of the accrued premium on the original variable life insurance policy from the date of issue to the date of request for exchange over the corresponding accrued premium on the new fixed benefit policy, except that any portion of such excess which is less than a regular mode premium on the new policy may either be applied as an advance premium or refunded in cash at the option of the insurer.

5. The insurer shall not require evidence of insurability for this exchange.

h. a provision that the policy and any papers attached thereto by the insurer, including the application if attached, constitute the entire insurance contract;

i. a designation of the officers of the insurer who are empowered to make an agreement or representation on behalf of the insurer and an indication that statements by the insured, or on his behalf, shall be considered as representations and not warranties;

j. an identification of the owner of the insurance contract;

k. a provision setting forth conditions or requirements as to the designation, or change of designation, of a beneficiary and a provision for disbursement of benefits in the absence of a beneficiary designation;

l. a statement of any conditions or requirements concerning the assignment of the policy;

m. description of any adjustments in policy values to be made in the event of misstatement of age or sex of the insured;

n. a provision that the policy shall be incontestable by the insurer after it has been in force for two years during the lifetime of the insured;

o. a provision stating that the investment policy of the separate account shall not be changed without the approval of the Insurance Commissioner of the state of domicile of the insurer, and that the approval process is on file with the Commissioner of this state;

p. a provision that payment of variable death benefits in excess of the minimum death benefits, cash values, policy loans, or partial withdrawals (except when used to pay premiums) or partial surrenders may be deferred:

1. for up to six months from the date of request; or

2. for any period during which the New York Stock Exchange is closed for trading (except for normal holiday closing) or when the Securities and Exchange Commission has determined that a state of emergency exists which may make such payment impractical.

q. Settlement options shall be provided on a fixed basis only;

r. a description of the basis for computing the cash surrender value under the policy shall be included. Such surrender value may be expressed as either:

1. a schedule of cash value amounts per one thousand dollars of variable face amount at each attained age or policy year for at least 20 years from issue, or for the premium paying period, if less than 20 years; or

(2) one cash value schedule as described in paragraph (1) for the death benefit, or for each one thousand dollars of death benefit, which would be in effect if the net investment return is always equal to the assumed investment rate and a second schedule applicable to any adjustments to the death benefit (disregarding the minimum death benefit guarantee and term insurance amounts) if the net investment return does not equal the assumed investment rate at each age for at least 20 years from issue, or for the premium paying period if it is less than 20 years.

s. Premiums for incidental insurance benefits shall be stated separately;

t. any other policy provisions required by this regulation;

u. such other items as are currently required for fixed benefit life insurance policies and are not inconsistent with this regulation.[9]

4. Non-Forfeiture, Partial Withdrawal, Policy Loan, and Partial Surrender Provisions: Every variable life insurance policy delivered or issued for delivery in this state shall contain provisions which are not less favorable to the policyholder than the following:

a. A provision for non-forfeiture insurance benefits so that at least one such benefit is offered on a fixed basis from the due date of the premium in default.

1. Variable extended term insurance may not be offered.

2. A given non-forfeiture option need not be offered on both a fixed and a variable basis.

3. The insurer may establish a reasonable minimum cash surrender value below which any such non-forfeiture insurance options will not be available.

b. A provision for policy loans (which may at the option of the insurer be entitled and referred to as a partial withdrawal provision) not less favorable to the policyholder than the following:

1. Up to 75% but if the loan is made from the general account not more than 90% of the policy's cash value may be borrowed;

2. The amount borrowed, or any repayment thereof, shall not affect the amount of the premium payable under the policy.

3. The amount borrowed shall bear interest at a rate not to exceed ___ %[10] per year compounded annually.

4. The proceeds payable on death after the exercise of the policy loan provision shall equal the greater of the minimum death benefit or the variable death benefit, less the indebtedness outstanding.

5. Any indebtness shall be deducted from the cash value upon surrender or in determining any non-forfeiture benefit.

6. Whenever the indebtedness exceeds the cash value, the insurer shall give notice of intent to cancel the policy if the excess indebtedness is not repaid within thirty-one days after the date of mailing of such notice.

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9. DRAFTING NOTE: The provisions of this Section having corresponding provisions in fixed life insurance regulation should be revised to conform to those corresponding provisions to the extent appropriate.

10. DRAFTING NOTE: Each state should fill this blank with its maximum permissible policy loan interest rate.

7. The policy may provide that if, at any time, the variable death benefit is less than it would have been if no loan or withdrawal had ever been made, the policyholder may increase such variable death benefit up to what it would have been if there had been no loan or withdrawal by paying an amount not exceeding 110% of the corresponding increase in cash value and by furnishing such evidence of insurability as the insurer may request.

8. The policy may specify a reasonable minimum amount which may be borrowed at any time but such minimum shall not apply to any automatic premium loan provision.

9. No policy loan provision is required if the policy is under the extended insurance non-forfeiture option.

10. In addition to the foregoing, the policy may contain a partial surrender provision; however, any such provision shall provide that the policyholder may request part of the cash value and both the variable and minimum death benefits will be reduced in proportion to the percentage of the cash value received by the policyholder and the premium for the remaining amount of insurance will also be reduced to the appropriate rates for the reduced amount of insurance. The policy may provide that a partial surrender provision shall not require the insurer to reduce the amount of the minimum death benefit to less than the lowest amount of minimum death benefit which would have been issued to the insured under the insurance plans of the insurer at the time the policy was issued. The policy must clearly provide that the policyholder has the option of electing to exercise the cash value privileges of the policy loan or partial withdrawal provision rather than the partial surrender provision.

11. All policy loan, partial withdrawal, or partial surrender provisions shall be constructed so that variable life insurance policyholders who have not exercised such provision are not disadvantaged by the exercise thereof.

12. Monies paid to the policyholders upon the exercise of any policy loan, partial withdrawal, or partial surrender provision shall be withdrawn from the separate account and shall be returned to the separate account upon repayment except that a stock insurer may provide the monies for policy loans from the general account.

5. Other Policy Provisions: The following provisions may in substance be included in a variable life insurance policy or related form delivered or issued for delivery in this state:

a. An exclusion for suicide within two years of the policy issue date;

b. incidental insurance benefits may be offered on a fixed basis only;

c. policies issued on a participating basis shall offer to pay dividend amounts in cash. In addition, such policies may offer the following dividend options:

1. the amount of the dividend may be credited against premium payments;

2. the amount of the dividend may be applied to provide paid-up amounts of additional fixed benefit whole life insurance;

3. the amount of the dividend may be applied to provide paid-up amounts of additional variable life insurance;

4. the amount of the dividend may be deposited in the general account at a specified minimum rate of interest;

5. the amount of the dividend may be applied to provide paid-up amounts of fixed benefit one-year term insurance;

6. the amount of the dividend may be deposited as a variable deposit in the separate account in the case of variable life insurance policies exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940 because of their tax qualified status.

d. A provision allowing the policyholder to elect in writing in the application for the policy or thereafter an automatic premium loan on a basis not less favorable than that required of policy loans or partial withdrawals under Section 4 of this Article, except that a restriction that no more than two consecutive premiums can be paid under this provision may be imposed.

## ARTICLE V. RESERVE LIABILITIES FOR VARIABLE LIFE INSURANCE

1. Reserve liabilities for variable life insurance policies shall be established under the Standard Valuation Law in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.

2. Reserve liabilities for the guaranteed minimum death benefit shall be the reserve needed to provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would be paid in the absence of the guarantee, and shall be maintained in the general account of the insurer and shall be not less than the greater of the following minimum reserves:

   a. The aggregate total of the term costs, if any, covering a period of one full year from the valuation date, of the guarantee on each variable life insurance contract, assuming an immediate one-third depreciation in the current value of the assets of the separate account followed by a net investment return equal to the assumed investment rate; or

   b. The aggregate total of the "attained age level" reserves on each variable life insurance contract. The "attained age level" reserve on each variable life insurance contract shall not be less than zero and shall equal the "residue," as described in paragraph (1), of the prior year's "attained age level" reserve on the contract, with any such "residue" increased or decreased by a payment computed on an attained age basis as described in paragraph (2) below.

      1. the "residue" of the prior year's "attained age level" reserve on each variable life insurance contract shall not be less than zero and shall be determined by adding interest at the valuation interest rate to such prior year's reserve, deducting the tabular claims based on the "excess," if any, of the guaranteed minimum death benefit over the death benefit that would be payable in the absence of such guarantee, and dividing the net result by the tabular probability of survival. The "excess" referred to in the preceding sentence shall be based on the actual level of death benefits that would have been in effect during the preceding year in the absence of the guarantee, taking appropriate account of the reserve assumptions regarding the distribution of death claim payments over the year.

      2. the payment referred to in Subsection 2b of this Article shall be computed so that the present value of a level payment of that amount each year over the future premium paying period of the contract is equal to (A) minus (B) minus (C), where (A) is the present value of the future guaranteed minimum death benefits, (B) is the present value of the future death benefits that would be payable in the absence of such guarantee, and (C) is any "residue," as described in paragraph (1), of the prior year's "attained age level" reserve on such variable life insurance contract. If the contract is paid-up, the payment shall equal (A) minus (B) minus (C). The amounts of future death benefits referred to in (B) shall be computed assuming a net investment return of the separate account which may differ from the assumed investment rate and/or the valuation interest rate but in no event may exceed the maximum interest rate permitted for the valuation of life insurance contracts.

   c. The valuation interest rate and mortality table used in computing the two minimum reserves described in (a) and (b) above shall conform to permissible standards for the valuation of life insurance contracts. In determining such minimum reserve, the company may employ suitable approximations and estimates, including but not limited to groupings and averages.[11]

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11. DRAFTING NOTE: At the December, 1972 meeting of the NAIC, this Section was adopted as an amendment to the model variable contract regulation with a proviso that the reserve calculation basis would be applicable for a five-year period only. The minutes of the (C4) Subcommittee indicate that the amendment was adopted "in order that a basis for reserves could be created now and that results of the accumulated statistics over a five-year period would be available for testing and credibility."

3. Reserve liabilities for all fixed incidental insurance benefits shall be maintained in the general account in amounts determined in accordance with the actuarial procedures appropriate to such benefit.

## ARTICLE VI: SEPARATE ACCOUNTS

The following requirements apply to the establishment and administration of variable life insurance separate accounts:

1. Establishment and Administration of Separate Accounts: An insurer issuing variable life insurance in this state shall establish one or more separate accounts pursuant to Sections ___ of the Insurance Laws of this state.

   a. If no law or other regulation provides for the custody of separate account assets and if the insurer itself is not the custodian of such assets, all contracts for such custody shall be in writing and the Commissioner of the insurer's state of domicile shall approve of both the terms of any such contract and the proposed custodian prior to the transfer of custody.

   b. An insurer shall not without the prior written approval of the Commissioner employ in any material connection with the handling of separate account assets any person who:[12]

      1. within the last 10 years has been convicted of any felony or a misdemeanor arising out of such person's conduct involving embezzlement, fraudulent conversion, or misappropriation of funds or securities or involving violation of Sections 1341, 1342, or 1343 of Title 18, United States Code; or

      2. within the last 10 years has been found by any state regulatory authority to have violated or has acknowledged violation of any provision of any state insurance law involving fraud, deceit, or knowing misrepresentation; or

      3. within the last 10 years has been found by federal or state regulatory authorities to have violated or has acknowledged violation of any provision of federal or state securities laws involving fraud, deceit, or knowing misrepresentation.

   c. All persons with access to the cash, securities, or other assets of the separate account shall be under bond in an amount of not less than $____ .

   d. If an insurer establishes more than one separate account for variable life insurance, justification for the establishment of each additional separate account shall also be filed with the Commissioner and shall be subject to his approval. The creation of additional separate accounts to avoid lower maximum charges against the separate account is prohibited.

   e. The assets of such separate accounts established for variable life insurance policies shall be valued at least as often as variable benefits are determined but in any event at least monthly.

   f. The same separate account shall not be used to fund both variable life insurance policies which are exempt pursuant to Section 3(c)(11) of the Investment Company Act of 1940 because of their tax qualified status and other variable life insurance policies not so exempt.

   g. Except as provided in Section 5c(6) of Article IV, variable life insurance separate accounts shall not be used for variable annuities or for the investment of funds corresponding to dividend accumulations or other policyholder liabilities not involving life contingencies.

2. Amounts in the Separate Account

   a. The insurer shall maintain in each variable life insurance separate account assets with a fair market value at least equal to the greater of the valuation reserves for the variable portion of the variable life insurance policies or the benefit base for such policies.

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12. DRAFTING NOTE: This subsection should be modified to conform to state laws concerning previous convictions, if necessary.

b. The benefit base of any variable life insurance policy as of the beginning of any valuation period shall not be less than the sum of the following factors after deducting amounts of any indebtedness pursuant to Section 4b of Article IV:

1. the valuation net premium for such period based upon the initial amount insured; and

2. the valuation terminal reserve at the end of the immediately preceding valuation period based upon the amount insured at the end of such period less the discounted cost of term insurance for the next period based upon tabular mortality and the interest rate used for such valuation reserves.

c. In lieu of the minimum benefit base requirement specified above, an insurer may otherwise qualify under this Section if it can be demonstrated, to the satisfaction of the Commissioner, that the policy benefits obtained over a 20-year period from the date of issue by the use of the insurer's benefit base are at least substantially equivalent in value to the benefits obtained by the use of the minimum benefit base specified above. The Commissioner may specify the range of net investment return to be used in this demonstration.

d. Notwithstanding the actual reserve basis used for policies that do not meet standard underwriting requirements, the benefit base for such policies may be the same as for corresponding policies which do meet standard underwriting requirements.

