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ETFs in Variable Contracts: A New Marketing Opportunity?

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The Secure Act of 2022, in order to facilitate the use of exchange-traded funds (ETFs) as investment options under variable contracts, directs the Treasury Department to amend the governing look-through rules under applicable tax regulations to provide for insurance-dedicated ETFs. The department would be allowed up to seven years to update its regulations. Amendments could be adopted much sooner, however, as we understand that the extended adoption period was provided for certain revenue and cost "scoring" purposes. Another timing factor is that SEC rules governing ETFs may also need to be amended.

What You Need to Know

Market and economic factors will drive decision-making by ETF sponsors and insurance companies considering partnerships to create and offer insurance-dedicated ETFs in variable products. Some pros and cons will need to be analyzed and weighed carefully.

- Some ETFs have lower costs than mutual funds. A primary reason is that ETFs are bought and sold in the secondary market through brokerage houses so that the ETF does not bear the costs of maintaining shareholder accounts. However, mutual funds underlying variable contracts (underlying funds) enjoy this same advantage because their only direct shareholders are insurance company separate accounts. Some underlying funds reimburse insurers for maintaining contract owner accounts (sometimes referred to as "sub-transfer agency expenses"). Insurance-dedicated ETFs will need to consider the extent to which they can modify typical retail ETF cost structures as well as whether insurers will show flexibility in negotiating sub-transfer agency agreements.
- Retail ETFs also have lower cost structures because they often sell or redeem their shares in "in-kind" transactions with broker-dealers, so the ETF avoids the brokerage and other expenses associated with buying and selling portfolio investments through intermediaries. Query whether insurance companies will be willing to do the same.
- ETFs generally do not have sales loads or 12b-1 fees.

- Mutual fund families that do not currently offer ETFs will incur the considerable expenses associated with either registering new ETFs or converting existing funds to ETFs.
- Insurance-dedicated ETF sponsors may be challenged to transform fluctuating intraday ETF share prices into a defined, repeatable, formulaic, and nondiscretionary process required for a separate account to qualify as a unit investment trust under the Investment Company Act of 1940.

In conclusion, weighing the pros and cons will certainly be important. The most significant factor, however, may be that insurers and ETF sponsors conclude that product offerings with ETFs offered as investment options is simply too fertile ground not to be plowed.

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