FITTING VARIABLE LIFE INSURANCE AND VARIABLE ANNUITIES INTO THE REGULATORY FRAMEWORK OF THE INVESTMENT COMPANY ACT OF 1940

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I. Introduction

This outline discusses the applicability of the Investment Company Act of 1940, as amended, (the “1940 Act”) to variable annuity contracts (“VA contracts”) and variable life insurance contracts (“VLI contracts”) (together, “variable contracts”) as well as to separate accounts supporting such contracts (either, “VA accounts” or “VLI accounts,” as appropriate). Outlines prepared by the other speakers at this conference explain why variable contracts are securities, as well as other closely related issues arising under 1940 Act, such as advertising and illustrations of variable contracts performance and market conduct in their sale.

The regulation of VA and VLI contracts and their related separate accounts under the federal securities laws, particularly the 1940 Act, presents questions of application and interpretation that defy easy analysis. The regulation of variable contracts represents an attempt to fit the round peg of insurance products into the square hole of federal securities regulation. This result is not surprising when viewed in its historic context. With the exception of two important provisions enacted in 1996 (discussed below), the 1940 Act presents a regulatory regime designed primarily with mutual funds and other investment products and services that existed in 1940 in mind. Such products did not include variable contracts.

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1 For a general overview of how variable contracts operate under federal securities and tax laws and regulations, see Frederick R. Bellamy & Steven B. Boehm, The Investment Company Regulation Desk Book, ch. 17 (Amy L. Goodman ed., Supp. 1998). Certain parts of this outline were excerpted from this source. For an in-depth discussion of the application of many of the federal securities laws to variable contracts, see Division of Investment Management, U.S. Securities and Exchange Commission, Protecting Investors: A Half Century of Investment Company Regulation at 373 (1992) (hereinafter, the “SEC Report”).
II. Variable Contracts and Separate Accounts

A. Variable Contracts

1. **Variable Annuity Contracts.** An annuity contract is one under which an insurer agrees to make a series of payments for a specified period, such as a fixed period or for the life of a designated individual. If the contract is an “immediate annuity,” payments begin shortly after the initial purchase payment. Under the more common “deferred annuity,” payments do not begin until some future date selected by the owner or set by the contract. Contract owners purchase annuity contracts by paying either single, periodic, or flexible purchase payments.

The benefits (i.e., the payments) under an annuity contract are either fixed in amount or variable (i.e., may vary from payment to payment). Likewise, during the accumulation period under a deferred annuity contract, the benefits (e.g., death benefits, cash surrender value) are funded on either a fixed or variable basis. Under a “fixed” payment contract, the insurance company guarantees that a minimum rate of interest will be credited to the owner’s account during the accumulation or pay-in period, and also guarantees that once the pay-out period begins, payments will be a certain guaranteed amount per dollar accumulated. During the accumulation period of a fixed annuity, payments are allocated to the insurance company’s general account, which is invested in accordance with state law. A VA contract, by contrast, provides for values that vary directly with the investment performance of the funding vehicle to which the contract owner’s payments are applied. Under a VA contract, cash value is invested in the insurer’s separate account, which typically offers the contract owner a number of investment options. Payment to the contract owner during the annuity period may be variable or fixed, depending on the annuity options selected.

2. **Variable Life Contracts.** VLI contracts are similar to whole life insurance contracts, except that the cash value and/or the death benefit vary with the investment performance of the separate account in which the cash value is invested. Under a whole life contract, purchase payments are allocated to an insurer’s general account and invested conservatively (as required by state law) to insure that the company is able to meet its death benefit and cash value guarantees. The investment return on assets in a general account has little or no direct effect on the cash value or on the death benefit received.
Net purchase payments and subsequent cash value under a VLI contract, by contrast, are invested in the insurance company’s separate account, which generally is not subject to state law requirements that the assets be invested conservatively. A VLI contract owner, like his or her VA contract counterpart, typically has a number of investment options from which to choose. Death benefits and cash values are directly related to performance of the separate account, although typically there is a minimum below which the death benefit is guaranteed not to fall. VLI contracts either require scheduled purchase payments or permit flexible payments. Under a scheduled payment contract, payments are fixed as to both timing and amount. Under a flexible payment contract, a so-called “variable universal life” contract, the owner may vary the amount and the frequency of the purchase payments as well as the level of the death benefit protection.

B. Separate Accounts Under State Insurance Law

Insurance company separate accounts are creatures of state law. Each of the states has adopted a legal framework under its insurance laws enabling insurers to establish separate accounts. Although separate account laws may vary from state to state, they generally contain several key provisions. The most fundamental statutory provision states that the income, gains and losses, realized or unrealized, from assets allocated to the separate account shall be credited to or charged against the account without regard to the other income, gains or losses of the insurer.

Separate account laws make it clear that the separate account is essentially an accounting mechanism. They ordinarily provide that amounts allocated to the account are owned by the insurer, and the insurer shall not be, nor hold itself out to be, a trustee with respect to those amounts. Variable contract owners thus neither hold legal title to, nor have any beneficial ownership interests in, the assets of the separate account. Separate account laws do, however, usually provide that the portion of the assets of the separate account equal to the reserves and other liabilities with respect to the variable contract issued through the account will not be charged with liabilities arising out of any other business the insurer conducts. To that extent, assets of separate accounts are segregated from other assets of the insurer that are subject to the claims of other creditors. Consistent with the segregation of separate account assets, insurers file separate financial reports for their separate accounts in addition to the annual financial statements required to be filed on prescribed forms with the insurance regulatory agency in their state or other jurisdiction of domicile as well as the insurance commissions of other jurisdictions.
C. **Separate Accounts Under the 1940 Act**

1. **Insurance Companies as Investment Companies.** Section 3(a)(1) of the 1940 Act generally defines an investment company as an issuer of securities whose assets are invested primarily in securities. Therefore, but for the general exclusion in Section 3(a)(8) of the Securities Act of 1933, as amended, (the “1933 Act”) of insurance contracts from the definition of a security, all life insurance companies would be investment companies. Fortunately, Section 3(c)(3) of the 1940 Act excludes insurance companies, as defined in Section 2(a)(17) of the 1940 Act, from the definition of an investment company. Section 2(a)(17), in turn, defines an insurance company as a state regulated company whose primary and predominant business is the writing of insurance. Regulation as investment companies would be unworkable for insurance companies because the 1940 Act subjects investment companies to corporate governance and operational requirements that conflict with the manner in which insurers conduct their business and are regulated by the state insurance departments.

2. **Separate Accounts as Investment Companies.** Notwithstanding that an insurance company is not an investment company, a VA or VLI account is generally an investment company under the 1940 Act and an insurance company’s operations related to VA and VLI contracts are generally subject to the various regulatory requirements of the 1940 Act.

   The recognition that a separate account should be viewed as an investment company that issues variable contracts separate from the insurance company dates from 1964. That year, the Third Circuit in *Prudential Ins. Co. v. Securities and Exchange Commission* upheld the position of the Securities and Exchange Commission (“SEC”) that, where the separate account was only part of the insurer’s business and the insurer was otherwise entitled to rely on the Section 3(c)(3) exclusion from the definition of an investment company, the separate account rather than the insurer should be treated as the issuer of an investment company security, and should therefore be deemed the “investment company” for purposes of the 1940 Act.

3. **The Consequences of Separate Accounts Being Investment Companies.** The federal securities laws, in effect, provide a separate account with legal existence independent of that of its insurance company. Thus, for 1940 Act purposes, the separate account is treated as the investment company and owner of its assets, and the insurer is treated as the sponsor or “depositor” of the separate account. For purposes of both the 1933 Act and the 1940 Act, a
separate account, as a separate entity, is generally treated as the issuer of the variable contract. The insurer establishing the separate account is viewed as a co-issuer or guarantor of the contracts issued through the separate account. Consistent with this analytical framework, both the separate account and the insurer are parties to the 1933 Act registration statement for the variable contracts, and financial statements for each are included in the registration statement.

4. **Separate Accounts That Are Not Investment Companies.**

Notwithstanding the foregoing, not all variable contract separate accounts are investment companies under the 1940 Act. There are three exclusions from the 1940 Act definition of an investment company that could, depending on the circumstances, apply to a separate account. One is an exclusion set forth in Section 3(c)(11) of the 1940 Act for separate accounts funding contracts issued to qualified retirement plans, and the other two are exclusions, set forth in Sections 3(c)(1) and 3(c)(7), for investment companies that only offer their securities in non-public offerings (i.e., private placements).

a. **Separate Accounts Supporting Variable Contracts Issued in Connection With Qualified Plans.**

(1) **Scope of the Section 3(c)(11) Exclusion.** Section 3(c)(11) excludes from the definition of an investment company any separate account the assets of which are derived solely from (i) contributions under pension or profit-sharing plans which meet the requirements of Section 401 of the Internal Revenue Code of 1986 (the “Code”) or the requirements for deduction of the employer’s contribution under Section 404(a)(2) of the Code, (ii) contributions under governmental plans meeting the requirements of Section 414(d) of the Code, and (iii) advances made by the insurer in connection with the operation of such separate account.

In order to fall within this exclusion, a separate account may not support any contracts issued by an insurer except those issued to the enumerated qualified or governmental plans. The failure to abide by this exclusivity requirement would cause the entire separate account to lose the exclusion.

The types of plans which are permitted are the same as those covered by the Section 3(a)(2) exemption under the 1933 Act,
except that the 3(c)(11) exclusion covers any plan qualified under Section 401 of the Code, including H.R. 10 or Keogh plans. As is the case with the 1933 Act exemption, the 3(c)(11) exclusion does not extend to separate accounts supporting contracts issued in connection with Section 403(b) plans, IRAs, and nonqualified deferred compensation plans which are not governmental plans. Section 457 governmental plans do, however, qualify for both the Section 3(a)(2) exemption under the 1933 Act and the Section 3(c)(11) exclusion under the 1940 Act.

(2) **Conditions Applicable Under Section 3(c)(11).** Questions have arisen from time to time concerning whether certain situations fall within the Section 3(c)(11) exclusion. For example, if the individual qualified plan assets are not contributed directly to the separate account but are invested in one or more intermediate investment vehicles which in turn invest in the separate account, questions have been raised concerning whether the separate account assets are in fact derived solely from qualified plans or whether those intermediate investment vehicles change the character of the assets. Similarly, because the definition of a “separate account” contained in Section 2(a)(37) of the 1940 Act provides that a separate account must be “established and maintained” by an insurance company, questions have been raised about situations where the insurer delegates some or all of the responsibility for operating the separate account to third parties.