3. Investments by the Separate Account

a. No sale, exchange, or other transfer of assets may be made by an insurer or any of its affiliates between any of its separate accounts or between any other investment account and one or more of its separate accounts unless:

1. in case of a transfer into a separate account, such transfer is made solely to establish the account or to support the operation of the policies with respect to the separate account to which the transfer is made; and

2. such transfer, whether into or from a separate account, is made by a transfer of cash; but other assets may be transferred if approved by the Commissioner in advance.

b. Assets allocated to a variable life insurance separate account shall be held in cash or investments having a reasonably ascertainable market price. For purposes of this subsection, only the following shall be considered "investments having a reasonably ascertainable market price:"

1. liens in favor of the insurer against separate account policy reserves resulting from use by policyholders of cash values;

2. securities listed and traded on the New York Stock Exchange, the American Stock Exchange, or regional stock exchanges or successors to such exchanges having the same or similar qualifications;

3. securities listed on the NASDAQ System;

4. shares of an investment company registered pursuant to the *Investment Company Act of 1940*. Where such an investment company issues book shares in lieu of share certificates, such book shares shall be deemed to be adequate evidence of ownership;

5. obligations of or guaranteed by the United States Government, the Canadian government, any state, or municipality or governmental subdivision of a state;

6. commercial paper issued by business corporations when the total of such paper issued by the corporation does not exceed in value a guaranteed short line of credit by a bank;

7. certificates of deposit issued by financial institutions the deposits of which are insured by the FDIC or FSLIC; and

8. new bond or debt issues which may reasonably be expected to be listed on an exchange regulated by the Securities Exchange Act of 1934.

c. Notwithstanding any other provision of law or the provisions of subsection b above, assets allocated to a variable life insurance separate account shall not be invested in:

1. commodities or commodity contracts;

2. put and call options or combinations of such options;

3. short sales;

4. purchases on margins;

5. letter or restricted stock;

6. units or other evidences of ownership of a separate account of another insurer, except those registered under the Investment Company Act of 1940; or

7. real estate other than shares of a real estate investment trust listed as described in subsection (2) above.

4. Limitations on Ownership

a. A variable life insurance separate account shall not purchase or otherwise acquire the securities of any issuer, other than securities issued or guaranteed as to principal and interest by the United States, if immediately after such purchase or acquisition the value of such investment, together with prior investments of such separate account in such security valued as required by these regulations, would exceed 10% of the value of the assets of the separate account. The Commissioner may waive this limitation in writing if he believes such waiver will not render the operation of the separate account hazardous to the public or the policyholders in this state.

b. No separate account shall purchase or otherwise acquire the voting securities of any issuer if as a result of such acquisition the insurer and its separate accounts, in the aggregate, will own more than 10% of the total issued and outstanding voting securities of such issuer. The Commissioner may waive this limitation in writing if he believes such waiver will not render the operation of the separate account hazardous to the public or the policyholders in this state or jeopardize the independent operation of the issuer of such securities.

c. The percentage limitation specified in subsection a of this Section shall not be construed to preclude the investment of the assets of separate accounts in shares of investment companies registered pursuant to the Investment Company Act of 1940 if the investments and investment policies of such investment companies comply substantially with the provisions of Section 3 of this Article and other applicable portions of this regulation.

5. Valuation of Assets of a Variable Life Insurance Separate Account

a. Investments of the separate account shall be valued at their market value on the date of valuation.

1. Market value for investments traded on the recognized exchanges means the last reported sale price on the date of valuation. If there has been no sale on that date, the market value means the last reported bid quotation on the date of valuation.

2. Market value for investments listed on the NASDAQ System means the last representative bid quotation on the valuation date. If an investment ceases to be listed but continues to be traded over the counter, it shall be valued at the lowest bid quotation as it appears on the National Quotation Bureau sheets.

3. If the valuation date referred to in paragraphs (1) and (2) above is a day when the exchange or the NASDAQ System is not open for business, the valuation date shall be the last date when the exchange or the NASDAQ System was open for business.

b. If an investment ceases to be traded, it shall be valued at fair value as determined in good faith by or at the direction of the Board of Directors of the insurer but not in excess of the last reported bid quotation.

Within thirty days notification of cessation of trading of any investment shall be reported by the insurer to the Insurance Commissioner of the state of domicile of the insurer. Such Commissioner shall within a reasonable period of time determine the method of valuation or disposition of such investment.

6. Separate Account Investment Policy

a. The investment policy of a separate account operated by a domestic insurer filed under Section 2c of Article III shall not be changed without the approval of the Insurance Commissioner.

b. With respect to changes of investment policy for which the Commissioner must give his approval, the following regulations shall apply:

1. Such approval shall be deemed to be given 60 days after the date the request for approval was filed with the Commissioner, unless he notifies the insurer before the end of such 60-day period of his determination that the proposed change is a material change in the investment policy.

2. If the change is deemed material by the Commissioner, he shall approve such change only if he determines, after a public hearing, that the change does not appear detrimental to the interest of the policyholders of the insurer.

3. At least 30 days prior to any public hearing under paragraph (2), the insurer shall mail a notice to each policyholder and to the Insurance Commissioner of each state in which the affected variable life insurance policies are being sold. Such notice shall describe the proposed change in investment policy, list the reasons therefor, designate the date and place of the public hearing, inform the policyholder of the procedures to be followed in commenting on the change, and describe the conduct of the meeting. Any such notice shall be in a form approved by the Commissioner.

4. Within 60 days after such public hearing, the Commissioner must approve or deny the proposed change in investment policy.

5. Should any policyholder object to the proposed change and the change is allowed by the Commissioner, the objecting policyholder shall be given the option within 60 days of notification to the policyholder of the approval by the Commissioner of such change, of converting, without evidence of insurability, under one of the following options, to a fixed benefit life insurance policy issued by the insurer or an affiliate:

A. a conversion as of the original issue age to a permanent form of life insurance, based on the insurer's premium rates for fixed life insurance at the original issue age, for an amount of insurance not exceeding the death benefit of the variable life insurance policy on the date of conversion. If the cash value of the variable life insurance policy exceeds the cash value of the fixed life insurance policy, the difference shall be paid to the policyholder. If the cash value of the fixed life insurance policy exceeds the cash value of the variable life insurance policy, the difference shall be paid by the policyholder;

B. surrender of the variable life insurance policy and conversion as of the attained age to a substantially comparable permanent form of life insurance for an amount of insurance not exceeding the excess of the death benefit of the variable life insurance policy over:

i. its cash value on the date of conversion if the withdrawing policyholder elects the cash surrender option, or

ii. the death benefit payable under any paid-up insurance option if the withdrawing policyholder elects such option.

7. Charges Against a Variable Life Insurance Separate Account

a. The insurer may deduct only the following from the separate account:

1. taxes or reserves for taxes attributable to investment gains and income of the separate account;

2. actual cost of reasonable brokerage fees and similar direct acquisition and sales costs incurred in the purchase or sale of separate account assets;

3. actuarially determined costs of insurance (tabular costs) and the release of reserves on the termination or partial surrender of the variable life insurance policy:

4. charges for investment management expenses, including internal costs attributable to the investment management of assets of the separate account, not exceeding the following percentages, on an annual basis, of the average net asset value of the separate account as of the dates of valuation under Section 1e of this Article:

   A. .75% of that portion of separate account assets valued at or under $75,000,000; and

   B. .50% of that portion of separate account assets valued in excess of $75,000,000 but less than $150,000,000; and

   C. .40% of that portion of separate account assets valued in excess of $150,000,000 but less than $400,000,000; and

   D. .35% of that portion of separate account assets valued in excess of $400,000,000 but less than $800,000,000; and

   E. .30% of that portion of separate account assets valued in excess of $800,000,000.

5. A charge, at a rate specified in the policy, not to exceed .50% per year for mortality and expense guarantees.

b. Any charges against the separate account made by either an affiliate of the insurer or an unaffiliated fund shall be considered part of the charges limited by paragraphs (4) and (5) of subsection a above. Any charge against the separate account, excluding taxes, shall not vary in accordance with the difference between the investment performance of the separate account and any index of securities prices or other measure of investment performance.

8. Standards of Conduct: Every insurer seeking approval to enter into the variable life insurance business in this state shall adopt by formal action of its Board of Directors and file with the Commissioner a written statement specifying the Standards of Conduct of the insurer, its officers, directors, employees, and affiliates with respect to investments of variable life insurance separate accounts and variable life insurance operations. Such Standards of Conduct shall be binding on the insurer and those to whom it refers and must contain at a minimum the items contained in subsection 9b of this Article.

9. Conflicts of Interest

a. Rules under any provision of the Insurance Laws of this state or any regulation applicable to the officers and directors of insurance companies with respect to conflicts of interest shall also apply to members of any separate account's committee or other similar body. No officer or director of such company nor any member of any managing committee or body of a separate account shall receive directly or indirectly any commission or any other compensation with respect to the purchase or sale of assets of such separate account. The Board of Directors of the insurer shall be responsible for all acts concerning the separate account.

b. Unless otherwise approved in writing by the Commissioner in advance of the transaction, with respect to variable life insurance separate accounts, an insurer or affiliate thereof shall not:

1. sell to or purchase from any such separate account established by the insurer any securities or other property, other than variable life insurance policies;

2. purchase or allow to be purchased for any such separate account any securities of which the insurer or an affiliate is the issuer;

3. accept any compensation, other than a regular salary or wages from such insurer or affiliate, for the sale or purchase of securities to or from any such separate account other than as provided in Section 9c(3) of this Article;

4. engage in any joint transaction, participation, or common undertaking whereby such insurer or an affiliate participates with such a separate account in any transaction in which an insurer or any of its affiliates obtains an advantage in the price or quality of the item purchased, in the service received, or in the cost of such service and the insurer or any of its other affiliates is disadvantaged in any of these respects by the same transaction;

5. borrow money or securities from any such separate account other than under a policy loan provision.

c. No provision of this regulation shall be construed to prohibit:

1. the investment of separate account assets in securities issued by one or more investment companies registered pursuant to the Investment Company Act of 1940 which is sponsored or managed by the insurer or an affiliate, and the payment of investment management or advisory fees on such assets;

2. the combination of orders for the purchase or sale of securities for the insurer, an affiliate thereof, any separate accounts, or any one or more of them, which is for their mutual benefit or convenience so long as any securities so purchased or the proceeds of any sale thereof are allocated among the participants on some predetermined basis expressed in writing which is designed to assure the equitable treatment of all participants;

3. an insurer or an affiliate to act as a broker or dealer in connection with the sale of securities to or by such separate account; however, any commission fee or remuneration charged therefor shall not exceed the minimum broker's commission established for any such transaction by any national securities exchange through which such transaction could be effected or where such charges prevailing, in the ordinary course of business in the community where such transaction is effected;

4. the rendering of investment management or investment advisory services by an insurer or affiliate, for a fee, subject to the provisions of this regulation.

d. The Commissioner may, upon the written request of an insurer or an affiliate, approve a particular transaction or series of proposed transactions which would otherwise be prohibited under subsection b if he determines such transaction is not unfair or inequitable to persons affected under the circumstances of such transactions.

10. <u>Investment Advisory Services to a Separate Account</u>

a. An insurer shall not enter into a contract under which any person undertakes, for a fee, to regularly furnish investment advice to such insurer with respect to its separate accounts maintained for variable life insurance policies unless:

1. the person providing such advice is registered as an investment adviser under the Investment Advisers Act of 1940; or

2. the insurer has filed with the Commissioner and continues to file annually the following information and statements concerning the proposed adviser:

A. the name and form of organization, state of organization, and its principal place of business;

B. the names and addresses of its partners, officers, directors, and persons performing similar functions or, if such an investment adviser be an individual, of such individual;

C. a written Standard of Conduct complying in substance with the requirements of Section 8 of this Article which has been adopted by the investment adviser and is applicable to the investment adviser, its officers, directors, and affiliates;

D. a statement provided by the proposed adviser as to whether the adviser or any person associated therewith:[13]

i. has been convicted within ten years of any felony or misdemeanor arising out of such person's conduct as an employee, salesman, officer or director of an insurance company, a bank, an insurance agent, a securities broker, or an investment adviser; involving embezzlement, fraudulent conversion, or misappropriation of funds or securities, or involving the violation of Sections 1341, 1342, or 1343 of Title 18 of the United States Code;

ii. has been permanently or temporarily enjoined by order, judgement, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or as an employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity;

iii. has been found by federal or state regulatory authorities to have willfully violated or has acknowledged willful violation of any provision of federal or state securities laws or state insurance laws or of any rule or regulation under any such laws; or

iv. has been censured, denied an investment adviser registration, had a registration as an investment adviser revoked or suspended, or been barred or suspended from being associated with an investment adviser by order of federal or state regulatory authorities; and

3. such investment advisory contract shall be in writing and provide that it may be terminated by the insurer without penalty to the insurer or the separate account upon no more than 60 day's written notice to the investment adviser.

b. The Commissioner may, after notice and opportunity for hearing, by order require such investment advisory contract to be terminated if he deems continued operation thereunder to be hazardous to the public or the insurance company's policyholders.

