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SEC PROPOSES SUMMARY PROSPECTUS FOR VARIABLE INSURANCE PRODUCTS

More than a decade after doing so for mutual funds, the SEC has proposed disclosure reforms for life insurance companies issuing variable annuities and variable life insurance. The key proposal is a summary prospectus that could facilitate decision-making for investors, boost sales for life insurance companies, and increase assets under management for mutual fund investment advisers. The author describes the proposal in the context of the SEC's checkered history of regulating variable insurance products.

By Gary O. Cohen *

The summary prospectus proposal of the U.S. Securities and Exchange Commission permits life insurance companies issuing variable annuity contracts (“variable annuities”) and variable life insurance policies (together, “variable insurance products” or “contracts”) to provide offerees with a brief disclosure document backed by electronic access to a full statutory prospectus available on the life insurance company’s website.

The proposal can be viewed, in a narrow sense, as a technical fix aligning the SEC’s regulation of variable insurance products with that of mutual funds in light of developing digital technology. However, the historical circumstances are such that the proposal can be viewed as a troubling reminder that the SEC has historically placed variable insurance products on the administrative back burner.

The SEC, in the 1950s and 1960s, fought tooth and nail to regulate variable annuities, winning two cases

against life insurance companies in the Supreme Court¹ and a third case in the Third Circuit.² In the 1970s, the SEC found itself enmeshed in seven years of administrative proceedings and litigation in determining the degree of regulation to assert over variable life insurance.³

¹ The Court held, in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959), and *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), that variable annuities gave rise to contract interests registerable with the SEC as securities under the Securities Act of 1933.

² The Court held, in *Prudential Ins. Co. v. SEC*, 326 F.2d 383 (3d Cir. 1964), that a life insurance company separate account is an investment company registerable with the SEC under the Investment Company Act of 1940.

³ Notice of and Order for Proceeding with Respect to Petition for Issuance and Amendment of Rules Requesting Exemption of Certain Variable Life Insurance Contracts and Their Issuers

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Despite its zeal to regulate variable insurance products, the SEC has a record of delay in adopting regulatory advances for such products. For example, the SEC has taken years to adopt registration statement forms tailored for variable insurance products⁴ and to reflect amendments to the federal securities law in SEC rules governing variable insurance products.⁵

This article describes the SEC's two-tier disclosure structure, outlines the SEC's proposal, and summarizes public comments on the proposal.

TWO-TIER DISCLOSURE STRUCTURE

The predominant arrangement for variable insurance products and their issuers is a two-tier structure of registered investment companies issuing registered securities. Accordingly, the SEC's regulatory scheme for variable insurance products, including the disclosure regime, is convoluted.

Life insurance companies issue variable annuities and variable life insurance policies, and allocate the purchase

payments to one or more separate accounts. The separate accounts are legally insulated from the life insurance company's other business. The separate accounts are registered with the SEC as unit investment trusts under the Investment Company Act of 1940, and the interests in the separate accounts under the products are registered with the SEC as securities under the Securities Act of 1933.

Life insurance company separate accounts invest in shares of investment companies. The investment companies are registered with the SEC as open-end management investment companies under the 1940 Act, and the shares are registered with the SEC as securities under the Securities Act. The investment companies are mutual funds, commonly referred to as "underlying funds," because they underlie the life insurance company separate accounts.

There are variations in the underlying funds. For example, underlying funds can be separate funds, each registered as an investment company, or a single fund with multiple series.

Underlying funds can be sponsored by the issuing life insurance company or an entity unaffiliated with the life insurance company. A typical arrangement is for a subsidiary of the life insurance company to serve as investment adviser to an underlying fund and an unaffiliated investment adviser to serve as subadviser to the underlying fund. Under such an arrangement, the life insurance company, in effect, retains a portion of the investment advisory fee that the underlying fund pays.

The SEC deems each of the two tiers to be making a public offering of securities. Consequently, the life insurance company must deliver a prospectus disclosing information about a separate account and the variable insurance products funded through that separate account. In addition, an underlying fund must deliver a prospectus disclosing information about the fund and its shares.

