Investor Alerts and Bulletins

Updated Investor Bulletin: Variable Annuities

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The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate investors about variable annuities and how they work.

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What Is A Variable Annuity?

A variable annuity is a contract between you and an insurance company. It serves as an investment account that may grow on a tax-deferred basis and includes certain insurance features, such as the ability to turn your account into a stream of periodic payments. You purchase a variable annuity contract by making either a single purchase payment or a series of purchase payments.

A variable annuity offers a range of investment options. The value of your contract will vary depending on the performance of the investment options you choose. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

Each variable annuity is unique. Most include features that make them different from other insurance products and investment options. ***Keep in mind that you will pay extra for the features offered by variable annuities.***

First, variable annuities have **insurance features**. For instance, if you die before the insurance company starts making income payments to you, many contracts guarantee that your beneficiary will receive at least a specified amount. This is typically at least the amount of your purchase payments. It may also offer additional insurance features such as promising you a certain account value or the ability to make withdrawals up to a certain amount each year for the rest of your life.

Second, variable annuities are **tax-deferred**. That means you pay no federal taxes on the income and investment gains from your annuity until you make a withdrawal, receive income payments, or a death benefit is paid. You may also transfer your money from one investment option to another within a variable annuity without paying federal tax at the time of the transfer. When you withdraw your money, however, you will pay tax on the gains at ordinary federal income tax rates rather than lower capital gains rates. Under certain circumstances, the death benefit may not be subject to federal estate tax. In general, the benefits of tax deferral may outweigh the costs of a variable annuity only if you hold it as a long-term investment.

Third, variable annuities let you receive **periodic income payments** for a specified period or the rest of your life (or the life of your spouse). This process of turning your investment into a stream of periodic income payments is known as annuitization. This feature offers protection against the possibility that you will outlive your assets.

Tax Rules

- The federal tax rules that apply to variable annuities can be complicated. In addition, there may be state tax implications. Before investing, you may want to consult a tax adviser about the tax consequences of investing in a variable annuity.
- Retirement plans, like IRAs and employer-sponsored 401(k) plans, may also provide you with tax-deferred growth and other tax advantages. For many investors, it will be best to max out their contributions to IRAs and 401(k) plans before investing in a variable annuity.
- If you are investing in a variable annuity through a tax-advantaged retirement plan, you will get **no additional tax advantage** from the variable annuity.
- There may be federal tax penalties if you withdraw your money before a certain age.

What Should I Do Before I Invest In A Variable Annuity?

- Know how it works. Look up key terms you might not be familiar with. Be prepared to ask your financial professional questions about whether the contract is right for you.
- Figure out how much it costs. Ask what the fees and expenses are. Are there surrender charges, and how long is the surrender period? Is there a bonus credit?

- Get the details. Different contracts have different features. Ask your financial professional for the variable annuity prospectus, which will describe the contract you're considering in detail. Read the prospectus carefully and ask questions about what you don't understand.

  The prospectus is available free of charge. It contains important information about the variable annuity, including fees and expenses, investment options, death benefits and other insurance features, and annuity payout options.

Remember:

- Variable annuities could help you meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals. Substantial taxes and surrender charges may apply if you withdraw your money early.
- Variable annuities involve investment risks just like mutual funds do. If the investment choices you selected for the variable annuity perform poorly, you could lose money.
- Contract fees may go towards your financial professional's compensation. That means they may receive higher compensation for selling some contracts or investment products than for others.

- Ask Yourself Questions. The variable annuity should be suitable to your particular investment needs.
  - Will I use the variable annuity primarily to save for a long-term goal like retirement?
  - Am I investing in the variable annuity outside of a retirement plan or IRA so that I can take advantage of the tax-deferral benefit of the variable annuity?
  - Am I willing to take the risk that my account value may decrease if the underlying mutual fund investment options perform badly?
  - Do I understand the insurance features of the variable annuity? How do the insurance features meet my needs?
  - Do I understand all of the fees and expenses that the variable annuity charges? How much would I pay for different insurance features or different mutual funds?
  - Do I intend to remain in the variable annuity long enough to avoid paying any surrender charges if I have to withdraw money?
  - How does the variable annuity fit in with my overall investment portfolio?
  - Are there features of the variable annuity, such as long-term care insurance, that I could purchase more cheaply separately?
  - Have I consulted with a tax adviser and considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on my tax status in retirement?
  - If I am exchanging one annuity for another one, do the benefits of the exchange outweigh the costs, such as any surrender charges I will have to pay if I withdraw my money before the end of the surrender charge period for the new annuity?

What If I Change My Mind?