## ARTICLE VII: INFORMATION FURNISHED TO APPLICANTS

An insurer delivering or issuing for delivery in this state any variable life insurance policies shall deliver to the applicant for the policy, and obtain a written acknowledgement of receipt from such applicant coincident with or prior to the execution of the application, the following information. The requirements of this Article shall be deemed to have been satisfied by the delivery to the applicant of a prospectus included in a registration statement which satisfies the requirements of the Securities Act of 1933 and which was declared effective by the Securities and Exchange Commission to the extent that the prospectus contains the information required by this Article.

1. A summary explanation, in non-technical terms, of the principal features of the policy, including a description of the manner in which the variable benefits will reflect the investment experience of the separate account and the factors which affect such variation;

2. a statement of the investment policy of the separate account, including:

a. a description of the investment objective and orientation intended for the separate account and the principal types of investments intended to be made; and

b. any restriction or limitations on the manner in which the operations of the separate account are intended to be conducted.

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13. DRAFTING NOTE: This subparagraph should be modified to conform to state laws concerning previous convictions, if necessary.

3. A statement of the net investment return of the separate account for each of the last ten years for which the separate account was in existence;

4. a statement describing, as an approximate percentage of an annual gross premium for each year and for the life of the policy all commission or equivalent payments to be paid to all agents or other persons as a result of the proposed sale for each year of the policy for which such payments are to be made. As used in this Section, "commissions" means all monies and other valuable consideration, including but not limited to prizes, bonuses paid directly or indirectly to, for, or on behalf of the selling agent as compensation for services in the sale of variable life insurance;

5. a statement of the annual taxes, brokerage fees, and similar costs, and the charges, expressed as an annual percentage, levied against the separate account during the previous year;

6. a summary of the method to be used in valuing assets held by the separate account;

7. a summary of the federal income tax liabilities of the policy applicable to the insured, the policy owner, and the beneficiary;

8. if the applicant is furnished illustrations of benefits payable under any variable life insurance contract, such illustrations shall be prepared by the insurer and shall not include projections of past investment experience into the future or attempted predictions of future investment experience, provided that nothing contained herein prohibits use of hypothetical assumed rates of return to illustrate possible levels of benefits if it is made clear that such assumed rates are hypothetical only;

9. a prominent statement either in contrasting color or in boldface type at least four points larger than the type size of the largest type used in the text of any provision on the page, providing in substance the following information:

> The purpose of this variable life insurance policy is to provide insurance protection for the beneficiary named therein.
>
> No claim is made that this variable life insurance policy is in any way similar or comparable to a systematic investment plan of a mutual fund.

## ARTICLE VIII: APPLICATIONS

The application for a variable life insurance policy shall contain:

1. a prominent statement that the death benefit may be variable or fixed under specified conditions;

2. a prominent statement that cash values may increase or decrease in accordance with the experience of the separate account (subject to any specified minimum guarantees);

3. questions designed to elicit information which enables the insurer to determine the suitability of variable life insurance for the applicant.

## ARTICLE IX: REPORTS TO POLICYHOLDERS

Any insurer delivering or issuing for delivery in this state any variable life insurance policies shall mail to each variable life insurance policyholder at his or her last known address the following reports:

1. Within 30 days after each anniversary of the policy, a statement or statements of the cash surrender value, death benefit, any partial withdrawal or policy loan, any interest charge, and any optional payments allowed pursuant to Section 4 of Article IV under the policy computed as of the policy anniversary date. Provided, however, that such statement may be furnished within 30 days after a specified date in each policy year so long as the information contained therein is computed as of a date not more than 45 days prior to the mailing of such notice. This statement shall state in contrasting color or distinctive type that, in accordance with the investment experience of the separate account, the cash values and the variable death benefit may increase or decrease, and shall prominently

identify any value described therein which may be recomputed prior to the next statement required by this Section. If the policy guarantees that the variable death benefit on the next policy anniversary date will not be less than the variable death benefit specified in such statement, the statement shall be modified to so indicate.

2. Annually, a statement or statements including:

a. a summary of the financial statement of the separate account based on the annual statement last filed with the Commissioner;

b. the net investment return of the separate account for the last year and, for each year after the first, a comparison of the investment rate of the separate account during the last year with the investment rate during prior years, up to a total of five years when available;

c. a list of investments held by the separate account as of a date not earlier than the end of the last year for which an annual statement was filed with the Commissioner;

d. any charges, taxes, and brokerage fees determined on an accrual basis payable by the separate account during the previous year, each expressed as a dollar amount and a percentage and the total expressed as a dollar amount and as a percentage, of the assets of the separate account;

e. a statement of the portfolio turnover rate as defined herein during the preceding fiscal year of investments allocated to the separate account.

1. The rate shall be calculated by dividing (A) the lesser of purchases or sales of portfolio securities for the particular fiscal year by (B) the monthly average of the value of the portfolio securities owned by the separate account during the particular fiscal year. Such monthly average shall be calculated by totaling the values of the portfolio securities as of the beginning and end of the first month of the particular fiscal year and as of the end of each of the succeeding 11 months, and dividing the sum by 13, except that the average value of securities for which market quotations are not available may be based upon the value of such securities as of the end of the preceding fiscal quarters.

2. For the purposes of this item, there shall be excluded from both the numerator and the denominator all U.S. Government securities (short-term and long-term) and all other securities whose maturities at the time of acquisition were one year or less. Purchases shall include any cash paid upon the conversion of one portfolio security into another. Purchases shall also include the cost of rights or warrants purchased. Sales shall include the net proceeds of the sale of rights or warrants. Sales shall also include the net proceeds of redemptions of portfolio securities by call or maturity.

3. The insurer shall show, in addition to the calculated portfolio turnover rate, both the amount of the purchases and the amount of the sales (calculated as prescribed in (2) above) and the monthly average (but not the individual monthly figures) of the value of the portfolio securities owned by the separate account during the fiscal year.

4. The insurer may, if it wishes, make any statement or explanation with respect to any significant variations in the portfolio turnover rate during the three fiscal years next preceding.

f. a statement of any change, since the last report, in the investment objective and orientation of the separate account, in any investment restriction or material quantitative or qualitative investment requirement applicable to the separate account, or in the investment adviser of the separate account;

g. the name of each broker or dealer handling portfolio transactions on behalf of the separate account in which the insurer or an affiliate has any material direct or indirect interest and the nature of such transactions and the amount of compensation received by each such broker or dealer from business originating with the separate account during the preceding fiscal year;

h. the names and principal occupations of each principal executive officer and each director of the insurer; and

i. the names of all parents of the insurer and the basis of control of the insurer, and the name of any person who is known to own, of record or beneficially, 10% or more of the outstanding voting securities of the company.

## ARTICLE X. QUALIFICATION OF AGENTS FOR THE SALE OF VARIABLE LIFE INSURANCE

1. Qualification to Sell Variable Life Insurance

a. No person may sell or offer for sale in this state any variable life insurance policy unless such person is an agent and has filed with the Commissioner, in a form satisfactory to the Commissioner, evidence that such person holds any license or authorization which may be required for the solicitation or sale of variable life insurance by any federal or state securities law.

b. Any examination administered by the Department for the purpose of determining the eligibility of any person for licensing as an agent shall, after the effective date of this regulation, include such questions concerning the history, purpose, regulation, and sale of variable life insurance as the Commissioner deems appropriate.

2. Reports of Disciplinary Actions. Any person qualified in this state under this Article to sell or offer to sell variable life insurance shall immediately report to the Commissioner:

a. any suspension or revocation of his agent's license in any other state or territory of the United States;

b. the imposition of any disciplinary sanction, including suspension or expulsion from membership, suspension, or revocation of or denial of registration, imposed upon him by any national securities exchange, or national securities association, or any federal, state, or territorial agency with jurisdiction over securities or variable life insurance;

c. any judgement or injunction entered against him on the basis of conduct deemed to have involved fraud, deceit, misrepresentation, or violation of any insurance or securities law or regulation.

3. Refusal to Qualify Agent to Sell Variable Life Insurance, Suspension, Revocation, or Nonrenewal of Qualification. The Commissioner may reject any application or suspend or revoke or refuse to renew any agent's qualification under this Article to sell or offer to sell variable life insurance upon any ground that would bar such applicant or such agent from being licensed to sell other life insurance contracts in this state. The rules governing any proceeding relating to the suspension or revocation of an agent's license shall also govern any proceeding for suspension or revocation of an agent's qualification to sell or offer to sell variable life insurance.

## ARTICLE XI. SEPARABILITY ARTICLE

If any provision of this regulation or the application thereof to any person or circumstance is for any reason held to be invalid, the remainder of the regulation and the application of such provision to other persons or circumstances shall not be affected thereby.

Variable Life Insurance and Variable Annuities (C4) Subcommittee

Hartford, Connecticut

July 11-12, 1973

The Variable Life Insurance (C4) Subcommittee met on July 11th and 12th, 1973 at the Connecticut Department, Hartford.

The meeting was an executive session and the Chairman called the meeting to order at 9:00 a.m.. A quorum was present.

The following action was taken:

1. The decision was made that a separate variable life insurance regulation would be drafted in lieu of attempting to amend the existing model regulation.

2. A target date of the second week of August was set for the release of the first draft of the model regulation.

3. The next meeting of the Subcommittee was set for August 8th and 9th, in Milwaukee, Wisconsin.

4. Decisions on the June 29, 1973 draft were as follows:

   A. Group variable is not permitted but group type marketing methods may be used provided all provisions of the regulation are complied with.

   B. Article VI, Sec. 3 was amended to eliminate "face" and "variable" in the fourth line, insert a period after benefit in second line, and add "irrespective of initial amount of coverage". Delete the second half of Article VI, Sec. 3.

   C. A 50% refund provision was accepted with wording on the accrued and unaccrued premiums. Notice must be given to policyholder of his rights when policy lapses for non-payment.

   D. The annual asset charges deducted from the separate account shall not exceed 1-1/2% of the assets held in the separate account.

   E. The investments in the separate account shall be limited securities traded on the NYSE, AMEX or over-the-counter and a method was adopted on valuing them when traded and when they cease to be traded.

   F. The suggested language on changes in investment policy was adopted in light of what the committee did in (E.), above.

   G. Suggested conflict-of-interest language was adopted.

   H. Automatic premium loans will be required.

   I. A drafting committee on policy loan language was appointed, with guidelines suggested by the Subcommittee.

   J. Disclosure of commissions will be required.

   K. A costing committee was appointed to review the 50% refund and 50% non-forfeiture value proposal.

   L. All advertising used shall be filed with the Commissioner.

The Subcommittee met on July 12, 1973 with representatives of the S.E.C. who were brought up-to-date on the activities of the Subcommittee and the target dates for action on the draft regulation. The S.E.C. personnel reviewed the filings made with them by insurance companies and highlighted the differences in the filings.

The meeting closed at 4:30 p.m. on July 12, 1973.

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Variable Life Insurance and Variable Annuities (C4) Subcommittee

Milwaukee, Wisconsin

August 8, 1973

The Variable Life Insurance (C4) Subcommittee met on August 8, 1973 in the Red Carpet Inn, Milwaukee, Wisconsin.

An executive session was held at 8:30 a.m.

At 10:00 a.m. the Chairman of the Subcommittee called the open session of the meeting to order. The entire day was devoted to presentations by industry representatives and the (C4) Industry Advisory Committee on the first draft of the proposed model variable life insurance regulation dated July 24, 1973. A court reporter was present and a complete transcript was made of the open session with exhibits attached. The open session closed at approximately 5:00 p.m. and the Subcommittee adjourned.

At 9:00 a.m. on August 9, 1973, the Chairman reconvened the meeting of the Subcommittee in executive session. In this session, the following action was taken:

1. Costing data on the 50% refund provision was presented by Mr. Conley and Mr. Hunt. This was reviewed and a task force made up of Director Jackson, Mr. Hunt and Mr. Hanson was appointed to explore possible alternatives to the 50% refund provision.

2. Mr. Clements was directed to prepare a new draft of the regulation for examination and comments of a drafting task force consisting of Mr. O'Regan (California), Mr. Rowe (Michigan), and Director Jackson.

3. A policy loan task force consisting of Mr. Dolman and Mr. Lomicky was appointed to review "policy loan" language and, if necessary, to redraft it to permit variable interest rates.

4. The next meeting of the Subcommittee was scheduled for September 5, 1973 in Chicago, Illinois.

5. The definition of securities was to be broadened to include U. S., state and municipal obligations; commercial paper; CD's; and would permit the normal insurance type assets such as policy loans and unpaid premiums involved in sale of such policies. Real estate mortgages and real estate were discussed, as well as investments in commodities and puts and calls. None of these are to be permitted.