The latest information from the Investment Company Institute shows that there are 8,078 mutual funds with

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from the Federal Securities Laws, Rel. No. 33-5234, Rel. No. 34-9494, Rel. No. IC-6999, and Rel. No. IA-310, File No. 4-149 (1972).

⁴ It took the SEC 27 years to adopt the Form N-6 Registration Statement for variable life insurance after the SEC took its first steps to do so. *Compare* Separate Accounts of Life Insurance Companies Funding Certain Variable Life Insurance Contracts, Rel. No. IC-9104 (1975)(announcing expectation to promulgate a registration statement form) *with* Registration Form for Insurance Company Separate Accounts Registered as Unit Investment Trusts that Offer Variable Life Insurance Policies, Rel. No. 33-8088, Rel. No. IC-25522 (2002)(adopting a registration statement form).

⁵ The SEC has not amended its exemptive rules for variable life insurance to reflect amendments to the 1940 Act that Congress adopted in 1996, 23 years ago. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996). However, the SEC is currently proposing to do so. Note 8 *infra*.

total net assets of more than 17.7 trillion dollars,⁶ including 1,713 underlying funds with total net assets of more than 1.6 trillion dollars.⁷ So, underlying funds represent more than 21 percent of all funds, and life insurance companies account for more than nine percent of total underlying fund assets.

A summary prospectus could make it easier for offerees to buy variable insurance products. Obviously, this could help life insurance companies boost sales of the products. Furthermore, given the two-tier structure described above, increased sales of products would flow more money to mutual fund investment advisers to manage.

SEC PROPOSAL: A LONG TIME COMING

On October 30, 2018, just a month shy of 11 years after proposing a mutual fund summary prospectus, the SEC proposed a summary prospectus for life insurance companies and their separate accounts offering variable annuities and variable life insurance policies (“separate account summary prospectus”).⁸ The proposal authorizes, but does not require, the summary prospectus.

The proposal also provides, among other things, for:

- layered disclosure where electronic access to a statutory prospectus on a life insurance company’s website is deemed to constitute delivery;
- electronic delivery of underlying fund prospectuses, including fund summary prospectuses; and
- a summary updating prospectus.

The deadline for public comment was March 15, 2019.⁹ Commenters included such industry groups as

⁶ Investment Company Institute, 2019 Investment Company Fact Book at Table 1 on page 192 (59th ed 2019), available at <https://www.ici.org/research/stats/factbook>.

⁷ *Id.* at Table 58 on page 249.

⁸ Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, Rel. No. 33-10569, Rel. No. 34-33286, Rel. No. IC-33286 (Oct. 30, 2018), available at <https://www.sec.gov/rules/proposed/2018/33-10569.pdf> [hereinafter SEC Separate Account Summary Prospectus Proposal Release].

⁹ The original deadline was February 15, 2019. *Id.* at 2. However, the SEC extended the original deadline for public comment to March 15, 2019.

the American Council of Life Insurers, Committee of Annuity Insurers, and Insured Retirement Institute. Industry comments on the thrust of the proposal were enthusiastic, although commenters had much to say at the technical level.

Purpose of the Proposal

The SEC states that the purpose of the proposal is “to help investors make informed investment decisions” regarding variable insurance products by providing them “with key information relating to the contract’s terms, benefits, and risks in a concise and more reader-friendly presentation, with access to more detailed information available online and electronically or in paper format on request.”¹⁰

SEC Chairman Jay Clayton stated the significance of the proposal to be: “[p]roviding key summary information about variable annuities and variable life insurance contracts to investors is particularly important in light of the long-term nature of these contracts and their potential complexity.”¹¹

Key Aspects of Proposal

The proposal would permit:

- the use of an initial summary prospectus for variable insurance products currently offered to new investors;
- the use of an updating summary prospectus for existing investors; and
- online delivery of underlying fund prospectuses and other documents.

In addition, the proposal would grandfather the industry’s longstanding practice of relying on the so-called “Great-West” line of SEC staff no-action letters that conditionally permit the delivery of alternative disclosures in lieu of updating a life insurance company’s registration statements and delivering current prospectuses for certain variable insurance products.