The SEC staff has issued a number of no-action letters addressing these types of situations. The letters involve complicated structures and the SEC responses turn on the particular facts and circumstances. These letters should be consulted to determine whether a particular separate account structure raises any significant issues under Section 3(c)(11).

b. **Private Placement Separate Accounts Under Section 3(c)(1).** Under Section 3(c)(1), any issuer of securities, including a separate account of an insurance company, that would otherwise meet the definition of investment company in Section 3(a)(1) of the 1940 Act is excluded from the definition if (i) its outstanding securities (here variable contracts) are beneficially owned by 100 persons or less, and (ii) it is
not making, and does not propose to make, a public offering of its securities.

Therefore, to fall within the Section 3(c)(1) exclusion, there can be no more than 100 beneficial owners of variable contracts (99 beneficial owners if the insurer has seed money in the separate account). The provisions of Section 3(c)(1) effectively state that a corporation is considered a single beneficial owner for this purpose, except that one must “look-through” the corporation to its underlying security holders if the company (i) owns 10% or more of the securities of the Section 3(c)(1) issuer, and (ii) is, or but for the exclusion under Section 3(c)(1) (or Section 3(c)(7) discussed below) would be, an investment company. In addition, the separate account must only be making, or proposing to make, offerings of securities qualifying for the Section 4(2) exemption under the 1933 Act or Regulation D thereunder.

There have been a series of interpretive and no-action letters issued by the SEC staff over the years that define the scope of the Section 3(c)(1) 100 beneficial owner requirement. For example, the SEC staff considers joint owners to each be one owner for purposes of this requirement. In addition, participants in participant-directed defined contribution plans generally are each considered a beneficial owner for this purpose. See, e.g., PanAgora Group Trust (pub. avail. Apr. 29, 1994).

Before relying on these letters, however, practitioners should carefully consider the impact of the “Investment Company Act Amendments of 1996” (“ICAA”) (Title II of the “National Securities Markets Improvement Act of 1996”) (discussed in more detail in Section III.A.1), which simplified the manner in which the number of beneficial owners is calculated for purposes of the 100-owner limit. In an interpretive letter to the American Bar Association Section of Business Law on April 22, 1999, the SEC responded to twenty-six specific questions prompted by provisions of the ICAA relating to private investment companies, and the rules enacted by the SEC to implement those provisions.

Separate accounts qualifying for the Section 3(c)(1) exclusion need not comply with any provision of the 1940 Act except certain provisions of Section 12. Those provisions prohibit such a separate account from purchasing more than 3% of any registered investment company’s
securities, and prohibit registered investment companies from selling more than 3% of their securities to any Section 3(c)(1) separate account. Section 12 does, however, contain conditional exceptions to the foregoing prohibitions.

c. **Private Placement Separate Accounts Under Section 3(c)(7).** The ICAA added Section 3(c)(7) to the 1940 Act as an additional exclusion from the definition of an investment company. As with the Section 3(c)(1) exclusion, to fall within the Section 3(c)(7) exclusion, the issuer may not make, or propose to make, a public offering of its securities (here variable contracts) under the 1933 Act. However, instead of limiting beneficial owners of the separate account’s securities to 100, Section 3(c)(7) in effect requires that all variable contract owners be “qualified purchasers” at the time the investment is made. “Qualified purchasers” are defined in Section 2(a)(51) to include:

- any natural person (including such person’s spouse if they invest jointly) who owns at least $5 million in “investments”;

- specified family-owned companies with at least $5 million in investments;

- certain trusts, not formed for the specific purpose of acquiring the securities offered, established and funded only by qualified purchasers for which investment decisions are made by a qualified purchaser; and

- other persons (such as institutional investors) that own and manage on a discretionary basis at least $25 million in investments.

The SEC has adopted rules defining “investments” for purposes of the Section 3(c)(7) exclusion.

Since the enactment of this exclusion, a number of questions have been raised about the proper interpretation of Section 3(c)(7) and the rules adopted by the SEC to implement Section 3(c)(7). The interpretive letter to the American Bar Association Section of Business Law noted above explores some of these questions, including questions related to the “qualified purchaser” determination.
D. **Separate Account Structures**

1. **Separate Account Structures Under the 1940 Act.** When registering under the 1940 Act, investment companies must elect one of the several classifications of investment companies listed in the 1940 Act. Separate accounts elect to register either as management investment companies (a “managed account”) or unit investment trusts (a “trust account”).

   a. **Managed Separate Accounts.** Managed accounts invest directly in a portfolio of securities or other investments. This type of separate account, which was the predominant type during the early years of variable product history, is registered as a management investment company because the active management of the investment portfolio occurs at the separate account level, and like other management investment companies (e.g., mutual funds), a managed account maintains a board of directors (sometimes called a board of managers or a management committee) that performs the functions imposed by the 1940 Act on the directors of a management investment company.

   b. **Unit Investment Trust Separate Accounts.** The trust account structure involves two tiers. Instead of the separate account investing directly in securities or other investments, it invests in the securities of another investment company whose portfolio, in turn, may be actively managed. The underlying investment company can be either an open-end management company, the most common scenario, or another unit investment trust. An underlying investment company offering securities to a trust account must itself be registered under the 1940 Act and register its securities under the 1933 Act. Most variable contracts on the market today are offered through this two-tier structure involving a trust account and an underlying management investment company (an “underlying fund”).

   Typically, variable contracts issued through trust accounts offer a number of underlying funds as investment options, such as money market funds, bond funds, common stock funds and other specialized funds. Where more than one investment option is offered, the trust account is usually divided into a number of subaccounts (sometimes called “divisions”) each of which holds exclusively the shares of one of the underlying funds.
2. **Separate Account Structures For Qualified Plan and Private Placement Separate Accounts.** Variable contract separate accounts relying on the Section 3(c)(1), 3(c)(7) and 3(c)(11) exclusions from the 1940 Act utilize both the managed account structure and the trust account structure.

III. **Regulation of Variable Contracts and Separate Accounts Under the 1940 Act**

A. **Variable Contract Charge Regulation Under the 1940 Act**

1. **1996 Legislation.** Until the ICAA’s passage in 1996, the 1940 Act and regulations thereunder placed specific limitations on the various charges that could be deducted under variable contracts. The nature of the limitation depended on the purpose of the charge, that is, the types of expenses the charge was designed to cover.

The ICAA amended the 1940 Act to change the manner in which the SEC regulates variable contract charges. By eliminating the regulatory “straight-jacket” that for years constrained the design of variable contracts, the ICAA has permitted insurers to begin developing and introducing new product features and designs and to charge consumers accordingly.

2. **Current SEC Limitation on Variable Contract Charges -- the Reasonableness Standard.** With the 1996 legislation, variable contract charges are subject only to one broad restriction set forth in Section 26(e) of the 1940 Act -- that aggregate fees and charges under a contract be reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company sponsoring the contract (the “Reasonableness Standard”). The Reasonableness Standard provides insurers with flexibility to price their variable contracts more rationally and more in line with their fixed annuity and life insurance contracts, as well as to design variable contracts with innovative product features and price those contracts accordingly.

3. **Variable Contract Charge Structures After Enactment of the Reasonableness Standard.**

a. **Effects of the Reasonableness Standard on Variable Contract Charges**

(1) **Administrative Charges.** Before enactment of the Reasonableness Standard, there was no numerical limit on
administrative charges, but the SEC staff had interpreted Section 26(a) of the 1940 Act as requiring administrative charges to be “at cost.” Now there is no direct limit on the amount of administrative charges under a variable contract. Rather, administrative charges are regulated as a component of aggregate charges under a contract, which must be “reasonable.”

(2) **Risk and Other Insurance-Related Charges.** Prior to enactment of the Reasonableness Standard, insurance-related charges, such as mortality and expense risk charges, were already required to be reasonable, but were also subject to SEC staff limits of 1.25% for VA contracts and 0.90% for flexible premium VLI contracts. VA contract issuers were required to apply to the SEC for an exemptive order before mortality and expense risk charges could be deducted. Now insurance-related charges are subject to the federal securities laws only as components of aggregate charges. Risk charges are no longer subject to any de facto SEC staff limits and issuers of VA contracts no longer must obtain exemptions from the SEC to deduct risk charges.

(3) **Sales Loads**

(a) **Variable Annuity Contracts.** Before enactment of the Reasonableness Standard, Section 27(a) of the 1940 Act limited sales loads to 9.0% of premiums to be paid in under a VA contract. After enactment of the Reasonableness Standard, sales loads on VA contracts are no longer subject to the 9.0% limitation. VA contract sales charges, however, currently remain subject to NASD Rule 2820, which limits VA sales loads to 8.5% of purchase payments to be paid under the contract. The NASD proposed eliminating this sales load limitation, and on October 20, 1999, the SEC approved this rule change. The NASD is expected to issue a Notice to Members with the effective date of this rule change shortly.

(b) **Variable Life Insurance Contracts.** Before enactment of the Reasonableness Standard, Rule 6e-
(T) limited the amount of sales load that could be deducted from flexible premium VLI contracts in several ways. If a contract owner surrendered his or her contract within 24 months of purchasing it, an insurer was required to refund any amount of sales load that exceeded 30% of premiums up to the first “guideline annual premium,” 10% of premiums up to the second “guideline annual premium,” and 9% of any additional premiums. This effectively functioned as a cap on sales loads. Additionally, no more than 50% of any premium could be deducted as sales load, sales loads could not exceed 9% of premiums equal to the sum of 20 “guideline annual premiums” (as defined in Rule 6e-3(T)), and a “non-increase” requirement forbid any sales load deduction from being proportionately higher than any prior sales load deduction under that contract. Restrictions applicable to sales loads on increases in face amounts were complex and expensive to administer. Finally, an SEC free-look right and cancellation notice was required if the sales load on any premium exceeded 9%.

With the Reasonableness Standard, sales loads on flexible premium VLI contracts are not subject to the limitations imposed by Rule 6e-3(T), and sales loads on scheduled premium VLI contracts are not subject to the limitations of Rule 6e-3(T)’s scheduled premium counterpart, Rule 6e-2. Instead, sales loads are subject to the reasonableness of aggregate charges. One result of the elimination of the sales load limitations is that insurers issuing flexible premium VLI contracts are no longer required to seek exemptions from them for “DAC tax” charges.

(4) **Cost of Insurance.** Before enactment of the Reasonableness Standard, any portion of the amount deducted as “cost of insurance” that exceeded cost of insurance rates based upon the 1980 CSO tables generally was deemed to be “sales load” and was subject to the SEC’s limitations on sales loads, with the following exceptions:
• Cost of insurance charges imposed for substandard risk classes; and

• Cost of insurance charges imposed under contracts issued pursuant to simplified underwriting or guaranteed issue procedures.

These limitations on cost of insurance charges are no longer applicable.

