A variable annuity is a hybrid investment product, which combines some of the features of a life insurance contract with some of the benefits of a mutual fund. Variable annuities are big business, and growing by leaps and bounds. In 1999, sales of variable annuities totaled $121 billion dollars, up 21 percent from the previous year. [FN1] This represents an increase of over $100 billion dollars in sales over the last decade, a nearly tenfold increase. [FN2]

As detailed below, variable annuities are complex instruments that are often not fully understood by the investing public or even by the financial advisors that recommend them. As a result, the financial industry has been beset by lawsuits and arbitration claims brought by disgruntled investors who claim that they were not fully apprised of the risks, restrictions, or expenses involved in these instruments. In addition, securities regulators, including the Securities and Exchange Commission and the National Association of Securities Dealers, (NASD) have recently issued investment advisories warning investors of the risks and costs attendant in variable annuities.

An annuity has been described, in user-friendly language, as "a contract between you and an insurance company where the company promises to make periodic payments to you, starting immediately or at some future time." [FN3]

A simple, or fixed annuity is an insurance product, regulated by state insurance departments, and is not considered a security within the meaning of federal securities laws. [FN4] In a fixed annuity, the earnings and pay-outs are guaranteed by the insurance company.

A variable annuity combines some of the features of a fixed annuity with some of the advantages of a mutual fund. Or, as one financial writer has explained: "A variable annuity is essentially a group of mutual funds inside an insurance wrapper." [FN5] Like a fixed annuity, the holder of a variable annuity makes periodic payments to the issuing company during the accumulation phase.

However, in a variable annuity, all or portions of the investment are placed into one or more mutual funds so that the investor can enjoy the prospect of profiting in a rising stock market.

Death and Taxes

A variable annuity generally has three features not commonly found in mutual funds: 1) tax deferred treatment of earnings; 2) the payment of a guaranteed death benefit; and 3) annuity pay-out options that can provide guaranteed income for a fixed period or for life. In the first instance, stock gains within an annuity, like an IRA, but unlike a mutual fund, are tax-deferred. The holder of a variable annuity is not responsible for capital gains on securities sold within the mutual fund sub-account during the course of a year. As a result, an investor can transfer money from one...
sub-account to another within the variable annuity without incurring any tax liability.

Thus, a variable annuity can provide a tax advantage for funds that would otherwise be subject to capital gains taxes.

Other considerations may arise in the case of assets which are already sheltered within a tax-deferred investment, such as an IRA or employer generated deferred compensation plan. In some circumstances, the transfer of IRA or 401 (c) funds into a variable annuity account has drawn the ire of investors and the scrutiny of regulators due to the additional fees and expenses involved for what is sometimes perceived as unnecessary redundant deferral of taxes. [FN6]

While all variable annuity contracts are different, a common feature of many is the death benefit. This feature provides a specified minimum payment to a designated beneficiary in the event of the policy holder's death. The advantage of the death benefit is that the beneficiary is entitled to receive a guaranteed minimum payment, even in the event of a decline in the mutual fund sub-accounts of the variable annuity. [FN7] The death benefit, then, operates as the life insurance aspect of a variable annuity inasmuch as it guarantees the beneficiary a specified minimum payment even in the event of an overall decline in the stock market and a diminution in the value of the mutual fund sub-accounts.

Variable annuities often offer additional optional features, such as a guaranteed minimum income benefit or long term care insurance, which pays for nursing home care in the event that the policy holder becomes ill or infirm.

Another important feature of variable annuities is the minimum payment known as "living income benefits." This benefit, offered by some but not all life insurance companies, guarantees the payment of a certain minimum monthly amount regardless of the fluctuations of the stock market or the diminution of the mutual funds in the sub-accounts. [FN8] This is the classic fixed annuity component of a variable annuity.

In short, variable annuities offer a combination of advantages that are not commonly available with mutual funds or other types of investments. They offer tax-deferred growth of principal and freedom from capital gains taxes, although the proceeds are taxed as ordinary income when paid out. They also offer a death benefit and, in some instances, living income benefits which allow investors to participate in the upside of the stock markets yet mitigating the blows of a bear market by providing certain minimum death or living income benefits. On the other hand, variable annuities bear certain disadvantages which render them unsuitable for many investors. These disadvantages are primarily high costs and lack of liquidity.

The Down Side

While variable annuities provide several advantages which are not available for either fixed annuities or mutual funds, there is an accompanying price. First of all, the brokerage firms which offer these instruments typically charge a management fee in addition to the fees traditionally imposed by the mutual fund company on the investments in the underlying sub-account.