¹⁰ *Id.* at 1.

¹¹ Press Release 2018-246, SEC, SEC Proposes Disclosure Improvements for Variable Annuities and Variable Life Insurance Contracts (Oct. 30, 2018), available at <https://www.sec.gov/news/press-release/2018-246>.

Scope of Proposal

The proposal would apply to variable insurance products registered on:

- Form N-4 for variable annuities issued through unit investment trust separate accounts, which is the prevalent organization form;
- Form N-6 for variable life insurance policies issued through unit investment trust separate accounts; and
- Form N-3 for variable annuities issued through management separate accounts, which was the original organization form.

The proposal also would affect the delivery of statutory and summary prospectuses of underlying funds whose shares are offered to separate accounts funding variable insurance products.

Conceptual Basis of Proposal

The SEC's proposal involves the concepts of layered disclosure and access equals delivery, and relates to the SEC's adoption, on October 30, 2018, of a rule permitting electronic delivery of annual reports to shareholders.¹²

¹² The SEC adopted Rule 30e-3 under the 1940 Act, which permits, but does not require, investment companies to transmit periodic reports to their shareholders by making the reports accessible on a website and satisfying certain other conditions. Optional Internet Availability of Investment Company Shareholder Reports, Rel. No. 33-10506, Rel. No. 34-83380, Rel. No. IC-33115 (2018), available at <https://www.sec.gov/rules/final/2018/33-10506.pdf>. Rule 30e-3 applies to "registered management companies and any separate series thereof and certain unit investment trusts." *Id.* at 6. These entities may rely on the new rule beginning no earlier than January 1, 2021.

More recently, the SEC's Division of Investment Management published guidance stating the SEC staff's position that electronic delivery of a notice pursuant to Rule 19a-1 under the 1940 Act, consistent with the SEC's electronic delivery guidance, would satisfy the purposes and policies underlying the Rule. See Division of Investment Management, SEC, *Shareholder Notices of the Sources of Fund Distributions – Electronic Delivery*, Division of Investment Management Guidance Update No. 2013-11 (Nov. 2013), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-11.pdf>.

The SEC's proposal follows the same legal approach as that for the mutual fund summary prospectus under the Securities Act and the 1940 Act. The proposed separate account summary prospectus for variable insurance products:

- is deemed to be a prospectus that is authorized under Section 10(b) of the Securities Act and 24(g) of the 1940 Act for purposes of Section 5(b)(1) of the Securities Act;
- can contain only the information required or permitted by the applicable form;
- must present the information required or permitted in a mandated sequence;
- may incorporate by reference the information contained in an underlying fund's statutory prospectus, statement of additional information, and reports to shareholders;
- is sent or given no later than the time of the carrying or delivery of the security; and
- is used only where an underlying fund's current summary prospectus, statutory prospectus, statement of additional information, and most recent annual and semi-annual reports to shareholders under Rule 30e-1 under the 1940 Act are publicly accessible, free of charge, at the website address specified on the cover page or at the beginning of the summary prospectus on or before the time that the summary prospectus is sent or given, and current versions of those documents remain on the website through the date that is at least 90 days thereafter.

Initial Summary Prospectus

The proposal includes new Rule 498A under the Securities Act, which would permit the optional delivery of an initial summary prospectus for variable insurance products. The initial summary prospectus would consist of key disclosures, which must appear in the specified order, including:

- a contract overview (including basic information about the contract and benefits);
- a key information table (providing a summary of fees and expenses, risks, restrictions, taxes, and conflicts of interest);
- a description of the standard death benefit;

- a summary of other benefits available under the contract;
- a description of the procedures for purchasing the contract;
- information regarding the possibility of contract lapse (for variable life insurance policies);
- information about contract surrenders or withdrawals;
- a full fee table; and
- an appendix (in tabular format) with summary information about the underlying funds.

The initial summary prospectus is required to include a cover page that identifies the depositor, registrant, and contract, and include certain legends.