6. The draftsmen were directed to reword the non-forfeiture language.

7. On Page 14, Item 5 of the draft and on Page 14, Item 2, technical changes were made; a statement shall be included in the draft which will provide that substandard premiums are not precluded.

There being no further business to come before the Subcommittee the meeting was adjourned.

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Variable Life Insurance and Variable Annuities (C4) Subcommittee

Omaha, Nebraska

September 19-20, 1973

The Variable Life (C4) Subcommittee met in the Caribbean Room of the Howard Johnson Motel, Omaha, Nebraska, at 9:00 a.m., September 19, 1973. Representatives from the following states were present: Joe O'Regan, California; Bill Conley, Michigan; Robert Rowe, Michigan; Norm Swenson, Tennessee; Jerry Dolman, New York; Jim Hunt, New Hampshire; Bill Homan, Iowa; Bill Woodward, Arkansas; James Jackson, Nebraska; Donald Erway, Nebraska; Neil Bernstein, Missouri. In addition, Mike Kessler, a representative of the NAIC Central Office was present. Bruce Clements from Allstate was also present.

> The Subcommittee unanimously adopted the following resolution: The Variable Life (C4) Subcommittee expresses its deep and sincere gratitude to Mr. Bruce Clements for his invaluable service in both time and effort since the inception of the efforts of this Subcommittee to draft a model variable life insurance regulation. Chairman Jackson supplemented the formal resolution with remarks of appreciation.

The Subcommittee resolved to produce drafting explanatory comments as a part of its model regulation to explain and clarify those decisions which were made and those proposals which were specifically not adopted. If all of such drafting explanatory comments cannot, as a practical matter, be made a part of the model regulation, it was the concensus that a summary of such decisions should be made a part of a future report of this Subcommittee.

With the approval of the Subcommittee, the Chairman appointed a drafting task force with authority to explore the feasibility of various proposals made by the Subcommittee.

The drafting task force will consist of Chairman Jackson, Nebraska; Mr. O'Regan, California; Mr. Rowe, Michigan; Mr. Lomicky, New York; and Mr. Wallach, District of Columbia.

With the Subcommittee's approval, the Chairman announced his intention to solicit specific comments from the Securities and Exchange Commission concerning the Subcommittee's work on the proposed model variable life insurance regulation.

The Subcommittee decided upon its future meeting schedule. The drafting task force will meet in San Francisco at the California Department on October 1 through October 3. The entire Subcommittee will meet in executive session in Chicago at a site to be announced October 23 and 24. The Subcommittee will hold a public session in Omaha on November 14 and 15 to hear the views of any interested person concerning the proposed model variable life insurance regulation.

The Subcommittee reviewed written comments submitted to it concerning the September 12, 1973 internal draft by industry and other persons.

The Subcommittee discussed the desirability of requiring that the variable death benefit be valued at least monthly. After lengthy discussion, the Subcommittee decided to retain the provision in the September 12 draft requiring at least annual death benefit valuation, but determined to require that cash values be determined at least monthly.

The Subcommittee decided to amend Article VII, Section 3(a) of the September 12 draft to require specific notification by the insurer of values which may vary or be re-determined in its annual report required by that section.

The Subcommittee next discussed what charges would be allowed against the separate account and determined to amend Article VI, Section 3(f) of the September 12 draft to allow only the following as charges against this separate account:

1. Actual brokerage and similar expenses.

2. Taxes paid or accrued arising out of the investment function of the separate account.

3. The tabular cost of mortality and the release of reserves upon the termination of the policy, and

4. Actual investment management expenses spent or attributable to investment management up to a maximum of the following percentages of the assets in the separate account:

   a. .50% of all assets in separate accounts with total assets of under $150 million.

   b. .40% of all assets for those separate accounts with total assets in excess of $150 million but less than $400 million.

   c. .35% of all assets for separate accounts with total assets in excess of $400 million but less than $800 million.

   d. .30% of all assets for separate accounts with total assets in excess of $800 million.

The Subcommittee discussed the possibility of providing for a board of directors to be elected as required by the Investment Company Act of 1940. The Subcommittee specifically rejected such a proposal for the election of such a separate board as set forth by the 1940 Act. It further reiterated that the responsibility for the management of the separate account was to be lodged ultimately in the insurer's board.

The Subcommittee discussed proposals to clarify its proposal on required nonforfeiture options. They then amended Artical VII, 2(f) of the September 12 draft to require at least one variable and one fixed nonforfeiture option, but specifically precluded the issuance of variable extended term insurance. An insurer need not offer the same nonforfeiture option in both variable and fixed forms.

After considerable discussion on present policy loans, the Subcommittee adopted a proposed redraft of the policy loan section. The Subcommittee further decided to allow a partial surrender provision but only as an additional option to the provisions required by the proposed redraft. It was decided that a company's policy loan provisions must be constructed in such a manner so as not to disadvantage those nonborrowing policyholders. It was decided that the NAIC should develop advertising rules to prohibit misleading advertising of various load or withdrawal provisions.

The Subcommittee then discussed the proposed 50% return of premium provision. Its Actuarial Task Force presented a report on the provision with revised cost estimates as well as several alternatives.

Mr. O'Regan then proposed the following provisions as substitutes for the present 50% return of premium provision:

1. Adoption by the Subcommittee of the suitability requirements as submitted by the NAIC Central Office (attached).

2. A 45-day free look.

3. Adoption of the concept underlying the proposal of the Industry Advisory Committee requiring higher cash values for companies with rates over the standard set. However, the level of premiums proposed by the industry would be studied by the Subcommittee's Actuarial Task Force to determine whether such premiums are reasonable for such purpose.

4. At the option of the policyholder who lapses within 12 months from the inception of the policy: (a) Two or three years of term insurance plus a refund of the excess premium over the cost of that term insurance, or; (b) Extended term insurance for the amount of premium paid.

After considerable discussion, the Subcommittee determined to give its drafting task force authority to explore the feasibility and desirability of these proposals.

The Subcommittee adopted the concept of requiring minimum reserves of the "benefit base" instead of the "attributed fund", in order to avoid the implication of pro rata ownership of separate account assets.

The Subcommittee then considered a proposal to amend the 50% return of premium provision to require within 12 months of the inception of policy that the insurer refund a reasonable percentage of the premium in excess of the cost of preliminary term insurance for that period. The possibility of requiring the charge-back of commissions in this instance was also proposed. After considerable discussion the Subcommittee directed its drafting task force to explore the feasibility and desirability of these provisions and to report back to it.

The Subcommittee received from its Actuarial Task Force a report on the feasibility of applying the interest adjusted method of cost comparison to variable life insurance policies.

The Subcommittee then discussed objections to Article VII, 2(d) of the September 12 draft and directed the drafting task force to propose technical solutions.

The Subcommittee heard a report by Chairman Jackson of a phone call he has received from a representative of the Securities and Exchange Commission concerning its new proposed rules (Investment Company Act of 1940 – Release Number 8000, September 20, 1973; Investment Advisors Act of 1940 – Release Number 391, September 20, 1973).

There being no further business, the Subcommittee adjourned.

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Proposed Suitability Requirements

Standards of Suitability: Every insurer seeking approval to enter into the variable life insurance business in this State shall adopt by formal action of its Board of Directors and file with the Commissioner a written statement specifying the Standards of Suitability applicable to the insurer, its officers, directors, employees, affiliates, and agents with respect to the suitability of variable life insurance for the applicant. Such Standards of Suitability shall be binding on the insurer and those to whom it refers, and shall specify:

a. that no recommendation shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of reasonable grounds to believe that the purchase of such policy is not unsuitable for such applicant on the basis of information furnished after reasonable inquiry of such applicant concerning the applicant's insurance and investment objectives, financial situation and needs, and any other information known to the insurer or to the agent making the recommendation.

b. Prior to the sale or acceptance of any application for a variable life insurance policy the insurer and its agents shall endeavor to obtain information which would enable a determination in good faith whether variable life insurance is generally suitable to the needs of the prospect, based upon the prospect's age, earnings, marital status, number and age of dependents, the amount of his savings and other assets, and his current life insurance program.

c. Upon obtaining information which would indicate that variable life insurance is unsuitable for the needs of the prospective purchaser, or upon the refusal of the prospect to reveal in information sufficient for the agent or insurer to make such a determination, no sale shall be complete nor any application accepted from that prospect unless and until the prospect has been informed, on a form to be approved by the Commissioner, either that he has not given information sufficient to enable the insurer to determine the general suitability of variable life insurance for his needs, or that the insurers guidelines indicate that variable life insurance would not be generally suitable for his needs and that it would be unlikely that its purchase would be in his best interests. The prospect upon being so informed may be issued variable life insurance.

d. The insurer shall obtain a written acknowledgement that the purchaser has been duly notified in accordance with Subsection c above, and shall retain such acknowledgement through its next regular examination.

e. Lapse rates for variable life insurance within the first two policy years, which are significantly higher than both those encountered by the insurer or an affiliate thereof for corresponding fixed benefit life insurance policies and lapse rates of other insurers issuing variable life insurance policies shall be considered in determining whether the guidelines adopted by the insurer are reasonable and also whether the insurer and its agents are engaging, as a general business practice, in the sale of variable life insurance to persons for whom it is unsuitable. For purposes of this subsection, conversions from variable life insurance to fixed benefit life insurance policies pursuant to this regulation, shall be be considered lapses.

Variable Life Insurance (C4) Drafting Task Force

San Francisco, California

October 1-3, 1973

The Drafting Task Force of the Variable Life (C4) Subcommittee met at the California Department in San Francisco at 2:00 p.m., October 1, 1973. Representatives from New York, California, Michigan, Nebraska and the NAIC Central Office were present. The task force met to consider a proposed redraft and reorganization of the model variable life insurance regulation submitted by the California Department, as well as a Subcommittee redraft, dated September 25, 1973, prepared by the NAIC Central Office. The Subcommittee redraft incorporated only those changes specifically made by the Subcommittee at its Omaha meeting, September 19 and 20.

In addition the task force discussed possible alternatives to the 50% return of premium provision and various other proposals which had been referred to it by the Subcommittee at the Omaha meeting.

The task force generally adopted the reorganized plan embodied in the California redraft and made several substantive decisions concerning it.

The task force decided to include a requirement that the board of directors of every insurer selling variable life insurance adopt and file with the Commissioner a statement specifying the standards of conduct to be followed by it and its agents which comply with minimum standards to be set forth in the regulation. These standards of conduct shall include suitability requirements.

The task force adopted a 45 day free look provision.

The task force adopted a provision which would allow the policyholder to elect an automatic premium loan provision rather than requiring such provision.

The task force revised its policy loan provision to prohibit the loan of more than 90% of the policy's cash value.

The task force decided to require rather than merely allow a partial surrender provision in addition to a policy loan provision.

The task force adopted a new definition of the benefit base.

The task force substantially redefined the permissible and non-permissible investments by insurance company separate accounts.

The task force adopted a provision which would permit more than 10% of the assets of the separate account to be invested in a single investment company registered under the Investment Company Act of 1940 if and only if such investment company complied with the investment provisions of the model regulation.

The task force substantially redefined the valuation of separate account assets.

The task force adopted a definition of "portfolio turnover rate" and a method of its calculation.

The task force prohibited the use of variable life insurance separate accounts for the investment of funds corresponding to dividend accumulations or other policyholder liabilities not involving life contingencies.

The task force discussed at great length proposed alternatives to the 50% return of premium provision and the limitations on the asset charge.

At approximately 2:00 p.m. on October 2, the task force met with various insurance industry representatives to explore the feasibility of various proposals and provisions of the model regulation. Among those issues discussed were:

1. Suitability requirements.

2. Alternatives to the 50% return of premium provision.

3. The effect of the asset charge limitations.

4. Reaction to the S.E.C.'s proposed rule.

After these discussions with industry, the task force reconvened in the executive session to consider the comments received. After further lengthly discussion. The task force determined to retain the 50% return of premium provision, but to also include in the next public draft of the regulation five alternative provisions with the hope that specific suggestions and comments would be received. The five alternatives to be included are:

1. The California proposal consisting of

   a. a 45 day free look

   b. suitability requirements

   c. adoption of the Industry Advisory Committee's maximum premium rates reduced by 10% for the time being and

   d. at the election of the policyholder who terminates his policy within 12 months of the issue date, either (a) up to two years of term insurance from the date of such lapse; or (b) extended term insurance in an amount equal to the unaccrued premium paid with the excess return to the policyholder in cash.

2. A return in cash to the policyholder of all amount in excess of the gross preliminary term insurance rates from date of issue to the date of election plus 15% of the original gross premium.

3. A return in cash to the policyholder of all amounts in excess of the net term premium from the date of issue to the date of surrender plus five dollars per thousand of the initial amount insured.

4. Non-forfeiture values at all times during the life of the policy equal to at least 75% of the net level reserve.

5. A conglomeration of all those portions of the above approaches which are not inconsistent with each other.

The task force eliminated a provision requiring a report of the approximate percentage of premiums paid which would be placed in the separate account by the insurer on the grounds that it was potentially misleading and did not necessarily bear a relationship to the relative value of policies.