(5) SEC’s “Latent” Jurisdiction Over Insurance Charges. The ICAA authorizes the SEC to adopt rules governing permissible charges, although the SEC has stated that such rules would be adopted only if it were demonstrated that there have been abusive pricing practices. This new authority is in effect the *quid pro quo* the insurance industry traded for the increased pricing flexibility -- the SEC now clearly has jurisdiction over the “insurance” charges, such as risk charges, that the industry had in the past maintained were beyond the SEC’s purview.

b. Effect of the Reasonableness Standard on Variable Annuity Contracts. The primary effect of the Reasonableness Standard so far on VA contracts has been to facilitate the introduction of new product features (such as enhanced death benefits, guaranteed minimum income benefits, and bonus credits), since insurers can now charge what these product features are “reasonably” worth to consumers without being subject to arbitrary price limitations. Different price structures are also beginning to be introduced.

c. Effect of the Reasonableness Standard on Variable Life Contracts

(1) Particular Problems With the “Old” Regime. Entering the variable life insurance market requires a heavy capital investment. For one, an insurer must develop elaborate administrative systems to handle the complexities of VLI contracts and monitor compliance with a variety of securities, insurance, and tax law provisions. The “at cost” standard for administrative charges under the prior SEC regulatory regime precluded insurers from realizing any profit on those
expenditures. In addition, the SEC sales load “refund” requirements resulted generally in an insurer’s having lower sales load revenue to pay for distribution of its VLI contracts than for its fixed contracts, which meant that the insurer either had to subsidize the distribution of its variable contracts or live with a “marketing bias” against its variable contracts.

(2) **Variable Life Product Design After Enactment of the Reasonableness Standard.** The increased pricing flexibility with the Reasonableness Standard has permitted insurers to design VLI contracts with charge structures that reflect more closely the actual expenses incurred by the insurer in distributing and administering its contracts. The amount and timing of sales loads, administrative charges, and mortality and expense risk charges can now reflect the amount and timing of the corresponding expenses. For example, sales loads can be expressed as a prescribed dollar amount per $1,000 of face amount of insurance, instead of as a percentage of premiums actually paid into the contract, permitting insurers to support distribution systems for their variable life contracts similar to their fixed contracts. There are also numerous possibilities for combining and simplifying variable life charges.

4. **Satisfying the Reasonableness Standard**

a. **Background.** While insurers may now price new product features and develop new pricing structures without being constrained by specific charge limitations, variable contract charges must be “reasonable” in relation to the services, expenses, and risks under a particular contract. There is little in the way of guidance to be found within the four corners of the ICAA legislation as to what constitutes “reasonable” charges. The House and Senate reports on the legislation offer little additional guidance -- the Senate Report provides no insight into the application of the Reasonableness Standard, while the House Report provides only limited information. However, there is some guidance to be had from SEC staff recommendations that preceded the introduction of legislation culminating in the ICAA. These recommendations appeared in the SEC Report. These recommendations suggested use of a reasonableness test for overall charges, and the Reasonableness Standard enacted tracks virtually verbatim the reasonableness test proposed in the SEC Report.
b. **Legislative Guidance.** Three factors must be assessed in determining the reasonableness of aggregate charges under a contract -- the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company.

(1) **Services Rendered.** Services rendered by an insurer can be conceptually broken into two general categories -- contract features and other services. Contract features would include all services the company provides under the variable contracts, such as transfer and withdrawal services, death benefit options, and payout options, to name a few. Other services provided may include asset allocation services, automatic cash value rebalancing services, automated telephone services for account value inquiries, or the accommodation of qualified plans.

(2) **Expenses Expected to be Incurred.** The expenses expected to be incurred can be conceptually broken into three general categories -- external expenses, internal expenses, and contract benefits. External expenses would include any expenses an insurer pays to outside persons, such as legal expenses, actuarial expenses, commissions, marketing expenses, and registration fees. Internal expenses, on the other hand, relate to the expense of internal company functions, such as for company personnel (including marketing and customer service), or administrative systems development. Finally, contract benefit expenses would include the payment of benefits under the variable contracts, such as death benefits, lifetime annuity or settlement payments, or surrender values.

(3) **Risks Assumed.** Risks assumed by the insurer can also be conceptually broken into three categories -- mortality risks, expense risks, and other risks. Mortality risks are the risk the insurance company assumes from the projected lives of contract owners, which can affect the timing of death benefits and/or lifetime payouts. Insurers are also subject to the risk that assumptions made in the pricing of contracts will prove inaccurate. Expense risks refer to the discrepancies in projected and actual expenses expected to be incurred in connection with the contracts. Finally, other risks assumed by
the insurance company might include risks associated with mistakes, product failures, or innovation.

c. **SEC Guidance.** The SEC Report warned that a reasonableness test would contemplate a facts and circumstances analysis of each case, and could require difficult determinations in particular situations. The Report identified several particular facts and circumstances deemed relevant, as discussed below.

(1) **Profit: Balancing of Interests.** The SEC Report acknowledges that a reasonable profit would be an allowable component in the overall “price” of a variable contract. In proposing its reasonableness test, the SEC Report states that a reasonable profit could be built into the price of a variable contract. In this regard, the SEC Report also states that its proposed reasonableness test should approximate the standard for regulating mutual fund sales charges in Section 22(b) of the 1940 Act. Section 22(b) allows for “reasonable compensation” for sales personnel, broker-dealers, and underwriters, and for “reasonable sales loads” to investors. According to the SEC Report, this standard considers the nature and quality of services necessary to ensure proper distribution of fund shares to the public and acknowledges the validity of weighing the interests of sellers as well as investors. The staff noted that higher sales charges could be warranted in situations when an insurance company takes on greater risks under a contract or when more selling effort is required. To appropriately analyze whether anticipated profit is reasonable, an insurer should generally compare anticipated profit from its variable contracts with that of its other product lines, as well as with that of other similarly situated insurance companies, to the extent available.

(2) **Industry Practice.** The SEC Report also expresses the staff’s view that whether the aggregate charges and fees are “within the range of industry practice” would be a factor supporting reasonableness. However, the report stressed that this factor would not alone provide a sufficient basis for assessing the reasonableness of variable contract charges. Nonetheless, considerable comfort can be drawn from a determination that the fees and charges are “in the pack” of comparable contracts.
In any event, when charges and fees under a variable contract exceed industry norms, the features and benefits of the contracts should be examined more closely.

(3) **Innovation.** The SEC Report states that a reasonableness test would give the insurance industry the business flexibility to develop and market variable contracts effectively. The Senate Report discusses as one of the purposes behind the legislation “the need to reform the Investment Company Act in keeping with changing technologies and market and investing conditions.” The Senate Report continues by noting that one of the effects of the new legislation will be to “broaden investor choices.” Arguably, innovation could be a factor to consider in connection with the reasonableness inquiry. Innovative contract design may often involve services, expenses, or risks that an insurance company may not have the experience or ability to gauge as accurately as it can for existing contract features, or that may entail additional expense.

d. **Other Factors**

(1) **Prior Regulatory Scheme.** Compliance with the requirements of the prior regulatory regime, while not determinative, may provide companies with some additional comfort, especially with regard to contracts issued before October 1996. Similarly, compliance with the terms of any prior SEC exemption granted to a variable contract may provide a company with some comfort, since the SEC staff would have implicitly reviewed the overall charge structure of the contract in granting the relief.

(2) **Economic Factors.** The SEC Report also identified certain factors that the SEC staff believed the SEC should consider if it adopted a rule prescribing guidelines for determining the reasonableness of variable contract charges. While the staff did not state that each insurer should consider these factors when it assessed the reasonableness of charges under variable contracts, it could be appropriate to take these factors into account when pricing a variable contract. The factors identified by the staff are “general economic factors and industry trends,
including product development, marketing practices, and contract design.”

(3) **Compliance with Other Regulatory Regimes.** The SEC Report stated that the model rules and regulations of the National Association of Insurance Commissioners (the “NAIC”) could be sources of information necessary to evaluate general economic factors and industry trends, including product development, marketing practices, and contract design. What can be inferred from this statement is that compliance with the NAIC model regulations or state-specific insurance regulations might be one measure for demonstrating the reasonableness of the charges and fees imposed under the variable contracts.

(4) **Other Considerations.** The Reasonableness Standard effectively imposes a continuing obligation on an insurance company to maintain reasonable fees and charges since the representation is “renewed” each time a post-effective amendment is filed. Moreover, the Reasonableness Standard applies effectively on a “retroactive” basis to all outstanding variable contracts, regardless of when designed or initially registered. In this regard, the Reasonableness Standard effectively could require insurers to modify fees and charges on outstanding contracts, if necessary, for the insurer to make the required reasonableness representation.

5. **The Required Representation Regarding Reasonableness**

   a. **The Representation Requirement.** Section 26(e) requires not only that aggregate charges under a contract be “reasonable,” but also that the insurance company sponsoring the contract express represent in the contract’s registration statement that the fees and charges deducted under the contract meet this Reasonableness Standard. The reasonableness representation must be made in all registration statements or post-effective amendments for variable insurance contracts.

   (1) **What Language Should Be Used?** A threshold question faced by variable contract issuers is what language should be used in making the required representation. The most common approach is simply to track the statutory requirement: “ABC
Insurance Company hereby represents that the fees and charges deducted under the contract, in the aggregate, are reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by ABC Insurance Company.”

(2) **Placement of the Representation.** Section 26(e) does not specify where in a registration statement the reasonableness representation must be made, and the staff has not required registrants to place the representation in variable contract prospectuses. Therefore, prospectus liability *per se* is avoided. However, as noted below, significant liability nonetheless may inure as a result of the requirement that variable contract registration statements contain the reasonableness representation.

b. **Directors’ Responsibility.** Directors of a company issuing securities may be held personally liable under Section 11 of the 1933 Act (discussed below) for material misstatements or omissions in a registration statement filed with the SEC, including the reasonableness representation required in a variable contract’s registration statement.

c. **Due Diligence.** Insurance companies sponsoring variable contracts may wish to provide their directors with information that will assist directors in their due diligence investigation with regard to the reasonableness representation and the opportunity to ask questions on registration statements or post-effective amendments that contain the reasonableness representation.

6. **The Impact of the Reasonableness Standard on Underlying Fund Fees and Expenses**

a. **Are Underlying Fund Fees and Expenses Subject to the Reasonableness Standard of Section 26(e)?** Section 26(e)(2) of the 1940 Act prohibits the sale of variable contracts unless the “fees and charges deducted under the contract” are reasonable. Section 26(e)(3) provides that the phrase “fees and charges deducted under the contract” shall include “all fees and charges imposed for any purpose and in any manner.” While the statute clearly requires the sponsoring insurance company, and not the directors of the underlying fund(s), to make this determination, the breadth of this provision raises the issue of
whether, in determining reasonableness, the sponsoring insurance company must analyze underlying fund fees and expenses together with the other fees and charges deducted under a variable contract.

