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Duties and Non-Duties of Directors of Mutual Funds Underlying Life Insurance Company Separate Accounts Funding Variable Insurance Contracts

By Gary O. Cohen

The US Securities and Exchange Commission (SEC) has adopted[1] sweeping reforms for disclosure documents of life insurance company (insurer) separate accounts[2] (separate accounts) funding variable annuity contracts[3] or variable life insurance contracts[4] (together, variable insurance contracts).

These reforms, which include summary prospectuses and layered disclosure, conceivably could boost sales of variable insurance contracts and call attention to the mutual funds (funds) in which separate accounts invest. These funds go by various names, such as "variable annuity mutual funds,"[5] "variable insurance funds,"[6] "variable insurance trusts,"[7] "insurance dedicated funds,"[8] "dedicated funds,"[9] "insurance products funds,"[10] and, as in this article, "underlying funds."[11]

At the end of 2020, there were l,647 underlying funds holding more than $1.98 trillion in total net assets.[12] The number was down from a high in 2006 of 1,922 underlying funds, but total net assets were up from $1.26 trillion that year.[13]

Neither the SEC[14] nor the courts have identified comprehensive[15] duties or non-duties of directors[16] of underlying funds, as distinguished from duties or non-duties of directors of funds sold directly to the public (retail funds). Consequently, no legal basis exists for this article to state definitively what are and what are not such duties and non-duties, and this article does not intend to do so. Instead, this article refers to certain federal securities laws, court decisions, SEC rule and form requirements, SEC Staff statements and administrative practices, Internal Revenue Code of 1986 (Code) provisions, and Internal Revenue Service (IRS) requirements that the SEC or the courts could deem to be the basis for duties or non-duties of underlying fund directors or that the mutual fund and life insurance industries could deem to be best practices.

Two-Tier Structure

Underlying fund directors should understand that separate accounts and underlying funds are components of a *two-tier* structure.[17] At the top tier, the separate accounts register with the SEC as unit investment trusts under the Investment Company Act of 1940 (1940 Act) and register interests in the separate accounts with the SEC as securities under the Securities Act of 1933 (1933 Act). Similarly, at the bottom tier, the underlying funds register with the SEC as open-end management investment companies under the 1940 Act and register their

shares with the SEC as securities under the 1933 Act.

Insurers sell variable insurance contracts and place the purchase payments into the insurers' legally-segregated separate accounts. The separate accounts invest the purchase payments in shares of underlying funds that the insurers make available to variable insurance contract owners as investment options. The underlying funds, because of federal tax law,[18] can sell their shares only to separate accounts and tax-qualified retirement and pension plans and not to the general public. The variable insurance contract owners select the underlying funds[19] in which the owners want their purchase payments invested.

Fiduciary Duty

Under the 1940 Act, directors of underlying funds have the same fundamental duty as directors of retail funds, namely, to act as a fiduciary[20] in the best interests of the funds, which is considered to include the best interests of fund shareholders. A number of sections of the 1940 Act, as well as a number of rules that the SEC has adopted under the 1940 Act, impose specific duties[21] on fund directors generally.

For many purposes, the SEC considers the shareholders of underlying funds to be the variable insurance contract owners and not the insurers and/or separate accounts that are the record owners of the fund shares.[22] This position is reflected in an SEC Staff letter stating: "The Division further emphasizes that, in the context of a two-tiered variable insurance offering, the finding of benefit to fund *shareholders* requires the likelihood of a benefit to the individual *contract owners*, not the insurance company separate account, which is the technical owner of the fund's shares."[23]

Underlying funds raise certain issues that retail funds do not raise. It follows that the duties of underlying fund directors[24] may be deemed to differ to some extent from the duties of retail fund directors, as discussed below.

Registration Statements

The SEC takes the general position[25] that an underlying fund offers and sells its shares to variable insurance contract owners at the same time the insurer offers and sells interests in its separate account to variable insurance contract owners.

It follows that underlying fund directors are responsible for the fund's registration statement that the SEC requires be filed under the 1940 Act for investment companies and the 1933 Act for offerings of securities. The registration statement includes the fund's prospectus and statement of additional information used in the offer and sale of fund shares to variable insurance contract owners. The federal securities laws require[26] the underlying fund directors to sign the registration statement and make the directors legally liable for inaccurate, misleading, or missing disclosure.

Rule 12b-1 Plans

The SEC, as noted above, considers an underlying fund to be making an offer and sale of its shares to variable insurance contract owners. A question arises whether underlying fund directors may adopt a Rule 12b-1 plan providing for fund assets to pay costs of these offers and sales.