The task force then considered the implications of various possible responses to the Securities and Exchange Commission's new proposed rules (Investment Company Act Release No. 8000, and Investment Advisor's Act Release No. 391). The drafting task force was also brought up to date on the current status of litigation concerning S.E.C. jurisdiction over variable life insurance.

The task force requested that the NAIC Central Office integrate the California redraft with the Subcommittee redraft dated September 25, 1973. The Chairman announced his intention to release this newly revised exposure draft well in advance of the Subcommittee's meeting in Chicago, October 23 and 24. This will provide all segments of the insurance industry, the securities industry, the S.E.C. and other interested persons, ample time to respond to it.

There being no further business, the drafting task force adjourned.

Variable Contracts and Variable Annuities (C4) Subcommittee

Chicago, Illinois

October 23-24, 1973

The Variable Life (C4) Subcommittee met in executive session at 9:30 a.m. on October 23, 1973 at the O'Hare International Tower Hotel, Chicago, Illinois. The attendance was as follows: Nebraska – Mr. Erway; California – Mr. O'Regan; Michigan – Mr. Rowe; Missouri – Mr. Bernstein; New York – Mr. Lomicky and Mr. Dolman; Tennessee – Mr. Swenson; Connecticut – Mr. Kelley; NAIC Central Office – Mr. Hanson and Mr. Kessler. Mr. Bruce Clements, Esq. formerly of the NAIC Central Office and presently with Allstate Insurance Company was also present at the request of the Subcommittee. Acting Superintendent Wallach of the District of Columbia was unable to attend but sent his comments to the October 23, 1973, exposure draft on tape.

Mr. Erway announced that Chairman Jackson would be unable to attend and relayed his request that Mr. O'Regan chair the meeting. Mr. Erway submitted a proxy by Director Jackson substantiating his comments.

The Subcommittee made several changes concerning the necessity of definitions in the definitions article.

The Subcommittee amended Article III, Sec. 1b, to require that the state of domicile of the insurer determine that not only changes in investment policy but also permissible investmetns be provided in a manner similar to this regulation.

The Subcommittee amended Article III, Sec. 2c, to provide for examination of the character of the proposed management of the insurer and suppliers of proposed contractural services so as to reasonably assure competent operation of variable life insurance operations.

The Subcommittee determined to delete in Article III, Sec. 2c, (page 4) the words "directly or indirectly".

The Subcommittee voted to delete Article III, Sec. 2d, as redundant.

The Subcommittee deleted article III, Sec. 3.

The Subcommittee amended Article III, Sec. 4 (Standards of Conduct) to include only Standards of Suitability and moved Standards of Conduct to Article VI since it was partially redundant.

The Subcommittee amended Standards of Suitability to require the notification of the insured that either the product was unsuitable for his needs, or that he had not given sufficient information to enable such a determination, as the case may be; and further modified former Article III, Sec. 4 to give the factors which should be considered in making such a determination. In former Article III, Sec. 5a, the Subcommittee determined to insert alternative provisions for "use and file" and "file and use" states.

The Subcommittee retitled former Article III, Sec. 6, to read "Requirements Applicable to Contractural Services," and included in those types of services sales, marketing, or other services which are material with respect to variable life insurance operations. They further required such contract between service suppliers and the insurer to require that the service supplier subject itself to examination by the commissioner.

The Subcommittee added a new Article III, Sec. 8, "Authority of Commissioner to Disapprove".

The Subcommittee deleted the first sentence of Article IV.

The Subcommittee amended Article IV, Sec. 1b, to provide that the Commissioner may approve policy forms not less favorable to the policyholder and the beneficiary than those required by this regulation.

The Subcommittee amended Article IV, Sec. 2c, to read "(subject to the provisions of Sec. 6b of this Article)".

The Subcommittee amended former Sec. 2h of Article IV to substitute the maximum interest rates permitted by the Standard Nonforfeiture Law in place of 3½%.

The Subcommittee amended former Article IV, Sec. 3a(5), to delete the words "prominently" and "if not satisfied with the policy for any reason".

The Subcommittee voted to delete former Article IV, Sec. 3e.

The Subcommittee voted to delete at this time former Article IV, Sec. 3g (the 50% return of premium provision).

There were several amendments to the alternative proposals. Former Alternative proposal #5 was deleted and two new alternative proposals were added as follows:

Alternative proposal number 5.

At any time during the first policy year, the insured may exchange the variable life insurance policy for any fixed benefit life, endowment, or level term policy having a level premium offered by the insurer or an affiliate as follows:

1. if the premium rate for the conversion policy is less than the premium rate for the variable life insurance policy the amount of insurance will be the variable life insurance initial amount. The difference between the conversion policy premium and the variable life insurance premium for the period for which premiums have been paid will be refunded to the insured.

2. if the premium rate for the conversion policy is greater than the variable life insurance premium rate, the conversion policy amount will be that amount provided by the variable life insurance premium.

3. if the conversion results in an increase or decrease in cash value, such increase or decrease will be payable to the insurer or the insured as the case may be.

4. If the policy lapses during the first policy year and no election is made by the insured, a conversion will be made to the level term plan with the lowest premium rate offered by the insurer or an affiliate in the amount of the variable life insurance policy, and the premium refund due the insured will be used to pay premiums in advance of such policy. At the subsequent request of the insured, any premiums so paid which are in advance of their due dates, shall be refunded.

Alternative proposal number 6.

1. a provision that at any time prior to the first anniversary of the variable life insurance policy, the owner may exchange the policy for a policy of level fixed benefits for the same amount provided that the new policy:

    A. shall bear the same date of issue and age of issue as the original variable life insurance policy;

    B. is issued on any plan of insurance offered by the insurer on the date of issue of the variable life insurance policy and premium rates in effect on that date for the same class of insurance.

    C. at the option of the insurer, may include such riders and supplementary benefits as were included in the original policy.

2. the insurer must apply the difference in premiums for the two policies on a pro rata basis from the date of issue on the new policy to the date of request for the exchange as premiums paid in advance.

3. the insurer shall not require evidence in insurability for this exchange.

The Subcommittee further adopted the following resolution:

At this time it is the sense of this Subcommittee that either Alternative number 3 or number 4 should be adopted.

The Subcommittee amended Alternative proposal number 3 to include a maximum dollar limitation.

The Subcommittee deleted former Article IV, Sec. 3s (3) as potentially misleading.

The Subcommittee added a new Sec. 3t of Article IV to include "such other items as are currently required for fixed benefit life insurance policies and which are not inconsistent with this regulation".

The Subcommittee amended former Article IV, Section 6b(8) to provide that minimum loan amounts established by the company should not bar an automatic premium loan.

The Subcommittee added a new article, "Reserve Liabilities for Variable Life Insurance" which is composed of former Article IV, Sec. 7.

The Committee amended former Article V, Sec. 1, to include provisions concerning approval by the Commissioner of any custodian, if not the insurer as well as a prohibition of the employment of certain persons handling separate account assets and a provision for bonding of such persons.

The Subcommittee amended former Article V, Sec. 3b to include Canadian government bonds.

The Subcommittee amended former Article V, Sec. 7, "Charges Against the Separate Account," to clarify its intention that a separate account with assets over eight hundred million dollars would be entitled to deduct charges of .50% of the first one hundred and fifty million dollars of that sum, as well as .40% of that amount between one hundred and fifty million dollars but less than four hundred million dollars, and .35% of those assets between four hundred million dollars and eight hundred million dollars, as well as .30% of all assets in excess of eight hundred million dollars.

The Subcommittee retitled former Article VI, "Information Furnished to Applicants", and the following sections were added to this article:

a. a provision prohibiting the projection of past earnings into the future and

b. a provision requiring a disclaimer by the company that the variable life insurance product is not in any way similar to a mutual fund.

The Subcommittee added a new article entitled "Applications", and determined to examine what material should be provided in the application for a variable life insurance policy.

There being no further business, the Subcommittee adjourned.

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Variable Life and Variable Annuities (C4) Subcommittee

Omaha, Nebraska

November 14, 1973

The Variable Life (C4) Subcommittee met in Omaha, Nebraska, November 14, 1973 at the Howard Johnson Motor Lodge at 9:30 a.m. A quorum was present.

The Subcommittee heard comments from Mr. Mason, Mr. Minck and Mr. Nickerson, representing the ALIA, concerning the October 30, 1973 variable life insurance exposure draft.

The Subcommittee heard comments on the draft from Mr. Gilbertson of Aetna Life and Casualty, Chairman of the Industry Advisory Committee. Additional comments from Mr. Blakeslee, Mr. Walker and Mr. Fraser as members of the Industry Advisory Committee were also made.

The Subcommittee heard comments on the draft by Mr. Baylor representing N.A.Re. Life Services.

Mr. Anderson, Connecticut General, spoke urging the NAIC not to take action on a variable life insurance regulation in December.

Mr. Younger, Prudential, and Mr. Joyner, Travelers, spoke in support of Mr. Anderson's position.

Mr. Walker, Equitable, urged the adoption of a regulation in December though only if it were modified as he suggested.

The Subcommittee heard comments by Mr. Pettes on behalf of Empire General in opposition to the exposure draft's present limitation of policy designs.

The Subcommittee heard comments by Mr. Cleary, John Hancock.

Mr. Knowlton, League Life, commented on the exposure draft.

The Subcommittee heard comments by Mr. Stocker, Equitable.

Mr. Bodenhamer, First Variable Life, commented on the maximum charges against the separate account.

The Subcommittee heard comments of Mr. Brown, representing Bankers Life Company, concerning limitations on product design.

There being no further speakers wishing to comment and no further business to come before the Subcommittee, the meeting was adjourned.

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Variable Life Insurance and Variable Annuities (C4) Subcommittee

Omaha, Nebraska

November 15, 1973

The Variable Life Insurance and Variable Annuities (C4) Subcommittee met in Omaha, Nebraska, November 15, 1973 at the Howard Johnson Motor Lodge at 9:00 a.m. The following subcommittee representatives were in attendance: Chairman Jackson and Mr. Erway, Nebraska; Mr. O'Regan, California; Mr. Lomicky and Mr. Dolman, New York; Mr. Swenson, Tennessee; Mr. Bernsteen, Missouri; Mr, Rowe, Michigan; Acting Superintendent Wallach, D. C.; Mr. Kessler, NAIC Central Office, and Mr. Clements, formerly of the NAIC and presently from Allstate, attended at the request of the Subcommittee. Mr. Woodyard, Arkansas, and representative from the West Virginia Department were also present. In addition, Ms. Jones, Mr. Myers, and Mr. Liebert from the Securities and Exchange Commission attended at the request of the Chairman.

After lengthy discussion the Subcommittee decided to add an additional permissible maximum charge of .50% against the separate account for mortality and expense guarantees.

The Subcommittee next discussed proposed redeemability provisions in its next exposure draft and solicit comments thereon. The two proposals are:

1. Within the first policy year, a return of cash to the policy holder of amounts in excess of the accrued revenue over (a) the mortality cost for the period (b) 15% of the accrued premium and (c) $5 per thousand up to a maximum of $______.

2. Adoption for the time being of the Industry Advisory Committee's maximum premium rates (with corresponding cash value increases for premium rate in excess thereof) along with a provision within the first 18 months allowing the policy holder without evidence of insurability to convert to any plan of level premium fixed insurance including

those offered by the insurer or an affiliate with the excess of premiums paid for the variable policy applied toward premiums in the fixed policy.

However, the Subcommittee determined that if adopted the premium rate would be for each issue age. It is also considering either a separate table for non-participating premium rates or some other method such as a formula.

The Subcommittee determined to remove the requirement of offering both variable and fixed non-forfeiture options but decided that if variable paid up insurance was to be offered it must contain a minimum death benefit guarantee at lease equal to the initial face value.

The suitability section was amended at the suggestion of the S.E.C. to conform to S.E.C. language. In addition, the lapse rate comparison was limited to the first two policy years. Also the Subcommittee made clear it was speaking of a comparison of the same insurers fixed benefit lapse rates and that comparison would in addition be made to industry-wide variable life lapse rates. High lapse rates would not be prime facie evidence but rather a consideration made by the Commissioner in determining the insurer's suitability compliance.

The Subcommittee reiterated its understanding that premium taxes should not be deducted or paid by a charge against the separate account.

Preliminary term insurance for a period of up to ninety days while the insurer was issuing the VLI policy was recognized as permissible in order to have uniform policy valuation dates. However, the free look provision would run from the VLI policy date not the preliminary term. In addition, the preliminary term premium must be stated separately from the variable life insurance premium.

The free look provision will apply to refund of premium only on the VLI policy.

The Subcommittee at this time specifically rejected the unit load or withdrawal concept as an acceptable alternative to the policy loan provision presently required.

The Subcommittee adopted several permissible dividend options and distinguished between those permitted for corporate tax qualified plans and policies not so qualified.

The Subcommittee determined that tax qualified and non-tax qualified plans should not share the same separate account.

The Subcommittee determined that a partial surrender should not require the insurer to carry policies below an amount which it would have originally issued.

The Subcommittee discussed and adopted definitions previously undefined.