(1) **Legislative History**

(a) **SEC Report.** The SEC Report does not expressly address whether underlying fund fees and expenses should be included in aggregate contract charges. The SEC Report could be read, however, as suggesting that investment advisory fees and other fund expenses should only be regulated under the regulatory structure that has existed for mutual funds fees and expenses for some time now -- Sections 15(c), 36(a), and 36(b) of the 1940 Act.

(b) **The House Report.** Congress stated in the House Report that the Reasonableness Standard applies to “all fees and charges imposed for any purpose and in any manner, including, without limitation, marketing, sales, and distribution charges, compensation for investment advisory, administrative, custodial, transfer agent, or other services . . . .”

(2) **Parity in Treatment of Trust Accounts and Managed Accounts.** In the case of a managed account, because advisory fees and other investment-related charges such as transfer agent and custody fees are all deducted from separate account assets, it would seem logical to assess the reasonableness of all such fees in determining the reasonableness of fees and charges “under the contract.” Although less intuitive in the case of a trust account when advisory fees and other investment-related fees are deducted from an underlying fund, rather than separate account assets, it could be argued that the trust account should be afforded the same analysis as if it were a managed account by including fund-level fees for purposes of “aggregate” charges.
(3) **SEC Staff Position.** Based in part on the broad language contained in the House Report, certain members of the SEC staff have in the past expressed the view that underlying fund fees and expenses should be taken into account when determining whether aggregate contract charges are reasonable. A particular concern of the staff is that underlying fund fees and charges not duplicate those at the separate account or contract level, so that investors are not charged more than once for the same services or benefits. Although such views do not necessarily reflect those of the SEC, they may be a barometer of SEC staff thinking and would suggest that a prudent course is to consider those underlying fund fees and expenses that relate to administration, shareholder servicing, and distribution in determining reasonableness.

b. **Evaluating Reasonableness When There Are Affiliated Underlying Funds.** In the case of affiliated underlying funds, insurers may take investment advisory fees into account when projecting their return on investment for the contract and therefore it makes some sense to include investment advisory fees in aggregate contract charges. However, under an adviser-subadviser structure, when the subadviser is not affiliated with either the adviser or the insurer, the subadvisory fee does not inure to the benefit of the insurer and should therefore at least arguably be excluded from aggregate contract charges. Expense caps and reimbursement arrangements would also seem to represent lost revenue for the insurer.

c. **Evaluating Reasonableness When There Are Unaffiliated Funds**

(1) **When No Revenue Sharing Arrangements or Rule 12b-1 Plans Are In Place.** Under Section 36(b) of the 1940 Act and relevant judicial interpretations, a fund’s board must determine whether advisory and subadvisory fees are so disproportionately large that they bear no relationship to the services rendered and could not have been the product of arms’ length negotiation. This standard is different than the Reasonableness Standard under Section 26(e). Conceivably, underlying fund fees and expenses may be determined to satisfy Section 36(b), but could cause aggregate contract charges to be unreasonable for purposes of Section 26(e). In the three
and a half years since its enactment, it does not appear that the level of underlying fund fees and expenses generally has had an impact on the Reasonableness Standard set forth in Section 26(e) of the 1940 Act. However, given the extensive regulatory framework surrounding the approval of advisory arrangements, it is at least arguably unlikely that Congress intended for insurers to step into the shoes of the underlying fund’s board. Moreover, given that the role of the fund’s board is to protect fund shareholders, including in some cases the insurer itself, the insurer arguably may be presumptively entitled to rely on the board’s judgment in evaluating fund fees and expenses, at least in the case when the underlying fund is unaffiliated and no revenue sharing arrangement or Rule 12b-1 plans are in place.

(2) **Revenue Sharing Arrangements or Rule 12b-1 Plans on the Effective Date.** To the extent an insurer receives payments from the underlying fund’s investment adviser for the performance of administrative or other services, or from the fund itself under a Rule 12b-1 plan for the provision of distribution services, the insurer is receiving a revenue stream that perhaps should be reflected in pricing the contract and in determining the reasonableness of aggregate contract charges.

(3) **New Revenue Sharing Arrangements or Rule 12b-1 Plans After the Effective Date.** To the extent an insurer enters into a revenue sharing arrangement or begins receiving distribution expenses under a Rule 12b-1 plan after sales of its product have commenced, this represents the receipt of revenue not previously reflected in pricing the contract. This may occur as new underlying funds are added as investment options under the contract or as underlying funds currently available under the contract adopt revenue sharing arrangements or Rule 12b-1 plans. In either case, it may be necessary or at least advisable for an insurer to reevaluate the reasonableness of aggregate contract charges.
B. Other 1940 Act Regulations Applicable to Variable Contracts

1. Applications and Purchase Payment Processing

a. **Variable Annuity Contracts.** Rule 22c-1(b) generally requires daily pricing of variable contracts (discussed below) while Rule 22c-1(a) requires that insurance companies process purchase payments (i.e., credit them to the investment options selected by the owner) as of the day that such payments are received. Rule 22c-1(c), however, states what is referred to as the “two-day/five day” rule for processing initial purchase payments and issuing new VA contracts. Once an insurance company receives a completed application and an initial purchase payment, it must process the purchase payment and issue the contract within two business days. If an insurance company receives an initial purchase payment and an incomplete application, it has five business days to obtain enough information to complete the application (it can hold the purchase payment for more than five days only if the applicant specifically consents) or return the purchase payment. Once that application is complete, the insurance company must, of course, process the payment and issue the contract within two business days. The clock does not start running under Rule 22c-1(c) until an insurance company receives an initial purchase payment. Subsequent purchase payments must be processed at the next daily price computed for the VA contract.

b. **Variable Life Insurance Contracts.** Unlike most VA contracts, VLI contracts usually require underwriting. Therefore, for scheduled premium VLI contracts, paragraph (b)(12) of Rule 6e-2 provides an exemption from Rule 22c-1 “to the extent . . . necessary for compliance with . . . established administrative procedures of the life insurer with respect to issuance, transfer, and redemption procedures . . . including, but not limited to, . . . premium processing, insurance underwriting standards, and the particular benefit afforded by the contract.” Paragraph (b)(12)(iii) of Rule 6e-3(T) provides a very similar but slightly broader exemption for flexible premium VLI contracts. As with VA contracts, subsequent purchase payments generally must be processed at the next daily price computed for the VLI contract unless additional underwriting is required.

c. **“Free-Look” Provisions.** Because of state insurance law requirements, variable contracts have “free-look” provisions that permit
owners to return the contract for a refund within a stated number of days of receiving it (usually between ten and twenty). The amount of the refund often differs between VA contracts and VLI contracts and varies among the states. Generally, however, it is either the cash value (without any deduction for surrender charges) or the amount of the purchase payments made.

Where the purchase payments must be refunded upon exercise of the “free-look” provision, either because required by state law or because the contract so provides, the SEC staff has permitted insurers to allocate the payments during the “free-look” period to a money market investment option (and in some circumstances, an insurance company’s general account) rather than to the investment options selected by the purchaser. This relief from Rule 22c-1 has been conditioned on refunding the greater of (i) purchase payments, or (ii) payments (without deduction of sales charges) plus any amount deducted from the payment prior to its allocation to the separate account, if the contract is canceled during the free look period. Also, on either the 15th or 20th day after the contract is issued (depending upon whether the contract is mailed to the contract owner or delivered by an agent), the cash value must be reallocated to the investment options selected by the purchaser in the application.

2. **Daily Pricing**

a. **Daily Pricing Requirement.** Rule 22c-1(a) requires that investor transactions in investment company securities be effected at the net asset value per share (or unit) next determined after receipt of the order. Rule 22c-1(b) requires that the net asset value per share (or unit) be determined on most business days. Taken together, paragraphs (a) and (b) of the Rule require insurers to determine a “net asset value” for variable contracts on most business days and process purchase payments, transfers, withdrawals, surrenders and death benefits using the “value” next computed after receipt of a transaction request or other triggering event. The cash value of a variable contract is usually calculated by reference to “accumulation units” (and, for VA contracts during the annuity period, by reference to “annuity units”) which are comparable to mutual fund shares and are used to fulfill the daily pricing requirement in Rule 22c-1(b).
b. **Days on Which a Price Must be Computed.** Rule 22c-1 requires that net asset value (\textit{i.e.}, unit values) be computed at least once daily (and may be calculated more often) on each day that the New York Stock Exchange is open for trading. However, the net asset value need not be computed on: (i) any day on which no purchase payments or orders for transfers, withdrawals, surrenders or other transactions are received, (ii) customary national business holidays listed in the contract prospectus, or (iii) days on which the SEC has declared an emergency. The Rule also requires the insurance company to set a time (or times) as of which it will perform the computation and disclose this time in the prospectus.

c. **Exemptions For VLI Contracts.** Paragraphs (b)(12) of Rules 6e-2 and 6e-3(T) provide limited exemptions from the daily pricing requirement of Rule 22c-1(b). For example, Rule 6e-3(T) permits monthly calculation of death benefits and cash value and Rule 6e-2 permits monthly calculation of death benefits. As a practical matter, however, most insurers calculate unit values or cash values on a daily basis in order to accommodate various contract owner transactions.

3. **Transfers and Exchange Offers.** Most variable contracts offer a variety of investment options, and contract owners generally are permitted to transfer cash values among these options. This privilege is sometimes subject to limits on frequency and to deduction of a flat charge to cover the administrative costs related to processing the transfer. Insurers or the principal underwriters of variable contracts also sometimes offer to exchange one variable contract for another of the same type, both in circumstances where the same insurer issues both contracts and where the contracts are issued by different insurers.

a. **Section 11 of the 1940 Act.** Transfers and offers to exchange one variable contract for another are both regulated under Section 11 of the 1940 Act. Section 11 does not regulate all replacements. With respect to exchange offers, Section 11 regulates only exchange offers made by the insurer or the principal underwriter of the variable contract. Section 11 does not cover “retail” transactions that simply result from a recommendation by a registered representative at the point of sale. Nor does it cover exchanges of fixed contracts for variable contracts, or variable contracts for fixed contracts, regardless of whether or not the fixed contracts are registered with the SEC.
In general, Section 11 applies only to exchange offers of variable contracts issued by the same insurer or affiliated insurers. See Alexander Hamilton Funds (pub. avail. July 20, 1994). It does not cover exchange offers involving variable contracts issued by unaffiliated insurers, except in certain circumstances, such as where unaffiliated insurers have agreed, formally or informally, to offer a waiver of sales load or some other incentive for an exchange from one to the other. Concerns about broker-dealers imprudently switching variable contract owners between unaffiliated insurers are addressed through NASD rules and federal securities laws other than the 1940 Act.