For many years, the SEC Staff said no,[27] reasoning that certain charges[28] under variable insurance contracts paid for distribution costs and that Rule 12b-1 plan payments, therefore, would constitute "double dipping" to the disadvantage of variable insurance contract owners. The SEC Staff ultimately reversed[29] its position and allowed underlying funds to adopt Rule 12b-1 plans.

However, in reversing its position, the SEC Staff stated that "directors should assure themselves that legitimate services will be rendered."[30] It follows that underlying fund directors, acting in the best interests of variable insurance contract owners, may find it advisable to inquire of insurers whether any Rule 12b-1 plan payments duplicate variable insurance contract fees and charges, so that there is no double charging for the same distribution services.

Rule 12b-1 cites[31] an SEC release stating that one of the factors fund directors should consider in approving or renewing a Rule 12-1 plan is the "nature . . . of the expenditures."[32]

SEC Staff inspectors have sometimes questioned whether an underlying fund uses Rule 12b-1 plan fees to pay for offering and selling the related variable insurance contracts, rather than the fund shares. Underlying fund directors can rely on such things as sales literature about the fund to show that Rule 12b-1 plan fees are used to offer and sell fund shares.

Participation Agreements

Industry practice is for insurers and their separate accounts to enter into so-called "participation agreements"[33] with underlying funds. Participation agreements spell out important aspects of the relationship among the insurer, separate account, and underlying fund. These aspects include such matters as: sale and redemption of underlying fund shares; preparation and distribution of fund disclosure and reporting, voting, and sales materials; fund diversification and qualification for tax purposes; expense allocation; and indemnification. Participation agreements serve as convenient vehicles for allocating responsibilities among the parties to facilitate compliance with regulatory requirements.

The SEC requires separate accounts to file participation agreements as exhibits[34] to their registration statements under the 1933 and 1940 Acts filed with the SEC. Some underlying funds also file participation agreements as exhibits[35] to their registration statements under the 1933 and 1940 Acts filed with the SEC.

The 1940 Act requires[36] that a fund's board approve underwriting agreements providing for the offer, sale, and delivery of fund shares. An argument can be made that a participation agreement is a form of underwriting agreement providing for the offer, sale, and delivery of underlying fund shares to insurers and/or their separate accounts. In addition, participation agreements usually obligate underlying funds to indemnify other parties.

For these reasons, underlying fund directors may find it advisable to approve participation agreements or, at least, exercise oversight regarding the negotiation and implementation of participation agreements.

Contract Fees and Charges

Underlying fund directors are not directly responsible for the reasonableness of fees and charges imposed on variable insurance contract owners, but may be deemed to have certain tangential duties regarding these fees and charges.

Congress has imposed the duty of reasonableness of fees and charges under variable insurance contracts on *insurers* rather than underlying fund directors. More specifically, Congress amended the 1940 Act to bar[37] an insurer from selling contracts, unless the aggregate fees and charges deducted under the contracts are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurer. The amended 1940 Act also requires[38] the insurer to represent so in the registration statement for the contract.

Nevertheless, underlying fund directors may find it advisable to consider the fees and charges imposed on variable insurance contract owners when they evaluate[39] and approve the renewal of investment advisory agreements with affiliates of the insurers. The courts,[40] including the US Supreme Court,[41] have enumerated factors that directors of retail funds should consider in their evaluation. These factors include so-called "fall-out" benefits[42] to the investment adviser or any affiliate. "Fall-out" benefits arguably include any profit from fees and charges imposed under variable insurance contracts where the underlying fund's investment adviser is an affiliate of the insurer.

Where an underlying fund is a fund of funds investing in shares of another fund, an SEC rule requires that such an underlying fund obtain a certification from the insurer. The certification is that the *insurer* has determined that the aggregate fees and expenses borne by the separate account,

the underlying fund, and the fund acquired by the underlying fund are "consistent with the standard"[43] of reasonableness in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurer. It follows that underlying fund directors may find it advisable to assure that the underlying fund has obtained the required certification.

Fund Share Voting

As noted above, for many purposes, the SEC treats variable insurance contract owners as owners of underlying fund shares, even though the shares are owned of record by the insurers and/or their separate accounts.

Consistent with this concept, the SEC requires that variable annuity contract owners[44] and variable life insurance contract owners[45] have voting rights in underlying funds, based on their interests[46] in separate accounts. As a practical matter, variable insurance contract owners exercise their voting rights by providing voting *instructions*[47] to insurers and/or their separate accounts who, as the record owners of underlying fund shares, actually vote the shares.

Moreover, the SEC does not permit insurers to vote their interests in separate accounts in the insurers' discretion. Instead, the SEC requires an insurer to vote its interests "in the same proportion as the votes cast by" variable insurance contract owners,[48] that is, the voting instructions received from contract owners.[49] This process is commonly referred to as "echo voting" or "mirror voting."

