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SEC Update

By Gary O. Cohen

SEC Chair Gensler and IM Division Director Birdthistle Books Show Imprecise Knowledge of Variable Insurance Contracts

Securities and Exchange Commission (SEC) Chair Gary Gensler and Division of Investment Management (IM Division) Director William A. Birdthistle each has written a book[1] about the United States' investment systems in general and mutual funds and other investment products in particular. The books, written several years ago, show imprecise knowledge of variable annuity contracts and variable life insurance contracts (together, variable insurance contracts).

Chair Gensler incorrectly states that "[t]here's no federal regulator . . . of the variable annuity industry,"[2] overlooking many decades of SEC regulation under the federal securities laws.[3] Federal tax authorities[4] and the Department of Labor also regulate certain aspects of variable insurance products.

Chair Gensler discusses the "advantages"[5] and "ocean of fees"[6] of variable annuity contracts, but does not recognize the existence of variable life insurance contracts. He states that variable annuity contracts provide "payments over a specified number of years"[7] without explaining that, more significantly for retirement purposes, annuities can provide payments for *life*.

Director Birdthistle refers to "annuities,"[8] but his references seem to be to fixed annuity contracts. He does not refer specifically to either variable annuity contracts or variable life insurance contracts. He seems, at one point, to conflate deferred and immediate annuities.[9]

Since taking their positions at the SEC, Chair Gensler and Director Birdthistle have exhibited an openness to updating their knowledge of variable insurance products. The Insured Retirement Institute, a life insurance industry trade association, reported to its member life insurance companies that Chair Gensler and some of his Staff met with Institute representatives in February. Director Birdthistle, in his recent maiden speech to the Investment Company Institute, a mutual fund industry trade association with life insurance company members, announced[10] that his Staff is monitoring variable insurance contract disclosure.

Variable Insurance Contracts

In their books, both Chair Gensler and Director Birdthistle address the difficulties that individuals face in providing adequate monies for retirement. They attribute much of the difficulty to the limitations of the US social security system, the demise of pensions, and the rise of Section 401(k) plans and Individual Retirement Accounts (IRAs). They inventory various problems facing individuals in using retirement accounts, such as the generally low level of financial literacy and the drawbacks of mutual funds. In the process, they tick through the different kinds of mutual funds, such as target date funds, money market funds, and exchange traded funds.

It is not clear why Chair Gensler and Director Birdthistle do not even mention, must less address, variable life insurance contracts and provide only limited discussion of variable annuity contracts in their sweeping reviews of investment options available to the public. Variable insurance contracts, like mutual funds, offer the possibility of investment gains. In addition, variable annuity contracts, unlike mutual funds, provide guarantees such as annuity payments for life.

As a legal matter, Section 401(k) plans can hold annuity contracts either fixed or variable[11] and life insurance contracts either fixed or variable.[12] IRAs can hold annuity contracts either fixed or variable, but not life insurance contracts.[13]

As a marketplace matter, the mutual fund industry has long viewed variable insurance contracts as significant competition. For example, in the 1970s, the mutual fund industry fought, through six years of SEC rulemaking proceedings and litigation,[14] against full exemption from the federal securities laws sought by the life insurance industry for variable life insurance.

As a regulatory matter, life insurance separate accounts, like mutual funds, register with the SEC as investment companies under the Investment Company Act of 1940 (1940 Act). Life insurance companies register their separate account interests (or variable insurance contracts), like mutual fund shares, with the SEC as securities under the Securities Act of 1933. And separate accounts, like mutual funds of funds, invest their assets in registered shares of registered underlying mutual funds.

The absence of any mention of variable life insurance contracts by Chair Gensler and Director Birdthistle and limited discussion of variable annuity contracts is not entirely surprising. Generally speaking, even the most dedicated financial experts, academics, and securities regulators have not had exposure to variable insurance contracts. When they do have exposure, they face a steep learning curve. The tendency, consciously or unconsciously, has been to delay having to deal with variable insurance contracts.