Section 11 generally requires that those transactions coming within its scope be effected based on relative net asset values, except that in the case of separate accounts registered as unit investment trusts, it prohibits any such transactions (even if at net asset value) unless prior approval has been obtained from the SEC.

b. Rule 11a-2. The SEC has adopted Rule 11a-2 to permit certain transfers and the exchange offers of variable contracts issued by the same insurer or affiliated insurers that otherwise would be prohibited by the terms of the statute. Specifically, transfers are permitted if they are at relative net asset values and the only charge deducted at the time of the transfer is an administrative charge to cover the associated processing costs.

Rule 11a-2 does not permit sales charges to be deducted in connection with exchange offers of one VLI contract for another. Permitted exchange offers of VA contracts under the Rule, however, must satisfy certain conditions related to the sales loads imposed on the exchanged and acquired contracts. For example, no deferred sales load may be deducted from the exchanged contract at the time of the exchange, and any deferred sales load applicable to amounts applied from the exchanged to the acquired VA contract must be calculated based on the issue date and relevant purchase payment dates of the exchanged VA contract -- so that the contract owner is given credit for the time amounts were invested in the exchanged VA contract. Moreover, the acquired VA contract may not assess a sales load on any appreciation attributable to the purchase payments made under the exchanged VA contract, and no sales load may exceed nine percent of the sum of the purchase payments made for the acquired and exchanged contracts.
4. **Withdrawals, Surrenders, Loans, Annuity Payments and Death Benefit Payments.** Because a variable contract is a redeemable security under the 1940 Act, any payment by an insurance company under a variable contract is considered a redemption under the 1940 Act. This includes contract owner initiated transactions such as withdrawals, surrenders, and loans, as well as automatic payments such as annuity payments and death benefits.

   a. **Section 22(e) of the 1940 Act.** Section 22(e) governs the timing of the actual payment of proceeds to investors. It provides that the issuer of a redeemable security (in this case, an insurer) may not suspend the right of redemption and must pay redemption proceeds within seven days. This seven day period includes weekends and holidays but does not include other periods during which the New York Stock Exchange is closed or trading on the exchange is restricted; any period during which an emergency exists as defined by SEC rules; and any other periods as the SEC by order may permit.

   b. **Payments Under VA Contracts.** During the accumulation phase of a VA contract, a redemption request must be honored, and generally must be processed on a daily basis at the net asset value next computed after receipt of the order. The SEC staff interprets this to mean that the contract can be surrendered at any time, and that partial withdrawals also can be taken at any time without any restrictions except for reasonable minimum amount requirements. The SEC permits contingent deferred sales charges, and certain administrative charges, to be assessed in connection with surrenders and partial withdrawals. Insurers must obtain individual exemptive relief to deduct any other charges on surrenders and partial withdrawals, such as insurance charges or any bonus credit recapture.

There are three notable exceptions to the redeemability requirement. First, Rule 6c-7 under the 1940 Act permits a VA contract to restrict or prohibit redemptions as necessary to comply with the Texas Optional Retirement Program, as long as disclosure regarding the restrictions is made in the registration statement. Second, under a “no-action” letter issued by the SEC staff, VA contracts issued in connection with Section 403(b) plans may restrict redemptions. Finally, during the annuity or pay-out phase of a VA, Rules 22e-1 and 27c-1 provide that redemptions may be suspended, but only with respect to VA contracts under which payments are being made based on life contingencies. For VA contracts making payments that are not
based on any life contingency (i.e., for a period certain), the SEC staff has taken the position that contract owners must be able to redeem without restriction (other than reasonable minimum amount requirements, noted above).

It is significant that no exception exists for death benefit payments under a VA contract. The contract’s cash value must remain invested in the separate account until the death benefit is determined (as provided for in the contract) and be paid to the beneficiary within seven days. Therefore, most VA contracts provide that the death benefit is determined as of the date that both due proof of death and the beneficiary’s elections and other instructions are received by the insurance company.

c. Payments Under VLI Contracts. As noted above in connection with applications and purchase payment processing, for VLI contracts, paragraphs (b)(12) of Rules 6e-2 and 6e-3(T) provide exemptions from the redeemability (and other) provisions of the 1940 Act to the extent necessary “to comply with ... established administrative procedures of the life insurer for ... redemption” of the contracts, subject to a “reasonable, fair, and not discriminatory” standard. Among other things, this allows insurers to process loan applications and death benefit claims for VLI contracts in the same time frames that they use for traditional life insurance contracts. This, for example, permits death benefits to be computed as of the date of the insured’s death (i.e., before due proof of death is received) and the cash value to be moved to the insurer’s general account until the benefits are paid.

5. “Corporate” Governance Requirements. The corporate governance requirements of the 1940 Act are applicable to any registered management investment company -- including underlying funds and managed accounts. They mandate board of director and shareholder (contract owner) approval of certain matters. For example, shareholders (contract owners) must approve investment advisory contracts, elect a fund’s (or managed account’s) directors, and ratify the appointment of independent public accountants. For most trust accounts, Section 12(d)(1)(A) and (E) of the 1940 Act and Rules 6e-2 and 6e-3(T) require that whenever an underlying fund solicits proxies or holds a shareholder meeting, the insurer must “pass-through” proxies to variable contract owners and solicit instructions from the contract owners on how to vote.
Section 9 of the 1940 Act prohibits certain persons found to have violated federal securities and commodity laws from serving in various capacities with registered investment companies.

Section 17(j) of the 1940 Act and Rule 17j-1 thereunder together, in effect, require that registered managed accounts and their principal underwriters and investment advisers adopt codes of ethics as prescribed in the Rule.

6. **Affiliated Transactions and Substitutions**

   a. **Affiliated Transaction Prohibitions.** Sections 17(a) and 17(d) prohibit affiliates of registered investment companies from engaging in certain transactions that would constitute self-dealing. The prohibitions on self-dealing operate to preclude any purchase or sale of property to or from an investment company by an affiliate of that company. They also prohibit any “joint transaction” by an investment company and with an affiliate. The SEC, however, often grants exemptions from these prohibitions if it determines that a proposed transaction would not harm investors and is otherwise in the public interest.

   b. **Substitutions of Underlying Funds.** Section 26(b) of the 1940 Act requires prior SEC approval before an insurer may substitute shares of one underlying fund held by a trust account for the shares of another underlying fund. Variable contracts usually permit an insurance company to make such substitutions without contract owner approval. In evaluating such substitution transactions, the SEC looks at a number of factors, including the similarity of investment objectives, the relative expenses, and the relevant historical performance of the funds involved.

7. **Record Keeping Requirements.** Section 31 of the 1940 Act and Rule 31a-1 thereunder require that registered investment companies, including VA accounts and VLI accounts, maintain and keep current the accounts, books, and other documents relating to their business that constitute the record forming the basis for financial statements that such accounts file with the SEC.

The records required to be maintained include: (1) journals that contain itemized daily records of contract owner transactions related to the separate accounts; (2) ledgers reflecting the various accounts maintained to reflect the separate account’s financial status; (3) monthly trial balances of the ledgers; (4) records of the portfolio investment transactions; (5) records of who has
authority to authorize the purchase and sale of the underlying funds’ shares; and (6) copies and evidence of filings made with the SEC.

The journals, ledgers, and some filings made with the SEC must be kept forever. Most of the other records must be kept for six years. SEC regulations generally permit records to be maintained in an electronic format.

8. **Annual and Semi-Annual Reports**

a. **Annual and Semi-Annual Reports to the SEC.** Rules 30a-1 and 30a-2, in effect, require that trust accounts file an annual report on Form N-SAR no later than sixty days after the end of the fiscal year and managed accounts to file both an annual and semi-annual report on Form N-SAR no later than sixty days after the end of the fiscal year and second fiscal quarter.

b. **Annual and Semi-Annual Reports to Contract Owners.** Rule 30d-1 requires an insurance company to prepare and send each contract owner invested in one of its managed accounts an annual and semi-annual report for the account. Rule 30d-2 requires insurance companies to transmit annual and semi-annual shareholder reports from underlying funds to each contract owner invested in one of its trust accounts. With regard to a trust account, contract owners only need to receive reports for underlying funds in which they have cash value invested. Rule 30b2-1 requires that copies of the reports to contract owners be filed with the SEC.

9. **SEC Examinations.** The 1940 Act authorizes the SEC to conduct such inspections of investment company operations that it deems necessary or appropriate to ensure compliance with the 1940 Act. Therefore, registered VA and VLI accounts are subject to SEC inspections. The SEC conducts both routine examinations and “for cause” examinations of the operations of variable contract issuers their registered separate accounts. Routine compliance examinations are conducted on a cyclical basis and test the insurers’ compliance with applicable laws and regulations. “For cause” examinations are conducted when the SEC staff has reason to believe that something is wrong.

During a routine compliance examination, the SEC staff may review, among other things, accounting and financial reporting procedures, pricing procedures, contract owner transactions, valuation procedures, and internal control procedures. In addition, the SEC staff may examine transfer agent and custody
arrangements, documents from a sample of contract owner files, execution of trades, performance calculations and other marketing materials, prohibited transactions, complaints lodged by contract owners, and distribution activities and expenses. Similar materials may be examined during a “for cause” examination.

10. Other SEC Filings Required Under the 1940 Act

a. Annual Registration Fees. Rule 24F-2 under the 1940 Act requires that VA accounts and VLI accounts file a Form 24F-2 every year in connection with the payment of SEC registration fees for securities sold during the prior year. The Form prescribes the method of computing the fees.

b. Litigation Documents. Section 33 of the 1940 Act requires that any VA account or VLI account named as party to certain types of legal actions or claims, file copies of certain prescribed litigation documents with the SEC.

c. Proxy Materials. Proxy materials prepared by insurance companies either for managed account contract owner meetings or for an underlying fund shareholder meeting also must be filed with the SEC.

IV. SEC Registration

A. Registration of Separate Accounts Under the 1940 Act

Both trust accounts and managed accounts become registered investment companies by filing a registration statement with the SEC on the appropriate registration form. VA trust accounts file a Form N-4, VA managed accounts a Form N-3, VLI trust accounts a Form N-8B-2 and VLI managed accounts a Form N-1. Forms N-1, N-3 and N-4 are integrated forms in that they are the same forms that VA and VLI accounts use to register their securities under the 1933 Act (discussed below). Form N-8B-2, however, is solely for registration as an investment company and not for registration of securities issued by such a company. The SEC has recently proposed an integrated registration form, Form N-6, for VLI trust accounts (discussed below). A VA or VLI account becomes a registered investment company automatically as soon as it files one of the above forms with the SEC.
B. Registration of Securities Issued by a Registered Separate Account

1. Registration of Securities Under the 1933 Act. Offerings of securities required to be registered generally cannot commence unless and until a registration statement for those securities has been filed and has become effective. Although the 1933 Act provides that registration statements can become effective automatically 20 days after filing, SEC regulations provide a mechanism for delaying the effective date until the SEC staff has completed its review of the registration statement.

