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SEC Limits Need for Substitution Applications

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On February 23, the Securities and Exchange Commission issued a statement setting forth a "no-action" position regarding when substitutions by an insurance company of mutual funds held in a variable separate account may be effected without SEC approval. In Investment Company Act Release No. 34199, the SEC stated that such substitution without an SEC order will not provide a basis for enforcement action under section 26(c) of the Investment Company Act, so long as the terms and conditions of the proposed substitution are "substantially similar" to those approved by a prior order for an earlier substitution obtained by the same insurance company since January 1, 2004.

Almost all insurance company separate accounts funding variable contracts are registered under the Investment Company Act as unit investment trusts that invest in underlying mutual funds. Section 26(c) of the act generally has been interpreted to prohibit the insurance company in such cases from substituting an underlying fund for a different underlying fund without obtaining SEC approval.

Section 26(c) provides that the SEC must approve by order a proposed substitution if the evidence — set forth in a substitution application — establishes that the substitution is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the act. To date, the SEC has granted nearly 200 substitution applications by insurance companies sponsoring variable annuity and variable life insurance contracts that offer multiple funds as investment options. These orders have been subject to conditions geared to address the concerns underlying section 26(c), including: (i) notification to affected contract owners; (ii) comparability of the existing and the replacement funds; and (iii) a cap on fund expenses at the level of the existing fund, typically for two years after the substitution.

The release instructs an insurance company seeking to rely on this new no-action position to submit correspondence, e.g., as part of the transmittal letter to the SEC, along with the filing of the prospectus supplement that discloses the upcoming substitution. The correspondence should:

- Indicate that the substitution is of the type discussed in the release;

- Identify the prior order with terms and conditions substantially similar to those in the substitution;
- Confirm that the substitution is consistent with the terms and conditions of the identified prior order; and
- Explain why each existing fund and corresponding replacement fund are substantially similar, including a comparison of the investment objectives, strategies, and risks of each existing fund and its corresponding replacement fund.

The release is notable in a few respects. First, it came from the SEC, whereas typically no-action assurance comes from the SEC staff (saying it will not recommend enforcement action to the SEC if a company pursues a course of action set forth in a letter requesting such assurance). Second, it is fairly narrow in scope in that it applies only to an insurance company that has already obtained a substitution order since January 1, 2004. Generally, the relief set forth in an SEC staff no-action letter is available to others whose circumstances match those of the requesting party. Third, it puts the onus on the insurance company to make the types of determinations that, in the context of an application, must be made by the SEC (normally by the staff under delegated authority).

It is also worth noting that the release comes on the heels of contention surrounding recent substitution applications. In the most recent of these, the SEC granted an order approving multiple fund substitutions, notwithstanding fierce opposition on the part of the advisers to some of the funds being replaced. Viewed in light of these proceedings, the release may signal reticence on the part of the SEC to serve — or appear to serve — as arbiter of the business decisions that result in fund substitutions in the variable products context.

The release makes clear, however, that insurance companies may still file applications for approval of substitutions, notwithstanding that they might satisfy the release's conditions. In theory, obtaining such approval may afford an insurance company a greater degree of certainty in pursuing one or more substitutions.

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