TRINIDAD & TOBAGO
SECURITIES AND EXCHANGE COMMISSION

THE REGULATORY TREATMENT OF DEFERRED TAX ANNUITY/SAVING PLANS SPONSORED BY NON-INSURANCE COMPANIES

(FOR PUBLIC COMMENT)

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Disclosure, Registration & Corporate Finance
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INTRODUCTION

Deferred Annuity/Savings Plans sponsored by non-insurance companies have posed a unique challenge for the regulatory authorities of Trinidad and Tobago. These hybrid insurance/savings vehicles have virtually escaped the regulatory net owing to the fact that they are neither covered by the Insurance Act of 1980 nor the Financial Institutions Act of 1993.

In the case of the Insurance Act, 1980, the regulator, the Central Bank of Trinidad and Tobago, supervises only those plans that are issued by licensed insurance companies. In the case of the Financial Institutions Act, 1993, the businesses of the plan sponsors are regulated from a prudential viewpoint. However, the Central Bank of Trinidad and Tobago does not regulate the plans to ensure that there is full and complete disclosure to investors of all facts that are material to their investment decision.

The transaction structure constitutes an arrangement in which individuals enter into a contract under which periodic payments (contributions) are held in trust and are invested or otherwise applied by the entity for the purpose of providing an annuity for life commencing at maturity of each contract.

It is in essence a saving plan for retirement with a tax incentive. Each contribution by the investor is treated as a deferred annuity contribution and is allowed as a tax deduction under Section 28 of the Income Tax Act.

This paper purposes to provide a framework for the registration and continuous disclosure regime for Deferred Annuity/Savings plans that are sponsored by non-insurance entities. The sections that follow will address the following topics:

i) the definition and varying forms of Deferred Annuity/Savings Plans;
ii) the legal argument for registration of the Plans as securities with the Securities and Exchange Commission ("the Commission");
iii) Deferred Annuity Plans currently in existence and not registered by the Commission;
iv) the structure and content of the prospectus and other documents constituting the plan; and
v) a plan of action for ensuring compliance by existing unregistered Plans.

WHAT ARE DEFERRED ANNUITY/SAVINGS PLANS?

A deferred annuity is a contract between an individual and an insurance company or financial institution, which delays the payments of income, installment, or a lump sum until the investor (or annuitant) elects to receive them. During the life of the contract, the annuitant contributes an agreed amount of money on a periodic basis to the plan. On maturity, where the contract is with an insurance company, the insurance company provides an annuity for the remainder of the individual's life i.e. it provides a series of fixed payments which are paid over the specified period.

Where the contract is made between an individual and a financial institution, the annuitant still provides funds periodically to the plan, but on maturity the capital contributions and income generated are used to purchase an annuity from a recognized insurance company.

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Deferred Annuity Plans may be either approved or unapproved. Approval in this case means approval from the Board of Inland Revenue ("BIR") to allow the payments made by the individual to be deducted on his tax return for the relevant period. Conversely, unapproved plans do not have this tax incentive feature and payments made under these plans obtain no tax relief in the relevant period.

The Structure of Deferred Annuity Plans

Generally, annuity plans may be classified into three (3) basic types that are designed to meet the different objectives of an investor. These classifications are:

(i) Fixed annuity
(ii) Variable annuity
(iii) Combination annuity

While all three types allow the investor's money to grow tax deferred or not, the type of investments made and how the money is invested by the trustee/manager will vary among them.

Fixed Annuity Plans

A fixed annuity offers investors a guaranteed rate of return regardless of whether or not the investment portfolio can produce the guaranteed rate. If the performance of the portfolio falls below the rate that was guaranteed, the sponsoring entity is liable for any shortfall. Since fixed annuities offer investors a guaranteed return, the money invested by the sponsoring entity will be used to purchase conservative investments whose historical performance is predictable enough so that a guaranteed rate can be offered to investors.