2. The Type of Securities Issued in Connection With Variable Contracts. Securities lawyers generally characterize the securities issued by a VA account or VLI account as either being the appropriate variable contract itself or interests in (or units of interest in) the separate account issued in the form of a variable contract. Regardless of the characterization, these securities must be registered under the 1933 Act by filing a registration statement on the prescribed form. Registration statements under the 1933 Act must be filed electronically through the Commission’s electronic filing system (the EDGAR system), and once filed, are reviewed and commented upon by the SEC staff. VA and VLI account registration statements are reviewed by personnel in the SEC’s Office of Insurance Products, which is a branch of the SEC’s Division of Investment Management.

3. 1933 Act Registration Statement Forms For Variable Contracts. Registered separate accounts must use the following forms for their 1933 Act registration statements: for VA trust accounts, Form N-4; for VA managed accounts, Form N-3; for VLI trust accounts, Form S-6; and for VLI managed accounts, Form N-1. When the SEC adopts Form N-6 for trust accounts, that form will replace Form S-6. Because trust accounts are the predominant structure for registered VA accounts and VLI accounts, this outline will discuss Forms N-4, S-6, and N-6.

Forms N-4 and N-6 are three part forms. Each has a Part A, which is the prospectus, a Part B, which is the statement of additional information, and a Part C (other information). Form S-6 is a two part form comprised of a Part I, which is the prospectus, and a Part II (other information). All of the forms also require certain exhibits that must be filed with the registration statement. These forms are discussed in more detail below.

4. Prospectus Delivery Requirements. Pursuant to Section 5(b)(2) under the 1933 Act, only the prospectus generally must be provided to investors. In
addition, investors must receive a prospectus for each underlying fund in which a VA or VLI trust account invests. This is because the SEC considers the offer or sale of the variable annuity contract through a trust account to be a public offering of both the trust account securities and those of the underlying funds. Although not required to be delivered initially to all investors, Part B of Forms N-4 and N-6 must be sent to investors upon request. Part C of these forms and Part II of Form S-6 (as well as any exhibits) are filed with the SEC but not sent to investors.

5. **Liability Under the 1933 Act.** The 1933 Act’s principal liability provisions are contained in Sections 11 and 12(a)(2). Section 11 imposes liability on any issuer, director of the issuer, officer of the issuer who signs the registration statement, or underwriter for the security covered by the registration statement, for any material misstatement or omission in the registration statement as of the effective date. Section 12(a)(2) imposes liability on any person who offers or sells a security by means of a prospectus that includes a material misstatement or omission.

The 1933 Act’s liability provisions have the effect of requiring a registration statement or prospectus to contain whatever information may be necessary or appropriate to avoid liability for a material misstatement or omission. This obligation applies for so long as the registration statement and prospectus are being used, and therefore means that insurers are obligated to amend or supplement their disclosure materials whenever necessary to ensure that they remain accurate and complete in all material respects.

Insurers are strictly liable for any material misstatements or omissions in the registration statement, whereas others are liable unless they can establish a due diligence defense. Violations of these provisions can be asserted by the SEC in an enforcement action brought in an administrative proceeding or in a court of law, as well as by aggrieved purchasers in a court of law. Available remedies for violations of these provisions include rescission of the transaction.

6. **The Anti-Fraud Provisions of the 1933 Act and the Securities Exchange Act of 1934.** Section 17(a) under the 1933 Act and Rule 10b-5 under the Securities Exchange Act of 1934, as amended, (the “1934 Act”) also have the effect of requiring a prospectus to contain whatever information may be necessary or appropriate to avoid liability for a material misstatement or omission. Section 17(a) contains an antifraud provision essentially prohibiting a person from offering or selling a security by means of a material misstatement or omission. Rule 10b-5 also contains an antifraud provision prohibiting a person
from buying or selling a security by means of a material misstatement or omission. Rule 10b-5, unlike Sections 11, 12(a)(2) or 17 under the 1933 Act, applies to the purchase as well as the sale of a security.

To establish liability under these provisions, both scienter on the part of the defendant and reliance on the part of the plaintiff generally must be established. Violations of these provisions can be asserted by the SEC in an enforcement action brought in an administrative proceeding or in a court of law, as well as by aggrieved purchasers in a court of law. Damages for violations of these provisions can include rescission as well as other possible measures of losses.

7. **Due Diligence By an Insurance Company’s Directors in Connection With a Variable Contract Registration Statement.** Directors can avoid liability under Section 11 only if they can show they conducted appropriate “due diligence” to ascertain that the registration statement contained no material misstatement or omission. The level of diligence required to meet the “due diligence” standard as to any statement depends on a number of factors, such as whether the statement is “expertised.” Another factor affecting the level of due diligence expected of a director or principal officer depends on the person’s professional duties and relationship with the issuer.

The due diligence performed by an insurance company’s board of directors should focus on the separate account, its operations, and the terms of the variable contract. The principal purpose of the due diligence is to ensure that the registration statement adequately describes the contract and how the contract will be administered. Because of the technical nature of variable contracts, it has been posited that directors and officers should be able to rely heavily on representations as to the accuracy and completeness of the registration statement disclosure from those employees and consultants involved in designing and administering the product and in preparing the disclosure. This due diligence process should continue as long as a registration statement is required to be kept current.

8. **Keeping Registration Statements and Prospectuses Current**

a. **Updating Requirements.** Section 10(a)(3) of the 1933 Act requires that variable contract issuers (and underlying funds) making a continuous offering of their securities maintain a current or “evergreen” prospectus. In particular, when a prospectus is used more than nine months after the effective date of the registration statement, the financial and other information contained therein must be as of a date no more
than 16 months prior to such use. In addition, where a trust account is filing an amendment to its registration statement, the financial statements therein cannot be as of a date more than 135 days prior to the date the filing is expected to become effective.

b. **Updating Procedures.** Disclosure may be updated using one of two procedures -- amending the registration statement by filing with the SEC what is referred to as a post-effective amendment, or by supplementing or “stickering” the prospectus. Which procedure is appropriate will depend on the nature and extent of the disclosure changes being made. Because any change to the audited financial statements (including updating) must only be made by filing a post-effective amendment, such an amendment must be filed at least once a year.

c. **Post-Effective Amendments to Registration Statements.** VA and VLI accounts must file post-effective amendments to their registration statements pursuant to Rule 485 of the 1933 Act. Rule 485(a) permits non-routine (i.e., containing material changes to the registration statement) post-effective amendments to become effective automatically between 60 - 80 days after filing, as specified by the issuer. Rule 485(b) permits routine post-effective amendments to become effective immediately or not later than 30 days after the date of filing, as specified by the issuer. Routine filings are those filings made, for instance, to update the audited financial statements in a registration statement, or to amend disclosure in the registration statement about underlying funds to conform with changes the fund’s registration statement. In addition, a Rule 485(b) filing may be made for any other purpose that the SEC or its staff may approve.

d. **Delivery of Updated Prospectuses.** The SEC has taken the position that each purchase payment made under a variable contract constitutes the sale of a new security. Under this interpretation, a copy of the updated prospectuses for the contract (and underlying funds in which the contract owner is invested) should be sent at least annually to contract owners as long as they may make purchase payments under the contract. Because of the expense of mailing these prospectuses, recent attention has focused on potential alternatives to satisfy this delivery requirement. In certain circumstances (such as when the
contract owner has consented), insurers may satisfy their prospectus delivery obligation through electronic delivery methods. Also, there have been recent industry proposals to develop a short annual prospectus update that could be delivered annually, in lieu of full prospectuses (discussed below).

C. Registration Statement Forms

1. **Registration Statement Forms and the General Materiality Provisions of the 1933 Act.** Each registration statement form requires disclosure of specific matters that are of particular relevance to prospective investors considering the purchase of the type of security to which the form relates. In addition, however, general standards of materiality may require that information be included in a registration statement even though such information may not be explicitly called for by the applicable form. Rule 408 under the 1933 Act provides that in addition to the information expressly required to be included in a registration statement, registrants must add such further material information, if any, as is necessary to make the required disclosures, in light of the circumstances under which they are made, not misleading. For this purpose, Rule 405 under the 1933 Act provides that the term “material” limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security being offered.

2. **Financial Statements Required by the Forms.** The SEC has regulations (Regulation S-X) which set forth specific requirements regarding the financial statements that must be included in a 1933 Act registration statement. In addition to these regulations, the registration statement forms usually modify the basic requirements to suit circumstances of the type of issuer whose securities would be registered using the particular form. Among other things, these requirements relate to how many years must be included, how current the financial statements must be, the form of required independent auditors opinions, etc.

These SEC regulations generally require that financial statements be prepared in accordance with generally accepted accounting principals (GAAP). However, they and certain of the forms permit insurance companies to use statutory financial statements in certain circumstances. For example, Form N-4 permits the use of an insurance company’s statutory financial statements if the company would not otherwise be required to prepare GAAP financial statements.
Nevertheless, Form N-4 still requires that GAAP financial statements for the trust account itself.

3. **Plain English.** On January 28, 1998, the SEC adopted sweeping new regulations to force all issuers of securities to explain the risks of investing in a way that the average investor can easily understand. Issuers must use plain English writing principles when drafting the front and back cover pages, the summary, and the risk factors sections of a prospectus (and in any Rule 498 profile). In addition, the entire prospectus must be clear, concise, and understandable and must be prepared using certain writing standards.

In the adopting release, the SEC stressed the “informational” function of disclosure and expressed its belief that “using plain English in prospectuses will lead to a better informed securities market -- a market in which investors can more easily understand the disclosure required by the federal securities laws.” The SEC also stated that “this new package of rules will change the face of *every* prospectus and make prospectuses simpler, clearer, more useful, and we hope, more widely read.”

a. **What is Plain English?** According to the SEC, plain English means “analyzing and deciding what information investors need to make informed decisions, before words, sentences, or paragraphs are considered.”

(1) **Not “Dumbing Down”**. The SEC insists that plain English does not entail simply deleting complex information to make the document easier to understand. Complex information should be presented in an orderly and clear way.

(2) **Must be Logically Organized**. A plain English document should be organized so that investors have the best possible chance of understanding it on the first reading.

(3) **Focus is on the Look and Tone**. A plain English document uses words “at a level the audience can understand. Its sentence structure is tight. Its tone is welcoming and direct. Its design is visually appealing. A plain English document is easy to read and looks like it’s meant to be read.”

b. **Effective Dates**. The plain English requirement applies to all registration statements on Forms S-1, S-3, S-6, N-3, N-4, and N-6
(and amendments to such registration statements) filed on or after October 1, 1998. Accordingly, by now, all registration statements for variable contracts currently being sold should have been revised to comply with the plain English requirements.

c. **Substantive Requirements:** The principles of plain English writing and design must be applied to the cover page, summary, and risk factors section of every prospectus.