The foregoing SEC voting provisions apply to insurers and/or their separate accounts. The SEC has not pronounced that underlying fund directors have any specific duty regarding the SEC voting provisions. Nevertheless, underlying fund directors may find it advisable to monitor insurer and separate account compliance with the SEC voting provisions.

Monitoring for Conflicts

The federal tax laws[50] permit underlying funds to sell shares to permissible investors, including separate accounts funding flexible premium variable life insurance contracts, scheduled premium variable life insurance contracts, variable annuity contracts, and tax-qualified pension or retirement plans. Underlying fund directors may be deemed to have duties regarding the different kinds of separate accounts, as well as certain federal tax-qualified pension or retirement plans (plans), that can own underlying fund shares.[51]

SEC rules[52] provide certain exemptions from the 1940 Act to insurers offering variable life insurance contracts, and the SEC has granted exemptive orders[53] authorizing underlying funds to serve as investments to fund various combinations of separate accounts and plans. The SEC has conditioned[54] the exemptions on: (1) an underlying fund directors' monitoring the fund for the existence of any material irreconcilable conflict among variable insurance contract owners and/or plans; and (2) the insurers' and plans' agreeing to be responsible for reporting any such potential or existing conflicts to the underlying fund directors and remedying any such conflicts at the insurer's or plan's own cost.

Therefore, if underlying fund directors rely on the exemptions, underlying fund directors may find it advisable to establish and follow procedures to meet the SEC's conditions. Even if no person relies on the exemptions at the time, underlying fund directors may find it advisable to establish and follow procedures for monitoring for conflicts[55] among variable insurance contract owners and/or plans.

The SEC, for years, was understood to require underlying funds to obtain exemptive orders to sell shares to certain combinations of insurer/separate accounts and/or plans, even if no person relies on the exemptions at the time. However, a few years ago, the SEC reversed[56] itself and took the position that underlying funds are not required to obtain exemptive relief, and funds that have previously obtained such an exemptive order need not comply with the conditions of that order, if no person relies on the exemptions at the time. Nevertheless, as noted

above, underlying fund directors may find it advisable to establish and follow procedures to meet the conditions of such orders regarding monitoring for conflicts.

Tax Status

A variable insurance contract cannot enjoy tax deferred treatment unless the underlying fund meets certain portfolio investment diversification requirements of the Code.

More technically, a variable insurance contract will not be treated as an annuity or life insurance contract for insurer tax purposes, as well as for purposes of Sections 72 (annuity taxation) and 7702 (life insurance taxation) of the Code, unless the investments made by the separate account are "adequately diversified"[57] in accordance with Section 817(h) of the Code and the regulations prescribed by the Secretary of the Treasury.

It follows that underlying fund directors may find it advisable to monitor the fund's investment adviser for compliance with the tax laws. Query whether underlying fund directors could be liable to variable insurance contract owners in the event of non-compliance and loss of a variable insurance contract's tax-deferred treatment. The question may not arise, because the IRS has developed remedial procedures[58] in the event of non-compliance with the diversification requirements.

Substitution

The 1940 Act provides[59] that an insurer can replace an existing underlying fund available under a variable insurance contract with another underlying fund, by applying for, and receiving, an SEC order approving the substitution. The 1940 Act authorizes[60] the SEC to issue an approval order if the evidence establishes that the substitution is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

The SEC recently announced[61] its interpretation of the statutory standard for issuing substitution approval orders and provided partial relief from seeking a substitution order for insurers that rely on a prior substitution order. The SEC does not state that underlying fund directors have any duty regarding substitutions.

Nevertheless, underlying fund directors may find it advisable to consider a substitution if the underlying fund is a party to the substitution application filed with the SEC or if the substitution results in significant redemptions for an existing underlying fund or significant new assets for the underlying fund being substituted.

Conclusion

Under the 1940 Act, directors of underlying funds have the same duty as directors of retail funds sold directly to the public, namely to act as a fiduciary in the best interests of the funds, which is considered to include the best interests of fund shareholders.

At the same time, underlying funds differ from retail funds in ways that may result in unique oversight functions for underlying fund directors regarding such matters as identification of fund shareholders, registration statements, Rule 12b-1 plans, participation agreements, variable insurance contract fees and charges, fund share voting, monitoring for conflicts among participating separate accounts and retirement plans, tax status, and substitutions.