Variable Annuity

An investor seeking to achieve a higher rate of return may elect to purchase a variable annuity. Variable annuity plans seek to obtain a higher rate of return by investing in stocks, bonds, or mutual fund units. These securities traditionally offer higher rates of return than more conservative investments. A variable annuity does not offer the investor a guaranteed rate of return and the investor places all or a substantial portion of his principal at risk. The plan may provide for investment in one of two methods:

- Direct. The funds are held in a separate account and are invested directly into individual stocks and bonds. The separate account has an investment advisor to actively manage the portfolio.

- Indirect. The funds are held in a separate account and used to purchase mutual funds. An investment advisor is not required to actively manage the portfolio.

Combination Annuity

For investors who feel that a fixed annuity plan is too conservative and that the variable annuity plan is too risky, a combination annuity offers the annuitant features of both a fixed and variable contract.

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A combination annuity has a fixed portion that offers a guaranteed rate and a variable portion that tries to achieve a higher rate of return. Most combination annuities will allow the investor to move money between the fixed and variable portions of the contract.

Table 1 - Comparison of Features of Fixed and Variable Annuity Plans

Feature	***Fixed Annuity Plan***	***Variable Annuity Plan***
Payment Received	Guaranteed/Fixed	Mary Vary in Amount
Return	Guaranteed Minimum	No Guarantee and Return may vary
Investment Risk	Assumed by Sponsor	Assumed by Investor
Portfolio	Real Estate, Mortgages and Fixed Income Securities	Stocks, Bonds or Mutual Fund Shares
Portfolio Held in	Genera Account	Separate Account
Inflation	Subject to Inflation	Resistant to Inflation

It should be noted that the Trinidad and Tobago market has not reached the stage where it has offered varying investment profiles to different investors. Although not currently in existence, the market for these securities may evolve to include the characteristics mentioned above.

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ANNUITY PURCHASE OPTIONS

An investor may purchase an annuity contract in one of three (3) ways. They are:

(i) Single payment deferred annuity
(ii) Single payment immediate annuity
(iii) Periodic payment deferred annuity

SINGLE PAYMENT DEFERRED ANNUITY

With a single payment deferred annuity, the investor funds the contract completely with one payment and defers receiving payments from the contract until some point in the future usually after retirement.

SINGLE PAYMENT IMMEDIATE ANNUITY

With a single payment immediate annuity, the investor funds the contract completely with one payment and begins receiving payments from the contract immediately, normally within 60 days.

PERIODIC PAYMENT DEFERRED ANNUITY

With a periodic payment annuity the investor purchases the annuity by making regularly scheduled payments into the contract. This is known as the accumulation stage. During the accumulation stage the terms are flexible and if the investor misses a payment there is no penalty.

ANNUITY PAYOUT OPTIONS

An investor in an annuity has the choice of taking a lump sum distribution or receiving scheduled payments from the contract. If the investor decides to annuitize the contract and receive scheduled payments, once the payout option is selected, it may not be changed. The following is a list of typical payout options in order from the largest monthly payment to the smallest. They are:

(iv) Life only / straight life
(v) Life with period certain
(vi) Joint with last survivor

LIFE ONLY/STRAIGHT LIFE

This payout option will give the annuitant the largest periodic payment from the contract and the investor will receive payments from the contract for their entire life. However, when the investor dies there are no additional benefits paid to their estate. If an investor has accumulated a large sum of money in the contract and dies unexpectedly shortly after annuitizing the contract, the insurance company keeps the money in their account.

LIFE WITH PERIOD CERTAIN

A life with period certain pay out option will pay out from the contract to the investor or to their estate for the life of the annuitant, or for the period certain whichever is longer. If an investor selects a ten-year period certain when they annuitize the contract and the investor lives for twenty years, payments will cease upon the death of the annuitant. However, if the same investor died only two years after annuitizing the contract payments would go to their estate for another eight years.

JOINT WITH LAST SURVIVOR

When an investor selects a joint with last survivor option, the annuity is jointly owned by more than one party and payments will continue until the last owner of the contract dies. For example, if a husband and wife are receiving payments from an annuity under a joint with last survivor option, and the husband dies, payments will continue to the wife for the rest of her life. The payments received by the wife could be at the same rate as when the husband was alive or at a reduced rate depending upon the contract. The monthly payments will initially be based on the life expectancy of the youngest annuitant.