The Subcommittee heard informal comments on the regulation by staff members of the S.E.C. who had been invited by the Chairman.

There being no further business to come before the Subcommittee, the meeting was adjourned.

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Variable Life and Variable Annuities (C4) Subcommittee

Las Vegas, Nevada

December 1, 1973

The Variable Life Insurance and Variable annuities was (C4) Subcommittee met at the Las Vegas Hilton, December 1, 1973 at 1:30 p.m. in public session. The following persons were in attendance: Chairman Jackson, Nebraska; Mr. Dolman and Mr. Lomicky, New York; Mr. Rowe, Michigan; Superintendent Wallach, D. C.; Commissioner Payne and Mr. O'Regan, California; Mr. Bernstein, Missouri; Mr. Swenson, Tennessee; Mr. Koleski, Minnesota; Mr. Kessler and Mr. Hanson, NAIC Central Office.

Mr. Gilbertson, Aetna Variable, Chairman of the Industry Advisory Committee, spoke and indicated that his committee had no further recommendations. Mr. Mason and Mr. Minck, ALIA, read a resolution of the ALIA Board of Directors requesting that the NAIC take no action on adoption of a variable life insurance regulation until the tax questions and the litigation involving jurisdiction to regulate have been resolved.

The Subcommittee heard Mr. Walker, Equitable, who strongly favored the adoption of a model variable life insurance regulation, with several changes characterized as critical, at the December 1973 meeting.

Mr. Blakeslee, Aetna, spoke in favor of the adoption of the variable life insurance regulation with substantially the changes recommended by Mr. Walker.

Mr. McCallion and Mr. Fraser, New York Life, spoke in favor of prompt approval of a variable life insurance regulation with certain changes suggested.

Mr. Hallett, Travelers, spoke in favor of the ALIA recommendation.

Mr. Younger, Prudential also spoke in favor of the ALIA recommendation and suggested that the NAIC at least delay action on the variable life insurance regulation until its June, 1974, Annual Meeting in San Francisco.

Mr. Janke, IDS, spoke in favor of adoption of the variable life insurance regulation at its December meeting and generally favored the substantive comments made by Mr. Walker.

Mr. Pettis, representing Empire General Life and the Capitol Group, suggested ammendments to the regulation to allow more flexibility in policy designs.

Mr. Googans, representing Connecticut Mutual, spoke generally in favor of prompt adoption of the regulation but recommended that any action concerning excessive administrative management and sales changes should be only a threshold position pending more detailed study. He compared the situation facing the Subcommittee to that facing the S.E.C. under the Investment Company Act, Sec. 22B.

Mr. Baylor, representing N.A.Re. Life Services strongly urged the NAIC to act at its December meeting in adopting a variable life insurance regulation.

There being no further business to come before the public session, the Subcommittee went into executive session.

In executive session, the following resolution was adopted by a vote of nine affirmative to one abstension: It is resolved that this Subcommittee adopt a model variable life insurance regulation during the December, 1973, Regular Meeting of the NAIC. The abstension was based on the feeling that no such resolution was required since the Subcommittee was already under direction to promptly draft a model variable life insurance regulation. It was the concensus of the Subcommittee that although it was correct that the Subcommittee was under such direction, this resolution clearly states the sentiment of the Subcommittee at the present time.

There being no further business to come before the Subcommittee, the meeting was adjourned.

Variable Life and Variable Annuities (C4) Subcommittee

Las Vegas Nevada

December 2, 1973

The NAIC Variable Life Insurance and Variable Annuities (C4) Subcommittee met in executive session at the Las Vegas Hilton, December 2, 1973 at 1:30 p.m. A quorum was present. In addition, Mr. Clements attended at the request of the Subcommittee. Also in attendance, at the Chairman's request, were representatives of the Securities and Exchange Commission, who gave informal comments on the December 1, 1973 exposure draft and then left.

The Subcommittee then amended the December 1, 1973 proposed model variable life insurance draft:

by a vote of five affirmative, three negative, and one abstention determined to delete former alternative redemption provision # 1.

by a vote of four affirmative to four abstentions, adopted former alternative redumption provision # 2 as amended.

The Subcommittee heard an oral report of its drafting task force.

The Subcommittee received a letter commenting on the fourth exposure draft of the model regulation from Senators Philip Hart and William Proxmire, United States Congress. The letter (together with the NAIC reply to it, drafted later) is attached.

There being no further business to come before the Subcommittee, the meeting was thereupon adjourned.

* * * * * *

U. S. Senate
Washington, D.C. 20510
November 29, 1973

Honorable James M. Jackson, Chairman
NAIC Variable Life (C4) Subcommittee
Las Vegas Hilton, Nevada 89114

Dear Mr. Chairman:

As you are aware, we are following with great interest your Subcommittee's proposed model variable life insurance regulation. As a personal note, we appreciate your prompt mailing of each of the four "exposure drafts". This has enabled us to examine closely the development of the proposed model regulation. We also have been assisted by your counsel, Mr. Kessler, and we thank him for his explanation of several technical points.

Upon your release of the fourth "exposure draft" of the proposed NAIC model variable life insurance regulation, comments were solicited for consideration of public reaction to the latest draft. We have chosen this opportunity to comment on the proposed model regulation.

You will recall that the Securities and Exchange Commission announced on September 20, 1973 (IC-8000) its proposal to condition the exemptions granted on January 31, 1973 (IC-7644). In so moving, it was stated that:

> The Commission hopes that the procedure contemplated by the proposed amendments will enable it to reach a single determination with respect to the adequacy of protections afforded by state insurance law. <u>The model variable life insurance regulations now being developed by the NAIC, if adequate, could form the basis of a Commission determination pursuant to the amended Rules.</u> As indicated in the proposed Rule amendments, the standard will not be whether a model law and regulations are identical to the relevant provisions of the Investment Company Act and the Investment Advisers Act, but whether they provide protections <u>substantially equivalent</u> to those provisions. (Emphasis added) (IC-8000, p. 8)

We share in your effort to create effective regulatory standards for this new product. Variable life insurance is an excellent concept. If the potential consumer is adequately protected and informed about the essential elements of variable life insurance, it could have an important role to play in the investment market.

Adequate protection requires that the consumer be provided with accurate and reliable information about price, benefits and potential investment return of variable life insurance. This in turn requires a vigorous system of mandatory disclosure at the point of sale in all states. Consumers must be able to compare all financial products which are competing for their investment dollars; this includes variable life insurance, fixed benefit insurance and other equity products.

In the view of legal scholar Tamar Frankel, variable life insurance is a hybrid product. Like fixed benefit life insurance, it bears the characteristics of both pure term insurance and pure investment. The observation of the late Justice Harlan writing for a unanimous Court regarding variable annuity contracts also applies to variable life insurance: "The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized". SEC v. United Benefit Life, 387 US 202 at 211 (1967). Thus, variable life insurance treads the line between Federal and State regulation. The insurance aspect requires state insurance regulation; the separate account feature calls for regulatory provisions at least "substantially equivalent" to those mandated by Congress under the 1940 Investment Company Act and the 1940 Investment Advisers Act.

It is in this vein that the Securities and Exchange Commission proposed in its recent notice of proposed rule amendments on variable life insurance that the federal regulatory exemptions involved be specifically conditioned upon a Commission determination that state laws or regulations affecting the operations of separate accounts do meet its "substantial equivalence" test. According to the SEC, the comprehensive NAIC proposal would be examined initially; if it met the Commission standards, then all states following the model could permit the sale of variable life insurance, or, in the alternative, the states could submit their own regulations to the Commission for individual determination. Thus, it appears clear that before variable life insurance will be sold in any state, the state law or regulations must meet the test of "substantial equivalence" to the 1940 Acts.

We believe that you will agree that if, in fact, state regulation is to be considered "substantially equivalent" to federal regulation of investment companies, it requires each state to have jurisdiction, money, laws, staff expertise and a commitment to such regulation.

We have reviewed carefully your drafts of October 30 and December 1, 1973. It is obvious that a good deal of hard work and detailed thought have gone into this model regulation. In certain areas, there are protections for the variable life insurance purchaser that are praiseworthy. For instance, the "Standards of Suitability" in Act III, Sec. 3 of the October 30 draft were exemplary of the disclosure philosophy essential to these regulations. Unfortunately, these standards appear to have been considerably weakened in the December 1 draft. We are hopeful that your Subcommittee will reconsider and reinstitute the October 30 draft version.

Yet, protections which are material to the insurance investor are lacking in even the latest model draft. We have prepared a summary outline in which we compare the major areas of investment regulatory concern and their NAIC model bill counterparts with the relevant provisions of the Investment Company and Adviser Acts. A copy of the summary outline is enclosed with this letter. After reviewing this outline, it is our hope that your Subcommittee will reconsider at least the following major areas of material policyholder protections which are now deficient or absent from the latest model draft: policyholder voting rights for change in investment policy, election of directors and appointment of auditors; redemption provisions; disclosure and limitations on sales charges and investment management fees; prevention of conflict of interest situations; and policyholder private rights of action.

If variable life insurance is to be regulated in the public interest, all states must enact and enforce these policyholder protections. Only this, and a rigorous disclosure system, would constitute effective and adequate regulation. Anything short of such regulation would place Government in the position of deceiving the consumer.

Progressive action by the NAIC now will give variable life insurance the opportunity to soon prove itself in the marketplace, and will provide enlightened regulation for a more competitive equity product environment.

Sincerely,

Senator Philip A. Hart, Michigan; Senator William Proxmire, Wisconsin.

A Comparison of the Proposed NAIC Model Variable Life Insurance Regulation (Dec. 1, 1973 "Exposure Draft") with the Relevant Portions of the 1940 Investment Company Act (ICA) and Investment Advisers Act (IAA)

I. Investment Advisory Services

A. Investment advisor registration.

Can be registered under either NAIC VI 10 a(2) or IAA 203(c). The NAIC regulation is less rigorous because no requirement of disclosure of educational background of the investment advisers or their past business dealings is included.

B. Investment advisor contract.

1. Written contract requirement?

Yes – See NAIC III 5(a)
Yes – See ICA 15(a)
Appear to be substantially the same.

2. See NAIC VI 10(a)

a. See NAIC VI 10(a)

b. See ICA 15(a), ICA 20-2

With respect to the following, ICA permits termination at any time by the directors, contains complete disclosure of investment advisory service particulars, requires termination in the event of assignment, and compels disclosure of the solicitation orgins of the contract.

NAIC provisions substituted for the above are not as extensive.

3. Power to revoke

a. See NAIC VI 10(b)

b. See IAA 203(d) and ICA 9(b)

The NAIC clause requires notice and hearing, then an Insurance Commissioner determination to revoke. This contrasts with automatic termination for specific offenses under the ICA and IAA.

C. Ineligible advisors

1. See NAIC VI 10 a (2)(d)

2. See ICA 9 (a) and IAA 203(d)(3)

The NAIC model requires a statement regarding past criminal convictions and civil injunctions in some security related matters concerning a proposed adviser while the IAA, in certain instances, flatly prohibits such persons from being investment advisers.

D. Outsider review

1. See NAIC III 6(a), 7; IX 2(a))

2. See ICA 32(a)

The NAIC proposals provide for reports to be filed with the Insurance Commissioner with respect to variable life insurance separate accounts. We assume this includes investment advisory services data. It is not clear whether the Commissioner can compel an independent audit. 1970 revisions to ICA provide for security holder selection and approval of the auditing services. There is no comparable NAIC provision.

II. Investment Policy

A. Statement of investment policy required

1. See NAIC III 2(c)

2. See ICA 8(b)

ICA requirements are more detailed even though some of the required data is covered by the NAIC model in the article on investment prohibitions – See NAIC VI Sec. 3(c).

B. Portfolio restrictions – general

1. See NAIC VI 3(c), VI 4, and VI 9(c) (1), (2)

2. See ICA 5(b) 12(a) 13(a).

With respect to diversification, concentration of holdings in one industry and joint transactions, the NAIC restrictions are not equivalent to the ICA standards. Percentage of diversification under NAIC is less than under ICA requirements; there appears to be no comparable provision converning concentration of holdings in NAIC draft; and NAIC appears to permit more opportunity for joint transactions.

C. Change of Investment Policy

1. See NAIC VI 6

2. See ICA 13(a)

Under the ICA, the security holders vote to change the investment policy. NAIC draft would substitute the discretion of the Insurance Commissioner after hearings <u>if</u> he acts in the first place. Thus, possible government supervision is substituted for policyholder control. Since risk of investment lies primarily with the policyholders, they should have control without having to rely on government.

III. Separate Account Management

A. General supervision

1. Control of Company affiliates

NAIC draft does not have an "interested person" (ICA 2(a)(19)) distinction; therefore, added potential investor protection is precluded. For example, see ICA 10(a) with 1970 Amendments.

2. Antifraud.

a. See NAIC VI 1 (b)

b. See IAA 206; ICA 17

While the NAIC draft forbids employment of persons who have been convicted of fraudulent behavior within the past ten years, does this cover affiliated and "interested person" involvement with the separate account?

3. Prohibitions on transfers by affiliates

   a. See NAIC VI 8, 9 (a)(b)

   b. See ICA 17(a)

   These appear to be "substantially equivalent".