Mr. Cohen is of counsel at Carlton Fields, P.A., in Washington, DC. Mr. Cohen spent five years on the Staff of the SEC's IM Division, ultimately serving as assistant chief counsel, and has dealt with the Division as a private practitioner for more than 50 years. He was on the SEC Staff in 1964 when the Third Circuit held that the SEC has jurisdiction to regulate variable annuity separate accounts and in 1967 when the US Supreme Court held that the SEC has jurisdiction to regulate variable annuity contracts, and

he participated in the development of the SEC's regulatory scheme. Later, he was with the law firm that represented the life insurance industry trade associations in seven years of SEC proceedings that led to the SEC's adoption of exemptive rules for variable life insurance contracts in 1976. Mr. Cohen has served on *The Investment Lawyer*'s Editorial Board since the outset of the publication and has published numerous articles in this publication over many years. He thanks his colleagues, Justin Chretien, Ann B. Furman, William J. Kotapish, Stephen W. Kraus, and Thomas C. Lauerman, his firm's librarian, Nicole Warren, and retired Dechert partner Jeffrey S. Puretz for reviewing and contributing to this article. The article has input from five former SEC Staff members. The views expressed are those of Mr. Cohen and do not necessarily reflect the views of his firm, its lawyers, its clients, or Mr. Puretz.

NOTES

1 *Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts,* SEC Securities Act Release No. 10765, Exchange Act Release No. 88358, Investment Company Act Release No. 33814 (Mar. 11, 2020) [hereinafter SEC Release Updating Disclosure for Variable Insurance Contracts], available at *sec.gov/rules/final/2020/33-10765pdf*; proposed in *Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts,* SEC Securities Act Release No. 10569, Exchange Act Release No. 84508, Investment Company Act Release No. 33286 (Oct. 30, 2018), available at *sec.gov/rules/proposed/2018/33-10569.pdf*. For a detailed summary of the SEC disclosure reforms, *see* Richard Choi, Stephen Choi, Gary O. Cohen, Ann B. Furman, Thomas C. Lauerman, and Chip Lunde, "SEC Approves Summary Prospectuses, Layered Disclosure for Variable Insurance Contracts," *The Investment Lawyer*, Vol. 27, No. 8 (Aug. 2020).

2 The term "separate account" is defined in Section 2(a)(37) of the Investment Company Act of 1940 Act (1940 Act) and, somewhat differently, in Rule 0-1(e)(1) under the 1940 Act.

3 The term "variable annuity contract" is defined in Rule 0-1(e)(1) under the 1940 Act.

4 The term "variable life insurance contract," in the context of *flexible* premium variable life insurance, is defined in Rule 6e-3(c)(1) under the 1940 Act, and, in the context of *scheduled* premium variable life insurance, in Rule 6e-2(c) under the 1940 Act.

5 Investment Company Institute, 2021 Investment Company Fact Book, A Review of Trends and Activities in the Investment Company Industry 267 (2021) [hereinafter ICI Fact Book], available at *https://www.ici.org/system/files/2021-05/2021_factbook.pdf.* (The ICI's Privacy & Cookie Policy, available at *dataprivacy@ici.org*, states, under "Copyright and Linking Policies": "The Investment Company Institute makes the information on its website available to anyone . . . . You may cite or refer to the information in this site in any media provided you include proper attribution indicating Investment Company Institute as the source and *http://www.ici.org as the URL*.") This article speaks as of March 22, 2022.

6 The term "variable insurance fund" or its acronym "VIF" appears in the names of the funds of several sponsors, including, for example, Morgan Stanley, available at *https://www.morganstanley.com/im/en-us/registered-investment-advisor/product-and-performance/variable-insurance-trusts.desktop.html.*

7 Some underlying trusts include the term "variable insurance trust" in their names. *See, e.g*, PIMCO Variable Insurance Trust, 1940 Act file number 811-8399.

8 Schulte Roth & Zabel, Insurance Dedicated Funds and Related Funds and Related Strategies, Private Investment Funds Seminar, title page (2019), available at *https://www.srz.com/images/content/1/6/v2/164804/SRZ-PIF-2019-Insurance-Dedicated-Funds-and-Related-Strategies.pd.pdf.*

9 American Bar Association, Fund Director's Guidebook 151 (4th edition 2015) (in section titled

"Funds Used as Funding Vehicles for Insurance Products") [hereinafter ABA Guidebook].

[10] Gary O. Cohen, "Advising the Directors of an Insurance Products Fund," Conference on Life Insurance Company Products, Current Securities and Tax Issues, ALI-ABA Course of Study Materials 205 (1990) [hereinafter Cohen Outline].