You may cancel your contract within a short period (usually lasting at least 10 days) of receiving it without a surrender charge. Upon cancellation, you will typically receive a refund of your purchase payments. The refund may be adjusted up or down to reflect the performance of your investment options. The length of the **free look period** may vary depending on the state where you signed your application.

How Variable Annuities Work

A variable annuity has two phases: an **accumulation phase** and a **payout (annuitization) phase**.

During the **accumulation phase**, you make purchase payments. The amount of the purchase payments that go into the account may be less than you paid because fees were taken out of the purchase payments. The money in the account gets invested in a menu of investment options—typically mutual funds—that you can select.

In addition, you may be able to allocate part of your purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (*e.g.*, 3% per year).

The money in the account will vary according to the amount of premiums you pay, the amount of contract fees and expenses, and the performance of the investment options you choose.

> **Example:** You purchase a variable annuity with an initial purchase payment of $100,000. You allocate 50% of that purchase payment ($50,000) to a bond fund, and 50% ($50,000) to a stock fund. Over the following year, the stock fund has a 10% return, and the bond fund has a 5% return. At the end of the year, your account has a value of $107,500 ($55,000 in the stock fund and $52,500 in the bond fund), minus fees and expenses (discussed below).

Your most important source of information about a variable annuity's mutual fund investment options are the funds' prospectuses. They are available without charge from your financial professional. Read them carefully before you pick your investment options. You should consider a variety of factors with respect to each fund option, including the fund's investment objectives and policies, management fees and expenses that the fund charges, the risks and volatility of the fund, and whether the fund contributes to the diversification of your overall investment portfolio.

During the accumulation phase, you can typically transfer your money from one investment option to another without paying federal tax on your investment income and gains. However, the insurance company may charge you for transfers. Also during the accumulation phase, you may choose to withdraw all or a portion of your purchase payments plus investment income and gains (if any) as a lump sum payment. However, if you withdraw money from your account during the early years of the accumulation phase, you may have to pay "surrender charges" (discussed below). In addition, you may have to pay a 10% federal tax penalty if you withdraw money before the age of 59½.

The **payout phase** begins if you choose to "annuitize" your contract. If you do, you may choose to receive your contract value as a stream of income payments at regular intervals (such as monthly). Your contract may automatically annuitize at a certain age, typically an advanced age such as age 95.

You may have a number of choices of how long the payments will last. Under most annuity contracts, you can choose to have your income payments last for a period that you set (such as 20 years) or for an indefinite period (such as your lifetime or the lifetime of your spouse). You may be able to choose between receiving income payments that are fixed in amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic income payment will depend, in part, on the time period that you select for receiving payments. Be aware that, in general, annuities do not allow you to withdraw money from your account once you have started receiving income payments.

In addition, some annuity contracts are structured as **immediate annuities**. This means that there is no accumulation phase and you will start receiving income payments shortly after you purchase the annuity.

Key Risks Of Your Variable Annuity Contract

- **Not a short-term savings vehicle.** Variable annuities are not a short-term investment vehicle. Surrender charges, which would reduce the value of your contract, may apply. The benefits of tax deferral and living benefit protections (explained in this bulletin) also mean the contract is most beneficial to those with a long time horizon.
- **Contract fees and expenses.** Contract fees and expenses may be significant. These may include deductions from purchase payments, surrender charges, and significant ongoing fees and expenses associated with owning a contract.
- **Risk of loss.** You can lose money in a variable annuity, including potential loss of your original investment.
- **Risks associated with investment options:**
    - The value of your investment and any returns will depend on the performance of the investment options you choose.
    - Each underlying fund may have its own unique risks. You should review the investment option's prospectus before making an investment decision. You should consider a variety of factors with respect to each fund option, including the fund's investment objectives and policies, management fees and other expenses that the fund charges, the risks and volatility of the fund, and whether the fund contributes to the diversification of your overall investment portfolio.
- **Optional Features.** Optional features may carry investment restrictions. Or, the benefits of the optional features may be significantly reduced if withdrawals over a certain amount are made or if withdrawals are taken before you reach a certain age.
- **Insurance company risk.** The financial strength of the insurance company that issues the contract backs all guarantees, including the death benefit, living benefits, and your annuity payments. If the insurance company experiences financial distress, it may not be able to meet its obligations to you.

The Death Benefit and Other Optional Insurance Features

A common feature of variable annuities during the accumulation phase is the **death benefit**. If you die, a person you select as a beneficiary (such as your spouse or child) will generally receive the greater of: (i) all the money in your account; or (ii) some guaranteed minimum (such as all purchase payments minus prior withdrawals).

