

**MEMO# 17892**

August 17, 2004

## **SEC AND NEW YORK REACH SETTLEMENTS WITH INSURANCE COMPANIES FOR MARKET TIMING OF MUTUAL FUNDS THROUGH VARIABLE ANNUITIES**

[17892] August 17, 2004 TO: BOARD OF GOVERNORS No. 53-04 COMPLIANCE ADVISORY COMMITTEE No. 81-04 PRIMARY CONTACTS - MEMBER COMPLEX No. 78-04 SEC RULES MEMBERS No. 116-04 SMALL FUNDS MEMBERS No. 89-04 VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 6-04 RE: SEC AND NEW YORK REACH SETTLEMENTS WITH INSURANCE COMPANIES FOR MARKET TIMING OF MUTUAL FUNDS THROUGH VARIABLE ANNUITIES The Securities and Exchange Commission has issued orders making findings and imposing disgorgement, penalties, and compliance reforms in enforcement actions charging two insurance companies and various subsidiaries (collectively, "Respondents") with securities fraud for facilitating market timing of mutual funds through the sale of variable annuities.<sup>1</sup> The Respondents consented to the entry of the SEC Orders without admitting or denying the SEC's findings. In addition, the Attorney General of New York announced a settlement with the insurance companies to resolve related allegations.<sup>2</sup> The SEC Orders are summarized below.<sup>3</sup>

1 See In the Matter of CIHC, Inc., Conseco Services, LLC, and Conseco Equity Sales, Inc., SEC Release Nos. 33-8455, 34-50165, and IC-26526, Admin. Proc. File No. 3-11578 (August 9, 2004) and In the Matter of Inviva, Inc. and Jefferson National Life Insurance Company, SEC Release Nos. 33-8456, 34-50166, and IC-26527, Admin. Proc. File No. 3-11579 (August 9, 2004) (together "SEC Orders"). The SEC Orders also impose cease and desist orders on the Respondents. Copies of the SEC Orders and accompanying press release are available at <http://www.sec.gov/litigation/admin/33-8455.htm>, <http://www.sec.gov/litigation/admin/33-8456.htm>, and <http://www.sec.gov/news/press/2004-109.htm>, respectively. In October 2002, Conseco Inc., a subsidiary of CIHC, Inc. and the parent company of Conseco Services, LLC and Conseco Equity Sales, Inc., sold its variable annuity business to Inviva, Inc.

2 See Insurance Companies Settle Improper Trading Case (press release issued by Office of NY State Attorney General Eliot Spitzer, August 9, 2004), available at [http://www.oag.state.ny.us/press/2004/aug/aug9b\\_04.html](http://www.oag.state.ny.us/press/2004/aug/aug9b_04.html). A copy of the complaint filed by the Attorney General is available at [http://www.oag.state.ny.us/press/2004/aug/aug9b\\_04\\_attach.pdf](http://www.oag.state.ny.us/press/2004/aug/aug9b_04_attach.pdf).

3 The settlement with the Attorney General, which according to the press release was negotiated jointly with the SEC, is not described separately in this memorandum. 2 Findings The SEC Orders find that from

late 1999 through September 2003, the Respondents sold variable annuity products to hedge funds and other individuals and entities seeking to market time the mutual fund portfolios offered through the variable annuities. According to the SEC Orders, such conduct was contrary to disclosures in the variable annuity products' prospectuses that these products were not for professional market timers and that the Respondents reserved the right to take steps to prevent detrimental market timing. The SEC Orders find that the prospectuses failed to disclose that the Respondents were marketing and selling the products to market timing customers. The SEC Orders further find that in some cases, investment advisers to the underlying mutual funds were aware of and permitted the market timing of the mutual funds. For example, employees of some of the Conseco Respondents negotiated capacity arrangements with certain fund complexes, which enabled timers to invest a particular amount of assets in these funds. The employees would then track the timers' trades in these funds' subaccounts and inform the funds about timing trades on a daily basis. In other cases, the Respondents did not inform the underlying fund complexes, many of which prohibited market timing or did not tolerate timers, that the Respondents not only tolerated market timing but actively solicited market timers. Specifically, although Respondents would block individual trades or warn a timer at the request of a fund company, the Respondents did not take any action to eliminate the particular timers who were responsible. Indeed, some of Respondents' employees falsely stated to fund companies that they did not permit timing when they knew market timers were timing specific variable annuity products. Finally, the SEC Orders find that the hedge funds and other market timers invested approximately \$120 million in the variable annuity products through approximately 100 contracts, and that in one of the products, the market timing assets dwarfed the assets of other variable annuity purchasers. As a result of the conduct generally described above, the SEC Orders find that the Respondents willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 under that Act, and Section 34(b) of the Investment Company Act of 1940, by making material misstatements and omissions in the variable annuity product prospectuses. Specifically, according to the SEC Orders, the prospectuses included, among other things, statements that these products were not designed for professional market timing and gave the misleading impression that the Respondents would act independently to monitor or block detrimental trades. Undertakings In determining to accept the settlement offers, the SEC considered the following undertakings by the Respondents:

- Ongoing Cooperation – The Respondents will cooperate fully with the SEC in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the SEC Orders.
- Independent Compliance Consultant – Within 30 days of the SEC Orders, the Inviva Respondents will retain an Independent Compliance Consultant acceptable to the SEC staff to conduct a comprehensive review of their supervisory, compliance, and other policies and procedures designed to prevent and detect market timing and related 3 practices that may violate the federal securities laws.<sup>4</sup> The review will include, but not be limited to, the Inviva Respondents' market timing controls across all areas of their business and the Inviva Respondents' utilization of short term trading fees or other controls for deterring excessive short term trading. The Inviva Respondents will require that the Independent Compliance Consultant complete its review and provide its recommendations in a report to Inviva Respondents and the SEC staff no more than 120 days after the entry of the SEC Orders.
- Periodic Compliance Review – At least once every other year, commencing in 2005, the Inviva Respondents will undergo a compliance review by a third party that is not an interested person of the Inviva Respondents. The third party will issue a report of its findings and recommendations to the Inviva Respondents' Chief Compliance Officer.
- Independent Distribution Consultant – Within 30 days of the SEC Orders, each of the Conseco Respondents and the Inviva

Respondents will retain an Independent Distribution Consultant acceptable to the SEC staff. Each consultant will develop a plan to distribute the total disgorgement and penalties ordered to compensate investors for losses attributable to market timing activity through variable annuity products and submit the distribution plan to each of the Conseco Respondents and the Inviva Respondents and the SEC staff within 100 days of the SEC Orders. Following the issuance of SEC orders approving final plans of disgorgement, the Independent Distribution Consultants and the Respondents will take all necessary and appropriate steps to administer the final plans. • Certification – No later than 24 months after the entry of the SEC Orders, the chief executive officer of each Respondent will certify to the SEC in writing that the Respondent has fully adopted and complied in all material respects with the undertakings and the recommendations of the Independent Compliance Consultant, or will describe any material non-adoption or non-compliance. • Recordkeeping – Any record of the Respondents' compliance with the undertakings will be preserved for at least six years from the end of the fiscal year last used, the first two years in an easily accessible place. Disgorgement, Civil Penalties, and Other Sanctions Pursuant to the SEC Orders, the Respondents will pay a total of \$20 million in disgorgement and penalties. Jane G. Heinrichs Assistant Counsel 4 This undertaking and that relating to periodic compliance reviews will apply to the Conseco Respondents only if they reenter the business of issuing variable annuity products within three years of the date of the SEC Orders.