[11] The SEC uses the name "underlying fund." SEC, Transcript of the Conference on the Role of Independent Investment Company Directors at Part 2 (1999) [hereinafter SEC Conference Transcript], available at *https://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm.*; SEC Division of Investment Management, IM Guidance Update, *Mixed and Shared Funding Orders,* No. 2014-10 at 2 (Oct. 2014) [hereinafter IM Guidance Update], available at *https://www.sec.gov/investment/im-guidance-2014-10.pdf.*

[12] The ICI Fact Book, *supra* n.5, sets out Table 58, at 267, titled "Variable Annuity Mutual Funds: Total Net Assets, Net New Cash Flow, and Number of Funds" (emphasis added). The footnote to the Table states: "This category includes mutual funds offered though variable annuity and variable life insurance contracts" and "[d]ata for funds that invest primarily in other mutual funds were excluded from the series."

[13] *Id.*

[14] The SEC has experienced difficulty in fitting variable insurance contracts and related entities under the federal securities laws, resulting in legal uncertainty. *See* Gary O. Cohen, "SEC Acts on Variable Insurance Matters Stretching Back for Decades," *The Investment Lawyer,* Vol. 27, No. 7, at 28-29 (July 2020); Gary O. Cohen, "A Short Telling of the Wacky History of How the SEC Came to Regulate Life Insurance Company Separate Accounts and Products," Vol. 23, No. 5, at 1 (May 2016).

[15] SEC rules and orders provide exemptions from certain sections of the 1940 Act conditioned on underlying fund directors' performing specified duties *See, e.g.*, *infra* nn.49, 54 and accompanying text. The SEC Staff identified a duty of underlying fund directors in connection with evaluating Rule 12b-1 plans, as addressed *infra* n.30 and accompanying text.

[16] References in this article to "directors" of underlying funds include trustees of underlying funds organized as trusts under state law, such as Massachusetts business trusts and Delaware statutory trusts.

[17] An SEC description of the *two*-tier structure appears in *Commission Statement on Insurance Product Fund Substitution Applications*, SEC Investment Company Act Release No. 34199 at 2 (Feb. 23, 2021) [hereinafter SEC Substitution Statement], available at *https://www.sec.gov/rules/policy/2021/ic-34199.pdf.* Elsewhere, the SEC has described the two-tier structure in an imprecise manner, as observed in Gary O. Cohen, "SEC Addresses Variable Insurance, But Not Always with Precision," *The Investment Lawyer*, Vol. 28, No. 5, at 28 (May 2021).

The two-tier structure is "the structure currently used by almost all insurers offering variable insurance contracts." IM Guidance Update, *supra* n.11, at 2. A *one*-tier structure exists where the separate account is itself registered with the SEC as a management investment company investing in a portfolio of securities rather than a unit investment trust investing in underlying funds. The biggest such separate account is College Retirement Equities Fund, 1940 Act file number 811-04415.

The SEC has deemed a "*three*-tier" structure to exist where an underlying fund invests in one or more other open-end management investment company in a "fund of funds" arrangement. *Fund of Funds Arrangements*, SEC Securities Act Release No. 33-10871 and Investment Company Act Release No. IC-34045 (Oct. 7, 2020) (adopting new Rule 12d1-4 under the 1940 Act to "streamline and enhance the regulatory framework applicable to funds that invest in other funds") [hereinafter SEC Fund of Funds Rule Adopting Release], available at *https://www.sec.gov/rules/final/2020/33-10871.pd.*

[18] *See* 26 CFR 1.817-5(f).

[19] Underlying funds are generally "series" funds under Section 18(f) of the 1940 Act. Variable insurance contract owners choose to have their purchase

payments invested in one or more subaccounts of a separate account that invest in corresponding series of an underlying fund. Variable insurance contract owners do not own underlying fund shares directly, but instead own units of interest (units) in the subaccounts of the separate account that directly owns underlying fund shares. The performance of the units tracks that of the underlying funds. Insurers frequently offer variable insurance contract owners underlying funds that are established and maintained as so-called "clones" of successful or popular retail funds.

20 *See* Section 36(a) of the 1940 Act, which refers, in pertinent part, to "a breach of fiduciary duty [of a fund director] involving personal misconduct in respect of any registered investment company for which such person so serves or acts . . . ." The courts have addressed the fiduciary duties of fund directors in Burks v. Lasker, 441 U.S. 471 (1979) and Moses v. Bergen (CA 1, 1971).

