Modernizing The Variable Contract Disclosure Regime

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The U.S. Securities and Exchange Commission recently proposed a new disclosure framework for SEC-registered variable annuity contracts and variable life insurance policies (together, variable contracts) that reflects almost a decade of major insurance industry (and SEC staff) efforts to develop a more modern and effective regime for variable contract prospectus disclosure. Among other things, proposed Rule 498A would permit (but not require) the use of summary prospectuses for variable contracts, with additional information available to investors online. To help investors make informed investment decisions, the SEC’s proposal uses a layered disclosure approach similar to what has been in place for mutual funds. It is designed to provide investors 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, or delivered in paper or electronic format on request.

The proposing release notes that variable contracts can be complicated products, whose operation and terminology can be difficult for investors to understand, and the contract prospectuses are often quite lengthy. Moreover, the contract prospectuses are typically bundled with, or accompanied by, prospectuses for all of the available underlying funds (averaging 59 for variable annuities, 64 for variable life insurance, and some offering more than 250) and that all of these prospectuses are delivered to investors not only at the time of purchase but also annually thereafter. The commission expressed its concern that the volume, format and content of these current disclosures may make it difficult for investors to find and understand key information that they need to make informed investment decisions. The summary prospectus and related proposals address these concerns.

In addition to the optional summary prospectus, the SEC, to its credit, has taken this opportunity to review and examine many, if not most, of its various disclosure requirements and Investment Company Act rules and regulations applicable to variable contracts. The SEC is proposing numerous updates and revisions (including required statutory prospectus revisions) and is inviting comment on a wide range of these matters. Overall, the proposals are the most significant advancement in variable contract disclosure since the adoption of registration statement forms
specifically designed for variable contracts. The proposals (and accompanying requests for comment) are also an opportunity to modernize a disclosure delivery regime that has clearly become outmoded, costly, and, perhaps most importantly, ineffective.

Because variable contracts typically include a number of optional benefits and numerous underlying investment options, a summary prospectus could not, by its very nature, include all relevant aspects and details regarding each of these contract features. The variable contract summary prospectus would serve as the cornerstone of a new layered disclosure framework that would alert investors to the availability of more detailed information in the statutory prospectus and in other locations.

The proposed new disclosure framework would include the following elements:

Option to Use Summary Prospectuses

Proposed new Rule 498A would permit the use of two distinct types of variable contract summary prospectuses:

1. An “initial summary prospectus” for new sales; and
2. An “updating summary prospectus” for in-force business (i.e., for annual updates to existing contract owners).

As discussed in detail below, both would include certain specified (required) information in plain English in a prescribed order with standardized headings.

Availability of Variable Contract Statutory Prospectus and Other Materials

The proposed rule would require the variable contract statutory (i.e., Section 10(a)) prospectus, as well as the contract’s statement of additional information (SAI) and summary prospectus, to be publicly accessible, free of charge, at a website address specified on the cover of the summary prospectus. An investor who receives a contract summary prospectus would be able to request the contract statutory prospectus and SAI in paper or electronically, at no cost to the investor.

Optional “Access Equals Delivery” Method to Satisfy Portfolio Company Prospectus Delivery Requirements

The commission is proposing a groundbreaking optional method for satisfying underlying mutual fund prospectus delivery obligations. This optional delivery method would make portfolio company summary and statutory prospectuses available online at the website address specified on the variable contract summary prospectus, which itself would contain certain information about the portfolio companies in tabular format. Investors would also be able to request and receive those portfolio company prospectuses on paper or electronically at no cost. This new option for satisfying portfolio company prospectus delivery requirements would be available only to variable contracts that use contract summary prospectuses pursuant to Rule 498A and only in conjunction with mutual funds that rely on the mutual fund summary prospectus rule.
“Great-Wested” Contracts

Based on the “Great-West” line of no-action letters, which date back to 1977, many insurance companies have stopped maintaining registration statements and delivering updated prospectuses for variable contracts that are no longer for sale and have relatively few contract owners (typically fewer than 5,000 contract owners, with certain no-action letters permitting substantially more). The proposing release notes that “more than half of variable contract Securities Act registration statements” combined annuity and life rely on Great-West, 855 out of 1,576, based on the SEC’s study of EDGAR filings. The commission intends to “grandfather” contracts that are relying on the Great-West line of no-action letters as of the effective date of the final summary prospectus rules, permitting them to continue the practice of not filing annual updates to their registration statements, but not allow “new” reliance on those no-action letters for contracts that are not Great-Wested as of the effective date. The commission is also soliciting comment on alternative approaches to providing disclosure for discontinued contracts. Grandfathered Great-Wested contracts would not be permitted to utilize the optional-access-equals-delivery method to satisfy underlying fund prospectus delivery requirements.