4. Bonding

   a. See NAIC VI 1c

   b. See ICA 17(g)

   These appear to be "substantially equivalent".

B. Conflict of Interest

1. See NAIC VI 9 (a)

2. See ICA 17

NAIC draft applies state law to conflict of interest situations. Are all state laws on this subject as extensive as ICA provisions? Appears that NAIC provision <u>assumes</u> that all state laws as to conflict of interest are as extensive.

C. Control charges against the separate account.

1. Advisory service and management charges

   a. See NAIC VI 7 a(4)

   b. See ICA 36(b)

   ICA deems the investment advisor to have a fiduciary duty with respect to the separate account not to charge unreasonably for his services. NAIC draft establishes a gradation of specific limits on the separate account charges attributed to investment management. If the specific limits are fair and equitable, this NAIC provision would be "substantially equivalent".

2. Sales charge

   a. See ICA 22(b)(1), and ICA 27

   b. See NAIC VII 4

   ICA 27(h) forbids a sales charge greater than 9% of the payments total, and forbids a sales charge greater than 20% on any given payment, or an average of more than 16% during the first 48 payments. NAIC disclosure provision fails to place any limitations on sales charges. Disclosure alone is not "substantially equivalent" to a sales charge limitation.

D. Breach of fiduciary duty – Rights of Action

1. See NAIC draft.

2. See ICA 36.

Under the ICA, the SEC or security holder may bring an action in Federal Court for acts or practices constituting a breach of fiduciary duty including personal misconduct against the company by the officers, directors, advisers, or principal underwriter. We can find no comparable provision in the NAIC draft allowing the insurance commission of policyholders to bring an action for such breach of fiduciary duty. In every state, does the Insurance Commissioner or do policyholders have a right to bring such an action in their respective state courts?

IV. Redemption provisions

A. See ICA 27

B. See NAIC IV 3(f)

It appears to us that NAIC redemption provisions would be "substantially equivalent" to ICA <u>if</u> NAIC proposal number 1 (p. 34 of Dec. 1 Draft) is adopted with the following modifications in (f)(2)(C): "$2.50 per $1,000 of initial amount insured but not in excess ________ dollars", and the $2.50 to be prorated. If the charge is not prorated, than a policyholder who had the policy for only one day would have to pay the entire $2.50.

V. Role of the Policyholder.

A. Election of Directors.

ICA 16(a) provides for securityholder election of directors.

In NAIC draft, there appears to be no independent board of directors for the separate account. While policyholders of mutual insurance companies may elect their company directors, policyholders of stock insurance companies have no such rights.

B. Voting Rights.

ICA 18 (i) provides that every securityholder have voting rights, for purposes of securityholder approval to change investment policy (ICA 13(a)), choice of independent public accountants (ICA 32(a)), and approval of advisory contracts (ICA 15(a)).

The NAIC draft does not provide these basic rights of corporate democracy.

* * * * * *

Hon. Phillip A. Hart
Hon. William Proxmire
U. S. Senate
Washington, D. C. 20510
January 11, 1974

Dear Senators Hart and Proxmire:

We have your letter of November 29th concerning the model variable life insurance regulation which was adopted by the NAIC during the week of December 3 after several months of deliberation. We appreciate your interest and submission of comments.

1. <u>Background.</u>

At the outset, we note the S.E.C.'s January 1973 release which said, among other things: "We expect that . . . (state variable life insurance regulation) will provide material <u>protections</u> to purchasers substantially equivalent to the <u>relevant protections</u> that would be available" under the Investment Company Act of 1940. The use of the word "relevant" is significant. The SEC recognized that since this product differed in many ways from a mutual fund, protections that were relevant in one case might be completely irrelevant in the other case. The states were not expected to duplicate every protection provided in the 1940 Act – nor were they expected to use the identical language of the 1940 Act. Protection and regulation are not synonymous.

In essence, your comments compare the provisions of the Investment Company Act of 1940 with a draft of the model regulation which was being worked upon by the NAIC Variable Life Insurance Subcommittee. Such an approach as to what a variable life insurance regulation should contain seems to address the problem from a very narrow framework. This approach assumes that legislation, enacted over 33 years ago to remedy specific abuses in another industry, should be applied carte blanche to an essentially life insurance product. To many, including the NAIC, such an assumption is at best a questionable one.

Furthermore, as you know, the jurisdiction of the SEC over variable life insurance and separate accounts funding variable life insurance under the federal securities laws is the subject of pending litigation before the United States Court of Appeals for the District of Columbia. Notwithstanding that litigation, however, no one contests the fact that variable life insurance, for the purpose of state insurance laws, is a life insurance product. Consequently, regardless of the final determination concerning SEC jurisdiction, the states are under an obligation to regulate that product to protect the interests of variable life insurance policyholders while simultaneously doing equity between all policyholders of the company. Literal application of the 1940 Act to variable life insurance would prevent the states from meeting this responsibility.

In discharging these responsibilities in the context of variable life insurance, the NAIC Variable Life Insurance Subcommittee has drawn from many sources including traditional state insurance law, potential changes in state insurance regulation, and the federal securities laws including the 1940 Act. In evaluating these sources, the Subcommittee has attempted to ascertain those various types of protections which are and are not relevant to variable life insurance. After considerable deliberation over many months (with input from many state insurance departments, staff representatives of the SEC and industry representatives), the Subcommittee determined those types of protections which are and are not relevant considering the nature of the product. With respect to the 1940 Act, in particular, the Subcommittee (as did the SEC in its January decision) concluded that some provisions are relevant, some are irrelevant, and some are partially relevant.

In veiw of the complexity of the subject, it would carry this letter to excessive lengths if we attempted to respond in detail with respect to our disposition of each provision of the 1940 Act; however, we have cited below some of the more prominent examples – policyholder voting rights for changes in investment policy and sales commissions – as illustrative of the considerations given by the Subcommittee.

2. Policyholder Voting Rights.

Under the 1940 Act, a security holder of a investment company has a right to vote upon proposed changes in investment policy. Such a provision, however, is inappropriate in the context of variable life insurance. Furthermore, the model regulation has developed more meaningful protection in this area which considers not only the interests of the variable life insurance policyholders but also of other policyholders of the issuing company. This stems from the fundamental interrelationship between the separate account and the rest of the insurer's operations.

a. Nature of the Separate Account. The operation of a separate account which funds variable life insurance intimately relates to and impacts upon the general account of the insurer. An insufficiency reserve will be established in the general account to cover the contingency that separate account assets may be less than that needed to support the guaranteed minimum death benefit. Furthermore, general account reserves must be established to support all other policy benefits. In the event the combination of the reserves in the separate account and the insufficiency reserves in the general account prove inadequate, the surplus of the insurer stands behind the variable as well as fixed dollar life policyholders.

A separate account is basically an accounting mechanism to measure the level of benefits the insurer owes to its variable life insurance policyholders. Unlike in a mutual fund, the insured or beneficiary does not own and the insurer's obligations are not limited to the separate account assets. All assets of the company, not just those underlying the separate account, stand behind the insurer's total obligation including the mortality and expense guarantees included in the guaranteed minimum death benefit. In fact, some do not understand that the concept of proportionate ownership crucial to the regulatory philosophy of the Investment Company Act is not only foreign to but inherently contradictory to the insurance concepts of pooling risks underlying variable as well as all other life insurance. Consequently, state insurance regulators have the responsibility to examine closely the investment practices and management of both the separate and general accounts and, where necessary, step in to protect the policyholders.

b. Inappropriateness of the 1940 Act Voting Scheme to Variable Life Insurance. The unitary nature of variable life insurance is inherently contradictory to the concept that the separate account is severable from the insurer so as to be a distinct investment company under the 1940 Act. As a consequence, the 1940 Act requirement that the security holder have voting rights over changes in investment policy can have no application to a life insurance company which has undertaken a contractual obligation to pay a death benefit. Requiring the insurer to turn over its separate account assets to a manager chosen by the purchasers of variable life insurance while the company's general assets are still at risk would conflict with insurance regulator's responsibility to all policyholders of the insurer. In short, an insurance regulator cannot permit one group of policyholders to be the ultimate arbiter of investment policies that can have a profound impact on other policyholders as well as upon the financial integrity of the company as a whole.

The SEC has apparently recognized this:

> It would also have been difficult, for example, to apply certain provisions of the Act relating to shareholder voting. If the assets of the variable life insurance separate account become inadequate to support the minimum death benefit, state insurance regulation might require the deficiency to be made up from the insurance company's general account. Accordingly, there is a question whether an insurance company would be willing to maintain a separate account for variable life insurance if, because of contractholder voting, the insurance company could not be certain it would continue to supervise and manage the account's activities.

Investment Company Act Release No. 8000 p. 7.

c. NAIC Alternative Protection. At the same time, however, the model regulation recognizes the necessity that variable life insurance policyholders be protected against undue changes in investment policy. To do so, the following procedure has been incorporated into the model regulation.

When any insurer proposes to change the investment orientation upon which the policyholder had relied in the purchase of variable life insurance, it must notify the commissioner of the insurer's state of domicile. The change would be submitted for his approval and if it is determined that such a change is substantial, notification must be made to all existing policyholders as well as the insurance commissioners of all states in which the insurer issues variable life insurance. The commissioner can approve or deny the proposed change in investment policy. This provides more meaningful protection to the policyholder than would the voting right approach since the proposed investment change is being reviewed by a person with the expertise and authority to make an objective determination. In contrast, we are unaware of a substantial number of occasions in which management proposed changes in investment policy have been rejected by mutual fund shareholder voltes. With respect, I must say that the NAIC does not share your confidence in the 1940 Act voting mechanism as an effective protection. Thus, the model regulation, cognizant of the total responsibility of the insurance regulator, protects not only the variable life insurance policyholder, but the other policyholders of the company.

Furthermore, the model regulation will guarantee the right of variable life insurance policyholders who object to a change in investment policy, which is ultimately approved by the commissioner, to continue their insurance protection by converting to a fixed insurance policy. No even remotely comparable protection is afforded by the Investment Company Act of 1940 to those security holders who vote against a proposed change but find themselves in a minority.

In short, the Subcommittee reviews the relevance of this 1940 Act voting provision and found it inapplicable because of a fundamental conflict with other regulatory considerations. Instead of automatically applying the 1940 Act provision, a more meaningful and effective alternative was developed. Furthermore, an additional benefit was developed for the dissenting variable life insurance policyholders.

3. Sales Commissions.

Regulation of "excessive" sales expenses in variable life insurance is a highly complex and interrelated area to which the Subcommittee devoted substantial thought. Some have suggested that the same sales load restrictions imposed by the 1940 Act on mutual funds should be applied to variable life insurance. As the Subcommittee concluded, this proposal ignores the inherent product differences and the fact that the Investment Company Act was designed without any consideration whatsoever to insurance products. As a result, several reasons lead to the rejection of this approach and the development of more relevant alternatives.

a. Basic Difference Between Mutual Funds and Variable Life Insurance. Variable life insurance is life insurance. Like conventional life insurance, its basic purpose is to provide death protection. As such, the 1940 Act sales load limitations are less relevant than the mutual fund situation. For example, Section 27 imposes limitation on front end load. However, the SEC itself has found that

"... there is no basis for analogizing the purchase of ... insurance on the installment basis to front end load plans for investing in mutual fund shares." (Public Policy Implications of Investment Company Growth p. 245.)

In a mutual fund the front end load limitations serve to assure that a minimum portion of the early periodic payments of the investor are actually invested for his benefit. However, in the purchase of life insurance this concern has significantly less relevance since regardless of the incidence of high first year commissions, the full death benefit is payable, not merely the amount of premium paid in minus sales commissions. As the SEC has acknowledged:

> the savings element in life insurance is an outgrowth of a subordinate to the death protection element, which is the central feature of a life policy. Hearing on S. 1659 before Senate Committee on Banking and Currency, 90th Cong., 1st Sess. pt. 25 at 1206 (1967).

Thus, regardless of any front end load, it is clear that the policyholder achieves the primary purpose of variable life insurance – i.e. death protection.

b. Ineffectiveness of the 1940 Act Sales Load Limitations as to Variable Life Insurance. Analysis of the Investment Company Act quickly reveals its inability and inapplicability to deal with the problem of insurance "excessive" sales charges in the context of variable life insurance.

1) There are three elements comprising the entire price of a mutual fund: (i) value of the underlying securities determined by the market (ii) management and administrative expenses – regulated by the Investment Company Act and (iii) sales expenses – also regulated by the Investment Company Act. Thus by limiting all cost elements which are within the control of the mutual fund insurer, i.e. management, administrative and sales expenses, the 1940 Act assures that the entire cost is regulated against "excessive" loading.

In contrast, variable life insurance, as do all life insurance, premiums contains inherent elements never contemplated by Congress in designing a regulatory scheme for mutual funds. These include mortality and expense guarantees required to support the risk borne by the insurer for the duration of life (e.g. 30, 40, 50 years) as well as underwriting expenses such as medical examination fees, and the cost of maintaining policies and records – all totally unrelated to any investment function. But rather, these elements are uniquely "insurance". Thus unlike the mutual fund situation, not all elements within the control of the issuer (i.e. the insurer) would be reached by the 1940 Act.