1. **New Rule 421(d).** New Rule 421(d) specifies 6 plain English “principles” of organization, language and design that must be applied to the front and back cover pages, summary and risk factors sections of every prospectus:
   - Short sentences;
   - Definite, concrete, everyday language;
   - Active voice;
   - Tabular presentation or “bullet” lists for complex material;
   - No legal jargon or highly technical business terms; and
   - No multiple negatives.

2. **Amended Rule 421(b).** Amended Rule 421(b) continues to require that the entire prospectus be clear, concise and understandable. (The general instructions to Forms N-3 and N-4 have contained this requirement since 1985. Old Form N-1A has contained them since 1983.) Amended Rule 421(b) mandates that the entire prospectus:
   - Use clear, concise sections, paragraphs, and sentences. Whenever possible, use short, explanatory sentences and bullet lists;
   - Use descriptive headings and subheadings;
   - Avoid relying on glossaries or defined terms as the primary means of explaining information in the prospectus. Define terms in a glossary or other section of the document only if the meaning is unclear from the context. Use a glossary only if it facilitates understanding of the disclosure;
   - Avoid legalistic and highly technical business terminology;
   - Avoid vague “boilerplate” explanations that are imprecise and subject to different interpretations;
Avoid complex information copied directly from legal documents without any clear and concise explanation of the provisions; and
Avoid repetitive disclosure that does not enhance the quality of the information.

(3) **Amended Rule 461(b)(1)**

(a) **Delay Acceleration Requests.** When considering a request to accelerate effectiveness, the staff must consider whether the issuer has made a “bona fide effort to make the prospectus reasonably concise, readable and in compliance with the plain English requirements” of Rule 421(d).

(b) **SEC Doesn’t Expect Delays.** In the adopting release, the SEC expressed the belief that plain English will not frequently delay the effective date of registration statements.

(4) **Amended Rule 481**

(a) **Legends.** Legends that are required in the prospectus are revised to conform to plain English principles. The use of ALL CAPITALIZED LETTERS is discouraged.

(b) **Table of Contents.** The table of contents must appear on either the outside front, inside front, or outside back cover. (The old rule required the table of contents to appear on the forepart, or outside back cover, of any prospectus.) The table of contents for any prospectus delivered electronically must appear immediately after the cover page.

d. **Plain English Handbook.** In August 1998, the SEC’s Office of Investor Education and Assistance published the Plain English Handbook, a copy of which is available on the SEC’s Worldwide Web Site (http://www.sec.gov). The handbook is intended to show public companies how they can “use well-established techniques of writing in plain English to create clearer and more informative disclosure documents.” Among the techniques discussed in the handbook are:
(1) **“Know Your Audience”**. To write an understandable document, the Handbook stresses that the issuer must know its audience and gauge the financial sophistication of its investors. The Handbook recommends using polls and market survey research to create a profile of prospective investors. If the pool includes individuals and institutions with varying degrees of financial sophistication, consider making basic educational information visually distinct from the rest of the text so that the sophisticated investors can easily recognize and scan it.

(2) **Apply Design Principles**. The Handbook states that no matter how well a prospectus is written, a good design can enhance its effectiveness. It urges companies to apply five basic design principles to plain English documents:

- **Hierarchy** or ranked levels of information;
- **Typeface** selection (use 10-12 point type);
- **Layout** (use left justified, ragged right text);
- **Graphics**; and
- **Color**.

(3) **Elements of Good Writing Style**. The Plain English Handbook provides guidance and examples on plain English style, such as:

- Use the active voice with strong verbs.
- Don’t ban the passive voice, but use it sparingly.
- Find hidden verbs.
- Try personal pronouns.
- Bring abstractions down to earth.
- Omit superfluous words.
- Write in the “positive.”
- Use short sentences.
- Replace jargon and legalese with short, common words.
- Choose the simpler synonym.
- Keep subject, verb, and object close together.
- Write using “if-then” conditionals.
- Keep sentence structure parallel.
- Steer clear of the word “respectively.”
e. **Subsequent Guidance.** The SEC staff provided additional guidance on plain English disclosure in Staff Legal Bulletin No. 7 (updated June 7, 1999). This bulletin includes frequently asked questions and answers and sample staff comments.

4. **Form N-4.** As indicated above, Form N-4 is a three part form with exhibits. The Form requires disclosure relating to 32 specific items. Items 1-14 must be included in the prospectus, items 15-23 must (if not disclosed in the prospectus) be included in the statement of additional information and items 24-32 must be included in Part C. There are also 14 required exhibits that, if applicable, must be filed with the registration statement. To provide some sense of what these items require, a brief description of items 1-23 follows.

a. **Item 1. Cover Page.** The cover page of the prospectus (which, in practice, is often the first inside, rather than the outside, page of the prospectus) provides basic information and cautionary legends about the VA contract.

b. **Item 2. Definitions.** Special terms used in the prospectus must be either defined in a glossary or indexed according to where in the prospectus they are defined.

c. **Item 3. Synopsis.** The synopsis, often referred to as the “Fee Table,” sets forth in a tabular presentation contract owner transaction expenses (for example, sales loads), administrative fees, trust account annual expenses (for example, mortality and expense risk fees), and underlying fund annual expenses. Certain other information expanding on the line item expenses, such as underlying fund advisory fee waivers, must also be presented.

d. **Item 4. Condensed Financial Information.** This table presents historic accumulation unit values for each subaccount of the trust account.

e. **Item 5. General Description of the Registrant, Depositor, and Portfolio Companies.** This section discusses the organization and proposed operation of the trust account (referred to in Form N-4 as the “registrant”), the insurance company (referred to as the “depositor”), and the underlying funds.
f. **Item 6. Deductions.** This section identifies the amount of and the services provided in return for the sales loads, administrative, mortality and expense risk, and other fees. Underlying fund expenses must be noted but the amounts do not have to be identified. Notably, commissions paid to dealers as a percentage of purchase payments must also be identified.

g. **Item 7. General Description of Variable Annuity Contracts.** This section puts the “meat on the bones” -- it describes the features of the VA contract, during both the “accumulation period,” when purchase payments are made by the owner, and the “annuity period,” when annuity payments are made by the insurer to the owner.

h. **Item 8. Annuity Period.** In this section, the particular annuity payment options that are offered under the contract are described.

i. **Item 9. Death Benefit.** Annuities generally offer a “death benefit” payable upon the death of the annuitant or owner.

j. **Item 10. Purchases and Contract Value.** This section describes how purchase payments are made, explains that investment performance of the underlying funds will affect contract values and when and how cash value is calculated, and identifies the principal underwriter of the contracts.

k. **Item 11. Redemptions.** In this section, redemption procedures, including “free-look” refund rights, withdrawals and surrenders, are discussed.

l. **Item 12. Taxes.** The tax section of a prospectus discusses the principal tax characteristics of the contracts as it relates to the types of owners to whom the contracts will be offered. Where the contracts are likely to be offered as funding vehicles for qualified retirement plans, the principal tax attributes of such plans is also discussed here.

m. **Item 13. Legal Proceedings.** Legal proceedings must be identified that are likely to have a material adverse effect upon the ability of the principal underwriter to distribute the contracts, upon the insurer to meet its obligations under the contracts, or upon the separate account itself.
n. **Item 14. Table of Contents of Statement of Additional Information.** As noted above, prospective contract owners may request the statement of additional information, which contains additional information about the contracts. To aid the investor in deciding whether to request the statement of additional information, the prospectus sets forth the table of contents of the statement.

o. **Item 15. Cover Page.** The cover page of the statement of additional information. Like the cover of the prospectus, it provides basic information.

p. **Item 16. Table of Contents.** Table of contents for the statement of additional information.

q. **Item 17. General Information and History.** To the extent not disclosed in the prospectus, this section discusses prescribed information about the insurance company and the trust account.

r. **Item 18. Services.** To the extent not already disclosed in the prospectus, this section explains any “back office” operations or other services related to the contracts or the trust account that the insurer has contracted out to a third party administrator or other provider.

s. **Item 19. Purchase of Securities Being Offered.** To the extent not already disclosed in the prospectus, this section describes the distribution network for the contracts and how sales charges are computed.

t. **Item 20. Underwriters.** To the extent not already disclosed in the prospectus, this section identifies the trust account’s principal underwriter and other affiliated selling dealers and describes the compensation paid to such persons for selling the contracts during the prior fiscal year.

u. **Item 21. Calculation of Performance Data.** This section provides detailed disclosure of the exact method of computing each type of performance data that the insurance company may publish about the trust account.
v. **Item 22. Annuity Payments.** To the extent not already disclosed in the prospectus, this section explains how variable annuity payments are computed.

w. **Item 23. Financial Statements.** This section provides instructions as to what financial statements are required to be included in the registration statement for the insurance company and the trust account.

5. **Form S-6 and Newly Proposed Form N-6**

a. **Current Situation.** At the current time, VLI contracts must be registered in a time-consuming dual registration process, which consists of preparing and filing registration statements on both Form S-6 (for the VLI contract) under the 1933 Act and Form N-8B-2 (for the VLI trust account) under the 1940 Act. Additionally, because financial statements and more technical product information cannot be placed in a separate statement of additional information, prospectuses tend to be long.

b. **Recent History - ACLI’s Proposed Form N-6.** In conjunction with their recommendation to eliminate SEC regulation of variable contract charges, the staff of the SEC stated in the SEC Report that the Division of Investment Management intended to give priority to developing an SEC registration form designed specifically for variable life insurance. In this connection, the American Council of Life Insurance (“ACLI”), on January 13, 1993, submitted to the SEC’s Division of Investment Management a proposed SEC registration form, designated Form N-6, designed specifically for use by registered trust accounts issuing VLI contracts.

c. **SEC’s Proposed New Form N-6.** On March 13, 1998, the SEC proposed new Form N-6 for registration of VLI contracts and VLI trust accounts. The proposed new Form N-6 would serve as an integrated registration statement form for both 1933 Act and 1940 Act registration and would include a new prospectus format specifically designed for VLI contracts. Like Form N-4, proposed new Form N-6 would be a three-part form consisting of a simplified prospectus, a statement of additional information and a part C. It would replace both the existing Form S-6 and Form N-8B-2 registration statements.
Proposed Form N-6 also would simplify VLI contract prospectuses by moving certain information that is currently required in the prospectus to the statement of additional information, which need be provided only to investors who specifically request it. Items moved to the statement of additional information include the financial statements, which typically add 10-15 pages to the length of the prospectus. In addition, the proposed new Form deletes certain information currently required by Form S-6 that is not material for such a product, such as compensation of the insurance company’s employees.