Statutory Prospectus and Registration Statement Form Amendments

The commission is also proposing major changes to variable contract registration statement forms (Forms N-3, N-4 and N-6), including substantial revisions to the form and content of statutory prospectus disclosure. The proposed statutory prospectus and form amendments would reflect the summary prospectus disclosure requirements (and would apply even if the summary prospectus is not used), and are intended to: achieve greater consistency in presentation of information in variable contract registration forms; consolidate certain summary information about the contract and the available underlying funds in a condensed, tabular presentation; highlight contract benefits (particularly optional living benefits), as well as the principal risks of investing in the contract; and otherwise improve disclosures provided to variable contract investors. Registrants would be required to use the inline XBRL format for the submission of certain variable contract information.

Updating, Conforming and Technical Rule Amendments

The SEC is proposing numerous rule revisions, rescissions, and technical and conforming amendments to reflect the proposed new variable contract disclosure regime, as well as to reflect statutory revisions and other developments that have occurred over the past 20-plus years.

Summary Variable Contract Prospectuses

One of the most significant aspects of the SEC’s proposed revisions is the permissible use of “summary” variable contract prospectuses for both new sales and annual “evergreen” prospectus delivery updates: the initial summary prospectus and the updating summary prospectus, respectively. The SEC’s proposed new disclosure framework reflects the commission’s consideration of multiple inputs, including: the operational complexity and unfamiliar terminology often associated with variable contracts; the length of contract prospectuses; the number of contract iterations covered by a single prospectus; the general availability of a wide range of investment options; the proliferation of guaranteed contract benefits; and the practice of bundling the underlying fund prospectuses with the variable contract prospectus. The sheer volume and complexity of disclosures investors now must wade through demonstrate that the current variable contract disclosure regime is ineffective in enabling investors to find and understand the key
information they need to make informed investment decisions. Through the proposal, the SEC seeks to improve this disclosure framework, as well as modernize the manner in which variable contract investors receive and review prospectuses.

Permitting the use of summary prospectuses for variable contracts reflects the SEC’s commitment to ensuring that investors have access to a well-crafted package of information that facilitates informed decision-making, and to building on its successful experience with Rule 498, the mutual fund summary prospectus rule, which served as a catalyst for the insurance industry’s long-standing advocacy for a parallel disclosure regime for variable contracts.

Like the mutual fund summary prospectus, proposed Rule 498A would rely on a layered disclosure approach, which is designed to provide investors with key information relating to the variable contract’s terms, benefits and risks in both a concise and more reader-friendly presentation, with summary prospectuses serving as the cornerstone of this layered disclosure framework. Like the mutual fund layered disclosure regime, the summary prospectuses would alert investors to the availability of more detailed information in the statutory prospectus and would incorporate that prospectus and SAI by reference. Such statutory prospectuses would be delivered upon demand, either electronically or in paper format, free of charge.

Initial Summary Prospectus

First and foremost, an initial summary prospectus would be a point-of-sale document that is used solely with new purchasers. In addition, while the general industry practice has been to combine multiple and/or iterative contract offerings reflecting product design updates into a single registration statement and/or prospectus, the initial summary prospectus would only be permitted to describe the features of a single, currently available contract (commonly referred to as a “new business” contract). The initial summary prospectus can, however, encompass multiple classes of that single contract. A “hypothetical” initial summary prospectus is included with the SEC release.

In an initial summary prospectus, proposed Rule 498A would require the following disclosure sections in this prescribed order: (1) a cover page; (2) contract overview; (3) important considerations; (4) standard death benefit; (5) other benefits; (6) buying the contracts (or premiums, for variable life); (7) lapse information (for variable life); (8) surrenders and withdrawals; (9) additional information about fees; and (10) an appendix containing specified underlying mutual fund information. In addition, the meaning of any “special terms” are required to be clearly conveyed, either in a glossary or on an “as used” basis.

Each section has a specified list of disclosure items that must be included. Several sections are required to be presented in a tabular format. There are various required legends in each section, presented either as lead-ins to certain information or as a simple stand-alone disclosure.

In the same or varying format, all required sections are also required to be repeated in the statutory prospectus. A version of the important considerations section, which is comprised of a “key information table,” and the fund appendix are also required in the updating summary prospectus.

Updating Summary Prospectus

Proposed Rule 498A would permit insurers to satisfy annual (“evergreen”) contract prospectus delivery obligations for existing contract owners by sending an annual updating summary
prospectus in lieu of the corresponding statutory prospectus. The updating summary prospectus is built off of the initial summary prospectus and would include a similar important considerations section and mutual fund appendix. A “hypothetical” updating summary prospectus is included with the SEC release.

Unlike the initial summary prospectus, the updating summary prospectus can cover multiple contracts. The audience is not new investors, but rather existing contract owners, i.e., investors who have already made an initial purchase decision. In effect, rather than sending variable contract owners a 100-plus page variable contract prospectus each year, which typically contains very few year-over-year changes that are not readily identifiable, Rule 498A would allow insurers to send the short updating summary prospectus highlighting important changes and other information.