The assumption, therefore, that the SEC and the 1940 Act could effectively regulate the cost of variable life insurance to the consumer in a manner similar to that of mutual fund regulation is open to substantial question. An insurer could render imposition of the 1940 Act limitations ineffective by merely increasing those elements of the gross premium, e.g. mortality assumptions, over which the 1940 Act has no control. With respect to sales load, the 1940 Act imposes limits in terms of percentages. The dollar amount of sale compensation depends not only upon the percentage specified but also the base to which the percentage is applied. Unlike the mutual fund situation, the base in the variable life insurance situation is the gross premium, the level of which even under the 1940 Act would remain within the control of the insurer.

2) There are some who erroneously have attempted to divide variable life insurance into an "insurance" portion (comprised of the pure term cost of insurance) and an "investment" portion (comprised of the amount of the gross premium in excess of the "insurance" element). The NAIC feels that life insurance premium is not capable of such division. As previously expressed by the life insurance industry in a letter to the S.E.C. ". . . under a life insurance policy whether variable or fixed, there is no simple relationship between the amount of the premium paid in any year and the cost to the insurance company of claims and expenses in that year. The policyholder pays level premiums and receives full immediate protection regardless of the incidence of disbursements by the company for benefits and for sales and administration expenses. The cost of providing coverage against the risk of death which rises each year. . ." and the cost of providing for varying but typically decreasing, expenses are blended in the determination of the level premium.

Unfortunately, the S.E.C. has apparently adopted the faulty analysis in characterizing the "investment" element a security. However even if the S.E.C. analysis is accepted arguendo, extended to its logical conclusion there is substantial doubt as to the authority of the S.E.C. under the provisions of the Investment Company Act to regulate the entire sales load of a variable life insurance policy.

This arises because the term "sales load" as used in Section 27 of the 1940 Act, is defined in Sec. 2(35) as ". . . the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer. . ." Regardless of the merits or demerits of this bifurcated "investment element" – "insurance element" analysis, it is clear that the so-called insurance element portion of the premium is not an amount "invested or held for investment". Thus by increasing commissions on the "insurance" portion, it is conceivable that insurers can continue to charge virtually their present commissions and thus avoid the restrictions of the 1940 Act.

Professor Frankel, to whom your letter refers as a legal scholar in this area, has made the same point.

> It seems to the writer that the protection of § 27 regarding load should not apply to variable policies without further research . . . (I)f § 27 applied only to the investment component in the premiums of variable policies, the company could charge the rest of its front-end load and commissions under the insurance rate and thus avoid the limitation. If the section applied to the whole amount of premium, the section would directly regulate the sale of life insurance. (48 Notre Dame Lawyer, 1017 at 1040)

Professor Frankel's statement not only points out the lack of S.E.C. authority to control the entire premium but also highlights that even if § 27 did cover the entire premium, such would constitute a direct regulation of insurance, the clear implication being that this would violate the McCarran Act.

c. NAIC Model Regulation Approach to Sales Load Limitations. As seen from above, the application of the 1940 Act mutual fund type sales load limitations to variable life insurance promises little in the way of effective or relevant regulatory protection. Although the limitations in § 27 of the 1940 Act were looked upon as a starting point in the NAIC Subcommittee deliberation concerning sales loads, after several public hearings and considerable discussion, it was determined that the following regulatory protections, now contained in the model regulation, are more appropriate for variable life insurance.

1) The inability of the S.E.C. to control the entire premium renders § 27 of the 1940 Act vulnerable to relatively easy circumvention. The 1940 Act mutual fund concept of limiting cost items in order to reduce the cost to the consumer is irrelevant unless all cost items are controlled. Forcing commissions down does not necessarily force premiums down since the insurer can still charge the same amount taking the excess as profit. Thus, the model regulation focuses on the entire premium. It establishes a set of maximum variable life insurance premium rates. An insurer who charges more than the rates prescribed will have to provide equivalent additional cash values. These additional cash values are

sufficiently costly to the insurer that it will be greatly discouraged from setting its rates in excess of the maximums set forth.

While the maximum premium rates may have to be adjusted upward or downward as variable life insurance regulatory experience grows (and such constant review is anticipated), it is believed that this approach is considerably more relevant than the Investment Company Act.

In adopting this approach, the drafters of the model regulation were cognizant of the fact that traditionally life insurance premiums have not been directly regulated by the states. Reliance has been placed on competition to keep premium levels and benefits within acceptable limits. Being for the duration of life, premiums, once fixed, may be in effect for decades regardless of what happens to the economy and to mortality results. Premiums may not be increased. Thus, the actuaries who calculate the premiums – and upon whose professional competency the insurers must rely – have necessarily tended to use conservative assumptions on the three key items – interest, mortality, and expense. The valuation standards for reserves, based on a legally approved mortality table and a legally specified interest rate, are, by their nature, conservative and tend to restrict pricing freedom.

The most comprehensive investigation of life insurance ever conducted, the New York Armstrong Investigation, did not adopt direct premium controls; instead it sought to keep costs down by putting a ceiling on new business, a restriction on surplus accumulations, and a limitation on expenses and commissions.

Conscious of this history and of the public policy consideration which influenced the choices made, the Subcommittee avoided traditional type rate regulation involving a case by case commissioner approval of filed rates. Instead, as described above, the Subcommittee has sought to discourage the exercise of the insurer's freedom to increase premiums, above certain limits, (to the extent not restricted by competition) by imposing a mandatory offsetting step-up in policyholder cash values. Whether the adopted maximum rates, which trigger the increased cash values if exceed, will need adjustment in the future can only be ascertained after some experience with the product. Nevertheless, the principle has been established and the "numbers" can be revised from time to time as experience dictates. This is an innovative regulatory development. It reflects the Subcommittee's recognition of the need for consumer protection controls to prevent abuses without being so heavy handed as to be unworkable.

2) The model regulation requires sales commissions to be disclosed. Although such a requirement is not free from pitfalls, it should have a salutory effect. It represents another innovation in the regulation of the life insurance business.

3) Section 27 also establishes certain redemption requirements so that if a mutual fund shareholder terminates his contract, a certain minimum amount of his investment should be returned. However, literal application of Section 27 to variable life insurance would most likely cause counter productive results, even if concessions recognizing the insurance nature of the product were made. For example, the substantial extra cost of a Section 27 type redemptive provision would be passed on to the persisting policyholders who did not exercise such "benefit", thereby producing potentially inequitable results. In addition, it seemed likely that the inclusion of such a "benefit" would greatly accelerate the number of early lapses, a problem already of concern to insurance regulators because of the adverse impact on policyholders and to the industry because of the expense. Unlike a mutual fund which can profit from an investor who discontinues within the first year, a life insurer normally suffers an actual loss when lapse occurs in the early years of the policy.

In a life insurance context, unlike the mutual fund area, termination by one policyholder impacts upon the other policyholders. Thus, the basic thrust of regulatory protection should be focused on avoiding or minimizing the likelihood of policyholders desiring to terminate. Consequently, in addition to exercising some restraint over the whole premium, the model regulation, to protect the policyholder against the oversale and/or missale of variable life insurance which lead to terminations, (a) allows the policyholder a free look at the policy for 45 days from the date of the application or ten days from the date the policy is received – whichever is longer; (b) allows the policyholder who becomes disenchanted with variable life insurance, regardless of market performance, to convert within the first 18 months to an equivalent fixed benefit policy and (c) imposes an obligation upon the insurer prior to sale to determine the suitability of variable life insurance for the insured's needs. Unlike the S.E.C.'s suitability requirements which must be enforced on a case by case basis, the NAIC regulation allows the commissioner to compare variable policy lapses with the insurers fixed benefit policy lapse rates to determine whether the company is selling as a general business practice to those for whom variable life insurance may be unsuitable.

The model regulation also requires all sales and advertising materials to be submitted to the commissioner and subject to his disapproval. Among other things, this should mitigate the potential problem that the public be misled into thinking that it is purchasing something other than a life insurance policy. In fact, the information provided to the applicant is expressly required to contain a disclaimer as to similarity between variable life insurance and mutual funds. In these areas, as in others mentioned above, the NAIC has not hesitated to devise and adopt new regulation concepts: no attempt has been made to preserve the status quo.

d. Competitive Equality. The basic purpose of insurance regulation is to regulate in the public interest. The primary focus is the protection of the insurance consuming public which includes policyholders and beneficiaries. The NAIC model regulation was drafted from this perspective. Nevertheless, in the proceedings before the SEC and the pending litigation, some mutual funds have urged competitive considerations, especially the impact of sales load limitations as between mutual funds and insurers as being the center piece in determining the applicability of the 1940 Act to variable life insurance. Thus, we would be remiss in not commenting on this point.

The mutual funds argue that competitive products should be subject to identical sales load limitations to avoid unfair advantage to either. From this the conclusion is reached that the 1940 Act sales load limitations should be applied to variable life insurance. Such rationale, however, suffers from at least three defects.

First, variable life insurance and mutual funds are significantly different products. Many question the degree to which they are in fact comparable and how much in fact they will compete with one another.

Second, even assuming comparability arguendo, the application of the sales load limitations to the entire variable life insurance premium would not result in equal regulation but rather more stringent regulation of variable life insurance. This is highlighted by the fact that for years mutual funds salesmen have sold separate contracts of term insurance along with the mutual funds as a part of an "insurance – mutual fund" package. The salesmen receive two commissions; one regulated by the S.E.C. for selling the mutual fund and the second the term insurance commission subject to state insurance department jurisdiction. Some mutual funds or their controlling entities organized or acquired their own life insurance companies to facilitate this approach. No one has ever suggested that the mutual fund salesman should go uncompensated for making this extra sale. If one accepts the erroneous argument of the mutual funds that variable life insurance is simply a combination of insurance and investment elements and the argument that 1940 Act load limitations should apply to variable life, logic dictates that the mutual fund sales of term insurance should likewise be subject to such requirements. Yet, we do not hear the mutual funds making this proposal.

Third, the potential competition between variable life insurance and fixed benefit insurance is certainly easier to visualize than the competition between variable life and mutual funds. Thus the imposition of different sales commission restrictions on these two much more readily comparable products suffers more from competitive inequality than that alleged to exist between a mutual fund and variable life insurance.

In short, the mutual fund position of applying the 1940 Act sales load limitations to variable life insurance to achieve alleged competitive equality might be seen by others as a guide to achieve a competitive advantage. In any event, the foregoing merely illustrates the inability to completely satisfy competing economic interests and confirms the need to develop variable life insurance regulation in the context of the public interest rather than merely serving as an arbitrator between two disputing industries.

4. Conclusion.

The foregoing analysis, using the examples of voting rights and sales loads, is intended to be solely illustrative of how the NAIC's Variable Life Insurance Subcommittee has attempted, in designing a regulation "particularly appropriate" to variable life insurance, to meaningfully solve the foreseeable problems associated with that product. As with any new regulation governing a new area, no one claims that the model regulation contains the ultimate answer to all problems. Since variable life insurance has not yet been marketed, it is impossible for anyone to be assured that all possible abuses have been provided for. However, consistent with the level of knowledge presently in existence concerning variable life insurance, we are confident that those problem areas that are reasonably foreseeable have been adequately regulated. Furthermore, over the years it is both expected and desirable that the model regulation will be adjusted to reflect expanding variable life insurance regulatory experience.

For example, one area in which the NAIC has been and continues to be active is that of disclosure and comparisons of life insurance costs to the policyholder. The NAIC has adopted the interest adjusted method as an interim solution. As better methods are developed for variable as well as fixed life insurance, it can be anticipated that these will become part of the variable life insurance regulatory framework.

Finally, while we would not agree that the model regulation is not "substantially equivalent to the relevant protections" of the Investment Company Act, we do question whether "substantial equivalence" to an act designed without any thought for insurance problems should be the artificial standard against which state variable life insurance regulation should be measured. Rather, as we have suggested to the S.E.C., (a copy of our submission is attached) the test should be whether the regulation meets the needs of the public and is likely to prevent foreseeable abuses, not whether the regulation is substantially equivalent to a legislative framework designed to attack abuses inherent in a different product. The end result of regulatory effort must be the interest of the insurance consuming public.

We think that the NAIC model regulation, when added to the full panapoly of general state insurance regulatory powers, provides a most meaningful and appropriate step forward in regulation in the public interest is "particularly appropriate" to variable life insurance. (A brief synopsis of the scope of state insurance regulation – formal and informal, which forms part of the NAIC brief in the jurisdictional litigation, is attached for your reference.) While incorporating a number of relevant concepts of the 1940 Act, the Subcommittee was able to freshly approach the problem and draw on a wide range of sources. The unilateral imposition of a solely securities oriented perspective upon a product which is essentially insurance could very well result in the destriction of what you have described as "an excellent concept". This would be a great disservice to potential variable life insurance policyholders as well as to fixed benefit policyholders and the public in general.

We appreciate your interest in the NAIC model variable life insurance regulation and welcome the opportunity to discuss this subject with you.

Sincerely,

James M. Jackson, Director
Nebraska Insurance Department