For example, an issuing firm might offer a variable annuity product in which the underlying sub-accounts include mutual funds with several other mutual fund companies, such as Vanguard, Fidelity or Janus. Each of these companies will charge a management fee, so the investor is, in effect, paying a double fee.

In addition, an investor who wishes to redeem an annuity within six years typically (but not always) must pay a surrender charge which can start as high as 7 percent of principal and declines on an annual basis over time.
For example, an investor who has a change of heart and decides to cash out of a $100,000 variable annuity in the first year of the investment might have to pay a 7 percent surrender charge, on top of management fees to the variable annuity underwriter as well as additional fees to the manager of the sub-account mutual funds.

In the above hypothetical, let us assume a surrender fee of 7 percent to the variable annuity underwriter, 2 percent to the annuity manager and 1 percent to the holder of the sub-account. In that hypothetical example, the investor would incur a total of 10 percent in fees and secure the refund of only $90,000 of the initial investment, assuming that the investments in the underlying sub-accounts remain flat.

As a result, there are many investors, for whom, the NASD warns, these fees may make such an illiquid investment inappropriate. [FN9] This is particularly the case, according to the NASD, for senior citizens or other investors who may need ready access to their money, such as homebuyers or parents of college age children. [FN10]

Recent enforcement actions brought by the NASD have illustrated some of the pitfalls associated with variable annuities.

For example, in February, 2001, a stockbroker was fined $10,000 and ordered to pay restitution to his customer for selling a $325,000 variable annuity to a 76 year-old widow which was unsuitable to her needs. [FN11] In order to finance the investment in the variable annuity, the customer had incurred substantial sales charges by selling mutual funds, and had further incurred interest expenses by a margin loan. These additional expenses were not offset by any benefit to the customer, according to the NASD Division of Enforcement, and the respondent stockbroker failed to adequately consider the investor's time frame objectives. [FN12]

In another recent enforcement action [FN13] the NASD alleged that the respondent firm issued misleading sales literature, falsely implying that additional tax benefits were available to customers who transferred funds into a variable annuity from other tax-deferred investments. The sales literature also misleadingly suggested that certain tax advantages were available only via an investment in a variable annuity.

Stockbroker Arbitrations

Recently, arbitration cases have been brought by investors who claim that their stockbrokers failed adequately to warn them of the expenses and costs involved in a variable annuity. All registered broker-dealers and associated persons are deemed to have consented to arbitration, by NASD rules. [FN14]

Typically, in these cases the investor has claimed a reduction in the value of her account, or, has argued that the stockbroker did not fully inform her of the costs and expenses involved in the purchase of a variable annuity, or both. Customers have argued that these investments were unsuitable because they were illiquid and also because they may have comprised a disproportionate percentage of the customer's entire net worth, thereby rendering the investor cash-poor. Some of these claims have been based upon the suitability requirement of the NASD and the New York Stock Exchange, which obligates registered representatives to make reasonable inquiries into the net worth, age and financial objectives of their customers in order to ascertain the suitability of any particular investment for the customer. [FN15]

Thus, in the view of industry regulators, a stockbroker must affirmatively take steps to inquire of a customer what percentage of his net worth is being invested, the customer's tolerance for risk and what the funds are earmarked for, e.g. college education for children, retirement or that red convertible with a V-8 engine. Ideally, the stockbroker should affirmatively ask the customer when the funds will be needed.
Conclusion

In summary, variable annuities are complex financial instruments which offer some of the benefits of mutual fund investing as well as some of the benefits of a life insurance contract. They also combine some of the advantages and disadvantages of an individual retirement account. The substantial costs and expenses involved in a variable annuity render them unsuitable for some investors and have spawned claims and arbitrations by investors who allege that they were not properly advised of the costs.

While the analysis involved in determining the suitability of these instruments may vary from customer to customer, variable annuities have many advantages that, when used judiciously, can enhance many portfolios.

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FN(2) "Variable annuity sales may hit $118 billion By Year 2000, Study Says," 2 Andrew's Derivative Litigation Report 9 (March 19, 1998).


FN(4) Id.


FN(6) See e.g, Kosness, Annuity Blues, supra; NASD Notice to Members 99-35 (May 1999) at p. 230-231.


FN(9) NASD Notice to Member 99-35, supra, at pg 231.

FN(10) Id.

FN(11) In re Ralph C. Evans, NASDR Division of Enforcement Case No. C0501009 (February 15, 2001).

FN(12) Id.


FN(14) NASD Regulation Inc., Code of Arbitration Procedure, Section 10201.

FN(15) See NASD Conduct Rule 2310; NYSE Rule 405.