This has certainly been true for the SEC. The SEC, in the 1950s and 1960s fought two lawsuits[15] to the US Supreme Court and one lawsuit[16] in the Third Circuit to assert jurisdiction over variable annuity contracts. The SEC, in the 1970s, sloughed through six years of rulemaking proceedings, as well as litigation, to implement[17] jurisdiction over variable life insurance contracts.

However, history shows that, once the SEC established jurisdiction, it has been slow to move variable insurance contracts into the regulatory mainstream.[18] For example, it took 11 years for the SEC to authorize[19] a summary prospectus for variable insurance contracts after the SEC did so[20] for mutual fund shares. It took 24 years for the SEC to amend[21] its rules to reflect Congressional amendments to the 1940 Act regarding variable insurance contract charges. It took 29 years for the SEC to adopt[22] a registration statement form for variable life insurance contracts and related separate accounts. It took 36 years for the SEC to convert[23] a temporary exemptive rule for variable life insurance into a permanent rule.

Chair Gensler on Variable Annuity Contracts

Chair Gensler makes the following statement:

> Economically, there is not much difference between mutual funds and variable annuities, especially when an annuity is invested in mutual funds. As

> a regulatory matter, however, the products differ a great deal. The Securities and Exchange Commission strictly regulates the mutual fund industry. They require a host of disclosures. *There's no federal regulator, however, of the variable annuity industry. Any disclosures depend on in which of the fifty states the insurance company operates.* (Memo to Congress: Isn't this a little silly?)[24]

Contrary to Chair Gensler's statement that there is no federal regulator of the variable annuity industry, the SEC has regulated variable annuity contracts and related entities under the federal securities acts for many decades. In addition, contrary to Chair Gensler's statement that the states regulate variable annuity contract disclosure, state insurance law[25] generally defers to the federal securities laws regulating disclosure, as well as such related matters as suitability. Congress has monitored the SEC's regulation of variable annuity contracts (as well as variable life insurance contracts) as evidenced by its amendment of the federal securities acts in various regards.[26]

Chair Gensler discusses "advantages"[27] of variable annuity contracts, stating that "variable annuities are akin to 401(k)s, albeit without qualifications or contribution limits."[28] He explains that "you purchase and contribute to an annuity during your productive years, and then begin receiving prefixed payments in retirement" or, with variable annuity payouts "retirement payments [that] depend on your investment returns."[29] He further explains that "variable annuities offer many of the same benefits as 401(k)s because earnings on your investments compound tax-free," and "[y]ou don't pay taxes on your yearly investment income and only begin paying taxes when you start receiving payments upon retirement."[30]

He notes that "[w]hen you reach retirement . . . variable annuities give you a choice" to "take your money in a lump sum . . . or . . . buy an annuity and receive payments over a specified number of years"[31] on either a fixed or variable basis. He neglects to state that variable annuity contracts offer the option of receiving payments for *life,* a major benefit in retirement.

Chair Gensler goes on to characterize "variable annuities" as the "[w]rong [w]ay to [p]repare for [r]etirement"[32] and to list the reasons.

He points out that "variable annuities are generally invested in high-cost mutual funds" and that the "insurance company takes a part of those fees either by operating the fund or by sharing a sales load with the fund company."[33] He claims that "[you] get practically nothing in return for the fees you pay the insurance company," because "the value of the insurance component in variable annuities is very small."[34] He also points to "a mortality fee," "'surrender fees' of up to 7 percent," and "a heavy 10 percent tax penalty."[35]

Chair Gensler's bottom line is "don't buy variable annuities."[36]

Director Birdthistle on Annuity Contracts

Director Birdthistle refers briefly to a "deferred annuity."[37] He does so in the context of an individual providing monies for his or her retirement.

He notes that an "an investor [can] draw down her own savings until her death—but those savings, if mismanaged, might easily run out too soon."[38] He hastens to explain that an annuity can protect a retiree against running out of assets, by providing "a regular stream of payments that the buyer will receive from the time of her retirement until her death."[39]

Director Birdthistle gives the example of "monthly payments of $50 for the rest of [the individual's] life."[40] This example seems to refer to fixed annuity contracts that pay a specified or fixed dollar amount of payments rather than variable annuity contracts that pay a varying dollar amount of payments.