21 A comprehensive but outdated identification of fund director duties appears in the ABA Guidebook, *supra* n.9. The American Bar Association has appointed a task force to update the ABA Guidebook. An earlier, but legally savvy, identification of duties appears in K&L Gates, Duties of Directors and Trustees of Registered Investment Companies (2013), available at *https://files.klgates.com/files/upload/dc_im_09_duties_directors_trustees.pdf.* A still earlier but highly readable specification appears in Independent Directors Council, Fundamentals for Newer Directors (2011) ("information about the role and responsibilities of fund directors, and the framework within which they operate"), available at *https://www.idc.org/system/files/private/2021-04/idc_14_fundamentals.pdf.* The SEC, in 1999, held a two-day exploration of the duties of fund directors, which is memorialized in SEC Conference Transcript, *supra* n.11.

22 This concept mirrors that in the retail fund space, where retail fund directors are deemed to owe fiduciary duties to the individual shareholders owning fund shares through an omnibus account, which is the owner of record of the fund shares.

23 Letter from Heidi Stam, associate director, SEC IM Division, to Gary E. Hughes, chief counsel, Securities and Banking, American Council of Life Insurance, Paul Schott Stevens, general counsel, Investment Company Institute, and Mark J. Mackey, president & CEO, National Association for Variable Annuities 2 (May 30, 1996) (emphasis added) [hereinafter SEC Staff Rule 12b-1 Plan Letter], available at *www.sec.gov/divisions/ investment/noaction/1996/hughes-acli052696.pdf*.

24 A discussion of the duties of underlying fund directors appears in the SEC Conference Transcript, *supra* n.11, at Part 2. An earlier summary by the author of this article of duties of underlying fund directors appears in the Cohen Outline, *supra* n.10, at III.B. and IV.

25 The SEC bases this position on Rule 140 under the 1933 Act, which provides that "[a] person [separate account], the chief part of whose business consists of the purchase of the securities of one issuer [underlying fund] or of two or more affiliated issuers, and the sale of its own securities [units of interest in the separate account] . . . to furnish the proceeds with which to acquire the securities [shares] of such issuer or affiliated issuers, is to be regarded as engaged in the distribution of the securities of such issuer or affiliated issuers [pursuant to a public offering] within the meaning of Section 2(11) of the Act. For a knowledgeable discussion of the SEC's administration of Rule 140, including inconsistencies in that administration, by then SEC Staff officials and a senior attorney, *see* Clifford E. Kirsch, Wendell M. Faria, and C. Christopher Sprague, "Master-Feeder Arrangements: Registration of a Master's Securities Under the Securities Act," *Insights*, Vol. 7. Number 10 (Oct.1993). Notwithstanding the foregoing, insurers and/or separate accounts, rather than variable insurance contract owners, are the record owners of underlying fund shares.

26 *See* Section 11 under the 1933 Act.

[27] For a detailed history of this matter, s*ee* Gary O. Cohen, "Underlying Fund Rule 12b-1 Plans: SEC Regulation and Director Duty," *The Investment Lawyer,* Vol. 24, No. 5, at 16 (May 2017).

[28] Insurers impose "mortality and expense risk charges" to cover risks that insurers' assumptions in pricing variable insurance contracts will turn out to be less favorable than predicted, *e.g.,* that annuitants will die later, insureds will die earlier, or expenses will be greater, than predicted. *See infra* n. 37 and accompanying text. Any profit from the charges flows into an insurer's general account where the profit is available to pay any insurer expenses, including distribution costs of variable insurance contracts.

[29] SEC Staff Rule 12b-1 Plan Letter, *supra* n.23. The SEC Staff's statement was in the context of an independent money management firm establishing mutual funds as underlying funding media for variable annuity contracts and variable life insurance contracts presumably issued by more than one unaffiliated insurer.

[30] *Id*. at 2.

[31] *See Note* following Rule 12b-1(d).

[32] *Bearing of Distribution Expenses by Mutual Funds*, Securities Act Release No. 6254 and Investment Company Act Release No. 11414 (Oct. 28, 2980) (adopting Rule 12b-1), 45 Fed. Reg. 73898, 73904 (Nov. 7, 1980), available at *https://tile.loc.gov/storage-services/service/ll/fedreg/fr045/fr045218/fr045218.pdf*.

[33] The title refers to the fact that a separate account, in buying and holding underlying fund shares, is "participating" in the fund. *See* the SEC's definition of the term "variable annuity contract" in Rule 0-1(e)(1) under the 1940 Act as meaning, with emphasis added, "any accumulation or annuity contract, any portion thereof, or any unit of interest or *participation* therein pursuant to which the value of the contract, either prior or subsequent to annuitization, or both, varies according to the investment experience of the separate account in which the contract *participates*." In practice, participation agreements may bear such titles as "buy-sell" or "fund sales and administration" agreements. Relevant terms and conditions may be divided among multiple differently-titled agreements rather than all being set forth in a single agreement. *See infra* n.34.