> **Example:** You own a variable annuity that offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. You have made purchase payments totaling $100,000. In addition, you have withdrawn $20,000 from your account. Because of these withdrawals and investment losses, your account value is currently $75,000. If you die, your designated beneficiary will receive $80,000 (the $100,000 in purchase payments you put in minus $20,000 in withdrawals).

Some variable annuities allow you to choose optional death benefits for an additional charge. For example:

- A stepped-up death benefit would increase your minimum death benefit amount by locking in market gains as of a specified date if your investment options perform well.
- An earnings enhancement death benefit pays an additional amount that is usually equal to a percentage (*e.g.*, 25% or 40%) of the contract's earnings at death. The purpose of this death benefit is to help offset any taxes due upon death.

Variable annuities commonly offer **other optional insurance features**, which also have extra fees. Many of these optional features are available only during the accumulation phase of the contract. Collectively, these features may be referred to as "living benefits." Such features may include:

- Guaranteed lifetime withdrawal benefits, which provide that you can withdraw up to a certain amount each year for as long as you live regardless of market performance;
    - *e.g.*, you can withdraw up to 6% of your purchase payments each year for as long as you live even if your contract value is reduced to zero.
- Guaranteed minimum income benefits, which provide a minimum value you can turn into a stream of income payments regardless of market performance; and
    - *e.g.*, at a minimum you will be able to annuitize the value of your initial purchase payments accruing interest at 5% per year.
- Guaranteed minimum accumulation benefits, which provide that your contract value will be at least equal to a stated minimum amount after a specified number of years regardless of market performance.

  - *e.g.*, at the end of year 10, your contract value will be at least 120% of your first year's purchase payments.

- Other features may include long-term care insurance, which pays for home health care or nursing home care if you become seriously ill.

Remember:

- You will pay extra for optional insurance features such as optional death benefits and living benefits. Be sure you understand the fees.
- Carefully consider whether you need the feature. If you do, consider whether you can buy the benefit more cheaply separately (*e.g.*, through a long-term care insurance policy).
- In addition, these optional features are complex and may carry certain risks and limitations. For example, some features require that you allocate all your assets to certain specified investment options. This can limit the return on your investment. Also, for certain features, large withdrawals can significantly reduce the value of your benefits.

Variable Annuity Fees and Expenses

You will pay several fees and expenses when you invest in a variable annuity. Be sure you understand all the fees and expenses before you invest. **These fees and expenses will reduce the value of your account and the return on your investment.** Often, they will include the following:

- **Surrender charge** – If you withdraw money from a variable annuity within a certain period after a purchase payment, the insurance company usually will assess a "surrender" charge. Generally, the surrender charge is a percentage of the amount withdrawn or purchase payments made.

The surrender charge often declines gradually over a period of several years, known as the "**surrender period.**" For example, a 7% charge might apply in the first year after a purchase payment, 6% in the second year, 5% in the third year, and so on. Typically, after six to eight years or sometimes as long as ten years, the surrender charge may no longer apply. Often, contracts will allow you to withdraw a portion of your account value each year without paying a surrender charge.

> **Example:** You purchase a variable annuity contract with a $100,000 purchase payment. The contract has a schedule of surrender charges, beginning with a 7% charge in the first year, and declining by 1% each year. In addition, you can withdraw 10% of your contract value each year free of surrender charges. In the first year, you decide to withdraw $50,000. This is one-half of your contract value of $100,000 (assuming that your contract value has not increased or decreased because of investment performance). In this case, you can withdraw $10,000 (10% of contract value) free of surrender charges. You will pay a surrender charge of 7%, or $2,800, on the other $40,000 withdrawn.

- **Base contract fee** – This fee (often referred to as "**Mortality and Expense (M&E) Risk Charge**") is equal to a certain percentage of your account value, typically in the range of 1.25% per year. This fee compensates the insurance company for insurance risks it assumes under the annuity contract. A portion of this fee is sometimes used to pay commissions to your financial professional for selling the variable annuity to you.

> **Example:** Your variable annuity has an M&E charge at an annual rate of 1.25% of account value. Your average account value during the year is $100,000, so you will pay $1,400 in M&E charges that year.

- **Administration fees** – The insurer may also deduct fees to cover record keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $50 per year) or as a percentage of your account value (typically in the range of 0.15% per year).

> **Example:** Your variable annuity charges administrative fees at an annual rate of 0.15% of account value. Your average account value during the year is $100,000. You will pay $150 in administrative fees.

- **Underlying Fund Expenses** – You will also indirectly pay the fees and expenses for the mutual funds that you pick as your investment options. These fees are in addition to the fees charged by the insurance company and are deducted from the returns of the investment options.
- **Fees and Expenses for Optional Features** – Special features offered by some variable annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and expenses.