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LEGAL ARGUMENTS FOR THE REGISTRATION DEFERRED ANNUITY PLANS

In the United States, the courts have determined that deferred annuity plans may be categorized as "investment contracts" and made subject to regulation under the Securities Act, 1933, if they meet criteria established in two landmark cases decided by the US Supreme Court – S.E.C. v. W. J. Howey and Co. and State of Hawaii v. Hawaii Market Center Inc.

In the first of these cases, S.E.C. v. W. J. Howey Co. (1946), the US Supreme Court devised the "common enterprise" test. The test requires:

(i) The existence of a contract, transaction or scheme whereby a person invests;
(ii) That the investment be in a common enterprise; and
(iii) That the person is led to expect profits solely from the efforts of a promoter or third party.

Problems that arose concerning the application of the common enterprise test due to a mechanical focus on the word "solely" and the need for broader interpretation to give effect to the purpose of the US securities legislation led to the enunciation of the "risk capital" test in State of Hawaii v. Hawaii Market Center Inc (1971). This test requires that:

(i) The offeree must furnish initial value;
(ii) A portion of the initial value must be subject to the risks of the enterprise;
(iii) The furnishing of initial value was induced by promises or representations leading to reasonable expectation or understanding that a benefit above initial value will accrue; and
(iv) The offeree does not have the right to exercise practical and actual control over the managerial decisions of the enterprise.

The Supreme Court of Canada has adopted the principles set out in both SEC v. W. J. Howey and Co. and State of Hawaii v. Hawaii Market Center Inc. in Pacific Coast Coin Exchange v. Ontario Securities Commission (1971) stating among other things that:

(i) the definition of "security" in the Securities Act of 1933 was similar to the definition in the Ontario Securities Act;
(ii) both definitions referred to an "investment contract"; and
(iii) the purpose of the legislation is the same.

THE LAW ON ANNUITY CONTRACTS: INVESTMENT VS. INSURANCE CONTRACTS

The decisions of the United States Supreme Court in the cases of S.E.C. v. Variable Annuity Life Insurance Co., S.E.C. v. United Benefit Life Insurance Co. and Peoria Union Stock Yards Co. v. Penn Mutual Life Insurance Co., provide the principles for distinguishing deferred annuity plans from insurance products.

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1. *Investment Contracts involve the sharing of investment risk and the investment experience*

   In S.E.C. v. Variable Annuity Life Insurance Co. (1959)[1], the Supreme Court considered whether a variable annuity was a security or insurance product. The Court discussed the characteristics distinguishing the variable annuity from the traditional fixed annuity. Generally, the funds underlying the fixed annuity are invested according to conservative standards, and the fixed annuity pays a specified and definite amount to the annuitant. In contrast, the variable annuity's funds are invested primarily in common stocks and other equities, and the variable annuity's benefits vary with the success of the company's investment experience. The holder of a variable annuity, therefore, is not able to depend upon the annuity's paying a fixed return.

2. *Insurance Contracts involve risk taking by the Sponsor*

   Insurance, according to the Court, "involves some investment risk-taking on the part of the company" and "a guarantee that at least some fraction of the benefits will be payable in fixed amounts". An annuity contract that did not guarantee a fixed return thus places all of the investment risk on the policyholder and none on the company. Because there was "no true underwriting of risks," the Variable Annuity Life Insurance Company ("VALIC") court concluded that the variable annuity was a security.

3. *The activities of the plan during the accumulation phase and those during the payout phase may be assessed separately.*

   In S.E.C. v. United Benefit Life Insurance Co. (1967)[2], the Court again explored the distinction between a security and insurance in considering a deferred, or optional, annuity plan. Under this "Flexible Fund" annuity program, the purchaser's premiums less a deduction for expenses (the net premium), and any money earned from investing the premiums, were held in a Flexible Fund Account, which United maintained separately from its other funds.

   The purchaser was entitled to withdraw the "cash value" of the policy before maturity. The "cash value" was equal to the higher of two amounts: the purchaser's proportional share of the fund or the "net premium guarantee," which was measured by a gradually increasing percentage of the purchaser's net premiums, from fifty percent of net premiums in the first year to one hundred percent after ten years.