The required legends include disclosure regarding how to obtain the statutory prospectus, free look rights, and the availability of additional general information about variable insurance products prepared and maintained by the SEC at its website Investor.gov.

An initial summary prospectus may only describe a single, currently offered contract, but may describe more than one class of a currently offered contract. This condition appears to be designed to prohibit a summary prospectus from describing multiple contracts or currently offered and no-longer-offered features and options of a single contract. This condition may cause significant work for life insurance companies to create separate summary prospectuses for contracts that are currently described in a single statutory prospectus, and may require systems changes to ensure the correct summary prospectus is delivered to each contract owner.

A striking aspect of the proposal is the “access equals delivery” approach to prospectus delivery for the mutual funds that serve as the underlying investments of these products. The initial summary prospectus must:

- be sent or given to an investor not later than the time of the “carrying or delivery” of the contract security; and
- not be bound with any other materials except underlying fund summary and statutory prospectuses, subject to certain conditions.

The initial summary prospectus, contract statutory prospectus, and contract statement of additional information must be publicly accessible, free of charge,

and available on a website in the manner specified in the proposed rule. The SEC provided a hypothetical initial summary prospectus to illustrate the proposed disclosure requirements.¹³

Underlying Fund Prospectuses

The proposal would permit online delivery of both underlying fund prospectuses and amendments to underlying fund prospectuses. This permission is based on the concept that electronic access to an underlying fund’s statutory prospectus equals delivery of that prospectus for purposes of Section 5 of the Securities Act. The foregoing approach would be conditioned on the following:

- an initial summary prospectus is used for each currently offered contract;
- an initial summary prospectus is used for the underlying fund (only if the underlying fund is registered on Form N-1A); and
- an underlying fund’s current summary prospectus, statutory prospectus, statement of additional information, and most recent shareholder reports are posted online in accordance with specified conditions.

The specified conditions require that:

- the initial summary prospectus for a product disclose a website address where investors can access underlying fund summary and statutory prospectuses;
- the underlying fund documents be publicly accessible, free of charge, on a website in the manner specified in the proposed rule; and
- investors be able to receive paper or electronic copies of the documents upon request.

In addition, any communication related to an underlying fund, other than a prospectus permitted or required by Section 10 of the Securities Act, would not be deemed a prospectus if the above conditions are satisfied. Moreover, if an underlying fund prospectus is amended between annual updates, the updated prospectus must be posted online, but need not be physically delivered to contract owners.

¹³ SEC Separate Account Summary Prospectus Proposal Release, *supra* note 8, at Appendix A.

PUBLIC COMMENTS

The SEC received 53 comments on its proposal, ranging from enthusiastic support from the life insurance industry to severe adverse criticism from two consumer groups.

Commenters from the life insurance industry, including six life insurance companies and three major industry groups, the American Council of Life Insurers (“ACLI”),¹⁴ Committee of Annuity Insurers (“CAI”),¹⁵ and Insured Retirement Institute (IRI),¹⁶ all favored the proposal. The ACLI, for example, said that it “strongly supports” the proposal as being “very constructive” with “noble objectives” and being “good government regulation at its best.”¹⁷ The CAI said that it “enthusiastically endorses” the proposal “with full support” as “the most significant advancement in variable product disclosure since the variable product registration statement forms were originally adopted.”¹⁸

Commenters from the mutual fund industry, which provides the underlying funds that serve as investment options, also favored the proposal. The Investment Company Institute said that it “strongly supports” the proposal, which would “benefit investors by allowing them to receive information in a more understandable manner.”¹⁹ The Capital Research and Management Company, a major sponsor of underlying funds, said that it “ardently support[s]” the proposal and “commend[s] the Commission’s efforts to advance the specific interests of variable contract holders.”²⁰

Two consumer groups, the Consumer Federation of America (“CFA”) and Better Markets condemned the proposal. The CFA said that the proposal had a “worthy goal,” but is “unlikely to achieve” it, because “improvements are needed.”²¹ Better Markets harshly accused the SEC of improperly advantaging the life insurance industry, stating that “the lack of serious analysis of the exceedingly complex and expensive nature of these variable contracts, and the fact that the new summary disclosure itself is optional, suggests that maximally accommodating the industry was the primary motive or goal here.”²²