Whatever Director Birdthistle has in mind, he recognizes that "[a]n annuity works just like—a pension."[41] He explains that "[a]nnuities are intended

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to ensure that their recipients are never left without any money."[42]

So, it would seem that he would proceed to explain how annuity contracts work and analyze their pros and cons, as he does with mutual fund shares. However, all he says is that "the cost of buying these individualized pensions is far, far higher than the cost of buying them in bulk as part of a large group of employees."[43]

As a technical matter, Director Birdthistle may not clearly distinguish between deferred and immediate annuity contracts. He refers to a "deferred annuity" bought for "a lump sum" and providing for "a regular stream of payments,"[44] which sounds more like an immediate annuity contract. In any event, he does not explain that a deferred annuity contract provides for a pay-in period that accumulates and invests purchase payments, on a tax-deferred basis, throughout an individual's working years and provides for conversion into a regular stream of payments at the individual's option upon retirement.

Conclusion

Books authored by Chair Gensler and Director Birdthistle address the fact that the United States generally has eliminated pensions, directed most individuals into retirement accounts of their own, and left them to fend for themselves by buying something just like a pension on their own. However, both stop short of discussing variable life insurance contracts and provide imprecise discussion of variable annuity contracts as products that individuals could buy for this purpose.

This could signal that Chair Gensler and Director Birdthistle will not be inclined to move variable insurance contracts into the SEC's regulatory mainstream. On the other hand, Chair Gensler and Director Birdthistle, early on in their tenures, have exhibited an openness to address variable insurance contracts.

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 and 1967 when the Third Circuit and US Supreme Court, respectively, held that the SEC has jurisdiction to regulate variable annuity separate accounts and 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 Ann B. Furman, Stephen W. Kraus, Thomas C. Lauerman, and the firm's librarian, Nicole Warren, for reviewing and contributing to this article. The views expressed are those of Mr. Cohen and do not necessarily reflect the views of his firm, its lawyers, or its clients.

NOTES

1 Chair Gensler's 2002 book is titled *The Great Mutual Fund Trap* [hereinafter Chair Gensler's Book]. For a summary and discussion of the Book, *see* Gary O. Cohen, "SEC Chair Gensler's Mutual Fund Views Revealed in His Book," *The Investment Lawyer*, Vol. 28, No. 11, at 21 (Nov. 2021). Director Birdthistle's 2016 book is titled *Empire of the Fund* and subtitled *The Way We Save Now* [hereinafter Director Birdthistle's Book]. For a summary and discussion of the Book, *see* Gary O. Cohen, "SEC IM Division Director William Birdthistle's Mutual Fund Views Revealed in His Book," Vol. 29, No. 4, at 24 (Apr. 2022).

2 Chair Gensler's Book, *supra* n.1., at 281-282. *See infra* ns.25 and 26 and accompanying text.

3 *See* Gary O. Cohen, "A Short Telling of the Wacky History of How the SEC Came to Regulate Life Insurance Company Separate Accounts and Products," *The Investment Lawyer,* Vol. 23, No. 5, at 1 (May 2016) [hereinafter Cohen History Article].

4 *See infra* nn.11-13 and accompanying text.

5 Chair Gensler's Book, *supra* n.1, at 280.

6 *Id*. at 283.

7 *Id*. at 280.

8 Director Birdthistle's Book, *supra* n.1 at 6-8, 20, 143, and 212-213.

9 *Id*. at 212. *See infra* nn.39-40 and accompanying text.

10 Director Birdthistle announced:

> Commission staff have also continued to assist registrants in providing the most useful disclosure to fund investors. Illustrating this commitment, the staff of our Disclosure Review and Accounting Office is currently deep into its second busy season reviewing variable annuity and variable life filings. Since the adoption of the variable products summary prospectus almost two years ago, DRAO has reviewed more than 220 filings relating to more than 280 contracts.

William A. Birdthistle, Director, SEC Division of Investment Management, Remarks at the ICI Investment Management Conference (Mar. 28, 2022), available at *https://www.sec.gov/news/speech/birdthistle-remarks-ici-investment-management-conference-032822?utm_medium=email&utm_source=govdelivery.*

11 *See* Section 404(a)(2) of the Internal Revenue Code of 1986.