   At maturity, the purchaser had the option of either receiving the cash value of the policy or converting that interest into a life annuity. Although the dollar amount of the fixed payments under the life annuity varied with the cash value of the policy, the net premium guarantee ensured that a minimum annuity would be available at maturity.

   The court assessed the Flexible Fund portion of the contract independently from the annuity portion of the contract and concluded that the Flexible Fund contract did not fall within the insurance exemption of the federal securities laws.

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[1] United States Supreme Court. SEC vs. Variable Annuity Life Insurance Company Limited 359 U.S. 65, 79 S. Ct. 618, 3 L.Ed.2d 640 (1959). Argued: January 15, 1959. Decided: March 23, 1959.
[2] United States Supreme Court. SEC vs. United Benefit Life Insurance Company Limited 387 U.S. 202, 87 S. Ct. 1557, 18 L.Ed.2d 673 (1967). Argued: April 10, 1967. Decided: May 22, 1967.

4. *Promises of "growth" as opposed to "security and balance" signal the existence of an investment contract as opposed to insurance contract*

The test to determine whether an instrument is an investment contract, according to the Court, "is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." The Court noted that the Flexible Fund completely reversed the role of the insurer during the accumulation period. Instead of offering the inducements typical for insurance, such as "stability" and "security", United proposed to serve as an investment agency and promised the policyholder "growth". At maturity, the insurer was obligated to produce only the guaranteed minimum, an amount substantially less than that guaranteed by the same premiums in a conventional deferred annuity contract. Although the minimum guarantee "substantially" reduced the investment risk of the purchaser, the Court pointed out that there was a "basic difference between a contract which to some degree is insured and a contract of insurance." The Court found the minimum guaranteed in United Benefit to be so low that the risk to the insurance company was insignificant.

5. *The principles apply to both individual and group annuity contracts*

The court considered whether a "group deposit administration annuity contract" constituted a security or insurance product in Peoria Union Stock Yards Co. v. Penn Mutual Life Insurance Co., (1983).[3] Under the contract at issue in Peoria Union, the employer contributed annually to a deposit account at Penn Mutual to fund a defined-benefit retirement plan for its employees. When an employee retired, the employer could purchase the annuity from the insurance company with a portion of the funds on deposit or it could withdraw funds and purchase the annuity for its employee from another insurance company. The income available to fund the employer's obligations to its employees for the fixed benefit annuity fluctuated with the investment experience of Penn Mutual. Penn Mutual guaranteed interest on the employer's contributions made during the first three years of the contract at a rate declining from 7½ percent the first year to 3½ percent the third year. Although there was no guarantee of interest after the first three years, any interest earned by the deposit account beyond the interest guarantee was to be credited to the deposit account. It is unclear from the opinion whether or not the funds for these contracts were held by Penn Mutual in a separate account segregated from its general assets.

This court observed that the contract in Peoria Union was similar to the deferred annuity contract in United Benefit in that the insurance company actually served as an investment agency and permitted the pension plan to share in the company's investment experience. Moreover, in both cases, the insurance company guaranteed a minimum return that was deemed to be so low as to place the investment risk on the investor rather than on the insurance company. Based on these characteristics of the plan, the court therefore concluded that during the accumulation phase the annuity plan was an investment contract.

[3] United States Supreme Court. SEC vs. United Benefit Life Insurance Company Limited 387 U.S. 202, 87 S. Ct. 1557, 18 L.Ed.2d 673 (1967). Argued: April 10, 1967. Decided: May 22, 1967.