[34] The SEC requires a variable annuity separate account to file "[a]ny participation agreement or other contract relating to the investment by the Registrant in a Portfolio Company" as exhibit 27(h) to the Form N-4 Registration Statement under the 1933 and 1940 Acts, available at *https://www.sec.gov/files/formn-4.pdf*. The SEC requires a variable life insurance separate account to file "[a]ny participation agreement or other contract relating to the investment by the Registrant in a Portfolio Company" as exhibit 30(h) to the Form N-6 Registration Statement under the 1933 and 1940 Acts, available at *https://www.sec.gov/files/formn-6.pdf*.

[35] The SEC does not expressly require underlying funds to file participation agreements as exhibits to the Form N-1A Registration Statement under the 1933 and 1940 Acts. However, underlying funds may file participation agreements as "material contracts not made in the ordinary course of business to be performed in whole or in part on or after the filing date of the registration statement" as exhibit 28(h), available at *https://www.sec.gov/about/forms/formn-1a.pdf*.

[36] Section 15(b) of the 1940 Act.

[37] Sections 26(f)(2)(A) and 27(i)(2)(b) of the 1940 Act.

[38] *Id*.

[39] Section 15(c) of the 1940 Act requires fund directors "to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such [fund]."

[40] Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F. 2d 923, 928 (2d Cir. 2010), available at *https://casetext.com/case/gartenberg-v-merrill-lynch-asset-management*.

[41] Jones v. Harris, 559 U. S. 335 (2010), available at *https://www.supremecourt.gov/opinions/09pdf/08-586.pdf*.

[42] The US Supreme Court stated:

> Other factors cited by the Gartenberg court include (1) the nature and quality of the services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) *any "fall-out financial benefits," those collateral benefits that accrue to the adviser because of its relationship with the mutual fund*; (4) comparative fee structure (meaning a comparison of the fees with those paid by similar funds); and (5) the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation. 694 F. 2d, at 929–932 (internal quotation marks omitted).

Id. at 8, n.5 (emphasis added).

43 Rule 12d1-4(b)(2)(iii) under the 1940 Act, adopted in SEC Fund of Funds Rule Adopting Release, *supra* n.17. Rule 12dl-4(c)(4) requires that an underlying fund preserve the insurer's certification for a period of not less than five years. The SEC has estimated that 191 funds will be subject to these requirements. *Id.* at 249.

44 *See* Section 12(d)(1)(E) of the 1940 Act and Rules 15(a)(3)(2) and 16(a)(1)(3) under the 1940 Act, which Rules imply an SEC requirement of voting rights for variable annuity contract owners.

45 *See* Section 12(d)(1)(E) of the 1940 Act and Rule 6e-3(b)(10)(i)(A) made applicable by Rule 6e-3(b)(15)(iii) for flexible premium variable life insurance contracts under the 1940 Act. Rule 6e-3(b)(14) for scheduled premium variable life insurance contracts has no parallel provision, but Rule 6e-3(b)(9)(i)(A) can be read to apply for scheduled premium variable life insurance contracts under the 1940 Act. The SEC has not adopted a parallel provision for variable annuity contracts, but has administered the 1940 Act to provide so.

46 Insurers hold their monies in separate accounts as reserves supporting insurers' liabilities under variable insurance contracts. *See* Rule 0-1(e)(2) under the 1940 Act. Such monies, for example, may be charges deducted under variable insurance contracts that insurers have not transferred from their separate accounts to their general accounts.

47 *See* Rule 6e-3(b)(15)(iii)(A) for flexible premium variable life insurance separate accounts and Rule 6e-2(b)(14)(iii) for scheduled premium variable life insurance separate accounts under the 1940 Act referring to "instructions from contract holders of the separate account." The SEC has not adopted a parallel provision for variable annuity contracts, but has administered the 1940 Act to provide so. The SEC has stated:

> Insurers serving as depositors of variable life insurance separate accounts the assets of which are invested in shares of mutual funds are the record owners of those shares, but are generally required to vote those shares in accordance with instructions of variable life contract owners whose assets are allocated to those funds.

IM Guidance Update, *supra* n.11, at 5 n.4 (citing "Investment Company Act Release No. 15651, Section B.4 (Mar. 30, 1987) [52 FR 11187, at 11190-91 (Apr. 8, 1987)]").

48 Rule 6e-3(b)(10)(i)(B) made applicable by Rule 6e-3(b)(15)(iii) for flexible premium variable life insurance contracts under the 1940 Act. Rule 6e-3(b)(14) for scheduled premium variable life insurance contracts has no parallel provision, but Rule 6e-2(b)(9)(i)(B) is deemed to apply for scheduled premium variable life insurance contracts under the 1940 Act. The SEC has not adopted a parallel provision for variable annuity contracts, but has administered the 1940 Act to provide so.