A number of individuals and insurance companies as well as the ACLI and NAVA submitted comments on the proposed new Form. Informal remarks by SEC staff members since that time indicate that they anticipate that the SEC will adopt a somewhat revised Form N-6 sometime in late 1999 or early 2000.

d. **Highlights of Proposed New Form N-6.** Many of the required disclosure items of proposed new Form N-6 are very similar to those of Form N-4 (e.g., general descriptions of the insurance company and the separate account, fees and charges, premium payment provisions and withdrawal and surrender provisions), while others are tailored to VLI contracts (e.g., descriptions of loan provisions and lapse provisions). In general, disclosure required by many of these items is substantially the same as that currently required in a VLI contract prospectus, but several items represent a departure from what is currently seen in VLI contract prospectuses. The most significant items of the proposed Form N-6 are briefly discussed below.

1. **Plain English Requirement.** The plain English disclosure requirements will apply to the front and back covers and the risk/benefit summary of a Form N-6 prospectus.

2. **Risk/Benefit Summary.** Proposed Form N-6 would require that every VLI contract prospectus begin with a risk/benefit summary that would provide key information about the contract’s risks, benefits, and fees in a standardized, easily accessible place. Risks associated with the underlying funds would be addressed in the prospectuses for such funds, not in the VLI contract prospectus.
The risk/benefit summary would require, in a single location in the prospectus, narrative information about the benefits available under a VLI contract; allocation of premiums to insurance coverage, investments, and charges; and the risks of purchasing a contract. Risks that must be disclosed include the risk of poor investment performance, unsuitability of variable life insurance as a short-term investment, risks of policy lapse, limitations on the ability to withdraw cash value, and possible adverse tax consequences.

(3) **Fee Table.** Proposed Form N-6 would require a standard fee table to follow the risk/benefit summary. The proposed fee table would have three sections: (a) contract owner transactions fees (such as sales loads and transfer fees), (b) annual charges (other than those for underlying funds), and (c) underlying fund charges. Each section would use a four column format, identifying the charge, when the charge is deducted, the amount of the charge, and whether the charge is deducted from all contracts or only certain contracts.

The “amount deducted” column would allow a description of the level of a particular charge and the basis on which it is deducted (e.g., percentage of premium, cost per $1,000 of face amount, etc.). For each charge, the maximum would generally be disclosed. For cost of insurance, the minimum and maximum charges, or range, would be disclosed along with brief explanatory material, such as the factors that affect the level of the charge.

In a significant change from current practice, the fee table would disclose fees and expenses of the underlying funds **before any fee waivers or expense reimbursements**. Actual fees and expenses after any waivers or reimbursements could be disclosed in a footnote. In addition, instead of showing fees and expenses separately for each underlying fund, the fee table would disclose the range of fees and expenses for all underlying funds. The proposed Form N-6 would not require fee table expense examples, as are required in Form N-4, because the individualized nature of certain charges for VLI contracts makes it difficult to design a single example or a small number of examples that would provide a useful comparison tool.
(4) **Financial Statements.** Proposed Form N-6 generally would follow Form N-4 with regard to financial statements for both the separate account and the insurance company. Most significantly, this would mean that such financial statements could be in the statement of additional information and need not be in the prospectus.

(5) **Performance Data.** Proposed Form N-6 would not require disclosure of any performance data in either the prospectus or statement of additional information. Nothing in proposed Form N-6, however, would prevent the inclusion of performance information (including underlying fund performance) provided that the information is not incomplete, inaccurate, or misleading and does not obscure or impede understanding of required information. In the release proposing Form N-6, the SEC does suggest that underlying fund performance is most appropriate in the prospectus for the fund. Notwithstanding the foregoing, the statement of additional information must contain an explanation of how any performance data used in advertising material is calculated, including how charges are reflected.

(6) **Hypothetical Illustrations.** Proposed Form N-6 would permit, but not require, including hypothetical illustrations in either the prospectus or the statement of additional information (based on assumed gross rates of return and individualized fees and charges). Illustrations that are included in a prospectus or statement of additional information would have to meet certain requirements intended to place reasonable limits on the assumptions that may be used and discourage the presentation of misleading illustrations. The SEC has indicated that these requirements are not, however, intended to standardize the illustrations.

Possibly the most significant proposed illustration requirement is the one limiting the maximum gross rate of return to 10% (instead of the current limit of 12%). The SEC reasons that in light of actual long-term stock market returns, investors may give undue weight to a 12% illustration because they may discount a 0% illustration as unrealistically low. Other proposed illustration requirements are that premiums should reflect actual or expected average contract size, ages should be
representative of actual or expected contract sales, and illustrations should reflect the rating classification with the greatest number of outstanding contracts. Both current and maximum charges would be required to be reflected in the illustrations. Proposed Form N-6 would require that underlying fund fees and expenses be reflected using the arithmetic average of the fees and expenses for all available funds, based on the most recent fiscal year and absent fee waivers or expense reimbursements.

(7) **Actuarial Opinion.** Proposed Form N-6 would require an actuarial opinion indicating that (a) any values illustrated are consistent with the provisions of the VLI contract and the issuer’s administrative procedures, (b) the rate structure of the contracts and the assumptions selected for any illustrations do not result in an illustration of the relationship between premiums and benefits that is materially more favorable than for a substantial majority of other prospective contract owners, and (c) any illustrations are based on a commonly used rating classification and premium amounts and ages appropriate for the markets in which the contracts are sold.

D. **Simplified Prospectuses and Profiles For VA Contracts**
At the current time, other than the plain English rules, the only “simplification” afforded to variable annuity prospectuses has been the following.

1. **Limited Relief From Sequencing Requirements.** In 1996, the SEC staff issued a no-action letter providing variable annuity issuers limited relief from the sequencing requirements of Form N-4. Registrants are now permitted to move condensed financial information to an appendix, provided it includes, where the table would have appeared in the prospectus, a cross-reference indicating the location of the table in the appendix.

2. **Simplified Description of Underlying Funds.** In the above-referenced letter, the SEC staff also confirmed it would not object if, for each underlying fund, the contract prospectus included only the name of the fund, its investment adviser, and a description of its type, if the fund name is not itself descriptive.

3. **Variable Annuity Profiles.** In a letter written to NAVA in 1996, the SEC staff approved guidelines for the preparation of variable annuity profiles.
a. **Eleven Disclosure Items.** The guidelines describe 11 disclosure items that must be included in a variable annuity profile. In order to provide consistency and easy comparability among variable annuity profiles, the guidelines specify the order in which the 11 disclosure items must be presented.

b. **Can Omit Prospectus Summary.** The guidelines provide that a registrant that uses a variable annuity profile may omit from its prospectus the summary or highlights section of the prospectus, as required by item 3(b) of Form N-4.

c. **Delivery With Full Statutory Prospectus.** The variable annuity profile may be used only if it is attached to, or accompanied by, the statutory VA contract prospectus required by Section 10(a) of the 1940 Act.

d. **May Not be Called a “Profile Prospectus”**. The guidelines provide that the variable annuity profile may not be referred to as a “profile prospectus.”

e. **Not a Rule 498 Profile.** The variable annuity profile is not a Rule 498 profile. Therefore, a variable annuity profile cannot stand-alone and must be filed with the SEC as part of the Form N-4 registration statement, either as a Rule 497 supplement or as a Rule 485(b) post-effective amendment.

4. **Individual Variable Annuity Prospectuses.** A number of variable annuity issuers have undertaken a limited restructuring of their variable annuity prospectuses. Changes have included:

a. **Restructure Prospectus Organization to Mirror Profile.** Several registrants have restructured their prospectus to mirror the items in the variable annuity profile, with the addition of the table of contents of the statement of additional information. Registrants can do this because the order of the items in the profile guidelines complies with the sequencing requirements of Form N-4.

b. **Move Information to the Statement of Additional Information.** Some registrants have shortened prospectus disclosure of tax consequences and performance information, and placed a more
complete discussion of taxes and performance calculations in the Statement of Additional Information.

c. **Replace Glossary With Index.** Some registrants have replaced the glossary of defined terms specified by Item 2 of Form N-4 with the alternative permitted by Item 2 of Form N-4 -- the index of special terms that refers to the page on which each special term is defined.

5. **Recent NAVA Proposals.** The National Association for Variable Annuities (“NAVA”) recently submitted to the SEC proposed revisions to Form N-4 to provide for a simpler variable annuity prospectus, a variable annuity profile rule, and additional related proposed rule revisions.

a. **Suggested Revisions to Form N-4.** The revisions to Form N-4 suggested by NAVA would:

   (1) streamline the variable annuity prospectus to focus disclosure on essential information investors need to decide whether to purchase a variable annuity contract by (among other things):

   C adding a risk/benefit summary similar to that required by proposed Form N-6,

   C simplifying the fee table to show only total expenses for the least and most expensive underlying funds,

   C deleting the accumulation unit value table currently required by Form N-4,

   C reducing information about the underwriter and commissions paid to the underwriter,

   C deleting the requirement to include a list or diagram of all persons directly or indirectly controlled by or under common control with the depositor or registrant,

   C deleting the undertakings currently required by Form N-4,

   C providing that, notwithstanding Rule 3-12 of Regulation S-X, financial statements of the separate account do
not need to be more current than as of the end of the most recent fiscal year,

C deleting the “new entrant” exception from the general provision that financial statements of the depositor do not need to be more current than as of the end of the most recent fiscal year, so that “new entrant” depositors (whose financial statements have never been included in a variable product registration statement) can now include financial statements as of the end of the most recent fiscal year, and

C providing that, when the anticipated effective date of the registration statement falls within 90 days subsequent to the end of the year, the financial statements do not need to be more current than as of the end of the third fiscal quarter of the most recently completed year unless the audited financial statements for such year are available;

(2) permit annuity contracts with “market value adjustment” features (“MVA contracts”) to be registered on Form N-4, greatly simplifying the registration process for MVA contracts and the disclosure required in MVA contract prospectuses; and

(3) permit registrants to satisfy any annual prospectus delivery obligation by providing existing contract owners with a 2-3 page “Annual Prospectus Update” rather than “evergreening” contract owners with full contract prospectuses.

b. **Suggested Variable Annuity Profile Rule.** The variable annuity profile rule suggested by NAVA would:

(1) prescribe the format and content of the profile and incorporate certain enhancements to the current profile;

(2) authorize insurers to distribute the profile to investors accompanied by an application that investors could use, at their option, either to purchase contracts or to order a full prospectus; and
require that all investors receive the full prospectus no later than the time they receive a confirmation of purchase.

S.E.R.