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DEFINITION OF A SECURITY

The Trinidad and Tobago Securities Industry Act, 1995 ("the Act") defines a "security" as follows:

> "… any document evidencing ownership or any interest in the capital or debt, property, profits, earnings or royalties of any enterprise or proposed enterprise and, *without limiting the generality of the foregoing*, includes any-
>
> (a) bond, debenture, note or other evidence of indebtedness;
> (b) share, stock, unit, unit certificate, participation certificate or certificate of share or interest;
> (c) instrument commonly known as security;
> (d) instrument or document constituting evidence of any interest or participation in-
>   (i) a profit sharing agreement;
>   (ii) a trust;
>   (iii) an oil, natural gas or mining lease, claim or royalty or other mineral right; or
> (e) right to acquire or dispose of anything specified in paragraphs (a) to (d);
>
> **but does not include-**
>
> (f) currency;
> (g) a cheque, bill of exchange or bank letter of credit;
> (h) a certificate or document constituting evidence of any interest in a deposit account with-
>   (i) a financial institution;
>   (ii) a credit union within the meaning of the Co-operative Societies Act;
>   (iii) an insurance company;
>   (iv) a contract of insurance issued by an issuer"

Although this definition does not refer to deferred annuity plans specifically, it employs the term "profit sharing agreement", a broad catch-all term whose current legal interpretation subsumes arrangements referred to as "investment contracts".

Given the existence of this catch-all term therefore makes it possible to adopt the principles above on the same terms espoused in the Pacific Coast Coin Exchange v. Ontario Securities Commission (1971) case.

DEFERRED ANNUITY/SAVING PLANS REGISTERED BY THE COMMISSION

Three (3) deferred annuity plans have been registered with the Commission to date. Table 2 (below) provides the main features of each plan.

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Table 2 - Deferred Annuity/Savings Plans Registered by the Commission

First Citizens Bank Limited	
The Retirement Provider	• Tax deductible contributions; • Contributions are pooled and invested in deposit certificates or interest bearing certificates in any bank, the equity market or other investments that the Trustee may think fit; • interest received varies according to the performance of the portfolio; • Purchase of annuity upon maturity; • Insurance Coverage for members to the extent of Accumulation.
The First Citizens Bank Group Retirement Provider	• Monthly contributions from employer in respect of employees held in trust; • Can be used as tax deductible; • Upon Maturity, a percentage of the contributions goes towards an annuity to be purchased with an Insurance Company, the remaining percentage can be accessed.

DEFERRED ANNUITY PLANS CURRENTLY IN EXISTENCE AND NOT REGISTERED BY THE COMMISSION

Table 3 (below) provides information with respect to the features of a number of deferred annuity/saving plans that are not regulated by the Commission.

Table 3 - Main Features of Plans Not Currently Registered by the Commission

RBTT Bank Limited	
Future Cash	• Tax deductible; contributions can be made annually, semi annually, quarterly etc; • Individual contributions are pooled together and invested in the bond and the equity markets; • Interest received varies according to the performance of the portfolio; • A beneficiary can be appointed; • Maturity date is between 50-70 yrs ; • At maturity, 100% of interest accumulated and 25% of contributions made can be accessed; • 75% of the accumulated contributions is used as a pension fund • 100% of contributions cannot be accessed.
Republic Bank Limited	
TISP	• Monthly contributions to be held in trust; • Can be used as tax deductible; • Upon maturity, a percentage of the contributions goes towards an annuity to be purchased with an Insurance Company, the remaining percentage can be accessed.
Equity TISP	• Contributions are invested in stocks and shares to purchase units, the value of which varies per day, according to trading on the Stock Exchange; • Investments in equity TISP can be transferred to TISP.

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Corporate TISP	• The contributor is an employer, who will make contributions on behalf of employees; • Maturity age is between 50-70 yrs; • Employees can claim tax deductions, and employers can claim as an expense. Corporate TISP consists of two elements: Income bearing – contributions are invested in bonds and interest is paid annually; Equity bearing – contributions are invested in equities.
Scotiabank Limited	
Future Earnings Plan	• Monthly contributions minimum of $100.00; • Present interest rate 5%; • At maturity, 25% of funds are accessible; • 75% of contributions to be used to purchase an annuity with selected Insurance Company.
Trinidad and Tobago Unit Trust	
Pension Plus Tax Deferred Annuity	• Flexible Contributions; • Guaranteed Principal; • Early Retirement Option; • Tax deduction and Insurance Protection from CUNA Insurance.