49 However, the SEC authorizes insurers to vote shares of underlying funds *without* regard to instructions from variable life insurance contract owners, if the instructions would require the shares to be voted: (i) to cause underlying funds to make (or retrain from making) certain investments that would result in changes in the sub-classification or investment objectives of underlying funds; (ii) to disapprove any contract between underlying funds and an investment

adviser when required to do so by an insurance regulatory authority; or (iii) in favor of changes in investment objectives, investment adviser of or principal underwriter for underlying funds. Rule 6e-3(b)(15)(iii)(A) for flexible premium variable life insurance contracts and Rule 6e-2(b)(14)(iii) for scheduled premium variable life insurance contracts under the 1940 Act. *See* IM Guidance Update, *supra* n.11, at 2. The SEC has not adopted a parallel provision for variable annuity contracts, but has administered the 1940 Act to provide so.

50 *See* Section 817(h)(1) of the Internal Revenue Code of 1986 and 26 CFR 1.817-5(a)(1).

51 The SEC refers to this cluster of issues as "mixed and shared funding," defined as follows:

> In the context of variable insurance contracts, "mixed funding" refers to the sale of the shares of a mutual fund to various types of offerees, such as when a fund is used as an investment option in both variable annuity contracts and variable life insurance contracts or when a fund is used as an investment option in both variable life insurance contracts and retirement plans. "Shared funding" refers to the sale of the shares of a mutual fund as an investment option in variable insurance contracts issued by multiple unaffiliated insurance companies.

IM Guidance Update, *supra* n.11, at 1.

52 Rule 6e-3 under the 1940 Act grants limited exemptions from Sections 9(a), 13(a), and 15(a) and (b) of the 1940 Act.

53 "For some time, mutual funds that are offered under variable life insurance contracts have typically applied for [exemptive] orders grant[ing] insurance companies and their affiliates the same exemptions from sections 9(a), 13(a), and 15(a) and (b) of the 1940 Act . . . ." IM Guidance Update, *supra* n.11, at 3.

54 "The conditions to this . . . relief include, among other things, that the fund board be composed of a majority of independent directors and that the board monitor for conflicts of interest among variable annuity contract owners and variable life insurance contract owners." *Id*. at 5, n.7.

55 Conflicts of interest contemplated by SEC rules have proved to be theoretical. Few, if any, material conflicts have been identified.

56 IM Guidance Update, *supra* n.11, citing, at 6 n.9; Maxim Series Fund, SEC No-Action Letter (pub. avail. July 31, 2009).

57 Section 817(h) of the Code imposes the following diversification requirements: no more than 55 percent of the value of the total assets of a separate account can be represented by any one investment; no more than 70 percent, by any two investments; no more than 80 percent, by any three investments; and no more than 90 percent, by any four investments. Section 817(h)(4) of the Code and the regulations thereunder provide a so-called "look-through rule" that tests compliance with the diversification requirement by looking not at the assets of a separate account, but rather the assets of the underlying funds whose shares the separate account owns. 26 CFR 1.817-5(c)(1) requires that compliance with the diversification requirements be tested at the end of each calendar quarter (or within 30 days thereafter).

58 26 CFR 1.817-5(a)(2) provides that if (i) the diversification failure was inadvertent, (ii) the failure is corrected within a reasonable time after the discovery of the failure, (iii) any adjustments required by the Commissioner of Internal Revenue are made and (iv) any amounts required by the Commissioner are paid, the variable insurance contract will be treated as having satisfied the diversification requirements.

59 Section 26(c) of the 1940 Act provides: "It shall be unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute another security for such security unless the Commission shall have approved such substitution." However, the SEC has announced its "position that the substitution by an insurance company of registered open-end investment companies used as Investment Options for variable life insurance policies or variable annuity contracts will not

provide a basis for an enforcement action if the insurance company does not obtain an order from the Commission under section 26(c) (and section 17(b) for certain substitutions) so long as the terms and conditions of the proposed substitution are substantially similar to those approved by a prior order for a substitution pursuant to section 26(c) obtained by the insurance company since January 1, 2004." SEC Substitution Statement, *supra* n.17, at 4-5 (footnote omitted).

[60] Section 26(c) of the 1940 Act provides: "The Commission shall issue an order approving such substitution if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

[61] SEC Substitution Statement, *supra* n.17. *See also* Allianz Life Ins. Co. of N. Am., Investment Company Act Release No. 34129 (Dec. 4, 2020), available at *https://www.sec.gov/rules/ic/2020/ic-34129.pdf*.