12 *See* Treas. Reg. 1-401-1(b)(1)(i). Revenue Service regulations and revenue rulings imposes premium limitations on life insurance contracts beyond those imposed in Section 7702.

13 *See* Section 408(b) of the Internal Revenue Code of 1986.

14 *See* Cohen History Article, *supra* n.3.

15 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).

16 Prudential Ins. Co. v. SEC, 326 F.2d 383 (3rd Cir.), *cert. denied*, 377 US 953 (1964).

17 *See Separate Accounts of Life Insurance Companies Funding Certain Variable Life Insurance Contracts,* Investment Company Act Release No. 9482 (Oct. 18, 1976) (adopting exemptive rules for variable life insurance).

18 *See* generally Gary O. Cohen, "SEC Acts on Variable Insurance Matters Stretching Back for Decades," *The Investment Lawyer,* Vol. 27, No. 7, at 28 (July 2020) [hereinafter Cohen Variable Insurance Article].

19 *Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts,* Securities Act Release No. 10765, Exchange Act Release No. 88358, Investment Company Act Release No. 33814 (Mar. 11, 2020) [hereinafter SEC Updated Disclosure Release], available at *https://www.sec.gov/rules/final/2020/33-10765.pdf. See* Cohen Variable Insurance Article, *id.* at 29.

20 *See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 8998, Investment Company Act Release No. 28584 (Jan. 13, 2009), available at *https://www.sec.gov/rules/final/2009/33-8998.pdf,* and Cohen Variable Insurance Article, *supra* n.18, at 29.

21 *See* SEC Updated Disclosure Release, *supra* n.19, and Cohen Variable Insurance Article, *supra* n.18, at 30.

22 *See Registration Form for Insurance Company Separate Accounts Registered as Unit Investment Trusts that Offer Variable Life Insurance Policies*, Securities Act Release No. 8088, Investment Company Act Release No. 25522 (Apr. 23, 2002) (adoption of Form N-6) and Cohen Variable Insurance Article, *supra* n.18, at 29.

23 *See* SEC Updated Disclosure Release, *supra* n.19, at 479, and Cohen Variable Insurance Article, *supra* n.18, at 30.

24 Chair Gensler's Book, *supra* n.1, at 281-282 (emphasis added).

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25 *See* the National Association of Insurance Commissioners [NAIC] 2021 "Annuity Disclosure Model Regulation (Model 245)," that provides, in Section 3.D.(1), that the Regulation does not apply to "[t]ransactions involving variable annuities and other registered products in compliance with Securities and Exchange Commission (SEC) rules and Financial Industry Regulatory Authority (FINRA) rules relating to disclosures and illustrations . . . ." available at *https://content.naic.org/sites/default/files/MO245_1.pdf; and* the NAIC 2020 "Suitability in Annuity Transactions Model Regulation (Model 275)" that provides, in Section 6.E., a "Safe harbor" for not complying with the Regulation to the extent that "[r]ecommendations and sales of annuities made in compliance with comparable standards [*e.g.*, SEC and FINRA best interest and suitability requirements under the federal securities laws] shall satisfy the requirements under this regulation," available at *https://content.naic.org/sites/default/files/MO275.pdf.*

26 For example, in 1996, Congress amended the Investment Company Act of 1940 to remove limitations on individual charges under variable insurance contracts and substitute a reasonableness standard for aggregate charges and to require disclosure of certain related representations. *See* National Securities Market Improvement Act of 111996 (Pub. L. No. 104-290, 110 Stat. 341666 (1996).

27 Chair Gensler's Book, *supra* n.1, at 280.

28 *Id*.

29 *Id*.

30 *Id*.

31 *Id*.

32 *Id*. Chair Gensler also states that "we don't like variable annuities." *Id*. at 281.

33 *Id*.

34 *Id*.

35 *Id*. at 282.

36 *Id*. at 280.

37 Director Birdthistle's Book, *supra* n.1, at 212.

38 *Id*.

39 *Id*.

40 *Id*.

41 *Id*. at 213.

42 *Id*. at 212.

43 *Id*. at 213.

44 *Id*. at 212.

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