THE REGISTRATION AND DISCLOSURE REGIME FOR DEFERRED ANNUITY/SAVINGS PLANS

Given the tests and principles referred to above, we are able to determine that many of the plans in existence are in fact securities and, as such, should fall under the purview of the Commission.

The Plans that remain unregulated may be grouped into three (3) broad categories:

(i) Plans originated prior to the Act. It is proposed that these plans shall be registered upon submission of the prescribed forms and documentation for registration as a Collective Investment Scheme.
(ii) Plans originated after the Act. It is proposed that these plans shall be registered upon the submission of the prescribed documentation and fee and the issue of a receipt by the Commission for a prospectus.
(iii) New Plans. It is proposed that the Commission, upon submission of the prescribed documentation and fee, shall receipt the prospectuses of all new plans.

The registration and disclosure regime prescribed in the sections that follow have the sole objective of ensuring the adequacy of information disclosures to investors both at the point of purchase of the security and on an ongoing basis.

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REGISTRATION AND DISCLOSURE

REGISTRATION VIA PROSPECTUS

The Registration process would begin with the submission of a draft prospectus and the legal documentation constituting the plan. At a minimum the submission must include:

(i) Prospectus
(ii) Legal documentation and managerial agreements constituting the Plan.
(iii) Rules of the Plan (if the Plan has a tax incentive, the Rules must be approved by the Board of Inland Revenue.)
(iv) Copy of Offer Document

In the preparation of the prospectus for the issue, the sponsor shall be guided by disclosures required in Prospectus Guidelines for Public Offerings issued in accordance with Section 6(b) of the Act.

The prospectus shall indicate at a minimum:

- Information concerning the Plan Sponsor;
- Information concerning the Trustee for the Issue;
- Information concerning the Plan Administrators;
- A Description of the Plan, with a discussion of the Material Aspects of the Working of the Plan which may include *inter alia*:
  - The Rules
  - Contributions/Subscriptions
  - Fees
  - Plan Options upon death or maturity
  - Policy on Withdrawal or Termination before maturity
  - Procedure in the event of Reconstruction, Amalgamation or Winding up of Parties to the Agreement
  - Winding Up of Plan
- Investment Objective;
- Investment Restrictions;
- Investment Policy;
- The Risks of Investing;
- Conflicts of Interest/Related Parties; and
- Additional Documentation Available for Viewing.

REGISTRATION OF THE INVESTMENT MANAGER UNDER THE ACT

The Investment Manager for the portfolio of funds shall be a person capable of executing that function with the care and diligence that would be reasonably expected from an expert in such matters.

The Investment Manager for the portfolio of funds shall be a registered market actor or a financial institution registered under the Financial Institutions Act.

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REGISTRATION OF THE PLAN SPONSOR AS A REPORTING ISSUER OF SECURITIES

The plan sponsor shall be registered as a reporting issuer and will be required to satisfy the stipulations of Section 66 in respect of the class of securities issued.

CONTINUOUS REPORTING REQUIREMENTS

The requirement for reporting by the Plan Sponsor recognizes that the Plan Sponsor is in most cases responsible for record keeping with respect to the Plans. He receives the funds and makes distributions to investors as necessary and is best positioned to report on the status of the Plan.

The Plan Sponsor or any other person designated as a reporting issuer, with respect to the securities issued under the Plan, shall provide the Commission with:

- Aggregate Plan Statistics that will allow the assessment of the performance of the plan. These statistics must include, *inter alia*:
    - Funds Under Management;
    - Withdrawals from the Plan;
    - Terminations;
    - Fees earned by the parties;
    - Audited Financial Statements for the Plan prepared in accordance with international financial reporting standards;
    - A measure of the rate of return on invested funds;

CORPORATE FINANCE

The sponsor shall submit the following documents for Corporate Finance Review by the Commission:

- Material change reports;
- A detailed asset allocation for the Plan;
- A discussion on the overall asset allocation and changes anticipated in this allocation in the next period;
- A discussion of fees earned by parties;
- A discussion of the performance of the Plan;
- Interim Financial Report for the Plan;
- Press and media releases concerning the Plan; and
- A copy of all advertisements soliciting participation in the scheme.

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