As proposed, the updating summary is designed to focus contract owners’ attention on new or updated information, as well as to remind them of the key features of their variable contracts. The SEC premised this disclosure approach, in part, on its belief that highlighting “important” changes — certain types of changes that would be prescribed — will provide the information investors need in considering whether to continue making additional purchase payments and/or to reallocate contract value (or even whether to continue or surrender their contracts).

Specifically, Rule 498A would require the following content items be presented in this order in an updating summary prospectus: (1) a cover page; (2) updated information about the contract (see below); (3) important information to consider; and (4) an appendix containing specified underlying fund information.

Updated information relating to the following changes would be required in the summary updating prospectus: (1) the availability of portfolio companies; (2) the statutory prospectus disclosure relating to the fee table; (3) the standard death benefit; and (4) the other benefits available under the contract. The updating summary prospectus could also include a concise description of any other changes to the contract that the registrant wishes to disclose, provided they occurred within the same time period.

Practical Implications, Implementation Steps and Challenges

As outlined above, the SEC’s proposed layered prospectus disclosure regime for variable contracts would allow insurers to provide a concise disclosure document at the point of sale — the point in time when investors are making an initial purchase decision. Subsequently, on an annual basis, contract owners would receive an updating summary prospectus that focuses their attention on important changes, as well as items that would be relevant to ongoing investment decisions. Both initial investors and existing contract owners would receive more fund information about available underlying funds in their variable contract prospectuses and be directed to online fund prospectuses for further information. In most cases, the initial and updating summary prospectuses, respectively, would be as much as 100 pages shorter than what investors currently receive. In addition, the inclusion of consolidated fund information, in lieu of actual delivery of fund prospectuses, could also result in investors receiving hundreds less pages.

Embracing this layered disclosure regime, however, will take some work and is not without certain challenges. The overarching implementation steps that life insurance companies will need to contemplate and plan for include the following:
• Amending all Form N-4 and N-6 registration statements to comply with the new form disclosure requirements. The new requirements, as proposed, are quite sweeping and will require considerable insurer resources and drafting time. Perhaps most notably, statutory prospectuses that cover multiple variable contract iterations will have to be modified to include tables that summarize certain key contract information specific to all such contract iterations, as well as the benefits (and their permitted funds) offered by each iteration. These changes will have to be reflected in Rule 485(a) filings.
  o The form amendments are not voluntary: they are required even if an insurer elects not to use a summary prospectus.
  o There will be a transition period from the effective date of the final rule and form amendments to the compliance date, i.e., insurers will have a period of 18 months to amend their registrations statements. However, insurers can begin using summary prospectuses any time after the effective date, provided that the correlating registration statement statutory prospectus and other information has been amended. This will likely put pressure on some insurers to amend their registration statements early in the transition period.
• Creating, for their active Form N-4 and Form N-6 registration statements, as applicable, a template initial summary prospectus and updating summary prospectus. These, too, will have to be included in Rule 485(a) filings.
• Work streams will have to be created to capture the increased fund information required to be included in the new fund appendix, which is required in the statutory prospectus, as well as in the initial and updating summary prospectuses.
• Insurers that wish to stage these steps should note that neither an initial nor an updating summary prospectus may be used unless the correlating statutory prospectus has been amended to reflect the new form disclosure requirements.
  o In addition, no updating summary prospectus can be used for any variable contracts registered in a registration statement that is the vehicle for a current variable contract offering unless that current contract offering relies on Rule 498A (i.e., utilizes an initial summary prospectus).

However, if no current variable contract offering is being made via a registration statement, an updating summary prospectus still can be used as long as the related statutory prospectus has been amended.
• Insurers will need to take the necessary steps to ensure that any current initial summary prospectuses, updating summary prospectuses, statutory prospectuses and SAI s are available online, printable and electronically retainable. The summary prospectuses must be hyperlinked in a prescribed manner, to the underlying statutory prospectus, and the statutory prospectus to the SAI.
• Insurers will need to take steps, for the first time in the context of variable contracts, to ensure they are able to file certain disclosure using the inline XBRL format.
The SEC’s proposed new layered prospectus disclosure regime for variable contracts represents a major step forward in modernizing the disclosure and delivery requirements imposed by the federal securities laws on the variable insurance products industry, and recognizes the pervasive use of electronic media by the investing public. The sheer breadth of the proposal represents a substantial effort by the Division of Investment Management to implement the overarching investor protection and disclosure effectiveness goals set by Chairman Jay Clayton. The proposing release raises a number of issues on which the commission is soliciting comment. Interested parties will be well-served to study carefully the details of what the commission has proposed and to comment on those aspects that can be refined or improved.

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