The CFA urged the SEC to reorganize the proposed summary prospectus to present information in “the sequence of the decisions investors make.”²³ The CFA sees three such investment decisions: (1) whether to buy a variable insurance product over another product such as a mutual fund or exchange traded fund; (2) which of the several alternatives of variable insurance products being offered is the best match in such terms as fees and costs, surrender period, and standard and optional death benefits; and (3) which specific options, such as share class, riders, and portfolio companies to select. The CFA does “not claim to have worked out all the details of such an approach,” but emphasizes that “the Commission would need to test our proposed approach to layered disclosure, as well as its own proposed approach, to reliably determine which actually works best [sic] to support informed investment decision-making.”²⁴

Both the CFA and Better Markets strenuously insisted that the SEC must test its proposal on retail investors. The CFA, in addition to urging “extensive redesign” of the proposal, called for the SEC to conduct “rigorous testing necessary to ensure that the summary itself actually supports informed investment decision-making.”²⁵ Better Markets similarly said that “[i]nstead of offering untested and ineffective new disclosures, the

¹⁴ Letter of Carl B. Wilkerson, Vice President & Chief Counsel, American Council of Life Insurers, Securities (Feb. 15, 2019) [hereinafter ACLI letter]. This letter and the letters cited below are addressed to the SEC Secretary or Acting Secretary and are available at <https://www.sec.gov/comments/s7-23-18/s72318.htm>.

¹⁵ Letter of Stephen E. Roth and Dodie C. Kent, Partners, Eversheds Sutherland (Feb. 14, 2019) [hereinafter CAI letter].

¹⁶ Letter of Wayne Chopus, President & CEO, Insured Retirement Institute (Mar. 15, 2019) [hereinafter IRI Letter].

¹⁷ ACLI Letter, *supra* note 14, at 3 and 4.

¹⁸ CAI Letter, *supra* note 15, at 2.

¹⁹ Letter of Susan Olson, General Counsel, Investment Company Institute 1 (Feb. 15, 2019).

²⁰ Letter of Stephen T. Joyce, American Funds Distributors, Inc., and Erik A. Vayntrub, Vice President, Associate Counsel, Capital Research and Management Company1 (Mar. 14, 2019).

²¹ Letter of Barbara Roper, Director of Investor Protection, and Micah Haupman, Financial Services Counsel, Consumer Federation of America 1 (Feb. 27, 2019) [hereinafter CFA Letter].

²² Letter of Dennis M. Kelleher, President & CEO, and Lev Bagramian, Senior Securities Policy Advisor, Better Markets 2 (Feb. 14, 2019) [hereinafter Better Markets Letter].

²³ CFA Letter, *supra* note 21, at 3.

²⁴ *Id.* at 5 and 6.

²⁵ *Id.* at 13.

Commission must first thoroughly test, and only then propose for comment new summary disclosures.”²⁶

The SEC’s comment process had an unusual aspect. The Director of the SEC’s Division of Investment Management made a speech stating:

[P]lease do not approach your comment letters as just a legal exercise. This rule — if it gets adopted — could be on the books for a long time. I don’t want a rule that is going to be

out of date the minute it is adopted — we want to future-proof it.”²⁷

The IRI focused its comment letter on future-proofing the proposal. Its principal recommendation was that the SEC “[e]xtend the ‘access equals delivery’ framework to all variable contract and mutual fund prospectuses.”²⁸

Life insurance and mutual fund industry observers expect the SEC to adopt its proposal, albeit with revisions reflecting technical industry comments. ■

²⁶ Better Markets Letter, *supra* note 22, at 8.

²⁷ Dalia Blass, Director, SEC Division of Investment Management, Address at the ALI CLE 2018 Conference on Life Insurance Company Products, Sec. 4 (Nov. 8, 2018), available at <https://www.sec.gov/news/speech/speech-blass-110818>.

²⁸ IRI Letter, *supra* note 16, at 4.