Other fees may also apply. These may include initial sales loads/charges or fees for transferring part of your account from one investment option to another. You should ask your financial professional to explain to you all fees and expenses that may apply. You can also find a description of the fees and expenses in the prospectus for any variable annuity that you are considering.

Remember:

- A variable annuity may offer different share "classes" with different fees and expenses (including differing M&E charges) and different surrender charge periods. For example, "L class" shares may have a shorter surrender charge period, but may have higher ongoing fees, while "B class" shares may have a longer surrender charge period and lower ongoing fees. Consider how long you expect to own the variable annuity and your need to access funds when you think of any tradeoff between the length of the surrender charge period and the level of ongoing fees.
- Contract fees may go towards your financial professional's compensation. That means they may receive higher compensation for selling some contracts (and for different share classes of the same contract) than for others.

Exchanging One Variable Annuity For Another

In some cases you may wish to exchange an existing variable annuity contract for a new annuity contract that has features that you prefer. If you exchange contracts, you may be required to pay surrender charges on the old annuity if you are still in the surrender charge period. In addition, a new surrender charge period may begin when you exchange into the new annuity.

Remember:

- If you are thinking about an exchange, you should compare the two annuities carefully. While the features may appear similar, you should consider the fees (insurance feature fees, as well any new surrender charge period), investment restrictions, and benefits and risks of the new variable annuity as compared to your current variable annuity.
- If you decide to do an exchange, talk to your financial professional or tax adviser to make sure the exchange will be tax-free.
- Consider the financial motivation your financial professional may have to recommend that you exchange one contract for another.

Bonus Credits

Some insurance companies offer variable annuities with "bonus credit" features. These contracts promise to add extra money to your contract value based on a specified percentage (typically ranging from 1% to 5%) of purchase payments.

> **Example:** You purchase a variable annuity contract that offers a bonus credit of 3% on each purchase payment. You make a purchase payment of $100,000. The insurance company issuing the contract adds a bonus of $3,000 to your account.

Before purchasing a variable annuity with a bonus credit, ask yourself and your financial professional whether the bonus is worth more to you than any increased fees and expenses you will pay for the bonus. This may depend on a variety of factors such as the amount of the bonus credit and the increased fees and expenses, how long you hold your annuity contract, and the return on the underlying investments. You also need to consider the other features of the annuity to determine whether it is a good investment for you.

> **Example:** You make purchase payments of $100,000 in Annuity A and $100,000 in Annuity B. Annuity A offers a bonus credit of 4% on your purchase payment, and deducts annual fees and expenses totaling 1.75%. Annuity B has no bonus credit and deducts annual fees and expenses totaling 1.25%. Let's assume that both annuities have an annual rate of return, prior to expenses, of 10%. By the tenth year, your account value in Annuity A will have grown to $229,780. But your account value in Annuity B will have grown more, to $231,360, because Annuity B deducts lower annual fees and expenses, even though it does not offer a bonus.

You should also note that a bonus may only apply to your initial purchase payment, or to purchase payments you make within the first year of the annuity contract.

Remember:

- Take a hard look at variable annuities offering bonus credits. In some cases, the "bonus" may not be in your best interest
- Variable annuities with bonus credits may impose higher fees and expenses than variable annuities that do not offer bonus credits. Higher expenses can outweigh the benefit of the bonus credit offered.
- In certain circumstances (such as death, annuitization, or surrendering your contract within a few years of purchasing it) you may be required to repay any bonus credits to the insurance company.

For More Information

Other SEC Online Publications

Investor Bulletin: Variable Annuities – Should You Accept A Buyout Offer?

Mutual Funds and ETFs – A Guide for Investors

Investor Bulletin: Performance Claims

Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio

Investor Bulletin: How to Check Out Your Financial Professional

Other Resources That May Be Helpful

- FINRA — FINRA is an independent self-regulatory organization charged with regulating the securities industry, including sellers of variable annuities. FINRA has issued several investor alerts on the topic of variable annuities. If you have a complaint or problem about sales practices involving variable annuities, you should contact the District Office of FINRA nearest you. A list of FINRA District Offices is available on FINRA's web site.
- National Association of Insurance Commissioners (NAIC) — The NAIC is the national organization of state insurance commissioners. Variable annuities are regulated by state insurance commissions, as well as by the SEC. The NAIC's web site contains an interactive map of the United States with links to the home pages of each state insurance commissioner. You may contact your state insurance commissioner with questions or complaints about variable annuities.

How To Contact the SEC With Questions or Complaints:

Office of Investor Education and Advocacy
U.S. Securities and Exchange Commission
Email: help@sec.gov

Telephone: (800) 732-0300
Submit Questions and Complaints

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